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EDITORIAL

The Credit Crunch: What's the Depth of the Bite?

Fabrice Desnos, Chief Executive, Euler Hermes, London, UK

You would have to have spent most of the last eight months in an igloo to have missed the words 'credit crunch'. The media has been full of news and comment about it and probably not a day goes by without the subject hitting the front pages of the news, with the Northern Rock story making it particularly dramatic and visible for the vast majority. Looking at the queues in front of the bank's branches, you didn't need to hold a PhD in economics to realise that something really wrong and really serious was happening, and everything that had to do with 'credit' suddenly became tainted with suspicion.

There has been a great deal said about the root causes of the crisis: about the banks attitude to credit risk, the greed of their managers and short-termism of the markets. But, once the dust settles on the collective hysteria of the first days of the crisis, it's probably useful to analyse its consequences on the real economy and in particular on corporate credit risk in general.

The crisis initially began in the summer of last year with what, at that time, was very much 'only' an inter-bank crisis; pockets of credit risk – notably related to the American sub prime mortgage markets – were reprised, and certainly they needed correction. When I say 'only', it is not to minimise the extent of what has been in fact a shock of unprecedented magnitude over the world's financial systems, but to state that – in its initial phase – this crisis had little or no consequence outside the banking industry.

In our position of actively insuring more than EUR 800 billion of business-to-business credit transactions worldwide each year, we were able to take an early view on what was happening. Whilst it was clear that the crisis might indeed have implications for the health of the economy and the corporate sector in the longer run, any such implications would be a secondary consequence of the crunch. Indeed, during most of the second half of last year, in their bid to restore market confidence, all of the banks have made a point of continuing to provide financing facilities to their corporate customers, and, although they were becoming undoubtedly more expensive, there were no obvious refinancing programmes that looked likely to stall.

A self-inflicted wound

Historically, a credit crunch can be typically linked to a central bank or government decision to reduce availability in the market, resulting in a squeeze. The principal difference this time is that the crisis was very much of the bank's own making – a self-inflicted wound. But what was initially only a financial crisis, is currently turning into an economic crisis.

Obviously, no two 'economic slowdowns' are ever identical. Certainly they stem from the same factors – credit, availability and cost – but what prompts these issues is never the same. However, what we have learnt in the past that, whether the slowdown is the result of a financial markets crisis, or any number of factors, its impact on the 'real economy' and in particular the way it spreads in terms of corporate risk stays predominantly the same.

We are now observing the consequences of an economic slowdown in terms of increased difficulties within the corporate environment that is not in itself untypical. Companies are doing what companies do in such situations when availability is tight. And I believe we are now, after six months of the current crisis, arguably at a tipping point, where reduced liquidity in the banking sector is filtering into the business community.

The economic indicators

Over 80% of all business-to-business transactions are conducted on credit terms and trade creditors are increasingly being used as a source of finance as banks tighten their lending. A reduction in bank credit means that businesses begin to extend their supplier terms. This leads to increased risk of payment defaults and ultimately business insolvencies increasing in the coming months.

The actual and forecast figures in a recent (December 2007) survey made by Euler Hermes suggest just this pattern of activity. For example, the pace of increase in payment delays from UK customers has returned to a level close to Q1's five-and-a-half year high – blamed on deteriorating cash flow and greater uncertainty amongst domestic clients. Firms in the construction sector recorded the sharpest rise in payment delays from

UK customers, and this was one factor that was reported to have depressed their growth of cash flow in Q3.

This fear over liquidity has led UK firms to downgrade their forecasts for cash flow growth to just 0.5% for the coming 12 months – the lowest in the survey history. If realised, this would mean a contraction in cash flow in real terms in 2008, and have serious negative implications for business investment and planning. Not surprisingly, the service sector expects to be worst affected, with firms forecasting an outright decline in their free cash flow of –2.5% over the coming year. And with LIBOR interbank rates remaining stubbornly higher than the base rate, further rate cuts by the Bank of England early in 2008 will be needed to help boost liquidity.

But one thing that is certain in a slowdown is that the number of insolvencies will rise. There is a direct correlation between GDP growth and levels of corporate insolvencies. In the UK alone, our research forecasts an 8-10% increase in insolvencies in 2008. Overtime, far from hitting only the banking sector, the 'credit crunch' will impact all sectors, but especially those in the consumer areas involving non-mandatory (i.e. discretionary) spend. The higher-leveraged businesses will struggle as access to refinancing becomes an issue. Companies evolving with low margins in sectors like non food retail or printing will find this year particularly challenging. Quebecor, one of the world largest printing companies with 28,000 employees worldwide, filed for Chapter 11 protection on 23 January for failing to refinance its debts in what appears to be an indirect, but very tangible, consequence of the credit crunch.

Rebalancing world wealth

But the world growth is still there, with most economists still forecasting +3% worldwide growth in 2008. In the UK, after five years of consecutive growth, balance sheets are globally in very good shape. Demand from developing countries, in particular from the Middle East, Asia and China is still strong, which, compounded with the weakness of the pound – relative to the euro and the US dollar – will help support UK exports. It is not pure chance that it happens to be these same countries who are coming to the rescue of our wounded banks by subscribing to the rights issue and allowing them to restore their balance sheets.

What will be the depth of the bite? It is still difficult to answer with certainty as we are only really observing the first consequences of the shock on the real economy. Our models tell us it should be pretty serious. To what extent emerging countries will help re-balance a failing US economy might be part of the answer.

Learning the lessons

But the last few months have already taught us many lessons if we are prepared to learn. More recent events, especially the EUR 5 billion loss reported by Société Générale as a result of fraud by one individual trader has shown us the alarming fragility of even the most robust of businesses. Few would have thought a business like Enron could have collapsed in a matter of weeks. Fewer still would have thought Société Générale could be at serious risk from a single employee. The lesson is that even the biggest, most reputable firms are not immune to such things and that what appears at a moment as a near certainty might actually represent your gravest risk. Another lesson is also that managing credit risk is something best left to experts and, of course, that insuring those risks is something that should be at the heart of any risk management strategy.

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International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

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