

# Strategy

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## Financial crisis update

The aim of this publication is to provide an overview of current stories/issues in relation to the financial market crisis. We will update this regularly going forward. Key points are:

- The troubles facing the bond insurers, also called **monoliners** keep mounting, and further downgrades are looming on the horizon. Warren Buffett's offer last week to be paid for taking over responsibility for USD 800bn in municipal bonds did little to ease concerns. The primary source of the current stress among monoliners is their exposure to mortgage-backed securities – not their exposure to municipal bonds. Reports that investors have begun to shun Auction Rate Securities, ARS, which constitute around USD 330bn of the USD 2,200bn municipal bond market, is yet another indication that perceived risks of further downgrades among monoliners are on the rise.
- Leveraged loans to finance buyouts, **LBOs**, have been a burden for many banks since last summer. However, the prices of these loans in secondary markets have started to decline. Last week, S&P warned that a growing number of leveraged loans are in danger of breaching covenants or defaulting. Any relief to banks' balance sheets from the LBO front are unlikely in the near term. Against this background of persistent concerns, **credit spreads** keep widening, and now stand at record wide levels during this crisis.
- The reports last week on 'material weakness' relating to the valuation of AIG's CDS portfolio highlight that independent auditors will be particularly thorough in their auditing of the 2007 **annual reports for financial institutions**. In the coming weeks, similar news stories may therefore emerge as the auditing processes for the annual reports progress. In the short term, this may pull down sentiment on financials.
- The size of **asset-backed commercial papers in the US** keeps contracting as SIV's are being unwound.
- Recently, **money market tensions** have picked up slightly after declining materially at the turn of the year. We see risks of further widening of money market spreads.
- The initial source of the shock driving the current crisis was the decline in the value of **US subprime mortgages**. Judged by ABX indices, the prices of US subprime mortgages have far from recovered.

## Monoliners

The heat remains on the monoliners. Moody's downgraded FGIC below AAA on 14 February. Rating agencies seem to be on the verge of delivering further downgrades of monoliners, monoliners' share prices are falling as they struggle to raise new capital. The current credit spread widening is a serious issue for them as it generates market-to-market losses on a lot of their outstanding insurance liabilities. US regulators are working closely with the industry on a coordinated effort rescue effort.

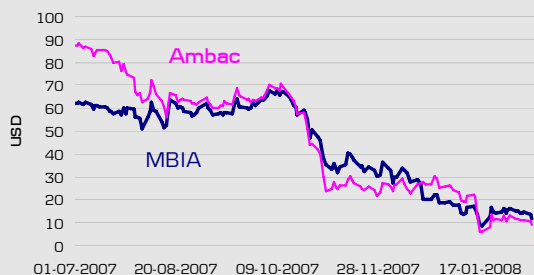
The free rider problem (individual banks have a strong incentive to let the other banks bail out the monoliners) should not be underestimated, though. The situation is very similar to that of the SIV issue where the free rider problem was present, too. In that case, banks ended taking SIVs back onto their balance sheets rather than engaging in the coordinated rescue action M-LEC. The monoliner issue might end up being resolved that way, too.

Warren Buffet's offer to take responsibility for USD 800 bn municipal bonds, at a compensation, would do little to ease the pressure on the monoliners. The source of the current stress among monoliners is their exposure to mortgage-backed securities - as opposed to the muni exposure. The chart to the right displays how municipal bonds have lost against Treasuries since October last year. This is consistent with market comments on the muni market indicating that many municipal bonds are trading as if the value of the underlying insurance protection, provided by the monoliners, is close to worthless.

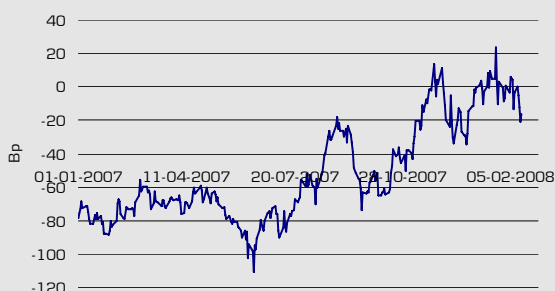
## Leveraged buy-out loans

Leveraged loans to finance buy-outs, LBOs, have been a burden for many banks since investors started to shun them last summer. Earlier this month, *Wall Street Journal* estimated that banks are sitting on a USD 152bn pipeline of loans that they have promised to make but have yet to sell to investors. This has been an issue for some time. However, there are two new developments. 1) These loans are now reeling in the secondary market, making it even more difficult for banks to unload the loans. 2) S&P warned on 12 February that a growing number of leveraged loans are in danger of breaching covenants or defaulting. The background is that many of the companies are carrying much more debt than they should, and this is worrying - particularly in the event of a US recession or further market turmoil. The bottom line is that recent price falls on LBOs in secondary markets, combined with the warning from S&P on the future performance of these loans, are unlikely to provide any relief to banks' balance sheets from the LBO front.

