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A winter of discontent

KRISTIAN RATHBONE AND **JOHN WALKER** DESCRIBE HOW THE DISLOCATION IN THE INTERBANK LENDING MARKETS AND A FULL DOSE OF PESSIMISM CAN QUICKLY GIVE RISE TO COLLECTIVE PARALYSIS IN THE MARKETS.

Executive summary

- At the advent of the credit crisis in July last year, few would have predicted that its impact would be so great or that the bank debt market would still be crippled eight months later. The world's big banks and broking houses have written off over $200bn since the collapse of Northern Rock last summer, Bear Stearns has fallen and we've seen the demise of IKB in Germany. Add to that the derailing of a number of high-profile hedge funds and the extent of the problem for the global economy becomes clear.

It may be a long time before the banks see much of a recovery in their lending capacity and the financial world returns to normal. One of the major results of the current market contagion is the dislocation seen in the interbank lending markets. The spread between base rate and Libor in the UK (see *Figure 1*) has seen several peaks and troughs since the onset of the credit/liquidity crunch and illustrates how quickly pessimism can give rise to collective paralysis.

The initial and highest peak came in early September, when the spread hit 115 basis points, as the severity of the banking crisis hit home and the full extent of mortgage bank Northern Rock's problems came to light.

In response to this, the Bank of England performed a u-turn; after much talk about moral hazard, it announced it would inject liquidity into the market. This action seemed to bring down the spread until December when the added pressures of the year-end caused the spread to spike once more.

Further joint action from the world's central banks was effective and by January the spread had come down significantly. It was felt by many that these crucial interbank markets were to some extent returning to normality. Indeed, the spread actually became negative, very briefly, in anticipation of rate cuts.

Figure 1: UK base rates vs three-month fixing

However, with banks remaining unwilling to lend to each other, a third wave of dislocation began and the base rate/Libor spread reverted to a widening trend. At the point of writing, three-month Libor is over 70bp above the base rate. It seems that this third phase of the credit crunch is as much to do with an erosion of the value of assets that may be pledged as it is with the withdrawal of interbank credit lines.

BANK OF ENGLAND INACTION The way in which the credit crunch has been dealt with by the central banks has played an interesting and crucial role, with the Federal Reserve Bank, the European Central Bank (ECB) and the Bank of England all taking a very different stance. The Fed has been quick to act in all that it has done, in marked contrast to the snail-like reactions of the Bank of England.

Compare the protracted death throes of Northern Rock, which was allowed to linger in the public gaze while the UK authorities dithered endlessly, to the three days flat it took the Fed and JPMorgan to organise the removal of the ailing Bear Stearns investment bank from the marketplace, and thus from public view, with the Fed funding most of the riskiest assets.

The Fed has been quick off the mark in terms of improving liquidity conditions, taking virtually anything, even bank loans, as collateral, while the Bank of England has a much narrower band of acceptable security. This has had the effect of restricting the amount of help it has been able to provide to the market. Its money market operations have been oversubscribed several times over.

Interest rate policy has been a third marker where some claim that the Bank has been slow to act. In the Bank's defence, its only mandate is price stability, while the Fed has a much broader remit, covering growth as well as price stability. *Figure 2* shows how aggressively the Fed has acted in comparison to the Bank. The Bank has cut the base rate by only 50bp since the beginning of the crisis while the Fed, which started with a Federal Funds rate 50bp lower than the Bank's, has cut the rate by 300bp, almost to the levels reached in 2004 during the era of the 'Greenspan put'.

BANKS' BALANCE SHEETS FULL TO THE BRIM One of the most serious and long-lasting problems for banks currently is the legacy of the huge growth in the amount of commercial mortgage-backed securities (CMBS) issued in the two years up to July 2007. Many of these issues were bought by highly geared hedge funds reliant on short-term funding; they used CMBS as collateral in off-balance sheet structured investment vehicles (SIVs), which were then financed in the asset-backed commercial paper market.

With the demise of that market, the SIVs have had to be refinanced by their originators and so the banks have the loans supporting the CMBS back on their books. This, of course, just adds to the loans they were unable to securitise before the crunch hit.

While the demise of the securitisation market has made most of the headlines, the loans supporting the flood of very large private equity transactions undertaken in the first half of 2007 that remain

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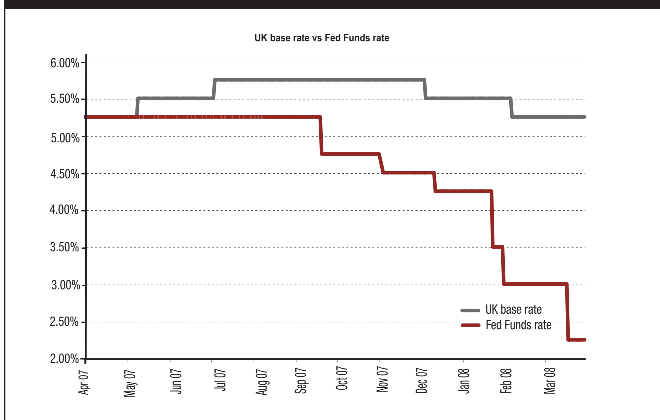
Figure 2: UK base rates vs Fed Funds rate



unplaced by the lead managers have probably had an equally large impact on the availability of funding.

