

The credit crunch: how did we get here?



By Trevor Robinson
Associate AEIA

In his second inaugural address, President Roosevelt stated "We have always known that heedless self-interest was bad morals; we know now that it is bad economics". Just as in his day, those words ring true in our own day.

The aim of this article and a subsequent article in the next issue of Perspectives is to look at the current credit crisis and to try to identify its origins. We believe that the seeds of the crisis were sown decades ago and we point out the errors that have been made over time. The "Law of Unexpected Consequences" can be seen to have been at work, along with stupidity and also - the Courts may yet find - simple fraud. Few financial market participants come out of the analysis smelling of roses.

The crisis started in the USA, but a lot of the investment techniques were imported by many other, supposedly sophisticated, Western nations. We do not believe that the current crisis is restricted to, nor was caused, solely by the housing market; however, it is a major contributor and that is why we focus on it in this article. A future article will focus on broader categories of debt and offer some solutions to the credit crisis.

In the USA in 1977, the CRA (Community Reinvestment Act) became law. Its objective was to encourage banks to provide financial services to everyone in their service area and to stop the practice of writing home loans **only** to the best credit risks buying properties in the best neighbourhoods. Banks mostly adhered to such principles until 1995 when the Clinton Administration changed the CRA to facilitate lending to less creditworthy customers. This was an explicit social

policy (akin to Margaret Thatcher's sale of council houses in the UK) to increase home ownership amongst those people who had traditionally rented - mainly the poor and the socially underprivileged. "Quotas" were set by government authorities, which the lenders were expected to meet. Lending standards - amount of deposit required, security of employment, ability to pay - were lowered. As interest rates came down and were maintained at very low levels by Greenspan's Federal Reserve, it became easier to encourage the above groups into home ownership.

Gradually, lenders became concerned about the long term quality of the loans that they were being "encouraged" to make, so they securitised them - i.e. packaged various mortgages into a vehicle ("Mortgage Backed Security" - MBS) which could then be sold to someone else. The income from the mortgages paid a coupon on the MBS and whenever the mortgages were repaid, the capital amount of the security could be repaid. An initial fee could be taken by the lender for creating the security and then once he had sold it, not only did he have cash ready to make new loans, but also he did not need to worry about whether the loans would default, because somebody else - the buyer of the security - now owned the mortgages.

The buyers of these securities were happy to add them to their portfolios, because the coupons were higher than they could get in the Government or corporate bond market. Moreover, the asset underlying the security was house prices "which always go up"; mortgage defaults were at record lows and the rating agencies were happy to give these securities a very favourable credit rating.

As interest rates came down, investors went on a search for yield and sought to buy more and more of the above securities. An interesting change then gradually took place. Instead of the lenders originating the loans, packaging them and "pushing" them out to investors such as pension funds, the investors started demanding greater numbers of these securities, so "pulling" them through the system. The mortgage

lenders suddenly found that they were being asked to provide ever increasing quantities of these MBS.

As the demand for MBS increased, so the lenders started to motivate their sales staff to make more loans. As bonuses started to rise, quality standards started to slip. Gradually, fraud began to rear its head, sometimes tacitly encouraged by the lenders! If lenders choose to offer mortgages based upon what the borrower says he can afford and then omit even basic checks on his income and assets, such lenders cannot be surprised when borrowers lie to them. When the same lenders are offering mortgages for more than the value of the property - "to help buy furniture", "to cover the taxes on the house" - such misleading behaviour will only escalate.

House prices started to rise to reflect the increased demand. House builders noticed the increased demand and started to increase the prices at which they would sell newly built homes. Surveyors and appraisers were encouraged by their bosses to agree to the asking price demanded by the builder, who was paying their fees. Whether bribes were widespread is suspected, but not yet proven.

In summary, there is a strong case to be made that stupidity - if not direct fraud - took place **throughout** the system. In far too many cases, house buyers misled lenders about their incomes and assets; mortgage lenders dropped their standards and undertook insufficient background checks; the securitisation of these risks meant that it was no longer the problem of the original mortgage lender, but of the security buyer, the buyer did not do his own due diligence, assuming that it had been done for him; computer risk models that had been used successfully to manage the risk of portfolios of mortgages in "the old days" - 10% deposit, mortgage not greater than 3.5 times income, borrower in full time employment - were used for the new paradigm - 0% deposit, 120% mortgage, mortgage greater than 5 times "stated" income, with no proof of that income nor other earnings / assets. Clearly such risk models were unsuited to this new

paradigm. But, whilst house prices were rising, there were apparently no disadvantages.

The spiral continued to grow - until house prices started to fall.

The homeowners who misled lenders about their income found that they could not, or did not want to, continue paying their mortgage. As many of them had none of their own money invested in their house, they could walk away with equanimity - especially as most mortgages in the USA are "non-recourse", so the lender cannot demand full payment of the loan if the borrower walks away.

As these defaults took place and the mortgage payments stopped arriving, the MBS issued by the lenders started to trade at lower prices. New products, created by investment banks, that had taken these MBS and added leverage or gearing to them, saw massive price falls. Investors were furious, pension funds also suffered. Suddenly market participants realised that, when so much gearing is involved in an investment, it only takes a slight loss of faith, a slight change in the prices of houses, to start a sell-off in the MBS market. This started a panic and some of these investments became illiquid. When investors in the funds that bought these MBS wanted their money back and the "bad" investments could not be sold, then the "good" investments had to be sold in a modern-day working of Gresham's Law. Stock markets and commodity markets collapsed.

Worse still for the wider financial system, banks kept some of these securities themselves. Worse still, they have hidden them off their balance sheets so that the regulators cannot require them to keep additional prudent capital in place. Arguably, this is fraudulent. Certainly, *prima facie*, this strategy was designed deliberately to mislead the regulators and therefore it may well be that the directors of certain banks could be banned from the financial services industry as not being "fit and proper" to conduct investment business. Worse still, because these securities are hidden, no-one knows what quantities are hidden away, nor what the value is.

There has been so much bad practice committed - in the UK as well as in the USA - that the only certainty over the next few years is that the lawyers will get rich.

How do financial markets resolve this crisis? That is for our next article.

December 2008