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The credit markets

In the shadows of debt

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Business is being reshaped by a massive borrowing binge, but much of it is unseen, unregulated and little understood

IN THE mid-1990s Spain's “King of Bricks”, the construction magnate Rafael del Pino, received a most unusual commission. His company, Ferrovial, was hired to work with Frank Gehry, a Los Angeles-based architect, to build a work of art: Bilbao's stunning titanium-skinned Guggenheim Museum, which dapples the waters of the Nervión river.

Mr Gehry, with his shock of Einstein-white hair, was a stickler for detail. No two parts of the 24,000 square metre (258,000 square foot) leviathan could be the same—or even symmetrical. The museum's cavernous halls would embrace one of Bilbao's gritty industrial-era bridges. And it had to project a sense of peace, an image the Basque authorities badly needed to send to the world.

Less than a decade later, Ferrovial, flush with the success of its Basque masterpiece, is engaged in engineering wizardry of a different sort—finance. This summer it obtained huge, privately issued loans to buy control of BAA, the world's largest airports operator and owner of London's Heathrow, Gatwick and Stansted airports. Though Ferrovial was much smaller than BAA, the consortium it led beat buy-out specialists, such as Goldman Sachs. Of the £16.4 billion ($30 billion) it paid for BAA, more than half was borrowed.

Ferrovial is among a growing number of companies exploiting a sophisticated grasp of the debt markets to make acquisitions that only a few years ago would have seemed impossible. “The market has changed,” says Richard Bartlett of Royal Bank of Scotland, one of Ferrovial's main creditors. “Twelve or 24 months ago this would have been a very challenging deal to pull off.”

Indeed, the market has changed so fast that regulators are not sure if it is spinning out of control. On one hand, innovations in the credit markets have helped to provide a remarkable period of stability in the world's financial system. In recent years, markets have lived through the end of the internet bubble, the collapse of Enron, the terror attacks of September 11th 2001, debt downgrades in the car industry and a stampede out of risky assets in May and June. Any one of these might once have triggered a financial crisis. But none did.

Cheap and liquid financing has enabled companies to make more efficient use of their balance sheets, potentially boosting returns to shareholders and allowing managers to concentrate on profits and cashflow. Despite the increased lending, banks have increased the cushions of capital that they rely on to be a safeguard.

On the other hand, as the debt and derivatives markets have grown out of all recognition, they have moved increasingly into the shadows. Regulators worry that some of the complex financial instruments conjured up around the lending and borrowing of money—worth trillions of dollars—may sow the seeds of the next financial crisis.

The credit markets are the motor for three of the big trends of the decade and some people find them unsettling. First, companies are raising more and more capital through privately issued loan instruments, as opposed to public equity—such as selling stocks or issuing bonds, which can be openly traded. Private deals are harder for regulators and ordinary investors to keep tabs on.

Second, the lending is increasingly being orchestrated from outside the regulated banking industry, by hedge funds and other credit investors that are often supervised only indirectly, if at all. These are especially big in the booming market for credit derivatives, which are also traded outside public exchanges.

Third, although some of this capital is available to public companies, such as Ferrovial, most of it is being gobbled up by leveraged buy-out firms, which use the money to buy public companies and remove them from the stockmarket.

Central bankers and supervisors increasingly worry about the risks to financial stability that may be lurking in the complex debt instruments dreamt up by the finance industry. One of their biggest concerns is how much danger there may be to regulated banks from the faceless institutions they now do much of their debt trading with: hedge funds.

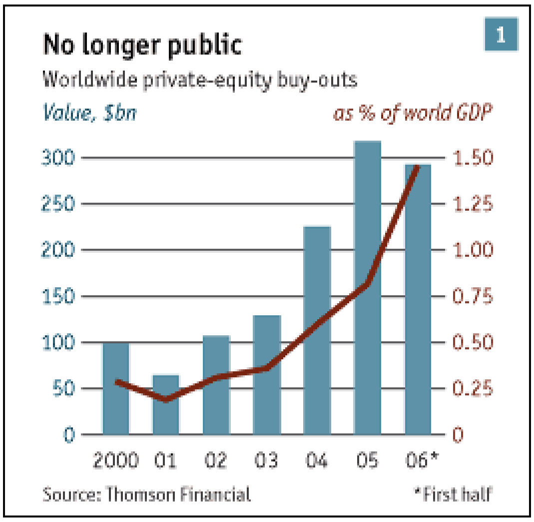
Regulators are beginning to ask themselves whether hedge funds are adequately monitored through the supervision of the banking industry. Pressure is growing on the banks to deal sensibly with their trading counterparties. Equally, some question whether over-zealous supervision may have had the perverse consequence of driving business and finance away from the public eye.

