The Dummies Guide to the Credit Crunch

Confidential spoke with Investment advisor, Nick Lumsden, on his recent visit to the Gulf, and asked him to explain exactly what the panic's about!

Nick Lumsden

When I started this article in mid October, the numbers on my screen were ominously red. In stark and worrying contrast to the previous day's welcoming green, they were hysterically marking another overnight market collapse in Asia. In London, the FTSE had fallen by 7 per cent and in New York the Dow Jones was down nearly 8 per cent - its biggest fall in more than 20 years. But these were just one day of numbers; before then, stocks had been rising and the world was breathing a sigh of relief: the worst apparently over. Later in the month, everything is green again, but framed by news stories of a global down turn; the R word (recession) is being widely and resignedly used. Who knows where they'll be by the time you read this.

"In the past four weeks, the whole world has been turned on its head. What was before is no longer what will be" says Nick Lumsden, Principal at London based Rosecastle Capital, a company rather dryly described on its website as, "an independent investment advisory company that provides specially selected investment products to institutional and family office investors in the Middle East."

It is so big, so all encompassing, that it is tempting to believe that there is not a single person alive that understands it all. And that is the most terrifying part.

In person, Nick is much jollier, and when he arrives for our meeting is immediately charming: shaking hands with everyone and joking. Smiling, he is forthright about what's going on. "It's a mess," he says, "these are interesting times."

Interesting in the sense that the world has woken up to the murky world of high finance, has woken up and is taking notice. Once the preserve of only a certain type of men and women - expensively booted, aggressive, they lived at the speed of light, speaking a different language - they have been called the Masters of the Universe because for a long time they seemed able to defy centuries old economic laws, and apparently magic money from thin air. The current crisis is the Emperor's New Clothes revealed: "the magic money wasn't real. But that does not mean that we won't all be paying it back."

And so begins an hour long odyssey into the previously unknown. Nick is eloquent about obscurities, shining light into the black hole that appears to have swallowed our savings, brought once great financial institutions to their knees - or even pushed them under. He's blunt too, freely admitting to not having the experience to answer some of our questions. “I can’t tell you anything about Iceland; I don’t have the faintest clue.” And this is the thing with this... thing: it is so big, so all encompassing that it is tempting to believe that there is not a single person alive that understands it all. And that is the most terrifying part: if experts can’t give you a solid, clear answer, what hope for any of us?

The world has just entered and lived through the calamitous end phase of a global credit crunch. “Basically, banks have stopped lending money to each other,” Nick explains. This is bad because the entire economic system is based on credit and liquidity - the money in the system - rather than physical assets. And the money being lent between banks is not necessarily real money but instead, the promise that money would be paid at a particular time.

“All banks do is to borrow money at one interest rate and lend it at another.”

Think about your credit card; how many times have you said to yourself, it’s not real money until next month’? We all know that it is, that come your next statement the number owing on the card will be bigger, the edge of your limit drawn closer. But in banking there is no limit, and it has a few tricks up its sleeves as well. “All banks do is to borrow money at one interest rate and lend it at another. As long as the rate at which is it is lent is higher than the rate at which it is borrowed, banks can all but forget about whatever it is that they owe. The money will be there in the form of repayments to loans they’ve made and the interest earned on the money they have lent.”

The net result of this is an entire system based on constantly rotating credit. In itself, credit is actually not a bad thing and can be seen as the oil in our economic machine. Credit allows us to buy houses, living in them as we pay for them, instead of having to save for years first. It allows businesses to expand and invest, creating jobs and growing the economy. Credit is not the enemy here, but a glut of credit, secured against practically nothing, almost certainly is. For individuals, the principle of credit is that we borrow cash against identifiable assets - a mortgage secured against the value of your home - but for banks, looking to manipulate the system in their favour; things are not necessarily so clear cut.

“The current crisis can be traced back about ten years,” declares Nick, leaning back in his chair. “The Asian crisis of ’97 hit global economies hard, as did the dotcom crash of ‘99/2000. And then came 9/11. All of these events spooked markets, sending them lower and causing reverberations far beyond the market or sector in which they occurred.” Because of this, “everything has been about continual growth: keeping interest rates low in order to promote growth and in theory, making everyone richer.”

Why did you choose one credit card over every other? For many, the most important factor is the interest rate: the lower it is, the less you have to pay for your loan, leaving you with more in your pocket to spend on other things. All banks work in exactly the same way. By keeping the cost of borrowing down, those that borrow have to pay less interest on their loans, leaving them more money to invest in expanding and developing their homes, companies or even national economies, thus increasing wealth across the board. “It also makes credit incredibly attractive and somewhere along the line, the world has borrowed too much.”

