

# Outlook



Winter 2008 – Special Question & Answer Issue

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## Is it a recession?

A recession is defined as 2 consecutive quarters of negative growth in an economy. The problem with the definition is it is only possible to determine if a recession has occurred after the fact. A number of well

regarded economists believe that the U.S. is in a recession. This opinion was reinforced when the latest numbers showed a decline in service jobs.

## What triggers a recession?

The last 2 recessions, in 1991 and 2001, were preceded by financial catastrophes, the Savings and Loan Fiasco and the Bursting of the Hi-Tech Bubble. When events like these occur, they not only take equity out of the economy, but more importantly, they reduce the consumer's confidence; that is, the consumer becomes concerned and reluctant to spend.



The intrepid consumer drives the U.S. economy, and for the last decade, it has been overspending. The U.S. has a

negative saving rate. The ballooning equity in homes or the paper profits in the Hi-Tech Stock Bubble allowed them to overspend based on credit secured by these assets.

When the value of the assets decline, the consumer is often left technically bankrupt.

The recovery from the Sub Prime problems may be protracted, as the full extent of the write-offs will not be known until 2010 and the poorest people, who are most affected by the loss of their homes, will definitely not be driving a consumer recovery.

## What is a Credit Crunch?

A number of the largest banks in the World have had to write off billions of dollars of investments in the Sub Prime mortgage market. When a bank lends money, it must always set aside a certain amount of capital to support the loan. The term is Capital Adequacy. To support the loans they are making, banks must have a certain Tier I Capital. If the bank has to write off large amounts of capital, it may no longer have adequate capital to meet the reserve requirements and it must either reduce its loan portfolio or obtain new capital. The basic impact is that credit becomes tighter and more expensive.

## What is Stagflation?

Stagflation as experienced in the 1970's was a combination of a slowdown in the economy at the same time as prices were rising. Today, the U.S. economy is definitely slowing, if it is not already in recession, and at the same time, we are seeing inflationary pressures on energy and food. When energy and food prices increase together, it often signals a recession as the consumer's discretionary spending is heavily constrained. A larger part of a decreasing pie is eaten up by these 2 items.

## How does a slowdown affect companies?

As demand is affected by a decline in consumer confidence, it becomes more and more difficult to maintain sales levels. The inflationary pressure felt on inputs becomes harder to pass on and margins become squeezed. As margins become squeezed, the companies must reduce costs by purchasing less and laying off workers. The recessionary spiral steepens.

## What action can be taken to address recessions?

Because recessions are often caused by decreasing demand, the financial engineers want to increase the demand by offering financial stimulants in the form of tax reductions, subsidies in the form of transfer payments or interest rate reductions to make credit easier to obtain. This slowdown is largely caused by a collapse of the debt structure resulting in many people declaring bankruptcy or being laid off. It is unlikely that easier credit is

the answer. As the Sub Prime collapse really affected poor and middle-class families, a tax break is not about to put much money in their pockets. The solution may take us back to the 1930's when the focus of Government had to be on creating real jobs. Fortunately, real jobs in Western Canada are insulating Canada from the full impact of the situation in the U.S., but there may only be a 3 to 6 month delay.

## How does theoretical economics affect credit decisions?

1. As we have seen in the recessions of 1991 and 2001, marginal companies in many sectors will be forced to file for protection because of liquidity problems caused by them failing to meet their financing covenants, or the bank not renewing their line of credit, or credit becoming more expensive. A failure of a major buyer can cause a company to break its covenants and be outside of its margining limit.
2. With publicly traded companies, the problems may occur, but at least there is disclosure required if public companies are not meeting forecasts or they are outside of their banking covenants or they are having difficulty renewing their lines of credit. Furthermore, often the

debt of these companies is rated and the company's fortunes are followed by industry analysts.

By the time a credit manager gets the information, the company may already have a large exposure to the buyer. As the situation deteriorates it may be difficult to bring the exposure down. It is a question of timing, the poor results may not be reported for several months and during that period the exposure has been continuing to run. The time between the disclosure of the problem and the reorganization may be very short as the buyer and secured creditors want to protect the assets.

3. With private companies the problem is exacerbated, as it is difficult to even obtain financial

information, let alone be advised in advance of developing problems. Suppliers don't know if sales are down, margins are being squeezed or there are problems with the bank. If a credit manager can obtain Financial Statements, they provide a historical picture at best. The effect of the recession is happening in real time, out of sight.

In summary, credit managers work with very imperfect information. Time works against them in obtaining information and they have to often make credit decisions projecting 3 to 6 months ahead. A recession in the U.S. affects many buyers, but in most cases, the credit manager can only guess at how much the buyer is impacted.

## Is credit insurance the answer to a credit manager's prayer?

Not in every case! By the time a credit limit is requested on a buyer, the writing may already be on the wall and the underwriters can't increase their exposure. This information in itself is useful.

In some cases, the underwriters may only be able to cover some of the exposure due to the credit evaluation or their current level of exposure. Again, this is useful information. In most cases, at least one of the underwriters will be able to approve the buyers. When this happens, credit managers can sleep like babies knowing that they are protected from the unforeseen. Once the credit limit is in place the underwriters monitor the buyer and they will advise you if problems are arising.

Underwriters can, and definitely will, cancel or reduce credit limits, but the cancellation or reduction only applies to future shipments. They have no retroactive effect. Your insured exposures remain insured.

## Why are Creditors' Meetings becoming less crowded?

Because more and more companies are credit insuring. When there is a Creditors' Meeting, they have already been paid and their rights have been subrogated to the poor underwriters who are at the meeting.