

# *Restructuring Trends*



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## at a glance

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#### **A landmark distribution: the single largest in a UK administration**

The depth and complexity of the relationships between LBI\*, LBIE\*\* and its underlying customers, the different insolvency regimes and the sheer size of the claims presented a highly complex set of circumstances. Following a settlement agreement with LBI, we were faced with the challenge of dealing with a mismatch between recoveries from the settlement and the claims of our clients. Through the development of an innovative solution for this complex problem we were able to settle c\$9bn of claims of nearly 300 hedge funds using a consensual approach. This was a major landmark of the administration as it enabled us to distribute c£7.5bn to Trust counterparties - the largest distribution out of a UK administration.

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#### **Statutory interest - an unexpected problem**

LBIE's unsecured creditors may have their claims paid in full and with interest, a very rare situation for a UK insolvency procedure and one which would have been unimaginable five years ago. However, working out the amount due to each creditor is not easy. LBIE and its shareholders have made a joint application to the UK High Court covering a number of questions relating to the respective rights of claims between LBIE, its unsecured creditors and its shareholders. The administrators also need to determine how interest claims should be calculated under the Insolvency Rules, particularly the interest rate to be applied and the date from which interest accrues. Given the amount of time it would likely take to resolve these details, through court directions or on a claim-by-claim basis, the administrators are developing a simplifying methodology to determine interest claims on an equitable basis for all LBIE's qualifying creditors.

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#### **Cracking "too big to fail" - are we nearly there yet?**

Lehman Brothers' collapse in September 2008 was a failure of historic proportions and five years later the banking industry is still evolving as it attempts to deal with the repercussions on both financial services and the global economy. To survive, banks, along with their advisers, are responding to changing regulation amid a new paradigm of public awareness and acute scrutiny of their activities by regulators. In the UK, the government has restructured financial regulation and the Independent Banking Commission has called for measures that go beyond the tougher Basel III capital requirements, but we believe stronger global coordination is required as banking is a global industry. Restoring public confidence and building trust should be high on banks' list of priorities as public opinion is helping shape the regulatory agenda.



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#### **Definitions:**

\* LBI - Lehman Brothers Inc.  
\*\*LBIE - Lehman Brothers International (Europe) - In Administration

### *Note from the Editors*

With the five-year anniversary of the Lehman Brothers insolvency passing in September, we wanted to take the opportunity in this special edition of Restructuring Trends to share with you some of the landmark issues that have arisen, and innovative

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### **Lehman Brothers: a timeline**

Following the recent five-year anniversary of the LBIE administration, we take a look at the progress of the estate over this period, including the dividend and trust returns that have been achieved. We also take a snapshot look at where we are now, as well as what remains to be done as we continue to progress winding up the estate and, in particular, look to resolve the respective rights of creditors to payment from any surplus that may arise after reaching returns of 100p in the pound on ordinary unsecured claims.

solutions that have been developed, since the administrator's appointment. We also wanted to take time to reflect on some of the market and regulatory issues that have developed as a result of the financial crisis.

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### **Restructuring**

Continuing strong debt market liquidity and the growing presence of alternative investors have created a benign refinancing environment, allowing some borrowers to avoid an involuntary restructuring. The shift from leveraged loans to high yield bonds is continuing and will have profound consequences for the restructuring market, delaying potential trigger events. Over the year, the leveraged loan default has continued to decline, and we do not expect it to increase in the near term. Deferring problems, however, does not solve them and significant downside macro risks remain. The outstanding pool of leveraged loan borrowers is of varying credit quality and we expect a steady stream of restructuring cases in the remainder of the year.

In addition, we also asked some of the LBIE and PwC staff who have been involved in the administration to give their more personal reflections on the administration, and included these 'memories from Lehman' throughout the document.

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### **In the debt markets**

The debt markets currently offer exceptionally favourable prices, terms and breadth of choice and companies would be wise to take advantage of these conditions while they last. In the leveraged loan market the combination of cash-rich institutional investors and a limited supply of primary deal flow has put companies in a strong position. While in high yield the strengthening economic recovery and continuing search for yield are encouraging many investors to take on more risk and reduce their return expectations. As a result companies have the opportunity to reduce pricing, seek improved terms and extend maturities. The competition among lenders is evident in the move by institutional investors into the mid-market and the strong liquidity in the German debt markets.

# Welcome



## Tony Lomas

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The timing of this edition of Restructuring Trends coincides with the five-year anniversary of the collapse of Lehman Brothers. This provides us with the opportunity to reflect on a sample of the landmark issues that have arisen during the course of winding down the UK operations and on some of the market, regulatory and legislative changes that these issues have prompted. As signs of economic recovery appear, we also comment on the current state of debt markets and their immediate-term outlook.

In one way or another, we were all impacted by the failure of Lehman and a number of other banks around the world. Those failures triggered the quest to find an antidote. Improved capitalisation, organisational simplification, ringfencing, greater transparency, better information and preparation and, crucially, greater powers of intervention have all featured in the global response. Interestingly, a series of late amendments to the Banking Bill which is currently passing through the House of Lords, promises to introduce “bail in” powers for the first time. This coincides with our announcement that there is likely to be an eventual £4bn-£5bn surplus in the LBIE estate, before taking account of subordinated debt and capital.

Could a “bail in” of LBIE have worked back in 2008? Probably not, as LBIE needed \$3bn of liquidity on the morning that it collapsed, which was not forthcoming because its US holding company LBHI\*, which acted as group treasurer, filed for bankruptcy protection hours before. LBIE’s liquidity requirements on the next and subsequent days were equally large, meaning that a massive alternative facility would have been needed if there had been any chance of LBIE continuing to trade. The extraordinarily complex and comprehensive range of operational and financial interdependencies between LBIE and other Lehman group affiliates meant that keeping LBIE operating while affiliates around it failed would have been an impossible challenge. It is interesting, however, that LBIE turns out to have been balance sheet solvent, before accounting for subordinated debt and capital – precisely the stakeholders that the new “bail in” provision are intended to target. In less complex banking groups than Lehman, these new measures might stand a chance of success.

### Definitions:

\* LBHI - Lehman Brothers Holding Inc.  
\*\* LBIE - Lehman Brothers International (Europe) - In Administration  
\*\*\* OTC - over-the-counter: a market in which securities, or other financial products, are traded by direct dealer-to-dealer communications.

Over the past five years, an industry has developed inside the financial services sector to deal with the growing list of legal and regulatory requirements that are being introduced. Recovery and resolution plans are just one example and in the early days of the Lehman collapse it might have been at least a little less chaotic and destabilising for financial markets if such plans had existed at that time.

Prime brokerage and derivative trading market practices have also adapted to the lessons learned from Lehman’s collapse. For example, pressure has grown to move OTC\*\*\* trading onto exchanges, providing counterparties with greater certainty of outcome when failure occurs, and custodian arrangements have been improved to give clients greater confidence of prompt asset returns when things go wrong.

Landmark judgments have been handed down in our Supreme Court, removing uncertainties concerning entitlements to Client Money protection and the ranking status of pension fund deficit claims in an insolvency environment. Both of these judgements have wide-ranging relevance for the Business Recovery and Restructuring community. Over the course of the Lehman assignment there have been numerous other useful court precedents set relating to counterparty disputes and there promises to be more to come.

