Are we out of the credit crisis? Implications for arm's length interest rates

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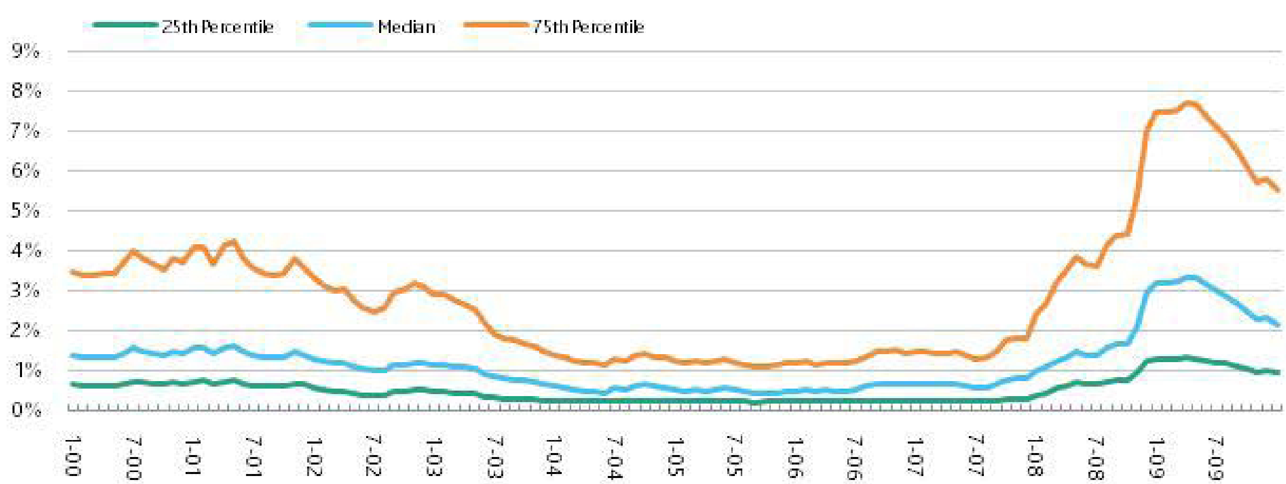
The credit cycle stage is a critical factor in the context of pricing intercompany loans and other debt instruments.

Since the end of 2007 the credit markets have seen the effect of the credit crisis in producing historically high loan pricing in the primary loan market, which consequently translates into higher intercompany lending rates. But, is the primary loan market pricing (specifically, lending margins on corporate loans) still being affected as dramatically as it has been by the credit crisis?

Recently, CUFTanalytics researched the changes in the level of one of the credit risk measures, the expected default rate of corporate borrowers, which has a significant impact on loan pricing (in the lenders' setting of lending margins) in order to determine if we are out of the credit crisis.

The first source of the data is the expected default rates, estimated by Moody's Analytics on the thousands of US private firms it tracks in its US Private Firm Credit Research Database (CRD). Specifically, Moody's published a paper in April 2010 that presented data on the one-year forward-looking expected default frequency(one-year EDF), which also included a credit-cycle adjustment, to account for the effect on the default rate of this particular credit cycle (referred to, in general, as a credit cycle adjusted EDF or CCA EDF).

The Moody's report provides data on the p25, p50 and p75 values (inter-quartile range and median) for the CCA EDF, on a monthly basis, for the entire population of US private companies that are tracked in Moody's Analytics' CRD. Refer to Graph 1 below.



