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The Sub-Prime Loan Debacle and Credit Crunch: Implications for Asia

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The European Central Bank (ECB) in particular, but also the Fed, the Bank of Canada, the Bank of Japan and the Reserve Bank of Australia have all injected liquidity into the banking systems to calm jittery markets and ensure orderly conditions in the global money markets. Many other Asian central banks have said they stand ready to inject liquidity in the financial system if needed.

The ECB was the most aggressive "lender-of-last-resort", intervening to prevent short-term rates from rising too sharply. This followed news that France's biggest publicly listed bank, BNP Paribas, had frozen US$2.2 billion worth of funds after it was negatively impacted by the ongoing US sub-prime mortgage meltdown.

In the simplest sense, sub-prime mortgages are loans to people with a poor credit profile – so-called "Ninja" loans, i.e. loans to individuals with no or bad credit history, no collateral and no income. These loans were often offered as "2/28" hybrids, i.e. two-year fixed rate mortgages that convert to 28-year Adjustable Rate Mortgages (ARMs) at the end of the second year.

Things went fine as long as property prices were rising and interest rates low -- borrowers were able to build up more equity and mortgage companies received high interest rates. However, this Ponzi game started to unravel once the US housing market started to turn south. Many borrowers were unable to fulfill their mortgage repayments, leaving them no choice but to default.

While the downturn in the US housing market has inevitably impacted the weakest / highest risk link – viz. the subprime mortgage market – this market makes up only about 10-15 percent of the overall US mortgage market. Most US banks were considered to be fairly safe in view of the sound prudential regulations in the country.

However, the US subprime meltdown is turning out to be deeper than originally thought and is apparently having a more widespread impact than many originally thought it would. Why have the mounting losses in the US subprime credit market led to a squeeze on credit markets and fall in global equity markets, leading even George Bush to come out and state that "I'm told there is enough liquidity in the system to enable markets to correct"? The US Treasury Secretary, Hank Paulson, too has felt it necessary to proclaim that subprime malaise was limited and can be contained.

Initially it was expected that the subprime issue would be limited to a few US lenders. However, according to some estimates, a hundred or more lenders have been impacted and the crisis has spread to some non-mortgage institutions as well. Part of the reason for the spread of the crisis has been that the mortgages had been repackaged and sold as collateralised debt obligations (CDOs) to financial institutions, pension funds and individuals (and, apparently, even some foreign central banks).

In effect, while the growth of credit derivatives and securitisation had allowed banks and other financial institutions to transfer / distribute risks off-balance sheet, they had also become more willing to relax lending conditions. With the housing downturn, agents not directly involved in the subprime market have also been impacted as their asset quality has deteriorated. There is clearly a great degree of uncertainty because no one is quite sure what the extent of exposure is, and who exactly is exposed.

Thus, with rising delinquencies and defaults on subprime mortgages (which actually started in 2006), it has

become an almost daily occurrence for one institution or the other in the US to announce losses relating to its exposure in the subprime market. While the fallout had been limited to the US market and any impact on the other equity markets was primarily due to positive correlations with the US equity market, the announcement of BNP opens an entirely new can of worms. -- It shows that some European financial institutions are also directly exposed to the subprime market in the US.

Apart from BNP, the investment arms of both Barclays Bank and HSBC have reported exposure to the subprime market. This has added a new and significant dimension to the problem. The markets expect as almost inevitable that other institutions in the US, Europe or elsewhere will announce large losses due to their exposure; but no one is sure who has been affected and to what extent.

Nobody knows where the risk lies now - and markets dislike uncertainty and are understandably jittery. Financial institutions have re-priced risk and have become much more conservative in lending, thus leading to a credit squeeze. The credit squeeze has led to the cancellation of many leveraged buyouts (LBOs) by private equity firms which are not able to borrow money cheaply anymore. This, in turn, has led to the share prices of many firms, including giant private equity ones such as Blackstone Group, to decline sharply.

The sub-prime malaise has also spread to global equity markets. The Asian equity markets can be expected to be negatively impacted as well, as foreign funds that make losses overseas will face redemption pressures. This will, in all likelihood, lead them to dump equity holdings in Asia - which has seen a significant price run-up - in order to consolidate gains and to cut losses. This should, in turn help alleviate upward pressures on Asian reserves and Asian currencies. This may then minimise the need to persist with ongoing monetary tightening measures.

Problems in Asia could become much more far-reaching if the sub-prime slump leads to a complete asset collapse in the US and Europe and there is a consequent recession, though this is unlikely to happen as central banks appear to be ready to intervene if need be. In the near term, however, given the credit squeeze and the re-pricing of risk, it is likely that the markets will remain volatile and the global contagion and sell-off could intensify.

The sub-prime mortgage meltdown also highlights the need to counter acute challenges posed by rapid financial innovations to financial regulators in Asia and elsewhere. In addition to safety-and-soundness oversight and crisis prevention, it is imperative that financial regulators have in place sound and well-planned out crisis management and resolution procedures in the event that a crisis is triggered.

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