

November 2007

### The “equifying” of credit

Much has been discussed and written recently in regard to the widespread turbulence in the credit markets, which had commenced with the sub-prime loan crisis before expanding to the syndicated loan and high yield markets, and is now plaguing the SIVs to which some of the world’s biggest banks maintain enormous direct or indirect exposure. The light at the end of the tunnel, which some market participants have gleamed from monumental write-offs taken by nearly all major financial institutions; the length of the tunnel (i.e., the timeframe necessary for credit markets to stabilize); and the economic implications of these factors in the near as well as longer term have all been the subject of extensive debate. What may be equally important, (although perhaps receiving less scrutiny), is the role played by changes in the very nature of the credit product, in leading to the underlying problem as well as the current attempts to resolve it. Here are a few observations:

The “easy credit” environment of the past several years has been akin to a redefinition of debt.

Like equity, the notion of “maturity” was displaced by an “exit”, or a “market” to sell into, and the recourse was in essence transferred from the borrower to a third party.

- The “easy credit” environment of the past several years has in ways been more truly a redefinition of debt and its structure and risk profile. In the corporate market, for instance, elimination of covenants and even principal amortization was commonplace for senior credit structures. The underlying premise was that borrowers could always refinance, and lenders could always sell off positions, in an increasingly sophisticated and liquid market. Thus, broadly speaking, fundamental credit analysis was replaced by syndication capabilities and trading activity. By the same token, interest-only mortgage products and other similarly attractive instruments that flooded the consumer market were largely based on the same concept of deferment, refinancing, and lenders’ ability to trade out of positions in a highly liquid environment that seemed perpetual.
- While other such examples from fixed income capital markets can complete the picture in a similar vein, we observe that debt capital had increasingly come to resemble equity – in the sense that, like equity, the notion of “maturity” was displaced by an “exit”, or a “market” to sell into, which displacement in essence transfers the recourse from the original borrower to a to-be-determined third party.
- A few months forward, and we bare witness to a disruption in the system. The market which was to assume the burden of what used to be an old-fashioned obligor has for all intents and purposes stopped facilitating “exits”. But has it really? Here is the interesting part: an artificial new market is being created in its place, really by lack of choice, devised to prop up the structures

built on refinancing rather than repayment, and to support the firms that were depending on a steady source of take-out finance, even if such support is artificial and temporary. Note the examples below.

In the current environment the financial burden remains in the realm of a “market”, and the notion of actual principal reduction remains remote.

- Citigroup, Bank of America, and other financial groups are attempting to establish a vehicle, using their own capital, to acquire some of the same groups’ SIV assets. While this idea seemingly serves only to take from one pocket to put in another, such a vehicle would essentially play the role of a healthy refinancing environment, allowing financial institutions to operate on a “normalized” basis, without loss, and enabling these firms to avoid egregious markings to market. When the “real” market resumes normal operation, this new vehicle can wind down and would have acted as a bridge to that point.
- In the mortgage arena we hear about numerous lenders who, rather than facing the unattractive prospect of collecting on defaulted credit in forced liquidations, are extending repayment terms (and now possibly freezing interest rates) to give borrowers breathing room. In essence, this too can be thought of as a bridge to a normal market, in which the provider of bridge capital is the original lender, just as in the prior example above.
- In both of these examples we see what might be referred to as a continuing “equifying” of debt, for lack of a better term to describe the equity-like features of an instrument that in its origins was meant to be repaid (i.e., as opposed to refinanced or sold). In the current environment, just as in the frothy environment that has led to our current state, the financial burden remains in the realm of a “market”, even if this is artificial, and the notion of actual principal reduction – from the perspective of a borrower – remains remote. (We should also point out that covenant-lite packages that had been structured during more frothy times will also reduce the likelihood of borrower default or payment acceleration.)

One has to question whether debt capital that in important ways behaves like equity is being mispriced in relation to its risk profile.

The environment described, (as well as the continuing ease of monetary policy by the Fed), while reducing the risk and pain of financial write-offs, bankruptcies, and the results thereof on the overall economy, comes with potentially adverse consequences of its own. For starters, the high leverage of both businesses and individuals seems likely to go unabated. In turn, our national dependence on overseas capital is likely to continue. Although a cheap dollar in this context may actually be positive, one cannot assume that overseas funds will forever be available for bail-outs.



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Secondly, one has to question whether debt capital that in important ways behaves like equity, as has been shown, is being mispriced in relation to its risk profile.

More interestingly perhaps, we wonder at what point the described extensions of credit maturities and the concurrent lack of actual repayments, will result in unhealthy portfolio durations and asset-liability terms mismatches for financial institutions. Perhaps the recent announcement of a \$7.5 billion capital infusion at Citigroup in the form of convertible preferred equity, and the less than attractive terms under which the transaction was negotiated (11% dividend rate and conversion price close to the common stock's 5-year low), is an indication that such pressures have already begun... and that maybe our point of reference for what constitutes adequate terms was based on a mispriced market perspective.

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