

'The credit crisis: How this happened'

by **Canadian Business Senior Writer Jeff Sanford**

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It was late July, and Adam Breslin, a partner at Penfund, an independent merchant bank based in Toronto, noticed fewer people than usual were on vacation. Financial types usually decamp from Bay Street's sweaty canyons for the cool woods of Muskoka by then — not this year. For Breslin, bankers running hard to get deals done provided evidence of one thing: the peak in the Great Liquidity Event of the Century had arrived.

It was high time. John Bradlow, another partner at Penfund, expresses incredulity at the levels of leverage and excess that had developed in the credit markets. "It's amazing. We've never seen anything like this. It's looser than I've seen in either '98 or '88." The evidence? Companies leveraged up to seven times EBITDA. Covenants on private equity deals that became ever lighter. The appearance of toggle bonds — which let a company pay interest by issuing more debt instead of parting with cash. The dénouement had to be near.

Sure enough, it arrived two weeks after Breslin's observation. The S&P/TSX composite dropped 500 points in a morning. In the States, Mad Money guru Jim Cramer descended into inanity on CNBC. And U.S. Federal Reserve chairman Ben Bernanke dropped more money on markets than Alan Greenspan did after 9/11.

The beginning of the end actually occurred late last year, when U.S. mortgage originators that had been writing so-called sub-prime loans began going under in large number. Then, in January here at home, Toronto-based Dominion Bond Rating Service announced it would tighten requirements for assigning ratings to controversial non-bank asset-backed commercial paper conduits, which often held sub-prime mortgages. But the big fun kicked off in July when a German bank, IKB, announced it wasn't able to roll over the short-term paper in one such conduit. The sell-off of August 2007 began.

How did it get to this point? Over the past decade, a slew of mortgage loan originators with names like Homeside Lending and Plaza Home Mortgage wrote some US\$100 billion to US\$200 billion in subprime loans and packaged them (along with all kinds of credit-card debt, car loans and standard mortgages) into collateralized debt obligations, or CDOs. These structured products are bundles of loans from banks, sliced into various new securities that receive various credit ratings.

This isn't bad, in itself. Securitization does have benefits in terms of risk diversification. But many CDOs came to be held in highly leveraged vehicles and, in some cases, offered investors access to high-yield return through the issuance of so-called asset-backed commercial paper (ABCP). One Canadian example, Coventree Inc. (TSX: COF), at one point offered \$1,000 of long-term, high-yield debt exposure for just \$100. By investing in these conduits, you could squeeze out an extra five to 10 basis points of return over similarly rated traditional commercial paper. So why not do it? For investors looking for income in a low-rate environment, it was a deal.

When the sub-prime credits (humans) began to default in large numbers, the buyers who had been funding the conduits by purchasing the short ABCP (to harvest the yield of long-term CDO debt) stopped buzzing around. The demand for commercial paper dropped sharply, and some of the conduits began to fall apart as the market seized up. The stock of Coventree, a company that could be described as a wall of CDO income on one side and a wall of ABCP debt on the other (it was basically arbitraging the difference between long- and short-term interest rates), fell by more than 80%, from over \$16 to \$2.42.

Some conduits cancelled redemptions and an array of companies put up their hands to announce they had money in non-bank ABCP — among them, uranium giant Cameco Corp. (TSX: CCO) and charter airline Transat A.T. Inc. (TSX: TRZ.B), along with a spate of junior miners. “Every time you chase a little bit of extra yield, it comes back to bite you,” says Todd Opalick, the consultant to a miner named Everton Resources Inc. (TSXV: EVR). His company put out a release to reassure investors it wasn’t holding any of the hot potatoes. “We just wanted to reassure investors their money was okay,” says Opalick. “Short-term money from the treasury is supposed to be sacred, safe and secure.”

So where are we today? If you’re not heavily leveraged or caught in a conduit, you should be okay if you want to borrow money. Safe credits should still be able to access funds, says Breslin. “I’m not sure I’d go so far as to say that safe credits will find it easier in the coming months,” he adds. “What I would say is that strong companies with debt loads that they can fully service without relying on exotic toggle features still have terrific access to capital.”

What do seem to be over are the massive deals that require billions in leveraged dollars to get done. “The mid-market seems to be okay — we don’t expect to see a noticeable change there,” says Rick Nathan, a managing director at Kensington Capital Partners and president of the Venture Capital and Private Equity Association. “The impact seems to be on the massive mega-deals.”

As for equity markets: there is still a lot of sub-prime exposure yet to surface, and that’s making markets extremely touchy.

The Thursday night of Meltdown Week, one successful hedge fund manager suggested investors were wondering what else still lay in wait. “E*Trade, the online discount broker, announced it was holding \$5 billion in sub-prime debt,” he noted. “That surprised a lot of people. Why would they be holding that? What other surprises are out there? That seems to be the question occupying investors.” “The market is very event-driven right now,” says Ed Devlin, a Canadian bond portfolio manager with U.S. bond fund PIMCO. “Any day we can wake up and find another situation.”

One place to expect writedowns is the hedge fund sector. “If I had to bet, I’d say look there,” says Bradlow. When the defaults at the individual level filter up to the institutional, there could be large consolidation coming to hedge funds. “The bloom is definitely off the rose on the hedge fund world,” says Bradlow. Some observers in the States are suggesting 4,000 of America’s 9,000 or so hedge funds could eventually go under. Breslin didn’t put a number on it, but he suggested blowups will become a common in the months ahead, perhaps picking up pace after Sept. 30, a key redemption date for money held in hedge funds. “You’re going to see disaster after disaster,” he adds.

“Anyone who suggests this is going to be done by Labour Day is missing the point. It’s just started.”

The finger-pointing has already begun. Many blame the hedge funds for taking huge risks; some might argue that the banks, who were contracted in some cases to step in and provide liquidity in the case of a “significant” market event, shirked their responsibility. Some will point to the bond raters. (DBRS was the only Canadian agency to rate non-bank ABCP conduits.) “Their reps are badly damaged,” says Devlin. “This is not the end of the rating agencies, but their role will be diminished.” To be clear, Devlin has less sympathy for investors who relied on raters rather than doing their homework. “People look to the rates for insight, but that’s only one piece of data. You still have to do your own analysis. Let’s hope lessons have been learned.”

If there is a lesson here, it may be this: Don’t invest in loan securities that have been handed off from the person who originated the loan. Banks used to hold on to the loans they originated; today, debt is sold out the back door to other institutions. Debt origination and ownership are split.

That allowed risk to be spread beyond the lender, but the new problem is that the motivation of the person originating the loan changes. If the originator isn’t the owner, the motivation is no longer to make sure the loan is good but rather to write as many loans and collect as many origination fees as possible. Long-term performance? Who cares? Grab the fee and get out. Throw in a dash of herd behaviour among institutions, all of which compete to keep up with the other guy over the short term, and soon you have everyone trying to originate (and then sell off) more loans than the next guy. Set the cycle to repeat, and watch a credit bubble develop.

And then watch it go pop.