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ECONOMIC REPORT

PRAGMATISM vs. SOCIALISM

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The world's financial markets are in trouble, after many investment banks and financial institutions who invested heavily in so-called toxic US mortgage assets, are faced with the twin problem of plummeting asset values distorting balance sheets and the uncertainty of mortgage loans ever being paid back. As a result, institutions are reluctant to lend to each other as they worry their rivals might not be able to weather the subprime crisis.

This credit crunch has resulted in the collapse of several iconic institutions both in the US and in Europe, including Bear Sterns, Northern Rock, Fannie Mae, Freddie Mac, Merrill Lynch, Lehman Brothers, AIG, Washington Mutual, Bradford & Bingley, HBOS and Fortis to name but a few. This paper will give a brief overview of the crisis and the now infamous bailout plan.

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INTRODUCTION

In retrospect, the most intriguing subplot in the collapse of the subprime mortgage market was not the size of the losses but their distribution. The carnage of the past few weeks may have an unreal air to it, but the damage is all too tangible; the seizure of Fannie Mae and Freddie Mac by their regulator, the record-breaking bankruptcy of Lehman Brothers (and the sale of its capital-markets arm to Barclays), Merrill Lynch's shotgun marriage to Bank of America and the most shocking of all, the government takeover of a desperately illiquid American International Group (AIG).

Wall Street firms seem to have a penchant for getting themselves into trouble together. They all were long Internet stocks (remember the nonsensical theories of the 90's that dot com companies thrived on clicks not profits?) when they collapsed and the smart money is on them all being long North Korean credit-default swaps whenever North Korea gets hot and then crashes.

When Warren Buffet famously said that derivatives were 'financial weapons of mass destruction', this crisis might just have been the kind of crisis the investment seer might have had in mind. Part of the reason investors are so nervous about the health of financial companies is uncertainty of not knowing how exposed they are to the complex intertwined derivatives market. The list of effectees now reads more and more as the who's who of Wall Street, and the subsequent withholding of funds by institutional investors is merely the modern version of an old-fashioned bank run.

