

## Credit Markets and How They Work

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### Definitions

- Capital – Funds subscribed and paid by stockholders representing ownership in a bank.
- Securitization – Pooling loans into packages and selling the pooled assets by issuing securities collateralized by the pooled assets.

- Tranche – The principal amount related to a specific class of stated maturities on a collateralized mortgage obligation.
- Collateralized Mortgage Obligation (CMO) – A security backed by a pool of mortgages that is structured to fall within an estimated maturity range (tranche), based on the timing of allocated interest and principal payments on the underlying mortgages.

- Credit Default Swap – A type of credit derivative which resembles an insurance policy.
- Credit Derivative – Contract between a buyer and seller under which the seller sells protections against the credit risk.

### Causes of current credit market turmoil

- \* Originate to distribute approach to credit extension:

Model spreads risk and reduces financing costs by offering greater access to capital to a wide range of borrowers while allowing investors greater flexibility in choosing and managing credit exposures.

### Problems with model: Example (Subprime Mortgages)

- Originators' revenues were tied to loan volume not quality. These problems were hidden for awhile by the continued appreciation in home values. As long as home values kept increasing borrowers were able to refinance into more sustainable mortgages. When values fell, borrowers were trapped in mortgages they couldn't afford.

- Because these subprime loans were frequently securitized and incorporated into complex structured products, the resulting losses were spread throughout the financial system.

#### Example (Loosening of credit standards)

- Investors were willing to purchase so called leveraged loans (used to finance mergers and buyouts) with few covenants or other protections.
- Investors did not evaluate the risks of credit products, in part because they relied too much on evaluations provided by the credit rating agencies.

- When rising delinquencies and losses began occurring on mortgages rating agencies began to sharply downgrade many of these products causing investors to lose confidence and they became unwilling to provide new funds. As financing disappeared, the markets for structured products and for related investments dried up.

#### Example (Risk management weaknesses at large global financial institutions)

- Large institutions held many of the complex credit products and the poor risk management at some of these institutions involving the spreading of risk which was supposed to be a benefit to this model proved to be much less extensive than believed.

- When investors were no longer willing or able to finance new structured credit products, many of the largest financial institutions had to fund these instruments they could not readily sell or had to meet contingent funding obligations for which they had not adequately planned. The combination of unanticipated losses, which ate into capital cushions, and severe liquidity pressures reduced the ability and willingness to extend new credit.

- Overall, the major reason for issues occurring in the financial market is the **amount of risk** institutions and investors were willing to hold.
- The resulting losses from this risk has eroded the capital of many financial institutions, leading them to become more reluctant to make not only mortgage loans, but other types of loans to consumers and businesses as well.

## Funding of Commercial Banks

### Four types of Funding

- 1) **Retail** = Deposits
- 2) **Borrowed** = Fed Funds, FHLB Borrowings
- 3) **Wholesale** = Large Institutional Deposits, Other Borrowed Funds
- 4) **Equity** = Common & Preferred Stock, Retained Earnings

## Funding for Farm Credit Associations

### Three main types

- 1) **Borrower Stock**
- 2) **Borrowed Funds** = Bonds/Investments sold through funding corporation – New Jersey
- 3) **Equity** = Retained Earnings, Preferred Stock

## Commercial Bank / Farm Credit Funding Comparison

	<u>Commercial Bank</u>	<u>Farm Credit</u>
Retail	63%-85%	.5%-1%
Borrowed	7%-27%	75%-88%
Equity	10%-12%	10%-22%

- Many larger commercial banking institutions have seen a decline in deposits and erosion of equity (capital) so they have been forced to increase borrowings and raise capital to fund loans or reduce lending.
- Smaller community banks have not seen as much pressure on deposits and equity with the financial market turmoil going on, however banks they over line with have become more conservative.

- Farm Credit has seen added pressure on funding due to investors seeking a higher return on short-term investments as well as backing away from long-term investments.
- Additional competition for investors is present today due to financial bailout as many investors see the debt being issued by other entities, being more attractive due to the guarantee provided by the U.S. Government.
- In addition many investors have increased their investment in Treasuries even with little or no return being received.

## Current Credit Conditions (Lone Star Perspective)

- Long-term interest rates (20-30 year) fixed rates are priced higher than past years due to funding issues, interest rate risk and credit conditions.
- Loan amortizations on real estate loans have been decreased for marginal credits.
- Underwriting standards have been tightened in regards to equity requirements for credits that may show more risk.

- Earnings for Lone Star have remained strong with net income increasing 10% in 2008.
- Spreads on loans are anticipated to increase over the next year due to the tight credit market.
- Opportunities to refinance high quality commercial bank customers will continue to present themselves as the credit market remains tight.

## Summary

- It is anticipated that there may be other issues within the financial community that have not been in the news.
- Additional problems that arise will continue to pressure markets and may lead to additional bank failures.
- Even with steps taken by the U.S. Government, it is expected that financial markets will remain very volatile throughout 2009.

Questions?