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The Perils of Aggregation and Contagion Risk

Borrowing money from banks has never been a more complicated and at times frustrating experience. It is incredible indeed that in this age of instant communication and advanced technology it now takes roughly twice as long to have a loan approved and documented as compared to the eighties.

Lurking in the background of this less than inspiring state of affairs is a regime of regulation and oversight that would have been unimaginable 40 years ago. Of course, some of the changes we have seen in the past 10 years have been a necessary outcome of the need to keep pace with a constantly changing business and technology environment while other changes reflect a lack of imagination at regulatory and government level.

In any event it is now more important than ever for borrowers to understand where they sit in this jigsaw puzzle that we refer to as the financial system.

This month we will take a very shallow dive into bank policies as they pertain to aggregated borrowings and contagion risk. It is important to understand that we will be delving into a part of bank policy which some banks can't really explain or indeed understand. It's just the vibe of the thing really.

Let's start with aggregation. Put simply banks aggregate risk exposures to ensure they understand the quantum of a group debt. If you borrow money in your own right and also borrow in partnership with another person or entity and all the debt is with the same bank they will roll up that total when assessing your so called group exposure. In this simple example the contagion risk is that your partner goes under and takes you with them. As such the bank will assess both your personal risk and your group risk when lending you money.

In the management rights industry the application of these policies is most often encountered when groups of investors get together to buy a business. It's not unusual for these groups to buy multiple businesses and it's not unusual for a variety of investors to be involved in various different transactions. Now, here's where things get weird.

Recently we were assisting a group of investors to acquire a management rights. One of the investors is involved in another partnership. The bank that was chosen did something quite remarkable. As expected , for the purposes of aggregation and contagion risk assessment , it looked at the subject transaction and the other transaction it had funded that involved the investor. The bank then extended that assessment to every other partnership it had funded that could in any way be linked back to our investor. The end result was that our investor got caught up in an assessment of contagion risk that involved partnerships he had no involvement in just because other investors were involved. Of course, that doesn't mean his guarantee or personal liability are caught in unrelated transactions. However, it does mean that on the basis of this policy that particular bank have reached their prudential lending limit for this entire group of investors and cannot lend any of them any more money.

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The banks position is that if Partnership A goes under and has even one partner who is in Partnership B then that partnership is at risk. If any partner in A or B are in Partnership C then that partnership gets dragged into the aggregation assessment and so on and so forth.

The application of this policy came as a complete surprise to us and it seemed, a surprise to some of the bank's own staff. Interestingly, we raised the prospect of a similar experience with other banks and none could give us a concise summary of their likely attitude or policy.

Clearly the lesson here for investors in multiple partnerships is to diversify lenders. In fact, it would seem the more loyal a borrower is to the bank the higher the risk of being sidelined. We will certainly be taking a much closer look at aggregation policies when advising partnership clients in the future.

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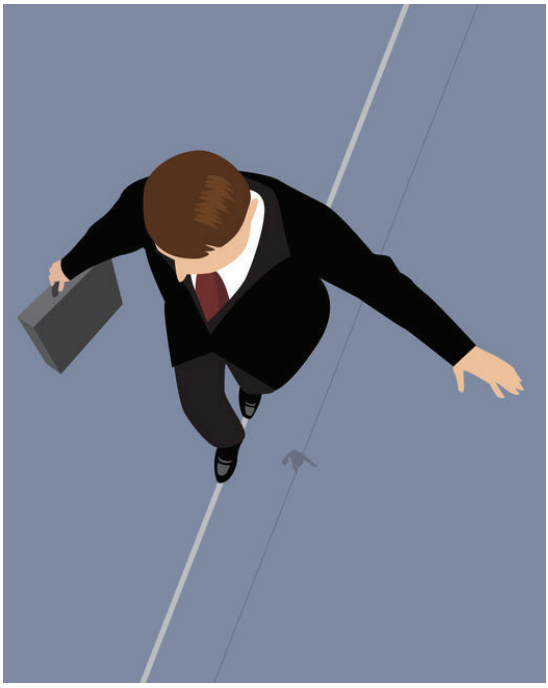

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