BUDDLE FINDLAY

Black Swan Events, COVID-19 and the Debt Markets

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Radio New Zealand interviewed Daniel Collins of Buddle Findlay, to talk about Black Swan Events, COVID-19 and how these impact on debt markets in New Zealand. To listen to the interview click here. In the following insight, Daniel discusses what corporate borrowers can do.

Daniel, tell us – what is a Black Swan Event?

In the most simple terms, a Black Swan event is a metaphor to describe an event that has a dramatic and profound impact on the world or financial markets but at the time of occurring was unexpected, hard-to-predict and generally speaking – not priced into our models of the world. The final condition to a Black Swan event is that, once occurred, it is rationalised in hindsight as being capable of being expected or predictable. The term was popularised by Nassim Taleb in his book, *The Black Swan: The Impact of the Highly Improbable.*

In a markets context, the financial markets typically assume that the likelihood of something unexpected and catastrophic happening is so small (if they have considered it at all) as to be not worth worrying about – and certainly not priced into the market. Taleb's point is that the thing about rare and un-predictable catastrophic events is that they do eventually happen – certainly, in the space of a lifetime. Just think about the Global Financial Crisis (GFC), the advent of personal computers, 9/11 – and now, COVID-19.

So how could COVID-19 impact on the debt markets in New Zealand?

Whilst COVID-19 and the GFC are two completely different events – we should, at the very least, be disaster planning for events that resemble what happened in the GFC. During the GFC, these included increasing defaults in banks' portfolios, fear and panic in the retail space - which could culminate in a 'run' on the banks placing pressure on bank liquidity and ultimately, issues of bank stability. I lived in the Middle East through the GFC – all of these things were very real. However, the good news is that this is not a financial crisis at the moment and our banking sector is in extremely good shape.

The Reserve Bank of New Zealand (RBNZ), together with the banking sector, has spent the last decade improving the capital ratios for locally incorporated banks – making our banks some of the most robust banks in the world. Just this morning the RBNZ announced that it would delay the start date for the implementation of its tougher capital requirements for banks by 12 months, to 1 July 2021, and down the track "will consider whether further delays are necessary." The RBNZ estimates that this delay will result in savings to the banks that could result in a further $47b in credit being available in the economy.

So what should corporate borrowers be thinking about with COVID-19?

Generally speaking, prepare for the worst, hope for the best – and talk to your relationship manager.

In preparing for the worst, corporate borrowers should first consider how reliant they are on 'on demand' overdrafts. The nature of an on demand overdraft is that it is available only at the lender's discretion. In return, the borrower does not typically pay a 'commitment fee' to the lender for its on-going availability. Perhaps not surprising, 'on demand' overdrafts are prevalent in the SME business world. The alternative to an 'on demand' overdraft is a 'committed' revolving line – a credit line where the lender is obliged to make funds available (subject to certain conditions precedent) and in return, you pay a fee to the lender. This small change could provide far greater certainty to borrowers and their resilience to weather a Black Swan event.

Taking it one step further, reports in the United States say that private equity titans Blackstone and Carlyle are urging portfolio companies to draw down on all open revolving credit lines to help prevent any liquidity shortfalls. This is a practice that emerged in the GFC and was designed to ensure that corporates had cash on hand to weather the storm and also hedge against a bank failure or tightening liquidity by the banks.

In the New Zealand context, this is less pressing for most corporates (at this stage at least), as most of the market is banked on a bilateral or club basis with a strong emphasis on the relationship and lenders can be expected to continue to support their customers. And the New Zealand banks are in great shape.

However, it may be prudent to start working through your finance documents and being knowledgeable of the following:

- Your limits and the differences between committed and 'on demand' facilities
- Your maturity dates and if you have facilities maturing in the next 12 months – we would suggest bringing forward discussions with your bank about extending these out now
- If you need any increases in facility limits in the next 12 months – we would suggest bring forward discussions with your bank about your requirements
- You may want to consider hedging your currency and interest exposures
- Any particular conditions precedent to drawing your facilities, this helps you understand the nature of 'committed'
- Any particular rights in your documents for your bank not to fund under a facility – these might include 'impossibility' provisions which are akin to force majeure and give the right to a bank to refuse a drawdown
- Any particular rights in your documents to allow your bank to re-price your facilities – these include 'market disruption provisions' in the top end of town and simple 'repricing provisions' in the SME space.

Finally, for those businesses that will be placed under strain by COVID-19, you will also need to turn your mind to default triggers in your documentation. In particular, the construction and application of the 'material adverse change' clause – which is a specific default intended to capture any material changes in the performance of a borrower that might have a material adverse impact on (i) that borrower's ability to meet its obligations under its facilities, or (ii) the business, operation, property or general condition of the borrower. To the extent that borrowers are facing financial strain from the impacts of COVID-19 we would recommend you seek legal advice.

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