Gibraltar Bankers Association Annual Conference

26th September 2007

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The Credit Crunch

What are the four most dangerous words in the English language? "It's different this time"

Firstly I would like to thank the Gibraltar Bankers Association for inviting me here to speak at their annual conference.

I was going to talk today about the growth of the Gibraltar finance industry, the likely developments in the year ahead and the role of the Commission. However, given recent events in the UK I thought it would be more relevant to talk a little about financial events global and particularly in the UK over the last few months and especially the last few days.

One thing I must state at the beginning is that we are not about to see a depression or even a significant recession. The global economy is growing at about 5% annually and is at the strongest it has been for three decades. The financial system is well capitalised. Yet recent times have reminded those who forgot, that continued growth is not guaranteed and that the lessons of the past remain valid.

There is a children's song which goes along the lines of "Shut the door, they're coming through the window; shut the window, they're coming through the door"

The last few months in the financial world has felt something like this. Whilst the financial community and the regulators have been busy dealing with one potential issue, others, like bush fires, have sprung up elsewhere. They are all connected but the connection is not always apparent.

The original fire started in the USA, a housing boom led to intense competition to find buyers, and between mortgage businesses to lend money to fund those purchases. In this race to the bottom money was lent, indeed a lot of money was lent, to the wrong people. Known as "sub prime mortgages", money was lent, often to "Ninjas" those with no income, no job and no assets.

It was frequently lent at teaser rates, that is interest rates that start low (and therefore affordable) but then, after a time, rise to higher, unaffordable levels. It was lent in the belief that the economy would continue to boom, house prices would rise and interest rates would stay low. They didn't

These adjustable sub prime mortgages were therefore a ticking bomb. As soon as the rates for the borrowers rose, many were unable to pay and defaulted. As at May 2007, the percentage of such loans that were delinquent (where payment was 60 days late or more) stood at 16.4%. The figure ten years earlier was 7.3%. $482 billion in sub prime loans are due to be adjusted in 2007/08.

House prices in the US are now falling and the number available for sale has risen from 2 million in 2001 to 4.2 million now. Industry estimates reckon that up to two million American families will lose their homes next year.

Countries have seen house price falls and increased repossessions before. They have historically been localised events. The impact of the sub prime problem is global. The reason for this is twofold.

Firstly, we live in a globalised world, capital moves freely across borders. Individuals and financial institutions can invest in financial products, many of them complex wherever they wish. Additionally given the size of the US economy, any downturn (of which there are contradictory signs) impacts the rest of the world as American demand for imports decreases.

The second reason is a result of securitisation.

Historically when a bank or building society lent money for someone to buy a house, they took the loan onto their own books. The money they lent came from their depositors or other banks (this is where Northern Rock comes in, but more of them later). Provided they lent at a higher price than they borrowed, kept their costs down and were careful who they lent to, it was a profitable business.

However, they could only lend what they themselves had borrowed. A comparatively recent development changed all this. This was the packaging (securitising) the loans made and selling them on. Banks turned from keeping loans on their balance sheet to an originate and distribute model.

The advantage of packaging is that it allowed the lender to get more money (from the sale of the securitisations) and so provide more mortgages. They became mortgage factories. And, because they didn't take on the risk of default themselves some became less fussy about the quality of the loans they were making.

Hundreds of these sub prime mortgages are bundled into asset backed securities. Then a Collateralised Debt Obligation (CDO) manager buys hundreds of these to create a CDO.

A CDO is a free standing company, often located in the Cayman Islands. They have a trustee, usually a bank that provides a monthly report on the content of the debt package.

Some CDO's issue commercial paper (ie a debt maturing in less than 270 days). Until the crunch $11 billion of investment grade commercial paper had been issued this year to money market funds alone.

CDO's had become the fastest growing debt market in the USA. About $600 billion was sold in 2006, compared with $99 billion in 2003. About a quarter of the content of all CDO's sold last year was made up of securitised sub prime debt.

