

The Global Risk of Subprime

*Remarks by Christopher Whalen to
The Global Interdependence Center
FRB Philadelphia
January 30, 2008*

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What is Global?

glob·al (glbl)adj.

- 1. Having the shape of a globe; spherical.
- 2. Of, relating to, or involving the entire earth; worldwide:
- 3. Comprehensive; total:

What is the Risk of Subprime?

- The subprime crisis is about the collapse of the unregulated, \$3 trillion over-the-counter market for complex structured assets, some of which happen to contain subprime residential mortgages.
- The subprime structured asset crisis of 2007 represents a sharp reversal in how global investors view all securitized assets and custom derivative structures, such as collateralized debt obligations or CDOs.

Is the Risk Only About Subprime?

- No. The “subprime crisis” is less about the credit quality of the mortgage loans behind a given bond issue and more about how banks package loans and other assets using complex derivative structures, ratings from Moody’s and S&P, and private mortgage insurance.
- More than a simple financial disruption, the subprime crisis is a “slow motion” systemic event which holds enormous long term implications for the global economy, the business models of entire industries and financial institutions, and for consumers.

A Conflict of Visions

- Economists long argued that securitized assets such as those developed by the GSEs to liquefy the market for residential mortgages would be more transparent and thus more efficient than bank assets.
- As the securitization market grew beyond the US market for GSE paper, the intermediary role of the commercial banking industry was expected to decline and banks would instead focus more and more effort on acting as agent and sponsor for these perfectly transparent and liquid vehicles.

Yield to Commission

- The rapid acceleration of financial technology created classes of assets that neither the academic community nor regulators anticipated. Regulators and the US Congress enabled this outcome.
- Unlike fairly simple GSE obligations or even OTC interest rate swaps, which are standardized and thus quite liquid, CDOs and other OTC derivatives blossomed into dozens of hideously complex and opaque permutations.

Flawed Securitization Model

- In place of the implicit guarantee of the US Treasury with GSE paper, Wall Street substituted a paid rating from Moody's or S&P and a guarantee from thinly capitalized municipal bond insurers or even hedge funds.
- Result is an enormous market comprised of unregistered securities which appear to be deliberately opaque and are thus unstable; which has virtually no support from dealers or investors; and for which banks retain de facto liability.

Market Situation: Unstable

- Approximately \$1 trillion in subprime mortgages was securitized as of Q3 2007, although the “fair value” of these securities is now significantly less since markets seized up last year.
- At the end of Q3 2007, there was \$7 trillion in total mortgage related issuance and \$2.7 trillion in asset backed securities in the US supported by just \$6.7 trillion in total bank deposits (SIFMA).

Effects: Global Economy

- The US economy has been shoved into recession by the sharp reduction in credit availability for real estate and commercial needs resulting from the systemic effect of the subprime crisis.
- Access to credit for small and medium sized businesses has been negatively impacted as \$3 trillion market for non-GSE securitizations is forced to shrink involuntarily.

Effects: Global Markets

- The collapse in investor confidence in many types of structured assets and financial institutions has led to a generalized retreat in global markets. Banks, ratings agencies and private insurers have suffered huge financial and operational losses.
- Sarbanes-Oxley and Fair Value accounting are forcing global banks and investors to write-down subprime assets far below economic value, feeding crisis atmosphere. Year-end reporting for many public companies could be problematic.

Effect: Banking Industry

- Immediate: Subprime crisis has torn a gaping hole in bank business models, eliminating volume and repeating income which was crucial for some large institutions while limiting ALM options for all banks.
- Long-term: The clock has been wound back decades in terms of bank ALM. Loan origination now implies retention of the asset as the default option, meaning that banks will have limited capacity to extend credit.

Effect: Consumer Spending

- Immediate: With the failure of the structured asset assembly line, consumers have lost access to home equity. New credit is likely to be scarce as banks raise internal target default rates.
- Long-term: Collapse of structured asset market implies a permanent reduction in availability of credit to the global economy as banks are forced to refinance much of the \$3 trillion in non-GSE issuance.

Global Solutions: Leadership

- The leaders of the political and financial communities in the industrial nations must quickly begin to discuss the global legal and regulatory changes required to bring bank capital requirements and risk taking in areas such as derivatives and securitization back into alignment.
- The US market desperately needs leadership on how to move from addressing institution specific concerns to repairing the overall market for private securitizations.

Global Solutions: Market Structure

- Private securitizations must be made more transparent, more uniform and thus more liquid. SEC registration and greater disclosure of collateral performance may be required to restore confidence.
- No reason why CDOs cannot be as liquid as GSE paper, given basic reforms in how these structures are created by dealers firms and monitored by ratings agencies.

Global Solutions: Ratings

- The role of the ratings agencies in creating & monitoring securitizations must be reformed, perhaps including direct SEC/NASD oversight for issuer-paid ratings activities.
- If a ratings professional acts like an investment banker and is paid by the issuer, then they should be regulated as investment bankers.
- Ratings agencies must “notch” CDOs and other securitization deals and provide updates to investors in real time.

Global Solutions: Banking

- Global regulators need to throw Basel II into the regulatory dustbin and purge the “risk based” mentality from regulatory vocabulary. Basel II is a monument to the derivative mindset which dominates bank risk analytics and lies at the heart of the subprime crisis.
- US regulatory framework must replace derivative risk measures with a more pragmatic, verifiable approach to bank safety and soundness which recognizes both direct and contingent risks.

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