www.nytimes.com
The New York Times ON THE WEB

July 21, 2002

A Torrent of Loans Becomes a Trickle

By RIVA D. ATLAS

Last year, as consumer spending slowed and demand sank for casual clothes, Cone Mills, the nation's largest denim maker, was one of the lucky ones. While several competitors sought the protection of Chapter 11, Cone cut costs, and in March it recorded its best quarter since 1998.

Now, trying to meet demand and pick up business from its struggling rivals, Cone wants to build a plant in Mexico. But the company can't borrow the money. Standard & Poor's recently lowered its debt rating to CCC+, too risky for banks. The Bank of America, Cone's lead lender, told analysts last fall that the ailing textile business was one of many industries it would avoid.

Cone is hardly the only business feeling the pinch. For the last 17 months, banks have been cutting back on corporate lending, shunning companies in problem industries like energy, textiles, steel and telecommunications, and charging higher interest rates and bigger upfront fees on most other loans, even to top-rated companies in healthy industries.

"I don't think it will reverse the recovery, but it could slow it," said Peter L. Bernstein, an economic consultant to institutional investors. "Up until now, businesses have been liquidating inventory so banks have been less important. But inventory liquidation will soon start to go the other way."

Already owed billions of dollars by companies that have filed for bankruptcy, and by companies near the brink, the nation's banks are nervous. Since the start of 2000, Moody's Investors Service has downgraded the bonds of 126 companies to junk status. More bad news came last month, when WorldCom said that it had improperly accounted for $3.8 billion in expenses just weeks after it had borrowed $2.6 billion from its banks.

"WorldCom is only the latest and the largest fallen angel, and it may be the straw that breaks the camel's back," said Peter Gleysteen, a consultant to banks and once a top credit

officer at J. P. Morgan Chase. "Banks are now concluding that the level of risk is higher than they anticipated."

Nine days ago, in a highly aggressive move, 25 of WorldCom's lenders went to court to try to stop the company from using the cash. Last week, they reached a settlement with WorldCom that restricted its use of the money. But the banks' attempt to freeze the funds shows just how afraid they are of losing their money.

That skittishness does not bode well. The recession — which appears to have ended in the first quarter — might have been mild, but the decline in lending to corporations looks much steeper than the one experienced by corporations during the last recession in the early 1990's, said John Lonski, chief economist at Moody's. As of June, banks had $1 trillion in outstanding commercial and industrial loans, according to Federal Reserve data, down 8.1 percent from the peak in February 2001. That is nearly as steep as the decline in the early 1990's, although the current credit drought has been under way for less than half the time.

"It's highly unlikely that business lending will pick up any time soon," Mr. Lonski said.

If he is right, the recovery would undoubtedly remain sluggish, despite 11 rate cuts by the Federal Reserve. Credit is the lifeblood of capital spending, which has languished since early 2001. Without loans, companies — currently focused on conserving their cash — cannot finance expansion or mergers. And some businesses, starved for money, simply will not survive.

In fact, some investors think that Alan Greenspan, the Fed chairman, should actively encourage banks to lend to companies.

"It is time for Mr. Greenspan to order banks to expand their `liquidity' lending and cease contracting it," said Paul McCulley, who oversees a group that handles more than $100 billion in commercial paper and other short-term debt investments at the Pacific Investment Management Company, in a recent commentary.

But banks face a conundrum. They would never leave the corporate lending business entirely, since it still accounts for a hefty piece of their profits. But banks with the strongest earnings and most buoyant stock prices are those that have redirected their assets, emphasizing loans to consumers and shrinking their corporate loan portfolios.

Last week's headlines told the story. " Citigroup, J. P. Morgan Profits Rise as Income from Consumer Lending Surges," one report from Bloomberg News said.

Shares of Citigroup, which has large consumer bank operations, rose 73 cents on Wednesday, when it reported earnings. But J. P. Morgan Chase fell 36 cents, despite that increase in consumer lending, because its earnings still depend more on corporate loans and investment banking than Citigroup's.