Full term, we hope to be able to return more than £35bn of cash and securities to LBIE’s creditors and clients, making them “whole”. That could leave as much as £5bn “surplus” cash to be allocated. Perhaps the most intriguing question remaining is the way in which this huge potential surplus would be shared amongst the many LBIE stakeholders. Resolution of that question by reference to individual contractual rights and – currently uncertain – legal principles could take another five years of litigation and negotiation if an equitable and consensual alternative solution cannot be found. Significant resource is being invested in finding that solution and a wrapper in which to deliver it, which suggests that still more groundbreaking precedents will be set from this case.

As we continue to return billions of pounds to counterparties, those recipients need to find alternative places to invest that money. There appear to be huge pools of money now looking for a home, and liquidity in our debt market is therefore likely to improve for the foreseeable future.

In parallel, a more benign refinancing environment has been evident as a result of the ongoing liquidity of the debt markets and the growing market of alternative investors enabling some borrowers to avoid restructuring.

I hope you find the materials in this edition of Restructuring Trends interesting and, as ever, your feedback is welcomed and appreciated.



*“ 15 September 2008 will forever be ingrained in my memory. At about 10.30am I was in the foyer of Lehman’s offices, having worked through the night, and I looked across to the 10-metre TV screen in reception, with its rolling news reports. The image was of Lehman’s Canary Wharf office reception – I could see myself on TV watching the screen. It became very clear to me that I was in the eye of the storm. We had to define a way to handle the most complex insolvency ever. I felt both fear and excitement. I then went to my office and jotted out three very simple objectives – to protect and realise the Lehman assets, to find and return client assets and to agree the creditor claims. Simple, I thought. The devil was in the detail that followed.”*

Steven Pearson, PwC BRS  
& joint administrator of LBIE

LEHMAN BROTHERS

*“ As a LBIE lawyer, I was listed as the contact on contracts should LBIE default. From never expecting that to be relevant, I ultimately received thousands of notices and valuation statements. Even emails from my family received an automatic response inviting them to pay monies owed to LBIE to the Bank of England!”*

Huw Merriman,  
LBIE Managing Director

# A landmark distribution: the single largest in a UK administration



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### An innovative and consensual approach to settle c\$9bn claims

We recently achieved a major landmark in the administration of LBIE with the distribution of c\$7.8bn to Trust counterparties – the single largest distribution out of a UK administration. Following a settlement agreement with LBI\* we were faced with a complex situation where the recovery we were due to receive back as part of the settlement did not match our client's claims that had to be resolved. We developed and then implemented a highly innovative and consensual approach which achieved a 95% acceptance rate (by best claim value) and settled c\$9bn of claims of nearly 300 hedge funds. This represents one of the most significant and complex initiatives over the course of the entire administration.

### Cross-border complexity

As the Lehman group's regulated broker-dealer in Europe, one of LBIE's major business areas was prime services, which involved LBIE acting as prime broker to institutional clients, mostly hedge funds. LBI acted as LBIE's primary clearing broker and custodian for LBIE's customers holding US securities.

The collapse of the Lehman group resulted in the insolvency of both LBIE and LBI. But whilst PwC administrators were appointed in the UK to LBIE on 15 September 2008, it was

not until 19 September 2008 that trustees were appointed to LBI in accordance with the Securities and Investor Protection Act 1970 ("SIPA") in the United States. The cross-border working of different regimes and objectives, and the complexity arising from the sheer volume of Lehman trades, presented significant challenges.

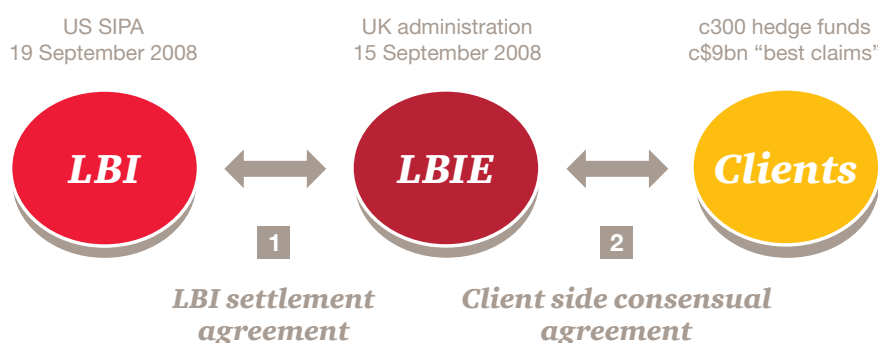
### Settlement agreement with LBI

LBIE filed multiple claims against LBI and vice versa amounting to \$38bn, which were settled earlier this year. These included the settlement of an omnibus customer claim to recover customer property held by LBI, as a result of which LBIE received a pool of over \$9bn of cash and securities.

That settlement in its own right received a widespread favourable reception from the US and UK courts, as a model for commercial resolution of cross-border issues.

However, LBI did not record in its books and records whether client securities held in an omnibus client account were held for any particular customer of LBIE. A consequence of the settlement was that whilst significant value was protected, there was no legal precedent for delivering this to clients with unsecured and priority claims, because of a mismatch between the recoveries and the entitlements of clients.

## Overview



Source: PwC

### Definitions:

\* LBI - Lehman Brothers Inc.

\*\*LBIE - Lehman Brothers International (Europe) - In Administration

### **Consensual agreement with customers**

There was significant legal uncertainty and complexity regarding LBIE's customers' basis for sharing in the pool. This reflected the unique interplay between UK administration and US SIPA procedures; non-coterminous appointment dates; diverse underlying contractual arrangements and customer jurisdictions; the mismatch between the securities claimed and the securities returned; and the variance in the relative performance of securities in the period since insolvency. Without a consensual solution, a protracted court process would have been likely, which could have led to disputes, lengthy delay and significant cost.

So we set about designing a solution to enable a more efficient and speedy distribution to customers. We developed a ground-breaking scheme in a consensual proposal to distribute in excess of \$9bn of cash and proceeds from the liquidation of securities to c300 hedge funds.

A cornerstone of our proposals was the allocation methodology. After evaluating numerous alternative approaches, we decided to allocate the pool relative to customers' "best claim". This meant for each customer the higher of their claim as at the SIPA date and at a recent date (representing current market value). Our approach also entailed the liquidation of securities received from LBI.

Having led counterparties through the process from conception to voting, we were delighted that our proposals achieved 95% acceptance (by customers' best claim), substantially exceeding the minimum threshold set for acceptance.

### **Distribution to customers**

The overwhelming support for the proposals underscores the benefits of the consensual approach – founded on an attractive commercial and equitable resolution – allowing us to accelerate distributions to customers.

Following our orderly liquidation of in excess of \$5bn of securities received from LBI, omnibus Trust customers will receive in excess of 100% of their best claim. And so, on 26 September 2013, we made a first interim distribution of \$7.8bn in respect of the majority of eligible customers.