CDO's were bought by, amongst others, insurance companies and financial institutions, including hedge funds. The trouble was that it was difficult to tell the quality of the underlying mortgages in the package. What percentage was risky? With each package containing thousands of mortgagees no one could go through and check each individual loan.

This is where the credit rating agencies come in. These agencies rate the quality of the debt issued. Depending on the agency the rating goes from, say, AAA downwards. A higher rating indicates the agency considers the debt has a lesser credit risk/risk of default. It is more complicated than that, but in principle investors require higher interest on the lower grade bonds than the higher as the lower ones carry a higher risk of them losing their money. This is known as a risk premium. Some investors, such as certain pension funds, are only allowed to own bonds of a certain quality. If the bond is downgraded they have to sell, so pushing down its price.

There was, however, a problem. The rating agencies were paid to rate the debt by those doing the securitisation, so creating a potential conflict of interest. Furthermore they were putting ratings on things which did not have a clear market value.

These securitisations do not have a liquid market. Therefore true marketing to market (valuing at the price they would fetch if sold) is impossible. It became, as Walter Buffet commented, less mark to market than "mark to myth". As there is no market the products were valued using mathematical models. Assumptions were plugged in to determine what theoretically the product was worth. However these assumptions were subjective and the models varied from institution to institution. Therefore different banks could value the same product differently.

Even today's accounting rules do not adequately cater for this. As Michel Prada, head of the French regulator, the AMP, has stated, "How in the world can all those [accounting rules] be of any use if one is not able to determine the price of any product?"

Ironically the banks were often congratulated for this securitisation as it took the risk off their balance sheets, thereby, in the view of some, making the system more robust. The risk had been spread amongst many players, so the system was better able to survive the shock of a single large default than a single bank was. However the risk was transferred not eliminated, it remained, like a ghost in the machine. The securitised debt was bought often in leveraged form (that is by using what you have bought as security to buy still more) by others. And who lent them the money, the banks!

As a result of these factors it became increasing difficult to work out where the risk finally lay. Some of the debt ended up in supposedly safe investments such as money market funds. Because no one could tell with precision where the risk lay, the quality of each security became uncertain. As a result, when the sub prime market began to implode the banks began to shun all potential risk areas, they lost trust in their fellow banks as no one knew who was actually vulnerable, the inter bank market dried up and the inevitable credit crunch occurred.

This is known as the “lemon theory” after the paper by the Nobel Prize winner George Akerlof. His paper used the market for used cars as an example of the problem of quality uncertainty and asymmetrical information. The theory runs, there are good used cars and defective used cars ("lemons"). The buyer of a car does not know beforehand whether it is a good car or a lemon. So the buyer's best guess for a given car is that the car is of average quality; accordingly, he/she will be willing to pay for it only the price of a car of known average quality.

This means that the owner of a good used car will be unable to get a high enough price to make selling that car worthwhile. Therefore, owners of good cars will not place their cars on the used car market. The withdrawal of good cars reduces the average quality of cars on the market, causing buyers to revise downward their expectations for any given car. This, in turn, motivates the owners of moderately good cars not to sell, and so on. The bad drives out the good.

This is exactly what happened in the credit market but as a mirror image. There was uncertainty as to who the safe borrowers were and who the risky ones were. Except, instead of dropping their price the buyers, in this case the lending banks put up their interest rates or, indeed stopped lending to each other altogether.

The impact is global. On the 12th September the European Central Bank (ECB) lent £51 billion to banks in the Euro zone. This was only it’s second ever offer to lend money outside its normal schedule. The Federal Reserve was similarly interventionist. Initially the Bank of England resisted, sticking to its standard facility of only allowing lenders to borrow on the overnight market at a rate 100 points above the base rate and restricting the type of collateral it would accept (This rate discourages borrowing unless necessary).

