Adding value

Representatives from leading corporate trust service providers met with **SCI** in December to discuss trustee independence and the flexibility of corporate trust services. Noteholder disputes, counterparty downgrades and pricing for restructurings and amendments were at the forefront of their minds

Index

Attendee biographies

David Bell, md in BNY Mellon Corporate Trust, is responsible for client relationships in the asset manager sector concentrating on delivering a variety of services for structured vehicles and investment funds. Prior to this role, he has enjoyed a number of positions in front, middle and back office disciplines for intuitions such as Goldman Sachs and JPMorgan.

Tamara Box is global head of structured finance at Reed Smith. She is responsible for a large and growing business that provides strategic and financial advice to large financial institutions and corporates from its 23 offices in the US, Middle East, Asia and Europe.

Edmond Leedham serves as chief counsel to US Bank's European Corporate Trust Group and has over 12 years of corporate trust-specific experience, both in legal and business positions. Prior to joining the US Bank team, he served as a senior counsel to The Bank of New York Mellon EMEA corporate trust business in the aftermath of the bank's acquisition of JPMorgan's corporate trust business and before that was the head of the EMEA restructuring, default and exchange management group at JPMorgan.

Helena Nathanson is a partner in structured finance at Reed Smith, with over ten years of experience. Recently, her main areas of work have included representation of a number of corporate trustee service providers in transactions involving restructurings or repackagings of note issuances in connection with any bankrupt Lehman entity, addressing various liquidity problems and the exiting of other participants from the market.

Helen Tricard is head of restructuring, corporate trust services, at BNP Paribas Securities Services and a director of BNP Paribas Trust Corporation UK Limited. She deals with post-close matters on a range of structured transactions; in particular, restructuring, events of default and litigation.

Corinne Smith is editor of SCI.

CORINNE SMITH, SCI: Beginning with flexibility of services, corporate trust service providers' problem-solving abilities have come to the fore since the financial crisis. In which areas are they particularly prevalent?

HELEN TRICARD, BNP PARIBAS: Corporate trust service providers' problem-solving skills are particularly evident on the restructuring side. Trustees have become a lot more proactive and are getting involved at a much earlier stage; frequently in terms of parties asking their views hypothetically on whether it is possible to do X or Y – and, if so, how? Good trustees respond quickly and are likely to be able to indicate whether it will be necessary to consult with noteholders at an early stage in the process.

DAVID BELL, BNY MELLON: Over the last 24 months, the trustee community has developed significant expertise dealing with multiple different types of scenarios – restructurings, ratings downgrades and so on. One of the benefits we've seen as a result is that there are some areas where a trustee can anticipate certain events, which can be brought to the attention of the client.

EDMOND LEEDHAM, US BANK: I actually think that trustees have successfully dealt with similar issues and scenarios prior to the financial crisis. It is just that the stakes have become higher in this environment.

We are seeing more and more examples of different classes of noteholders investing significant levels of time and resources pursuing interpretations that favour their respective prospects of recovery, and the fine balances with which trustees have always had to deal in respect of difficult issues of interpretation and structural amendments are becoming more and more visible to the market. While on one hand this makes things more difficult for trustees, I think it also has fostered an increased level of respect for the position of trustees and their credibility in framing the issues and possible courses of action to deal with such issues as they arise.

Restructurings

SMITH: Has the restructuring of transactions generally become easier or less contentious?


David Bell

BELL: From a documentation perspective, conflicts of interest between investors don't appear to be as grave as they were, but the potential remains. It can be very difficult to get participants on board and get a client engaged with the fact that such matters require significant input to resolve. It's a question of managing expectations.

SMITH: Are expectations a bit more realistic these days?

TRICARD: It varies. Once you've been through the process a few times of explaining to an issuer that they're no longer really the client, the investor is, they begin to understand our situation.

But I also feel sometimes it's flipped the other way and we're being approached too early in the process. I've occasionally had to push back a little bit and ask clients to contact me when they have something approaching a concrete idea of what they'd like to do.

