Recovering from the Sub-Prime Debacle: The Coming Crisis

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Joergen Oerstroem Moeller 09 Oct 2007 Opinion Asia

The financial markets all over the world seem to be in jubilant mood that timely central bank intervention has prevented a major crisis. It may well prove to be a short respite.

The sub-prime crisis was predictable in two ways. Firstly, all the analysis over the last years revealed disturbing imbalances in the US economy revolving around dis-savings in the household sector. Something had to give; the question was what and when.

Secondly, sub-prime lending reiterated lending behavior time and again leading to financial upsets or crisis: the collateral is neither the debtor's income nor existing assets, but future increase in asset prices allowing the debtor to repay old loans with new loans. Every time asset prices go up, the debtor takes new loans or increases existing loans to reduce the debt burden of the original loan. Repayment of old loans conveys a sense of solidity to the outsiders obscuring the fact that total debt is actually going up.

This works wonderfully under the assumption that asset prices continue to rise, but creates havoc in the market when asset prices stagnate or start to fall. And this is what happened in the course of 2007. US property prices did not rise anymore; they started to fall, throwing a spanner in the works of the above-mentioned mechanism.

It is not possible to predict with accuracy when the next crisis will announce its arrival and threaten the global financial markets, but it is a fairly good bet to predict what will take over from sub-prime as the spoiler - the new investment funds, which have sprung up like mushrooms over the last 15 years overshadowing respectable and reputable established funds.

It all started in the late 1980s with deregulation. A large number of public utilities and public services were privatised. Toll roads, water supply, bridges, and airports – you name it. In the initial phase the market was hesitant: institutional financial investors did not feel confident knowing their limited experience in evaluating the income potential and even more their limited ability to run such services and utilities. But it did not last long.

Investors sensed potentially large profits and moved in to set up new investment funds designed to buy these services, now so conveniently on the market. Existing pension funds and investors who held back in the first phase did not take long to spot this glorious opportunity and recognised the new funds as suitable instruments. The new investment funds, however, financed a large part of their operations through borrowing.

Public assets put on the market were under priced, because no one had a good idea of what they were worth, therefore playing it safe. The potential for a strong increase in asset prices were at hand and it duly materialised. That allowed investment funds to repay the initial loans with new loans. As long as asset prices continued to rise, it worked exactly as sub-prime operations: old loans were repaid with new loans. Expanding their business opened the doors for the investment funds to climb upward all the time. Their revenue rose and so did the impression that they were running a lucrative and forward looking new business.

Furthermore they often borrowed with the proviso that interest payments on loans were small sometimes extremely small in the initial phase to rise exponentially in the last phase of the loan’s duration. Not surprisingly profits looked handsome for these companies making the financial markets believe that here was really something worth investing in. Share prices rose majestically opening another channel for capital.

Profits jumped upwards. The funds did not see themselves as long-term investors or long-term owners and even less, as custodians for the services/utilities they had bought. Their interests in long-term maintenance were not the same as had been the case when the service/utility was under public ownership.

There is a big difference between the public running utilities/services in the general interest of the public and an investment fund running them to rein in a profit. Compared to the results under public ownership the impression soon spread that the new owners were financial wizards. And so they were, but not necessarily as originally perceived.

The next phase consisted in complicating the financial structure by creating more companies out of the single one starting this business. Another mushrooming took place with financial operations inside the investment fund and its various subsidiaries making it very difficult and in several cases impossible to know who exactly owed what to whom.

None of these operations were illegal or contradicted regulations, but they obfuscated the picture of how big the debt burden is and to which extent risk taking has moved into the dark zone where prudence gives way to recklessness. In the same way as sub-prime, these operations rest on the assumption of further expansion. If the investment funds can enlarge their operations by buying new services and utilities and if services and utilities continue to rise in price everything will be all right.

The appalling thing is, however, that the whole mechanism is designed in such a way that if these conditions do not materialise, the whole house of cards will come tumbling down. With lower asset prices, new loans will not be sufficient to repay old loans and the funds cannot fulfill their obligations. The argument is sometimes advanced that public utilities/services offer a steady cash flow being less sensitive to the business cycle classifying it as a 'sound' investment. That is correct, but a steady cash flow is not enough if the price paid for the purchase is based upon either a rising cash flow or rising asset prices.

No one knows for sure how long it will take for this to work through the financial networks put up by the funds. They may be able to hold on for a while or they may collapse suddenly. The competition to acquire utilities/services has risen significantly recently as more and more funds enter the game exercising aggressive biding, pressing asset prices downwards thus undermining the business philosophy of the first comers.

Investment funds have one more common denominator with sub-prime. The former is a business which has been allowed to run out of control although one can visualise what is happening, not to mention, the embedded risk for global financial markets. As was the case with sub-prime debacle, the US seems poised to fall into this trap although deregulation in other parts of the world such as Australia and Europe clearly point to the reality that this is a global business, complete with all its attendant implications.

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