What has happened is that with credit so attractively priced, banks have been borrowing heavily all over the world. As described above, they didn’t actually have to have the money to pay back their loans because, as well as borrowing, they have been lending too. One should have covered the other, with any difference becoming the bank’s profits and the means by which it paid huge bonuses to its brokers and dividends to its shareholders.

A few years ago however, “something started to go seriously wrong.” As we have seen, interbank lending should be reasonably secure. “In addition to the inbuilt security of borrowing being covered by loans, every transaction was insured.” The problems started when individuals became involved and started defaulting on loans.

With some considerable deference then, enter please the SUBPRIME mortgage.

Conceived as a means to share wealth, “a subprime mortgage is a higher risk loan offered to people with bad credit ratings at higher rates of interest.” This last was the safety net of the system; yes it was a higher risk to lend, but the returns would be higher too. The idea was that through property ownership, “even the poorest could begin to climb the money ladder.”

With thanks to Peter, www.cartooncreator.nl

It worked like this. “World economies had been growing steadily for years and, as a result, real estate values also continued to grow. People had money, and were looking to move up the property ladder; demand outstripped supply and prices soared. The thinking was that if more people owned property, then more people would benefit from seeing the value of their homes increase.” It was a nice plan: everyone got richer, had more money to spend and in spending it, would further promote continued growth, and real estate would grow further still...and on and on and on.

“But economies slowed: inflation

started to creep up on the back of rocketing fuel and food prices and everything started to cost more. To battle inflation, interest rates were raised, meaning that the cost of your loan increased. People, and more importantly businesses, had less money to invest, and unemployment began to rise. People started to default on their loans."

First it was a trickle and then it was a flood, and the full level of the risk that the banks had taken was exposed. If one person defaults on a mortgage, the bank repossesses their house and sells it to recoup its monies. It's bad for the newly homeless family, but that's the deal you sign. However, if tens of thousands of people are defaulting every month, it becomes really bad news for the banks. Suddenly their safely managed raft of debt doesn't look so safe any more. They have considerably less money coming in to service the debts they have accrued elsewhere and worse, the value of the debt owed to them diminishes in line with the perceived ability of its debtors to pay. And they can't borrow against it any more.

"Credit became incredibly attractive and somewhere along the line, the world has borrowed too much."

People are struggling to pay their home morgages.

Because, ridiculous as it may look now, banks were doing that as well. "Part of the problem was that banks weren't borrowing against anything as solid as assets or the cash in their vaults, but against the amount of money they were owed."

If John owes Bob BD10, and Bob wants to borrow BD15 from Jane, Jane might use, as part of her decision making process, the ability of John to pay Bob. If Jane believes that John is good for the money and will pay Bob on time, then Jane can count on getting back at least ten of her fifteen; and she is really only risking BD5. But if she doesn't think that John will pay up, she is risking all BD15, and may charge Bob more for her loan.

Economics is about two things: supply and demand. The market for these types of credit and debt swap was huge; lots of people were making a lot of money and everyone wanted a part of it. But as the perceived value of these debts fell - if Jane doubts Bob's ability to pay - they became riskier and less attractive: if a debtor loses the ability to pay his debt, the value of that debt is nil.

"Even worse, a glut of foreclosures means a glut of available properties. And in a market in which there are more sellers than buyers, prices are driven down, thus diminishing in value the limited real assets that the banks still had." Banks began to fall.

Once it started, it seemed impossible to stop. Not every bank was in the subprime game, but such is the interweaving of a globalised banking economy that even those not directly affected by the fallout from subprime mortgages felt its effects. The cost of interbank lending rocketed as fears spread about the liquidity of every bank. If Jane doesn't think John will be around tomorrow, she is risking all fifteen when lending it to Bob. But if she thinks that Bob won't be around either the day after that because he hasn't got his ten from John, she is not going to lend at all.

In an economy oiled by the availability of credit, the system ground to a halt. Banks stopped lending to each other, to businesses and consumers alike. Mortgages became impossible to get, thus further devaluing the property market. No mortgages meant no buyers, and more sellers than buyers led to a price collapse. Without loans, companies could not invest, stifling growth, and causing share prices to sink.

