

# **Global Financial Melt Down & Effects on Pakistan**

# Root Cause

It can be argued that the seeds for this man made earthquake were planted when the Federal Reserve, lead by Greenspan decided to lower interest rates down to 1 percent in 2003 in an effort to counter potential deflation. The banks could not sustain this low rate and got heavily engaged in financial derivatives on the back of credit default insurance and also exporting the high yield securities in international markets.

# Mortgage Boom

According to Susan Wachter, professor of real estate and finance at Wharton School of Management, the looser credit standards brought a mortgage boom in 2005 when sub-prime mortgages made up 22% of new loans compared to 8% in 2003. These loans had 30 years term but with annual rate adjustments after the first two years and carried repayment penalties making it expensive for borrowers to refinance when their payments got too high.

# **Mortgage Backed Securities converted into Bonds**

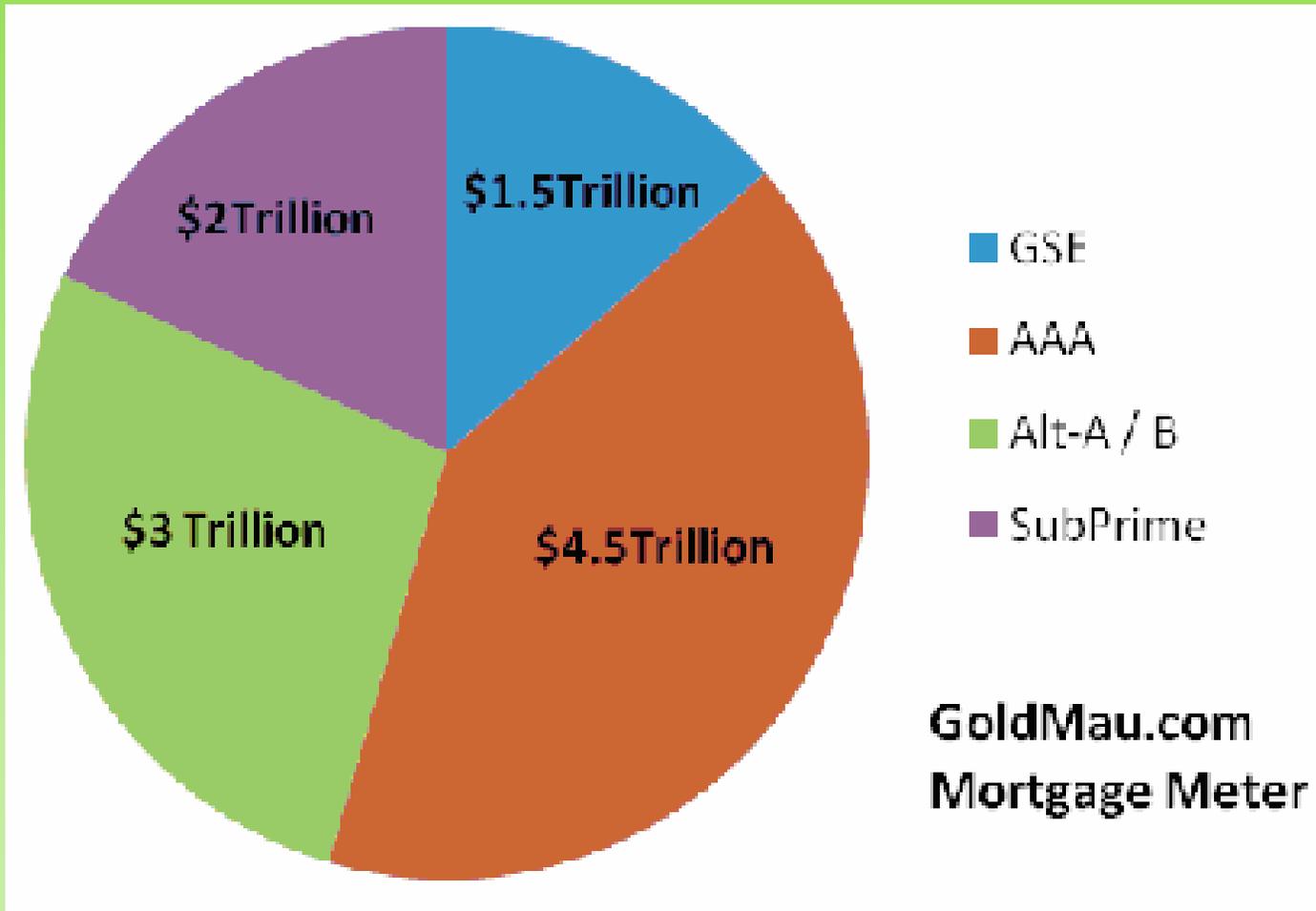
Loans were bundled into mortgage-backed securities thereby creating a series of bonds that pass borrowers' principal and interest payments on to the bond owners. Many of these lenders bought credit insurance from institution such as AIG and besides taking a share on their own account passed the risk on to investors around the world, who were eager to buy these securities since the yield offered in Treasury Bonds was producing a negative return after adding the inflation.

