SUBPRIME UPDATE: THE GLOBAL FINANCIAL CONTAGION

It has been generally accepted wisdom that the spreading of risk is a good thing. With the recent problems stemming from subprime mortgages, mortgage-backed securities and the resulting credit crunch, this article of faith is being called into question. In this Alert, the fourth in our series on the subprime crisis, we will examine the global financial contagion that has been instigated by the crisis.

The U.S. was the first to contract the bug, but due to the global flow of capital and dispersal of innovative mortgage products with underlying subprime risks, parts of the rest of the world are now experiencing distressing symptoms. Signs include significant losses with write-downs in the hundreds of millions to the tens of billions of dollars, credit distress and, in some terminal cases, bankruptcy. The widespread U.S. housing slow-down is also being mirrored in other previously hot spots. For example, property prices are now falling in Madrid, Barcelona, Valencia and Seville, ending a spectacular boom that had made Spain the hottest property market in Western Europe for roughly a decade. Now, with an estimated 98% of Spanish home loans on adjustable rates, local banks are tightening credit and raising rates so quickly that Spain’s prime minister begged national lenders not to pull back too quickly and send the economy into a tailspin. Further warnings have come from the Organization for Economic Cooperation and Development (OECD), which recently predicted that Ireland and Denmark would experience “a further large fall in housing investment as a share of GDP.” As housing is a key economic driver, a falling housing market suggests more economic indigestion to come.

Generally, the lower the barriers to entry into the local financial markets, the more common interactions with complex financial instruments will be and the greater the spread of the subprime contagion. When banks’ assets are hit, their ability to lend is hurt, causing contractions in credit. These follow-on interruptions in the flow of funds can be even more deadly than the initial illness.
WELCOME TO THE WORLD OF STRUCTURED FINANCIAL INSTRUMENTS

In our first subprime Alert, we described how asset-backed securities (ABSs), including mortgage-backed securities, may be issued by special purpose vehicles (SPVs) set up by investment banks. Investment banks have also bought ABSs and bundled these for the purposes of selling other instruments known as collateralized debt obligations (CDOs). Alternatively, investment banks sell instruments through structured investment vehicles (SIVs) which issue short-term commercial paper, leveraging the spread in yields between long-term investments and short-term borrowing. More recently, the “SIV Lite” was introduced, combining aspects of SIVs and CDOs. In the subprime crisis, many of these investment instruments have turned into NPAs (nonperforming assets).

Large numbers, very large numbers, are at stake. The total value of all outstanding U.S. mortgage-backed securities in early 2006 was reported to be $6.1 trillion. Over the course of 2006, the value of new ABS-backed CDOs issued was another $200 billion. According to Moody’s, SIVs account collectively for approximately $400 billion worth of assets. To put this in perspective, when Credit Suisse and Deutsche Bank reported significant write-downs of $1 billion and $1.5 billion respectively, they were viewed as having “relative low” exposure to this class of losses.

Of course, only a small percentage of mortgages are subprime and not all subprime mortgages are in grave shape. According to the U.S. Mortgage Bankers Association, as of March 2007, the subprime market was 13% or $1.27 trillion (that’s trillion with a t) of the total $9.8 trillion outstanding in the U.S. residential mortgage debt market.

Unfortunately, subprime mortgages, and real estate generally, is not the only category of credit experiencing defaults; now credit card companies, as well as the auto and school loan sectors, are anticipating payment problems.

THE DANGEROUS CREDIT CRUNCH

One of the harshest results of the subprime crisis has been the current, severe credit crunch. After years of mainlining cheap credit, companies are seeing their strategies overturned and their very survival endangered as the in-flow of capital is curtailed. The leading victim of the credit crisis may be Northern Rock, the British mortgage lender. The firm’s strategy of lending long and borrowing short led to a run on the bank, which had to be bailed out by the Bank of England. The company is currently struggling to survive as a viable entity but may end up selling off pieces of its business.
A SAMPLING OF THE GLOBAL IMPACT

As mentioned above, the more open the financial market, the greater the potential exposure to the subprime malaise. In Europe, the malady initially spread quickly across the continent. In Asia, the relative containment of many of the financial markets largely blunted the spread of the contagion.

