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Lethal Debt

The American subprime mortgage crisis has hit banks and stock markets worldwide. Billions of dollars have been wiped off share prices; while the credit markets have been going through a period of re pricing that have aroused fears of a global meltdown.

This report will begin with a brief recount of the evolution of the American subprime lending industry which recorded spectacular growth alongside the thriving housing market in the beginning of the current decade. It will then move on to analyze the factors which led to the current crisis in the industry before examining the global impact of the collapse of the subprime lending industry.

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The Blame Game - Who Wins?

The American subprime mortgage crisis, marked by a sharp rise in foreclosures in the subprime mortgage market, has hit banks and stock markets worldwide. Billions of dollars have been wiped off share prices; while the credit markets have been going through a period of re pricing that have aroused fears of a global meltdown.

The subprime mortgage financial crisis began in late 2006 in the United States when rising interest rates increased the cost of borrowings and property values declined after the collapse of the housing bubble. This left home owners unable to meet the financial commitments and lenders without a means to recover their losses. Since then several major subprime mortgage lenders have filed for bankruptcy or have terminated their operations all together.


As mortgage foreclosures skyrocket and financial markets panic, the finger-pointing game amongst the stakeholders, spread all over the globe continues apace. Some blame the US Government for nurturing the subprime mortgage crisis while some accuse the predatory lending practices of the subprime lenders. Others have indicted mortgage brokers with steering borrowers to unaffordable loans, appraisers with inflating housing values and Wall Street investors for backing mortgage backed securities without verifying the actual strength of the portfolios. At some instances borrowers have also been criticized for over stating their incomes and entering into loan agreements they could not meet.

This blame game is likely to continue as long as the crisis persists, with no clear winner coming out anytime soon. However we believe that it is rather more important to examine the fundamental economic and political decisions that have led to this crisis, to analyze the impact of the set of problems in the market for subprime mortgages on the housing markets and the economy of the US and the extent to which the global economy will be impacted.

Fulfilling the *American Dream*

Having emerged more than two decades ago, subprime mortgage lending began to expand in the US in the mid-1990s, and even more rapidly in the beginning of the current decade. In 2001, the Wall Street Journal reported a tripling in the number of outstanding subprime mortgages from 1995.

Subprime mortgages are loans made to borrowers who do not qualify for market interest rates because of their deficient credit history. Due to the murky financial situations often associated with subprime borrowers who have poor credit history, the subprime lenders therefore lend only at rates higher than the commercial lending rate while fixing high



collateral to compensate for the high risk of default. It is this characteristic of subprime lending which makes the whole practice highly controversial.


The subprime lenders are often alleged of engaging in predatory lending practices by deliberately lending to borrowers who could never meet the terms of their loans, thus leading to default and seizure of collateral. Proponents of subprime lending, on the other hand, argue that subprime lending extends credit to people who would otherwise not have access to the credit market. We shall discuss the controversy surrounding subprime lending in the latter part of the paper but what we would like to address here is a more critical question that why did home buyers suddenly started to take out so many risky loans and why the lenders decided to suddenly arrange so much financing for these borrowers.

The expansion of subprime lending was spurred by many factors such as increases in capital made possible by securitization and development of the secondary markets, technological innovations that reduced the costs for lenders of assessing and pricing risks, and deregulation of the banking industry.

The growth of the subprime industry is largely attributable to the increase in securitization. Securitization is the pooling of loans to form structured securities which are subsequently sold in the secondary market. What actually happens is that big banks buy subprime loans from subprime lending companies on which the borrowers pay annual mortgage rates that are at least 2% points more than the rates that banks charge borrowers with sound credit history. The banks then bundle the debt and sell it to Wall Street firms which package subprime loans into MBSs (mortgage-backed securities) and CDOs (collateralized debt obligations).

