

Debt Crisis or Liquidity Crisis?

There are many conversations about the “debt crisis” caused by subprime lending. Everyone is trying to guess the effect it is going to have on the housing market, the economy and individual’s lives. The speculation of what will happen is just that, speculation. No one knows for sure what is going to happen to subprime loans because no one knows for sure how much of the debt will default.

Until this question is answered, we are going to be dealing with a liquidity crisis. Liquidity is the ability to sell your investments to willing buyers at a fair price. Credit issues have led buyers to the safety of government bonds. This has driven down the value of non-government debt, especially in Structured Investment Vehicles or SIVs.

SIVs are investment funds that borrow money to invest in a portfolio of securities. An SIV borrows money from investors on a short term basis and invests those funds in longer term debt paying them a higher rate of return. They make their money on the difference or spread between these rates. This spread is not very large but if you borrow enough money, say a billion dollars, it becomes a substantial profit.

Some SIVs hold subprime debt. Although the amount may be small and all losses have yet to materialize, the thought that there might be losses has caused investors to stop lending to many SIVs. Much like banks during the depression SIVs have had “runs” on them. Investors are asking for their money to be returned to them.

To add to the problem, many SIV’s are partially insured by banks and other financial institutions that agree to cover certain portions of the losses for a fee. So if the SIVs are forced to sell securities at a loss, the financial institution backing it then has to make up the difference. This contributes to the lack of liquidity because money that financial institution would have used to issue loans is now used to cover losses.

SIVs and the financial institutions that backed them have lost money because they had to sell securities at fire sale prices. This is in contrast to the value of the assets backing these securities. Many may not have gone down in value. We may not know the true value of the securities for sometime. Remember they were borrowing

short term from investors and lending long term to borrowers.

You cannot just assume all subprime loans will default. Many of the loans that were classified as subprime in fact went to prime borrowers who have the financial ability to pay their loans. A study by First American Loan Performance, a San Francisco research company, says that 61% of subprime loans issued in 2006 were to prime borrowers. Prime borrowers paid subprime rates for one of two reasons. Either the borrower was taken advantage of by the lender or the borrower chose to take a subprime loan because it was faster and easier.

Only time will tell the actual extent of subprime losses. For example, we will not know the value/return of an auto loan until one of two things happens; either the car loan is paid in full including interest or the borrower stops making payments and the car is repossessed and sold with the proceeds going to the lender. Home loans work the same way.

Another added twist is refinancing. The Federal Reserve lowered the Discount Rate $\frac{3}{4}\%$ which in turns lowers rates charged to borrowers. If the subprime loan was taken out when rates were higher, the borrower might lower his payments by refinancing. The Federal Reserve is also helping the liquidity squeeze by lowering the rate it charges banks to borrow. This helps banks by making their cost of capital less, giving them more profit on their loans. They have also made it clear they will continue to lower the Discount Rate further or employ other options to keep the economy growing as they feel necessary.

In summary, real money has been lost by SIVs and the financial institution that backed them because of the liquidity crisis. The credit market needs time to heal while the loans work themselves out. This lack of liquidity has slowed the economy and Federal Reserve is working hard to prevent a recession. Only time will tell if this will work. This time next year we will most likely be worrying about something else and just like 2007, the market will be higher at the end of the year than when it started.

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