A freeze in summer

Executive summary

- **While it may be too early to say what the long-term effects of this summer's debt market drama could be, there is some value in taking a few snapshots of the financial horizon. The intention of this article is not to be definitive, but to stimulate discussion and offer treasurers some thoughts from the capital market.**

Over one aspect there seems to be unanimity: this summer represented a liquidity freeze rather than a credit-driven event. There is no evidence from either the ratings agencies or the credit reference industry that 2006/07 has seen a material increase in corporate failures – even of the most highly leveraged businesses. It may be true that companies and individuals in the micro-sector are suffering but this has not yet moved up the food-chain.

The ACT's Policy and Technical team has contacted a variety of corporate treasurers in different industries and circumstances to ascertain their views on what the consequences for corporates could be. For ease of approach, we have divided the areas in a relatively straightforward manner, with no particular order and with no weighting.

LOAN BORROWERS Will there be reduced lending capacity for corporate borrowers? Will Basel II add to the crunch?

Early soundings in the loan market suggest a number of factors at play. In general, treasurers have been prudent in having committed facilities available as their primary fall-back against market illiquidity. However, the ability of treasurers to rely on uncommitted lines may fall away – this summer's events, allied with the changes in Basel II, may have sounded their death knell. That's not to say the market is perfectly stable and worry-free; rather, that prudent treasurers can afford to be patient for more relaxed conditions.

Phil Dyke, Head of Treasury Dealing at FTSE 100 company BAT, says: "Over the summer, we had a short-term requirement to fund some corporate payments. Where normally BAT would use surplus cash and/or uncommitted lines, on this occasion we advised our lead syndicate banks that we would borrow directly from our committed facilities to guarantee liquidity when we needed it. This may have cost a small extra amount in both margin and funding costs but clearly showed the value in having committed facilities and the banking relationships that go with them."

Alison Dolan, Group Treasurer at British Sky Broadcasting Group, says: "We haven't been made aware of any particular credit constraints on derivative lines, but we had been in discussions with a number of our banks on options to refinance our revolving credit facility and have decided – given the lack of urgency – to hold off until current conditions improve. The issue seems to be more one of a difficulty in pricing the loan than strict credit constraints, however."

Treasurers representing small and medium-sized enterprises speaking recently at the ACT's South West regional conference also thought that well-managed businesses with good bank relationships would continue to receive support from their bankers.

Borrowers will need to understand that the costs of (committed) facilities now represent two elements: the cost to the bank providing the facility (Basel II again, which therefore includes the credit/capital cost) and the opportunity cost to the corporate of not having access to liquidity.

BOND ISSUERS Has the widening of credit spreads become permanent? Is there likely to be an impact on covenants?

During the summer months, those corporates brave enough to venture into the bond markets saw a rise in their credit spreads and their floating rate costs, although their overall fixed coupons were fairly steady due to falls in underlying government yields. More interestingly, investors were looking for much wider negative basis spreads (for example, between the issue level and the equivalent corporate credit default swaps). More recent transactions, such as those involving E.ON and Veolia in the sterling market, have seen these fall back. The situation remains in lower-rated bond issuance with difficulties in the high-yield markets. One side observation here has been the relative strength and spread performance of emerging market sovereign bonds.

Alison Stevens, Manager, Capital Markets, at National Grid, says: "Although we have felt some impact from the credit crunch – shortened tenors for US dollar commercial paper issuance, for example – there have been no other immediate impacts. We recognise that credit and swap spreads have risen in the bond markets and think that the secondary market is still unsettled with a lack of liquidity. Recent corporate issuance activity, however, has seen spreads falling back from the peak levels reached during the start of the credit crisis, although a full reversion to pre-crisis levels is perhaps unlikely."

As yet there is no discernible demand from investors for additional covenant protection at any levels of credit. It remains the case that clauses such as change of control are a matter for negotiation between borrower, adviser and investor, and will vary from market to market.

PETER MATZA ASSESSES THE POTENTIAL IMPACT OF THE CREDIT CRUNCH.

