"A sound banker, alas, is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional way along with his fellows, so that no one can really blame him”

John Maynard Keynes
A credit crunch (also known as a credit squeeze) is a sudden reduction in the general availability of loans (or credit), or a sudden increase in the cost of obtaining loans from banks.
What is ABCP?

- Asset-Backed Commercial Paper — is short-term corporate debt that is made up of a bundle of loans like credit card receivables and car loans. This debt is then resold to other investors, taking the original loans off the books of the company that first issued them. That can lead to lower lending standards because the originator of the loans doesn't have to worry about collecting.
- ABCP tends to yield more than treasury bills, making it a popular place for money market funds and pension funds to park money.
CHART 2
POTPOURRI
ABCP Multi-Seller Conduits—Canada (June 2007)
Asset Class Composition

- Auto Loans/Leases: 31.0%
- CDOs: 25.8%
- Residential Mortgages/CMBS: 23.8%
- Business Loans/Leases: 11.5%
- Personal Lines of Credit/Credit Cards: 5.3%
- Other: 2.6%

Source: DBRS

The Subprime Primer
Ace Mortgage Brokers
"We Make Your Dreams Come True"

Gee, I'd like to buy a house but I haven't saved any money for a downpayment and I don't think I can afford the monthly payments. Can you help me?

Sure! Since the value of your house will always go up, we don't need downpayments anymore.

Ace Mortgage Brokers
"We Make Your Dreams Come True"

And we can give you a really really low interest rate for a few years. We'll raise it later, okay?

Sure, no problem. Uh, there's one other thing... my employer is a real prick and might not verify my employment. Would that be a problem?

Oops. We can get you a special "Liar's Loan" and you can verify your own employment and income!
Ace Mortgage Brokers
"We Make Your Dreams Come True"

You guys are awesome! You are really willing to work with guys like me.

Well, we don’t actually lend you the money — a bank will do that — so we don’t really care if you repay the loan. We still get our commission.

Wow! Let’s get started.

Blaney McMurtry

Subprime Mortgage Crisis — Diagram 2 of 2

Housing Market

- Home building declines
- Government mortgage guarantees

Financial Market

- Liquidity crunch for businesses
- Bank failures
- Bank capital levels depleted
- Bank losses

Government & Industry Reponses

- Central Bank Actions
- Fiscal Stimulus Package
- Homeownership Assistance
- One-Off Bailouts
- Systemic Rescue

- Lower interest rates
- Increased lending
- Economic Stabilization Act of 2008
- Hope Now Alliance
- Housing & Economic Recovery Act of 2008
- Fannie & Freddie
- Bear Stearns
- Lehman Brothers
- AIG

Negative Effects on Economy

- Housing bubble bursts
- Household wealth declines
- Job market declines
- Stock market declines
- Lower interest rates

Mortgage Defaults

- Frequent changes in interest rates
- Fixed interest rates

Collapse of Subprime Lending

- Erosion of mortgage spreads
- Losses on mortgage-backed securities (MBS)
- High default rates (PMO)
The Ratings Agencies

Mortgage-Backed Securities (MBS) Downgrades

Rating agencies (e.g., S&P and Moody's) have downgraded the credit rating on nearly $1.7 trillion in MBS. This has prompted action by many financial institutions that held MBS as collateral for margin calls, potentially requiring them to secure additional capital.

