Shelter from subprime?

The US mortgage securities crisis has thrown up several lessons for investors, banks and policy makers, writes *Imad Moosa*.

The US subprime banking crisis has proved to be more contagious than any previous financial crisis: Mexico in 1994, Asia in 1997-98, Russia in 1998, the dotcom bubble in 2002 and the Enron and WorldCom corporate scandals early this century.

Subprime mortgages are risky or less than ideal loans or mortgages extended to borrowers with questionable credit worthiness. The crisis in the US subprime mortgage market came about because of the number of defaults on these mortgages and the consequent loss of faith in securities backed by these loans.

The crisis can be attributed to many factors: long-term lax monetary policies (hence, low interest rates), reckless lending by US banks to unsuitable borrowers and excessive securitisation that has led to the emergence of complex debt securities. Globalisation contributed to the contagious effect of the crisis as it spread across the Atlantic and Pacific. Even *The Economist*, a champion of *laissez-faire*, identified globalisation as a contributory factor in a leader article on 20 October 2007.

The crisis has hit financial institutions in Europe and Australasia: IKB (Germany), Northern Rock (UK), Paribas (France), Shin Kong Financial Holdings (Taiwan), RAMS Home Loans (Australia), Mitsubishi UFJ (Japan) and Mizuho Financial Group (Japan). Contagion spread from the housing and credit markets to all other financial markets, including the bond market, money market, sharemarket, primary securities markets, foreign exchange market and interbank market.

Doomsayers argued that the crisis signalled the end of the financial system as we know it and that hyperinflation similar to that in Germany in 1923 would occur. These claims are unnecessarily exaggerated and blown out of proportion.

ORIGIN OF THE CRISIS

The subprime mortgage market encompasses all activities to do with granting home loans to borrowers with inferior credit worthiness. Then, through the process of securitisation, complex financial products are created using these loans as collateral. These derivatives come in all shapes and forms, but in general are known as mortgage-backed securities (MBS), a class of asset-backed securities (ABS) and the so-called collateralised debt obligations (CDO). Often these products take the form of asset-backed bonds or asset-backed commercial papers (ABCP).

These financial products were marketed successfully because they offered high yields and initially attracted high ratings as a good debt with little risk of default by ratings agencies such as Standard & Poor's and Moody's.

Faced with the double whammy of declining house prices in the US and the decision of the rating agencies to downgrade ABS ratings, the subprime market started to experience some strain in June 2007. The US housing market was not particularly overvalued, but it was in a vulnerable position because of the large proportion of subprime loans. On 15 June 2007, Moody's downgraded the ratings of 131 ABS backed by subprime home loans and placed another 250 on a downgrade review. This action immediately affected hedge funds investing in these securities.

On 20 June, two hedge funds managed by US securities house Bear Stearns that invested in securities backed by subprime mortgages were in trouble. Subsequently, one of the funds was shut down and the other was salvaged through an injection of a $3.2bn loan.

The spiral continued with bad news from the housing market and the rating agencies. On 10 July 2007, Standard and Poor's placed $7.3bn worth of mortgage-backed ABSs on a negative ratings watch and Moody's downgraded $5bn of subprime mortgage-backed bonds. On 11 July Moody's placed 184 mortgage-backed CDO tranches on a downgrade review.

On 26 July, the housing market announced a 6.6 per cent year-on-year drop in US house prices. US financial and non-financial institutions started to feel the heat. On the same day, the largest US house builder, DR Horton, reported an April-June quarter loss, then on 31 July filed for Chapter 11 bankruptcy.

On 24 October, major US investment bank Merrill Lynch recorded a $2.3bn first quarter loss, the largest quarterly loss in its history, as a result of writing down $8bn worth of mortgage-related securities. New home sales in August were 8.3 per cent lower than July and 21 per cent down on a year earlier. Merrill Lynch ended up sacking CEO Stanley O'Neal and Citigroup's Charles Prince resigned a week later with losses of $11bn.

A CHAIN REACTION

The meltdown was not limited to the US. In Germany on 30 July, IBK warned of losses then subsequently revealed an injection of 3.5bn euros from its main shareholder, Kreditanstalt fur Wiedenraufbau (KfW) in collaboration with a group of public and private sector banks. On 9 August, BNP Paribas froze redemptions for three investment funds because it was unable to value them in the current market environment.

On 13 September, British bank Northern Rock suffered a run by its depositors. Northern Rock had grown using the liquidity available in the interbank market. But the subprime contagion hit the interbank market and dried it up. The bank run on Northern Rock made it a target for bargain hunters, including Virgin's Richard Branson, and subsequently led to it being nationalised by the Bank of England in February 2008. But why Northern Rock? Because it relied on other banks and capital markets for three quarters of its funding, hence it had too wide a gap between loans and deposits. This extreme financing model was not adopted by other banks.

In Singapore, UOB announced a S$34m markdown on its CDO portfolio at the end of June. The Overseas Chinese Banking Corporation booked losses amounting to S$33m in June. In Taiwan, 16 banks booked losses amounting to NT$1.2bn on subprime products and in Korea, financial institutions booked losses of $850m.

