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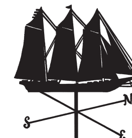

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BEHIND THE CREDIT CRUNCH

"No guts, no glory" is a phrase many of us learned as children during the summer we first contemplated taking our first big jump into the waters below. Running with the big kids meant taking risks, and jumping in with all the others was certainly better than staying on the sidelines, taking no risk at all.

Even after many years, the risks of taking that first big jump are still intuitively understood. But all too often, risk becomes an abstract concept, barely considered and mostly ignored on Wall Street. This usually happens when the mood is eager and the crowd is following the "hot money" into uncharted territory. Trading more risk for greater return seems smart, even if the dynamics of the trade-off are poorly understood.

But the financial markets can change rapidly, with the mood on Wall Street shifting in an instant. And when investors suddenly are confronted with losses beyond recovery, they often find that ignoring risk may not have been that smart after all.

In the last few months, conditions in the financial markets have deteriorated. Lax lending standards in the mortgage industry came home to roost over the summer and now the effects are rippling through the global financial system. Complex and high-yield financial instruments became increasingly popular in recent years, purchased by financial firms, large institutions, banks, pension and endowment funds as well as hedge funds, private equity firms and others around the world.

The strong global economy in conjunction with the historically low default rates of the last few years helped the market for these and other securities to surge, much like the dot-com and telecommunication bubbles of the late 1990s. But when investors grew concerned about the pace of economic growth earlier this year, appetites for these securities suddenly waned and the credit markets tightened significantly.

The impact from the crunch is still developing -- large financial institutions are announcing significant losses and a number of hedge funds have shut down or declared bankruptcy. Private equity firms also have been severely curtailed. The current fear is that economic growth both here and abroad will be affected and that other unforeseen effects may develop.

In this Newsletter, we will briefly review credit derivatives, one of the financial instruments behind the current credit crunch. We will also discuss the tendency on Wall Street to follow the herd, focusing only on the short-term, ignoring risk, and neglecting the broader picture.

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The Development of Credit Derivatives

Years ago, the typical credit relationship between a lender and a borrower was straightforward and fairly standard. The credit instrument was the loan and most loans were similar in terms of their covenants, amortization schedules and interest rates. This was true for individual as well as for corporate borrowers.

Banks generally followed an "originate and hold" model in their lending activities. While some loans were sold, the majority were held by the bank on its balance sheet. This meant that there was an incentive for the bank to evaluate fully the borrower's ability to repay and then to monitor the borrower's progress in repaying the loan.

With the founding in the 1980s of Fannie Mae and Freddie Mac, the government-sponsored agencies, and the subsequent wave of banking deregulation, the model began to shift to "originate and distribute." Banks still made mortgage loans, but instead of holding the loan to maturity, the bank would sell the loan to Fannie Mae or Freddie Mac and book immediate revenue while at the same time freeing up its balance sheet to make additional loans. Purchasing loans from many banks, Fannie Mae and Freddie Mac would then pool the loans and issue bonds based on the cash flows generated by the different pools.

This process of transforming a pool of assets, such as mortgage loans, into a marketable security is called "securitization" and was very likely the most important innovation on Wall Street in the last twenty-five years. In just the last decade, a variety of new hybrid financial instruments, such as credit derivatives, evolved from the process of securitization as financial institutions sought to expand their products and services while also hedging the resulting risks.

Ten years ago, the market for credit derivatives was virtually nonexistent while last year, there was an estimated $20 trillion of credit derivatives in existence. In its basic form, a credit derivative is a bet that a borrower will suffer some fundamental change which will then affect both creditworthiness and the ability to repay the loan.

There are two basic types of credit derivatives. The first, credit default swaps, are private contracts in which the loan is hedged against the likelihood of a bankruptcy, default or restructuring. Banks making a loan to one business may enter into a credit default swap in an equal amount with another entity as a hedge against a default on the loan. In addition to hedging, credit default swaps are also used for speculation and arbitrage purposes.

Banks like credit default swaps as they allow them to hedge their lending exposure to a specific company or even an entire industry. Some studies have suggested that the failures of Enron and WorldCom were not as damaging as they might have been because many of the lenders had hedged their exposures with credit default swaps.

The hedging effectively spread the risk out among many different participants. While this may have acted as a shock absorber, it also shielded the banks, the participants and the financial system as a whole from the consequences of their decision-making.

The second type of credit derivatives is collateralized debt obligations, or "CDOs," which are based on a pool of debt that is sliced according to credit quality and then sold by the slice. In general, slices with lower credit quality are priced to yield more than higher-quality slices.