*“LBIE was faced with liquidating \$4.5bn across 3,500 securities in the midst of the tapering debate. Speed of execution, tight control of information and, in fixed income securities, creating pricing tension were key drivers to success. Inside four days we had successfully sold over 90% of our portfolio by value.”*

Billy Radicopoulous, LBIE Managing Director



A further distribution will be made next year once remaining tax and other reserves have been addressed. LBIE's unsecured creditors also benefited from this expedited resolution because \$2bn of these assets were appropriated from clients in settlement of their obligations to the "House" estate.

The \$7.8bn distribution is in addition to the £13.7bn of Trust assets returned bringing the total return to date to £18bn.

The depth and complexity of the relationships between LBI, LBIE and its underlying customers, the different insolvency regimes and the sheer size of the claims presented a highly complex set of circumstances. The settlement agreement with LBI and the consensual agreement with customers have been defining milestones in the administration.

This initiative demonstrates how a scheme or consensual approach can be used to drive change. The innovative solution provides a precedent for using a consensual approach to help clients resolve claims management problems where they face high-value, high-volume claims and legal uncertainty or complexity.

Our experience also illustrates the value of living wills. Consideration of the potential issues that arise in the event of the untangling of complex, cross-border organisations could help the development of business models that avoid some of those issues arising in the first place.



# Statutory interest - an unexpected problem



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The global financial crisis signalled by the Lehman collapse highlighted a number of unprecedented regulatory, economic, legal and restructuring issues on a macro-level. As the Lehman European hub, LBIE\* was the most complex part of the group and the unwinding of its balance sheet has given rise to a number of unprecedented challenges of its own: LBIE had around 6,000 clients across the globe, thousands of derivatives contracts, repos, stock loans, prime brokerage and equity trades and two Trust estates in addition to the general unsecured estate and multi-faceted relationships with other insolvent Lehman entities in different jurisdictions. A number of the most material issues have now been resolved and the upper end of the range of financial outcomes for the general estate suggests that creditors may have their claims repaid in full and with interest – an outcome that was unimaginable five years ago. However, as with many things relating to Lehman, working out the amount due to each creditor is not as easy as might be assumed.

In the five years since the Lehman collapse, LBIE has realised almost £20bn of cash for the general estate, and made interim distributions of £5.9bn to unsecured creditors, representing 68.5p in the pound for admitted claims. The administrators now believe that there may eventually be a surplus of up to c£5bn in the general estate after settling all ordinary unsecured claims in full. It is extremely rare for unsecured creditors to recover 100% from a UK insolvency procedure, and even more exceptional given LBIE's scale and complexity. Consequently, a number of questions have arisen in considering how any surplus should be shared between relevant stakeholders.

The principal question arises from LBIE's pre-administration capital structure: LBIE was, unusually for a UK corporate, an unlimited company and its funding structure included £1.25bn of subordinated debt from its majority shareholder. Whilst it is clear that the claims of ordinary unsecured creditors rank ahead of this subordinated debt, it is not certain whether interest on unsecured claims should be paid in priority to shareholder claims and/or amounts due in respect of the subordinated debt.

To obtain clarity on this point, LBIE and its shareholders have made a joint application to the UK High Court covering a number of questions relating to respective rights of claims between LBIE, its unsecured creditors and its shareholders. The administrators' view is that interest on unsecured creditor claims is payable ahead of shareholder and subordinated debt claims and they anticipate that this will be confirmed by the court early in 2014, following the hearing due shortly.

The second question, which arguably has greater significance in value terms, is how interest claims should be calculated under the Insolvency Rules, particularly the interest rate to be applied and the date from which interest accrues. Given the amount of time it would likely take to resolve these details, through court directions or on a claim-by-claim basis, the administrators are developing a simplifying methodology to determine interest claims on an equitable basis for all LBIE's qualifying creditors.

***“ I will never forget deadline day for the first unsecured dividend in November 2012. The buzz on the floor was incredible - the culmination of four years' hard work. I was approving last-minute settlements until about midnight and when the phones finally stopped ringing it felt like a watershed moment.”***

**Paul Copley, PwC BRS  
& joint administrator of LBIE**

#### Definitions:

\* LBIE - Lehman Brothers International (Europe) - In Administration  
 \*\*OTC - over-the-counter: a market in which securities, or other financial products, are traded by direct dealer-to-dealer communications.





### *The interest conundrum*

In calculating the statutory interest rate, the administrators are faced with a number of challenges:

#### **Rate:**

- Simple interest at 8% p.a. accrues in accordance with the Insolvency Rules.
- If the underlying contract between the company in administration and a creditor specifies a rate higher than 8% p.a. should be used in the interest calculation, the Insolvency Rules allows this rate to be applied.
- For LBIE, this could affect claims arising from certain OTC\*\* derivative agreements, principally ISDA master agreements under which the relevant rate is typically cited as the counterparty's cost of funds plus 1% per annum.

#### **Date:**

- Interest is due in respect of the periods during which the relevant claims were outstanding since the date of the appointment.
- It is unclear from what date a creditor's interest claim is to be calculated.
- Master agreements constituted the majority of LBIE's trading contracts. One interpretation of these contracts is that claims arising from them do not represent outstanding debts until at least the date of termination under the close-out netting provisions.
- This could mean that interest accrues from the termination date not the date of administration; in certain cases this could significantly reduce the period for which interest is due.

#### **Other factors to consider:**

- The set-off of amounts receivable and payable under different master agreements, often with different termination dates, to derive a single net claim against LBIE for each counterparty.
- Claim transfers to third parties, particularly where the original holder may no longer exist – there is an active secondary market in LBIE claims.
- The date, or dates, that a counterparty's cost of funds should be fixed for the purpose of determining the interest rate applicable to an ISDA claim.

### *Finding the solution - keeping it simple*

The administrators are aware that LBIE claims are currently trading at amounts in excess of 130p in the pound on the secondary market, with a third distribution due before the end of 2013. Faced with these challenges, they have started to develop an interest resolution mechanism that will enable both LBIE and its creditors to circumvent many of the uncertainties associated with calculation on a statutory or contractual basis.

The primary objective of this approach is to facilitate an accelerated payment of interest on unsecured claims, assuming that the outcome of this month's UK High Court application hearing enables this. It is possible that the chosen mechanism will be implemented by a Company Voluntary Arrangement or a Scheme of Arrangement.

Alternatively, a consensual solution may be possible, albeit a very high acceptance hurdle-rate is likely to be required in order that a manageable reserve can be made for non-consenting creditors under such an approach. LBIE expects to announce further details regarding the resolution mechanism during the first half of 2014.

# Cracking “too big to fail” – are we nearly there yet?



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Lehman Brothers’ collapse was a failure of historic proportions, and naturally the repercussions for the banking sector, financial services and the European and global economies were extraordinary. With the benefit of five years of hindsight, two key questions arise: what have we learnt and how has the market responded?

