


June 28, 2007

HEARD ON THE STREET

DOW JONES REPRINTS

 This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Order Reprints tool at the bottom of any article or visit: www.djreprints.com.

- [See a sample reprint in PDF format.](#)
- [Order a reprint of this article now.](#)

Banks on a Bridge Too Far?

As Risk Rises in LBOs, Investors Start to Balk; Warning From Overseas

By **ROBIN SIDEL, VALERIE BAUERLEIN and CARRICK MOLLENKAMP**

June 28, 2007; Page C1

The nation's largest financial institutions have spent the past year relying on robust capital markets to offset woes in their retail-banking operations. Now, that big revenue stream may be starting to dry up.

A sudden retrenchment in debt markets is likely to nip at profits at the big banks that have been financing the leveraged-buyout boom around the globe. The latest deal bonanza, in which private-equity firms buy public companies and load them up with debt, has created several new financing techniques that mint money for the banks, but can also leave them holding more risk.

A day after investors recoiled from a \$1.55 billion debt offering by U.S. Foodservice, Vancouver-based **Catalyst Paper** Corp. yesterday pulled a \$150 million bond offering that already had been cut from \$200 million.

Bankers said investors have grown wary of debt deals that offer few financial protections and yields that don't reflect potential risk.

IS CHANGE IN THE WIND?

- [Capital: Market's Shock Absorbers Have Improved Since 1987](#)¹
- [Investors Wonder When Buyout Spree Will Cool](#)²
- [Market's Jitters Stir Fears for Buyout Boom](#)³



For **J.P. Morgan Chase & Co., Citigroup Inc. and Bank of America Corp.**, the biggest players in the

leveraged-loan business, a slowdown in deal financings comes as they grapple with difficult issues. Among them: a tricky interest-rate environment that makes it less lucrative to make loans, a slowdown in mortgage and home-equity lending, and fierce competition to acquire deposits, even as banks are still struggling to assess the fallout from the turmoil in subprime housing.

Banks won't "lose money, but what will happen is that they won't make as much and earnings may decline," said Ganesh Rathnam, a banking analyst at Morningstar Inc. in Chicago.

As they have raced to finance leveraged buyouts, the banks have also steadily taken on more risk. Although much of it is typically parceled out to investors, the banks can be left holding the bag, as happened when investors balked at the U.S. Foodservice deal.