It's a process of education; it really depends on whether the issuer (and other parties) has been through similar experiences before and how sophisticated they are. Issuers have very different approaches in terms of costs and it varies from one transaction to another. Once they realise that the trustee is not simply a thorn in their side, but can actually add value and sometimes make suggestions that might not have been thought of, there is a lot less resistance.

Exercising discretion

LEEDHAM: Investors and other counterparties are beginning to understand that in seeking various comfort items, such as legal opinions and rating confirmations and so on in connection with a request to exercise discretion, the trustee isn't just seeking to cover its backside or showing a lack of conviction in its own analysis. These are tools that are available under the terms of the trust deed and in law, which fortify the trustee's position in respect of the exercise of the discretion.

At the end of the day, trustees just want to make the best decision and where necessary be able to demonstrate that they reached a decision in a reasonable way. An exercise of discretion that is made on a weak foundation and is potentially open to challenge doesn't serve the interests of any party to the affected transaction.

BELL: Some of the requests are quite interesting, particularly where an issuer or a manager may have a particular view. The responsibility of the trustee is to point out, where appropriate, that something we're being asked to do doesn't work in the documentation.

HELENA NATHANSON, REED SMITH: Nobody wants to be put in a position where they have to say "I told you so". Issuers have to understand that trustees are restricted by what is in the documents: you can't just ignore a right that you've given to a party.

TRICARD: At the end of the day, those rights are what the investor bought. It's plain wrong to think that you can simply change the status quo unilaterally later on.

LEEDHAM: The whole point in respect to the trustee's power of discretion is that it's not meant to be exercised at will or to empower the trustee to make its own judgment as to what is in the noteholders' commercial or economic interests. The power is there to expedite rectification of obvious mistakes and errors and the filling of gaps in the documentation with amendments that clearly are not prejudicial to the interests of the noteholders.

Litigation

SMITH: Are there any cases in particular that have proved difficult over the last year?

LEEDHAM: There have been a couple of recent cases where the trustee has found itself to be an unwitting pawn in struggles between different classes of investors with varying commercial interests. For instance, we have seen a situation where a junior investor, who no longer had a tangible economic interest left in a deal, attempted to exercise certain rights to influence the resolution of the transaction on the basis that such rights in themselves have an economic value.

While a trustee will have no interest in the outcome of such controversies and its primary focus will be on its rights and obligations under the operative transaction documents, it cannot help but become an intermediary between the disputing parties. In this regard, the trustee has to walk a fine line in helping to further a resolution of the controversy without becoming entangled in the tactical nuisances of the dispute. Needless to say, this is not always a comfortable position in which to find oneself.

TAMARA BOX, REED SMITH: We've seen folks sell out of the senior position and buy into the junior, for a lot less money obviously. They do it because the power sits down the chain: not the power to actually do something, but the power to stop something – which they are perfectly entitled to do. I think we'll see more and more of these cases as noteholders become savvier in terms of what they can buy and as clarity increases around losses.

BELL: The crystallisation of those losses is at a critical point: you can only park troubled assets for a limited time. I think the time is coming where the ability to retain certain assets at certain houses is being questioned, and that will cause more friction but also opportunity for other market players.

The tempo has also increased due to the amount of litigation that's occurring, particularly in the US. With the emergence of class actions, deeper questions are being asked about transactions. If there is a loss, investors want to know what triggered it – was it a structural defect, or is it something that the issuer, the trustee or the agent had any impact on?

BOX: I think this is going to put trustees in increasingly awkward positions around bringing those causes of action. The extent to which a trustee is just fronting a cause of action could be perceived as unclear, for example. In one recent case, the trustee was the only party who could bring the action because it was against the manager.

SMITH: Do trustees have the resources to be able to play that role?

BOX: As long as they're getting paid for it.

TRICARD: Certainly teams have been beefed up to handle such cases. And a trustee must be able to deal with litigation.


Tamara Box

Going back to the initial question, we are having to be very flexible in terms of the corporate trust services we offer, as part of the market has

migrated away from what were regarded as the more traditional sorts of structures. We're seeing a lot more bespoke arrangements these days, which means getting involved earlier on in the structuring process. In addition, we're being asked to provide different services in terms of escrow and asset protection structures.