AUSTRALIA

The country’s second-largest shopping center owner, Centro Properties, may, in the worst case, struggle to remain operational after disclosing that its assets are collateral for almost $5 billion in bonds. The proceeds of the bonds were used to purchase hundreds of U.S. properties. When the company’s chief executive officer announced that certain mall properties might need to be sold to meet its coming payment obligations, asset holders became concerned. In a week, the company lost $3.3 billion in market capitalization, 80% of its value, worsening the potential problem.

BERMUDA

Another symptom of the subprime crisis and credit crunch has been the pressure on credit ratings (which can, in turn, put further pressure on credit and profitability). Merely having one’s rating put on review, can itself cause discomfort. As a global insurance capital, Bermuda is not immune. Moody’s Investor Services placed the senior debt rating of XL Capital Ltd. and XL’s operating subsidiaries on review for possible downgrade. The concern is apparently focused on XL’s sizable equity stake in Security Capital Assurance Ltd. (SCA) and to a lesser extent on XL’s $1.3 billion direct investment in subprime mortgage assets. The warning followed an announcement of a loss of $145 million in SCA’s credit derivative portfolio. The ratings of the Bermuda-based provider of financial guaranty insurance and credit enhancement products was itself placed on alert for possible downgrading and the firm received at least one shareholder suit. Two transactions that it had insured, valued at $792 million, were downgraded. If the guarantors of complex financial instruments backed by deteriorating mortgages themselves go under, the value of these investment vehicles will suffer additional shocks, shocks from which they may not be able to recover.

CANADA

North of the U.S. border, there are few barriers to stop the flow of investments and spread of the subprime contagion. The Canadian Imperial Bank of Commerce (CIBC) announced $9.8 billion in subprime debt. More than a third ($3.5 billion) of this had been insured by a secure guarantor. When the guarantor was downgraded from investment grade to junk, the bank’s band aid had to be considered a failure. Canada’s Bank of Commerce also announced write-downs of almost $3 billion of subprime mortgage debt.
CHINA
The China Banking Regulatory Commission has indicated that domestic banks have only a “limited” exposure to subprime problems. Still, China Construction Bank is left with roughly $1 billion in U.S. subprime mortgage-backed securities and state-lender Bank of China with almost $10 billion in subprime mortgage-related assets in the U.S., plus another $1.6 billion of exposure in its Hong Kong arm.

FRANCE
Credit Agricole, France’s largest retail bank, took a €3.3 billion hit to cover possible subprime consequences. Société Générale, the country’s second biggest bank announced that it was going to bring back onto its balance sheet SFr 4.2 billion in assets previously in a structured investment vehicle (SIV) after a decision by Moody’s to put the fund on negative watch. BNP Paribas suspended redemptions from three investment funds worth $2 billion, citing problems in the U.S. subprime mortgage sector. After third-quarter earnings were hurt by write downs and subprime-related trading losses, France’s fourth largest bank by market value, Natixis SA, will reportedly reorganize its corporate and investment banking division.

GERMANY
Germany’s financial sector has exhibited few symptoms because homeownership rates are relatively low, and there is no subprime mortgage market to speak of. It has not, however, remained totally immune from the credit crisis. IKB, one of the first banks to fall victim to the credit crunch, looks likely to need more than the €3.5 billion rescue package put together by a number of banks. Sachsen LB, another small German bank, also had to be resuscitated this past summer. Both banks had diversified into areas outside their usual core competences to make up for falling earnings at home, a function of the Germany’s fragmented three-pillar banking structure, according to critics of the system. Market consolidation is thought to be on the horizon. On the investment side, Union Investment, Germany’s third biggest mutual fund manager, stopped redemptions from one of its funds after investors pulled out about 10% of its assets.

