



## **IT'S A LENDERS' MARKET OUT THERE!**

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The days of inexpensive, readily accessible credit for businesses are over. In Canada, lending policies of Canadian financial institutions appear to have tightened up considerably, despite the fact that lending guidelines seem to have been more prudent than what has been the case in the United States. It now appears to be a lenders' market, with tightened lending criteria in all industries and products, including home mortgages, credit cards and business loan products.

Banks today are looking more carefully at ultimate exit strategies and ways in which to minimize exposure to riskier investments. There remains a high demand for capital, yet the cost to banks has risen dramatically, thereby raising the cost to borrowers. Contributing to this are changes in the interbank lending market where the London interbank offered rate, or LIBOR, rose dramatically to an all-time high of 6.88% in September of 2008.

### **When did this shift towards tightening lending standards and minimizing risk begin?**

An increase in the tightening of lending standards and the need to minimize risk began in June 2007, when a number of investors and banks realized that many of their loans were aggressively positioned with only modest revenue expectations, in an environment of rising costs and increased capital requirements. Covenants in loan agreements were extremely light, and in a number of instances, nonexistent. Banks and investors, realizing that they were over-leveraged and over-exposed to high levels of risk, began refusing to lend to current and prospective clients on the same or similar terms. Statistical results from the October 2008 U.S. Federal Reserve's Senior Officer Survey (the "October 2008 Fed Survey") help illustrate and explain the breadth of this shift from the perspective of United States banks.

### **Explaining the shift? The breadth of tightened lending standards in the United States.**

The October 2008 Fed Survey suggested that more U.S. banks tightened their lending standards and terms for business loans between the months of August and October, while borrowers continued to

feel the effects of the current credit crunch. A similar tightening of lending guidelines appears to have taken place in Canada, despite the fact that statistical data is still required to confirm what many believe to be true.

Interestingly, the October 2008 Fed Survey noted the following statistics with respect to the tightening of lending standards:

- About 85% of U.S. banks – up substantially from 60% as reported in the July 2008 U.S. Federal Reserve's Senior Officer Survey (the "July 2008 Fed Survey") – reported having tightened lending standards on commercial and industrial loans to large and middle-market firms. About 75% of U.S. banks said they tightened standards on such loans to small firms, up from July 2008. Of the above U.S. banks tightening credit terms for commercial and industrial loans, almost all of them pointed to a less favourable or a more uncertain economic outlook;
- About 75% of foreign respondents to the July 2008 Fed Survey, and 40% of U.S. respondents, noted that a deterioration in their bank's current or expected capital position had contributed to the move toward more stringent lending policies between the months of September and November, a larger number than had cited that factor in the July 2008 Fed Survey;
- For commercial real estate loans, 85% of U.S. banks reported that they had tightened lending standards. About 65% of the foreign banks had done the same, up considerably from about 35% in the July 2008 Fed Survey. About 55% of U.S. banks – up from 30% in the July 2008 Fed Survey – reported weaker demand for such loans; and
- Lending standards for consumer loans and revolving home equity lines of credit tightened again for most banks due to weaker demands for such loans.

Despite the perceived heightened level of prudence present in Canadian lending standards over those in the United States, it will be interesting to see whether statistics in Canada will parallel the October 2008 Fed Survey results.

## **What are the obstacles to borrowing being faced by businesses today?**

Resulting from a similar tightening of lending standards here in Canada, Canadian businesses are now faced with a number of new-found obstacles to borrowing.

### *Difficulty in the syndication market*

Difficulty in the syndication market today is making it extremely cumbersome for banks to lend money to businesses seeking the financing they need. Currently, it is very difficult for banks to underwrite transactions, due largely in part to the lack of available lending participants willing to provide the required funds and to take on a proportion of the risk. This lack of participants could be the result of a number of factors, including increased capital requirements for banks. Before the credit crisis, it was commonplace for banks to underwrite and commit to the full amount of a loan and then, only after committing the funds to the borrower, would the bank portion off pieces of the loan among a lending syndicate in order to effectively minimize its exposure. Today, these mechanics have changed. Banks are not underwriting and committing to the full amount of a loan at the outset. Rather, they are trying to organize and allocate amongst a syndicate before ever committing any funds to the borrower. The effects of this change are twofold: while banks are focused on eliminating underwriting risk, borrowers are losing the timeliness with which they can secure financing and, if able to secure financing, are forced to accept such financing on much less favourable terms with increased costs.

### *The shift towards relationship banking and away from a focus on new clients*

There appears to be a general shift in motivation of the banks towards 'relationship banking', whereby banks are now preserving their capital for their relationship clients where they can generate additional fees with the provision of other offerings such as research, foreign exchange products and investment banking products. It would appear that, given the current environment, banks will be somewhat reluctant to participate in a syndicate led by another lender where there are likely no ancillary revenue generating opportunities. It would appear that generating new business with a new client which does not have "up-sell" opportunities will decline in importance. What does this mean for today's borrowers? In addition to facing obstacles with respect to market syndication, today's borrowers will have to more actively manage each lender in their lending syndicate, and provide multiple revenue

generating opportunities to all members of the syndicate to keep them committed and content.

## **Where do we go from here?**

In today's lending market, banks and investors will continue to seek more conservative risk/reward equations. As a result, we believe that the availability of affordable credit or refinancing opportunities for over-leveraged businesses will remain relatively restricted. Some businesses may become financially distressed, and will be forced to seek strategic alternatives such as restructurings or sales of their businesses or parts thereof. If done effectively, these alternatives could give stakeholders an opportunity to rescue some value. Despite seeing big casualties in the current credit crisis, it is believed that lending capacity should begin to improve as the quality of the security improves and investor confidence returns.

***This update is intended as a summary only and should not be regarded or relied upon as advice to any specific client or regarding any specific situation.***

***If you would like further information regarding the issues discussed in this update or if you wish to discuss any aspect of this commentary, please feel free to contact us.***

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