# Sub-Prime Estimates

The sub-prime market mushroomed from \$240 billion in 2003 to \$ 2 trillion in 2007. Ben Bernanke, Federal Reserve Chairman told the US Congress that Fed data pegs the total US residential housing stock at \$20trillion, and the US residential mortgage market is worth \$11 trillion. This number is substantial, as it eclipses the US Treasury bond market of US \$9 trillion.

Of the \$11 trillion mortgage market, Government Sponsored Enterprises (GSEs) such as Fannie and Freddie hold about \$1.5 trillion, leaving \$9.5 trillion in various grades, with credit ratings ranging from AAA to BBB, and categories such as the traditional 30-year fixed right through to ARM.

# Sub-Prime Estimates



# High Delinquency Rates & Foreclosures

Duca Senior Policy Advisor at the Federal Reserve Bank of Dallas reported that in early 2007, investors and lenders began to realize the ramifications of credit-standard easing. Delinquency rates for 6-month-old sub-prime underwritten in 2006 were far higher than those of the same age originated in 2004. Lenders reacted to these signs by tightening credit standards resulting in reduced demand for homes. Foreclosures added to downward pressures on home prices by raising the supply of houses on the market. And after peaking in September 2005, single-family home sales fell in September 2007 to their lowest level since January 1998.

# Halt of Redemptions & triggers of Financial Earthquake

According to Federal Reserve Bank of Dallas on Aug 14, 2007, the paralysis in the capital markets led three investment funds to halt redemptions because they couldn't reasonably calculate the prices at which their shares could be valued. This event triggered widespread concern about the pricing of new instruments, calling into question many financial firms' market values and disrupting the normal workings of the financial markets. Initially it started with Citibank and later took the Wall Street and some of the European and Asian markets by surprise until the triggers of this Financial Earthquake were felt Worldwide on September 16, 2008.

# Parties To The Crisis

There are four parties to this crisis;

- The Borrower
- The Lender
- The Insurer and
- The Regulator

While in first and second there is a common element of greed which caused this crisis, but the role of third one being insurer by nature has to be prudent and finally, what regulator was doing when all this was happening. In the following I will deal with the role of both but in the context of AIG.

# Financial Services & Sub-Prime

Sullivan in Group's 2007 Annual Report stated that "we continue to believe that AIGFP will not realize significant losses from this derivative business, which insures against the default of certain securities. Since its creation, AIGFP has been strong performer and is an important component of AIG's diverse portfolio of businesses. We continue to see good potential across all product segments of our Financial Services group. Together, they diversify our revenues and complement our core insurance operations".

The Financial Services group recorded an operating loss of \$9.52 billion for 2007 primarily due to the unrealized market valuation losses related to the AIGFP super senior credit default swap portfolio.

