



PROPERTY MORTGAGE DEBENTURE STOCKS - A COMMENTARY ON RECENT DEVELOPMENTS

1 INTRODUCTION

1.1 As a result of a number of events in the debenture market in 1992/93 an ABI Committee was established to review the operation of this important sector of the investment markets. This paper summarises its considerations.

1.2 Among the factors which contributed to this review were:-

- (i) the speed of collapse of the property market and resultant difficulties for certain debenture stocks;
- (ii) concerns as to the level of discretion given to Trustees;
- (iii) the operation of the mechanisms for withdrawals and substitutions to the charged portfolios;
- (iv) responsibility for monitoring charged properties and
- (v) the necessity of a floating charge to complete bond holders' control.

1.3 Although the absence of a floating charge does not affect priority of repayment, protection for unpaid interest could be deemed inadequate since it would continue to accrue against a background of a limited security and a fear that an administrator might siphon off rent income to other expenditure.

Holder of a floating charge over the whole of a company's assets have the right to appoint an Administrative Receiver and thereby counter any petition for the appointment of an Administrator who could prevent the sale of charged assets for the principal benefit of debenture holders and interrupt the payment of interest.

2 RESOLVING THE PROBLEMS

2.1 Any approach to the problems revealed by events in 1992/93 should:-

- (i) be clear and unambiguous as regards the duties of the Trustee;
- (ii) provide for Trust Deed covenants which are clear, unambiguous and understandable;

- (iii) not require terms so onerous as to undermine the debenture market, leading to borrowers concentrating on unsecured issues despite the greater cost;
- (iv) recognise that certain types of issuer, such as Housing Associations, may require special treatment.

2.2 It appears that solutions are required to three broad areas of concern:-

- (i) a greater and more frequent disclosure of information to bond holders;
- (ii) a reduction in the level of discretion given to the Trustee;
- (iii) the security provided by covenants in the event of default.

A number of suggestions are set out below.

3 DISCLOSURES

3.1 Preliminary statements of annual results should confirm that, subject to audit, ratios and covenants have not been broken. It is possible that the current debate on companies "going concern" status will not address the degree of asset and income security contracted to and expected by debenture holders. Recent proposals from professional bodies suggest that a company should make a positive statement that it is not in breach of its covenants. We think it should be mandatory.

3.2 Items to be provided in the Report and Accounts:-

- (i) Audited comment on ratios and adherence to covenants.
- (ii) Details of each property disposed of and any substitutions (see below).
- (iii) For each new property substituted such details (inter alia, description, age and location, tenure, terms of existing tenants' leases or underleases, estimated current net annual rents, open market value in existing state, any instance of group occupation) so as to bring bond holders to the same level of knowledge as at the date of issue of the bond.

3.3 A full valuation should be undertaken at least once every five years by valuers approved by the Trustees, with a desktop valuation every other year which is certificated by the directors. The disclosure should include the methodology and key assumptions in the valuation and the level of investigation into the contamination of land site. The principle of accountability of valuers ultimately to bond holders and shareholders, is important.

3.4 Full and immediate disclosure through the Stock Exchange of all changes to the charged portfolio since the end of the last company year, if in total they are greater than 15% of the valuation of the charged assets.

3.5 Report and Accounts to be formally sent to all bond holders.

4 TRUSTEE DISCRETION

- 4.1 Whilst some suggest that some Trustees have in the past been at fault by showing too much discretion it is the Trust Deed that needs attention as it is this that governs the Trustee's actions. The following suggestions are made regarding Trustee discretion.
- 4.2 If 75% by value of bondholders request a full valuation of the charged portfolio then the trustees should implement this and the cost be borne by the company. Some restriction on the frequency of this may be requested (not more than once in say any 12 month period).
- 4.3 The replacement of a trustee may be forced by special resolution should at least 75% by value of bondholders at a meeting request such action; such a meeting may be called by request of 10% or more of the bondholders. In addition, a company may request the replacement of a trustee by proposing a special resolution to bond holders at a class meeting.
- 4.4 The Trustee should not act for debts of different ranking.
- 4.5 The Trust Deed should impose a duty on the Trustee to ensure that all charges are properly registered. This will give added comfort as an aid to preventing fraud, mishap or maladministration. Searches conducted during a property transaction will reveal such charges and any sale made without their release will not invalidate the charge.

5 COVENANTS

- 5.1 Top up cover should be implemented within three months of the delivery date of the relevant valuation, such valuation to be received no later than three months from its request date. An issuer may opt to use an existing valuation and such valuation must have been received within the last three months and in these circumstances for top up purposes, the delivery date will be deemed to be the request date. Cash and bank guarantees should not be allowed special status in terms of asset coverage calculations.
- 5.2 A floating charge should be provided over the assets and income of the charged portfolio which may be crystallised by the Trustee on any default to provide protection for the interest and capital payable on the bond.

