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The effect on financial firms

Holiday horrors

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There are losers, but some winners too

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“I KEEP thinking how nice it would be to turn off my computer and not come back until September,” says the head of leveraged-lending at a large bank. As the spasms in the credit markets claim more casualties, and unsold bonds and loans for funding leveraged buyouts pile up, wails of pain are echoing across Wall Street and beyond. But they are interrupted by the occasional hoot of pleasure.

Start with the victims. For private-equity firms new deals are suddenly harder to do and existing ones costlier to refinance. Their mega-funds may struggle to deploy their estimated $300 billion-500 billion of financial muscle. This could scupper Kohlberg Kravis Roberts's hopes of following Blackstone to the stockmarket. KKR looks particularly vulnerable because it is less diversified than its arch-rival in the leveraged-buyout business.

As credit for buyouts dries up, the biggest losers are the banks left holding “hung bridges”. These are loans to buyers that were supposed to be temporary and for which the banks charged fees. As the price of the loans falls in the secondary market—to below 85% of their value in some cases—a number of banks could face big losses. To add to their woes, private-equity clients are also more likely to tap undrawn loan facilities which were negotiated some time ago on more favourable terms.

Some of these risks can be hedged in the derivatives markets. But with a backlog of more than $300 billion, banks may end up selling loans at a discount to make room on their books for new commitments. According to the head of a hedge fund that does a lot of business with large banks, their lending desks are now being stripped of risk-management responsibilities by livid chief executives.

One boss who is probably more embarrassed than angry is Citigroup's Chuck Prince. His recent comment that the bank was “still dancing” in the loan markets has quickly returned to haunt him. Citi is the most exposed of all banks, having “tried to buy the market at the worst of times”, as one competitor puts it. It was the lead arranger on $25 billion of the roughly $40 billion of bonds and loans withdrawn in recent weeks. Things may get worse: Citi is involved in financing some giant buyouts still to come to the market, such as TXU, a Texas energy-utility, and First Data, which processes credit cards.

Citi should be able to take the losses in its stride, given its enormous balance sheet and low cost of funds (thanks to cheap deposit funding). But most investment banks do not have the luxury of also being a big universal bank. No longer happy to act mainly as middlemen, many have wanted a slice of the action themselves. Wall Street's five big investment banks—Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers and Bear Stearns—have piled into potentially illiquid (and thus risky) assets, from bridge loans to collateralised-debt obligations (pools of tranched debt), over the past three years. Their lending commitments rose from around $50 billion in 2002 to over $180 billion in 2006, according to Moody's, a credit-rating agency. In Merrill Lynch's case, these commitments far exceed the bank's capital base—although they also include safe loans to blue-chip companies.

Buying shares of an investment bank today is “more of a religious experience—one based on faith—than an investment”, says Dick Bove, of Punk Ziegel, an investment bank. Bear Stearns's shareholders have had their faith severely tested. Two of the bank's hedge funds have imploded and a third has stopped investors from withdrawing funds. Even more vulnerable are stand-alone hedge funds that borrow heavily to dabble in debt. As easy financing evaporates, investors want their money back and the prime-brokerage units of banks that lend

to them want more collateral, or “margin”. Credit funds were up by a mere 0.2% in June, according to Credit Suisse. Returns in July are expected to be negative.

Highly leveraged funds sink quickly in such choppy markets. Witness the demise of Sowood Capital, a $3 billion fund that lost half its value in short order and this week sold its credit holdings at a discount to Citadel, another hedge fund. Sowood was caught out in two ways: it over-borrowed and its hedges failed to neutralise its risks as expected. The debacle suggests that even the canniest of investors can slip up: the managers of Harvard's successful endowment have lost $350m investing in Sowood, according to reports.

The intervention of Citadel—which last year snapped up bits of Amaranth, another troubled hedge fund—is seen by some as encouraging. It suggests that large, diversified funds will not only survive, but could prosper by swooping on assets they consider cheap. The top 20 or so funds, including Citadel, have the reputation (and pay big enough fees) to negotiate hard for more flexible financing arrangements. So they are less likely to get caught out.

Short on the problem

Smaller funds can prosper too. Paulson & Co, a fund based in New York, has done well from betting early that securities backed by subprime mortgages would fall in value. The good times may continue for other funds that are “short” on subprime.

But there are signs that the pain is spreading to other countries. Several European banks and insurers are rumoured to be sitting on “mortgage bombs”—troubled assets linked to America's subprime mess. IKB Deutsche Industriebank, which lends money to Germany's middle-sized companies, is being bailed out by a group of banks including the state-owned bank that partly owns it, thanks to ill-judged punts on American mortgages. And Australia's Macquarie Bank, which has been growing rapidly and buying up big infrastructure projects, has said two of its funds may post losses because of subprime woes.

One German bank, however, is doing well out of the subprime mess. After one of its analysts predicted two years ago that a slump was coming, Deutsche Bank piled into derivatives contracts that gain in value as the housing market sinks. These bets are thought to have netted the bank at least $250m, perhaps much more.

But it is traders of distressed corporate debt who are wearing the broadest smiles. After four years of infuriatingly strong markets, they finally have wads of discounted bonds and loans to feed on. Goldman Sachs, for one, has upped the size of a junk debt-fund it is raising, from $12.5 billion to $20 billion.

Though the mood has clearly darkened, no one really knows if this is the crunch that the markets have been anticipating. As Stephen Green, boss of HSBC, a global bank with copious subprime troubles, put it this week: “It is too early to tell if this is a temporary bout of indigestion or whether a whole new pricing structure will have established itself when people get back from their holidays.” Turn off the computer, head to the beach, and hope.

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