PRUDENTIAL

Riders on the Storm: CFOs and the Credit Crisis

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As the credit market storm of late 2008 and early 2009 fades, hopefully not to return, it's time to take stock of where it has left us. The causes of this credit cycle are well-known and widely discussed. We have summarized our own views of the root causes of the crisis in a separate paper, "Turbulent Markets: Challenges and Opportunities for the Institutional Investor",[1] and do not think they need repeating here. At this point, to borrow a phrase, we think it's better to look forward than to look back, trying to understand how the landscape has been altered by the crisis.

At Prudential, we have an unusual vantage point from which to assess the changes that have resulted. We are a significant investor for our own account and for other investors, a significant provider of long-term financing to corporate America and the commercial real estate market, and a provider of employee benefits and financing of employee benefits. For the CFOs of corporate America, this is a time of considerable reflection. Having had lots of discussions with them about their views across our various businesses, we thought it would be worthwhile to summarize what we are hearing and what the lessons learned appear to be.

Much has been made about how unusual this downturn is. There is certainly truth to that assertion, even though effects like the restriction of credit for riskier borrowers are hardly unusual. In fact, one of the recurring themes in our observations is that many of the lessons learned are not new. We have all been forcefully reminded of their importance, but many of the insights are simply reminders of what prudent CFOs have always known and practiced.

However, there is one unique element of this credit cycle that is likely to have long-lasting effects. For the first time, the fundamental viability of the securitization markets is being called into question. Securitized lending markets have collapsed as investors have lost faith in how these products are structured and the ratings agencies that rate them. Overall, net global securitization issuance fell by nearly 80% in 2008, removing about $1.7 trillion as a source of credit from the markets.[2] While there is significant uncertainty in this market, we can venture the following pair of predictions with increased confidence at this stage.

- The most complex structured products are unlikely to return. Investors simply will not place much faith in any ratings on these products, and will believe that these products are too complex for them to analyze and value independently.
- New rules of the road will be defined. The rights of investors with different levels of seniority in structured products will likely be clarified through litigation. In addition, new rules for how future products will handle loan modifications may emerge.

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1 Can be accessed at www.prudential.com/retirementissues.

2 "Securitisation 2009", International Financial Services London, 2009.

Accordingly, while the securitization market is likely to come back, it may very well be a smaller and less accommodating market than it was before. This will make financial intermediaries like insurance companies and banks more important to corporate America than they have been for some time.

If so, what are the key lessons about financing to be learned from this crisis? No list can be complete, but our nominees would surely include the following:

- A business is not likely to win by being very clever about the right hand side of its balance sheet, but mistakes on that side of the balance sheet can be fatal. This asymmetric risk highlights the importance of safety when designing a firm's capital structure. In general, corporate success is much more durable if it is grounded in decisions about investing, the left-hand side of the balance sheet, than about risk-taking through clever uses of leverage.

- When evaluating potential sources of capital, availability is more important than cost, particularly during challenging times. Many businesses based their entire financing model on an assumption of permanent access to narrow sources of financing, such as the securitization markets, that turned out to be unavailable when the economy faltered.

- Credit ratings matter much more in negative credit cycles. During good economic times, credit ratings primarily impact the cost of capital. However, during challenging economic times, credit ratings can impact whether capital is available at any price. This cycle was an unusually severe demonstration of this lesson, in that even AA ratings were not necessarily good enough to assure market access at the peak of the crisis, although the better-rated issuers were the first to regain access to credit when liquidity reappeared. When economic conditions improve, issuers may need to run their businesses more conservatively to achieve higher credit ratings to protect themselves during adverse credit cycles.

- Relationships with lenders matter much more during negative credit cycles. As a direct lender, we are heavily focused on supporting our existing clients. It is clearly valuable during good times to develop close relationships with lenders in order to maintain access to an understanding source of capital when times turn.

- Not all lenders are created equal. Insurance companies such as Prudential manage their loan portfolio for the long term. As a result, we are generally able to be more flexible when our borrowers face challenging economic conditions. Issuers should think about their mix of creditors, and seek to diversify their sources of capital.