Mark to Market Rule

- This accounting rule requires companies to adjust the value of marketable securities (such as the mortgage-backed securities (MBS) at the center of the crisis) to their market value. The intent of the standard is to help investors understand the value of these assets at a point in time, rather than just their historical purchase price. Because the market for these assets is distressed, it is difficult to sell many MBS at other than fire-sale prices, which may be below the actual value that the mortgage cash flow related to the MBS would merit. Many large financial institutions recognized significant losses during 2007 and 2008 as a result of marking-down MBS asset prices to market value. For some institutions, this also triggered a margin call, where lenders that had provided the funds using the MBS as collateral had contractual rights to get their money back. This resulted in further forced sales of MBS and emergency efforts to obtain cash (liquidity) to pay off the margin call. It is the combination of the extensive use of financial leverage (i.e., borrowing to invest, leaving limited room in the event of a downturn), margin calls and large reported losses that may have exacerbated the crisis.
Credit Default Swaps

- Credit default swaps (CDS) are insurance contracts used to protect debtholders, in particular MBS investors, from the risk of default.
- CDS may either be used to hedge risks (specifically, to insure creditors against default) or to profit from speculation. The volume of CDS outstanding increased 100-fold from 1998 to 2008, with estimates of the debt covered by CDS contracts, as of November 2008, ranging from US$33 to $47 trillion.
- Insurance companies such as American International Group (AIG), MBIA, and Ambac faced ratings downgrades because widespread mortgage defaults increased their potential exposure to CDS losses. These firms had to obtain additional funds (capital) to offset this exposure. AIG’s having CDSs insuring $440 billion of MBS resulted in its seeking and obtaining a Federal government bailout.
Economic Consequences

Company failures
- New Century Financial Corporation
- American Freedom Mortgage
- American Home Mortgage
- Lehman Brothers (bankruptcy)
- NetBank
- Terra Securities (scandal)
- Sentinel Management Group
- Washington Mutual
- Icesave
- Kaupthing Singer & Friedlander
- Yamato Life
- Circuit City

Government bailouts and takeovers
- Northern Rock (nationalization)
- IndyMac Federal Bank
- Fannie Mae (takeover)
- Freddie Mac (takeover)
- American International Group
- Bradford & Bingley
- Fortis
- Glitnir
- Hypo Real Estate
- Dexia
- Landsbanki
- Kaupthing
- ING Group
- Citigroup

Company acquisitions
- Ameriquest Mortgage
- Countrywide Financial
- Bear Stearns
- Alliance & Leicester
- Merrill Lynch
- Washington Mutual
- Derbyshire Building Society
- Cheshire Building Society
- HBOS
- Lehman Brothers
- Wachovia
- Sovereign Bank
- Barnsley Building Society
- Scarborough Building Society
- National City Corp.
Economic Consequences- Canadian Pension Funds

- Canada's biggest pension fund, Caisse de dépôt et placement du Québec, needed cash to shore up or shut down money-losing positions.
- The CPP Investment Board recently announced an 8.5-per-cent loss for the three months ended Sept. 30, which translates to a $10.3-billion slide in the value of its assets.
- However, performance and liquidity problems are more acute for the Caisse because the fund has $13-billion tied up in asset backed commercial paper. The Caisse's ABCP holdings have been locked up in a restructuring since August, 2007.

Meltdowns to Come..CBMS

- Fears about rising default rates and declining property values, which engulfed the home mortgage market at the start of the credit crisis, are spreading to the commercial real estate market, hammering the value of bonds backed by loans made to office buildings, shopping centers and apartment complexes.
- As a result, the market for commercial-mortgage-backed securities has been sent into a tailspin by the now-familiar combination of forced selling and bleak economic forecasts.
Meltdowns to Come ..Credit Cards
Meltdowns to Come ..Credit Cards

- Total loans from commercial banks to consumers grew by $89 billion for the 12 months ending in September. $61 billion of that was credit card debt, and the amount in recent weeks has exploded. Let's look at this analysis from my favorite slicer and dicer of numbers, data-wizard Greg Weldon.
- Credit Card Loans, 10 months Sep07-thru-Jul-08 ... up + $29.1 billion
- Credit Card Loans, 10 weeks Aug-08-to-mid-Oct-08 ... up + $32.3 billion
- "In other words, Commercial Bank 'exposure' via the total amount of Credit Card 'loans' outstanding has risen MORE in the last ten WEEKS, than it did in the previous ten MONTHS COMBINED

"According to American Express, delinquencies on credit payments rose to 4.1% of all credit outstanding in the 3Q, up from 2.5% in 3Q of 2007, with Bank of America's rate rising even more steeply, to 5.9% in the quarter.