INDIA
According to the World Bank’s lead economist, the economies of developing countries are unlikely to be directly affected by the U.S. subprime mortgage crisis. None of the major Indian banks have direct investment in U.S. subprime debt, but some fear the indirect effect of reduced capital flows. The initial aftermath of the subprime blowout saw some $2 billion of foreign investments being withdrawn from Indian stock markets. This equates to 25% of the $8 billion invested in Indian stock exchanges in the first seven months of 2007.

IRELAND
While not uniform across the sector, domestic pension funds were hit hard in the fourth quarter of last year, largely attributable to exposure to local equities. The Irish stock market has a relatively high percentage of financial and housing-related investments which suffered reduced demand and the effects of the global credit crunch. This wiped out expected returns for the year and left them, as a group, with a loss of roughly €4 billion.

JAPAN
While a recent poll of Japan’s regional banks and financial institutions on their exposure to U.S. subprime mortgages revealed that 23 of the 109 institutions may be impacted, only two Japanese banks have reported $10 billion or more in potential subprime losses. San-in Godo Bank reported subprime exposure of roughly ¥13 billion, equivalent to about 1% of its securities holdings. Joyo Bank reported a potential exposure of ¥10 billion and said it expects to write off about ¥1.5 billion in losses. While numbers keep coming in, in part due to the difficulty in pricing securities for which there is a limited or evaporating market, Japanese mega bank Mitsubishi UFJ Financial Group (MUFG) said that its losses on U.S. subprime loans soared by as much as six-fold over two months, bringing losses to a grand total of $263 million. Still later, it raised its estimate to $470 million in potential losses.

NETHERLANDS
Dutch investment bank NIBC Holding NV announced losses of $188.6 million from asset-backed securities in the first half of 2007.

NORWAY
Many were stunned by the announcement that four small Norwegian towns near the Arctic Circle had taken serious subprime losses. Collectively, their approximately $64 million in subprime-related investment had fallen to less than 55% of its original value. Norway’s main financial regulator opined that the firm that sold them the securities had violated the “good code of conduct” by failing to adequately inform them of the possible
risks related to the complex investment securities that it had sold them. This firm revealed that it would file for bankruptcy protection after losing its license as a result of these events.

**SINGAPORE**
While Singapore banks have invested in debt instruments such as collateralized debt obligations (CDOs), because most of their business is concentrated locally, they have invested less in CDOs as a percentage of assets than some western banks. DBS has revealed the largest exposure at $1.7 billion. However, stakeholders remain jittery because the bank had initially released a lower estimate of its CDO exposure. Some have suggested that the firm has still only accounted for 5% of its total CDO exposure.

**SWITZERLAND**
The Swiss lender UBS AG took a serious hit from the subprime crisis with a $10 billion write down. The Swiss banking regulator has indicated that it intends to investigate the matter once the current crisis has passed. Credit Suisse revealed a $1 billion write-down on bad debts. In the insurance sector, Swiss Re announced $1 billion of losses related to the subprime crisis.

**UNITED KINGDOM**
The Royal Bank of Scotland expects to have subprime losses of £950 million. Barclays announced potential losses in the region of £1.3 billion. Following similar moves by institutional funds, Friends Provident’s U.K. commercial property fund froze withdrawals by its retail investors for up to six months due to cash liquidity issues. Naturally, with property values falling, redemption requests increase. The Financial Services Authority (FSA), probing the U.K.’s own domestic subprime mortgage market, found defaults in this segment running at 20 times those on prime mortgages. The FSA has identified the subprime mortgage market as a priority area for supervision. Domestic subprime mortgages now account for 8% of the overall U.K. market and are estimated at £15-£16 billion.

**CONCLUSION**
The spreading of risk is paradoxical: it makes the global financial markets both stronger and more vulnerable. In the case of the subprime contagion, not all countries and institutions have been struck to the same degree. In addition, the body financial has its defenses – for most countries, their central bank – and those defenses have been responding. On the whole, the spreading of risk in this case remains an effective force for stability.

This is an evolving story. The global financial markets suffered large losses on January 21 and January 22. The U.S. Federal Reserve Bank cut the Fed Funds rate by three quarters of a point, the largest decrease in 26 years.

Willis will continue to monitor developments and will issue future Alerts as the story unfolds.

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