

## Urquhart

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**Subject:** Three "Impact on Cost of Credit" Studies Agree with My Independent Research that Preferred Status Has Small Incremental Impact

**Attachments:** Melborne Centre for Financial Studies - Employee entitlements and secured creditors SSRN-id853524.pdf; Corporate pension funding and credit spreads Mirko Cardinale Watson Wyatt June 2005.pdf; Credit Spread Puzzle Jeffery Amato Eli Remolona.pdf; Moodys 2007 Annual Global Corporate Default Study.pdf; Standard and Poors - Default transition and recovery - 2009 annual global corporate default study and rating transitions 03172010.pdf

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**From:** Urquhart [mailto:urquhart@rogers.com]

**Sent:** April-28-10 11:58 AM

**To:**

**Cc:** "Diane & Hugh Urquhart"; 'Peter Burns'; 'Josee Marin'; Arlene Borenstein (aborenstein@me.com)

**Subject:** Three "Impact on Cost of Credit" Studies Agree with My Independent Research that Preferred Status Has Small Incremental Impact

Here are three studies that are relevant to the impact of priority in bankruptcies affecting the cost of credit.

**Melborne Center for Financial Studies - Employee Entitlements and Secured Creditors SSRN-id853524, September 28, 2005**

Kevin Davis

Commonwealth Bank Group Chair of Finance

Department of Finance, The University of Melbourne

Director, Melbourne Centre for Financial Studies\*

and

Jeannette Lee

Risk Analytics Group

Ernst & Young

Melbourne

"This paper analyses and provides quantitative estimates of the consequences of changing creditor priority in this manner. Contrary to conventional wisdom and arguments mounted in opposition to such a change, the effect on corporate funding costs would be extremely small. The paper argues that legislation to effect such a change warrants further consideration as a complement to the existing compensation scheme."

## 6. Conclusion

In this paper we have applied modern finance theory techniques for modeling credit risk spreads to assess the likely impact of the maximum priority proposal for employee entitlements on the cost of secured debt for Australian companies. We find that the impact is likely to be extremely small, contrary to conventional wisdom. Underpinning that result is the relatively small size of employee entitlements in corporate balance sheets, together with the significant buffer of equity and unsecured creditors whose less preferred status provides some shield for the loss given default (LGD) experienced by secured creditors in the event of insolvency. Also important is the fact that credit spreads also depend upon the probability of default (PD) which is not affected by the MPP. Most commentators appear to have focused upon the fact that, given default, the MPP would involve a higher LGD for secured creditors, and reacted adversely to that. However, given introduction of the MPP, lenders would factor that higher LGD into credit spreads charged to borrowers.

### **Corporate Pension Funding and Credit Spreads, Mirko Cardinale, Watson Wyatt, June 2005**

1. From Table 5 results in Panel A and Panel B for the two overall samples it appears that the relative size of pension deficits is priced by corporate spreads, supporting the extended balance sheet hypothesis and consistently with the results of credit ratings models such as Carroll and Niehaus (1998). Moreover, in both samples estimated coefficients for relative pension deficit exposure are twice as large in magnitude as coefficients for ordinary leverage, which could be a reflection of market perception of additional risk in unfunded pension promises compared to more traditional forms of debt.

2. The unfunded pension leverage effect on credit spreads appears to be economically significant. Using sample mean values in Table 4 we derive the average investment grade and aggregate spread predicted by the model for each year, as reported in Table 7. For instance in 2002, when the relative size of pension deficits was highest (2.70%), the average predicted spread was 1.8% in the investment grades sample and 2.8% in the aggregate sample.

Keeping everything else constant but setting the pension deficit to zero, the model in 2002 predicts spreads which are respectively 16 and 40 basis points lower, implying a 9% decrease in the investment grades sample and a 15% shift in the aggregate one.

Conversely in 2003, when the average ratio of pension deficit to enterprise value was 1.85%, the model predicts spreads 20 basis

points higher in the investment grades sample and 30 basis points higher in the aggregate one (this is respectively a 20% and a 30% shift) if the relative size of pension deficit is set to 5% while everything else stays constant. These numbers suggest that cross-sectional variation in spreads driven by pension deficits could potentially become very large in the presence of substantial unfunded liabilities.

### Credit Spread Puzzle - Jeffrey Amato & Eli Remolona

#### Decomposing the spreads

Average spreads on US corporate debt across rating categories and maturity buckets are given in Table 1. These values are computed using option-adjusted spread (OAS) bond indices provided by Merrill Lynch.<sup>5</sup> The period covered is January 1997 to August 2003.<sup>6</sup> Spreads on AAA debt have averaged about 50 basis points at short maturities and 74 basis points at maturities of seven to 10 years.<sup>7</sup> Spreads increase significantly at lower ratings down to BBB, and even more so across sub-par investment grade debt, reaching as high as 761 basis points on B-rated bonds at one- to three-year maturities. In addition, the term structures are upward-sloping for the higher-rated investment grade bonds, hump-shaped for BBB debt and downward-

Average spreads are high, especially on low-rated bonds

Spreads and expected default losses <sup>1</sup>								
Rating	Maturity							
	1-3 years		3-5 years		5-7 years		7-10 years	
	Spread	Expected loss	Spread	Expected loss	Spread	Expected loss	Spread	Expected loss
AAA	49.50	0.06	63.86	0.18	70.47	0.33	73.95	0.61
AA	58.97	1.24	71.22	1.44	82.36	1.86	88.57	2.70
A	88.82	1.12	102.91	2.78	110.71	4.71	117.52	7.32
BBB	168.99	12.48	170.89	20.12	185.34	27.17	179.63	34.56
BB	421.20	103.09	364.55	126.74	345.37	140.52	322.32	148.05
B	760.84	426.16	691.81	400.52	571.94	368.38	512.43	329.40

<sup>1</sup> In basis points. Spreads are averages over the period January 1997-August 2003 of Merrill Lynch option-adjusted spread indices for US corporate bonds. See text for details on computation of expected loss.

Sources: Altman and Kishore (1998); Bloomberg; Moody's Investors Service; authors' calculations. Table 1