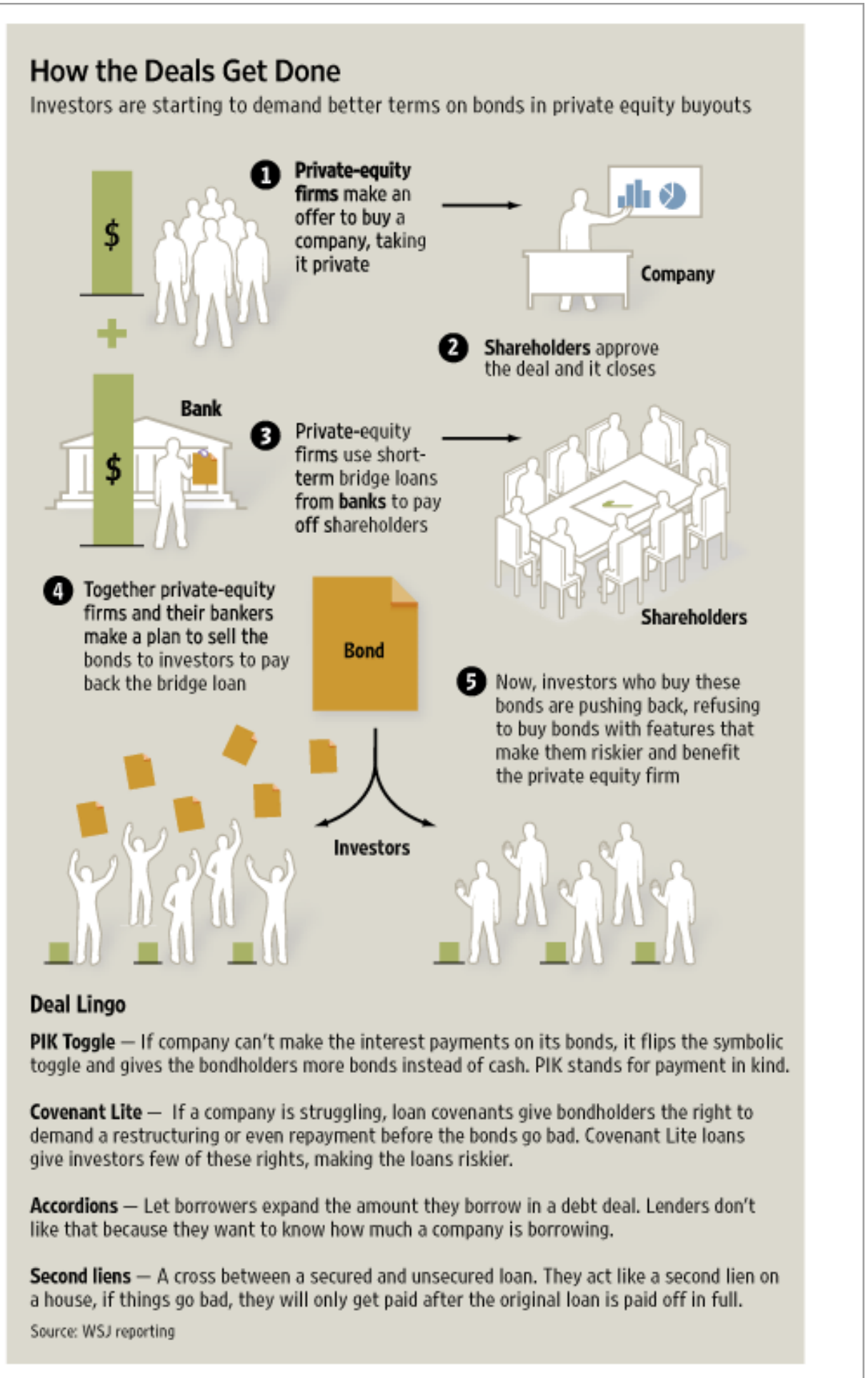
In the U.S., so-called covenant-lite deals accounted for about 26% of first-quarter deals versus 4.6% in European leveraged-loan issues. The pace began to sharply increase in Europe in March, according to Bank of America research. The "cov-lite" deals -- where a bank's covenant protections are weakened -- have been a result of the cheap financing, allowing borrowers to reduce financial covenants that typically require borrowers to meet financial hurdles on a quarterly basis, the report noted earlier this week.

In particular, regulators are expressing concern about "equity bridge loans" in which private-equity firms ask their banks to provide stop-gap financing for some deals. The loans, which carry high interest rates, last from three to 24 months and are repaid once the sale of below-investment-grade, or junk, bonds has occurred.

So far this year, banks have provided \$33.38 billion in bridge loans to leveraged-buyout deals, more than double last year's \$12.87 billion, according to Reuters Loan Pricing/DealScan. The volume is the highest since the LBO heyday 20 years ago, when \$48.14 billion in bridge loans was issued in 1988.

Of the banks, Citigroup, **Deutsche Bank** AG and J.P. Morgan have arranged the most bridge loans for leveraged-buyout deals this year.

Regulators expect to take another look at guidance they issued in 2001 on leveraged lending to see if it still fits. At the time, banks kept most leveraged loans on their balance sheets, and regulators thus expected them to consider the borrower's ability to repay principal, not just interest. Banks now typically distribute their loans to institutional investors, so regulators say they may need



to consider different criteria. It may be less important for a bank to consider the borrower's ability to amortize a loan, and more important to weigh the "reputational risk" that a loan it sold to investors goes bad, or "pipeline risk" -- when adverse financing conditions force it to keep a loan on its balance sheet rather than distributing it.