Some CDOs are based on actual assets, such as underlying debt or equity, while other CDOs are based on a series of credit default swaps. These CDOs are "synthetic" financial instruments, that is, they are not based on real underlying assets. These became popular on Wall Street when interest rates were at historically low levels -- they had higher yields and thus offered better returns.

There are some benefits to collateralized debt obligations. They create investment opportunities that may not otherwise exist and they may increase diversification in a portfolio of fixed income securities. But these same features may magnify risk as well as create other problems, especially when the mood on Wall Street changes and there is a mass stampede for the exits.

The Current Situation

In normal times, the financial markets are complicated and difficult to dissect. In times of fear and panic and heightened volatility, they are even more so. The market for credit derivatives basically fell apart. Wall Street is uncertain as to their actual worth, so many of the holders of these instruments can now only estimate their value.

In order to stave off what is seen as a major threat to the global financial markets, several large financial institutions are proposing a plan to restore order to the credit markets. If the dozens of huge bank-affiliated funds are forced to sell billions of dollars of these securities and other assets to facilitate their own operations, it could drive prices down further. This could precipitate tremendous write-offs by the banks, brokerage firms and hedge funds owning similar securities. The fear is that this would then broaden the credit crunch, making it hard for consumers and businesses to obtain loans and thus impact economic growth.

The proposed bail-out plan basically involves establishing a superfund in which to place all of the suspect, and possibly toxic, financial instruments. According to the financial institutions, housing them all in one fund would make it easier to sort everything out. No matter how the situation is eventually resolved, two important and obvious questions come to the fore: Why didn't Wall Street see the problems developing? And why did the problems develop in the first place?

One of the main reasons that Wall Street was caught off guard is that many of these securities were not held directly on the balance sheets of the financial institutions. This made them beyond the purview of investor scrutiny. Some observers have noted the similarities between this arrangement and the off balance sheet financing activities of previous scandals. While fraud does not appear to be a current factor, it does highlight the fact that just because you can't see it doesn't mean a problem doesn't exist.

As to how the problems evolved, one of the main issues with the recent financial innovations is that it has become more and more difficult for anyone, including investors, regulators and bankers, to monitor their holdings of these complicated instruments.

In the "old style" of lending, a bank had many incentives first to evaluate thoroughly a borrower and then constantly check the status of the loan as it was paid off. However, a bank that has sold its loans and/or hedged away its risks has little incentive to monitor the situation. The hedge ensures that if something adverse happens, the bank is protected.

Some hedges may be impossible for anyone to monitor. One collateralized debt obligation, created from many credit default swaps, is complicated. Many CDOs held by one organization are beyond the capabilities of most sophisticated computer software programs. Multiply that by the number of financial institutions, as well as the hedge funds, private equity firms, pension and endowment funds and others around the world participating in these instruments, and the scope of the problem becomes breathtaking.

So Where Do We Go From Here?

Even though the situation is troubling and may become more so in the months ahead, it is important to remember that little on Wall Street is ever actually new. In other words, even though the scenery is different, we've been down this road before.

Over the last two decades, a number of crises have hit the financial markets. The infamous stock market crash of October 1987 was followed by three others: the credit crunch of 1990-92, the emerging markets turmoil of 1997-98, and the bursting of the dot-com bubble in 2000-02.

So far, these crises have scared investors away from their previously exuberant behavior without severely impacting economic growth. In fact, since 1987 global growth has averaged just under 4% on an annual basis. This may be an indication that the global economy is functioning well enough to be able to withstand periods of high volatility and fear without sustaining permanent damage.

It may be that a financial crisis every so often becomes part of the global economy's self-equilibrating mechanism, provided of course that the central banks react quickly enough to any developing situation. A major problem is that the different components of the global system are now more tightly linked to each other than ever before, increasing the danger of a cascading, snowball effect. Thus, there is no guarantee that this or a future crisis won't evolve into "The Big One" which undermines the entire financial system.

The good news is that high-quality growth companies, with their strong balance sheets and experienced management teams, are likely to remain above the fray. And investors in these companies should take pride in the fact that they seem to have more common sense than the crowd on Wall Street which always seems to be mindlessly pursuing yet another popular fad.

Those who purchase the shares of leading, high-quality growth companies are part owners of real businesses which have above-average prospects for growth in earnings and dividends per share. With their superior track records, these companies have staying power for the long term while speculative schemes on Wall Street will come and go.