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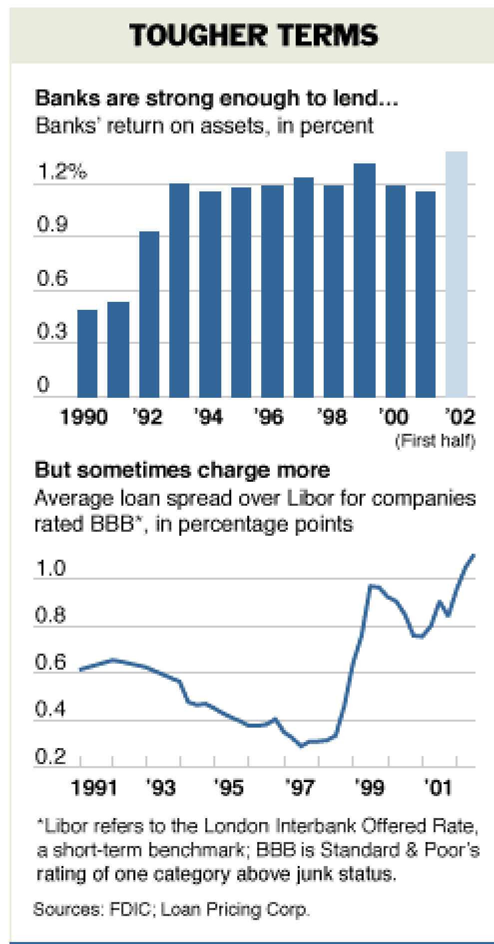
Wary Banks Link Loans To Fickle Capital Markets

Greg Ip, *The Wall Street Journal*, September 23, 2002.

When numerous companies suddenly found investors unwilling to buy their debt this year, amid a rocky economy and accounting scandals, many turned to their lenders of last resort, their banks. They discovered banking has changed a lot. And some discovered that loans cost them a good deal more.

Banks traditionally have been the institutions that take a long-term view of a company's prospects, management and ability to repay a debt. By contrast, the fast-paced, fickle bond market can change its mind in an instant about a company's creditworthiness and how much to charge. But many borrowers are finding that banks' loan business has come to look a lot like the markets.



Burned by costly lending decisions a decade ago, banks increasingly look to the impatient and unforgiving public markets to guide how much to lend and under what terms. The good news is, credit is available. The bad news is, it's often at a high price.

Eager Bankers

Five years ago, Solutia Inc. found plenty of banks were eager to provide a five-year, $800 million line of credit to the St. Louis chemical company. The rate would float at just three-eighths of a percentage point above a short-term interest-rate benchmark known as Libor. Solutia didn't need the loans, though, because it could borrow directly by selling investors bonds or short-term "commercial paper."

Then over the past year, Solutia saw its profits squeezed by recession and high energy prices, and it lost an environmental lawsuit. Those factors helped strip the company of its investment-grade credit rating. All that made it hard to issue debt directly, so Solutia borrowed about $500 million from banks. When the line came due last month, the company asked for a two-year extension.

Solutia offered to pay 3.5 percentage points above Libor. Then it bumped that up to 4.75 points. But, reflecting an increasingly common practice, the banks had sold to investment funds pieces of what they'd lent under the line of credit. And Solutia needed the funds' agreement to amend the line's terms. One fund held out until Solutia agreed to pay 5.75 points above Libor.

"The only recourse was to seek Chapter 11, and that was in no one's interest," says Solutia's treasurer, Kevin Wilson.

The case reflects changes in the positions of both banks and borrowers. At the beginning of the 1990s, many banks were unable or unwilling to lend. They were burdened by bad loans to commercial real estate, leveraged buyouts or developing nations, and also were under pressure from regulators to boost their capital. Their reluctance hastened the growth of bond and commercial-paper markets as a source of credit for corporations.

Now many companies' credit ratings have slipped so much that borrowing that way is impractical -- while banks are healthier and able to lend.

Scarred by Early '90s

But when banks lend now, they don't behave the same way. Scarred by their early-1990s experience, they often don't hold onto loans, especially those to lower-quality companies. Increasingly, banks sell pieces of their loans to other banks, to specialized investment funds, insurance companies or to other institutional investors. As a result, the loans are subject to all the pricing and other tactics of the markets. And the banks are acting less like lenders and more like middlemen between borrowers and investors.