Few people would have believed, that in 2007, people would be stood in line outside a well respected, solvent, UK bank trying to get their money out. It is not my role to comment on the specifics of the Northern Rock panic. Much has been and will be written and said about it. I will instead concentrate on the concept of panic and possible regulatory and other ramifications.

Bank panics happen, they are a fact. The USA alone had 13 between 1814 and 1914. Panics often appear irrational but they are devastating. Before Northern Rock, the last had occurred in the UK in 1866 when Overend and Guerney, a discount bank, providing money for commercial and retail banks declared bankruptcy. As a result many smaller banks, even though they were solvent, were unable to get funds and collapsed, The 1866 crisis led to the Bank of England becoming the "lender of last resort" with the role of providing liquidity to the financial system during similar crises. The aim was not to prevent the failure of one bank but rather to stop such a failure causing a systemic failure by affecting others.

The role of lender of the last resort was first demonstrated in the 1890 Barings Crisis when the Bank of England covered losses Barings had made on investments in Argentina,

If one discounts BCCI (1991), the £1 purchase of Johnson Mathey in 1984, and Barings again (1995), the last similar problem in the UK occurred in the early 1970's and was known as the Secondary Banking Crisis. Then the mighty National Westminster had to deny it was in financial difficulty. Here again the Bank of England helped protect the system by launching, what became known as the "lifeboat" injecting £100 million into the banking system.

Today there is no global banking crisis; this is not a repeat of the 1929 Crash or the Asian Banking Crisis. In August, the Royal Bank of Scotland Group announced that its first half year operating profit, before tax, was up 11% to £5.1bn. Barclays rose 12% to £4.1bn. Despite writing off $1.7 billion in sub prime loans, Goldman Sachs still unveiled a $4.26 billion profit, a 79% rise, in the three months to August. Even Bear Sterns still made money overall during the period.

I mentioned earlier that panics "appeared" irrational. The problem is that those who deposit money in a bank are generally risk averse. To them, what is the downside of taking their money out? Some may suffer a penalty if they have their money on term deposit but most won't. To panic is totally rationale, even if not always articulated in a rationale way.

It is like the story of the man walking down a main road when suddenly a crowd appeared racing along. The man shouted "what's happening?" to which someone in the crowd replied "A lion has escaped from the zoo". The man, somewhat concerned responded "where is it?" to which the shout came back "well we aren't chasing it!"

So could the Bank of England have averted the panic? In 1890 secret negotiations between the Bank and London financiers led to the creation of an £18m rescue fund before the extent of Barings' losses became publicly known. The Governor of the Bank of England has publicly stated that such covert actions are not now possible because of the Market Abuse Directive. This interpretation is disputed. He also states that other legislation hampered his room for manoeuvre.

The question of the subsequent, alleged, "U turn" is somewhat more difficult. The £10 billion today pumped into the system for three month lending to banks does indicate the Bank shifted its position. Furthermore a wider range of collateral will be permitted, including mortgages although subject to the usual bank haircuts. The question that will be asked is, "should this have happened earlier?"

So is there blame also to be attached to regulators? Should regulators in the US have taken action against irresponsible lending? In hindsight yes, but the political movement was in favour of greater home ownership. Similarly accusations have been made that the Bank of England staff did not understand what Collateralised Loan Obligations were or the risks they carried. Yet regulators had issued warnings about these and other products but often had not been given the powers to act.

In respect of Northern Rock, should the FSA have taken action in respect of its aggressive growth strategy and dependence on the wholesale market? The trouble was, until 2007 the strategy worked. No one anticipated the closedown of the inter bank market. Again with hindsight there were warning signs. Northern Rock relied upon the wholesale market for 75% of its funding, far more than anyone else. Also its share of the mortgage market was 20% in the first half of 2007, a stunning growth.

