J.P. Morgan Pulls Back On Its Loans

DEALS & DEAL MAKERS

By PAUL M. SHERER
Staff Reporter of THE WALL STREET JOURNAL

Hedging Its Risks

J.P. Morgan accounts for 48% of credit derivatives held by U.S.-regulated banks. Here are the top credit derivatives users among U.S.-regulated banks, second quarter 1999, in billions of dollars

Bank	Amount
J.P. Morgan	$123.0
Citibank	32.4
Chase Manhattan	26.6
Banca Commerciale Italiana (NY branch)	14.3
NationsBank	12.4

Source: Comptroller of the Currency

J.P. Morgan & Co.'s loan business is shrinking — and the bank's executives couldn't be happier.

The bank has dropped to sixth this year from third in 1998 and second in 1997 in the ranking of the nation's lead banks in syndicated lending. It has led just 81 deals valued at $85 billion in the first three quarters of 1999, down from 147 deals valued at $165.5 billion in the first three quarters of last year, according to Loan Pricing Corp.

But while loan volume is down, profitability is up. That's because a lot of the syndicated loans that J.P. Morgan made in the past were, in effect, loss leaders—cheap credit extended to borrowers in the hope that the borrowers would give more profitable business to the bank.

Now, J.P. Morgan is scrutinizing those longstanding relationships, first evaluating how much revenue the client generates from other business before extending loans. "There were a number of examples where the only thing we did with the clients was lend them money, and that was a losing proposition," explains J.P. Morgan credit chief William Demchak. "So either we got out of that lending relationship" or began working with the client on a range of products, he says.

J.P. Morgan's new approach to lending is part of a broader credit makeover that speaks volumes about the state of the global lending business. It shows how banks are evolving out of their traditional role of being holders of debt, and helps explain why companies' relative cost of borrowing has risen sharply over the past two years. In an effort to boost earnings, other banks are making more efficient use of capital, and even investment banks are trying to curtail their lending capital, too. Credit Suisse First Boston, for example, cut its equity capital devoted to lending from $3.2 billion at the start of 1997 to $800 million now.

It was in the wake of the Asian and Latin American financial crises of 1997 and

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J.P. Morgan Shrinks Its Loans and Likes It

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1998 that J.P. Morgan went back to the drawing board on its lending business. Armed with a set of newly developed financial tools, the bank in the spring of 1998 took a hard look at its $127 billion (excluding derivatives) credit portfolio. What it found, says Mr. Demchak, was "relatively shocking": J.P. Morgan's lending portfolio was far riskier then the bank had thought, with dire implications for the bank's profitability.

That discovery led to an overhaul, culminating in last week's announcement that it had slashed 50% of the capital committed to its lending business, three months ahead of the end-of-1999 target announced in May 1998. It did so by selling off big chunks of its loan holdings, by cutting the amount of new credit it takes on through new loans and by using new types of derivatives to unload credit risk.

The makeover has helped boost J.P. Morgan's return on equity to 18.6% so far this year, up from 13.4% in 1997 and 8.6% last year, and within the 15% to 20% return on equity that J.P. Morgan Chairman and Chief Executive Douglas A. "Sandy" Warner set as the firm's goal in May 1998. The shift of capital from lending will help pay for the $3 billion stock-buyback program the bank launched last week.

But as J.P. Morgan set out to slash its capital, the fifth-largest U.S. bank was faced with a dilemma: how to cut its holdings of loans to its blue-chip client base without losing those clients in the process. "You can ruin a 30-year relationship in three days, and that's not how we do things," says Kelley Millet, J.P. Morgan's head of investment-grade-debt capital markets.

As with other large banks, one of the biggest and least profitable parts of J.P. Morgan's credit portfolio has been backup lines of credit for investment-grade corporations. Most of those credit lines are never drawn upon and generate scant profits. The $600 billion in U.S. syndicated lending to investment-grade companies in 1998 accounted for 69% of all syndicated loans, but generated less than 20% of the fees, according to PaineWebber.

The trouble is, it isn't easy taking away something companies are used to getting for little or nothing. So how this pullback will affect J.P. Morgan's long-term relationship with clients remains to be seen.