Sales of new MBSs soared to USD 2.4 trillion in 2006 while USD 375 billion went into the sales of CDOs. CDOs constitute a mix of bonds and securities backed by mortgages and home equity loans. MBSs and CDOs typically offer various risk profiles and durations to meet the investment strategies of a wide range of investors. Moreover CDOs offer potentially higher returns than bonds with the same rating. Though securities backed by home mortgages have been traded since the 1970s, it has been only since 2002 or so that investors, including pension funds, insurance companies, hedge funds and other institutions, have shown an increasing appetite for them. Hence increased securitization of mortgages in the recent years has provided lenders with excess capital, that ordinarily would not be available, to make additional loans; thus securitization fuels the subprime loan industry.

In addition to securitization of subprime mortgages, innovations in technology have also contributed towards heavy subprime lending seen in the past few years. Technological advances facilitated credit scoring by making it easier for lenders to collect and circulate information on the creditworthiness of prospective borrowers. Moreover lenders



developed new techniques for using this information to determine underwriting standards, set interest rates, and manage their risks.

Legislative deregulation of the banking industry has also fueled the subprime lending industry by enabling lenders to offer more varied loan products, which were attractive to more varied consumers, and further gave incentives for more lenders to enter the market.


These factors laid the groundwork for an expansion of higher-risk mortgage lending since mid 1990s. Though growth in the market has not proceeded at a uniform pace, but on net it has been spectacular. It is estimated that the subprime industry originated loans worth USD 722 billion in the previous year. The expansion of subprime mortgage lending has made homeownership possible for households that in the past might not have qualified for a mortgage and has thereby contributed to the rise in the homeownership rate since the mid-1990s. In 2006, 69% of households owned their homes.

The American Dream turns into a Nightmare

When interest rates in the US remained low for several years before 2004, a practice aimed to soften the blow from the collapse of the dot com bubble, the appetite for mortgage based securities rose which in turn spurred the subprime lenders to increase their lending. The subprime borrowers lured by home ownership entitlement continued to borrow heavily either directly from subprime lending companies or through brokers. Thus in the wake of low interest rates and thereby massive prime and subprime lending an economic bubble was witnessed in many parts of the US housing market from 2001 to 2005. The housing bubble was characterized by rapid increases in the valuations of real estate.

However it must be noted that access to mortgage credit is not without its downside. As explained earlier, in light of their weaker credit histories and financial conditions, subprime borrowers face higher costs of borrowing than prime borrowers do while subprime lenders face a higher risk of default than prime lenders do. For borrowers, the consequences of defaulting can be severe; possibly including foreclosure, the loss of accumulated home equity, and reduced access to credit. Their neighbors may also suffer, as geographically concentrated foreclosures tend to reduce property values in the surrounding area. For lenders who roll these mortgages into MBSs or CDOs, the risk of default may not be as worrisome, as the re-packaged mortgages belong to other financial organizations.

Nevertheless all was good for both subprime borrowers and lenders during the housing bubble. This is because rising property value meant positive equity for homeowners who were able to use the increased value of their property to refinance their homes with lower interest rates. However the housing bubble could not have continued to balloon




indefinitely. As the Federal Reserve followed a cycle of interest rate hikes to combat inflation from June 2004 to June 2006, the home prices began to decline leaving homeowners with negative equity, which is a mortgage debt higher than the value of the property. Thus it is not surprising that after years of easy profits, a chain reaction of delinquency, default and foreclosures began to rip through the subprime mortgage industry.

As the fall in property values and the rise in short term interest rates have made it almost impossible for subprime borrowers to refinance their loans, the rate of foreclosures accelerates. Foreclosures began to increase in 2005 and in 2006 hit a 1.2 million mark, up some 42% from the prior year. This amounts to a shocking ratio of 1 mortgage foreclosure for every 92 households. Some states are now reporting as much as a stunning 700% increase in foreclosure filings in 2006 over 2005 and it is estimated that as many as 2.2 million households could face losing their homes in the not too distant future. Subsequently the subprime lenders are seeing their profits quickly erode. To stay afloat, many subprime lenders have been forced to increase their rates, and have been unable to attract as many borrowers with increased rates. As a result, a number of subprime mortgage firms have either shutdown, filed for bankruptcy, and/or have reported unsatisfactory earnings. A few subprime lending companies have been bought by Wall Street's big securities firms such as Morgan Stanley, Merrill Lynch and Bear Stearns. In addition to this funds whose bonds are backed by subprime loans have fallen sharply, particularly due to defaults in the loans backing the securities. Since of the USD 1.02 trillion of MBSs issued in the first half of 2006, more than 40% were linked to subprime loans, considerable losses occurred across the American stock market

