Where next

Executive summary

- Greater regulatory convergence, improved supervision of the financial markets and an EU-wide early warning system are all possible governmental responses to the credit crisis. Europe and the US are also rumoured to be devising ways of improving co-operation to develop measures that would help prevent any future financial crisis.

This year has already seen the US Federal Reserve mount a massive rescue operation, bailing out the investment banks to avert the possibility of the global financial system going into meltdown. Efforts to contain inflation have gone on the backburner as the Fed continues to cut interest rates.

The European Central Bank has followed the Fed's lead, committing itself to acting as provider of almost unlimited liquidity should the need arise. The Bank of England's reluctance to be as explicit triggered a bear raid on HBOS on 18 March, following which Mervyn King conceded that more would be done to help UK banks overcome their liquidity problems. He indicated that a more permanent solution was being worked on to address the fragility of the financial markets and to relieve the "overhang on banks' balance sheets of assets in which markets have closed".

EU leaders have indicated that the task of resolving the crisis is very much down to the banks and mortgage lenders that created it, but have also promised to "take regulatory and supervisory actions where necessary". Such actions would include regulating the financial innovations of recent years, finding better ways of identifying risky assets (and setting down a higher capital requirement should they turn sour), and tighter rules for the credit rating agencies that have been accused of over-rating packaged debt securities.

Providing there are no further major shocks such as Northern Rock, or Société Générale's rogue trader losses, no major legislation is likely in the short term. But as we went to press plans for the April meeting of the Economic and Financial Affairs Council (Ecofin) included greater regulatory convergence, improved supervision of the financial markets and an EU-wide early warning system. The next few years could also see greater co-operation between Europe and the US in developing measures to prevent future financial crises.

COPING WITH THE FALL-OUT Although the risk of any of Europe's major banks suffering a major liquidity crisis has lessened, the wider credit crunch could have further to run. Indeed, the process of deleveraging to remove debt from the financial system has shown every sign of accelerating in the mortgage lending sector as banks withdraw products and tighten up terms.

One member of the Bank of England's monetary policy committee, Paul Tucker, has warned that the process is not yet complete, giving a risk that credit creation – "the lubricant that the financial system provides to the real economy" – will be further impaired. But some commentators are more sanguine. Edward Menashy, Chief Economist for Charles Stanley, suggests that the Federal Reserve's rescue of Bear Stearns was "instructive".

He observes that the Fed's taking on of $35bn in sub-prime debt and giving the proceeds to JPMorgan broke with all central bank tradition by using taxpayers' money for questionable loans. Other central banks are likely to follow, bailing out financial institutions with public money. This decisive break with the past proves that the credit crisis is soluble if you resort to using public funds and has already affected investor sentiment. Bad news is now having less impact on prices than before and several banks have found investor support for their rights issues.

Barclays Capital, which put out a particularly gloomy assessment of the economic outlook at the end of 2007, also proved more upbeat when its quarterly update was issued in late March. It suggested that decisive moves by the US authorities offered the hope of stabilisation and banks' funding problems would gradually ease. However, it warned that the process by which conditions returned to normal would be gradual and it was unlikely that all the market's original players would survive.

Meanwhile, according to the group's Head of Economic Research, Julian Callow, the euro zone is vulnerable to much slower economic growth, as housing and exports have been its twin motors. As both continue to deteriorate, the non-financial corporate sector will suffer a significant slowdown. This, he predicts, will eventually force the European Central Bank to cut EU interest rates, while the Bank of England, which, as he forecast, agreed a further 0.25% reduction in base rate to 5% in April, will follow up with two further 0.25% cuts in June and August respectively.

But the relief offered by lower rates is likely to be limited. As James Douglas, a Debt Advisory Partner at Deloitte, observes, most commentators expect the rest of this year to be difficult, "which means that if you are able to refinance sooner rather than later, then

SETTING THE SCENE FOR THE ACT ANNUAL CONFERENCE, **GRAHAM BUCK** LOOKS AT THE THEMES THAT ARE LIKELY TO DOMINATE PROCEEDINGS.

you should go ahead and do so". The advice applies particularly to higher risk credits, where access to new debt finance is being most acutely squeezed by the flight to quality.

