

Neue Privat Bank

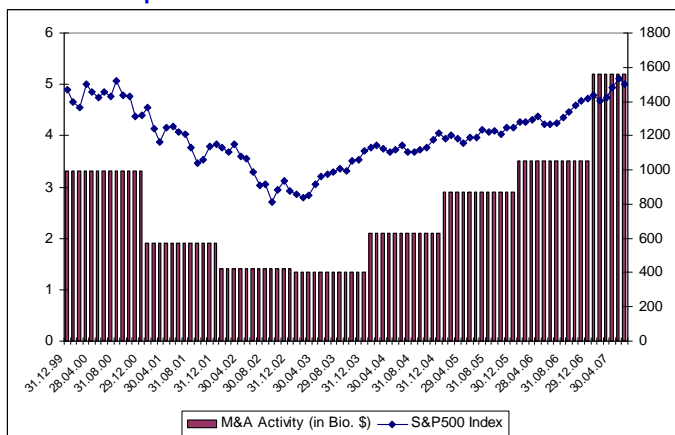
An overdue correction on the credit markets Central banks on the alert

- The credit market crisis triggered by defaults in the segment of American sub-prime mortgages has led to growing concerns about the stability of the international financial system. The most significant central banks have sent out clear signals that they will do everything they can to place the credit market crisis onto a more orderly course by appropriate injections of liquidity and co-ordinated rescue measures for institutes which have fallen into a precarious position.
- The central banks are confronted by the difficult task of cushioning the negative consequences on consumption in general of more restrictive lending and the price declines on the US real estate market by adopting an appropriate interest rate policy, and simultaneously avoiding a situation in which an all too compliant central bank policy, as a result of all the bad investments in the sub-prime segment and any other exaggerations on the credit market, overburdens the general public. Given the clear signs of a weakening US economy, we expect an initial reduction of the Fed target rate by September 18th.
- The turbulence on the credit markets gives rise to fundamental questions about the way a financial system works in which credit risks are largely securitised and packed into anonymous vehicles without adequately functioning mechanisms to monitor the underlying debt. A further "teething pain" of the market for mortgage loans is the significant divergence between the volume and insufficient market liquidity.

About cheap money ...

The last few years have provided most borrowers with ideal circumstances. Tempted not least of all by the low money market interest rates, set for the world's economy by the former head of the US Federal Reserve in order to avoid a (supposed) recession, the real estate markets in the USA and elsewhere recorded significant price rises and a massive expansion of the mortgage loan volume. Particularly "innovative" were a few mortgage institutes in the USA which, despite earlier warning signals from the Fed, developed "sub-prime mortgage models" which were supposed to enable low-income households to acquire residential property that was not particularly attractive in terms of quality and was already overpriced when it was bought in many cases. The lending banks also felt comfortable with the expansion of the financing volume because they were able to sell the associated risks out of their own books to other investors in packages and in the form of so-called Collateralised Debt Obligations (CDO). Securitised mortgage bonds of that kind, in which interest payments as well as capital redemption are linked to the creditworthiness of the individual mortgagee and the ability of the relevant property to retain its value, were greeted with high demand, primarily from institutional investors and specialised hedge funds.

Volume of corporate takeovers and S&P500



Source: KPMG, Bloomberg

For hedge funds and the Private Equity companies active in the business of corporate takeovers, cheap money was an ideal motor to raise the volume of business. For these players on the market, it has been easy in recent years to gather large amounts of equity and additional loan finance to support their hunt for large companies. Once a company was acquired, most of the

borrowings were transferred to it. The job in a second step was to push the returns of those companies to a high level so that they could be sold on to other buyers, completely or in slices, after a period of time.

Noteworthy in this respect is that the financing of acquisitions by means of borrowings has risen strongly in the last few years. The average ratio between equity and borrowings for European corporate acquisitions by Private Equity companies and hedge funds was at 1:3 in 2004, but it rose to 1:6 in 2006. The worldwide volume of corporate acquisitions rose correspondingly in these ideal circumstances and amounted in 2006 to an almost incredible 3.2 billion = 3.2 million million (see the graph). Here again, it was the investment banks who were happy to finance the associated loans and sell the corresponding risks on to other investors in the form of so-called Collateralised Loan Obligations (CLO) with fat structuring profits.

... when the credit bubble bursts

The growing mortgage debt of low-income US households could, however, only continue to function smoothly for as long as the real estate prices were still pointing clearly upwards. In the USA, rising interest rates and real estate prices which have been sinking sharply for months have led to a situation in the sub-prime segment that innumerable borrowers are no longer able to serve their mortgage debt. This, in turn, has meant that the immense, newly created credit system has started to shake, and it is not only the banks who are the prime bearers of the loan risks but, to an ever greater extent, various categories of investor such as hedge funds, pension funds and others. As modern credit instruments such as CDOs and CLOs enable the packaging of credit risks with varying degrees of creditworthiness, it is hardly surprising that, in the first wave, it was not the banks who were caught on the wrong foot but mainly those investors who, like a few hedge funds that have been liquidated in the meantime, had bought the weakest risk bundles with a high proportion of borrowed money.

The increasing number of announcements about the sharply rising number of defaulting mortgage borrowers in the USA, liquidity problems for a few US mortgage institutes and the compulsory liquidation or temporary closure of a few individual hedge funds has led to a general loss of trust and a threatened shortage of credit. Particularly affected is the interbank market, i.e. the short-term refinancing transactions between banks. Also particularly hard-hit in the recent past has been the strongly grown market for (short-term) Asset-Backed Commercial Papers. In view of the sharply risen,

short-term financing rates, the numerous central banks have seen themselves repeatedly forced to pacify the markets by means of reductions in the refinancing rates which apply for banks.