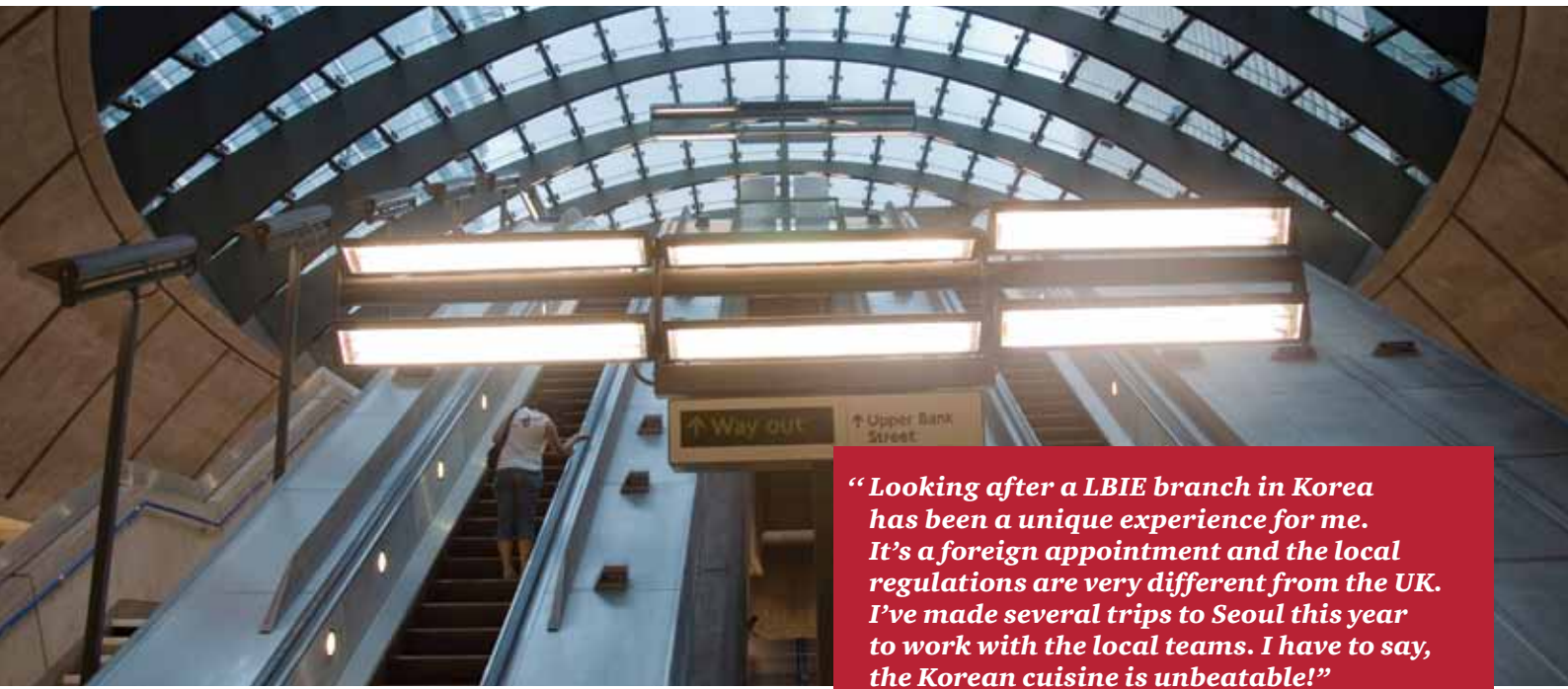
The banking industry has been at the core of the financial crisis and the continued stresses and strains arising from it in the short term may be diverting attention away from the fact that the world, and the way it does business, is changing profoundly. This includes the on-going growth in emerging markets and consequential shifts in capital and trade flows away from the West. To survive, banks, along with their advisers, have been addressing the immediate issues of their response to changing regulation amid a new paradigm of public awareness and the regulators’ acute scrutiny of their activities. Over the past five years we have led a number of bank restructurings and recapitalisations, helping them deal with this evolving environment and build business models that avoid longer-term irrelevancy.

*“Having been seconded to credit and workout teams I was interested to see how PwC had integrated with Investment Banking staff two years post appointment. I wasn’t disappointed: through inclusion, hard work and targeted use of specialist skills I have witnessed the right result being achieved for creditors again and again.”*

Helen Gaillard, PwC BRS - Senior Manager

In the UK, following the collapse of a number of banks and financial institutions, the government restructured financial regulation and, in April 2013, abolished the Financial Services Authority. Its responsibilities have been split between two new organisations: the Prudential Regulation Authority (“PRA”) and the Financial Conduct Authority (“FCA”), both of which are parts of the Bank of England. This move to put regulation back in the hands of the central bank is being replicated in the Eurozone with the creation of the Single Supervisor who will be a part of the ECB. Along with the creation of these new bodies, there has been a re-focusing of the purposes of such regulatory organisations. The PRA will concentrate on promoting the safety, soundness and stability of the UK financial system. The FCA, on the other hand, will focus on maintaining the integrity of the UK’s financial markets for the customer. These changes reflect a more clearly defined spotlight on not only the “what”, but also the “how” of banking, with reputation, perhaps, taking a higher profile than previously. Aside from the increased scrutiny of the various regulatory bodies, the wider public have never been more sceptical towards the banking sector. The consequences of failure to meet the standards set by regulators will go far beyond the fines and restrictions the regulators can enforce, because of the extreme damage they cause to the public image of organisations in a market where consumers have a choice.

In the UK, the theory of “too big to fail” was addressed to a degree by the Sir John Vicker’s Independent Banking Commission report, which set out a series of recommendations for the banking industry. The report proposed that the capital requirements of Basel III, which is to be implemented by 2019, needed to be extended. Rather than banks needing to hold a minimum equity capital of 7% of risk weighted assets as required by Basel III, the report argues this should be extended to 10% for retail banks, with such operations being ring-fenced from more risky investment banking units. These capital hurdles, whilst



***“Looking after a LBIE branch in Korea has been a unique experience for me. It’s a foreign appointment and the local regulations are very different from the UK. I’ve made several trips to Seoul this year to work with the local teams. I have to say, the Korean cuisine is unbeatable!”***

**May Cheng, PwC BRS - Senior Manager**

providing a more prudent operating environment, are not without significant challenge. Over the last five years we have assisted various financial institutions in reshaping their UK businesses, exiting from loss-making operations and unwinding non-core units whilst seeking to demonstrate to the regulators sufficient capital adequacy. For some, this is an exceptionally difficult challenge in the current economic environment with risk that the authorities take pre-emptive action by “bailing in” creditors to avoid insolvency (which would disrupt the bank’s operations and services) and prevent serious repercussions for the economy.

Outside the Vickers report, there has been some debate about the appropriateness of higher capital ratio measures. On one side, there has been criticism that, given banks are permitted to determine their risk-weighted assets themselves, there is potential for errors in their self-assessment and for inconsistencies to arise because of the differing methodologies being adopted. From the perspective of the banks, the perception is that these new measures have added a substantial cost burden that they will be forced to meet. Over a number of years of inflated returns, investors have become conditioned to expect a high return on equity, providing an additional challenge for banks seeking to attract and maintain the levels of equity required by the regulators. There are signs, however, that both as a direct and an indirect result of regulatory reform, issues such as weak cost and risk controls, as well as ill-disciplined investment are being addressed.

