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Credit Turmoil: It's a Vicious Cycle

"When the tide goes out, we find out who's been swimming without a bathing suit."—Warren Buffett

by Michael T. Newsome

Suffice it to say, we live in interesting and turbulent times, as witnessed by the unpredictable, broad-based upheaval in global credit markets. Turmoil first cropped up in the housing, mortgage and leveraged loan markets; but, contrary to most media coverage, the problems have not been confined to these economic sectors. Rather, the real concern is pervasive leverage that cuts across global finance and has been brought about by the aggressive and creative application of asset securitization, risk tranching, and derivatives. These elements combined with a glut of cheap money to ignite an unbridled

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boom in complex financing activity spanning nearly five years. The net result of this frenzy has been unsustainable leverage and bone-rattling volatility in the credit markets. Like the air rapidly escaping a balloon, the boom ended last summer and, in its place, an urgent deleveraging process is playing out in what is often described as a "vicious cycle."

- First, asset values begin to erode; in this case, the original catalysts were faltering housing values and suspect mortgage loans.
- As asset values decline, the negative power of leverage kicks in to shrink the equity value of the bank or asset manager (hedge fund or special investment vehicle) holding the financial assets at an even faster rate and pushes down collateral coverage ratios.
- Lenders, fretting about deteriorating collateral coverages, resort to calling in loans, which forces a sell-off of assets to raise cash, flooding the market to drive values even lower, leading to more losses and further margin calls.
- Suddenly, the need for cash to satisfy repayment demands creates a self-reinforcing panic, where fire sales accelerate the plunge in asset values.

Leverage is a dual-edged sword that swiftly amplifies returns in robust markets and losses in bear markets. Of course, there are no greater mavens of leverage than large commercial and investment banks, where a dollar of equity capital may serve as the foundation for up to $30 of assets. By nature, they rely on short-term liabilities to fund long-term assets. Under the right circumstances, these enterprises are acutely vulnerable to a downward spiral in asset values, particularly given the regulatory mandate requiring that asset portfolios be routinely marked-to-market. In a chaotic environment, where anxiety overcomes reason, the resulting market-clearing price may bear little relation to the ultimate value to be realized, if the assets are held to maturity.

In the midst of a vicious cycle, the credit crisis is being aggravated by understated asset values and excessive write-offs. Nevertheless, the impact is all too real. As asset values and bank equity capital erode, fear of further loan losses and asset write-downs builds among lenders. The natural reaction is to curtail lending to conserve liquidity that may be needed later. Lender and asset manager confidence is sapped and liquidity is wrung out of the credit markets. So far, more than a few highly leveraged financial entities (Citigroup, UBS, Merrill Lynch, Bear Stearns, Carlyle Capital, CIT) have been forced to scramble for capital in a market with few providers. Undoubtedly, many others have come perilously close to the edge.

THE RESPONSE

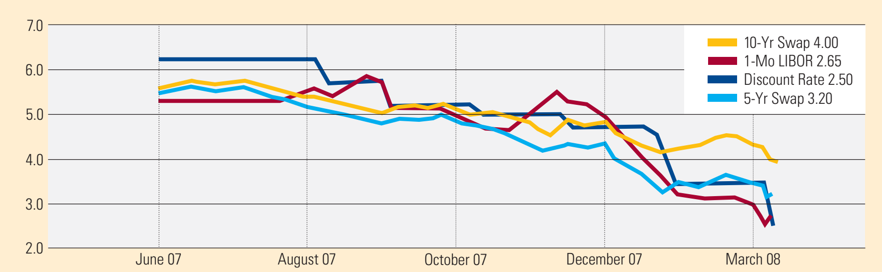
The Federal Reserve is obviously concerned about the health of the financial markets and broader economy, as witnessed by highly publicized short-term interest rate cuts and the liquidity (newly printed dollars) being pumped into the banking system. The discount rate at which banks borrow from the Fed, has been whittled down by 375 basis points in a series of cuts, from 6.25% last August to 2.50% as of this printing. Market rates have moved down with the discount rate. Further cuts appear to be in store.

The Fed hopes that cheap and abundant money will:

- Inject confidence into credit markets to encourage the rational assessment of asset values and stem the deleveraging freefall;
- Allow financial entities room to recognize and write-down impaired assets in an orderly fashion; and
- Lower the cost of capital through the ample availability of credit, in order to rekindle consumer and business spending to head off an economic contraction.

At the same time, the Fed, in an unprecedented move, opened the discount window to lend to capital-short investment banks (primary broker-dealers), as well as retail banks, which has found very strong demand. Moreover, they are offering to swap Treasury securities for poorly trading AAA-rated mortgage-backed securities to shift the balance between supply and demand and relieve the downward pressure on prices. Here again, the goals are

Interest Rates



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to provide liquidity as a lender of last resort, short-circuit the deleveraging process, and help markets function smoothly again.

As aggressive as the Fed has been recently, there is no certainty that its actions will resolve the problems and break the vicious cycle. The course of the economy and financial markets is at the mercy of human psychology and unexpected events. It cannot be fine-tuned with precision. Much may depend on whether consumer and business confidence have already been sufficiently undercut to slide the economy into a broad-based recession. The effectiveness of the Fed's expansionary monetary policy and other actions will only be known, in retrospect, over the next six to twelve months.

AN EXPECTED CONSEQUENCE

Unfortunately, the Fed's approach has a troubling flip side. When the money supply expands at a faster rate than the economy's expected average long-term growth, as it is doing now, the likely result is inflation. This, in turn, drives up interest rates, particularly long-term rates. Many economists believe that the recent surge in commodity prices, as evidenced in food, energy, and metals, is an indication of mounting inflationary pressure. The most recent consumer and producer price indices reflected an unfamiliar level of inflation at 4.3% and 6.4%, respectively. The Fed is on the horns of a dilemma—it can affect short-term rates in the market simply as a result of altering the supply of dollars, but eventually the market will clear and concerns about a faltering economy, a weak dollar, and inflation will drive rates higher. The Fed has a fine line to tread.

NORTHWEST IMPACT

While this drama is playing out on a global stage, the implications will be felt here in the Northwest. First, interest rates are likely to rise. With that in mind, some hedging suggestions are provided in the following article.

The pressing concern is the availability of credit for middle-market businesses. Major banks, including Bank of America and Wells Fargo, have reported losses and found it necessary to raise additional capital. Without naming names, certain lenders are sufficiently capital-constrained to be reluctant or even unable to take on new business.

Due to the liquidity crunch, the costs of funds for most banks are well above historical norms. Higher costs, coupled with increasingly wary credit decision-makers, translate into higher credit spreads for borrowers. As this filters down to the local market, bankers can be expected to deliver messages of either higher pricing or lukewarm support for marginally profitable relationships. Capital will be allocated to the most attractive risk-adjusted opportunities. Unless the business is deemed bulletproof in a downturn, banks will demand higher pricing at renewals or for incremental credit commitments.

Terms are tightening too. Less leverage, stricter covenants, more collateral, lower hold positions, and personal guaranties all are on the agenda. More importantly, companies that hit a rock in the road can expect less lender cooperation and patience, simply because troubled loans require higher allocations of scarce capital. So, the pressure will mount to "get it up or out"—either fix credit problems quickly or the sell the loans at a discount.

The sky is not falling. The economy is as healthy in the Pacific Northwest as anywhere in the country. Nevertheless, companies that rely on senior debt would be wise to stockpile liquidity to ride out the vicious cycle. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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