The problem with such a growth is that stress testing and regulatory monitoring is more likely to focus upon the quality of the loan book and whether the bank had higher bad debts, than where the money to lend was coming from. Furthermore the bank met its capital and solvency requirements and regulators have little power to intervene in such circumstances. Even so it appears the FSA did question whether the bank's stress testing did take account of its reliance on short term credit. And, as I said earlier, no one saw the complete drying up of the market coming.

A third culprit has been named as the low level of deposit protection. There is talk of raising the level of deposit protection to £100,000 from its current £33,000. Whether the UK Government chooses to do this is a matter for them. However, there are a number of significant risks in taking such a step. The most critical of this is "moral hazard"

Protecting a person's savings is the work of three groups. The institution in which the money is entrusted, the regulator and the individual himself. It only works when all three are engaged. Remove one and the system becomes weaker. The investor/saver must take responsibility for their choice of institution. If a deposit protection scheme removes the incentive for a depositor to choose something that suits their own risk appetite (as they are protected whatever they choose), many will be tempted simply to chase the highest return. This, in turn encourages businesses to take risks in order to maximise the attractiveness of their offering.

The USA has protection of up to $100,000. During the Savings and Loans crisis of the 1980's this is exactly what happened. There was a race to the bottom. Large numbers of S&L's went bust and the compensation cost was £62 billion.

There is another issue. Who pays? If the industry, then healthy banks will have to pay for the mistakes of their competitors. Ok to a point, but to the extent the system encouraged depositors to go to their rivals?

If the Government, aka the tax payer, funds it, isn't there a danger that money is spent on protecting people who could have protected themselves?

If it is to be a premium on accounts, a type of insurance, what would the competitive impacts with banks in other places without this charge be?

Would customers of a foreign branch of a UK bank be covered? What about depositors with foreign banks operating in the UK?

That does not mean that there are not arguments for increasing the level of compensation, rather that it is not an open and shut case. I worry at knee jerk responses. Far better to concentrate on how to ensure compensation is paid swiftly. In any event I think that in a panic, knowledge that a compensation scheme exists is likely to have little if any dampening effect. People will still want their money out now.

Possibly statutory changes as to the seizing of bank assets and speedy disposal may also be worth considering. But again, such an approach may not be in the long term interests of depositors.

What about the role of the regulator, isn't the regulator supposed to keep out high risk institutions thereby ensuring the depositor only has a choice amongst safe institutions, thereby reducing the impact of moral hazard.

The role of the regulator is not to prevent failure. A zero failure environment would stifle growth and innovation. The regulator would have to go from risk management to risk avoidance. Certainly we do not want failure; we work hard to create an environment where it is far less likely for failure to occur. But we cannot ensure an environment where moral hazard does not exist.

So what next?

What happened to Northern Rock was not foreseeable, what is happening in the market as a whole was. There was too little premium for risk. The difference in interest charges between high and low risk lending was too narrow.

In his Mansion House speech last week the Chairman of the FSA gave two examples of this:

- the spreads between investment grade and non-investment grade corporate debt have been at historically low levels – for example, on 29 May 2007 the spread between AAA and BBB securities was as low as 64 basis points;
- the growth of leverage buy-out financing has been rapid and subject to declining credit quality – for example leveraged loan issuance grew by 65 per cent between the first quarter of 2006 and 2007.

Part of the credit crunch can be seen as a needed over correction of this. Corrections are seldom smooth. If one is optimistic, lending will resume but with a higher spread.

Lending to people who are unlikely to be able to repay is reckless, and if on sold to unsuspecting investors, possibly criminal. It seems obvious but clearly some need reminding of this.

So what will happen to Northern Rock? I doubt the existing management will survive. The market is unforgiving of their gods, who they find, in hindsight, had feet of clay. The bank did not know the level of risk it was taking. It could have protected itself by securing lines of credit. It did not. Regarding whether the bank will be acquired or broken up or even survive in a lesser form. Well time will tell.