CERTAIN AREAS WILL CLEARLY NEED REVIEW: IMPROVED MANAGEMENT OF LIQUIDITY; MORE TRANSPARENCY IN THE COMPOSITION AND VALUATION OF STRUCTURED PRODUCTS AND BANKS' EXPOSURES TO OFF-BALANCE SHEET VEHICLES; AND BETTER STRESS-TESTING AND CONTINGENCY PLANNING.

CORPORATE TREASURERS Will recent events reinforce the concepts of relationship banking? Is liquidity risk a new risk? How committed is committed? Should we be thinking far more about diversification of funding?

The ACT has spoken with two senior bankers who work closely with corporate customers in the derivative and capital markets, one in Frankfurt and one in London, to gauge their views on these events. In general their positions are similar.

"This summer's events provide a context for these changes in banks' credit management but not the catalyst," says the UK banker. "We have not cut lines but make every effort to use credit as efficiently as possible for each [UK] customer. Continental European corporates are ahead of their UK peers in running collateral arrangements with their banks. This, together with the increasing influence of Basel II, has meant that UK corporates are beginning to recognise the elements of pricing and capital cost that represent pricing in these types of derivatives."

Dislocation in the money markets has clearly had an impact in the short-term interest rate and foreign exchange (FX) markets in terms of Libor/Euribor/Eonia pricing. Some of this remains, with banks wary of their calendar/financial year-end positions. Credit spreads for corporate customers were also affected, but these are returning to more normal levels. The longer-dated (more than five years) interest rate and FX markets have seen elements of their pricing widen, but, generally, liquidity has been available for regular corporate hedging.

Brand-new customers would be subject to more stringent credit assessment and it seems that banks may become circumspect in providing these types of products to any and all customers. The limited evidence suggests that relationship banking will become increasingly important as banks seek to maximise their credit usage and returns, and that corporates plan to ensure diversity of funding and financial products and to create financial mobility to ensure their businesses are equipped to meet both positive and negative challenges.

FINANCIAL MARKETS Will there be a shake out of financial players in hedge funds and private equity? Would more financial/market regulation be beneficial? Is the current regime compromised in the UK? Has London and the UK government lost credibility?

The Bank of England's most recent *Financial Stability Report*, published on 25 October, makes interesting reading. While it may be too early for a full assessment of the causes of the recent financial turmoil, certain areas will clearly need review: the need for improved management of liquidity; more transparency in the composition and valuation of structured products and banks' exposures to off-balance sheet vehicles; and better stress-testing and contingency planning. The tripartite alliance between HM Treasury, the Bank and the Financial Services Authority may also attract scrutiny.

Regulators on both sides of the Atlantic and elsewhere are sure to look at the role of the ratings agencies. The ACT's view is that they act efficiently and effectively in the corporate market but will clearly come under intense scrutiny in the more aggressive and arcane structured mortgage bond markets.

In private equity, large-scale transactions (more than $2bn) have become scarce, but merger and acquisition (M&A) activity in mid-market deals has continued. Anecdotal evidence suggests that trade buyers are at least back on the same playing field. However, some of these changes have resulted from political interest in private equity and wealth generation rather than specifically from a credit crunch.

It is also noticeable that the hedge fund world has not suffered the financial collapse many commentators had predicted in the event of a financial market crisis. Individual funds have suffered badly but a collective failure is not on the radar. The reasons are varied but the sheer diversity of the asset base would seem a crucial factor. Indeed, it is the Wall Street investment banks that have taken the biggest hits.

On 25 October the *Financial Times* reported: "The costs of the credit squeeze mounted on Wall Street… as Merrill Lynch revealed a 'staggering' $7.9bn writedown on mortgage-backed securities. The Merrill losses were the biggest reported by any bank since the credit turmoil began. The losses dwarfed those reported by other banks. Ken Lewis, chief executive, Bank of America, last week said he had had 'all the fun' he could stand in investment banking."

The fall-out from the summer's events will continue to be felt. The effects may be seen in regulation, consumer spending or tighter credit access for borrowers. What is certain, however, is that 2007 has given all the stakeholders in the capital markets pause for thought.

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