Action had to be taken and governments, fearing total economic armageddon, stepped in. (We asked Nick to paint a picture of what this would look like but he was either unwilling or unable to do so. "I don't know what would have happened," is all he'd say: it wasn't very reassuring.) In the US, the US$700 billion 'bailout,' prompted by the demise of Lehman Brothers, and coming hard on the heels of bailouts of Fannie and Freddy - the country's two biggest subprime lenders - and AIG - the US's biggest insurer and underwriter of many of these dodgy credit swaps - did nothing to stop the market collapse. Banking shares were hit hardest as investors fretted about whether or not they had enough money stashed to service their huge, suddenly toxic debts. The US bailout was supposed to take these toxic debts under governmental control and prompt banks into lending to each other, and us, again. It didn't work, and more banks were taken closer to the edge.

All public companies can be measured by what is known as their market capitalisation; the value of the company as expressed through the sale value of all their shares. As the share price slumps, this number falls with it, taking a considerable chunk of asset value along for the ride. If market capitalisation falls below the value of debt, the company is effectively dead. With banks, this is a major problem, and the removal of toxic debt was supposed to sure up their values in an increasingly virulent and turbulent market.

Next there was a coordinated cut in interest rates by the world's central banks. The interest rate cut was again supposed to promote lending between banks, thus increasing the liquidity of the system. Cheaper loans, remember, encourage lending. Except that thus far, it hasn't happened and interbank lending rates are still sky high in comparison to a year ago. The final raft of measures taken was to prop up individual banks with taxpayer's money.

This last can be seen as governments asserting their control over the markets. 'You banks,' they seem to have been saying, 'have got us all into a bit of a mess. We will protect you - because not to is not worth even imagining - but we want some of our control back over you.' For

Some transactions are so complicated that they are performed automatically by computers, with no human intervention whatsoever.

the past 30 years, the financial world has been largely deregulated. Everything is for sale, irrespective of when and where, and the transactions have become more and more complicated. Indeed, some of them, made largely by the hedge fund industry, are so complicated that they are performed automatically by computers, with no human intervention whatsoever.

So in return for some seriously bamboozling amounts of our money, the banks have ceded some of the freedoms back to governments who have demanded that they not pay their shareholders any dividends until taxpayers money has been returned; and the days of vast broker bonuses are surely numbered. Not paying dividends is being challenged by the banks who complain that such a rule will stop investors from investing in banks and so governments may back down, but tighter rules on the types of trades permissible are widely predicted.

So where does all this leave you and me? As I write this, government intervention seems to have saved all our savings; ever increasing guarantees have been given to savers by governments terrified that we would all withdraw our cash, and further reduce the money

A trader examining a FTSE screen

available to banks. But the world is pretty much resigned to the fact of a global recession.

"Europe, the US and parts of Asia will be hardest hit; the Gulf, because it is so cash rich, is best prepared to weather the storm." But then, one of the consequences of recession is that demand shrinks and prices start to fall. "Oil is already half the value it was a few months ago and there is less money coming in to fund the developmental surge we have seen in recent years."

Nick says of Dubai: "there is no bid on off-plan." He means that the days of speculative property investment have recently come to an abrupt end. "No one is buying off plan at the moment because no one can raise the capital to buy something that doesn't yet exist." He says that because there is still a housing shortage there, the market for completed properties, "is still strong" but that without the financing, new developments may "not even get started."

Not yet an issue in the Gulf, but another consequence of all this money being thrown at the problem may be higher taxation, or diminished public spending. The money pumped into banks has to come from somewhere, and whilst the US simply extended its national debt to over US$11 trillion, at some point that money is going to have to be paid back. Taxation generates funds, and not spending saves them: the decision to take either tack will not be popular with the same taxpayers whose money has just been handed to the banks.

These are indeed, interesting times. Returning to Nick's opening statement, that "what was before is no longer what will be," it is tempting to imagine a less frantic time in our futures where money markets make sense to all of us. Not because they have been over simplified by fearful government regulation, but because they have once again assumed human characteristics. It is an over simplification of course, but supply and demand of real things has naturally and continually affected the notion of value ever since we first walked the earth. It may not be clever or impressive - it is certainly not complicated - but it has a rather beautiful simplicity that lends the idea solidity; making it real to anyone who has ever wanted anything - real not imagined; conjured from thin air - and understood that there is a price to pay for having it. These last few months have been a lesson to us all: if something seems too good to be true, it probably, and usually, is ■

Nick was resident in Bahrain from 1992-1996 and has been returning here six times a year ever since; indeed, he callls it his "second home."'