What a summer!

JOHN WALKER EXAMINES THE CREDIT CRISIS AND REVIEWS THE WAY AHEAD.

As the old song goes, “It might as well rain until September.” Well it did. It was the worst summer on record and not just for the weather. The summer produced a systemic failure in the financial markets that spread so fast we have forgotten all about the pandemic threat of bird flu. We have suffered and are still suffering from a pandemic threat to the stability of financial markets around the world.

If only we had had managers and decision-makers old enough to remember the words to Carole King’s refrain. If we had, we would have had people in positions of responsibility who could have drawn on experiences gained in the last major credit crunch to hit the markets.

So how did it happen? How did a low interest rate environment in one country lead to the collapse of financial institutions in another? How was it that the failure of borrowers to service their mortgages in one continent brought down financial institutions of which they had never heard in another?

Executive summary

- Anyone who has been involved in home loan finance knows that prudence was sent on her way a long time ago.
- US sub-prime losses of $50bn pale into insignificance compared with the global losses that have arisen from the sub-prime collapse.
- For corporate treasurers, life has become distinctly uncomfortable, as many of their Libor-linked loans were due to roll over. But the crisis has provided treasurers with an opportunity for some sensible housekeeping.

COTTONING ON For some, the crisis hit the financial markets on a global scale on 27 July when the world’s equity markets cottoned on to the fact that there was a serious problem and that it had been incubating for quite some time. Some commentators claim the crisis began in 2006, but that was simply when the symptoms began to emerge. The circumstances that gave rise to the crisis were in place several years earlier.

Prior to June 2004, the US authorities had followed a policy of accommodation to ward off the effects on the financial system of the last crisis. It was known as the Greenspan put, and had been remarkably successful in warding off recession in the US. With rates at 2% mortgage aspirants in the US with poor credit records had been able to fulfil their dreams of home ownership. At the same time existing home owners were able to refinance their homes, which provided them with the finance to extend the consumer-led economic boom in the US.

Anyone who has been involved in home loan finance knows that prudence was sent on her way a long time ago. Bankers had been replaced by bonus-led salesmen and lenders were driven by league tables and market share. Loans are sold like white goods, often with no need to pay for many months.

Innovative lenders were not confined by prudential ratios because their loans could be securitised or sold on in parcels by investment banks to less innovative banks at a profit. Globalisation, the new panacea, allowed these loans to be distributed around the world to previously unheard of institutions that placed their faith in the rating agencies for their credit decisions.

SEVENTEEN SUCCESSIVE RISES *Figure 1* shows that the cost of money more than trebled as the US authorities hiked the primary discount rate with 17 successive monthly increases of 0.25%. If borrowers were sub-prime in 2004, they certainly could not withstand the effects of such an increase in borrowing costs. Furthermore, the rise in interest rates from such a low base was so severe that many otherwise creditworthy borrowers were sucked into the problem. The construction of new houses went unchecked, leading to oversupply and falling prices. By 2006 foreclosures were commonplace. We in the UK became more aware of the problem in December 2006 as the US subsidiary of HSBC announced losses of $8bn. The problem was soon put to one side – after all, it was a local issue.

By June 2007, we started to hear that investors in Bear Stearns hedge funds could neither get their money out nor obtain a valuation of their asset. All of a sudden, innovative lending became recklessness. We no longer had to explain to people the meaning of securitisation or the concept of globalisation for they had come to mean contagion. Panic set in and it seemed that no one was old enough to know how to behave.

Banks refused to contribute to the system they depended on for their own existence. Bankers refused to speak to their customers because, being in unknown territory, they had no answers. Customers were unable to get answers from their bankers because they were unable to establish just who their current bankers were.

The contagion became a pandemic. Losses directly linked to the US sub-prime market have been emerging as far afield as Europe, India and China. Share prices plummeted around the world. Losses to sub-prime loans in the US are estimated at $50bn but this pales into insignificance compared with the global sub-prime losses.

In the UK we are watching the demise of Northern Rock. The mortgage bank is holed below the waterline and has borrowed £10.7bn from the Bank of England at 6.75% while most of its lending is linked to base rate at 5.75%. Northern Rock is not exposed to the US sub-prime market but created its own problems with aggressive marketing. Bank survival is all about confidence; even with government support, investors and depositors no longer trust the management.

Those returning to the market from a desert island will have found a changed world. Banks are refusing to lend to each other, thus exacerbating the contraction in market liquidity. By the middle of September three months Libor had risen to 6.90% while base rates remained unchanged at 5.75%. *Figure 2* illustrates the degree of dislocation that has taken place.

If, during the period of dislocation, a company had a Libor-linked

rollover and was able to select Libor or base rate, as many did, a simple decision was made. At one point, the private client division of a clearing bank was offering its favoured high-net-worth customers base rate-linked loans on the basis that they arranged the placement of the funds with another bank for three months at a rate linked to Libor. The balloon went up at Northern Rock the following day and these individuals may have had much to worry about.