The result of all this unplaced issuance is that AAA-rated CMBS are currently offered in excess of 200bp over Libor. In retrospect, it appears extraordinary that a year ago AAA paper was being placed as low as 19bp over Libor. On top of the already large pile of unplaced loans and CMBS have come the portfolios of Bear Stearns and a number of hedge funds that have collapsed, notably Carlyle Capital Corporation (CCC). All CCC's assets were AAA-rated bonds, and thus there were no real credit issues. However, reportedly, for every $32 invested, $31 was borrowed, so little movement in the value of its bonds was required for CCC to be unable to meet its margin calls. Thus the contagion spread to high-quality assets for which, currently, there is no readily available market.

There have been no CMBS issues at all in the UK so far this year, and the common view is that no issuance of any size will take place in 2008, and possibly 2009 as well.

TESTING TIMES FOR TREASURERS The dire straits within the CMBS market and the consequent major widening of AAA-rated spreads must influence the level at which banks are prepared to lend. With major banks battered by their commitments and the securitisation market dormant, the focus has returned to the balance sheet lenders with a strong deposit base. Relationship banking has become key, and there will be a reversion to lower loan-to-value ratios, higher margins and higher arrangement and early prepayment fees. Private equity has been particularly badly hit with the £1bn+ transactions that had become commonplace almost completely disappearing. While conditions are tough for the commercial property industry, lenders and investors still prefer the comfort of well-let property, providing physical security, to operating companies' trading risk.

LIGHT AT THE END OF THE TUNNEL? Of great importance in correcting the dysfunction in the interbank market is for the Bank to sort out the problems caused by the persistently high Libor levels. But this will only occur if the Bank is prepared to work with the banking sector to find ways of injecting yet more liquidity for longer maturities. The

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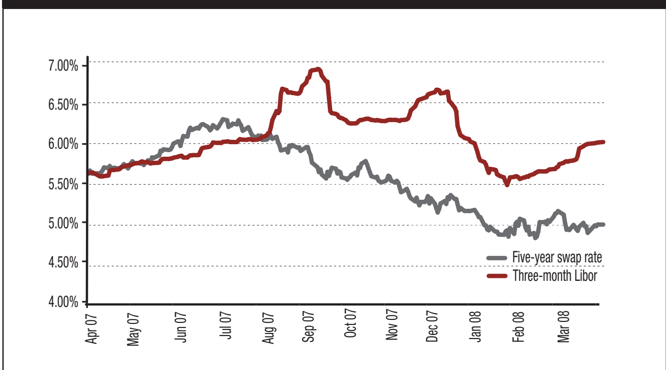
Bank seems torn between providing sufficient funds to the market and punishing the banks for profligate lending. For the time being, the Bank should put aside the moral hazard argument and remember that its main duty is to ensure that the market for which it is responsible functions in an orderly fashion. Equally, the banks need to return to lending to each other.

In terms of banks becoming more active lenders again there are one or two positive signs in what is otherwise a very bleak outlook. First, following the large write-downs by the major banks, the focus is now on achieving rights issues to help recapitalise and thus restore their ability to function, with sovereign-backed wealth funds proving major sources of new capital. Second, some funds have begun to appreciate the pricing of CMBS and are buying AAA corporate paper, yielding as much as 8%. For the cash-rich, there is the opportunity of earning junk-like earnings on high-quality assets. Truly, cash is king!

It is vital to restore some degree of tranquillity, which will divert the media to other matters. But this is not likely to happen while there are still concerns over banks having to make major write-offs or false rumours being given sufficient credibility to generate panic selling of shares in financial institutions.

While there will undoubtedly be ongoing problems, the system should have now absorbed the worst of the credit problems. Although this may not be immediately apparent, we suspect that ongoing equity raising through rights issues will gradually convince investors that no further reduction in the value of high-class assets can be expected. This restoration of confidence will, in time, engender a rally in the value of currently illiquid but high-quality assets. Investors will then return to the market and gradually relieve the banks off their over-stretched loan obligations. However, the market in lower credit assets is likely to take much longer to return. Borrowers expecting the market to return to the heady days of a year ago are in for a very long wait.

Figure 3: Five-year swap vs three-month Libor



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