Ideally bond holders should seek the extension of the floating charge over the whole, or substantially the whole, of the company's assets to give greater security and the opportunity to block the creation of an administrative order. The true protection for bond holders lies not here, however, but in the assurance that capital and income ratios are sufficient and reliable and that the floating charge over the charged portfolio provides protection for the interest payments in the event of default.

6 LEGISLATIVE CHANGE

- 6.1 Future legislative changes cannot be anticipated, but it is likely that property market values may increase in volatility, perhaps due to changes in the system of upward only rent reviews or privity of contract. Whilst it must be assumed that valuers will undertake their roles with such influences in mind, a greater level of disclosure of

information will help the market to price and accommodate such changes. In general, the suggestions made here are aimed at allowing the market to resolve future problems, this being the most efficient and satisfactory method.

- 6.2 On 9 November 1993 the Department of Trade and Industry issued a consultative document reviewing the company rescue provisions of the Insolvency Act 1986. If implemented the somewhat general proposals contained therein would have a major impact on security and floating charge provisions.

7 COMMUNICATIONS

- 7.1 In addition to the above comments the Special Committee make the following suggestions:-
- (i) The issue of bonds under a shelf registration process would aid the policing by institutions of new trust deeds.
 - (ii) Companies should consider, on an infrequent basis, some form of presentation to bond holders as a matter of good practice.
 - (iii) In situations of default Trustees should be entitled to receive the same quantity and quality of information available to other lenders and are encouraged to consult with bond holders. In addition, Trustees are encouraged to consult with bond holders or groups of bond holders where a situation of default threatens.

CHECKLIST FOR PROPERTY COMPANY MORTGAGE DEBENTURES

The following comprise outline conditions which would ordinarily be expected for a mortgage debenture of a property company. Items in bold type are deemed essential.

1 TRUSTEE

The Trustee to the stock should be suitable by dint of experience or perceived ability and corporate in status. There will be provision for bond holders to be able to replace the trustee by special resolution.

2 SECURITY

Stock to be secured by fixed charge over identified assets and consideration to be given to taking specific charge over income and also the proceeds of insurance policies and the policies themselves, guarantees, cash, deposits and other security for the payment of rent, shares in Special Purpose Vehicles (SPVs) holding mortgaged property and any management company shares necessary for the proper realisation of the security.

In addition, bond holders should ideally take a floating charge over all assets.

3 MARKET PURCHASES

A company may buy in stock by open tender or from the market subject to an overall limit of 20% of the bond issue over its entire lifetime.

4 FURTHER ISSUANCE

Subject to minimum coverage of 167% asset cover and 110% income cover.

5 SUBSTITUTION OF SECURITY

Substitution of security will be allowed at the discretion of the Trustee. The Trustee to be satisfied that the general nature and tenure of the charged assets is preserved. Annual notification of changes in the charged portfolio should be made in the Report and Accounts including, for all properties new to the portfolio in the period, information on address, age, tenure, details of leases. In addition bond holders must be notified by public announcement (Stock Exchange) should the change in the charged portfolio through substitutions and withdrawals amount to more than 15% by value from the last statement of charged properties. In such circumstances bond holders must be made aware of all transactions undertaken and the details of any new charged properties.

6 VALUATION OF SECURITY

A full valuation carried out by a valuer approved by the Trustee will take place at least once every five years with an annual desktop valuation in between.

The valuation basis should be disclosed.

Details of these figures and adherence to cover ratios should be provided in the provisional figures and confirmed as audited in the Reports and Accounts.

There should be provision for bond holders to request a special valuation once in any year by special resolution.

7 TOP UP

The minimum top up asset and income cover ratios to be ordinarily 1.5 and 1.05 respectively.

The period of grace shall be three months.

Cash and bank guarantees have no special status in terms of asset coverage calculations.

8 RESTRICTIONS

No charging subsidiary shall cease to be such. No further lower ranking fixed charges will be permitted without agreement of the Trustees and unless an agreement has been entered into covering priority of enforcement.

9 INSURANCE

Suitable insurance cover on the charged portfolio must be maintained.

10 INFORMATION TO BOND HOLDERS

On an annual basis bond holders will be entitled to receive:-

- (i) annual certification of all capital and income cover ratios;**
 - (ii) annual certification of all withdrawals, additions of security and details thereof;**
 - (iii) a copy of each Report and Accounts of the issuer and group (if different) to which the issuer belongs.**
- (i)-(ii) above shall occur not later than 3 months after the end of the issuer's financial year; or**
- (iii) shall occur concurrently with the distribution of Report and Accounts to shareholders.**

11 MODIFICATION OF RIGHTS

Only by bond holders' extraordinary resolution.

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