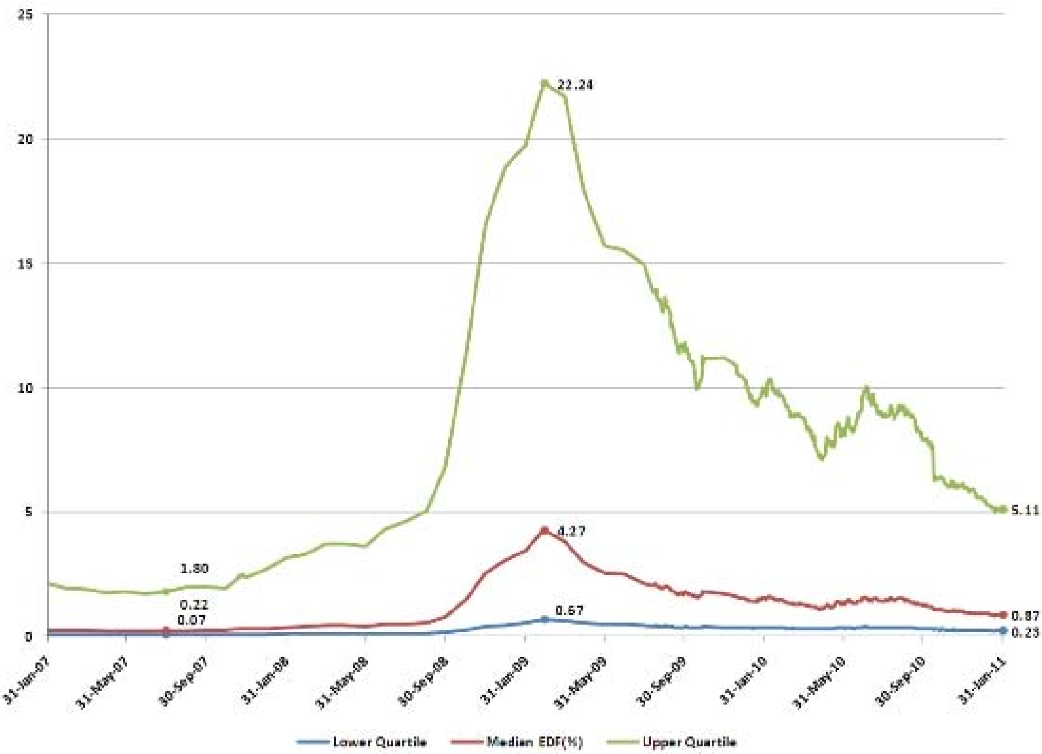
Graph 1: US Middle Market Private Firm CCA EDF January 2000 – December 2009 (Source: Moody's)

As we can see from Graph 1, the CCA EDF for US Private Firms started to increase in latter part of 2007 to levels significantly beyond those of more recently. Arguably lenders were expecting, as early as the end of 2007, higher future default rates and therefore lenders started to adjust their lending practices, including credit rationing and increasing lending margins.

From this data we can see the start of the contraction stage of the present credit cycle. In July 2007 the inter-quartile range for US private firms CCA EDF was 0.25% to 1.29% with a median of 0.55%. This is the trough point of the previous credit cycle in this market. After the July 2007 trough point, the credit crisis began to get worse. By April 2009, the inter-quartile range was 1.27% to 7.51% with the median CCA EDF at 3.15%.

This appears to be the peak of the credit crisis in the US mid-market. While the expected default rates were then in decline, they had not, as in December 2009, returned to the levels that existed before the beginning of the contraction stage of the present credit cycle. In December 2009, the inter-quartile range was 0.94% to 5.64% with a median of 2.15%.

The second source of data was the EDF data from Moody's Public Company Credit Risk Estimation model, which provides, in a web-enabled application, the monthly EDF for most public companies. CUFTanalytics obtained the EDF data, on a monthly basis, for all corporates, between January 2007 to January 2011, for USA and Canada and Western Europe) and constructed the following graphs:

