If the assets of a family office include securities (e.g., publicly listed shares or bonds), it may wish to raise finance against those assets. What kinds of issues should it watch out for?

Securities may be used as collateral for various finance products ranging from highly specialist margin loans to corporate style loans. The terms offered by lenders will depend on factors such as the jurisdiction of the issuer of the security and/or the account (if any) in which such securities are held, whether the transaction involves a portfolio of securities or securities issued by a single issuer and the type, listing and liquidity of the securities.

Margin Loans

Margin loans are loans collateralized by listed securities, with the available funding and the requirements relating to the provision of collateral to the lender(s) depending, among other things, on the value of the securities and how easy it is for the lender in an enforcement scenario to get repaid.

In our experience acting for both borrowers and lenders, the areas of negotiation include the extent of recourse of the lender(s), the level of restrictions on the business, pricing (including any yield protection provisions), collateral maintenance requirements, mandatory prepayment triggers (in particular, extraordinary events affecting the relevant securities), lenders' rights to adjust terms and the extent to which the borrower is allowed to deal with the collateral (such as substitute collateral or receive income). We have focused on some of these issues below.

Recourse and Restrictions on the Business

Is the recourse to the borrower limited? The recourse of the lender(s) for the loan may be (but is not always) limited to the collateral for the loan. Apart from provisions aimed at preserving the value of the collateral, margin style loans usually include limited restrictions on the activities of the borrower. This can be attractive to borrowers with investments in securities. Often also the securities are held through single asset owning special purpose vehicles.

Loan to Value Ratio

The loan to value ratio (the LTV Ratio) measures the aggregate amount of the outstanding loan(s) to the value of the collateral. There are a number of typical negotiating points on how the ratio is set, such as is the value of the securities determined on a particular day or based on a rolling average? If the security is listed on different exchanges, which exchange is used to determine the price? Once the calculation of the LTV Ratio is agreed, there is then typically a number of different levels set for different purposes.

Firstly, there is the Initial or Maintenance LTV Ratio, which requires the borrower to provide collateral of a prescribed minimum value for the drawdown of loans. Secondly, there is the Top-Up or Margin Call LTV Ratio so that if the value of the securities subsequently falls below a pre-agreed threshold, the lender may require the collateral to be topped up by the borrower transferring: (i) cash directly to the lender or to a secured account of the lender; or (ii) additional securities.

Thirdly, if the collateral value increases above a pre-agreed threshold, the borrower may be entitled to have a portion of the collateral it has posted pursuant to a margin call released to it, which may be shares or cash depending on what is agreed.

Fourthly, there may be a further level of the LTV Ratio at which collateral to support the initial loan may be returned to the borrower.

The levels at which such triggers are set and the flexibility to provide/release both securities and cash are important to the borrower. It may also be important to the borrower to be able to voluntarily post additional collateral, e.g., to avoid sudden margin calls.

Mandatory Prepayment, Deleveraging Events and Adjustment Events

Certain negative events that relate to the securities will often be included as mandatory prepayment events. There can be significant negotiation around these often depending on the nature of the security. Where the security is volatile, e.g., if it is in the emerging markets, the lender may want to have prepayment events triggered by significant sudden price falls. Similarly, the lender may wish to be prepaid if the relevant exchange is disrupted or if the volume of trading falls significantly. The borrower may wish to avoid certain events resulting in an immediate right to prepayment by arguing that the relevant event should instead be a Deleveraging Event or an Adjustment Event.

In the case of a Deleveraging Event, instead of a right to be prepaid, the LTV Ratio levels may be reset in a manner that is more in favor of the lender on the understanding that they will revert to their original levels if the original deleveraging event is reversed sufficiently. In the case of an Adjustment Event, the relevant event, such as a tender offer, for or a merger event affecting the relevant issuer of the security may only be a prepayment event if amendments cannot be made to the loan agreement so as to preserve the original commercial positions of the parties.

Other Borrower Flexibility

The Borrower may also want the right to dispose of the relevant securities or substitute alternative securities, e.g., in a portfolio deal. Also on the assumption that the relevant LTV Ratio is satisfied, it will want to be able to receive income from the security such as dividends. There is typically negotiation around the above provisions.

Corporate Style Loans

In our experience, there is a wide spectrum of loans secured over securities ranging from margin loans through hybrid products to more corporate style loans. At one end of the spectrum, there could just be an initial LTV Ratio test with no margining requirements. In this context, the lenders will typically have full recourse to the borrower, a more extensive covenant package aimed at preserving the value of the borrower's assets and may also benefit from other credit support (such as guarantees and/or security over other assets).

Sometimes a loan may be secured over a mixture of liquid publicly listed securities and illiquid private securities. Different considerations will come into play where the securities are illiquid and the loan terms will begin to resemble much more a corporate style loan. The key as always is to deliver to the lender an effective security package so that any haircut on the value of the securities is limited and the maximum amount of finance may be raised. Where the privately owned securities are (sometimes significant) minority interests in a joint venture vehicle, the negotiations tend to be more complex, as both the lenders and the joint venture partner focus on what would happen upon the enforcement of the security. Therefore, where possible, it is helpful to build in flexibility to secure the shares when negotiating the joint venture terms.

How We Can Help

We advise family offices on financings collateralized by securities across a wide range of jurisdictions and types of security and structure of financing. We have deep experience in a large number of jurisdictions, both where we have offices and where we do not, of the issues that need to be addressed when providing collateral over securities, including enforcement strategies and where the securities are listed regulatory expertise so that a bankable proposition may be delivered by the family office to the applicable financier.

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