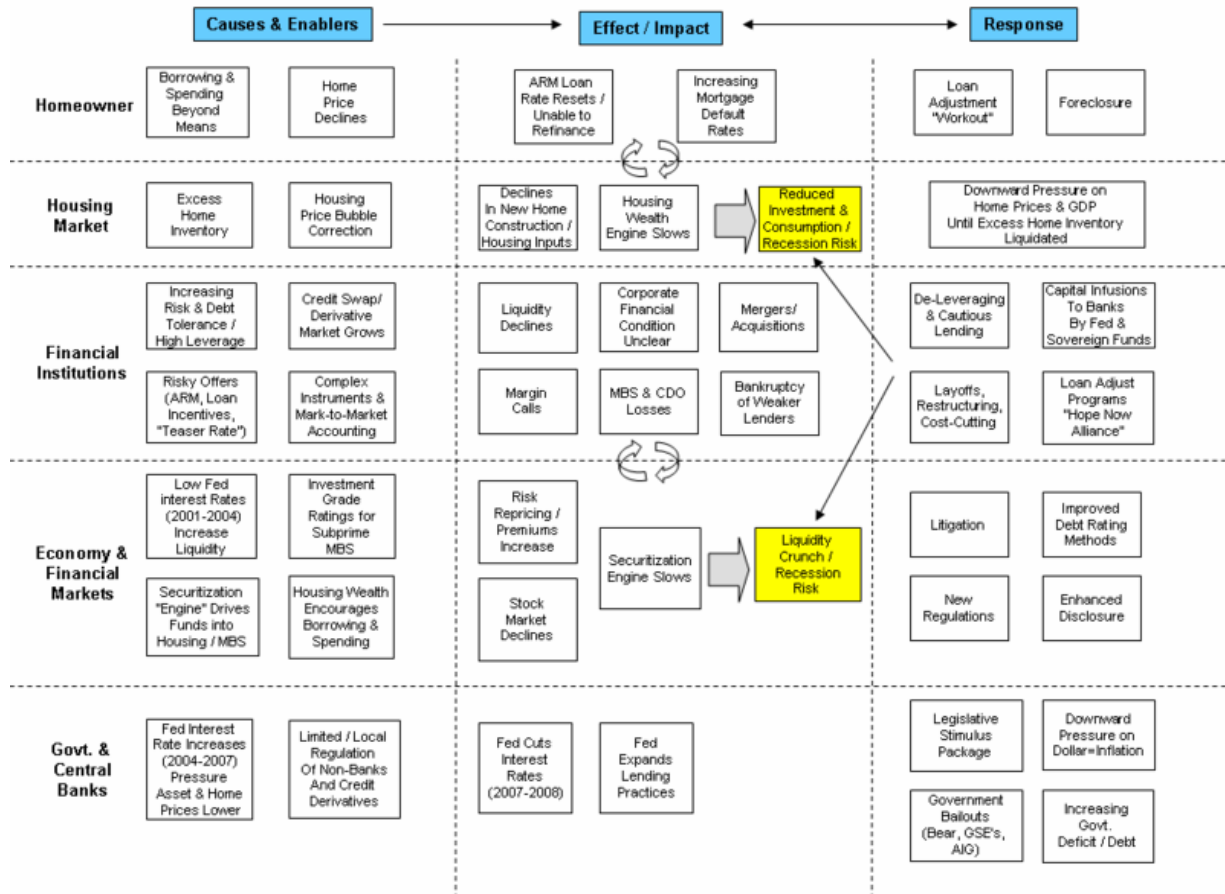




BACKGROUND

By 2007 financial markets were witnessing the most benign risk environment seen in years; falling credit spreads, low interest rates and virtually no defaults led to historically low volatility levels. The possibility of a trend reversal seemed unlikely as Institutional investors, hedge funds, private-equity firms and sovereign-wealth funds were all looking to invest in increasingly complex and risky assets. This explains the growth in appetite for subprime debts.

However, recent months have changed the global financial climate significantly. Observers are left scratching their heads to think of any other industry that has been reshaped so quickly or dramatically. We have seen it all; bankruptcies, sell-offs and bailouts of some the biggest heavyweights on Wall Street. The subprime crisis which was initially triggered by sharp falls in US housing prices has now manifested itself in the shape of a global credit crunch. The story is both complex and multifaceted with a labyrinth of reasons behind the global crisis, as depicted below:





BACKGROUND ... Continued

It all started when aspiring homeowners started borrowing to finance their homes. Even though some weren't credit worthy they were still financed under subprime lending. This type of lending is the practice of providing loans for borrowers who otherwise would not qualify due to a variety of reasons e.g. income level, credit history and employment status to name a few. Everyone seemed to buy the idea that a few shaky homebuyers would not hurt overall returns. This new class of home owners contributed to the US mortgage market swelling to over \$12 trillion in 2008.

After having financed these risky homeowners, the next step was to package and sell these mortgages to investment banks by a process called securitization. Traditionally banks would lend money to homeowners and subsequently accept the credit or default risk. However, through securitization mortgage lenders packaged these loans into bonds called mortgage backed securities (MBS), which they then sold further on. By doing so, writers of MBS sold the right to mortgage payments to a variety of investors and hence no longer needed to worry about default risks, allowing them to concentrate on selling fresh home loans.

Selling MBS initially proved difficult as the credit quality of subprime loans was poor or non-investment grade, meaning many investors would simply not buy them. To get around this (minor technicality), financial engineers combined the MBS with other higher grade bonds and sold off the entire package in 'tranches', known as Collateralized Debt Obligations (CDOs). A typical CDO, for instance, could have 80% investment grade bonds (low risk), 10% mezzanine (middle risk) and 10% equity (high risk MBS). As a result of this financial ingenuity many CDOs began to qualify as investment grade, thereby making them an easier sell.

This new 'originate to distribute' banking model shifted the credit risk to a diversified investor base, increasing the interdependence between US housing and global financial markets. These hybrid instruments were theoretically supposed to shower high yields on investors without commensurate risk, but when homeowners began defaulting on their loans the highly leveraged investors suffered the brunt.





REASONS FOR CRISIS

It is safe to say the crisis was triggered by falling home values in the US, but this cannot be pinned as the sole reason behind this debacle. Raison d'être for the crisis are varied and present both in the housing as well as credit markets. Some of these factors include poor judgment by borrowers/lenders, unwarranted speculation in housing market, excessive building of homes during boom period, risky mortgage products, highly leveraged individuals/financial institutions and inept central bank policies and government regulations.

Interest rates during the first half of this decade were low, to combat concerns regarding deflation in the aftermath of the dot com crash. This naturally encouraged spending and was accompanied by large capital inflows from outside the US thus adding to the pool of surplus loanable funds. A chunk of this liquidity found its way to the housing market, fuelling prices. However, on the flip side, overbuilding during this boom period led to a surplus inventory of houses, which eventually started reducing their prices. Due to this decline, homeowners who were unable to refinance their homes started to default. Subsequently loan payments for the subprime category began to reset at higher rates putting further strain on borrowers and marking the beginning of the subprime crisis. Defaults and foreclosures intensified once prices of homes plummeted so sharply that an increasing number of homeowners had zero or negative equity because their homes were now worth less than their mortgage, encouraging them to walk away from the loan.

