

Prospects on Credit

NYU Stern School of Management

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Historically: *institutionally* intermediated, not *market* intermediated exchange

- Flows not arbitrated by price but by institutional considerations
 - Credit pricing set by convention
 - Turns problem into one of “gate-keeping”
 - Importance of relationship and covenants
 - Role of the balance sheet
 - Extension of credit depends upon circumstance of bank rather than borrower
- Why? Default risk and the agency problem
 - External agency problem
 - Information advantage of borrower
 - Escape hatch of bankruptcy
 - Internal agency problem
 - Timing, frequency and difficulty of internal monitoring
 - Subjective evaluation of risk
- Lack of external secondary market

Historical perspective on the corporate bond market

post Great Depression experience

- Strong gate-keeping function played by rating agencies
- Mostly about issuance, not secondary trading
- Shaped by Glass-Steagall
- Sellers
 - Large non-financial corporations
- Buyers
 - Insurance
 - Pension
 - Endowment

⇒ Not really about credit

- Begins to change with emergence of high yield market

The main trend

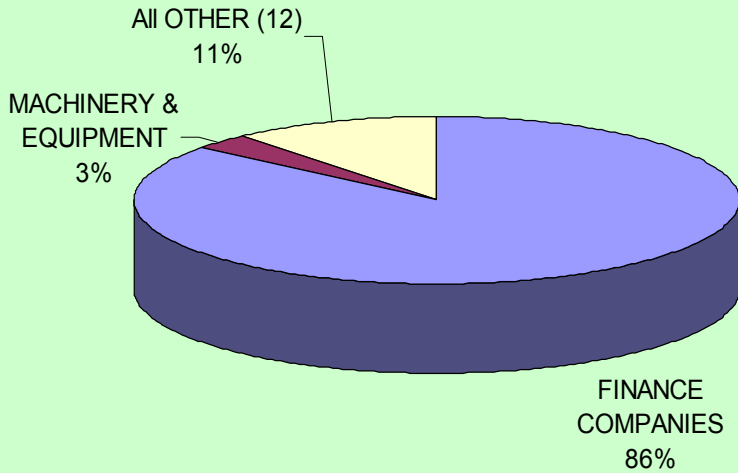
- More firms have access to capital, equity and debt, than ever before
 - Secular increase in default rates
- More people have access to debt than ever before
 - Access spearheaded by non-financial corporations, not financial businesses

Implications

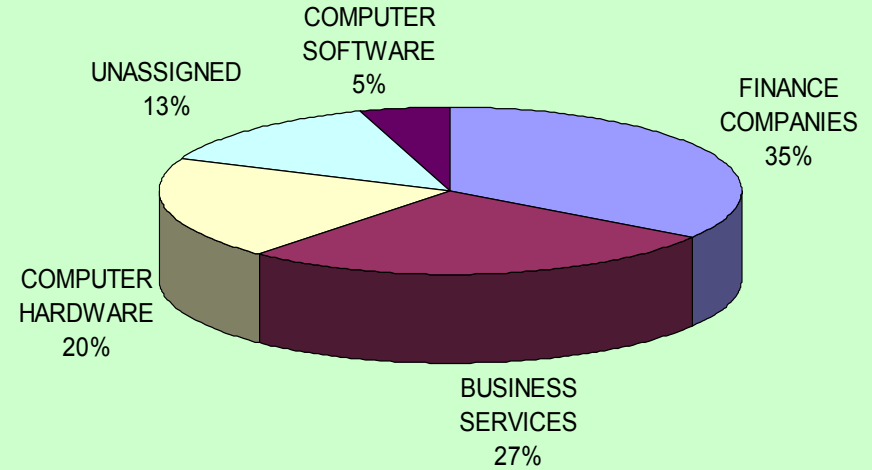
- Bulging balance sheets of credit originators
 - Problem of franchise risk overlaying portfolio risk
 - ABS & importance of packaging
- Increasing emphasis on secondary market
 - CDS
 - Prices replacing the gate-keeping function
- Increasing complexity of credit “niches”
 - New specialty intermediation
 - Sub-management of risks

