SOUTH INDIAN Bank

STUDENTS' ECONOMIC FORUM

To kindle interest in economic affairs...
To empower the student community...

Open Access

www.sib.co.in

ho2099@sib.co.in

October 2007

Theme 191

THE SUB-PRIME BUBBLE

A monthly publication from South Indian Bank

Youth PLUS
SOUTH INDIAN Bank
Our Bank
Our Account
Free Internet Banking facility & fund transfer
Free International ATM cum Debit Card
Free Mobile Banking Service
Free usage of our ATM network
Free Any Branch Banking facilities
Free Personalised cheque book
Free Depository account opening
Free for life International Credit Card
Free subscription to Students' Economic Forum.
And it's time to free your dreams.
Admit age: 20 to 35 years
Youth Plus account holders are preferred for project work with the bank.
*Conditions apply

SOUTH INDIAN Bank
Experience Next Generation Banking
The South Indian Bank Ltd., H.O. : 'S.I.B. House', Thrissur, Kerala

SIB STUDENTS' ECONOMIC FORUM

OCTOBER 2007

Theme No. 191 : THE SUB-PRIME BUBBLE

Introduction

"If you have arrears, defaults or pending court Judgements you might find that your credit applications are rejected by high street banks and major loan companies, but finance may still be available. We specialise in matching your application to the lenders most likely to approve it, so your chances of getting a loan are greatly increased, no matter what your credit rating is....". This is the home page announcement of an American loan broking agency in its website. Having emerged more than two decades ago, sub-prime mortgage lending began to expand in earnest in the mid-1990s. But the expansion spurred in large by the innovations which reduced the costs for lenders in assessing and pricing risks. The concept of securitization and the growth of secondary market helped mortgage lenders to have greater access to the capital markets, thereby increasing the supply of mortgage credit to all types of households. This month, we will have a discussion on the sub-prime lending crisis or the so called sub-prime bubble, which shook the financial markets across the world.

Define Sub-Prime Lending.

Sub-prime lending are loans made to borrowers who are perceived to have high credit risk, often because they lack a strong credit history or have other characteristics that are associated with high probabilities of default. As a result of the borrower's lowered credit rating, a conventional mortgage is not offered because the lender views the borrower as having a larger-than-average risk of defaulting on the loan. Lending institutions often charge interest on sub-prime mortgages at a rate that is higher than the conventional mortgage in order to compensate them for carrying more risk.

What you mean by Sub-prime crisis?

The sub-prime crisis began on June 30, 2004, when the Federal Reserve (the central bank in the US) began a cycle of interest rate hikes that raised the cost of borrowing. It increased the interest rates seventeen times and it got stabilized only in June 2006 when the Federal funds rate touched 5.25 per cent, the highest since March 2001. (Please see the Table). The US housing market began sliding in August 2005 and that continued through mid 2007. Building rates and housing prices tumbled and a large number of borrowers with ARM (Adjustable Interest

Rate Mortgage / Floating Interest Rate – that varies along with current market rates) defaulted in making their repayments. As a result, hundreds of thousands of borrowers received foreclosure notices and several major sub-prime lenders filed for bankruptcy.

Do you think that sub-prime lending was something illegal?
No. Two decades ago sub-prime borrowers would typically have been denied credit. But the 1980 Depository Institutions Deregulation and Monetary Control Act (DIDMCA) eliminated controls on first-lien mortgage rates, which permitted lenders to charge higher rates of interest on borrowers with poor FICO rating or who pose elevated credit risk. The Alternative Mortgage Transaction Parity Act (AMTPA) in 1982 permitted the use of variable interest rates and balloon type repayments. But sub-prime lending would not have become a viable large-scale lending alternative until the Tax Reform Act of 1986. TRA 1986 prohibited the deduction of interest on consumer loans, but allowed deductions of interest on account of mortgages for a primary residence as well as one additional home.