The three largest corporate lenders — J. P. Morgan, Bank of America and Citigroup, in that order — have all sharply reduced the amount of loans on their books. "We are being cautious," Sanford I. Weill, the chief executive of Citigroup, said in an interview last week about the bank's corporate lending business.

Banks have been writing off more loans, too. At the end of 2001, write-offs of bad corporate loans for the 100 largest banks hit a peak of 2.41 percent of outstanding loans, or around $5 billion, according to Federal Reserve data, nearly four times the percentage just two years earlier. J. P. Morgan alone took $807 million in write-offs in the fourth quarter of 2001, related to loan and trading losses tied to Enron and Argentina.

J. P. Morgan, whose large loans to companies like Enron and Global Crossing have brought plenty of unfavorable publicity, has been scaling back the amount of loans it holds on its books. "We continue to support our best clients, but we are seeking to increase our return on the money we lend," said Donald McCree, the head of global credit management at J. P. Morgan Chase. "We are focused on how we can mitigate our risk."

J. P. Morgan, like other large banks, is lending to only a select group of companies. "It's a case of haves and have-nots," said Meredith Coffey, head of research at the Loan Pricing Corporation, which tracks the corporate lending market. "If you have a high credit rating and are in an industry people like, you can still get deals done."

Companies that are getting financing are paying the price, literally. To minimize losses, banks have raised the interest rates on corporate loans. Since 1998, the rate to companies whose debt is rated BBB has risen, on average, to 1.10 percentage points above the benchmark London Interbank Offered Rate, or Libor, from 0.34 percentage points above Libor.

Even the best companies are paying slightly more: companies with A-rated debt are now paying 0.35 percentage points above Libor, up from 0.20 points in 1998.

Banks are also tightening conditions under which companies can borrow money. In loan covenants, some borrowers have had to promise to restrict certain investments, for example, or to maintain certain levels of cash flow to cover interest costs. Banks are trying to hedge their risks in the event of a bankruptcy by buying credit default insurance, an increasingly popular derivative contract. They are also proving quicker to sell loans at a loss, often to funds specializing in debt of troubled companies.

Besides taking heavy losses on some recent loans, the banks that arrange jumbo corporate loans have another reason to pull back. They usually lower their exposure to a big borrower by lining up a group of smaller banks to take part in a syndicate for a large loan. But after a decade of bank mergers, there are far fewer banks to participate in lending syndicates.

More recently, smaller banks, suffering losses from bankrupt borrowers, have scaled back their participation in syndications for business reasons. Because of their passive role in the financings, these banks have little to gain in ancillary business — like underwriting or merger advisory work. Banks that arrange the loans often receive such added business as a reward for their services.

"In most cases, the returns in large corporate lending are no longer sufficient to justify the risk," said James E. Rohr, chief executive of PNC Financial Services, the nation's 17th-largest bank, which is based in Pittsburgh.

Mr. Rohr cites the bank's experience with Armstrong World Industries, which filed for bankruptcy in December 2000. PNC had only $16.5 million of a $450 million loan to the

company, but the value of that debt fell from near 100 cents on the dollar to just over 50 cents in the weeks preceding the bankruptcy filing.

Instead of joining syndicates, PNC is now focusing on small loans to companies near its branches in Pennsylvania and five other states, Mr. Rohr said.

Some foreign banks — traditionally syndicate stalwarts — have also pulled back, said Steven Miller, managing director at Standard & Poor's PMD, which tracks the loan market.

"In the late 1980's, you would see a single Japanese bank put up $500 million to finance a leveraged buyout," he said. "Today, the entire global banking system won't do much more than what one Japanese bank was willing to do then."

Some lenders who have left the business have been replaced over the last decade by institutional investors, including mutual funds. But they tend to invest in below-investment-grade loans in hopes of a big win, Mr. Miller said.

Investment banks, like Merrill Lynch, Morgan Stanley and Goldman, Sachs, are also relatively new to the lending business, but they are proving very particular about the loans they extend, typically catering to their investment banking clients.

