Bank Chaos Isn't The Only Factor Hurting The Lending Market

By **Bobbi Acord Noland** (April 25, 2023)


Bobbi Acord Noland

The unexpected bank failures of Silicon Valley Bank and Signature Bank and increased concerns regarding certain other international, national and regional lenders have sent shock waves through the lending industry.

The combination of bank failures, government intervention, continuing interest rate increases and challenges in the capital markets have heightened anxieties regarding the lending outlook for this year that did not exist to the same extent at the beginning of the year. The bank failures were an unforeseen piece of the lending puzzle within the last two months, with prior concerns focused more on increased interest rates and lack of ongoing government stimulus to support certain companies and inflation.

The tightening of credit available for certain commercial borrowers and the level of increased distress that borrowers are starting to experience are common themes now. This is in stark contrast to the high level of competition for deals, fewer distressed transactions, brisk mergers and acquisitions activity, and a more borrower-friendly lending environment that the industry surprisingly experienced during the pandemic.

In the strong lending environment that existed in recent years, borrowers were able to obtain more advantageous terms and more flexibility in credit documentation to undertake acquisitions, investments and other desired activities often without having to obtain their lenders' consent.

One result for the lenders, however, is that the triggers in loan documentation that traditionally would be in place to enable a lender to maneuver a distress situation at the first sign of trouble may not exist in many current loan documents. The related effect may be that a lender and borrower will have less time to manage a troubled credit through various phases to a potential solution and may be left with fewer restructuring options.

What does the tightening of credit mean for companies?

A prospective borrower may have less competition among lenders to provide financing to the company. A borrower also may have to pledge more assets to support a new financing and may experience increased interest rates and fees.

Lenders also may require more stringent documentation terms so that the lender is back to the bargaining table if the company experiences performance issues.

In the syndicated deal market, it may be increasingly more difficult for an agent to arrange a syndicate of lenders for new credit facilities. Lenders also may choose to opt out from accommodations that borrowers may request under existing credit facilities such as increased lines of credit.

This trend was beginning even before the recent bank failures. In contrast, borrowers will want to have as much liquidity as they can obtain especially given the uncertain market conditions. If a borrower has pending maturities of its credit facilities, it may want to act more quickly to obtain certainty of a renewal of the facility even at the cost of increased pricing.

Lenders may be more conservative about deploying funds especially if the economics paid to the lender for a transaction are not as compelling, the borrower's credit profile is not as strong or the documentation structure is too permissive.

Lower- and middle-market companies are starting to experience more distress. Those borrowers are experiencing more financial covenant breaches and liquidity challenges. As a result, they are facing more workouts and forbearance arrangements than in recent years.

For those companies that are unable to achieve an effective debt restructuring to address their current challenges, bankruptcy or the exercise of other remedies by lenders, such as foreclosures and liquidations, may occur. Also, during economic downturns, fraudulent activity may increase as certain companies try to prolong their economic survival.

Will this cycle of distress be similar to prior ones that the industry has experienced? It is probably too early to assess at this point, although several factors appear to distinguish the current cycle from previous ones.

To date, consumer products and retail industries have seen a number of challenges early in this cycle, but market participants in other industries probably should not conclude they are insulated from current trends. There also appear to be fewer so-called fallen angels that have migrated from cash flow lending structures to asset-based structures, which often provide more liquidity.

This trend may, however, start to reverse itself this year. Also, lenders who provide more expensive credit and are often seen as an exit strategy for many other lenders may be less aggressive in this cycle due to their cost of funds and tightened credit standards.

The lending industry also saw a large increase in nonbank lenders since the last market disruption, and their appetite for different types of credits and their approach to distress situations may vary from traditional bank lenders.

Liability management will become increasingly more important to borrowers seeking credit. While lenders have expressed concerns about so-called up-tiering and drop-down transactions that have occurred in certain noteworthy cases, borrowers may view this flexibility as more critical than ever in a tightening credit environment.

Lenders have attempted in the negotiation of transactions in prior years to address these potential loopholes, but the robust competitive landscape often prevented them from achieving meaningful curbs on this type of flexibility. With credit tightening, lenders may be more focused on addressing these flexible structures — at the precise time when borrowers are even more focused on them.

Companies and lenders are asking what else could change the current lending environment especially since the bank failures were unanticipated by most people. Global tensions with China and other regions could disrupt the lending landscape and supply chains again. A rising interest rate environment could put even more stress on companies that already are experiencing economic headwinds.

The pending cessation of Libor on June 30 of this year may also affect the effective rate of interest paid by a given borrower. A tighter banking regulatory environment that may be intended to prevent the next bank failure also could further exacerbate challenges that already exist among lenders serving smaller and middle-market companies.

Despite the factors noted above and the evolving lending landscape, lenders will continue to find funding opportunities with a wide array of companies. Companies that are well capitalized and have a reason to continue to exist will not experience the same level of tightening.

The challenges above will probably affect more lower- and middle-market companies that have had underlying issues for some period of time but the resolution of which was delayed by the pandemic, government stimulus and the prior competitive lending environment.

Bobbi Acord Noland is a partner at Parker Hudson Rainer & Dobbs LLP.