- Spreads matter to lenders, but absolute rates matter more to borrowers. Some issuers, particularly investment grade issuers, are hesitant to borrow when spreads are historically high, even if Treasury rates are so low that absolute rates are not high. When a financial institution like Prudential issues debt, we are very conscious of spread because a large part of our business model is built around products that earn a financial spread on capital. For an industrial company, the tradeoff is not the same, since the assets of a non-financial corporation are more likely to earn a less volatile return that is weakly correlated to spreads.

But there is more to the post-mortem analysis than financing lessons. Companies are facing up to the importance of effective risk management in a more holistic way than ever before. While this is not a new insight to financial companies, where the questions that are being addressed are aimed at how and why risk management practices failed, it is a fairly new concept in industrial America. Consequently, it's worth summarizing just what is involved.

- First, effective risk management requires a comprehensive identification of all the risks that impact a business. At Prudential, we assess the potential impact of a wide range of risks in our businesses, including mortality, interest rates, credit, equity market performance, real estate market performance, and country-specific risks. We closely monitor each of these risks, seek to develop ever better insight into how these risks relate to each other, and ultimately use this understanding to inform, but not necessarily drive, both our investment and overall business strategy. We also make conscious decisions about which risks we should take, such as credit risk or mortality risk, and which risks we should avoid, such as betting on the direction of interest rates.

- Second, effective risk management requires a holistic approach to managing risk. Many industrial firms with businesses whose performance is tied closely to macroeconomic conditions invested aggressively within their defined benefit (DB) plans and also heavily leveraged their businesses. These decisions may have been reasonable and rational when viewed independently. However, when viewed collectively, it becomes clear that such firms put themselves in the position of having to deal with many problems at the same time when the economy faltered. We know that this dynamic is impacting many firms. For example, we recently surveyed more than 100 senior finance executives at medium and large companies, and learned that 40% of these executives reported that their DB plan was having a substantial impact on their firm's financial results.[3]

- Third, previously under-appreciated risks need to be incorporated into everyone's thinking. For example, many organizations did not focus on liquidity risk within their investment portfolios. As a result, institutions that rely on investment portfolios to pay current expenses, such as DB plans making benefits payments or endowments disbursing funds, are facing a liquidity crunch. In assessing risk, liquidity is not just part of the asset allocation framework, or how much to allocate to stocks, bonds, cash and alternatives. It also needs to be separately planned to assure that liquidity demands will not interrupt the investment or business plans of the organization. Going forward, many organizations need to more closely monitor liquidity across their portfolios.

- Fourth, risk management tools, such as Value at Risk (VaR) analysis, are useful when used to better understand and illustrate risk and can be helpful as part of a broader risk management framework to aggregate risk. However, many organizations developed a false sense of security by relying too heavily on these models. These tools measure risk based on historical data, and as a result, did not help risk managers prepare for the once-in-a-generation type of conditions that were far more frequent and severe than models predicted. It is therefore imperative for an organization not only to incorporate risk measures that they deem relevant to their business, but also to establish plans that prepare for foreseeable events and improve the chances of surviving when unforeseen losses occur.

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[3] CFO Research Services/Prudential survey, 2009.

- Fifth, removing liabilities from corporate balance sheets through the “selling” of liabilities can be prudent, and can have benefits other than the implicit cost of financing. For example, insurance companies are better positioned to manage certain kinds of risk than most industrial companies, especially for retiree populations for whom direct contact is less important than for active employees. Pension and Other Post-Employment Benefits (OPEB) liabilities (such as retiree life insurance) should be examined for possible outsourcing or financing with third parties.

- Finally, asset and liability imbalances persist and continue to create risks for many organizations and individuals. For example, many pension plans that invested for total return without regard to their liability structure are finding themselves in a challenging position today, although the severity of the effect varies greatly among firms, depending on the scale of their pension liabilities relative to the rest of their balance sheets. CFOs need to assess these issues in light of their organization’s overall risks, and consider policies that limit the mismatch. Likewise, individuals saving for retirement are not well-suited to manage the risks of their own longevity, and target-date funds in corporate defined contribution plans have been convincingly shown to be an inadequate solution to that problem.

We are all living with reminders of the dividends that effective risk management can pay, and of the depth of the problems that ensue when it is done badly. Many senior finance executives are increasingly focused on risk management across the enterprise, as well they should be. The good news is that there are ways available to diminish balance sheet risks. And, from a macroeconomic point of view, the systemic recalibration of attitudes towards credit and risk that is underway is likely to lay the groundwork for a durable economic recovery.

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