A report this month by the Bank for International Settlements said, "The fact that banks are now increasingly providing bridge equity, along with bridge loans, to support the still growing number of corporate mergers and acquisitions is not a good sign." It went on to say: "A closely related concern is the possibility that banks have, either intentionally or inadvertently, retained a significant degree of credit risk on their books."

Overseas Warning

The warning bell is also sounding overseas, where a report by the European Central Bank notes that while banks claim they used careful credit analysis, "it cannot be excluded that such pressures could encourage banks to compromise their due diligence and loosen their credit standards should rapid growth in the market continue."

The big banks typically don't provide details on revenue or fees derived just from the lucrative leveraged loans. Still, it is clear that the wave of financings has made a big contribution to the bottom line. Last year, for example, J.P. Morgan earned \$2.7 billion from all debt-underwriting fees, up 37% from 2005. By comparison, the bank generated \$1.2 billion in equity-underwriting fees and \$1.7 billion in merger-advisory fees. So far this year, J.P. Morgan is the top arranger of U.S. leveraged loans, according to Thomson Financial, putting together \$123.6 billion of deals in 234 transactions.

In recent weeks, some high-level bankers privately have started to condemn the practice of providing bridge loans, although most firms still find it difficult to turn down a lucrative deal from a client with deep pockets. And Kenneth D. Lewis, chairman and chief executive of Bank of America, has repeatedly said that the bank is starting to turn down deals and heed investor pushback on thin pricing and lack of protection.

So far, analysts say it appears the banks are well-capitalized to sop up their exposure. In most cases, they say, deals will get restructured on terms investors will swallow, significantly reducing the originating bank's risk.

Banks are already expected to start building reserves to cover potential bad loans. Ultimately, says Bear Stearns banking analyst David Hilder, a loan-market shake-up could be just what the banks need. "If [the current situation] actually results in tighter covenants or tougher underwriting or more equity in the loan structures, it could actually be good for the banks because it would diminish the likelihood of future loan losses," he said.


--Greg Ip contributed to this article.

Write to Robin Sidel at robin.sidel@wsj.com⁴, Valerie Bauerlein at valerie.bauerlein@wsj.com⁵ and Carrick Mollenkamp at carrick.mollenkamp@wsj.com⁶

June 28, 2007
CAPITAL

By DAVID WESSEL


DOW JONES REPRINTS

 This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Order Reprints tool at the bottom of any article or visit: www.djreprints.com.

- [See a sample reprint in PDF format.](#)
- [Order a reprint of this article now.](#)

If a Quake Hits Markets, At Least Shock Absorbers Have Improved Since 1987

June 28, 2007; Page A2

Wall Street wizards discover the world is riskier and more complex than they -- and their foolproof computer models -- recognize. Congress ponders tweaking the tax code to squeeze takeover kings. The U.S. trade deficit is widening, and the dollar is sinking. Inflation jitters are in the air.

It's October 1987, just before the stock-market crash.

CAPITAL EXCHANGE FORUM

[Do you think the continued growth of the economy is at risk?](#) ¹



This isn't a prediction that the crash of 2007 is at hand. (It might be. I just don't believe anyone can predict such events.) It's a reason to ask if events in Washington, on Wall Street and in global financial markets are tremors that signal a shifting of the tectonic plates that underlie the economy.

For the past several years, global markets have been kind to the economy, and the global economy has enjoyed a great run. Interest rates and inflation have been low. Credit has been readily available; even near-deadbeats have been able to borrow cheaply. Wall Street has come up with ever-more-complicated ways to make bets, leverage them and hedge them in ways that diffuse risk far more widely than ever before. It has profited handsomely from doing so.

Today, there are signs that the era of placid markets and cheap money may be coming to an end. Inflation pressures are emerging as the global economy strains to supply growing demand from India and China. Gone is the talk of China exporting deflation. Central banks are pushing up short-term interest rates, and

bond markets are pushing up long-term rates. Falling U.S. home prices are ending the frenzy of lending to subprime borrowers.

More broadly, it looks like lenders aren't going to be quite so generous with the terms they offer in making risky loans, whether to home buyers or companies.