At the forefront of concerned regulators is Timothy Geithner, president of the Federal Reserve Bank of New York and one of the financial world's most powerful voices. In a speech in Hong Kong on September 14th, Mr Geithner praised the banking industry for becoming more robust, overseeing growth in the number and size of lending firms and innovating in credit instruments. These, he said, had “strengthened the efficiency and resiliency of the overall financial system.”

But he gave warning: “The same factors that may have reduced the probability of future systemic events, however, may amplify the damage caused by, and complicate the management of, very severe financial shocks. The changes that have reduced the vulnerability of the system to smaller shocks may have increased the severity of the larger ones.”

For most regulators, the safest thing you can have to protect against such shocks is liquidity, and this has been abundant for years. But as the old adage goes, a banker is someone who lends you an umbrella when it is sunny and asks for it back when it starts to rain. Liquidity in the debt markets has an annoying habit of disappearing just when you most need it.

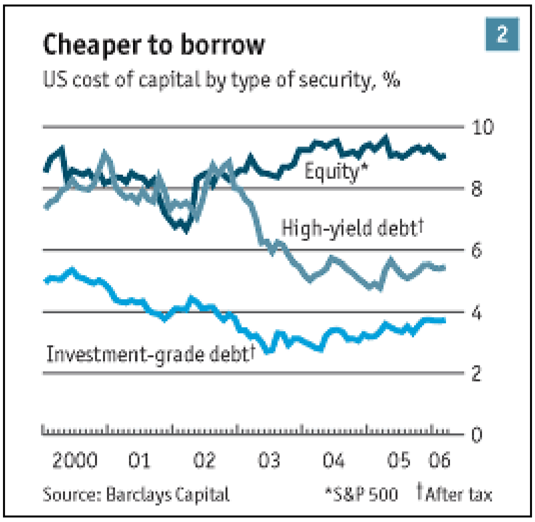
The main drivers of innovation in the debt markets have been the buy-out specialists. The private-equity firms seized on cheap credit to buy $300 billion of businesses in the first half of the year (see chart 1). If they carry on at that pace, they could theoretically beg and borrow enough money in 2006 to buy almost a fifth of all companies listed on America's NASDAQ, or nearly a quarter of Britain's FTSE 100. Citigroup, one of the cheerleaders of the borrowing boom, says buy-outs, foreign takeovers and debt-funded share buybacks have removed shares from stockmarkets, especially in Britain, faster than companies could issue them. The decline is still small and you can argue over which shares should count in the calculation, but Citigroup says this year is the first in more than 20 years that European stockmarkets have shrunk in this way.



Even companies avoiding the acquisition trail have raised borrowing levels to buy back shares—if only to keep private-equity groups at bay. Such buybacks surged to $117 billion in the second quarter, according to the Bank for International Settlements, compared with a quarterly average of $87 billion last year. Such is the extent of “shareholder enhancements”—share-boosting measures that increase debt on the balance sheet—that irate bondholders have begun to fight back. Activist shareholders are now competing against activist bondholders.

Egging borrowers on are bankers, who sometimes admit to lending amounts, as a multiple of underlying cashflows, that are against their better judgment. This, they say, is partly because the competition to provide credit is so fierce, however cheap it is. Since 2003, the after-tax cost of raising debt has been much lower than the cost of issuing shares, even in the more expensive high-yield market (see chart 2).

No longer do banks have a cosy monopoly on finance. Years of low interest rates and abundant liquidity have led investors to pursue higher-yielding assets, even if that means taking on greater risk. This means new firms, such as hedge funds, have flocked into the loan market, where they can super-size yields by investing in tranches of debt with a higher risk of default, and by borrowing from banks to buy those loans.