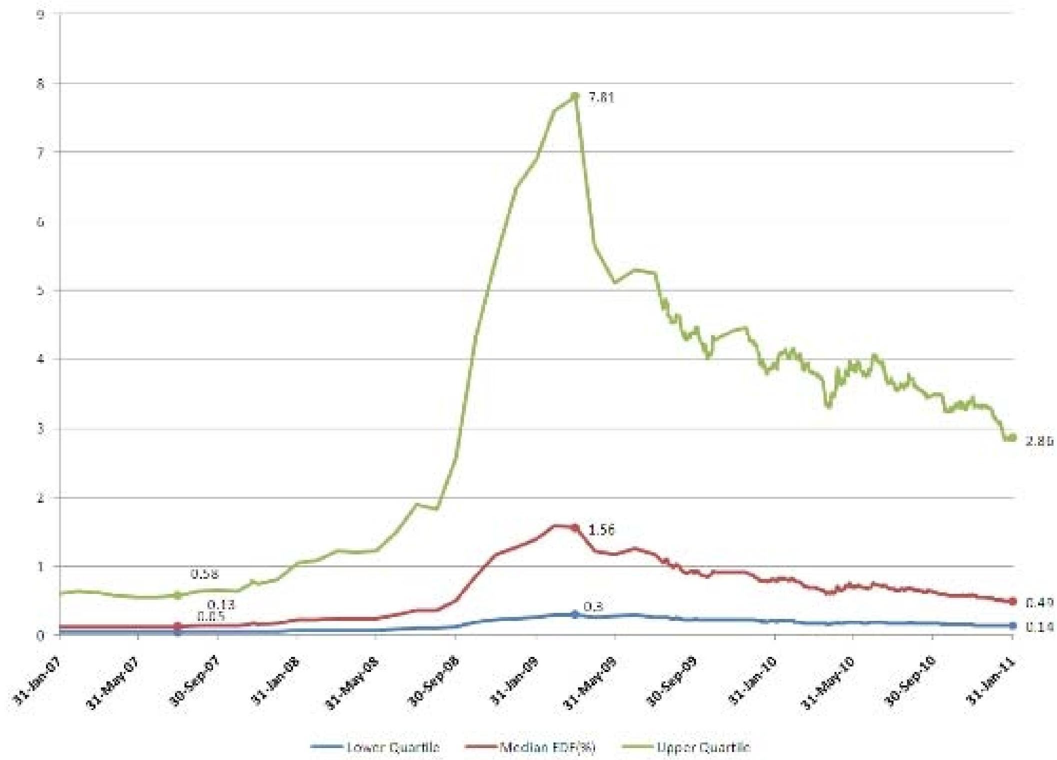


Graph 2: USA/Canada Public Companies EDF January 2007 – January 2011

In Graph 2 we plotted the EDF (median and inter-quartiles) for all US and Canadian public companies from January 2007 to January 2011. In July 2007 the inter-quartile range was 0.07% to 1.80%, with a median EDF of 0.22%. By the peak of the credit crisis (around February 2009 for the USA/Canada public company set) the inter-quartile was 0.67% to 22.24% (median 4.27%). As at January 2011 the EDFs had declined to an inter-quartile range of 0.23% to 5.11% (median 0.87%) but are still higher than in July 2007.

In Europe the trend was similar. Graph 3 plots the EDF for Western European public companies.

In July 2007 the inter-quartile range was 0.05% to 0.58% (median 0.13%). The peak was around February to March 2009. The March 2009 inter-quartile was 0.30% to 7.81% (median 1.56%). By January 2011 the inter-quartile was 0.14% to 2.86% (median 0.49%).



Graph 3: Western Europe Public Companies EDF January 2007 – January 2011

While the credit markets have not fully recovered from the impact of the credit crisis there is, however, some evidence that lenders' expectations, regarding the future default rates of their borrowers and loan portfolios, are returning to pre-credit crisis levels. But we are not there yet. If, in general, lenders expect the trend in future default rates to continue to decline then they will offer credit facilities to corporate borrowers at ever lower lending margins.

The implication for intercompany lending is that lending margins will be sticky and slow in the decline but, in the meantime, multinationals should monitor and consider this improving trend in the credit market conditions when setting intercompany lending rates.

In addition, where there is flexibility to repay or refinance intercompany loans, it may be imperative that multinationals monitor and capitalise on lower lending margins, once the impact of the credit crisis is finally over and lending margins return to pre-contraction stage pricing or they may face transfer pricing adjustments.

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