

## **Lack of Trust in the Credit Crunch**

One of the seemingly instinctive defence mechanisms of leveraged companies caught up in the credit crunch is to keep their heads down, hoping it will go away. Hear no evil, see no evil, speak no evil. This ostrich like behavior was epitomised by Alan Schwartz, CEO of Bear Stearns, when he publicly denied Bear faced a liquidity squeeze just days before it required an emergency line of credit from the US Federal Reserve and was then sold to JP Morgan at \$2 per share.

The way in which credit risk has been created and spread internationally, through mortgage and other asset backed securitisation, has facilitated this behavior and has created the credit crunch by making it difficult to identify who missed out on a seat when the music stopped in the securitization markets.

The current substantive problems in financial markets of illiquidity and increased spreads stem primarily from institutions that have exposure to mortgage backed securities.

Total losses on these securities have recently been estimated at about US\$400 billion. The overall decline in lending following these losses has been estimated at about US\$2 trillion in intermediary balance sheets, of which roughly US\$900 billion represents a decline in lending to households, businesses and other non-leveraged entities. To put this in perspective, total US equity holdings (including foreign stocks) as of 2007 Q3 stood at \$22.7 trillion.

Despite the US Federal Reserve cutting its target rate from 5.25% in August 07 to 2.25% last week, where corporate borrowers can still access loan finance, they are paying between 1% and 5% more than in early 2007 when securitized financing was available.

Add to this the downward pressure on prices in the physical markets, particularly property markets, caused by the diminished finance available to maintain upward price pressures and you have many distressed businesses unable to maintain pre credit crunch earnings, even if they can refinance short term debt.

Companies like Centro, Allco and MFS all entered the credit crunch with opaque leveraged structures, reliant on cheap, short term debt to sustain liquidity and margins.

Here lies the problem we need to solve; the problem far greater than the companies caught without a chair when the music stopped. The real problem is a lack of trust. Cash has become King, not because the world's economies are not growing, but because lenders and investors don't know who to trust. The contagion throughout debt markets from the sub prime fiasco in the US in its depth and duration is about uncertainty more than risk. The uncertainty as to the liquidity issues confronting companies is fueled by the ostriches such as Bear Stearns. With every desperate deception and failure to disclose the truth, mistrust grows.

Prompt and complete disclosure in our markets is needed before volatility will subside and appropriate allocation of capital to deserving businesses returns.

Our markets need leadership to reinstate this confidence. Full and frank disclosure is required from our major corporations concerning their liquidity, yield, finance costs and exposure to derivatives. This disclosure is essential in order to limit the cause of the credit crunch's depth and duration to substantive risks rather than uncertainty resulting from misinformation and non disclosure. A good first step would be for our Australian banks to disclose the marked to market positions on their derivative investments. Whilst Accounting Standards, Corporation Act disclosure obligations, ASX, APRA and ASIC may not require this, based on the often illusory distinction between illiquidity and impairment, it would be along a path that will bring this credit crunch to an end sooner rather than later. Disclosure by market participants concerning information material to the allocation of capital must be made, and be required to be made, in order to get the music started again.

**John Walker**  
**Managing Director**  
**IMF (Australia) Ltd**