Although this has not prevented deals from being completed, especially in the midmarket space, structuring and guidance are crucial and it is imperative that companies have the best overall debt package available. Deloitte is engaged in a number of restructurings of structured investment vehicles (SIVs), which invested in assets whose price has fallen sharply. The near collapse of Bear Stearns in March threatened to worsen the situation and the upshot is that US banks will need to continue recapitalising and credit conditions will remain tough. Nearer home, the gap between base rate and Libor has widened in recent months and could increase further if the Bank sanctions further reductions in the UK base rate this summer.

DEALING WITH DECLINE The outlook is clouded by uncertainty as to when asset prices will stabilise – and when they do, who will have the money to take advantage of the depressed prices. Sovereign wealth funds are the most obvious candidates. Already Citigroup, Merrill Lynch and other commercial banks have secured injections of new capital from sovereign wealth funds to revive their balance sheets and more such deals can be expected.

Meanwhile the decline is not yet over, suggests Douglas, although as we are now much closer to the bottom than in the second half of 2007 the slowdown should now start to ease. This does not rule out the likelihood of more significant losses still coming through the banking system, as write-offs have yet to reach the level commensurate with the slicing and dicing of sub-prime risk.

The other big unknown is caused by the dislocation between the equity market, where prices have declined (but not slumped) since last summer's peak, and the credit market, where conditions are far gloomier. Should the impact of the credit crunch – which has so far largely been confined to the financial sector – deepen and affect the wider economy much more than it has done so far, equity markets will fall more sharply. So far, the banking and retail sectors have borne the brunt while others, particularly mining which has been buoyed by high commodity prices, have held up strongly. But with the new mood of risk aversion making any early resumption of securitisation highly unlikely, credit will remain expensive and difficult to obtain.

In this uncertain environment, corporate treasurers are faced with the question of how best to fund their companies. Credit spreads have already widened, from 50 basis points to 100bp, inevitably affecting businesses as the returns from any project must increase before it becomes worthwhile. The key aims for treasurers should be twofold, suggests Avarina Miller, Senior Vice President of working capital solutions consultant and adviser Demica: first, to have various funding options at their disposal, and second, to determine which assets will provide them with immediate value.

"Over the past few years liquidity was both plentiful and cheap, so there was no pressing need to structure assets," she says, adding that in more difficult conditions, trade receivables will have an increased appeal as an attractive and easy means of providing cheap funding for all grades of risk. One of their main virtues is that they can be bundled up into a structure that ratings agencies can assess, which makes them attractive to banks from a capital weighting perspective.

Treasurers will also pay increasing attention to their supply chains, Miller predicts, with much of the emphasis on aligning the company's credit costs across specific supply chains and structures that involve buyers and suppliers working together to share the benefits. "Much attention has been paid to the physical aspects of the supply chain. The focus is now shifting to the financial aspects with the result that there are more forms of supply chain finance," she says.

OVERCOMING MISCONCEPTIONS Since the credit crunch hit in the second half of 2007, asset finance provider Siemens Financial Services reports that customers and vendor partners are worried about tightening credit conditions and have enquired whether it intends to alter its credit assessment criteria and rates. This is even the case for the many companies whose sales have held up strongly so far this year.

The fact that they are asking this question points to several misconceptions about the difference between bank credit and asset finance, according to the group's Finance Director Steve Mason. The credit crunch is, very evidently, concerned with vanilla bank lending, on which many companies have become over-reliant during the years of cheap credit and have therefore left themselves vulnerable. A top priority for companies should be diversifying their credit lines so they are less exposed to the impact of a squeeze.

One obvious solution is asset finance, which companies will still be able to access as it is secured against an asset rather than the borrower's credit rating. "Our own research estimates that, of the UK's £90bn a year investment in equipment and facilities excluding property, only 30% is acquired using asset finance such as leasing," says Mason. "Therefore, it is possible to estimate that between £30bn and £40bn of capital is frozen in business assets that are purchased outright – using bank borrowing, for instance."

This suggests there is considerable scope for improving the efficiency of business investment in the UK, he adds. "In fact, forcing companies to reassess the suitability of their credit lines may well be an unexpectedly positive effect of the credit crunch. We are certainly seeing a swing towards lease finance as loan credit tightens."

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