"The giant market for securities backed by US subprime mortgages was thrown into turmoil on Wednesday as lenders struggled to sell more than $1bn of assets seized from two Bear Stearns hedge funds that suffered heavy losses on subprime bets."

This lead paragraph from a *Financial Times* article published on 21 June 2007 marked a tipping point, where whispers about liquidity in the subprime mortgage market made way for the drumbeat of bad news.

In response to the crisis, central banks reacted by injecting liquidity into the system. On 9 August the European Central Bank injected 95bn euros into the interbank market. And on 17 August, the Federal Reserve's Board introduced a 50 basis point cut in the discount rate and announced that term financing would be provided for 30 days. Further events from the subprime shakeout are still unfolding.

Stockmarkets around the world have been sold off under the weight of mounting losses resulting from the upward repricing of credit risk. Particularly hit were housing-related and financial sector stocks.

The decline in stock markets has come as a natural consequence of lower risk appetite or risk tolerance as investors reassessed US corporate profit and the economy as a whole. Stock markets rebounded subsequently in reaction to supportive intervention by central banks and the activities of bargain hunters.

The deteriorating situation has hit the leveraged buy-out (LBO) market where funds to finance LBOs of listed companies are raised. By the end of the first half of 2007 the value of the announced takeovers reached new highs, requiring some $230 billion worth of funds. However, as a result of the subprime crisis the LBO market came under strain and a large number of ongoing deals were reportedly delayed, restructured or pulled from the market. For example, the bid to take over Sainsbury's (a British supermarket chain) failed because of the unavailability of funds.

MACROECONOMIC IMPLICATIONS

Traditionally, credit has been strictly rationed until a wave of deregulation and innovation in the 1980s and 1990s led to credit expansion that gave firms and consumers the means to plug temporary gaps in spending power, leading at the same time to excessive indebtedness. The very stability of growth may have encouraged people to take on an increased debt burden.

Economic growth needs liquidity, perhaps cheap liquidity. The subprime crisis has led to deteriorating liquidity, with investors shying away from private-sector securities. The longer this situation persists, the greater is the danger of an economic downturn. There is also the prospect of a global housing slump. But even if house prices hold up, credit market disruption (which will persist for some time) is likely to harm growth during 2008. OECD growth forecasts have already been revised downwards.

It is arguable that central banks will continue to come to the rescue as they have already done. If central banks try to mitigate risk to economic growth they may end up becoming complacent about inflation. One reason for the smoothness and sustainability of economic growth in recent years is the containment of inflation. Hence, there would be some policy conflict between the objectives of sustaining growth in the short run and the long run. However, the doomsayers' 'hyperinflation' predictions are unlikely to materialise and notwithstanding the seriousness of the situation, it is unlikely that even a 1970s-style inflation is envisaged. After all, and despite significant loopholes, the global economy has proved to be more resilient than some expected.

THE LESSONS

Several lessons should be learned from the subprime crisis. Banks must assess the damage inflicted by years of easy credit and the creation of complex financial products. They should be choosier about whom they lend to. Complex debt instruments make transparency rather important. Investors need to know who is holding what and how it should be valued. One way out is greater standardisation of structured products, which means that more should be traded on organised exchanges rather than on over-the-counter markets.

Another lesson is for the regulators, as inadequate or inappropriate financial supervision contributed to the crisis. The crisis also cast doubt on the division of labour in the financial supervision process. For example, the run on Northern Rock cast doubt on the viability of separating the lender of last resort function (the responsibility of the Bank of England) from other supervisory roles (undertaken by the Financial Services Authority or FSA and Treasury). Australian regulators may, therefore, want to reconsider the dichotomy between the regulatory functions of APRA and the Reserve Bank.

It is important to monitor the funding gaps of banks to avoid bank runs, Northern-Rock style. It is hazardous to rely on capital adequacy as an indicator of bank resilience. While capital adequacy rules are designed to protect banks from insolvency, the main problem in the subprime crisis is illiquidity. It has now become apparent that the FSA should have done something about Northern Rock's risky funding strategy.

Authorities in charge of designing and implementing national macroeconomic policies need to learn their lesson. For some time there has been the belief that the business cycle has been tamed, which means that economies experience smooth growth. This belief is based on three factors: financial innovation (securitisation), inflation control and the transformation that has made national economies more flexible in absorbing shocks.

The subprime crisis has taught us that excessive financial innovation could be a destabilising factor with ramifications for both growth and inflation. Financial markets are supposed to perform the function of providing lubrication for the real side of the economy which means there should be some proportional growth in the real and financial sectors. But this has not been the case as the growth of financial markets has been ludicrously disproportionate to that of the real side of the global economy. Financial markets, rather than the real sector, call the shots and are no longer a means to an end, which is a matter that is worthy of consideration by policy makers.

CONCLUSION

The crisis has, among other things, caused a loss of faith in the international financial system and the ability of central banks to manage financial crises. It will take some time to clear the mess created by this crisis in a process that will bring about a large number of bankruptcies and corporate losses. The outcome is bound to have significant ramifications for the global economy.

But looking at the bright side of the crisis, it has provided a number of lessons for investors, commercial banks, central banks, other regulators and policy makers. What will happen in the future depends on how much we learn from these lessons.

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