**In contrast to above statement and as against premium of \$ 1.4 Billion, AIG's US regulatory filing, according to Panmure Gordon & Co findings; included a \$441 billion notional exposure of its super senior credit default swap portfolio as of June 30, 2008.**

# Role of Auditors

Washington – 8th October 2008 Representative Henry Waxman, chairman of the Government Oversight Committee presented a March 10, 2008 letter sent to AIG from a government regulator showing concerns that the “corporate oversight of AIG financial products lacks critical elements of independence, transparency and lack of auditing transparency granularity”.

"Price Waterhouse Cooper told the committee that they did not get enough access to AIG's risky financial ventures and the root cause of AIG's problems was that risk control groups did not have appropriate access to the financial products division.

# Why AIG was Bailed Out

Besides Sub Prime Mortgage exposure of \$500 billion, AIG's exposure in General and Life Insurance plans was in trillions of \$ at 30th June 2008, with 245 subsidiaries and a trillion dollars in assets, presence in 130 countries, 116,000 employees, 700,000 agents and 74 million customers; it was by far the world's largest insurer.

If AIG was allowed to fail, its knock on effects would have been greater resulting in huge losses and non payment of claims to policyholders besides loss of employments and export of crisis to more than 100 countries including China where Group had a major presence.

# **Global Economic Condition**

- In USA economic slow down and rising unemployment coupled with huge budget deficits shows signs of double dip recession**
- In Far East with reduced exports economic slow down is continuing**
- Chinese economy due to Strong Yuan slowly recovering from tremors of global economic catastrophe**
- Japan was hit strongly by Tsunami causing substantial impact on its recovery but strong Yen is helping the economy to stabilize**
- France was able to handle the 2008 recession better than most other EU economies, but inefficiency of its major bank Societe Generale caused great repercussion on its Finance & Banking**

- **UK economic conditions are in a critical state. wide scale banking reforms have to be instituted in order to address and improve economic situation. Government is facing a tough situation trying to balance its domestic unemployment, levels of which are rising on a steady basis**
- **Italy, Greece and Spain are also hit badly by recession, requiring rescue from European Union**
- **Indian economy has benefited from outsourcing of work though at reduced revenue, and has a strong manufacturing and export oriented industrial framework**
- **Economic conditions of Tunisia, Egypt, Syria, Bahrain and Libya are at distress due to political turmoil. Recovery in UAE is also slow whereas Saudi Arabia due to large oil revenue is not adversely affected**

# **Recession in Major Economies & Pakistan's Home Grown Issues of deteriorating law & Order, Political Instability and Energy crisis**

1. High interest rate + Banks' and DFIs' lack of trust on borrowers
  - Increased cost of production
  - Reduced lending
2. Decline in value of Pak Rupees
3. Fall in exports
  - Decline in receipts, weak rupee encourages holding of receipts abroad
4. Decline in investment
  - FDI + credit rating + opportunities in other markets
  - DI due to shortage of energy & 3 above
5. Low tax to GDP ratio
6. Corruption & bad governance in SOE's
7. High Inflation
8. Rising unemployment
9. Population growth and low literacy

# Remedies and Opportunities

1. Improve law & order and curb Terrorism
2. Increase energy output and resolve circular debt
3. Good Governance & eradicate Corruption
4. Right-sizing and non interference in the SOE's
5. Increase Agriculture & Dairy output.
6. Reduced mark-up rate for essential manufacturing sectors & Microfinance
7. Improve Tax to GDP ratio
8. Curb smuggling & controlled import of luxury items
9. Implementation of SME's & Entrepreneurships policies particularly for women
10. Mandatory elementary school enrolment, establish Technical & Vocational Training centers for Youth

**Story Behind**

**World Financial Earthquake**

# Michael 28, an IT Engineer – Atlanta Georgia



The year is 2004. Michael is a 28 year old man from Atlanta, Georgia. He wants to buy a \$450,000 Mansion in the brand new suburban development on the outskirts of Atlanta, but he doesn't have enough money to do so. Michael is earning \$45,000 per year at an I.T. company where he has worked for the past six months and his decision making abilities have always been questionable.