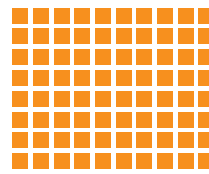
The International Monetary Fund recently highlighted the need for stronger global coordination to address the regulatory requirements of the banking sector, and the need to work together to “clean up” the weaker banks to avoid future collapses. Banking is a global industry and therefore needs a global solution. Addressing banking regulation in isolation from other parts of the financial services sector could limit the effectiveness of the reforms because of the interconnectedness of our financial systems. Accordingly, without clearer and aligned regulation of, for example, hedge funds, offshore financial vehicles and money market funds alongside the banks, key vulnerabilities remain. Mr Tucker, the outgoing deputy governor of the Bank of England, has underscored this point in a recent interview.

It is clear that the banking industry is still evolving and attempting to respond to the collapse of Lehman Brothers and the global economic crisis. The wider public are amongst the most demanding of the stakeholder groups to be satisfied: it is crucial that restoring public confidence and building trust are high on the priority list of banking organisations as public opinion is helping shape the regulatory agenda. Whilst there continues to be debate on both the reach and content of banking sector regulatory reform, achieving a balance that supports short-term stability alongside establishing foundations for sustainable business models in a dynamic financial environment remains a challenge. We will only know with the benefit of hindsight how effective the current reforms have been.



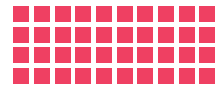
# Lehman Brothers: a timeline

## Trust returns



£8bn

## Trust returns



£4bn

2008

2009

2010

LBIE debt trades @ c20p

LBIE debt trades @ c50p

15 September

**07:56 AM**

LBIE<sup>1</sup> enters administration

**2,500 jobs**

Sale to Nomura of LBIE's investment banking arm – 2,500 jobs transferred

**One thousand**

creditors attend the O2 arena

**Appointment** of the Creditors' Committee

**3,000**

individual client queries processed

**2,100**

legal agreements reviewed

**6,000**

counterparties with live positions

**90%**

of Trust creditors accepted LBIE's settlement framework offer (CRA)

**\$1bn**

asset exchange with the Japanese affiliate was the first large settlement between Lehman affiliates

Launched the Consensual Approach (**Canada**) to agree unsecured claims

**Court of Appeal** ruling on Client Money

Unwind of open trades with exchange and clearing houses  
– 80 markets, more than 800,000 trades

## Where are we now across the House Estate and the proprietary estates of Client Assets and Client Money...

Cumulative dividend rate to date of **68.5%** with a third dividend due in late November

**£19.6bn** of cash and securities recovered

**425** LBIE<sup>1</sup> staff and contractors and **215** PwC staff

**c2,100** unsecured creditor claims (**c£9bn**) admitted

**£5.9bn** of interim dividends and small claims settlement payments made to unsecured creditors

**£18bn** of Trust Property (securities & cash) now returned to clients

The majority of LBIE's highest value Affiliate relationships resolved

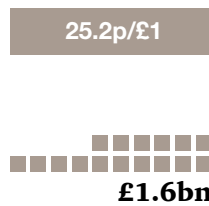
**c\$1.2bn** of pre-Administration Client Money recovered and Client Money Entitlements clarified

**c\$3bn** of non-Affiliate post-Administration Client Money recovered

Trust returns



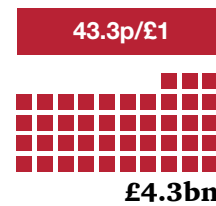
Unsecured dividend



Trust returns



Unsecured dividend



Trust returns



**Cumulative total unsecured returns £5.9bn**  
**Cumulative total Trust returns £18bn**

2011

LBIE debt trades @ c60p

Rascal judgement in LBIE's favour

**\$2.5bn**

recovers in the Citi debtor settlement

**LBHI<sup>3</sup> settlement**

Multi \$bns of complex liabilities resolved

2012

LBIE debt trades @ c80p

Supreme court ruling on Client Money

**LBHK<sup>4</sup> and LBS<sup>5</sup> settlements**

Multi \$bns of complex liabilities resolved

1st interim unsecured distribution – 25.2p/£1 (£1.6bn)

2013 to date

LBIE debt trades @ c120p - in excess of c130p

Supreme court ruling on Pension Fund Deficit

**\$bns**

LBEF<sup>6</sup>, LBF<sup>7</sup>, LBI<sup>2</sup> and LB Lux<sup>8</sup> settlements  
 Multi \$bns of complex liabilities resolved

**c\$2bn**

Trust debtor recoveries

1st interim Client Money distribution – 23.2p/£1 (\$18.2m)

1st interim distribution from the "Omnibus Trust" – \$7.8bn

2nd interim unsecured distribution – 48.3p/£1 (£4.3bn)

**What does the future hold...**

LBIE announced the prospect of a full return to creditors on the fifth anniversary of the administration, with an estimated high-case outcome of c139p in the pound for unsecured creditors and potentially a total return of **£40bn** to all creditors combined

**c1,300** unsecured creditor claims (**£7.5bn**) remaining to be resolved

Future resolution of the respective rights of ordinary unsecured and subordinated creditors to payment from the funds remaining after reaching 100p in the pound on ordinary unsecured claims

**Definitions:**

- 1 LBIE - Lehman Brothers International (Europe) - In Administration
- 2 LBI - Lehman Brothers Inc.
- 3 LBHI - Lehman Brothers Holding Inc.
- 4 LBHK - Lehman Brothers Hong Kong
- 5 LBS - Lehman Brothers Securities N.V.
- 6 LBEF - Lehman Brothers (Luxembourg) Equity Finance S.A.
- 7 LBF - Lehman Brothers Finance S.A. (Switzerland)
- 8 LB Lux - Lehman Brothers (Luxembourg) S.A.
- 9 CRA - Claim Resolution Agreement

# Restructuring

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Continuing strong liquidity in the debt markets, coupled with an increasing prevalence of alternative investors, has enabled a number of borrowers to refinance in the first half of this year, who, in a less benign environment, may have faced a restructuring.

The shift from leveraged loans to high yield bonds continues apace – the latter market has more than tripled in size since 2008, whilst the former has shrunk by a third over the same period. This has profound consequences for any subsequent restructuring of those weaker credits: in delaying potential trigger events; shifting the stakeholder base; and making the eventual restructuring more fundamental.

However more borrowers, who have already been through one round of amend and extend, are facing financial difficulties. Similarly, S&P notes that 44% of all defaulters since 2011 have already had one previous default. Problems have therefore been deferred, but not necessarily solved. This time round the solution may need to be more radical.

Also, the credit quality of the remaining pool of leveraged loan borrowers has deteriorated and is significantly worse than their public bond counterparts. Recent upticks in the default rate in France and the Netherlands suggest lenders may be becoming less tolerant about continuing to amend and extend.

We continue to expect a steady stream of new restructuring cases in the remainder of the year. This is perhaps more true of continental Europe, with particular focus on Spain, but generally we see significant activity in each of the major continental western European economies.

There remain significant risks to the downside, particularly in credit markets. Investors in the Eurozone are closely watching Ireland's attempts to issue bonds on a standalone basis later this year and the macroeconomic positions of the peripheral economies, whilst improving, remain fragile. At some point, central banks will also need to reverse the last few years' extremely accommodative policy stance. That could lead to a major correction in bond yields, causing dislocation in the European high yield market and leaving highly leveraged borrowers out in the cold.