A huge credit volume without adequate market liquidity

It has become clear that for the securitised mortgage and credit loans, the liquidity in this market has in no way remained in step with the growth in volume. Hedge funds which, because of the return of participations and/or refinancing difficulties, have to reduce their positions are selling into a "market" insofar that they are having to live with very high discounts for credit risks which have nothing to do with the sub-prime market. One might well ask in this connection who monitors the proper behaviour of the borrowers in anonymous loan packages because by securitising them, one of the original and traditional activities of banks, namely the monitoring of credit and borrowers, falls away completely. It seems clear that little trust can be placed in the rating agencies whose far too optimistic assessment of packaged credit instruments can only be explained by a gravely false estimation or a view clouded by their own interests.

One of the central causes of the problems being faced by numerous hedge funds and investment vehicles is also the high degree to which they have financed themselves with borrowings with which investments in CLOs and CDOs have been leveraged. Against this background, and not quite without their own interests in mind, various banks see themselves forced to rush to the aid of some of their strongly exposed hedge fund clients with special finance injections in order to reduce emergency sales of credit positions to a minimum. This should particularly serve to avoid a situation in which price collapses in individual credit segments turn into a spiral which could force other hedge funds into panic sales. In the last few weeks, various promoters of hedge funds have feverishly tried to establish new investment vehicles as catch-basins for credit instruments which have become cheap.

A difficult walk on the tightrope for central banks

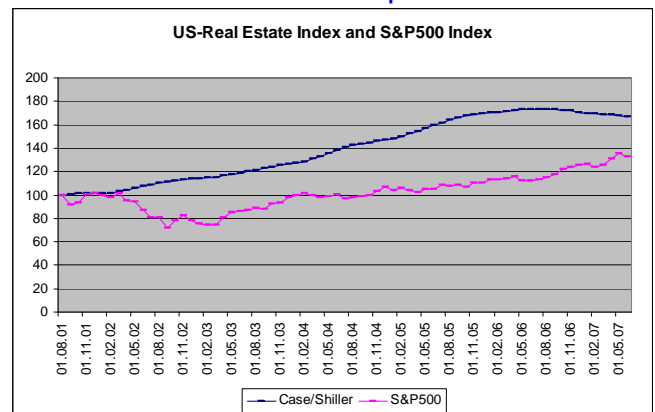
The substantial losses which are beginning to appear on the US mortgage market for sub-prime risks have led to a general re-assessment of credit risks. Consequently, after years of extremely low risk premiums, the interest rate differences for differing credit ratings have risen significantly in recent weeks. An example is that the yield difference of the JP Morgan European High Yield Bond Index - a benchmark for the level of risk premiums for corporate borrowers with a low credit rating - rose in comparison with the yield for treasury bonds by 121 basis points (bp) to 344 bp. One can also observe that numerous financial institutes have become generally more hesitant in granting credit.

In this environment, the central banks are faced by the somewhat difficult problem of, on the one hand, avoiding a bushfire in the international credit system and, on the other hand, of avoiding the mistake of passing on to the general public the bad investments of many market players in the sub-prime segment and with junk bonds. One can assume that the bad loans in the sub-prime segment, according to estimates of the independent economic research institute Bank Credit Analysis, lie at a maximum of 165 billion USD (of a total of 1,200 billion of securitised sub-prime mortgages). That sum is significantly lower than the risk positions during the American Savings & Loan crisis at the end of the eighties.

With a view to the stability of the financial markets and the banking system, the circumstance is beneficial that the sub-prime risks are broadly spread thanks to their securitisation and - in contrast to earlier credit crises - no longer have to be borne by the banking system alone. One can also assume that the central banks will do everything they can to prevent the sub-prime crisis from slopping over to other credit segments by continuing to supply the banks with adequate liquidity. If large

institutes, like the most significant American mortgage loan lender Countrywide Financial Corp. get into trouble, strong stockholders such as the Bank of America will be mobilised. One can only reckon with an imminent reduction of the US base rates as the epicentre of the credit market debacle if there are increasing signs that the decline in US real estate prices and a more restrictive credit policy lead to a new and significant slow-down of the US economy. It appears that the Fed's chairman Bernanke makes more hesitant use of interest rate reductions as a cure-all for any kind of default on the financial markets than his predecessor, Alan Greenspan, who is meanwhile known in financial circles by the nickname "Easy Alan". In addition, the central banks have clearly signalled that a clean-up of the loan excesses is strongly desired. Conversely, and in view of a base rate of 5.25% and the dampening effect on inflation of real estate prices, the Fed seems to have sufficient leeway to calm the waves with interest rate reductions if there is further turbulence on the loan market.

Real estate and stock markets in comparison



Source: Bloomberg

Differing impacts on stock markets

In the next few weeks and months, we are almost certain to see further headlines about major losses suffered by hedge funds and financial institutes, and that is likely to keep volatility on the stock markets at a high level. However, the central banks have left no doubt until now that they will do everything they can to prevent the credit market crisis from mutating into an actual "credit crunch". Apart from the major investment banks, the earnings situation for most companies have not changed drastically, so due to the fundamentally moderate valuation of the stock markets, the risk of further, significant setbacks does not appear to be particularly high. Merely limited declines might also be expected for hedge funds with long-short stock strategies because on average, they are financed to a much lower extent by borrowings compared to those hedge funds which invest in loan instruments. Shares could also benefit from the regrouping of portfolios out of the real estate sector, where high price rises must, at least temporarily, be regarded as a thing of the past (see the chart). Another factor which speaks in favour of the attractiveness of shares is that thanks to the growth in profits of recent years, companies can finance most of their growth strategies from their own balance sheets and are therefore not likely to be too badly affected by a more restrictive lending policy.

MR/September 2007