Bulging Balance Sheets

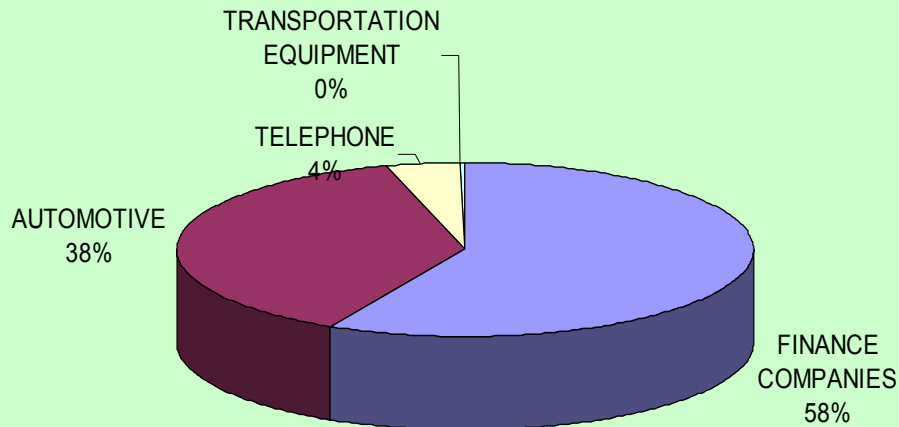
General Electric



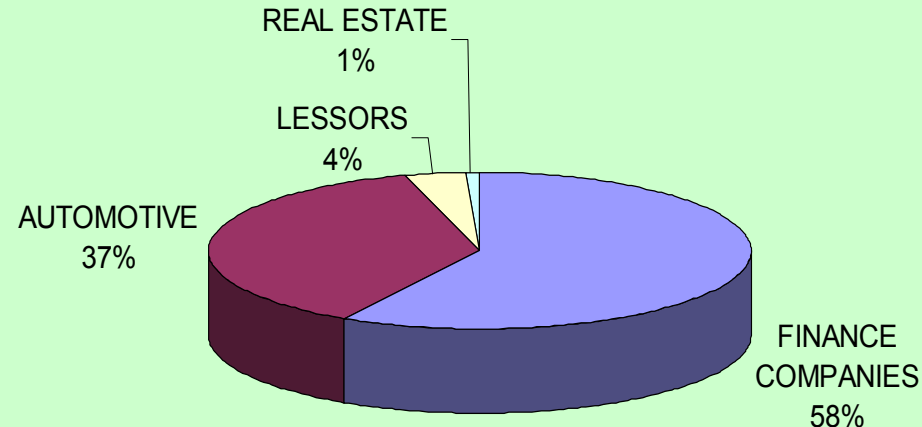
IBM



General Motors Corp



Ford Motor Co



Concentration of Balance Sheet Exposures

- The 30,000 largest obligors (in, approximately, the G30) represent 5,000 financial institutions and 25,000 non-financial firms.
- The 5000 financial firms have \$13.5 trillion in debt.
 - One quarter of the total debt issued by 5,000 financials is represented by just 10 financial institutions (0.2% of the total number).
- The 25,000 non-financial firms issue \$3.5 trillion in debt.
 - Among the 25,000 non-financials, 56 (again, about 0.2%) companies issue 25% of the total.
- These concentrations are greater than the corresponding equity issuance concentrations.

Is this a problem?