FICO Rating?
In US, a borrower's credit history is usually summarized by a FICO credit score. It is an acronym for the creators of the FICO score - Fair Isaac Credit Organization. FICO scores range from a low of 300 (highest risk) points to a high of 850 points (lowest risk). Everything else being the same, borrowers with FICO scores below 620 are viewed as higher risk and generally ineligible for prime loans unless they make significant down payments. Using mathematical models, the FICO score takes into account five major areas - payment history, current level of indebtedness, types of credit used, length of credit history and new credit in determining the credit risk.

Can you trace out some reasons which inflated this bubble?
In the simplest terms, what went wrong in the sub prime mortgage market is that the people responsible for giving loans had too little financial interest in the performance of those loans and the people with financial interest in the loans had too little involvement in the process of how the loans were given. Most people will borrow more than they can afford, but only if the lender also goes along with them. The whole thing was a party of cheap and easy credit.

Hikes in interest rates by Federal Reserve, falling house prices, job cuts especially in the auto industry, weakening of loan sanctioning norms, inadequate capital of loan originators and the high degree of separation that exists in US housing market have been the main attributors to the sub-prime bubble. The capital markets are a wonderful vehicle for transferring risk and providing capital to lending activities. But when the transfer of risk leads to a lack of diligence, markets become dysfunctional. Mortgage market participants have long recognized that there is substantial risk in acquiring loans originated by someone else.

What you mean by "degrees of separation"?

There can be different levels of insulation between the loan origination process and the investment process. The current secondary market for sub-prime mortgages has as many as nine participants - Borrowers, Brokers, Mortgage Bankers , Servicing Agents, Aggregators, Investment Banks, CDO (Collateralized Debt Obligation) Managers, Rating Agencies and then the Investers. This resulted in a great level of separation between the mortgage origination process and the investment process. Each participant has a specialized role. Specialization serves the market well, as it allows each function to be performed efficiently. ***Specialization, however also means that risk assessment and risk bearing are separated.***

Can you describe the roles of these players in inflating the sub-prime bubble?

Rating agencies do not share the economic costs of loan defaults and their methodology allowed for the inclusion of loans of dubious quality into sub-prime mortgage pools. The rating agency is paid if the CDO is created and there is no compensation if the CDO is not created. There will be very few rating institutions that can remain objective under such a compensation scheme.

CDO investors also relied upon the CDO manager to guide them in the dangerous waters of mortgage investing. Moreover, many of the CDOs were managed by start-up firms with little or no capital at risk. There were clear warning signs for several years as to the problems and risk of investing in sub prime mortgages. Once the investors closed their eyes to the level of risk in their mortgage investment, market forces bulled to increase the risk of those instruments beyond the expectations of the investors.

At the origination end, without the discipline of a sceptical buyer, abuses grew. The buyer was not sufficiently concerned with the process of loan origination and the broker was not subject to sufficient constraints. The mortgage investor was like an absentee landlord.

Can you comment on "The burst of Dot-com bubble gave birth to Sub-prime bubble"?

Economists have argued that the stock market crash, especially in the dot-com and technology sectors, in 2000 and the subsequent drop of the NASDAQ composite index resulted in many people taking their money out of the stock market and purchasing real estate, which they believed to be a more reliable investment. Another important consequence of the dot-com crash and the subsequent 2001–2002 recession was that the Federal Reserve brought down the interest rates to historically low levels, from that of 6.5% to just 1%.

Impact on Indian markets?

Several Foreign Institutional Investors (FIIs) are straining under the impact of non performance of loans originated in the US sub-prime market. Huge withdrawals of FIIs from Indian market and the crash of equity markets in August had its footing on the US sub-prime crisis. But the equity markets recovered followed by sustained buying pressure from local mutual funds and unaffected FIIs. If we analyse, we can see some trends in the Indian housing sector which resemble the trends in US, which preceded the sub-prime mortgage crisis. Gross NPA of banks and other lending institutions are inching up the ladder, while property prices have gone up tremendously and borrowing and lending rates have been on steady increase. These signs have its own relevance in the Indian markets. All truth passes through three stages. First, it is ridiculed. Second, it is violently opposed and third, it is accepted as being self-evident. Keeping this proverb in mind, regulators in India have taken prompt steps to avert such a bubble in Indian soil. RBI and SEBI are steering the wheels in right direction by putting preventive policy measures in place.