Share prices of Ambac and MBIA



10Y spread: Municipal bond yield – Treasury bond yield



CSFB leveraged loan index, world, annualised three-month total returns

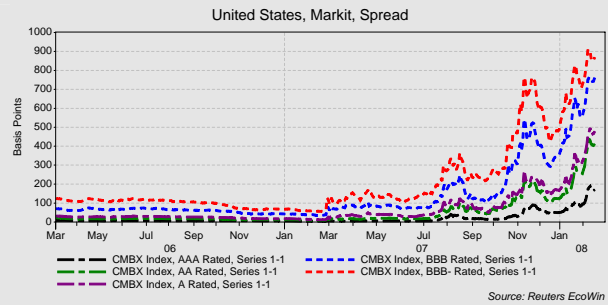


### Commercial property loans

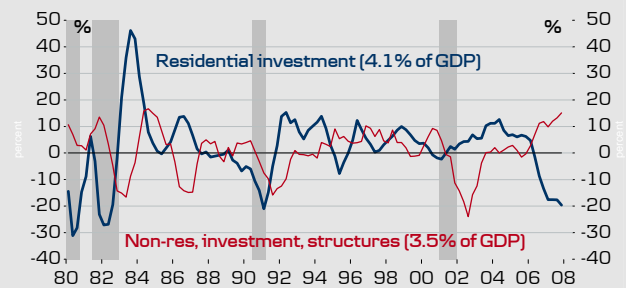
According to CMBX indices of credit default swaps on US commercial property, the cost of insuring against defaults on US property loans is surging. This is an issue because it poses a negative risk factor for US non-residential construction spending which has held up well so far in this cycle, in contrast to residential investments. The bottom chart illustrates how credit standards on commercial property loans in the US have been tightened substantially.

As can be seen in the chart in the middle (right), the non-residential investments have been particularly strong in the past two years, thus compensating for some of the weakness in residential construction. This is important because the non-residential sector is almost as big as the residential construction sector. To a large extent, job losses in residential construction have thus been absorbed by job creation in non-residential construction. If the latter starts to weaken as well there is a risk of a bigger hit to construction employment with negative implications for the overall job market and hence private consumption.

CMBX Index, Series 1-1



Residential and non-residential construction spending



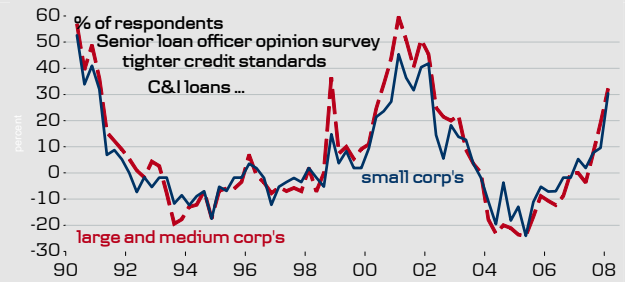
Senior Loan Officer Survey: Credit standards on commercial loans



### Lending standards

According to the Fed's Senior Officer Loan survey, banks are tightening credit standards for corporate clients. This represents a risk for the US economy. A similar tightening of credit standards is present in ECB's Euro area Bank Lending Survey. The bottom chart indicates that the tightening credit standards also pose a risk for global defaults.

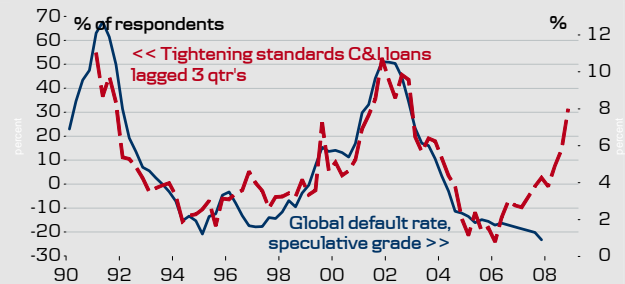
Senior Loan Officer Survey: Credit standards



Euro area Bank Lending Survey: Changes in credit standards applied to loans/credit lines to enterprises



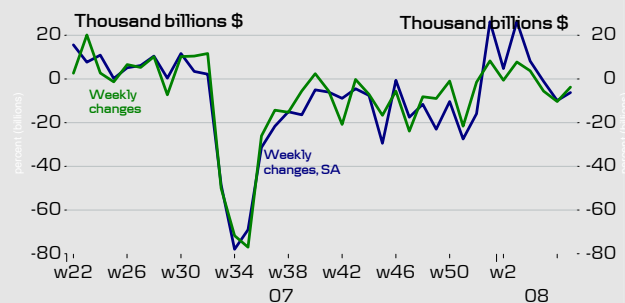
US lending standards and global default rates



### Asset-backed commercial paper

The size of the asset-backed commercial paper market keeps contracting as banks are bringing off-balance investment vehicles back onto their balances.

