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- Interview

Sub-prime malaise: Markets jittery, FIs reprice risk

In the near term, it is likely that the markets will remain nervous and the global contagion and sell-off may intensify.

D. Murali

Chennai, Aug. 13 After the 'complete evaporation of liquidity' that the French banking group BNP Paribas reported on August 9, markets around the world have been witness to dramatic vaporisation of values. At the core of the problem is the sub-prime crisis, with its roots in the US.

"The sub-prime malaise has spread to global equity markets," observes sombrely **Mr Ramkishen S. Rajan, Associate Professor, School of Public Policy, George Mason University, US,** in an interaction with the Business Line. T he Indian market can be expected to be negatively impacted as well, as foreign funds that make losses overseas will face redemption pressures, he adds.

"This will likely lead them to dump equity holdings in India which has seen a significant price run-up, so as to consolidate gains. This, along with the new restrictions on external commercial borrowings, should in turn help alleviate upward pressures on Indian reserves and the rupee. This in turn may reduce the need to persist with ongoing monetary tightening measures."

Thus, there is a mix of both positives and negatives. However, problems in India could become much more far-reaching if the sub-prime slump leads to a complete asset collapse in the US and Europe and consequent recession, cautions Mr Rajan.

Reassuringly, though, he is of the view that such a collapse is unlikely to happen as central banks appear to be ready to intervene if need be.

"The ECB (European Central Bank) in particular, but also the Fed, the Bank of Canada, the BOJ (Bank of Japan) and RBA (Reserve Bank of Australia) have 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."

In the near term, it is likely that the markets will remain nervous and the global contagion and sell-off may intensify and markets will remain highly volatile for some time to come, opines Mr Rajan. “Caveat emptor.”

Excerpts from an interview:

Why did the ECB react the way it did?

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 $2.2 billion worth of funds after it was hit by the ongoing US sub-prime mortgage meltdown.

How is sub-prime mortgage defined?

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.

What went wrong?

Things were fine as long as property prices were rising — borrowers were able to build up more equity and mortgage companies received high interest rates. However, this Ponzi game started to fall apart once the US housing market started to turn south.

While the downturn in the US housing market has inevitably impacted the weakest / highest risk link – viz. the sub-prime mortgage market – this market makes up only about 10-15 per cent 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.

Did the problem come as a surprise?

The US sub-prime meltdown is turning to be deeper and having more widespread impact than many originally thought it might have.

Why have the mounting losses in the US sub-prime 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 sub-prime malaise is limited and can be contained. Thus, the extent of exposure has come as a surprise.

Do we know how much is the extent of exposure?

The flare-up in global credit jitters has arisen because of the exposure that banks, hedge funds and other high-quality mortgage firms have to the sub-prime mortgage market. 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 in sub-prime mortgages, 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 sub-prime market.
How widespread is the impact?

Initially it was expected that the sub-prime 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. Part of the reason for the spread of the crisis has been because the mortgages had been repackaged and sold as collateralised debt obligations or CDOs to financial institutions, pension funds and individuals. Thus, agents not directly involved in the sub-prime market have also been impacted as their asset quality has deteriorated.

And the problem is spreading to other countries.

While hitherto any fallout has been limited to the US market and any impact on the other equity markets have been primarily due to positive correlations with the US equity market, the announcement of BNP opens an entirely new can of worms. This is so as it shows that some European financial institutions are also directly exposed to the sub-prime market in the US. Apart from BNP, both Barclays Bank and Hong Kong and Shanghai Bank have reported exposure to troubled hedge funds that had invested in the sub-prime market. This has added a completely new and significant dimension to the problem.
What's killing?

The uncertainty. Nobody knows where the risk now lies and markets dislike uncertainty. The markets expect as almost inevitable other institutions in the US, Europe or elsewhere to announce large losses due to their exposure; but no one is sure who has been affected and by how much.
The result, therefore?

Financial markets are jittery, financial institutions have re-priced risk and they have become much more conservative in lending, leading to a credit squeeze. The credit squeeze has also led to the cancellation of many leveraged buyouts (LBOs) by private equity firms, which are not able to borrow money cheaply. This in turn has led to the share prices of many firms, including giant private equity ones such as Blackstone, to decline sharply.

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