

Investment Terminology 1

The Credit Crunch

What is a credit crunch?

A credit crunch is a sudden reduction in the availability of loans or a sudden increase in the cost of obtaining a loan from banks.

There are a number of reasons why banks may suddenly increase the costs of borrowing or make borrowing more difficult. Concerns over the solvency or the ability to repay of the borrower or other banks, a decline in the value of the underlying security for the loan, a change in interest rates or even government intervention can all have an effect.

It can be caused by a sustained period of relaxed and inappropriate lending leading to bad debts and losses for lending institutions and investors in debt. In some cases lenders may be unable to lend further, even if they wish, as a result of earlier losses. The impact is felt whether the borrowing is long-term, or short-term using commercial paper.

What is commercial paper?

Commercial paper is a system of IOUs used by banks and big companies to borrow money for short periods, usually 60 to 90 days. This market has grown massively over the last ten years, from approximately \$25.8bn outstanding in Europe alone in December 1997 to \$510.9bn in May 2007 (source: Moody's). One of the main benefits is that issuing commercial paper is usually cheaper than borrowing from a bank, as the loans are regarded as extremely safe.

However, a sub-sector of the commercial paper market known as Asset-Backed Commercial Paper (ABCP) has been instrumental in the recent credit crunch. ABCP involves loans backed by assets such as mortgages or credit-card debt, which in many cases have been dramatically impacted by interest rate rises, property devaluation and the ability of the borrowers to make repayments. In addition, the fall in the value of mortgages means that the assets are no longer able to cover the value of the loan, hence the market for commercial paper has become stagnant.

What is the sub-prime mortgage market?

Sub-prime lending (sometimes known as second chance lending) means making a loan to those who do not qualify for the best interest rates or normal loan terms due to their credit rating, employment status or the type of asset taken as security. Interest rates on sub-prime loans are higher than normal loans and default rates are typically higher. As interest rates rose, and repayment costs escalated, so did the number of people defaulting. This has been widespread in the United States. Several major American sub-prime lenders have filed for bankruptcy.

What is a 'NINJA' loan?

Many of the loans made in the US sub-prime market were made to people with **No Income**, **No Jobs** and **no Assets**, other than a house to use as collateral, so-called Ninja loans.

Banks made 'Ninja' loans because they thought they were protected for two reasons.

Firstly, US house prices were rising and if the worst came to the worst, they could repossess the house and sell it to recoup the loan. However US house prices have fallen dramatically. As defaults have increased the banks' losses increased as property values fell.

Secondly, the banks packaged the loans up and sold them off to debt investors as CDOs.

What is a Collateralised Debt Obligation (CDO)?

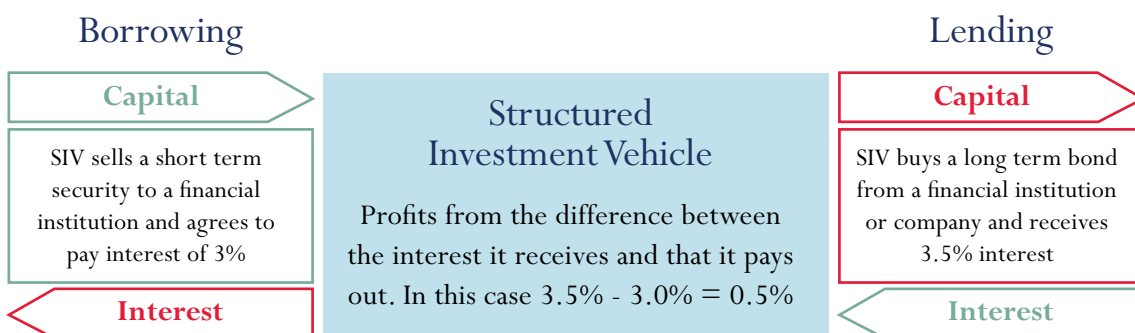
The banks take large numbers, sometimes millions, of these smaller loans and mortgages and pull them together into a Collateralised Debt Obligations or CDO. Much as a bond, the CDO will pay interest to the buyer over a specified time period. The principle is that one default will form such a small part of the overall package that it will have little impact. For this reason CDOs have good credit ratings and pay a good level of interest.

By 2006 demand for CDOs in the United States had grown to \$489bn from financial institutions, predominantly hedge funds, because of the perceived safety.

Defaults have increased to such an extent that CDOs have been unable to service interest payments. Also their underlying value has dropped alarmingly as investors shy away from them and the assets on which they are based are devalued. Many investors have suffered massive losses, especially hedge funds.

What is a Structured Investment Vehicle (SIV)?

A Structured Investment Vehicle (SIV) is a fund which borrows money at low interest and then lends at higher interest, making a profit for investors from the difference. Typically they borrow money by selling various types of short-term securities (commercial paper) to financial institutions. SIVs normally lend for the longer term by buying bonds so they need to actively trade short-term securities to maintain funding.



The sub-prime crisis caused a widespread liquidity crunch in the very markets SIVs rely upon, commercial paper. Since they needed to trade actively and were prevented many fell victim to the lack of liquidity. A number of banks have stepped in to support the SIVs which they originally set up and sponsor. In a recent case a German bank had to go to its majority shareholder, a state-owned bank, for an emergency \$10.8bn credit line last year. The strain on banks' liquidity has been tremendous.

What is an LBO?

A leveraged buyout or highly-leveraged transaction occurs when one company gains control of another using borrowed money to meet the cost of acquisition. It allows companies to make large acquisitions without having to commit a lot of capital. Mergers and acquisitions, whether by companies or private equity firms, have served to add impetus to market returns. However since the credit crunch has taken hold this activity has slowed dramatically adding to the impact on global markets.

Why has the credit crunch had such an impact?

Banks, in the main, are ultimately responsible for SIVs. Their sponsorship of these funds gave investors confidence that emergency credit would be available if necessary. The banks, however, never thought they would be called upon to bail these vehicles out, nor to the levels experienced. Both individual and corporate investors have lost confidence whilst banks have lost confidence in lending.

Consumers are feeling the impact of lenders tightening criteria or withdrawing facilities. This in turn impacts sectors reliant on the consumer such as retail.

Industry is finding it more difficult to borrow money to fund development and expansion, especially at a time when resource costs are spiralling. Reduced availability of money to support mergers and acquisitions has further put a brake on world markets.

All these factors have generated a big rise in risk aversion, with everyone from the man in the street to the global conglomerate reducing spending and looking to reduce debt, underlining the extent of the impact of the problems caused by the credit crunch.

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