New transactions

SMITH: There has been quite a shift in terms of the work that you're doing, then? One of the issues that came up historically was that trustees were somewhat frustrated in their inability to get involved early enough in the structuring process.

NATHANSON: Unfortunately, there are still some transactions where trustees are brought in at the last possible minute. But generally it is changing for new deals.

With wide-scale job cuts and so on at banks, it is really only corporate trust houses that have retained the intelligence regarding how transactions were originally put together. And now they are best-placed to actually advise on how deals should be structured or restructured. Clients are finally realising that trustees have more knowledge in these areas than they have.

BELL: From an issuer or manager perspective, there is awareness that it is better for the transaction to bring the trustee or agent in as quickly as possible because it provides comfort to investors. Given the bespoke nature of transactions now, investors require a great degree of transparency.

SMITH: From a corporate trust provider's perspective, what are the advantages of being involved earlier on in a transaction?

TRICARD: If a client wants to include a negative consent mechanism in the documentation, for example, a trustee can discuss its expectations of how it should be structured from the start. It means that the parties can discuss what they'd like to see upfront, rather than spending ages going back and forth on drafts at a later stage.

LEEDHAM: Bringing the trustee to the party early is reflective of the reality that deal counterparties are beginning to appreciate that trustees do make a difference and are not merely party to the transaction as some kind of belts-and-braces measure to deal with scenarios that are unlikely to arise.

TRICARD: That's a good point. Pre-financial crisis, the trustee was someone that was sometimes only remembered on the eve of closing. Nowadays, although the focus remains on closing, how the deal functions and survives once everyone who initially structured and drafted it walks away is equally as important.

NATHANSON: You are not just trustees in a transaction anymore: you are also custodians, security agents and you're providing escrow services. It is so much more important to be involved from the beginning because you see every aspect of the transaction, not only the funds flow.

It is also important to be able to identify where the risk is for you. When you're involved from the get-go, you can run everything by your internal credit committee first.

BELL: The internal approval process for new transactions has become a lot more robust.

BOX: Do you think that is inhibiting business?

BELL: If I'm honest, it slows business down a little bit.

TRICARD: It's not so much that it inhibits business; it's that more resources are necessary now internally to deal with those committees.

NATHANSON: It also depends on how a transaction has evolved from mandate to closing. We've all seen deals that would have sailed through the committee if they had remained as they were on the mandate, but six months down the line they are a different beast.

Pricing

BELL: Regarding resources, I think pricing is likely to become another potential area of contention, given all the restructurings and amendments we're seeing. Trustees will either have to review their overall pricing framework or begin pricing for amendments in a very structured way. While this is already happening informally, it needs to become more formal.

BOX: If only to make sure that your mandates don't give anybody the right to question it, if it comes to that.


Edmond Leedham

LEEDHAM: Perhaps the real trick is to get everyone to appreciate that this is important work that requires the best resourcing possible and it is in no-one's interest to take a penny-wise and pound-foolish approach to such matters.

BOX: There is still a long way to go on an industry-wide level such that people actually understand the costs – not only in terms of amendments and defaults, but also with discretion and all the other things you are being asked to do – and why it's not appropriate to assume that trustees have already been paid for them. Some people have been quite slow to grasp that, which is negative for the industry as a whole.

SMITH: In terms of charging for amendments in a more structured way, is that already emerging in new transactions?

BELL: There are greater provisions in the mandate or in the fee arrangements in new transactions. There is more clarity as far as future amendments are concerned, which is a positive step. But it remains challenging for legacy deals.

LEEDHAM: In legacy deals there is the concept of the trustee being able to seek extraordinary fees and expenses. It is just that there has not always been a consensus as to what constitutes an extraordinary fee or expense. So, hopefully, the practices we are establishing on the point going forward will be accepted even in respect of legacy transactions.

BOX: Due to the bespoke nature of new transactions, trustees are often being asked to help issuers develop a strategy to cook the transaction. Yet you are being

"When you're involved from the get-go, you can run everything by your internal credit committee first"

asked to price the deal as you would for a more traditional structure.