Although this shift means painfully high interest rates for some, it has benefits to the overall economy in making credit available. Even if a bank considers a particular borrower too risky, it can usually find someone willing to share the risk. And the capital markets help it find out what interest rate is needed to compensate for the risk.

"The actual creditworthiness of borrowers has come down," Federal Reserve Chairman Alan Greenspan observed earlier this year. "There has, however, been no evidence of anything remotely resembling the credit crunch that we had a decade ago, where you just could not get a loan out of a commercial bank no matter what your creditworthiness was, at least in some cases."

There are two markets for big corporate loans. One is for high-quality companies. Here, relationships still matter, and banks may lend at lower rates than capital markets would dictate because they hope to get fees from the borrowers for other services.

The other tier -- called "leveraged loans" -- involves companies rated below investment grade or nearly so. "That part of the market behaves very much like any other capital market," says Tom Okel, global head of loan syndications at Bank of America.

The terms on leveraged loans are strongly linked to where the companies' securities trade. Borrowers' fortunes are continuously re-evaluated by the markets for bonds, stocks and "credit derivatives" -- essentially insurance that banks take out to protect against a default. When a bank is about to make a loan, it can get a snapshot of how these markets are judging the company's creditworthiness, and use this snapshot to guide its own decision.

For companies such as Solutia that have slipped into the second category, the cost of credit is rising sharply. Companies rated triple-B by Standard & Poor's -- one category above junk, and the most common rating today -- paid an average of 1.1 percentage points over Libor on bank loans in the second quarter, according to Loan Pricing Corp., a unit of Reuters Group PLC. That's triple the premium they paid four years ago. (Libor, the London interbank offered rate, changes daily and closely tracks the U.S. federal-funds rate, now 1.75%.)

More Like Bonds

Traditionally, bank loans and lines of credit have differed from bonds in a number of ways, such as by carrying a floating interest rate, not a fixed one. Another difference is that a typical bank line of credit

lets the client borrow as much or as little as it wants up to a ceiling, and to repay early with little or no penalty. But beyond those basic differences, banks' increasing syndication of their loans is blurring some distinctions between loans and bonds. The banks now often split loans into pieces and sell chunks off, to such a degree that the bank may have only a small part, if any, left on its own books.

A majority of loans to leveraged companies now end up in the hands of institutional investors, market participants say. Among the investors are "prime loan funds," which offer a slightly higher yield than money-market funds. Other pieces go into loan pools called "collateralized debt obligations," in which insurance companies and other big investors buy stakes. Institutional investors hold about $99 billion in bank loans, according to Loan Pricing Corp. Banks still hold $1 trillion of business loans, including many to small businesses.

Bank loans and pieces of them now change hands in an increasingly active secondary market. Its daily turnover of about $500 million is puny next to the stock and bond markets but up 15-fold from a decade earlier, according to Credit Suisse First Boston. When a company sets out to borrow now, its lenders can see how this secondary market is valuing its old loans, and adjust terms of this new borrowing accordingly.

Initially, many companies weren't happy that banks were selling off their loans. "Today everyone accepts that if you want a noninvestment-grade loan, it's very similar to a bond deal," says Scott Page, co-manager of senior debt portfolios at Eaton Vance Management in Boston. "You're not doing a handshake deal on the golf course with a handful of banks. But ultimately you have a more reliable source of capital."

Banks increasingly arrange loans to suit the institutions that may end up holding the debt. In 1997, Chase Manhattan (now part of J.P. Morgan Chase) introduced "market flex," under which terms of a loan could be adjusted during the syndication process for new events or for how a borrower's bonds behaved.

Sometimes that helps a borrower: Last year, J.P. Morgan, Credit Suisse First Boston, Deutsche Bank and Merrill Lynch arranged a $575 million loan to Michigan auto-parts company Collins & Aikman Corp. The rate originally was to be 4.75 percentage points above Libor. The banks promised investors that if the yield on a bond being marketed at the same time was higher than expected, the rate on the bank loan would rise accordingly. Instead, the opposite happened, and the borrower got the loan at a spread of only 3.75 to 4 points.