Conclusion

As the problems in the sub-prime mortgage market have become manifest, we have seen some signs of self-correction in the market. Federal Reserve reduced the funds rate by 75 basis points during Sept. - Oct. 2007. (The Federal funds rate is the overnight lending rate at which depository institutions lend balances at the Federal Reserve to other depository institutions.) Now the Investors are scrutinizing sub-prime loans more carefully and, in turn, lenders have tightened the loan sanctioning standards. A door is not a door when it is ajar (partially opened). That was the problem with the secondary market in US, especially with the sub-prime loan securitization. No gate keeper was there to shut the door on uneconomic loans. There has to be capital at the origination end of the mortgage process. Without capital, warranties have no value. To achieve this, all the players in the mortgage market need to maintain sufficient reserves to support their financial promises. Ultimately the mortgage market can only function properly when those who are involved in the process of mortgage origination are motivated to limit the risk of mortgage investments. To some extent markets are self correcting, but markets have surprisingly short memories and seemed to be easily fooled by structural innovations that cleverly hide the underlying risk. Therefore, without some institutional changes, these inherent problems are likely to re-emerge in the form of some other bubble.

Federal Reserve Funds Rate 2000 - 2007

Year	Date	Ups (in *bps)	Downs (in bps)	Rate in %
2007	Oct-31	...	25	4.5
	Sep-18	...	50	4.75 ↓
2006	Jun-29	25	...	5.25 ↑
	May-10	25	...	5
	Mar-28	25	...	4.75
	Jan-31	25	...	4.5
2005	Dec-13	25	...	4.25 ↑
	Nov-01	25	...	4
	Sep-20	25	...	3.75
	Aug-09	25	...	3.5
	Jun-30	25	...	3.25
	May-03	25	...	3
	Mar-22	25	...	2.75
	Feb-02	25	...	2.5
2004	Dec-14	25	...	2.25 ↑
	Nov-10	25	...	2
	Sep-21	25	...	1.75
	Aug-10	25	...	1.5
	Jun-30	25	...	1.25 ↑
2003	Jun-25	...	25	1 ↓
2002	Nov-06	...	50	1.25 ↓
2001	Dec-11	...	25	1.75
	Nov-06	...	50	2
	Oct-02	...	50	2.5
	Sep-17	...	50	3
	Aug-21	...	25	3.5
	Jun-27	...	25	3.75
	May-15	...	50	4
	Apr-18	...	50	4.5
	Mar-20	...	50	5
	Jan-31	...	50	5.5
	Jan-03	...	50	6 ↓
2000	May-16	50	...	6.5
	Mar-21	25	...	6
	Feb-02	25	...	5.75 ↑

* **Basis Points (bps)** is a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security.

South Indian Bank Ties Up With HSBC Mutual Funds

While investors in the urban and metro bank branches have clearing membership and are given free banking facilities for investing in mutual funds, their rural counterparts are denied the same. In order to rectify this anomaly, South Indian Bank, in business partnership with HSBC Asset Management Company, has introduced a facility, which is the first in the country, in which rural investors would not be losing through cheque / DD collection/DD commission charges when investing in HSBC Mutual Fund Products.

This facility was launched when South Indian Bank Chairman & CEO Dr. V.A. Joseph and HSBC AMC CEO Mr. Sanjay Prakash exchanged the agreement for distribution of the entire bouquet of HSBC Mutual Fund Schemes through all the 485 CORE Banking branches of the Bank spread over 23 states/UTs.

Speaking on the occasion, Dr. V A Joseph stated that the Bank is now being transformed into a financial supermarket. The tie-up with HSBC would provide with consistently strong investment performance, efficient service and a flexible product range to meet the clients' individual investment requirements .

In Photo: South Indian Bank Chairman & CEO Dr. V.A. Joseph and HSBC AMC CEO Mr. Sanjay Prakash exchanging the agreement for distribution of the entire bouquet of HSBC Mutual Fund Schemes at a function held at SIB Corporate Office, Thrissur.