***Problems have been deferred, but not necessarily solved.  
This time round the solution may need to be more radical.***





### Distressed credits

The number of borrowers incurring a payment default in Q2 2013 remained broadly in line with previous quarters. The publicly disclosed defaults and restructurings included Camieu SA and Ceva Group amongst others.

Our own experience shows that there continues to be a number of corporates facing challenges across Europe. This includes a number of cases where an initial covenant amendment marks the start of a more fundamental restructuring process.

### Distress metrics

The lagging 12-month default rate for the S&P European Leveraged Loan Index (“ELLI”) continued to fall over the first half of this year. In the 12 months ended 30 June 2013, the ELLI tracked €5.7bn of institutional loan defaults and restructurings, considerably lower than the €7.2bn as at 31 December 2012.

The ELLI default rate measured by number of issuers also decreased to 6.6% in June – reflecting that 14 issuers as measured by ELLI had defaulted or commenced restructuring over the last 12 months. This is down from 18 issuers at the end of last year.

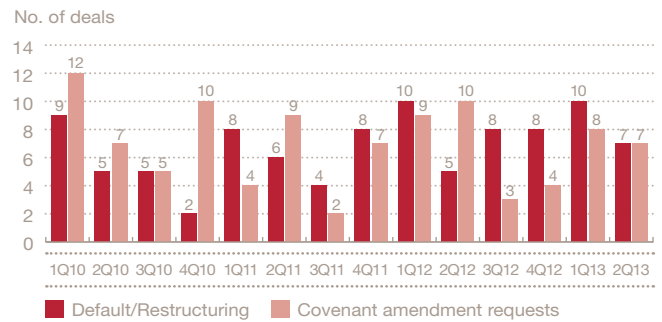
With the economic environment gradually improving, and if credit markets remain liquid, then we would not expect the level of defaults to tick up in the short-term.

Over the first half of 2013, the number of absolute upgrades to ELLI continued to decline. This resulted in the ratio of downgrades to upgrades being maintained at 1.3x, which indicates continuing pressure on leveraged credits.

In contrast, the ELLI distress ratio – the percentage of performing loans trading below 80 – continued its gradual decline and reached its lowest level since the middle of 2011. The ratio fell from 18.7% at the end of 2012 to 16.2% by the end of June 2013. In our view this reflects liquidity in the market as much as anything else.

Furthermore the share of facilities rated CCC+ or lower increased to 9.1% up from 7.3% at the end of 2012. Whilst below the peak of 11.9% seen at the end of 2011, the trend over H1 2013 would suggest that there remain a number of credits that are too challenged to access the bond markets.

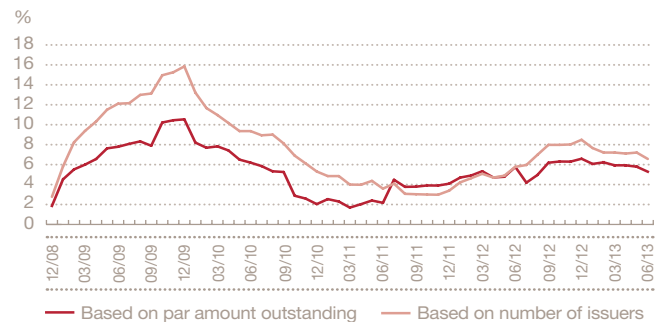
### Distressed leveraged loans



Source: S&P Capital IQ LCD

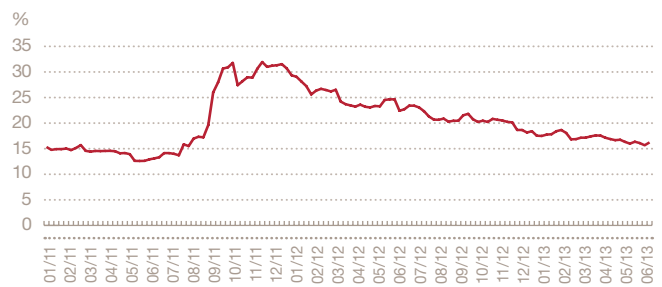
Note: Distressed credits are classified as loans rated D or in a restructuring

### 12 month default rate



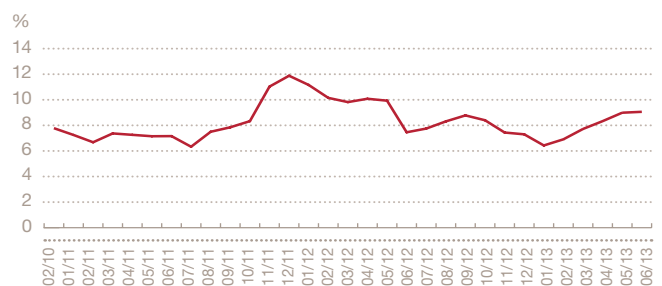
Source: S&P Capital IQ LCD

### ELLI distress ratio



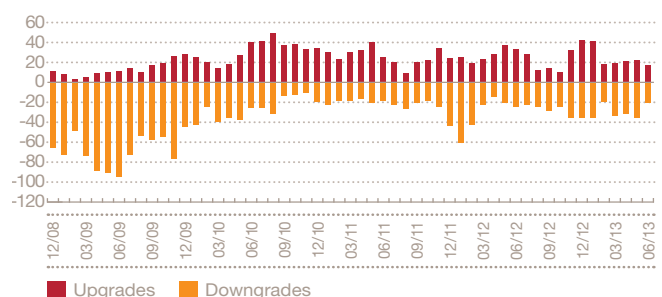
Source: S&P Capital IQ LCD

### Share of facilities rated CCC+ or lower



Source: S&P Capital IQ LCD

### Upgrades/downgrades of ELLI



Source: S&P Capital IQ LCD

### Market size and maturity profile

The chart opposite illustrates the market size for sub-investment grade debt by reference to European high yield bonds and institutional leveraged loans. As can be seen, the total market size has continued to grow to €328bn by August 2013 (54% larger than in 2008) driven by a more than three-fold increase in the size of the high yield bond market.

In contrast, the level of institutional leveraged loans continues to fall and as at August 2013 amounted to €97bn, the lowest level since 2005. The reduction mainly continues to be, through exit data from ELLI, via repayments and the use of bond take-outs to refinance.

Data as at end of June 2013 shows that the quantum of institutional leveraged debt maturing by the end of 2015 has now fallen to €21.7bn. This is a reduction of €13.8bn from the level outstanding at the end of 2012. Of additional note, the peak in the maturity profile of institutional leveraged debt has now shifted out to 2017. The “maturity wall” seems to have been addressed.

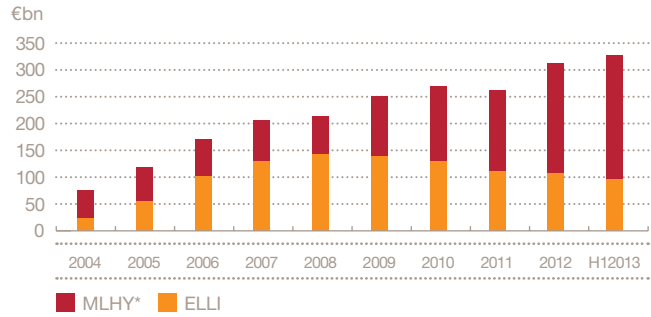
Despite the buoyancy of the bond market, lower quality credits in the near term will continue to find it difficult to refinance. Accordingly, we foresee there will remain a stub of involuntary refinancing or restructurings over the next 12 months or so.