Slack credit ratings were a major contributing factor to the housing market collapse. Critics blame this on a conflict of interest, as rating agencies were paid by the firms that organized and marketed mortgage backed securities. When the crisis took off, steps were taken to realign credit ratings with market conditions, this resulted in agencies lowering the ratings on MBS, subsequently lowering their value. The offshoot of this meant investors and financial institutions had to endure lower value of MBS and CDOs. To counter this, investors in mortgage assets had to acquire additional capital to cover for their falling value and maintaining their own books. More often than not this was achieved through the sale of new shares, consequently reducing the value of existing shares. The end result was downward pressure on MBS and dramatic reduction in the stock values.



REASONS FOR CRISIS ... Continued

Apart from slack ratings excessive underwriting for mortgages are also to blame. The job of an underwriter is to determine if the risk for lending to a particular borrower is within acceptable parameters. Mortgages during the boom period were approved through a process of automated underwriting that took only a few minutes for approval, compared to several days taken previously. By automating the process lenders were able to approve loans for borrowers who otherwise would have failed to meet standards. A slipshod underwriting process coupled with sloppy ratings amplified the affects and depth of the mortgage crisis.

Finally, complementing all of the above were negligent government policies and reluctance of central banks to act preemptively. Arguably failure of government regulations encouraged the housing bubble, something that was recently accepted by the Securities and Exchange Commission (SEC) which conceded that self-regulation of investment banks led to the crisis. Central banks meanwhile were only concerned with managing the rate of inflation and avoiding a recession. They were less concerned with avoiding asset bubbles than with minimizing collateral damage once those bubbles had burst. The Fed has received heavy criticism for its role in the credit crisis, as mentioned earlier, the reduction of interest rates in the beginning of this decade - from 6.5% to 1% - provided cheap loans for the housing market.



COMBATTING THE CRISIS - The \$700 Billion Solution

The plan is for banks to sell their mortgage backed securities in a series of auctions. The first of which is not likely to be held for at least a month as private financial firms will have to be hired to handle the process. Up to 10 asset management companies are likely to be used by the US Treasury.

There will be an enormous amount of interest in the first auction to see if it works and what sort of price buyers are willing to pay for these toxic assets. The Treasury has up to \$700 bn to spend, but it hopes that other private buyers will also emerge. According to market estimates there is a considerable pool of private capital available to buy distressed mortgage related assets now that the Treasury has put a floor under the market, using the bailout plan.

If this auction process is typical, buyers will bid the price they want for the amount of MBS they want. Once the bids are received securities will be allocated to buyers at the highest price which ensures that they're all sold. Banks have typically marked down the price of their MBS to around 20% of their face value. So for them to obtain any relief, the auction process will have to obtain a price higher than 20 cents on the dollar.

If private buyers aren't willing to pay that price at the auction, then the US Treasury will have to use taxpayers' money to pay above the market price for toxic assets in the hope that they will appreciate in value over the next few years. In return, US taxpayers will gain a non-voting stake in the banks they rescue. So if the banks recover, taxpayers may make a profit. The money will be borrowed by floating up to an additional \$700 bn worth of Treasury securities.

The hope is eventually the Treasury can sell these distressed assets back to financial markets once the housing market has stabilized and hopefully make a profit in the process.



CAUGHT IN THE STORM

Until the first quarter of FY08, Pakistan enjoyed a stable economic environment with strong growth fundamentals. The economy grew by an average 5.4% per annum from 1999-2008, with investment averaging 15.7%. In addition, Karachi Stock Exchange (KSE) reached a record level of 15,676 in April 08 from 994 in June 1999, which is an unprecedented growth of around 1500%. Looking at these impressive figures international rating agencies like S&P and Moody's improved Pakistan's ratings, increasing the economy's appeal to foreign investors by reducing cost of risk. Additionally Pakistan was put on the 'Next 11' list after the BRIC (Brazil, Russia, India and China) nations.

The stable rupee coupled with strong economic growth strengthened confidence of foreign investors by projecting healthy growth prospects. The outcome was significant foreign inflow into domestic markets, FDI and home remittances both reached record highs. Foreign exchange reserves also surged to a record \$16.48 bn in Oct07.

However, towards the end of 2007 the global credit crunch came into full affect. Commodity and oil prices reached record highs, thereby inflating price levels in our domestic markets. Subsequently inflation skyrocketed, headline inflation went up to 25.3% in Aug08 YoY, while food inflation reached at an all time high of 34.1% in the same period. In order to check the growing inflationary pressures, SBP took a tight monetary stance. Discount rates were raised three times in 2008 alone, a 50 bps hike came in Feb (from 10% to 10.5%), the next was a 150 bps raise to 12% in May and the final hike was 100 bps to 13% in July. Despite price levels increasing, government borrowing from SBP has risen meteorically, reaching PKR 179 bn already in FY09. This has the result of increasing M2 growth which puts additional pressure on price levels.





