

The Credit Crisis – Summary and Update to September 29, 2008

As part of the continuing fallout from the credit crisis which began over a year ago, the past couple of weeks have witnessed heightened levels of volatility and a flurry of activity with government bailouts and bankruptcies amongst some of the most-storied names on Wall Street.

Background

The problem began in the U.S. mortgage market. As interest rates drifted lower over the past decade, savers sought out higher yielding debt instruments. In order to accommodate this demand, financial institutions expanded their lending portfolios to lower quality borrowers at higher interest rates. This *easy credit* led to the development of the *sub-prime mortgage market*. Sub-prime mortgages were issued to borrowers who otherwise did not qualify for a traditional mortgage due to a range of factors including poor credit history, lack of income or absence of a down payment. While housing prices seemed to be on a continual upward trend, many borrowers purchased homes they could not afford – and received the financing through the sub-prime market – with the belief that refinancing would always be available at historically low rates and rising house prices would provide a buffer against any difficulties. Financial institutions then pooled these loans – as well as other types of commercial and credit card loan portfolios – together into debt instruments through a process known as *securitization*. One of the theories behind securitization is that by pooling the debts together, the risk that any single borrower will default is diversified away and has a lessened impact on the overall portfolio. The newly created debt instruments were then sold to the investing public as higher-yielding fixed income instruments with a series of different credit ratings. In the meantime, financial innovation brought to markets products that further ‘sliced up’ the risk (such as *collateralized debt obligations* – *CDO*’s) or provided a means by which to insure against default through *credit default swaps* – *CDS*’s.

Many of the institutions involved in issuing the repackaged instruments in the market were independent investment banks which are less regulated compared to retail and commercial banks. The investment banks were able to leverage their assets at a much higher rate, which means they were not required to hold as much capital for each dollar they created in obligations against themselves.

The real trouble began in the spring of 2007 when the U.S. housing bubble began to burst. With housing prices slowing down, over-extended borrowers were no longer able to refinance against their homes. Defaults began to rise and credit conditions began to tighten – suddenly money was not so easy to get. Many sub-prime borrowers faced resets on their mortgage rates where they had enjoyed very low ‘teaser’ rates for an introductory period. The rate then increased substantially for the remaining term. Many entered into these types of products with the belief that they would be able to renegotiate a new mortgage with another low rate when the time came to reset. With the housing slowdown though, refinancing was not an option and defaults began to pile up when they could not afford the new payments.

By late summer 2008, the situation spilled over into other financial markets. Because the debts had been pooled, repackaged, divided, re-pooled, and so on, no one was certain where the real risk of these mortgages and other products lay and who was holding what.

All of this has culminated in a ‘credit crunch’ or inability to access capital for the past year. The essential problem boils down to the inability of financial institutions to raise cash and maintain a sufficient capital base. As confidence continues to erode and fear begins to reign, financial institutions are not even willing to lend to each other – even at much higher interest rates to compensate for the increased risk. Because much uncertainty exists about the true value of these financial instruments, banks, insurers and anyone else holding them has been forced to write-down the value of them and post large losses. At the same time, these companies are turning to financial markets to raise new capital or new sources of financing in attempts to ensure their balance sheets are able to absorb further losses. However, because of the high level of leverage, relatively small levels of default have caused large losses and led to the collapse of some of the biggest names on Wall Street.

How are the problems being addressed?

Because capital markets are global in nature, the problems of the U.S. housing markets have spread to institutions around the globe. Major central banks have implemented coordinated measures in attempts to restore liquidity to short-term money markets. These actions have been ongoing for the past year; however, they have so far failed to restore full confidence to the markets.

The first major casualty of the crisis was the venerable investment bank Bear Stearns. In spring 2008, Bear experienced a ‘run’ as investors lost confidence that the bank would be able to meet its short-term obligations. Without fresh capital coming in and clients moving business elsewhere, Bear faced bankruptcy. The U.S. Federal Reserve stepped in and arranged for JP Morgan to purchase Bear at what most commentators viewed as a ‘fire sale’ price, while the Fed agree to guarantee approximately \$30 billion in liabilities. With the exception of some failures in small, regional U.S. banks, these actions calmed markets over the summer. However, by the beginning of September, the system began to unravel and it became clear that more significant actions would be necessary.

Over the past few weeks, we have seen the bailout of U.S. government backed mortgage financing firms Fannie Mae and Freddie Mac, the bankruptcy filing of the Lehman Bros. investment bank, the last minute takeover of Merrill Lynch by Bank of America, the U.S. Federal Reserve bailout of insurance giant AIG, the conversion of the remaining investment banks – Morgan Stanley and Goldman Sachs – to commercial banks, the takeover of Washington Mutual by JP Morgan and the Citibank purchase of Wachovia. In attempts to shore up equity markets, the short-selling of shares of financial companies has been banned temporarily. Most substantially, over the weekend, it was announced that an agreement had been reached, subject to passage by the U.S. Congress (expected this week), on a US\$700 billion bailout package. The primary intent of the deal is for the U.S. Treasury to purchase toxic assets from financial institutions in order to remove the bad assets from balance sheets and provide fresh capital. In exchange for the bailout, a number of restrictions are expected to be imposed ranging from limits on executive compensation to equity positions being issued to the government.