### Pricing

Average margins on new deals continued to decline in Q2 2013, reaching 423bps. This reflected the availability of US money to European corporates and heightened competition on these cross-border deals. These conditions even enabled a return to ‘cov-lite’ terms on deals such as Oxea and Springer. There could potentially be a crossover point where investors increasingly target amended or outstanding deals for yield. However, it is difficult to gauge if this will be observed over the short-term, or be a part of longer-term trend.

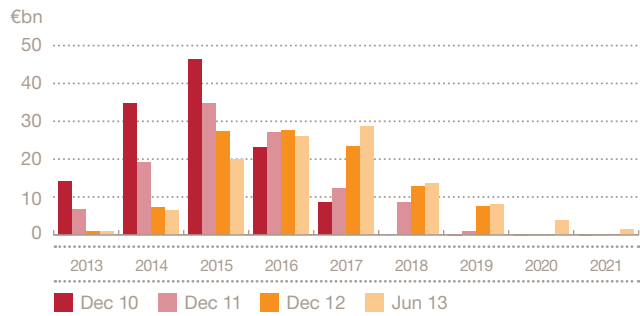
Average amendment fees for Q2 2013 of 51bps were in line with Q1. There were a range of deals which attracted fees, such as Northgate, where a request for covenant relief and a two year extension attracted a fee of 100bps. In comparison a similar request by Schenk attracted a fee of 50bps, although there was also a margin uplift of 100bps. As ever, the specifics of the borrower’s requests and the complexity of the case are key factors in determining the fee level.

Market size - outstanding balance



Source: S&P Capital IQ LCD  
\*Bank of America Merrill Lynch European high-yield Bond Index

European institutional leveraged debt



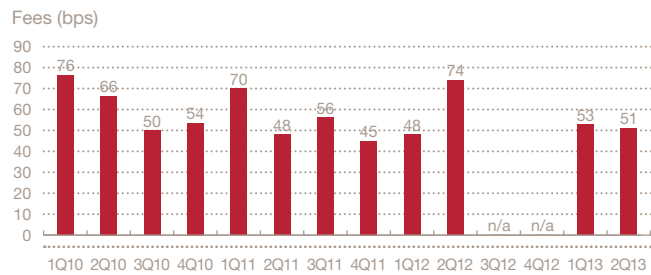
Source: S&P Capital IQ LCD

Average margins on LBO facilities



Source: S&P Capital IQ LCD

Amendment fees (bps)



Source: S&P Capital IQ LCD





## In the debt markets



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### **CEO/CFO summary**

As recent months have shown, market sentiment can change quickly. Earlier concerns over an imminent and rapid tapering of monetary stimulus by the US Federal Reserve and the rise in credit prices that followed have largely abated. For now at least, most investors are banking on a later and more measured withdrawal, opening the door to a renewed surge in confidence and liquidity, which was highlighted by Verizon's record \$49bn bond financing in September. The appetite for investment has been further buoyed by the growing signs of recovery within the Eurozone.

With a surfeit of funds and a lack of M&A deal flow making it difficult for investors to put their money to work, investors are prepared to accept lower yields and invest in a broader range of instruments than we've seen for several years. This mood was reflected in Phone 4U's issuance of a £205m Payment in Kind (PIK) Toggle Note, a relatively high risk product, which until recently had typically only been seen during bull markets. While larger and higher rated companies have enjoyed greater availability and flexibility of funding than their mid-market counterparts, the latter are now

beginning to reap the benefits of this dynamic market, thanks to fresh interest from institutional investors and the variety of hybrid structures now on offer. The key challenge for all market segments is how to find the best available option for their particular needs when there are so many to choose from.

In addition to providing capital for refinancing and dividend payments, the attractive market conditions could provide a further boost to acquisition activity. Even if finance isn't needed at present, it may be worth locking it in now ready for later as this window of opportunity may quickly close. The Federal Reserve's tapering timetable hinges on jobs, housing and wider economic data, which remain mixed. While the recent news has been better, the Cyprus bailout earlier in the year highlights the continuing fragility of the Eurozone.

In this edition of In the debt markets, we look at how to make the most of the market trends that have made this such an opportune time for financing. Our 'hot topic' is the increasingly competitive and fast moving German market.

**European debt market issuance reached a post-financial crisis high of €41.9bn in the second quarter of 2013 (combined leveraged loan and high yield bond issuance)**



### Leveraged loans

European borrowers raised €23.5bn in the leveraged loan market in the second quarter of 2013 – a five-year high.

More than 60% of the funds raised in the first half of the year were used for refinancing as yields tightened to historical lows. Although the proportion of funds being used for M&A was at a record low (32%), this could change as expansion moves back onto the agenda amid a more confident economic outlook.

Even with the surge in issuance in the first half of the year, increasing liquidity has outstripped new issue supply, which has resulted in attractive pricing and leverage terms. As a result, companies may now be able to embark on transactions that might not have been possible in recent years, including super-sized buyouts and covenant-lite cross-border facilities with very tight spreads, along with add-ons to fund dividend pay-outs.

The increase in liquidity is coming from both banks and non-bank lenders, such as life insurers and pension funds. The expanding range of buyout options for mid-market deals also includes flexible unitranche lending; much of it backed by private equity and credit funds.

However, this high level of liquidity and choice, particularly at the larger end of the market, is dependent on central bank monetary policy and short-term technical dynamics and therefore may not last for very much longer.

### High yield: increasing risk appetite

The value of high yield bond transactions in Europe was €39.7bn in the first half of 2013, 2.4 times the equivalent period in 2012.

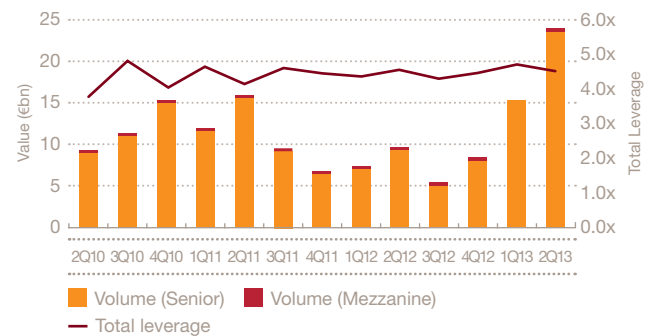
The widening in pricing prompted by expectations that the Federal Reserve would start to scale back its monthly asset purchases in September has now given way to a re-tightening. Investor risk appetite has also bounced back.

Many investors are prepared to be patient in return for premium yields, which is giving companies the option to extend maturities and increase leverage. There has even been a re-emergence this year of Payment in Kind (PIK) Toggle Notes, including, most recently, Phones 4U's £205m issuance in September. Most of the PIK notes issued this year have been pay if you can (PIYC), reducing the cash demands on the issuer if its ability to service cash interest payments is constrained. These are clearly higher risk instruments for investors and, as such, their re-emergence is a clear sign of resurgent investor confidence.

