Anatomy of a Credit Crisis

September 2007

In April 2007 increasing losses sustained by bonds with exposure to subprime mortgages became apparent. [See "The Subprime Flu," April 2007] In the months that followed, this brought on a widespread credit contagion and took many investors by surprise. Among the hardest-hit areas was the short-term credit market that came to a screeching halt in mid-August and saw commercial paper yields soar to a six-year high.

The Chain of Events

There exists a long list of factors that led to the credit market crunch of 2007, including: easy money after years of low interest rates, record corporate profitability, rapid home price appreciation, relaxed mortgage underwriting standards, overextended and speculative home buyers, increased use of derivatives and leverage by investors, perhaps undeserving AAA credit ratings... The list goes on.

The table of Chronological Events provides a detailed account of the key events that led up to the stalemate in the short-term credit market. Our synopsis will focus on what we consider to be the catalysts that caused the credit contagion in the commercial paper (CP) market, an investment staple for institutional cash investors.

Since spring 2007, rising delinquencies and defaults in subprime, and later "Alt-A", mortgages quickly led to large paper losses in bonds backed by such mortgage loans. Funds using borrowed money to invest in collateralized debt obligations (CDOs) that invested in repackaged subprime loans first began to show signs of stress. Bear Stearns' failed efforts to salvage its two internal hedge funds last June only served to "re-price", or bring down the prices, on securities held by the funds as well as by many others. A crisis of confidence soon developed as fund managers on several continents restricted customer withdrawals from "money market-like" investment funds after sustaining large marked-to-market losses in subprime-tainted asset-backed securities (ABS) and CDOs.

Meanwhile, more mortgage companies in the U.S. found themselves in trouble. On August 6, after failing to find investors, three CP issuers extended the maturities on their outstanding debt known as secured liquidity notes (SLNs), a special type of asset-backed commercial paper (ABCP) that held mortgage-related assets and have a feature to extend maturities. The act of extension, a rare event that has happened only once before, served as a stress signal to investors that some issuers might have liquidity problems rolling over their maturing CPs.

What happened next was a virtual seizure of the credit market where investors seemed to stop buying CP programs of all types regardless of credit quality, and instead sought the safety of U.S. Treasury securities. By August 21, the yield on 30-day ABCP with top tier (A-1/P-1) credit ratings shot up to 6.05%, or 0.75% higher than a month earlier. By contrast, the 3-month Treasury bill yield dropped 1.38% to 3.61%. Graph

Lessons Learned

The end of easy money and the re-pricing of credit risk may have come after years of insatiable appetite for yield while the availability of new cash investments strayed from the traditional principle of safety and liquidity. Robust economic growth and strong corporate balance sheets may also have lowered investors' guard toward credit risk. While we're certainly not out of the woods with the current credit crunch, it helps to touch upon some lessons to be learned by cash investors.

A. Overconfidence in Credit Ratings: There is a risk in relying on rating agencies to address the pertinent credit risks of a given investment. Major rating agencies (Moody's, S&P, and Fitch) are facing increasing accusations that many of the ABS and CDOs created from subprime mortgages loans in 2005 and 2006 probably never deserved to be rated AAA and AA. We believe the loss of confidence in credit ratings was one of the major factors of why investors refused to buy complex securities with such high ratings, even though they may not have had subprime exposure. [See "Common Credit Deficiencies," April 2005]

B. Proliferation of "Engineered" Investments: The last decade saw a proliferation of new or revamped investment products that promised to provide higher yield than traditional corporate and asset-backed securities. Money market investors have faced a slew of options such as auction rate securities (ARS), structured investment vehicles (SIVs), CDOs and structured notes. These products were designed to transfer credit, liquidity, and other investment risks from other parties to cash investors for slightly higher yield than traditional investments. Since these products' underlying risk is more difficult to discern and analyze, investors may flee from them first in an event of a market crisis.

C. Commercial Paper Extensions: Our view of SLNs and other forms of extendible CP programs is one where investors essentially agree to stay with a troubled CP issuer if it has difficult making payments. [See "Eight Portfolio Potholes," July 2007]. This may be a counter-intuitive and often poor credit decision. The issue remains that the extension itself, similar to a failed auction, is almost always viewed as a stress signal that could have a contagion effect on the issuer's other programs and other similar issuers. This is what occurred in August. Note that most CP programs do not have extension features, but mortgage companies and other finance companies are more likely to use them to fund asset purchases in case funding from banks is either too expensive or unavailable.

D. Money Fund Misfortune: Money market funds have been major purchasers of ABCPs, SIVs and CDOs recently and have shown increased liquidity and structure risk as a group. [See "How Safe Are Money Market Funds," April 2006]. Headline news of several money funds having exposure to extended ABCPs, SIVs, or subprime credits heightened the anxiety of risk-averse investors who previously viewed the funds as safe havens. As a result, some money funds have gone from aggressive buyers of ABCP to completely exiting the market which has further exasperated the liquidity crisis in the CP market.

E. The Risk of Enhanced Cash Funds: Hedge funds, including one of the failed Bear Stearns funds have, for years, marketed themselves as high-quality, zero interest rate risk investments for conservative cash investors. They, along with the recently popular "enhanced cash" or "yield plus" funds, rang up large losses during the credit crunch. In addition, these so-called "LIBOR-plus" funds, some of which mimic money market funds in offering stable $1 net asset values, do not follow the strict "Rule 2a-7" of risk control prescribed by the SEC for money market funds.

What May Be Expected

From our vantage point, we believe global economic growth will remain intact and the global financial system will continue safe and sound. Major financial institutions in the U.S. and the developed world should have strong capitalization, liquidity and risk management capabilities to manage their way out of an expected period of lower profits and higher credit losses. Pruning of excess risk is already under way and it is against this backdrop that we see the following trends developing in the short-term credit market.

a. The CP market will likely recover from current distress levels, but overall ABCP issuance may decline, with many of the current SLNs, SIVs and CDOs being shutdown, cut back, or reorganized.
b. Investors may focus more on multi-seller ABCP programs with credit and backup liquidity support from strong banks. More scrutiny and transparency of asset collateral are also expected. [See "Demystifying Asset-Backed Commercial Paper," May 2005].
c. ABCP, ABS, CDOs and other complex securities may experience wider yield spreads to Government and corporate paper than their pre-crisis levels to reflect their complexity and risk uncertainty.
d. There will likely be more scrutiny and differentiation in money market and enhanced cash fund investing. Investors will be expected to pay more attention to fund managers' risk management track record in addition to yield differential.
e. The use of leverage and derivatives to enhance returns will likely be discouraged and met with greater skepticism. Investors may return to more conventional methods of investing in Treasuries, agencies, corporate and bank debt in their cash portfolios.

Conclusion

Wall Street will always have the ingenuity to create new products that satisfy a thirst for returns, but we should perhaps learn from this credit market contagion and stay on a steady diet of risk aversion. How soon until investors will once again demand a few extra basis points in yield and loosen their discipline by willingly accepting securities that contradict their risk conscience? Is "everyone was doing it" enough of an excuse to reach for yield while ignoring the core principles of safety and liquidity? Consensus appears to be building that the simple answer is "no."

Lance Pan, CFA
Director of Investment Research
Main: 617.630.8100
Research: 617.244.3488
lpan@capitaladvisors.com