In arranging loans, the commercial banks face increased competition from Wall Street. Verizon Wireless needed a complex loan last month to finance the purchase of a wireless business in the Southeast. It turned to Goldman Sachs Group Inc. Goldman pitched the $350 million loan to institutional investors. It enticed them by tying the interest rate to the existing bonds of Verizon Wireless, a joint venture of Verizon Communications Inc. and Vodafone Group PLC.

Telecom Decline

Eaton Vance, which holds $9 billion of bank loans in its institutional and mutual funds, was eager to participate. But investors' view of telecom companies continued to worsen. Eaton Vance remained interested, because the bad news in telecom sent the yields on Verizon Wireless' bonds soaring, and thus also the rate on the loan. It went to about 5.75 percentage points above Libor.

Ultimately, Verizon found that too high and decided to do the acquisition with its own cash. Yet the episode shows how even when an industry is under stress, there is usually some interest rate that will entice lenders.

The biggest, healthiest companies still find that bank loans are cheaper than the markets for their bonds or stocks would suggest. "Ten years ago, banks lent money to get the interest income. Today, banks look at the loan as ticket to admission to a relationship," says Dan Toscano, a debt-market executive at Deutsche Bank.

But even when lending to this top tier, banks are managing their business differently. After the 1990-91 recession, many banks vowed to avoid having too much money in a single company or sector. "You had banks taking on the order of $750 million in exposure to RJR Nabisco," says Mr. Toscano. "If RJR had gone under, a lot of important banks would have taken a massive hit."

Banks began scrutinizing their corporate-loan portfolios as they might a mutual fund. They looked for too much concentration in an industry or region and judged whether the income -- both from interest charges and fees for services or investment banking -- adequately compensated them for the risk of default. Software developed by Bankers Trust (now part of Deutsche Bank) and others helped compute the risk, based on factors ranging from the borrower's financial ratios to its stock price.

Some banks concluded the returns from business lending weren't worth the risks. "Large corporate [lending] is a tough business," Bank One Corp. Chief Executive Jamie Dimon said recently. "If you're not paid, you will lose." Bank One has slashed its total corporate-loan portfolio by 42% since the third quarter of 2000. When it does make a loan, the Chicago-based bank often buys insurance against default in the form of credit derivatives.

Banks have been stunned by the speed with which the reputations and financial vigor of some big, respected companies have deteriorated, and are moving to protect themselves. Banks have long provided backup lines of credit that companies could tap if they couldn't get access to the capital markets. These were seldom needed in the booming 1990s. But in the past year many companies, because of accounting concerns or stress in their industries, have been unable to issue securities and turned to their banks. Enron Corp., WorldCom Inc., Xerox Corp. and Qwest Communications International Inc. borrowed billions under existing lines of credit. Suddenly, banks were lending billions on terms negotiated when the companies seemed far safer.

A new credit line negotiated by Sprint Corp. shows how banks are making sure they are compensated when a company's fortunes change. It also shows how the credit-derivatives market influences borrowing even by top companies.

When Sprint set out this spring to renegotiate its credit lines, it sought $3 billion -- half for one year, the other half for three -- says Chris Donnelly, an analyst at S&P Portfolio Management Data. But the woes of Global Crossing, Qwest and WorldCom had frightened bankers. Sprint treasurer Gene Betts, while declining to specify how big a line of credit was sought or the final terms, says: "The banks said, 'We're not concerned about you, but when we go into a [lenders'] committee, they've seen these huge losses in telecom. People are obviously concerned about sector and event risk.' "

Sprint got a credit line for Libor plus 1.375 percentage points, according to Mr. Donnelly. But it had to agree to a series of other provisions to be triggered if something goes amiss, such as if Sprint's credit rating falls or it needs to extend the line for an added year. If all the penalties were triggered, the spread would soar to five percentage points above Libor, Mr. Donnelly says.

He says Sprint settled for a $1.5 billion credit line, half of what it had sought. For a larger line, it would have had to attract some Wall Street investment banks, and they would have insisted on a higher interest rate to cover the cost of hedging against a default.