When CVS Corp. took out a $1 billion syndicated loan in 1997 in conjunction with its acquisition of Revco D.S., J.P. Morgan was the syndication agent. But when the Woonsocket, R.I., drugstore chain took a $630 million loan this June, J.P. Morgan no longer played a major role, though it was in the list of participating banks, according to Loan Pricing. "If someone is helpful to us in one kind of service we will consider them for another kind of service," notes Dave Rickard, chief financial officer of CVS, while adding that the retailer is "satisfied" with the relationship.

J.P. Morgan's re-thinking of its lending after the Asian and Latin American crises relied on new risk-measurement models where the concentration of risk in any one company, industry or country is measured across all of the bank's global lending activities, and then hedged by buying or selling loans or derivatives.

Banks had long figured that they were being forced to hold too much capital relative to the risks in their lending. But to J.P. Morgan's surprise, the new models showed that the real risk in its portfolio was far higher than it had expected. It had thought its risk was about one-third of the $11.4 billion in capital it had in 1997, but instead it turned out to be about half its capital.

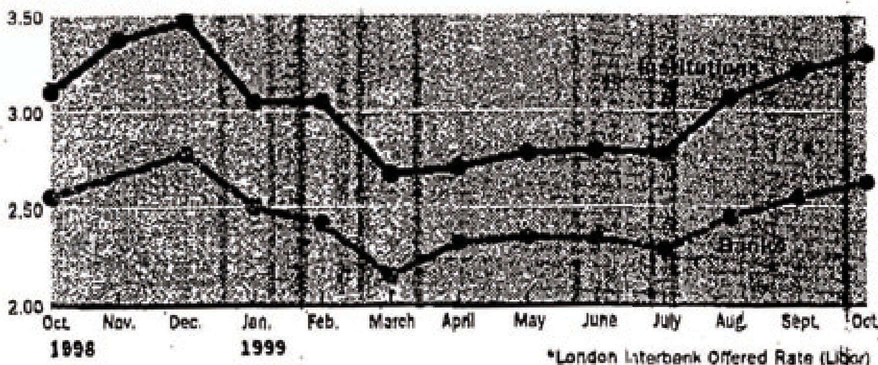
That led to J.P. Morgan's second device for cutting its lending exposure: a massive selloff of its riskier loans, many of them to Asia and Latin America. From December 1997 through September this year, it cut its lending, loan commitments and derivatives exposure to Asia (excluding Japan) to $4.4 billion from $10.4 billion. Over the same period, it cut its credit to Latin America to $5 billion from $11.1 billion.

As the Asian crisis roiled markets, banks began turning to a new tool, called credit derivatives, that let them hedge their credit risk, or their vulnerability to customer defaults. In return for a payment from J.P. Morgan, the seller of a credit de-

Snapshot: Leveraged Syndicated Loans

How Much Do Loans Cost?

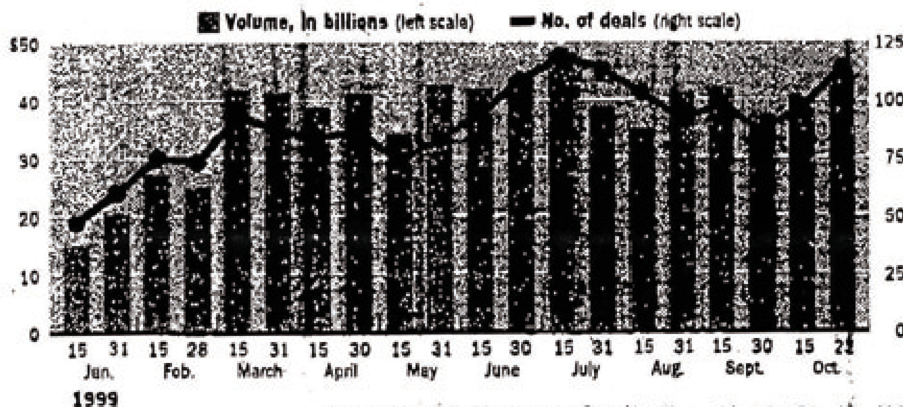
Average new-issue yields over benchmark* for loans rated below investment-grade (BB/BB-) or "junk", in percentage points



*London Interbank Offered Rate (Libor)

Lending Volume Builds

Syndicated loans rated "junk" coming to market



Sources: Portfolio Management Data LLC; Banc of America Securities LLC

Marsh & McLennan Posts 20% Rise In 3rd-Quarter Net, Cites Revenue Gains

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In 3rd-Quarter Net, Cites Revenue Gains

By DEBORAH LOHSE
Staff Reporter of THE WALL STREET JOURNAL

Marsh & McLennan Cos. posted a 20% rise in third-quarter net income, reflecting solid revenue gains in its investment-management, consulting and insurance-brokerage units, as well as cost cutting at recently acquired Sedgwick Group PLC.