UNCOMFORTABLE FOR TREASURERS For corporate treasurers, life became distinctly uncomfortable, for many of their Libor-linked loans were due to roll over. Currently, three month Libor is trading at 6.25% or 0.50% above base rate. During this period it is unlikely that their income will have increased proportionately. This dislocation is not restricted to the UK interbank markets but is also evident in the US and the euro zone interbank markets.

Treasurers will have also found an almost complete breakdown of the disintermediation process, with investors holding back from purchasing financial instruments including commercial paper and commercial mortgage-backed securities (CMBS). This in itself contributed greatly to the lack of liquidity in the interbank market.

These markets have critical implications for the commercial property market as the vast majority of loans made recently have, either directly or indirectly, been securitised. They will have found that property sales that they had expected to be completed have been pulled to await more receptive conditions.

It is a similar story for the larger private equity transactions where banks have been unable to syndicate large tranches of debt arising from their underwriting of leveraged buy-outs. Until they are able to complete the syndication process they must fund the debt underwritten and may have difficulty in absorbing new transactions. The current overhang is said to be as much as $600bn.

For the bankers the woe does not end there. The commercial paper market has all but dried up as cautious institutions and other investors refuse to take up rollover issuance. This leaves issuers with little alternative but to fall back on their liquidity lines. Until there is a return of non-bank investors to this market, ongoing maturities will simply mean a greater demand on banks providing liquidity lines.

WHEN WILL THE CRISIS END? The key to re-establishing an active lending market will be the return of the securitisation and syndication markets. Given the demand on banks' resources it is hard to believe that this can be achieved until investors have recovered their nerve and start to relieve the pressure on banks by returning to buy up commercial paper and demonstrate renewed faith in the CMBS market. The CMBS market has been used to a great extent in the UK over the past few years for refinancing investment portfolios on advantageous terms. That ability can now be regarded as dead.

Confidence will not return until the bad news has been taken off the front pages.

Unfortunately, bad news continues to emerge. On 5 October Merrill Lynch announced losses of $5bn. Northern Rock has not been removed from the front line, although at the time of writing Citi is reported to be ready to offer it a lifeline of up to £10bn. Also on 5 October another large mortgage lender was offering to pay potential wholesale depositors 6.60% for three-month money.

In the meantime, the focus is likely to move back to those banks that are primarily balance sheet lenders and have a strong deposit base. Old-fashioned lending relationships will be important, with a reversion to tighter pricing. It is inevitable that the amount of funds available to the marketplace will decline, thus restricting the overall volume of transactions.

Figure 1: US primary discount rate

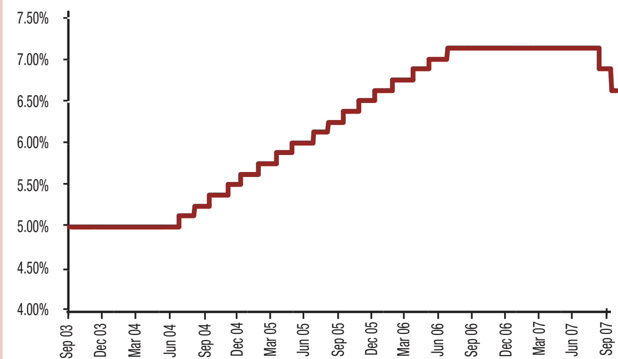

Figure 2: Three-month Libor vs base rate

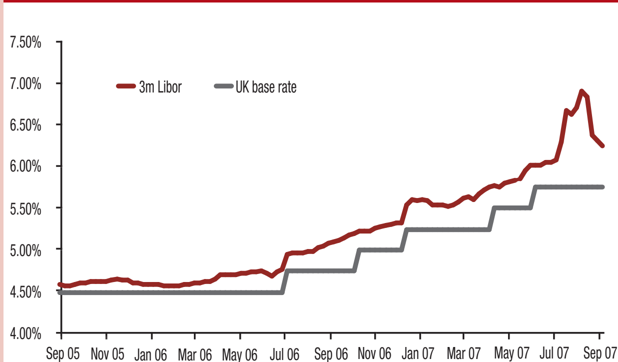

Figure 3: Three-month Libor vs five-year swap rate

There is no reason for corporate treasurers to do nothing while waiting for the capital markets to recover. The crisis has provided them with an opportunity for some sensible housekeeping.

Before the onset of the crisis, medium-term sterling swap rates had risen above 6.25% and looked as though they were set to carry on rising. As a consequence of the crisis, swap rates have fallen to levels not seen since earlier in the year (see *Figure 3*) thus providing treasurers with an opportunity to revisit their hedging strategies and alleviate some of the current pain.

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