The losses faced by the mortgage industry have started to cut across sectors, with some of the worst-hit industries, such as metals and mining companies, having only the vaguest connection with lending or mortgages. Real GDP has expanded only a little more than 2% over the past year, compared with an average annual growth rate of 3-3.25% over the preceding three years. Sales of both new and existing homes have dropped sharply from their peak in the summer of 2005, the inventory of unsold homes has risen substantially, and single-family housing starts have fallen by roughly one-third since the beginning of 2006. Sales of new homes moved down to an appreciably lower level in February and March and sales of existing homes have also come down on net since the beginning of this year. Dow Jones Industrial Average dropped below 13000 points by Aug-15th as opposed to its record high of 14000 points recorded just a little earlier on 19th Jul 2007.

The American Nightmare: A Nightmare for all?

Though looking from a conservative lens, subprime mortgage crisis seems to be localized in the US alone, it must be noted that the landscape of the global economy is also likely



to be impacted as the world is more globalize than ever before. Changes are already visible in some parts of the world.


During the subprime lending boom many foreign investors had invested heavily in bonds and other products made up of pools of mortgages in the lust for higher returns. Now as risky borrowers began to default on their loans and banks became increasingly shy about offering credit, the foreign players have also been hit. For example, European investors were said to be heavily involved in two hedge funds operated by Bear Stearns. As a result of bad subprime bets, shares in Bear Stearns came under intense pressure in May and reports soon emerged that the investment bank maybe liquidating its assets in a hedge fund. This meant tremendous losses for the bank's local and foreign investors.

As the number of defaults increases and more companies report bankruptcy or disappointing returns, fears of a credit crunch amongst all investors across the globe intensify, adding to general risk aversion in the global financial markets. Investors fear that funds for businesses may soon be drying up as a result of the US subprime mortgage crisis and therefore have shifted their investments from the stock markets in favor of less risky investments. Subsequently alongside the drop in the US stock market, we see billions of dollars being wiped off from stock markets all over the world, particularly Europe. London's FTSE 100 index suffered its biggest one-day percentage fall in more than four years, dropping 4.1% or 250 points to close at 5,859 on 16th Aug. The French and German markets have also seen their worst declines in the past month. The Swiss bank UBS has warned that the market turmoil is likely to hit its earnings in the July to September period while a few Australian mortgage lenders have claimed that the credit crisis may reduce their profits.

In order to calm the fears of credit crunch, central banks of many economies have been increasingly injecting money in their respective financial markets. For example the ECB (European Central Bank), Fed and Reserve Bank of Australia have injected tremendous amounts of money in the past month or so. Although Asian exposure to the US subprime lending market appears to be limited, some Asian banks are still feeling the pinch, particularly those of Asia Pacific. Japan's Nikkei 225 index reached its 5 month low last week when it closed down at 16 while South Korea's Kospi Index and Hong Kong's Hang Seng Index have witnessed tremendous declines.

What happens elsewhere will happen in Pakistan?

While ongoing worries about US housing downturn and fears of global credit squeeze affect global markets adversely, Pakistan also seems to be catching the cold. Foreign divestment from the local equity markets has been witnessed in the recent weeks. Thus along with other global bourses, foreign investors are withdrawing their capital from Pakistani stock markets as well, amid the persisting subprime crisis in the US economy.