With banks so reluctant to lend, many companies, particularly ones in out-of-favor industries, are having to make do with less. Sprint, which is hoping to capitalize on the troubles of its beleaguered competitor, WorldCom, has been trying in the last few weeks to raise $3 billion from banks. But after the company was downgraded last month by Standard & Poor's and Moody's, it will be lucky to get $2 billion, according to executives in the loan market. A spokesman for Sprint declined to comment on the terms of the loan, which is still being negotiated.

Other companies that have had trouble raising money include the Williams Companies, which is aiming to raise $1.2 billion from its banks, $600 million less than what it had originally sought, according to the Loan Pricing Corporation. A spokeswoman for Williams said the company had reduced its liquidity needs. One competitor, Dynegy, in April raised $300 million less than the $1.2 billion it had hoped to borrow. Both are currently being investigated by federal agencies for their trading activities.

Some companies, of course, are getting a warmer reception from lenders.

GE Capital, a division of General Electric, recently sought a $15 billion line of credit as a backup to its short-term commercial paper loans. Banks have become increasingly reluctant to provide these sorts of credit lines, for which they profit very little, but G.E., with its credit rating of A, was able to raise $3 billion more than it anticipated, Ms. Coffey said.

More surprisingly, AOL Time Warner, which announced a management shake-up last week and whose shares have fallen 64 percent this year after a slump in its Internet business, raised $10 billion this month and turned away an additional $2 billion that banks sought to lend.

But there's an explanation: The banks were eager to curry favor with AOL, which often

looks to them for other services, including advisory work and stock and bond underwritings, bankers who participated in the financing said.

"There's a lot that banks can do for this company," said an executive at one bank who declined to speak for attribution. He said several investment banks — including Merrill, Morgan Stanley and Lehman Brothers — all bought pieces of the loan. These firms, who participate in relatively few financings, clearly wanted to stay on AOL's good side.

Still, some banks are clearly nervous about the AOL loan, based on the prices being quoted for credit default insurance, or a form of derivative contract that allows banks to protect their principal in the event of a loan default. This "insurance," available from some banks and from insurance companies, requires a company to pay an annual fee in return for the guarantee. In this case, some banks are agreeing to pay more than the AOL loan is yielding in return for the protection against losses, traders said. But the banks may be willing to give up their returns to strengthen the relationship with the company. Some investment banks may have been selling their portions of the loan soon after it was completed, said Lucine A. Kirchhoff, managing director for syndicated finance research at Banc of America Securities.

Banks have also been much more aggressive at trading loans in the secondary market, selling what they own of loans to troubled companies well before the businesses land in bankruptcy. "We try to anticipate problems," said Mr. McCree of J. P. Morgan.

To lower bad-loan exposure further, some banks in the last two years have encouraged corporate clients to raise money in the bond market instead. Last year, for example, Citigroup and J. P. Morgan raised $12 billion that way for WorldCom, which then seemed to be booming.

A year later, those bonds are trading at 13 cents on the dollar, and bond investors are a little more skeptical about assuming risks that the lenders are loath to take. "If banks disappear from the scene, they can't expect bondholders or stockholders to fill the gap," said William Gross, who manages the $58 billion Pimco Total Return mutual fund, the largest bond fund in the world.

Bonds, meanwhile, are increasingly being downgraded by the ratings agencies based on concerns over whether loans for a corporation will be renewed.

"We have had a significant number of downgrades tied to the ability of lower-rated companies to get access to capital," said Mr. Lonski of Moody's.

With Cone Mills, for example, S.& P. downgraded the company purely on refinancing concerns, said Susan Ding, an analyst at the rating agency. "Were it not for the financing issue we would not have lowered them," she said.

Bank lending tends to lag behind a corporate recovery, so it is not surprising that even now that the recovery appears to have begun, banks are still reluctant to lend, said Mr. Bernstein, the consultant. After the last recession at the beginning of the 1990's, it took several years for lending to rebound. It wasn't until 1994 that outstanding corporate loans started to grow again, according to Federal Reserve data.

But this time, in the wake of the many corporate scandals, it may take a bit more time for banks to feel comfortable again. "Bank lending is simply a matter of trust," Mr. Bernstein said. "If trust is shaken it will have an effect."

Copyright 2002 The New York Times Company | Permissions | Privacy Policy