HAVEN'T WE BEEN HERE BEFORE?

KEEPING THINGS IN PERSPECTIVE AND DRAWING ON THE EXPERIENCE OF PAST DOWNTURNS IS THE KEY TO SURVIVING CURRENT DEBT MARKET DOLDRUMS, SAYS **NEILL THOMAS** OF KPMG.

There is an inherent danger when markets are perceived generally to be heading in only one direction. Whether rising or falling, there is a risk that overall sentiment dictates that each market development and each piece of new information is interpreted in the context of the overall trend. Therefore, there is a danger that the trend becomes self-fulfilling.

Fundamental principles tend to be ignored, perspectives become distorted and memories fail to recall how market conditions could ever have been any different. During the latter years of the bull market of the 1990s, experts referred to a new paradigm driven by the disintermediation offered by the internet and instant global communication. The information 'super highway' was here to stay, helping to deliver a 'Goldilocks' scenario that was neither too hot nor too cold. It took a brave person to call the end of the bull market and to remind everyone that Goldilocks is, after all, only a fairy tale.

Equally, as it now appears, it is the bears and not Goldilocks that are all-pervading and world events seem deliberately designed to fuel market uncertainty, there is a risk that again perspective is lost and fundamental principles ignored. If a sense of perspective is to be regained, then it is important to draw on experience of previous market downturns to understand whether essential differences are emerging and, if so, how do they inform our judgement as to the nature of the current downturn?

WE'VE SEEN IT ALL BEFORE. From a debt market perspective, we have seen most of the broad themes before. There is undoubtedly a basic credit cycle, with the only question being the length and extent of the peaks and troughs. Lending decisions taken during the boom period are often instrumental in leading to the losses that drive us down the other side of the cycle. Therefore, in the late 1980s, it was money lent against property, and development property in particular, where the loan-to-value ratios assumed only a rising market and forgot to take into account the crippling carrying cost at high interest rates of unfinished or unlet buildings. The extraordinary diminution in asset values which then occurred undermined many borrowers and left their lenders as reluctant holders of real estate to add to the woes of significant sovereign bad debt exposures from earlier in the same decade. In the same way in the late 1990s, the mantra became cashflow lending. Never mind the asset backing, look at the revenue growth. The business might not be profitable for three years, but it was Ebitda-positive and projected take up was exponential. When the revenue line went in to reverse, there was nowhere for borrowers or lenders to go.

It is easy to be wise with hindsight but, essentially, while the causal links may be different, the decline in credit quality in both the late 1980s and since 2000 has the same broad features. Nevertheless, it could be argued that the late 1980s decline was more severe and widespread, being indiscriminate as to sector or geography, while the recent downturn has, to date at least, with one or two notable exceptions, been most severe in the telecoms sector.

LINKS TO THE PAST. So are there any debt market issues associated with the current downturn that are different from before and should we be concerned if there are?

Debt markets have certainly become more sophisticated in the period since the late 1980s, and the credit evaluation techniques now employed by lenders and investors would be unrecognisable to a credit officer who retired in 1990. Associated with this evolution has been a rise in the significance of ratings and of the credit rating agencies, which, whether they like it or not, have played a significant role in the current downturn.

So much emphasis is now placed on corporate credit ratings that there may be a danger of lenders and investors subordinating any independent credit assessment to that of a third party. Should this be a concern? Maybe not, but when liquidity concerns lead to a downgrade to sub-investment grade that reduces capital markets' access, which in turn unsettles bank lenders (which may be the sole remaining source of liquidity), then the chain of events can become self-fulfilling.

At the same time, debt markets have strived to become more liquid, and with liquidity comes greater depth. This is to be welcomed when it brings with it transparency across markets and the ability for lenders and investors to manage their portfolios in accordance with established criteria. When, however, institutional investors operating on a marked-to-market basis become forced sellers at the very time when conventional forms of liquidity are reducing, then the effect of selling into a falling market can be devastating both in terms of spreads and market capacity.

There have certainly been other beneficial debt market developments that have ensured that the effect of the market downturn has been diffused, rather than concentrated. Credit derivatives have allowed institutions to lay off risk and to hedge exposures in a manner not previously available. Wider distribution of risk, not only among a class of lenders, but also among more classes of lenders, has resulted in no particular section of the lending community being disproportionately affected by the downturn, as evidenced by recently reported bank results showing levels of provisioning considerably below those witnessed in the early 1990s.

Nevertheless, a nagging thought remains that as debt markets become apparently ever more sophisticated, we are building in a level of systemic risk that may not be appreciated. Indeed, credit markets stand on the verge of a further development, the complexity of which may make current practices appear amateurish, namely the implementation of the Basel II Capital Accord. As a new measure of capital adequacy based on widespread date capture, detailed empirical evidence and assessment of default probabilities, it has much to recommend it. An institution adopting the 'advanced approach' under Basel II will be allowed to use its own internal ratings system to assess the capital to be allocated against each individual exposure. As credit quality improves, less capital will be required to support any given exposure. However, when credit quality deteriorates, the reverse will be true.

Consider the earlier example of the self-fulfilling liquidity crisis following a ratings downgrade to sub-investment grade. Then overlay the banking syndicate that suddenly find their internal ratings models predicting significantly increased probability of default, thereby demanding considerably higher capital allocation. Apply this across a loan portfolio at a time when bad debts are also eroding the same banks' capital bases that cannot be replenished because equity markets are closed. Fanciful perhaps, but UK insurance companies are currently facing solvency ratio concerns through a confluence of not dissimilar factors.

LET'S GO ROUND AGAIN. Each cycle of the debt markets brings with it a new set of factors which need to be assessed and understood. Such a perspective is often difficult to develop at the time. It may be argued, however, that, while the current downturn has seen its share of high-profile corporate collapses, the effect on lenders and investors has not been as dramatic as in previous downturns. We may well owe this to more sophisticated analytical tools and to market developments which have allowed the dispersal of risk.

We may owe it equally to a dose of good fortune that sectoral concentration and low interest rates have limited what could have been a more widespread problem. What is certain is that the credit cycle will continue to revolve and the lessons learned from the current downturn now need to be absorbed and applied during any market recovery. Debt markets now need to ensure that systemic risk is controlled and that they emerge stronger as a result of the last two years.

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