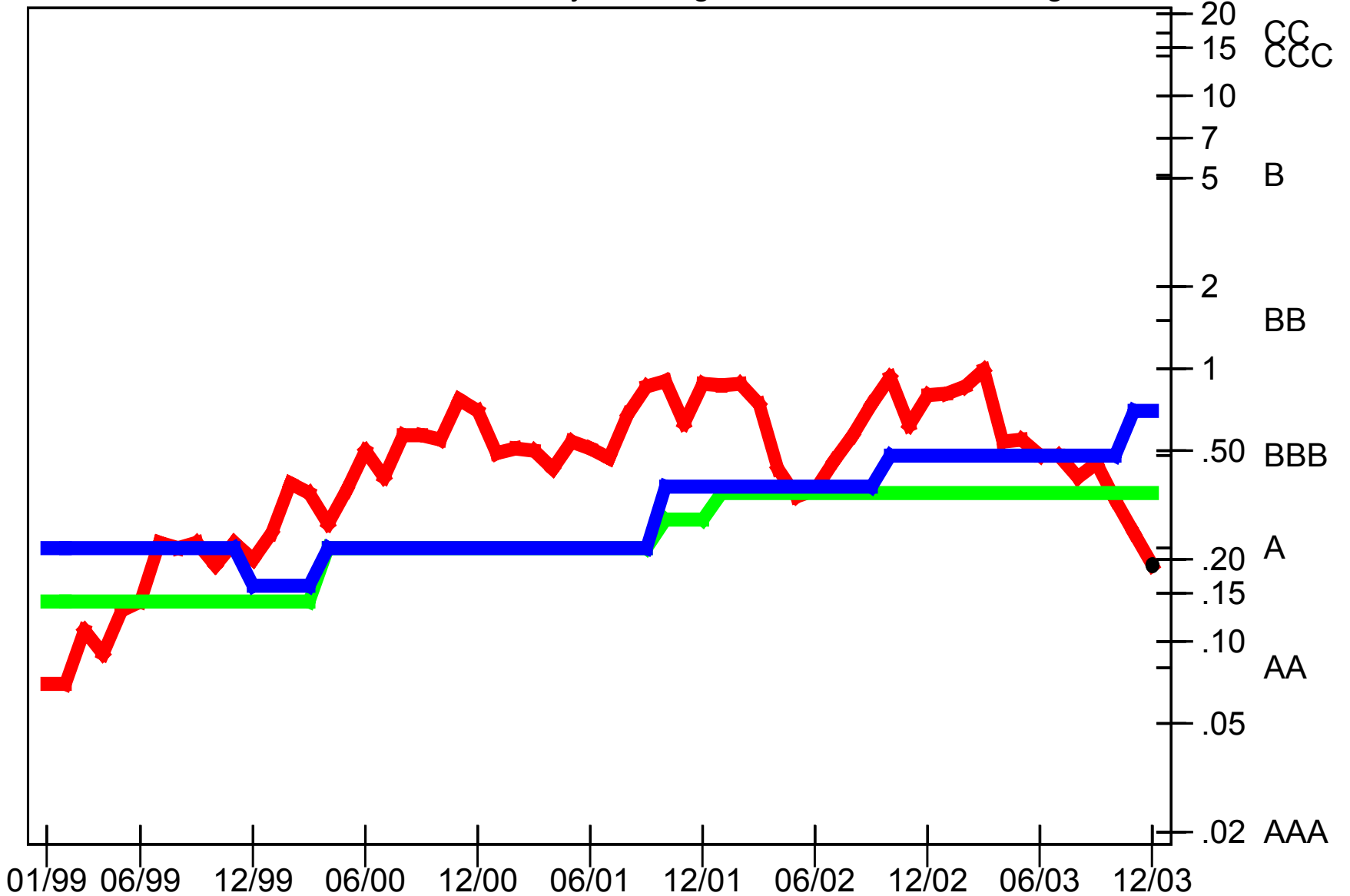
- Ford, for example, has an automotive business
- It is also acting as a debt intermediary
- When you lend money to Ford, most of it is going to finance Ford's debt portfolio
- However, your risk is Ford, mostly driven by its automotive business because that is the risky part
- Does this make sense?