CAUGHT IN THE STORM ... Continued

Pakistan's balance of payments also took a hit. Imports of essential commodities like oil and wheat increased the import bill considerably - food and oil constituted roughly 40% of import costs in FY08. Due to this, in FY08 Pakistan registered record current account and trade deficits of 8.4% and 12% of GDP respectively. Reserves have thus far fallen to \$8.13 bn in the week ended September 27th 2008 and the Pak Rupee has depreciated by 27.93% against the dollar since the beginning of 2008. To stop further devaluation, SBP has temporarily suspended forward booking of foreign currency on imports and has opted to make all oil import payments.

Taking into account the disappointing economic indicators and ensuing instability in the rupee, Standard & Poor's Ratings Services lowered its ratings for Pakistan on May 15th and again on 6th October 2008. As of now long-term foreign currency sovereign credit rating for Pakistan is 'CCC+' down from 'B', long-term local currency rating is 'B-' down from 'BB-', and short term rating on the sovereign is 'C' down from 'B'. Similarly Moody's on Sep 23rd further lowered its outlook from stable to negative on the government bond rating of 'B2'.

Although a culmination of domestic frailties and international crisis have sent the economy into a downward spiral. Pakistan's foreign exchange position and balance of payments are unlikely to improve unless the global credit crunch eases. Flow of liquidity to developing nations has dried up, not least because of the crunch but also because of reduced spending of consumers around the world. The global economy is well and truly in decline and all eyes are on the bailout package and its effectiveness to bring itself and the global markets out of recession.



LOOKING AHEAD...

Since the problem is deeply rooted in money markets, it will feed through to businesses and households in every economy it hits. This is why those who set the interests of Wall Street before the Main Street were wrong in doing so. Sooner or later the money markets will affect every business. Companies facing higher interest charges will start hoarding cash, canceling acquisitions and investments, in order to meet debt payments. Manufacturers are likely to delay projects and cut costs by reducing payrolls (latest data shows US job losses at 159,000). Loans will simply become elusive and expensive, eventually consumers will suffer and unemployment will rise.

To be fair to central banks it is difficult to spot bubbles while they are being inflated, hence its often more prudent mopping up the mess once the bubble has burst. Financial markets do need governments to set rules for them. Once markets fail, governments are often best placed to get them going again and that's not socialism in this new world order - its pragmatism.

Despite the growing popularity of central bank interventions to prop up markets (as few relish banking collapses or recessions), it does create certain problems in the long run. The first is that consumers (and companies) are encouraged to borrow and not save due to a belief that central banks and governments will always rescue them if things go wrong. The second danger is that the system becomes progressively less stable as risk-taking is encouraged. Therefore the central banks should permit some short-term cyclicalities in order to purge the system of excesses. Let's just call these the winds of creative destruction – ugly but necessary.





ECONOMIC SNAPSHOT

Fiscal Year 2008-09														
	Units	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
<u>Inflation</u>														
Headline Inflation	%	6.5	8.4	9.3	8.7	8.8	11.9	11.3	14.1	17.2	19.3	21.5	24.3	25.3
Core inflation	%	6.0	6.1	6.5	6.9	7.2	7.8	8.1	9.3	10.8	12.3	13.0	14.7	16.4
Food inflation	%	8.6	13	14.7	12.5	12.2	18.2	16	20.6	25.5	28.5	32.0	33.8	34.1
Non-food inflation	%	4.9	5	5.4	5.9	6.3	7.3	7.8	9.4	11.2	12.5	13.8	17.3	18.7
<u>T-bill (Wgt Avg)</u>														
3 month	%	9.05	9.05	9.05	9.05	9.09	9.09	9.38	9.59	9.59	9.95	11.3	12.2	12.4
6 month	%	9.12	9.12	9.12	9.21	9.29	9.29	9.61	9.86	9.86	9.86	11.5	n/a	n/a
12 month	%	9.39	9.39	9.39	9.4	9.49	9.44	9.87	10.13	10.13	10.32	11.7	n/a	n/a
<u>External Sector</u>														
Export	Mln US\$	1,475	1,463	1,593	1,524	1,500	1,634	1,591	1,833	1,862	1,954	1,089	1,921	1,726
Import	Mln US\$	2,206	2,150	2,555	2,864	2,910	3,316	2,909	3,549	3,406	3,241	7,869	3,117	3,153
Trade balance	Mln US\$	(731)	(687)	(962)	(1340)	(1410)	(1637)	(1637)	(1716)	(1,544)	(1,287)	(6,900)	(1,196)	(1427)
<u>Remittances</u>	Mln US\$	489	516	580	505	479	557	502	602	590	584	547	627	592
<u>Forex Reserves</u>	Mln US\$	16,106	16,145	16,354	15,807	15,589	14,657	14,031	13,232	12,362	11,258	11,285	9,920	9,130



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