The New York company's net rose to $223 million, or 81 cents a diluted share, from $186 million, or 69 cents a share, for the year-ago period. Results were in line with consensus estimates from analysts surveyed by First Call/Thomson Financial. Revenue gained 30% to $2.23 billion from $1.72 billion.

Despite continued difficulties in the commercial-insurance segment, revenue at Marsh & McLennan's insurance-brokerage unit, known as Marsh Inc., increased 38% to $1.06 billion, thanks largely to acquisitions and, to a lesser degree, to new products and international expansion, according to Jay Cohen, an analyst with Merrill Lynch & Co. Excluding the growth from acquired companies, the insurance-brokerage unit's revenue grew 5%.

"That's impressive given the market conditions, but clearly they'd like to grow that faster," Mr. Cohen said. Some analysts have been hopeful that insurance brokers, which get fees for helping large corporations buy insurance coverage, will benefit once pricing for such insurance products began to firm up after years of competition-driven price declines.

The Sedgwick acquisition also bolstered Marsh's bottom line, as integration-related cost-cutting in that unit helped Marsh & McLennan increase profit margins in its insurance-brokerage unit to 16.6% pretax from 15.2%. "They are now seeing the cost reductions they have been working on," Mr. Cohen said.

In Marsh & McLennan's investment-management unit, Putnam Investments, assets under management declined 2.2% to $318 billion compared with the second quarter of 1999, thanks to stock-market declines overall, the first such sequential decline since the third quarter of 1998. However, net new sales of investment products stayed positive, at about $2 billion, Mr. Cohen said.

Marsh & McLennan fell $2.5625 to $72.25 in New York Stock Exchange composite trading, on a day marked by widespread declines in financial-services stocks.

Fox Paine to Acquire Watkins-Johnson Co.

By a WALL STREET JOURNAL *Staff Reporter*

PALO ALTO, Calif. — Watkins-Johnson Co., a communications-equipment manufacturer, agreed to be acquired by Fox Paine & Co. for about $330 million.

Fox Paine is a Foster City, Calif., buy-out firm formed by an alumnus of Kohlberg Kravis Roberts & Co. Fox Paine agreed to pay $41.125 a share for the company, a 30% premium on Watkins-Johnson's Monday closing price of $31.625.

Watkins-Johnson, formerly a defense-industry conglomerate, has been in the process this year of selling itself off. A number of assets sales have already been announced. Fox Paine will be acquiring a company whose primary remaining asset is a wireless products group, which supplies wireless components for communication equipment.

CIBC World Markets Corp. provided a fairness opinion, and advised the buyer on debt financing.

their credit risk, or their vulnerabiP. 4 to customer defaults. In return for a payment from J.P. Morgan, the seller of a credit derivative, such as an insurance company, assumes the risk of a borrower defaulting on its loan.

J.P. Morgan seized the technology and quickly became its biggest user. The firm is the largest U.S. bank holder of credit derivatives, with 48% of the $258 billion in these derivatives held by U.S. commercial banks, according to the U.S. Treasury's Comptroller of the Currency (the $258 billion represents notional, or face value). Of J.P. Morgan's $123 billion in those derivatives, about $40 billion hedges the firm's own portfolio, while the rest has been sold to other firms.

In all, J.P. Morgan cut its total credit outstanding (excluding derivatives) from $127 billion at the end of 1997 to $106 billion at the end of June 1999.

"I think [the credit cutback] is an intelligent move on their part, but it's separate and distinct from the question of whether they can continue to build their investment-banking franchise," says Peter Nerby, vice president and senior analyst at Moody's Investors Service.

Measured by volume of transactions, J.P. Morgan's investment-banking performance has been mixed, though its profitability is up sharply. Its rank in volume of world-wide equity underwriting soared from 15th in 1996 to seventh in 1998 and seventh again so far in 1999, according to Thomson Financial Securities Data. In merger advisory, it fell slightly from fifth in 1996 to sixth in 1998 and 1999, and in debt underwriting it fell from fourth in 1996 to sixth in 1998 and 1999.

VIACOM INC.

MTV Creates Online Unit For Youth-Directed Sites