FORD MOTOR CO

EDF

Moody's Rating

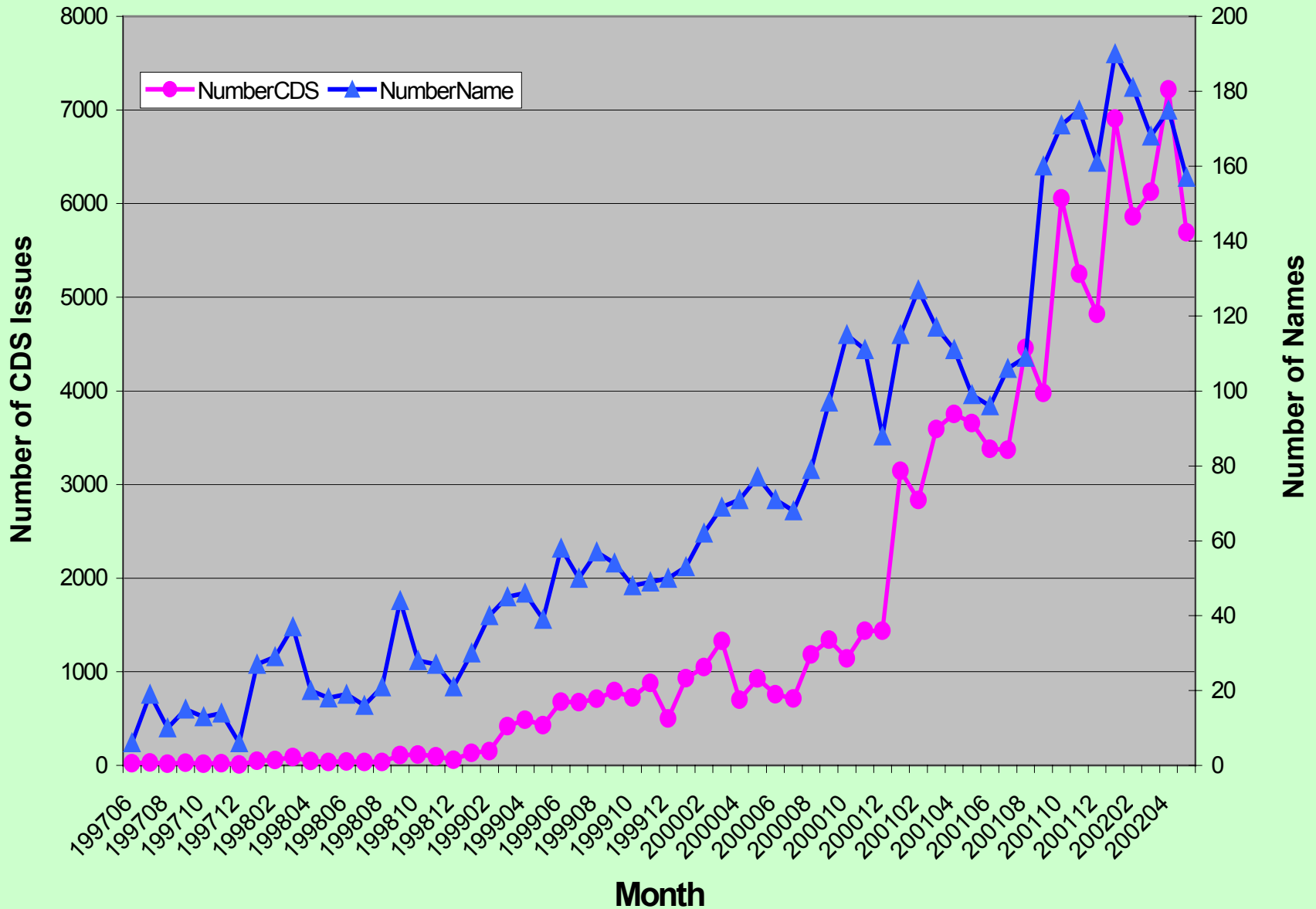
S&P Rating



Problem faced by fixed income manager

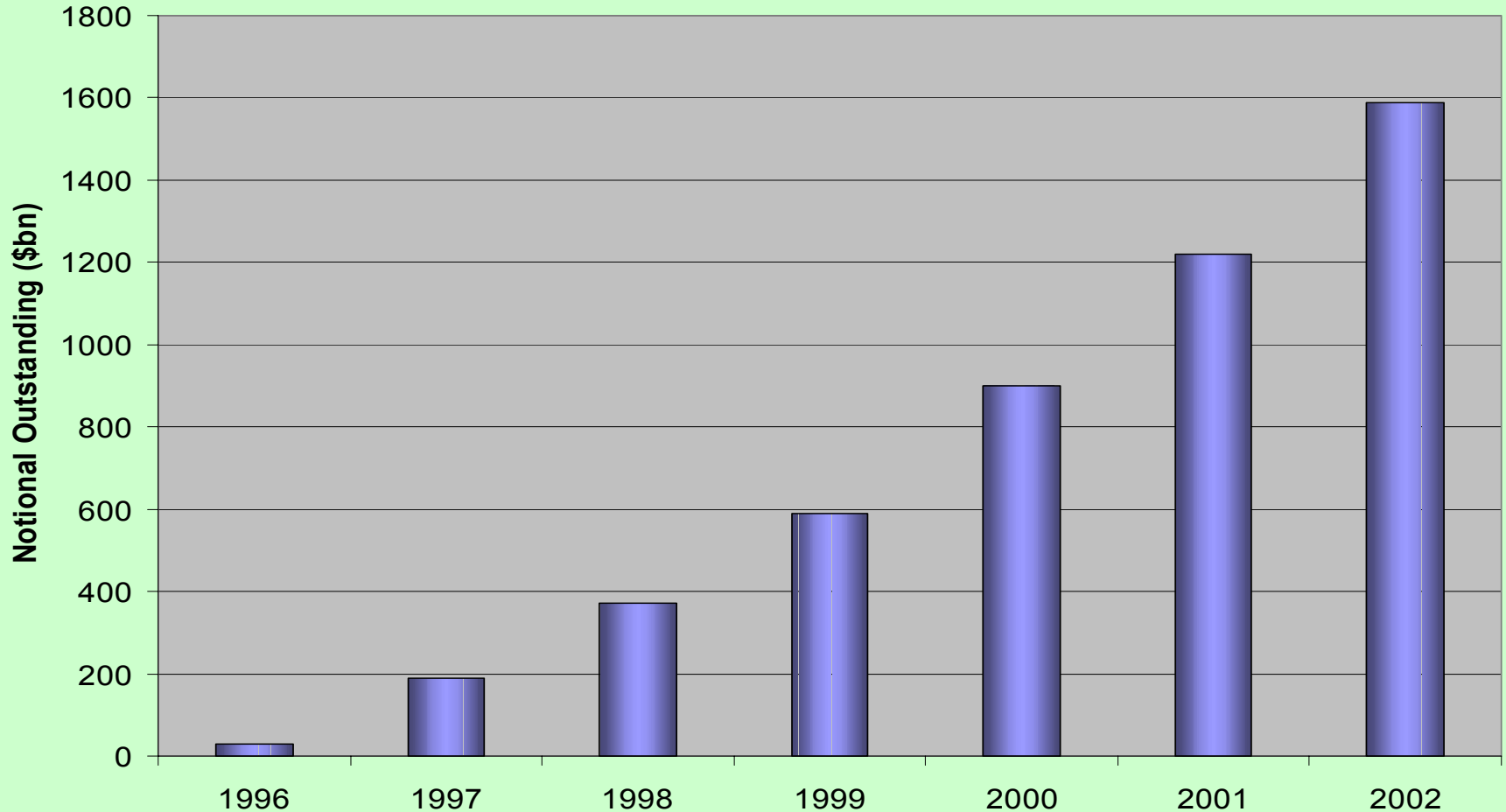
- Indexed to something like the Lehman investment grade
- These indexes are essentially issuance weighted
 - Ford is greater than 3% of the Lehman
- No one should want to hold this much Ford as its risk goes up
 - However, it would be fine to hold all the names in the debt portfolio, i.e. disintermediate Ford

Figure 5: Growth of CDS Market in US by Month



Credit Derivatives Market Size

Notional Outstanding (\$ Bn)

