What's the value of a borrower's covenant?

By Greg Lacey

I was recently required to give evidence in court in a case where I had been instructed by solicitors acting on behalf of a surveyor's professional indemnity insurers to prepare a report setting out my views on the value of the Borrowers' covenant at the points in time when a mortgage had been advanced and when the Borrowers first defaulted on their mortgage payments and, if possible, at quarterly intervals in between these dates, explaining how and why I had reached my conclusions.

I had not previously been instructed to attempt to assess the value of a borrower's covenant, and so far as I was aware, there was no accepted standard way of going about this exercise. However, in order to assist the Court, I sought to assess a range of values of the Borrowers' covenant taking account of the information then available to me concerning the Borrowers' available assets and income and allowing for a number of alternative assumptions which seemed to me to be relevant and appropriate. The assumptions that I had to make stemmed largely from a lack of information being available regarding a number of relevant factors, notably the following:

- the value of other loans/credit card debts held by the Borrowers;
- the Borrowers' net income over the relevant period; one was a self employed builder/developer for whom we only had out of date abbreviated company accounts available; and
- typical monthly outgoings.

With regard to the relevance of accounting evidence in assessing the value of a borrower's covenant Recorder Halpern QC commented:

> *"Mr Lacey as a chartered accountant is governed by rules of conduct which are designed to promote honesty and competence and he applies recognised principles and assumptions in seeking to build a picture of the Borrowers' financial worth and future prospects. Their worth and future prospects do not themselves equate to a valuation of the Covenant, but they are clearly relevant and essential ingredients in reaching a valuation. I am therefore assisted by hearing evidence from a competent accountant who is used to evaluating the worth and future prospects of individuals, even if he has never previously had to value a mortgage covenant as such."*

In broad terms, I understood the value of the Borrowers' covenant to be the value attributable to their "promise" to repay the loan advanced to them by their mortgage company. I assumed that the value of that covenant did not include the value of any equity attributable to the property itself which was the subject of the mortgage loan - as the equity value in the property would not be available for the purposes of paying off a loan secured against the property. I also understood that, as a matter of law, the value of the security property is a discrete element of the calculation of any loss and it would be wrong to take it into account twice. I assumed though that the value of the covenant should take account of any other funds and net assets available to the Borrowers, as well as any income they expected to earn, from which sources they might then have been able to service the loan.

In assessing the value of the Borrowers' covenant I sought to assess at different points in time what I considered to be the value of the Borrowers' expected available resources to meet the mortgage liability. By "available resources" I mean the amount of free cash/assets from which the mortgage liability could be met. In effect I sought to assess the value of the Borrowers' combined personal net worth at a particular point in time along with the value of any expected future increments to their net worth which might reasonably be expected to be available to them over the time that they would be expected to service the mortgage liability. In other words, as well as the available resources at a particular point of time I also factored in the expected accrual of additional net resources to the Borrowers over the life of the mortgage (i.e. the net amounts available from their expected future cash flow).

It seemed to me that to take the position of the net worth of the Borrowers at one point in time was an inappropriate measure of the value of their covenant as it failed to take account of the fact that the liability was to be repaid over an extended future period, over which period the Borrowers would expect to generate further income with which to meet their mortgage liability, albeit they might also expect to incur further costs.

Any mortgage payments actually made to the mortgage lender by the Borrowers would potentially form part of the value of their covenant. However, this of itself would depend on whether the Borrowers' own overall available resources diminished as a consequence of making these payments, and if so, to what extent. If the payment of the mortgage to the mortgage lender reduced the overall net value of the Borrowers' available resources then it suggests to me that the payments were not affordable and simply reflected a displacement of one creditor by another. In those circumstances, I considered that the value of the covenant would be limited to, and equivalent to, the Borrowers' actual net worth at that specific point in time.

The approach I adopted in my calculations of the value of the Borrowers' covenant was as follows:

a. I sought to assess movements in the Borrowers' quarterly cash position over the period that payments were made to the mortgage lender, taking account of their income and other equity releases and deducting any expenses they would expect to incur, such as the lender's mortgage costs, other loan costs, day to day living expenses etc – this in order to establish the value of cash held by the Borrowers at each quarter end;

b. I then adjusted the projected monthly movement in cash to establish the net movement excluding the mortgage. I discounted these future monthly cash movements back to the start date of the mortgage in order to reflect the net present value of future cash flows as at that date; and

c. I then assessed the value of the Borrowers' covenant at each quarter end date taking account of the available cash at each quarter end as calculated in line with (a) above, I then added to this the net present value of the future cash flows as calculated in line with (b) above, and I then factored in the value of other available assets and liabilities (excluding the mortgage liability) as at each quarter end.

I am pleased to say that the judge in his summing up accepted that my combined net asset/ cash flow approach was appropriate and so he ultimately concluded in favour of the surveyor that there was a shortfall in the value of the covenant at a date much earlier than the mortgage default date such that the claim was statute barred.

For those interested, I shall be happy to supply a copy of the full judgment on this case: *Canada Square Operations Limited v Kinleigh Folkard & Hayward Limited (2015)*