

THE CREDIT CRISIS – HOW IT ALL BEGAN

The current turmoil engulfing financial markets commonly referred to as the 'credit crisis' or 'credit crunch' is over one year old. The crisis began in August 2007 when international wholesale money markets started to 'freeze up' as it became clear that USA 'sub-prime' borrowers had begun defaulting on their mortgage payments in record numbers. As house prices began to fall after a twelve year 'boom', large numbers of 'sub-prime' borrowers experienced 'foreclosure', known in the UK as 'repossession'. Sub-prime essentially refers to mortgages advanced to borrowers with a low credit rating including those with a history of previous credit problems.

It soon became clear that the problems extended beyond the sub-prime market and into the 'Alt-A' market (some element of impaired credit rating) and the 'Prime' market (credit worthy individuals) where many borrowers had over extended themselves. Neither were the problems confined to the US; many European lenders were also starting to experience similar defaults. The boom was well and truly over.

Many new entrants to the residential property market in North America and in Europe had been 'enticed' to buy on the basis of rapidly rising prices. As prices began appreciating, 'buy to let' investors also flooded the marketplace further driving up the prices of 'starter homes' with the inevitable inflationary impact all the way up the price chain. Rising prices led to an ever increasing demand for mortgages to buy property. Property valuations reached unprecedented levels. A long established measure of the under or over valuation of residential property is the ratio of average property prices to average incomes. The long run average in the UK is approximately 3-3.5 times prices to incomes although by June 1995 this had fallen to a historically low level of 2.3 following the prolonged six year recession. By the middle of 2007 this had risen to in excess of 8 times earnings, clearly a level which was not sustainable.

Since the early part of the decade, borrowing money to buy a house had never been easier and therein lies the root of the credit crisis as 'hungry' bankers and executives at other financial institutions 'piled' into what seemed a golden opportunity to make vast piles of cash for shareholders and themselves.

It is important to understand what had fuelled the global residential and indeed, commercial property price bubble. Firstly, there was a plentiful supply of money available to borrowers at extremely low interest rates and secondly, a complete relaxation of tried and tested lending criteria. Each of these requires further examination.

In the UK mortgages were originally provided by Building Societies who utilised savers deposits to lend money to individuals to buy a home. The difference between the savings and mortgage rate known as the 'retail margin' was typically 2%. Around twenty years ago banks became very interested in building market share in the mortgage market. However, unlike Building Societies they obtained their mortgage funds from the wholesale money markets, a more expensive form of funding than using savers deposits. Although banks profit margins were initially thin in comparison with the Societies the market was clearly lucrative.

Their only limitation was the amount of 'business' they could write given the 'capital ratio' requirements imposed by the banking regulators. Eventually the market developed to the

point where a variety of new fangled financial instruments were devised that effectively removed the barriers to growth.

In the case of Northern Rock, money was raised in the wholesale money markets and lent to borrowers. The money raised was largely on a short term basis, say two or three years, whilst at the point of lending most borrowers were being offered twenty five year mortgages or in many cases interest only loans. The business model assumed that as each tranche of short term borrowing matured the loans could simply be rolled over or replaced by new loans at an interest rate that would be less than the rate paid by the mortgagees. Unfortunately as the credit crisis began interest rates albeit low in historical terms, began rising as the availability of funding dried up; Northern Rock was history.

Another great wheeze across the financial community was termed 'securitisation'. If balance sheet capital constraints were restricting the amount of lending a bank could undertake why not simply sell the mortgage book on to the ever present stream of buyers for such 'solid assets' at a nice tidy profit. Such sales of 'packages' of mortgages were brokered by leading investment houses such as Bear Stearns, Lehman Brothers, Merrill Lynch, Morgan Stanley and Goldman Sachs. The buyer of the securities accepted a relatively small income return from their investment given the low interest rate climate and looked forward to enjoying a 'solid and reliable' income stream until the mortgages were eventually repaid. Once sold, the bank would be free to raise even more money to lend to a fresh batch of borrowers and so it went on.