"Moreover, the 'pool' of loans deemed 'uncollectable' rose to a high 6.7% in the 3Q, soaring from 3.6% last September."What consumer spending there is has been fueled in part by credit card. Greg notes this uncomfortable piece of data: the second largest "merchant-vendor" for credit card use is now McDonalds. This suggests that many consumers are in serious distress when they need to get their $4 Big Mac and fries with a credit card"
The Effect of the Credit Crunch

For Lenders:
- Less appetite for advancing additional credit.
- Requiring additional security for credit advances
  - additional security
  - guarantees from related companies
  - personal guarantees
- Stricter enforcement of covenants on existing loans

The Effect of the Credit Crunch (con't)

For Debtors
- Less credit available for financing operations
- Seek Alternative ways to increase cash availability:
  - Lengthen payment terms to suppliers
  - Deductions and Rebates
  - Shorten payment terms extended to customers
  - Sale of certain capital assets
Sectors Affected by Credit Crunch

Freight

Currently, the Baltic Dry Index, which tracks dry bulk shipping rates, is at 826. As recently as August it was above 8,000 and in May it was at an all-time high above 11,000. But, as Jefferies & Co. analyst Douglas Mavrinac tells the Associated Press, many buyers of bulk ocean freight, such as power plants, steel producers and food makers are unable to take advantage of those rates because they cannot secure letters of credit to facilitate shipments of coal, iron ore and grain they need.
The Credit Crunch and Cross-Border Issues – A case study

InterTAN Canada Ltd. (“InterTAN”)
- Canadian subsidiary of Circuit City Stores Inc. (“Circuit City”)
- InterTAN operates as “The Source by Circuit City” in Canada.
- Circuit City filed for bankruptcy protection in the United States pursuant to Chapter 11 of the Bankruptcy Code (the “Chapter 11 Filing”).
The Credit Crunch and Cross-Border Issues – A case study (con’t)

- InterTAN was part of the Chapter 11 filing in the United States and also sought protection in Canada pursuant to the Companies’ Creditors Arrangement Act (“CCAA”)
- In its materials InterTAN admits that it is not insolvent in that its assets exceed its liabilities by a significant amount.

The Credit Crunch and Cross-Border Issues – A case study (con’t)

- InterTAN’s financing was intertwined with Circuit City’s facility in the United States.
- Prior to the CCAA filing and the Chapter 11 Filing, the facility used by both InterTAN and Circuit City was secured against all of Circuit City’s however only $50 million of the debt was secured against InterTAN assets.
The Credit Crunch and Cross-Border Issues – A case study (con’t)

- As a condition of providing Debtor in Possession ("DIP") financing, the bank demanded security over all of Circuit City and InterTAN assets for the entire DIP facility (which could be as high as $1 billion).
- This could have the effect of priming InterTAN’s suppliers and trade creditors for debts incurred by Circuit City during the restructuring process.

The Credit Crunch and Cross-Border Issues – A case study (con’t)

- InterTAN - What the Court Ordered
  - Granted the DIP Facility and the security requested by the bank, BUT:
    - Any advances made directly to InterTAN (up to a maximum of $60 million) take in priority to any unsecured claims.
    - However, InterTAN will provide unsecured creditors with a $25 million charge that ranks in priority to any advances made under the DIP Facility other than the amount’s previously mentioned.
The Credit Crunch and Cross-Border Issues – A case study (con’t)

InterTAN – The Takeaways

1. Just because a Canadian company is solvent does not mean that it cannot be the subject of an insolvency proceeding.

2. It is possible for the courts to prime unsecured creditors with a DIP facility that encumbers the Canadian subsidiary’s assets as security for debts incurred by the foreign parent.