There is a lot of competition for new transactions and newer players are essentially building their businesses on the back of trustees. I think there needs to be some careful thought about how to address this in a non-competition violating manner, because it is going to become an acute problem.

SMITH: Ideally, how should this issue be addressed then?

BOX: Well, I actually think trustees ought to include structuring fees in their mandates. By that I don't mean where they are taking on restructuring for the client, but where the client's structure is not fully baked.

You could have a clause in the mandate letter that allows additional fees to be recouped if the deal turns out to be different in any way. Or you could structure it along the lines of: for every week we go beyond a given date and for every document turn there is, there is a fixed additional fee and therefore it's in the client's control.

LEEDHAM: I think that such intent is already expressed in many of the forms of mandate letters I have seen over my career – perhaps not so obviously – but certainly most forms of such letters reserve a right to revisit fees if certain assumptions are invalidated. So, perhaps the key is to get parties to better appreciate the support a trustee often lends to evolution of a deal structure during origination, with a view towards developing a consensus that this is something worth paying a bit extra for.

Amendments

SMITH: What kind of amendment requests are common at the moment?

TRICARD: It's extremely varied, but you see some over and over again – such as amendments as a result of counterparty downgrades.

BELL: On that particular topic, a further round of bank downgrades seem to be in the offing – and it will be a steeper mountain to climb this time because of all the triggers that will be hit.

BOX: The rating agency confirmations during the last wave of downgrades provided a kind of fourth limb to transactions, where certain actions could be taken and the ratings on the notes wouldn't be affected. But we are going to hit triggers where that won't work.

Increasingly there will be significant issues around swaps and the posting of collateral. We're already seeing one or two swap counterparties being asked to post securities.

Some transactions don't provide for this, yet the CSA does, so amendments will be required to allow for the posting of securities into an account with an appropriately rated institution. There is also the potential for buyers to come up with creative ways of getting their securities right back. I think that will force corporate trusts to develop specialist knowledge about swaps.

A similar situation could arise with account bank movements in terms of figuring out ways to deal with downgrades. Pressure will inevitably increase on the banks that do have the appropriate ratings to do something to help.

TRICARD: We can't necessarily come up with solutions now because we don't know how it's going to play out. But I think all houses are looking at various scenarios and trying to plan ahead.


Helena Nathanson

SMITH: All these bank downgrades are increasing the potential for concentration risk among counterparties.

TRICARD: When only a few players remain, they can be quite picky in terms of what business they take on or on what terms. So, not only is there concentration risk, there is also the potential to be left with nowhere to park your deal. The worry is that a deadlock situation could emerge and, to an extent, we are already starting to see that happening.

> "Investors typically prefer not to draw down to avoid the resulting expense to the transaction"

BELL: The volume of deals in question is significant and concerning, given the possibility of suddenly having to find alternative agents.

BOX: GICs are another area where difficulties are likely to arise because they have interest rates associated with them. It could prove impossible to find a replacement GIC provider that will pay the same interest rate. So trustees could end up being stuck between a rock and a hard place, with noteholders getting increasingly agitated because that little bit of interest means an awful lot in the current environment.

SMITH: How are trustees preparing for such events?

BELL: We are engaging proactively with these institutions and have been asked to provide a specific framework for action, but there are many obstacles and subtle nuances to overcome. For example, with mortgage prepayments that weren't necessarily built into the original waterfall, some issuers are trying to keep that element outside of the implications of a ratings downgrade.

LEEDHAM: That is especially true in respect of deals with liquidity facilities. There is little scope to find replacement facility providers full stop, never mind on the terms of the original facility. Where the original provider no longer meets the required rating and a replacement cannot be found, the issuer is meant to draw down on the full facility. In some instances, the provider cannot or will not honour such draw-down requests.

Fortunately, there has been little controversy on this front to date because investors typically prefer not to draw down to avoid the resulting expense to the transaction. As credit ratings continue to deteriorate, I can't help but wonder if investors might rethink their present approach to such issues.