The 'bright sparks' then came up with an even better wheeze. Why not bundle up the mortgage books being sold by various lenders with differing levels of credit rating (some sub-prime, some Alt-A and some Prime) and then 'slice and dice' this into smaller packages to satisfy investors looking for a slightly higher rate of return. Unfortunately, nobody really knew what each slice contained; as we now know many packages were extremely 'toxic'.

To cap it all many investment banks were highly 'levered' or 'geared', borrowing £30 for each £1 of capital they held. Hedge funds often operated on even greater levels of gearing with £100 / £1 being seen in extreme examples of the credit 'binge'. This excess leverage meant that even a relatively small fall in the price of the assets created a vicious downward spiral as assets were written down or 'marked to market', requiring more capital to be secured, further share price weakness etc.

The second important contributory factor behind the property bubble was the relaxation of prudent lending criteria that had existed for decades. Most institutions abandoned the tried and tested formula of lending 3 times annual income or 2.5 times joint income and declared they were now more interested in affordability. By 2005, loans of up to 5 or 6 times annual income were commonplace. In addition loans were regularly offered on an interest only basis and often without the need to put down a deposit.

Moreover Northern Rock encouraged many borrowers to take out its 'Together' Mortgage with the mortgage representing anything up to 125% of the value of the property; a value which itself was overstated by virtue of the speculative bubble in the property market. Self certification mortgages became readily available with borrowers 'declaring' their income on the application form. Many such loans were offered without any verification of the earnings

information by the lender. Americans came to know these as 'no doc' loans i.e. no documentation required.

Very little attention was paid to a borrowers overall ability to service mortgage repayments with scant regard for existing credit card and personal loan commitments.

As mortgage defaults accelerated toxic mortgage assets were clearly worth a fraction of what the buyers had paid. In August 2007 many of the world's leading banks and financial institutions were left holding large amounts of this debt as the buyers disappeared from view. The value of these assets had to be written down and forced institutions to raise more share capital from investors including sovereign wealth funds (state backed investment funds from the Middle East, Asia and elsewhere) to prop up their balance sheet and avoid credit rating downgrades from the rating agencies such as Standard & Poors, Moody's and Fitch.

The collapse of the global financial system in the form it had existed for decades was truly underway. Banks began hoarding cash and refusing to lend to one another as the financial stability of all participants in the market was called into question. Share prices of all financial institutions plummeted as 'deleveraging' began in earnest. Central banks around the globe were forced to introduce 'special liquidity schemes' and pump billions of dollars into the banking system to prop up the money markets. In March 2008 the US Federal Reserve (Central Bank) and Treasury engineered a rescue by JP Morgan of Bear Stearns one of the oldest and largest investment banks.

More recently in early September 2008 Fannie Mae and Freddie Mac, the two largest mortgage lenders in the US were effectively 'nationalised' or placed into 'conservatorship'. In the week ending Friday 19th September 2008, Lehman Brothers collapsed into Chapter 11 bankruptcy whilst Merrill Lynch was forced into accepting a takeover by Bank of America. AIG, until recently the largest insurance company in the world, was bailed out with an \$85 billion loan from the US government. Here in the UK, the Treasury engineered a takeover of our largest mortgage lender HBOS, by Lloyds TSB who until recently was a substantially smaller rival in terms of market capitalisation.

At the time of writing this article the US Treasury and Federal Reserve have proposed a 'stabilisation' fund amounting to some \$700 billion dollars in order to buy toxic mortgage securities from US banks. Somewhere along the line the regulatory authorities will need to redefine 'moral hazard' (refusal to bailout companies who have by their own recklessness come unstuck). They will surely seek to introduce new regulations to prevent the future build up of such excess liquidity and eventual deflation of a property or other financial asset price bubbles which has brought the financial system to the brink of collapse.