US Asset-backed commercial paper market, weekly changes



### Credit spreads

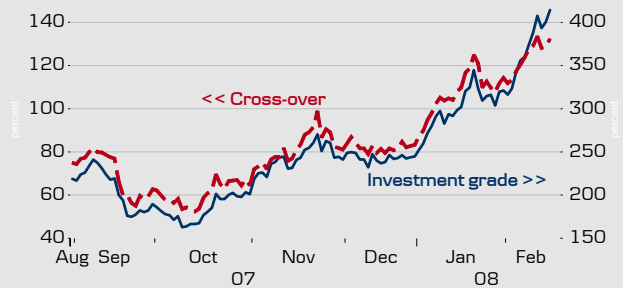
Credit spreads keep widening. Spreads are far above the levels observed at the peak in November last year.

*iTraxx EUR Main is composed of 125 investment grade entities. iTraxx EUR Cross-over is composed of 45 sub-investment grade entities. Markit CDX CDS index is composed of 125 investment grade entities domiciled in North America. Markit CDX index is composed of 35 sub-investment grade entities.*

EUR: iTraxx, 5 Year, Series 8



USD: Markit CDX indices, 5 Year

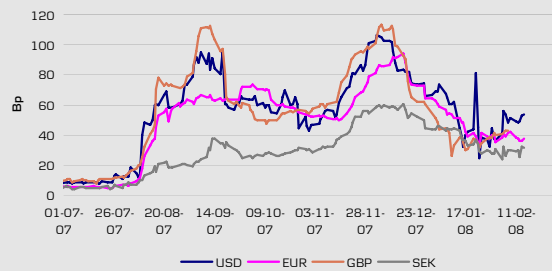


### Money markets

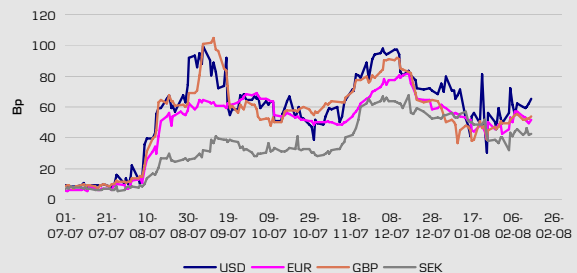
Money market pressures, measured as the spread between Libor fixings and Overnight Interest Rate swaps (OIS), have eased since the turn of the year, especially for short maturities of 1-3 months. However, at longer maturities, six months and beyond, money market pressures persist. None of these spreads are back to the levels observed before the crisis.

Looking at the very recent development in money market spreads, it appears that they have started to widen slightly during the past couple of weeks. We see upside risks to money market spreads going forward due to a range of risk factors, including monoliners, credit spread worries, annual bank statements etc.

3M Libor/OIS spreads

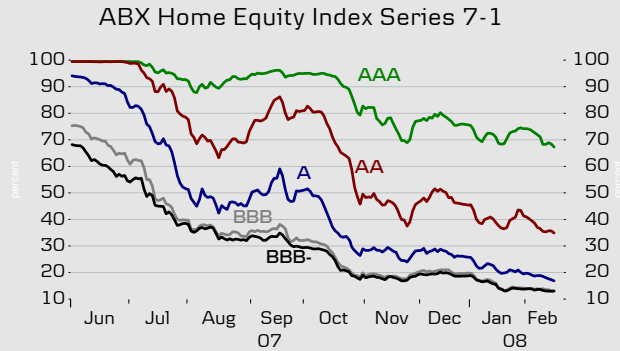


6M Libor/OIS spreads



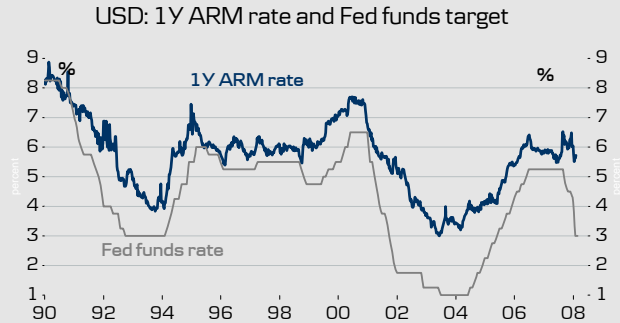
### Subprime mortgages

The initial source of the shock underlying the current crisis was the decline in value of US subprime mortgages. ABX, derivatives indices measuring price developments in the less liquid market for US subprime mortgage bonds, show no sign of recovery. If anything, prices are still on a slight down trend.



### Mortgage interest rates facing US consumers

It is remarkable how the rates on 1Y Adjustable-Rate-Mortgages, ARM, have remained stable in the face of the dramatic easing of US monetary policy. Combined with the general tightening of lending standards this means the transmission mechanism from monetary policy to the economy is less effective at the moment. To compensate for the spread widening and tighter standards, the Fed has to cut deeper than normal to get the same effect.



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