As of 22nd Aug the total net outflow recorded in the SCRA accounts since the beginning of the new fiscal year stands at USD 194.212 million. If the US subprime mortgage muddle is not brought under control, the foreign investors will further offload their position in Pakistani and other stock markets across the world.

Where is the subprime heading?

As the problems in the subprime mortgage market have become manifest, some signs of self-correction in the market are also visible and therefore it may be too early to say that the world is heading for global slowdown.

Investors are scrutinizing subprime loans more carefully and lenders are now turning cautious and are tightening their underwriting guidelines. Credit spreads on new subprime securitizations have increased, and the volume of MBSs issued indicates that subprime originations have slowed. This however has further added to fears of a credit crunch. Nevertheless it must be noted that although the supply of credit to this market has been reduced, credit has by no means evaporated. For example, even as purchases of securitized subprime mortgages for CDOs have declined, increased purchases by investment banks, hedge funds, and other private pools of capital are beginning to fill the void.

The Fed has also taken some significant efforts to control the crisis. Federal supervisory agencies have been encouraging the banks and thrift institutions which they supervise to work with borrowers who may be having trouble meeting their mortgage obligations. With effective loan restructuring, borrowers facing temporary economic setbacks may be able to work through their problems while staying in their homes, and lenders may be able to avoid the costs of foreclosure and the losses usually associated with selling a repossessed home. In addition to this the Fed cut the discount rate by half a percent to 5.75% from 6.25% in order to stabilize the financial markets.

Moreover coordinated efforts of central banks of many developed and emerging economies to increase liquidity in their own currencies will calm fears of credit crisis as explained above.

The impact that we are witnessing currently is thus largely reflective of psychological fears rather than anything else and therefore we may see further declines in the short to medium term. In longer term a global slowdown will be inevitable if the US economy slows substantially as this would mean reduced demand for foreign goods and services. On the other hand if the situation is controlled in the appropriate time then these fears will prove to be in vain.



Economic Snapshot

Fiscal year 06-07														
	Units	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	March	April	May	June
<u>Inflation</u>														
Headline Inflation	%	7.65	7.63	8.93	8.73	8.11	8.07	8.88	6.64	7.39	7.67	6.9	7.4	7.0
Core inflation	%	6.29	6.28	6.20	6.16	5.70	5.62	5.5	5.3	5.72	5.42	5.2	4.7	5.1
Food inflation	%	7.78	7.44	11.08	11.26	10.54	10.62	12.71	8.7	9.99	10.74	9.4	11.3	9.7
Non-food inflation	%	7.55	7.77	7.43	6.98	6.41	6.27	6.22	5.2	5.59	5.54	5.2	4.7	5.1
<u>T-bill (Wgt Avg)</u>														
3 month	%	8.29	8.32	8.63	8.64	8.64	8.65	8.64	8.64	8.64	8.65	8.69	8.69	8.69
6 month	%	8.45	8.49	8.81	8.81	8.81	8.81	8.81	8.81	8.81	8.82	8.9	8.9	8.9
12 month	%	8.79	8.79	9.00	9.00	9.00	9.00	9.00	9.00	9.01	9.01	9.08	9.10	9.16
<u>External Sector</u>														
Export	Mln US\$	1,533	1,334	1,392	1,392	1,288	1,448	1,536	1,227	1,421	1,536	1,446	1,540	1,583
Import	Mln US\$	2,685	2,383	2,267	2,172	2,162	2,139	2,365	2,100	2,103	2,070	2,159	2,190	2,373
Trade balance	Mln US\$	(1152)	(1049)	(875)	(780)	(874)	(691)	(829)	(873)	(682)	(534)	(713)	(650)	(790)
<u>Remittances</u>	Mln US\$	464	376	435	422	410	448	475	391	457	520	513	537	505
<u>Forex Reserves</u>	Mln US\$	13,137	12,725	12,631	12,512	12,503	12,460	12,960	13,212	13,378	13,624	13,661	13,778	15,182



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