There is also the risk, possibly the inevitability, of a class action by shareholders against the bank and its board for falling to disclose its problems early enough.

In respect of rescue operations, should there be a retreat from transparency? Should rescues be mounted in secret, under cover of darkness? I understand the Bank of England's wish to have been able to do this but we cannot now put this genie back in the bottle. To change to this now would create a threat to trust. The rumour mill will be in full flood. We will be back to asymmetric information and lemons. The problem is not transparency but understanding. The facility granted to Northern Rock protected it, yet the publicity around it was mishandled. Instead of reassuring, it caused panic. Obviously the media did not help. TV footage of queues and interviewing scared people as if they were experts hardly calmed matters.

Is legislation at fault? Certainly that is the view of the Bank of England. If EU directives or other legislation prevents a rescue then it must be revisited. Possibly the practice by the UK of gold plating EU legislation may seen to have accidentally caused the issue. I am sure we will see a conflict between legislation and this too will need to be addressed.

For banks in addition to the possibility in the UK of an enhanced compensation scheme there is the possibility that banks will be required to increase their holdings of cash and near cash. This obviously will have an impact on profits as this money will no longer be available for other uses.

Similarly the role of lender of last resort will need reconsidering as will the Bank of England's long term stance on what it will accept as collateral.

Gibraltar has been unaffected by these events, but may be impacted by consequent international changes in regulatory approach. The FSC will continue to monitor events and recommend statutory or regulatory changes to Government if it considers appropriate. It will, as always, remain available to provide any advice the Government may request.

And as for the customer, those looking to borrow high loan to value mortgages will find them harder to come by and will certainly be dearer. This will hit first time buyers. Similarly those with a poor credit history will find borrowing more difficult. Similarly mortgages of multiples of five or six time's earnings will be revisited. This may impact house prices, or at least certain houses. Whether interest rates themselves rise or fall will be seen over time.

Until Northern Rock, there had not been a run on a bank in the UK for 140 years. This is not a common occurrence. The system is robust, no depositor lost a penny. The events must be looked at and lessons learnt but not in panic. It is not Northern Rock that should worry people but the factors which caused it. Care must also be taken to ensure any response does not sow the seeds for future crises. The UK Treasury decision to underwrite Northern Rock depositors may have stopped this panic and, indeed, may not cost the taxpayer a penny, but what precedent does it set?

The factors behind the Northern Rock panic still exist and must be tackled. The opaqueness of the securitisation process, under which people are not sure the quality of what they have, can no longer be tolerated. The rating agencies, regulators and industry must bring transparency to the market. Banks and others must be open as to their direct and indirect exposure to the sub prime issue if trust is to be restored.

In conclusion we are at the least in for a bumpy time. No depression, no recession, but sub prime growth. A number of deals have already been scuppered. Wm Morrison's has put on hold a £1 billion sale of investment properties because of the credit squeeze. A £700 million hotel chain sale has also been postponed. The issue has also affected other countries. On the 21st September the Financial Times reported that the credit crunch had claimed its first Spanish victim when a Valencia real estate group admitted it was in emergency talks to renegotiate 300 million euros owed to suppliers and local savings banks.

The credit crunch will also threaten the corporate buyouts by the private equity funds that have relied upon cheap money to fund their deals. The return of a higher risk premium will see a significant increase in their funding costs. The faith of some funds in complex computer modelling is also being questioned. We have had too many 1 in 100,000 year events this year to continue to place total reliance on quantitative analysis.

Another side effect that may distort the market is an increase in collateral requirements. If fund managers have to post more cash against their trades, they will have to sell their more liquid assets, such as equities, as the market for the securitised assets they hold is non existent. This again will distort the market.

We have survived, so far, but confidence and trust underpin the world of finance and they have been damaged. This will take time to rebuild, the risk during this period is another hit, perhaps in the currency markets. At that point we may find that the current inclement financial weather risk rapidly turns into a perfect storm.