BOX: This is another area that is challenging from a resources perspective, especially when you're in the cash manager role and have agreed to take on other replacement responsibilities. There is the potential to get rolled up when nobody is paying attention and


Helen Tricard

all of a sudden you've got a corporate trust provider with the responsibility of cash manager having to replace the account bank – and that's not helpful.

LEEDHAM: Yes, there are some potentially daunting problems on the horizon. But somehow we do seem to find solutions to these sorts of problems and common sense usually prevails.

Trustee independence

TRICARD: But, to expand on Tamara's point in the context of downgrades, this ties in with the independence of trustees. We're having to create Chinese walls where we're the account bank as well as the trustee on a deal. Certainly we're very much treating them as totally separate roles – which they need to be because you can't have one single person dealing with potentially conflicting roles.

BELL: Correct, the concern is to do it right. That conflict question is at the forefront of our minds in terms of how we should be set up and which roles/activities individuals within our shop should be dealing with.

TRICARD: It's not just a question of managing perception. There is a genuine separation of roles.

LEEDHAM: Right, and knowing that our actions will be closely scrutinised in the present environment does provide extra incentive to ensure that we properly segregate agency roles that are in conflict with any fiduciary roles we perform on a transaction. However, I am with David; we just want to do it right, full stop.

NATHANSON: It comes back to the point about convincing your credit committee that you've done the right thing.

Documentation

SMITH: Moving on, documentation has long been an area of contention for corporate trust service providers. Has this improved over the last 12 months or so?

NATHANSON: It's a slow and painful process of re-educating the market to ensure that everybody understands what really needs to be in those documents. We're still seeing documents based on precedents, where the key points that should have been addressed absolutely were not addressed.

LEEDHAM: But there have been some substantive changes in documentation for certain asset classes, such as the introduction of mechanics to deal with issues arising in the event a swap counterparty on a bond transaction goes into default, such as the appointment of a replacement swap calculation agent and so on.

TRICARD: It comes back to the added value that trustees bring: because on the restructuring side we are seeing what isn't working, we need to make sure that this is fed through to new documentation. Generally, such input is well received.

SMITH: Is it generally easier to bring documentation up to scratch for the new players entering the market?

BELL: Yes, but a good degree of discussions are still required to highlight the standards and explain the process.

TRICARD: It's also driven by the fact that some new players are essentially changing products and need to be educated about what is needed for a deal to work. Experienced corporate service providers know when to stand their ground on these issues.

NATHANSON: Still, my biggest bugbear is when I'm representing a trustee on a transaction and the argument from the other side is that everyone else would have accepted such and such a thing. I'm fed up of hearing: "It's market practise to do this".

"The industry seems to be engaged in an uphill struggle against market practice"

TRICARD: It is a frustration.

BELL: And we do get played off against each other.

TRICARD: It's useful to be able to call lawyers to ask whether they're generally seeing others agreeing to certain things.

NATHANSON: And to the extent that it doesn't breach any confidentiality, we're absolutely happy to share such information. I think it works both ways.

SMITH: The industry seems to be engaged in an uphill struggle against market practice.

Structural change

BELL: The market is going through a process of structural change. You can call it a "challenging environment" if you want to, but this is the new world and it will remain for a period of time. Market players, market practices, documentation and expectations are all evolving.

SMITH: We've still got some way to go though. But at least there is better recognition of the corporate trust service provider's role.

LEEDHAM: While there are many problems and challenges to face, there is room for some optimism too. There a lot of people in the industry that want to make a difference and can make a difference, and we seem to always find a way through even the most difficult challenges. We cannot always make everyone perfectly happy, but we do tend to find solutions that work on a practical level and we'll continue to do so.

TRICARD: Cerebrally, it's quite a good time to be a trustee really.

BELL: The need for trustees will continue and their role will evolve. The services that we provide are a necessity to get new transactions away – parties require our independence, input, experience, reporting and so on. But there's also an opportunity to reflect this evolution back into transactions.

SMITH: Has the concept of a "super-trustee" gained any ground recently?

LEEDHAM: Not especially. But, given everything that we do, I think we're all super-trustees really. SCI