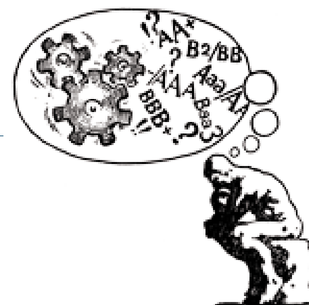
CREDIT MATTERS



Zen and the art of credit analysis

The idea that instead of buying bonds directly the EFSF provides a partial guarantee on new issuance just doesn't stack up. More meditation is needed — and quickly — says **Gary Jenkins**.

I was considered a dull and uninteresting child (whereas now I am considered a dull and uninteresting adult…) and thus my parents thought it would be appropriate to send me away to a Monastery in the Himalayas to learn the ancient and noble art of credit analysis.

After years of silently learning all there was to know about balance sheets, profit and loss and cashflow statements I thought I was ready to re-enter Western society. But before the monks allowed me to leave they explained that these skills were nothing more than a starting point for the noble art and that I had still to master the Zen of analysis.

Without outside assistance Italy could have been heading towards default

This consisted of many lessons of learning how to think inside the box, not get fooled by figures and to contemplate the bleeding obvious. They also taught me that the most important attribute in the lending and borrowing of money was confidence. With that I bowed deeply, humbly requested a loan of £3,000 to return home for a "short period" and left the monastery for ever knowing that I had been lucky enough to take a lot from the monks. Namely their life savings.

Anyhow, the skills that they taught me led me to a career in the City as a credit analyst. After a time in this field I used my old textbook *Zen and the Art of Credit Analysis* and nicked most of it in order to publish a document called *Analysing Credit from a Market Perspective* which tried to bring the monks' teachings to a wider audience (although I never gave them any credit and pretended it was all my own and Laura Winchester's work).

Lately I have found my thoughts drifting back to the old days and I have been wondering what the monks would make of some of the proposals which appear to be on the agenda in order to resolve the European crisis. Especially the idea that in order to get around the problem that the EFSF just does not have enough funds available to it, that instead of buying bonds directly it provides a partial guarantee on new issuance. There are several advantages to this approach; not least the EFSF would not be required to raise any funds. Depending on what proportion of a country's issuance the guarantees covers (20% seems to be a favourite), the actual funds provided to the issuer is a multiple of the EFSF guarantee and private investors remain involved in primary market activity.

If the first loss guarantee works it will buy the likes of Italy time to implement structural reforms to boost growth which in turn will make the debt burden more affordable. After some time confidence in the standalone credit should then return and the need to issue guarantees fall away. As the monks would say "restoring investor confidence is key" and if a first loss guarantee does that it doesn't matter what reservations people may have about such a guarantee structure and likelihood of paying out in case of default.

But how would the monks analyse such a guarantee? Well, they would first imagine that it was their own money that they were investing (not that they have any left — see above) and second they would want to look at the borrower itself and its standalone ability to pay. Thus for a country such as Italy they may consider it in a better position than many sovereigns; smaller deficit, lower private sector indebtedness etc, but then they would think inside the box and consider the fact that earlier this year Italy's funding costs shot up and if it wasn't for ECB intervention funding would have been prohibitively expensive. Without outside assistance Italy could have been heading towards default. That would make them cautious.

They would move on to analyse the strength of any outside support and in particular the EFSF as a guarantor. The philosophy as described in the book *Zen and the Art of Credit Analysis* states that any guarantor has to be considered as if it was the borrower itself and its ability and willingness to pay must be considered at a time when the principal borrower has failed to repay. Thus any close trading link between the principal and the guarantor would diminish the value of the guarantee. Therefore they would not consider the EFSF as a triple-A rated entity which has the undoubted capability to repay any monies owed today, but instead they would consider the impact of a default of the principal on the EFSF and whether that event would significantly alter the ability and willingness of the EFSF to meet its obligations.

One cannot help but think that the monks would question how anyone can possibly analyse the financial, political and social impact of the world's third largest bond issuer defaulting. They might decide that the likelihood of the EFSF having both the ability and willingness to pay in such circumstances would be questionable, at best.

There are flaws with the first loss guarantee, but on the positive side it does show a commitment by euro area members to each other. The monks might say that the EU has gone from "no bail-outs" to potentially guaranteeing each other's debts (among other things), and that ought to give investors some confidence. But they might also conclude that such a guarantee would be of little value in the worst case scenario (which is the only time it would be tested) and thus methinks they would say "love, light and peace….but no thanks". ■

Contemplating the bleeding obvious: weighing up the value of a partial guarantee in the worst case scenario

Gary Jenkins is head of fixed income and yogic flying at Evolution Securities. All the opinions expressed are those of the author.

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