Also, the desire of pension-fund managers to buy long-term assets to match their payout commitments has led them into most parts of the credit market. Mutual funds and insurers have flocked in to diversify their portfolios and to spice up their returns.

According to Standard & Poor's Leveraged Commentary and Data, a part of the rating agency that tracks the loan market, credit-investment institutions backed by pension funds, mutual funds and insurance companies have mushroomed in recent years, replacing banks in loan-syndication deals.

In America they bought two-thirds of all leveraged loans issued in the first half of this year, up from 45% seven years ago. In Europe the growth has been stronger still. It had just three such institutions in 1999, a tiny share of the loan-syndication market. At the end of June there were 76, or 45%, of a much bigger market. This slice of the business has been seized from banks.

Credit where credit is due

Partly thanks to the shared risk, record-breaking deals have been done with hardly a hitch. Ferrovial's acquisition, which had many of the characteristics of a leveraged buy-out, came close to the size of the largest buy-out to be agreed ever (in nominal terms)—that of HCA, an American health-care provider. It agreed to be bought earlier this year by a team of private-equity groups for $33 billion.

Though interest rates and debt have both risen around the world, this has not yet led to more defaults. Rating agencies have lowered their projected default rates for several years; Moody's Investors Service says only 12 firms that it follows have defaulted this year, compared with 19 in the same period in 2005. The dollar volume of defaults is also much lower. That is partly why in the markets for corporate debt, the interest rates at which companies can borrow are almost as low as they have ever been, according to Citigroup.

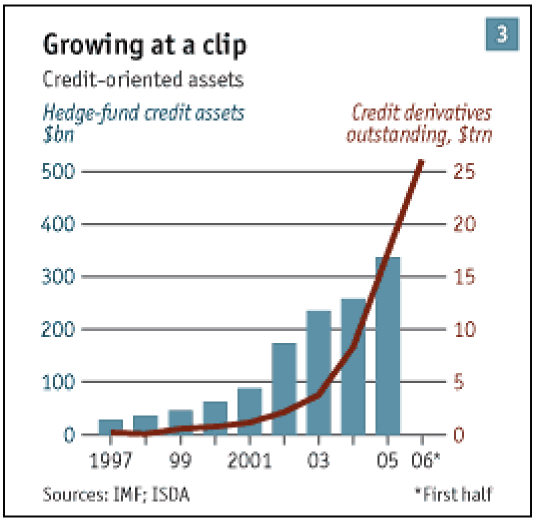
Even when companies have run into trouble, the debt markets have just hiccuped and soldiered on. In May 2005 the bonds of the two largest and most actively traded issuers in the market, General Motors and Ford, were downgraded to “junk” status as the risk of default increased, leading to fears of a meltdown in the credit markets. But far from drying up, junk bond issues increased to more than $120 billion in 2005, nearly twice as much as in the depths of the lending drought after the telecoms crash in 2002. Such is the staying power of the market that CreditSights, a consultancy, wondered this summer whether it was fair to call high-yield bonds “junk” after all.

These rated corporate bonds—whether junk or not—used to be the height of sophistication. In the days of Michael Milken and Drexel Burnham Lambert in the 1980s, junk bonds helped reshape and modernise corporate America, no matter how unpopular they were at the time. But now they are being eclipsed by privately arranged loan transactions, especially “leveraged finance” (which carries a similar risk to junk bonds, but involves loans that are not publicly traded).

Leveraged finance is growing fast. According to Merrill Lynch, the leveraged-loan market in Europe is already larger than the junk-bond market—which, admittedly, was not very deep in the first place. In America the issuance of leveraged loans is growing much faster than high-yield bonds, though the overall amounts are still smaller. The debt includes second-lien loans, which have a floating rate and give creditors lower levels of security, but potentially higher returns. In the riskiest end of the credit spectrum are mezzanine finance and payment-in-kind notes. A bit like the more toxic end of mortgage finance, nobody knows how liquid they will be when the credit cycle turns.

