Kam's Mortgage Monthly

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Credit Crunch 101

I decided to write this month on what's happening in the mortgage industry and the challenges facing it, because I think we all need to get some perspective on it. The industry is suffering great fears. It seems that everyone on Wall Street feels that every property in America is in danger of going into foreclosure, and therefore, they do not wish to buy the mortgage backed securities. No bids means eventually, no business. There are also fears that what's happening south of us is bound to head north. So how did we get here and what does all of this mean? Well, let's take a look a find out. You've heard that this all began with the sub-prime mortgage industry and has spread from there, so that would seem a good a place to start as any!

Q: What is a sub-prime mortgage?
A: It's a mortgage given to a home-buyer with less than perfect credit, or someone who finds it difficult to prove an income that can support the payments. Now I'm sure some of you may be wondering whose brilliant idea this was. Unfortunately, however, lenders flush with money south of us were making loans to almost anyone who asked and could prove that they had a pulse. What was in it for them, you ask? They were able to charge a little more in interest for these riskier loans. They bet on the fact that rising U.S. house prices would make up for any mistakes.
But when U.S. housing prices started to fall, and interest rates began to rise, many borrowers ended up in trouble and stopped making payments, and lenders started to become insolvent (at last count, about 50 have been wound down).

Q: Who were those lenders?
A: For the most part, they were specialty finance companies such as American Home Mortgage (which filed for bankruptcy earlier last month), as well as large, well-known banks such as HSBC PLC (which is still standing, but weakened after it's U.S. counterpart took a big loss on sub-prime loans).

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Newsletter Highlights

Something to Ponder

"Failure is the price of Success"

Kam Brar

Credit Crunch 101, continued…

Q: How did the problem spread from subprime lenders into the rest of the financial world?
A: Many of the companies that were making these sub-prime loans weren't actually holding onto the loans, but instead, were selling them to other parties, including hedge funds and pension funds who were looking for higher rates of return. Often, the loans were packaged together (think of a mutual fund holding thousands of individual loans), and sold to investors.
So when those loans started going sideways, all of a sudden lots of people all across the financial world were impacted. Concerned about mounting losses, investors and lenders started demanding even higher interest rates to make these loans, or stopped doing them completely. This vicious cycle was the beginning of the credit crunch.
From consumers, who are finding mortgages have now become more expensive and tougher to get, to massive buyout funds such as Kohlberg Kravis Roberts & Co., which are having to pay more for loans to carry out takeovers, tougher credit terms are slowing purchases. That is slowing the economy and hurting the stock markets, which have been on a roller coaster ride of late. Now the latest problem to surface from all of this fallout is in the asset-backed commercial paper market.

Q: What is commercial paper?
A: Commercial paper is short-term debt issued by companies, usually coming due in under a year and often in as little as a month. Buyers tend to be institutional investors such as money-market mutual funds, and low-yielding funds where investors park cash, believing that they are safe. As a result, only highly rated companies with strong balance sheets can generally issue commercial paper, limiting the size of the market.

Q: So exactly how big is this market?
A: It's worth at least $120-billion in asset-backed commercial paper alone. About two-thirds of that paper is sold by trusts run by banks, and that segment of the market is holding up. About another third, or $40-billion, is issued by trusts created by non-bank financial companies such as Coventree (Sub-prime lender), and those have suddenly gone "no-bid" — Bay Street lingo for "nobody will buy at any price."

Q: What's happening in the market?
A: Suddenly, portfolio managers at money-market mutual funds are waking up and asking themselves whether they really want to be investing in commercial paper that is backed by assets such as mortgages, when the housing market is sinking. As a result, the trusts can't find buyers for their paper, leaving them short of money. Which forces them to turn to banks, such as Deutsche Bank AG, that had agreed to provide loans in a situation where the market flounders, but now some of these banks are balking, which would lead to some of these trusts being wound up.

Q: What does it mean for my money-market mutual fund?
A: If a money market mutual fund is invested in a trust that is in trouble, it could spell losses in a fund that most investors probably bought precisely as a way to safeguard against losses. But, so far it's only a small slice of the market that's in trouble, and not every money market fund holds paper issued by the troubled trusts.

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Q: What steps have been taken to alleviate the situation?
A: Back in the middle of August, the US Federal Reserve cut the interest rates by 1/2% to help things; an unexpected move. In addition to this, the US Federal Reserve also poured 119.5 billion into the banking industry to try to calm the industry. The US Federal reserve wasn't alone in this action, as many other governments, including ours, also stepped in and poured money into the banking system to further help. This, for the interim, has appeared to slow the worsening of the situation, but only time will tell.

My final thoughts on this are that we need to return to the basics of the industry that has financed home ownership all these years. Now I'm not advocating that we get rid of every loan that someone thinks is bad, or one they would never enter into themselves. Unfortunately, sometimes bad things happen to good people, and if we have no financial products available to these folks that give them a chance at home ownership, that's not the answer either. I believe that above all, everyone who takes out a loan of any kind should have a complete understanding of the ramifications of that loan. Consumers **MUST** bear some of the responsibility in the financing of their houses, vehicles and etc., because in the end they are ultimately responsible for the debt. It's just not acceptable to say, "I didn't really know what I was signing and committing to."! I'm sure that in a short while, this all will be past history, and we will all go on with business as usual. I just hope that some good comes from this, in the form of better products, sensible guidelines and a more informed consumer, who is active in the borrowing process. If that happens, then this current disruption may turn out to be extremely beneficial for all of us.

Management Humor 101

LESSON 3:
A sales rep, an administration clerk, and the manager are walking to lunch when they find an antique oil lamp. They rub it and a Genie comes out.
The Genie says, "I'll give each of you just one wish."
"Me first! Me first!", says the admin clerk. "I want to be in the Bahamas, driving a speedboat, without a care in the world."
Puff! She's gone.
"Me next! Me next!", says the sales rep. "I want to be in Hawaii, relaxing on the beach with my personal masseuse, an endless supply of Pina Coladas and the love of my life."
Puff! He's gone.
"OK, you're up,", the Genie says to the manager.
The manager says, "I want those two back in the office after lunch."
Moral of the story:
Always make sure your boss has the first say.

If you have any questions or comments please contact Kam at kam.brar@vericoselect.com or visit www.kamthemortgageman.com