As well as using the high yield market to refinance bank loans and to pay shareholders' dividends, companies have also increased their usage of the bond markets for M&A financing.

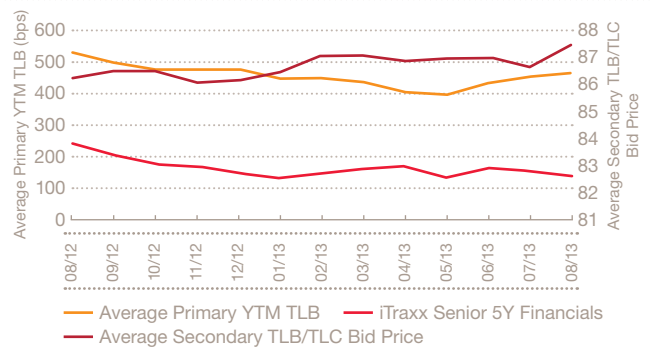
The spread differential between high yield and Treasury bonds means that, in theory, they should be more insulated from the impact of eventual tapering than corporate bonds. In practice, however, they are correlated with other debt market instruments and will be impacted by changes in market sentiment. There are, therefore, strong reasons to act now while market conditions are so favourable.

### European leveraged loan volume and debt multiples



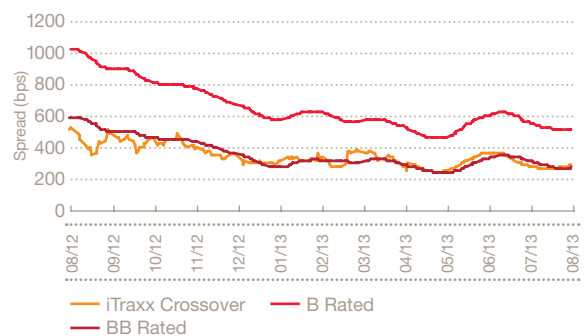
Source: S&P Capital IQ LCD

### Comparative analysis of primary and secondary loan pricing



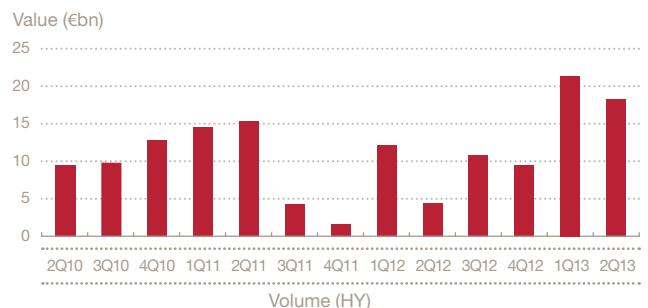
Source: S&P Capital IQ LCD, Thomson Reuters

### European BB and B rated bonds vs iTraxx Crossover



Source: S&P Capital IQ LCD, Thomson Reuters

### European high yield volume (primary issue)



Source: LCD Q1 2013 overview

### Corporate loans & bonds

In recent years there has been a growing trend in Europe away from bank lending towards a US-style corporate financing model in which bonds dominate.

Investment grade companies have been attracted by falling borrowing costs in the bond market. The attractiveness of the bond market has been heightened further by increased investor appetite for equity-linked instruments such as convertible bonds.

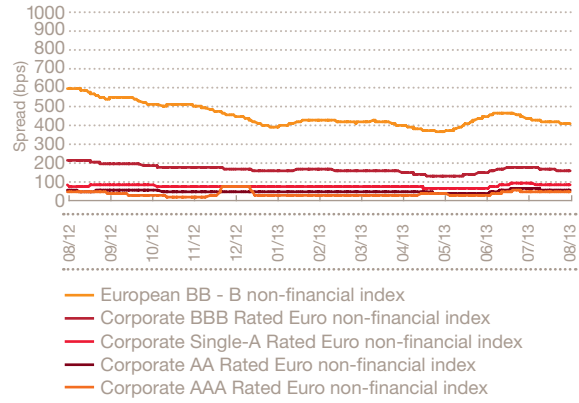
Loans remained relatively insulated from the broader correction in fixed income markets following the Fed's tapering announcement in June and technical conditions remain strong.

A parallel development has been the move by institutional and other non-bank lenders into the loan market. Until recently, investors have primarily focused on larger companies, although a significant proportion of the available funding has remained unused, as most investment grade groups can secure better pricing in the bond market.

Now, institutional lenders such as M&G, Delta Lloyd, AXA and Allianz are moving into the mid-market segment, offering a real alternative to traditional bank financing. One of the key advantages is their readiness to offer longer duration loans.

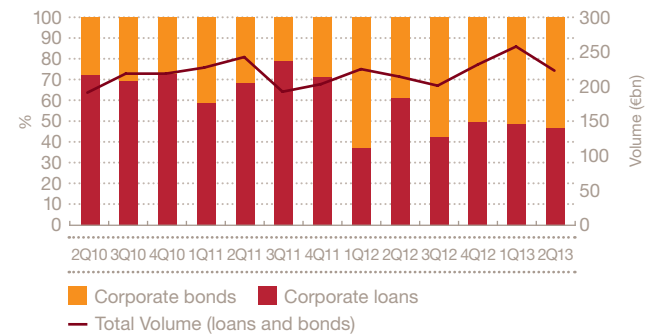
Mid-market loan conditions are currently very attractive, and remain insulated from the macroeconomic factors that impact the more liquid, larger capitalisation markets.

### European corporate investment grade bond yields



Source: Thomson Reuters

### Corporate loans and bonds volume (primary issue)



Sources: Dealogic - PwC Analysis





### *Germany sets the pace*

The German debt market is competitive, and this trend is likely to be mirrored elsewhere in Europe as the continent's recovery gathers pace.

Global investment banks have been making determined moves into the larger end of the market. Their focus includes high yield bonds (examples include FTE Automotive, Linde and Continental) and/or a combination of US dollar and Euro term loan Bs (such as those used in the Ceramtec, Springer and Armacell deals and the repricing of BSN Medical), often with reduced covenant requirements.

In the mid-market, more than a dozen banks, both foreign and domestic, are using aggressive terms to compete for deals in the corporate and private equity segments.

The main focus is club-type deals, such as Alloheim, although there is underwriting appetite for the right credit (AHT Cooling was a three-handed deal), as banks look at ways to meet their budgets. Nonetheless, the leveraged buyout pipeline continues to be rather thin (e.g. Scout 24, Scandlines and Eschenbach Optics) – and mostly consists of secondary deals. Some market participants have been preparing for the first quarter of 2014 for some weeks.

Continued liquidity provision by the banks means that debt funds looking to enter the market have been left on the sidelines as they are either perceived to be too expensive or lack access to corporates.

The investment grade corporate space is even more competitive due to the resurgence of the Schuldschein market in the past couple of years. Even cross-over credits are financed on aggressive terms of 250bps or less. Credit demand is still largely driven by refinancings.

Germany's perceived safe haven status and breadth of funding sources – ranging from foreign banks to local savings banks – mean that liquidity is likely to remain strong and market conditions should continue to be competitive even if other markets fall back over the coming year.



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