On a global scale, the vast syndicated-loan market, including leveraged finance and more senior debt, is also growing more swiftly than public bond and share markets. Dealogic, a data provider, says global share issuance last year was a bit less than at its peak in 2000, at almost $600 billion and corporate-bond issuance was a bit higher than in 2000, at $685 billion. Loan volumes, meanwhile, soared from $2.3 trillion to $3.5 trillion over the same period.

More febrile still has been the popularity of newfangled derivatives with difficult names, such as credit-default swaps (CDSs). These are as complex as they sound. But they are also among the past decade's most important financial innovations—and a cause of both regulatory hand-clapping and hand-wringing. The International Swaps and Derivatives Association said on September 19th that the notional amount outstanding of credit derivatives rose by 52% in the first six months of the year to $26 trillion (see chart 3). That number would be far smaller if banks' positions were netted out for offsetting exposures. But less than a decade ago, the credit-swaps market barely existed.



Credit derivatives, which behave a bit like insurance contracts, allow investors to buy or sell cover against default by a borrower, and the price moves depending on perceptions about the borrower's creditworthiness. Increasingly, they are being pooled into collateralised debt obligations (CDOs), another form of investment vehicle that is growing as fast as a hedge-fund manager's bank balance.

Such products, known as “structured credit”, encourage liquidity, partly because they can be created out of thin air. They also allow banks to sell on the risk of loans turning bad, possibly enabling them to lend more. Robert McAdie, head of credit research at Barclays Capital, says the change has been profound—and for the better. After the dotcom boom, when heavily indebted telecoms firms were on their knees, banks had almost no way to hedge themselves. Now they do: “The use of credit derivatives has totally liberalised the debt market,” he says. “It has created an enormous shift in the risk profile of banks. It allows them to hedge against their risk and manage their regulatory and economic capital more efficiently.”

Hedges and hedge funds

On the other hand, a recent paper by researchers at the European Central Bank says part of the problem with CDSs is that they are used for speculation, as well as hedging. “We have introduced a new product, “insurance”, that appears to be used by people not looking for insurance. It is not the instrument[s] which [are] causing liquidity concerns but the way market participants may be using them.”

On September 11th, in its semi-annual Global Financial Stability Report, the IMF warned that such “structured credit products” were one of its main concerns, especially if financial markets take a turn for the worse and liquidity dries up.

The problem, broadly identified by many regulators, is that not a lot is known about how structured-credit products behave in unusual conditions. Even if they normally mitigate risks, they might suddenly magnify them when financial conditions seriously deteriorate. The products have been developed in a decade when interest rates have been low, the appetite for risk high and liquidity ample. It is easy to assume they are always a benign influence. But it is hard to know how they will react when hard times return.

Mr Geithner, whose role at the New York Fed makes him supervisor-in-chief of Wall Street, appears to take them particularly seriously. In his speech he said that leveraged firms trading credit instruments may well improve liquidity, pricing and diversification opportunities for investors, which should lead to lower risk and ultimately cheaper capital.

But there were problems monitoring the positions taken by firms, he added, which may pose risks to financial stability. Banks, for example, may not fully understand all the positions of a hedge-fund counterparty before lending to it, he said; hedge funds are not required to give this information publicly. Banks can model future risks, but reasonable people differ widely on where those risks lie. And policies to reduce the risks of failure at banks may cause moral hazard if they dull the incentive of individual firms to police their lending criteria.

Mr Geithner encouraged banks to deepen the margin cushion they extend to counterparties and sort out back-office processing of credit-derivative trades as short-term ways to shore up the system. He hinted that regulators might have to supervise large hedge funds directly, rather than indirectly, through banks.

But more scrutiny can be a double-edged sword. Some argue that the regulatory climate is partly what first drove public firms into private hands, encouraged the brightest bank employees to move to hedge funds, and spurred companies to borrow privately.

According to Jonathan Macey, a professor at the Yale Law School, the people who such regulation is supposed to benefit—ordinary, non-professional investors—are those most likely to miss out from the trend to raise capital privately. Of course, they can always take part via their pension funds—though that will be little comfort if the credit cycle ever becomes a crunch.