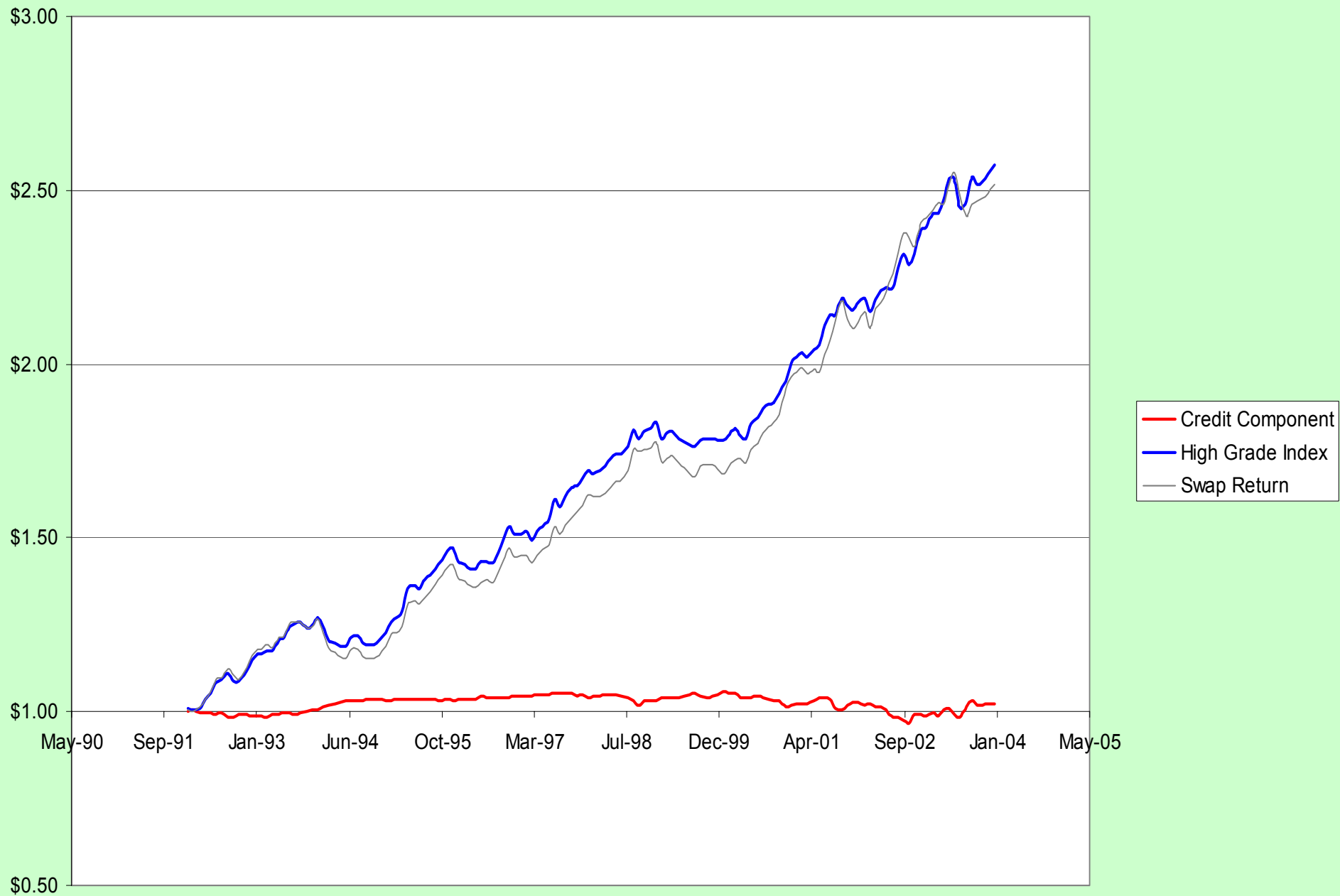


Credit as an Asset Class

Considerations:

- Is it a fundamental, aggregate risk or can it be eliminated in the aggregate?
- Can the risk be separated out from other risks and managed?
- Is the risk simply derivative of another asset class or does it have unique characteristics?
 - Liability side balance sheet behavior
 - Loss given default
- Does it have a risk/return profile that is intelligible to investors?

Credit Component of High Grade Credit Index



Conclusions

- Credit is emerging as an asset class for investors
 - “Purified”, traded and priced
- Small lot and large lot credit must be packaged and moved out of originator balance sheets
- Existing packaging arrangements are problematic
 - Retained risk for originator, expensive, opaque to investor, unmanaged or poorly managed, index construction
- Main problem: no intelligible risk/return trade-off for final investors