Now, **Bear Stearns** has discovered that financial innovation has moved faster than its high-paid employees' ability to understand what's going on -- and someone is going to lose a lot of money as a result.

There is an aura of inevitability to this. Twenty years ago, it was portfolio insurance and index arbitrage. Nine years ago, it was the hubris of Long-Term Capital Management, the big, leveraged fund that thought it was smarter than everyone else. Today's financial instruments are so opaque that almost no one can be certain how risky they are.

"It's not hard to argue that our understanding of economic processes may even be less today than it was in the past," says the Bank for International Settlements -- the central bank for central bankers -- in a thoughtful essay in its just-published annual report.

"On the real side of the economy, a combination of technological progress and globalization has revolutionized production. On the financial side, new players, new instruments and new attitudes have proven equally revolutionary," adds the BIS. "There seems to be a natural tendency in markets for past successes to lead to more risk-taking, more leverage, more funding, higher prices, more collateral and, in turn, more risk-taking."

"The danger with such...market processes is that they can, indeed must, eventually go into reverse if the fundamentals have been overpriced," the BIS continues, its worries beginning to show.

"Should liquidity dry up and correlations among asset prices rise" (That's central-banker-speak for: too many investors trying to sell all sorts of things at the same time.) "the concern would be that prices might also overshoot on the downside." (That's central-banker-speak for "crash.") "Such cycles have been seen many times in the past," it adds. (That's central-banker-speak for "We told you so.")

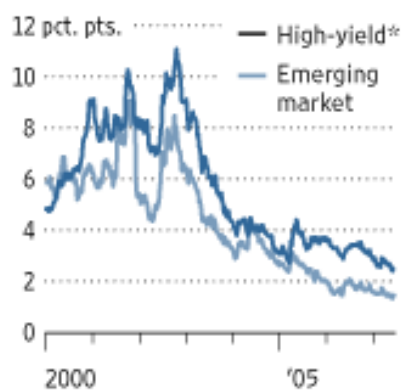
Inflection Point?

Yields on long-term Treasuries have begun to rise from unusually low levels, but spreads between Treasuries and riskier debt remain small by historic standards.

Yield on the 10-year Treasury note



Spread over Treasuries



*Based on Merrill Lynch High Yield Master II Index

Source: Treasury Department (yield); Merrill Lynch (spread)

Now maybe these are just tremors. Maybe the woes that recently brought two Bear Stearns hedge funds to the brink of a meltdown will shake Wall Street out of its complacency. Maybe the inflation scare fades. Maybe the markets are a little bumpy, but there's no confidence-rattling crash. Maybe Congress tweaks the tax code enough to raise some revenue and let off populist steam without

overdoing it.

But what happens if it's more than that, if these tremors turn out to presage an earthquake? Obviously, that will hurt those who lose money. But what about the rest of us?

Part of the answer lies in the strength of the financial system's shock absorbers, which have improved since 1987, the 1997 Asian financial crisis, the 1998 Long-Term Capital mess and Sept. 11 attacks. Hedge fund Amaranth Advisors collapsed without many side effects. It looks like the same may go for the two Bear Stearns funds, whatever their fate.

Recent history is encouraging. The 1987 stock-market crash, as frightening as it was, didn't tank the U.S. economy. Neither did the horror of the Sept. 11 attacks. The economy gulped and then rebounded. That isn't any guarantee that the next crash or crisis, and there will be one someday, will have similarly passing effects on the impressively resilient U.S. economy. But it is encouraging.

Mr. Wessel responds to reader comments at WSJ.com/CapitalExchange². Or email him at capital@wsj.com³.

URL for this article: <http://online.wsj.com/article/SB118298231245450684.html>

Hyperlinks in this Article: (1) <http://forums.wsj.com/viewtopic.php?t=595> (2) <http://www.WSJ.com/CapitalExchange> (3) <mailto:capital@wsj.com>

Copyright 2007 Dow Jones & Company, Inc. All Rights Reserved

This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our [Subscriber Agreement](#) and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit www.djreprints.com.