# Michael 22, a Pizza Delivery Boy - Atlanta Georgia

At 22, he leased a BMW on his credit card even though he worked as a pizza delivery boy. Within three months Michael wasn't able to pay his credit card bill and the BMW was repossessed. He is jealous that a number of his friends have bought houses and apartments and therefore he believes that he is entitled to live in a big fancy Mansion with his girl friend. So he meets Jimmy at a local one stop mortgage shop and shows him a \$4700 in his bank account.



# Michael at One Stop Mortgage Shop with Jimmy



Jimmy the mortgage broker advises Michael that while he can't get him a 30 year fixed rate mortgage due to his poor credit score there is the "loan product that's perfect" for him called an Adjustable Rate Mortgage (ARM) because the interest rate is currently only 3%, and that a 30 year fixed rate is at 5.7%. "Fixed rate mortgages" says Jimmy "are for old people carrying high rates because when they die the loan has to be paid by insurance company, whereas ARM rates are for young people, offering attractive rates and if the interest rates go up, you can just call me and I will get it refinanced, and best thing is that it's a piece of cake since I can get it for you at a down payment of \$4500.

"Awesome!" says Michael "Where do I sign?". Being impulsive and fiscally irresponsible by nature, he never stops to think about what would happen if the interest rates go up and he suddenly has to pay 6% interest. Jimmy, on the other hand, doesn't give a dam. He is not lending out his own money, he's only a mortgage broker. Besides, he gets a hefty commission each time he gets another ARM signed up.

# Jimmy the Mortgage Broker with Bill at 1st Regional Bank

After Michael left office, Jimmy calls his pal Bill the banker at the mortgage department of the 1st Regional Bank of Georgia. "Bill," Jimmy says, "I've got another one for you. The loan is for \$450,000- adjustable rate. Our guy has six months work history, but his credit is terrible, and he has no major assets, but \$4500 down payment. Is that ok?" Another sub-prime? Sure! Bill, You see, a 'sub-prime' is a mortgage given out to people who are a high credit risk, like Michael "Sign him and I'll have the money to you by closing."



# Linda of Lehman Brothers buying Mortgage from Bill of 1st Regional Bank

So is Bill totally nuts or just plain stupid? Actually, he's neither. He is not worried about nonpayment of installments by Michael. Once the deal is closed, his mortgage is placed into a vast pool along with thousands of other sub prime mortgages given out by the 1st Regional Bank of Georgia. This vast pool is then divided up into shares, each one is called a 'mortgage backed security' that can be bought and sold like stocks or bonds.



Now that the Bill has thrown Michael's mortgage into a pool, he has to find buyers for these shares. The phone rings - its Linda the investment banker from Lehman Brothers in New York City! Do you have any mortgage shares for me to buy? We just can't get enough of them! We love mortgage shares because real estate is such a safe investment. Well Linda," says Bill "I do happen to have mortgage shares for you, but they're sub-prime shares. They're riskier than other types of shares. But don't fear- we called our friends over at AIG this morning and for a token fee they've agreed to insure the shares against default! Isn't that great?"

# Hong Kong Investors in Lehman's Bonds

That's awesome! I'll buy all of the mortgage shares you have since I have investors waiting around the world desperate to earn high yield, you see Alan Greenspan had brought miseries to these investors who could only earn 1.5%



# Housing Development in Georgia 2007



After three years in 2007 in suburban Atlanta, a number of new developments have sprung up, chock full of Mansions that there aren't enough people to buy all of them. Things for Michael aren't so wonderful. His ARM rates have risen placing him in danger of running out of money. In a pinch, Michael calls Jimmy the mortgage broker. "I would like to re-finance to the fixed rate mortgage", you see, the thing is that you are a bad credit risk, so I can't arrange re-finance for you. Says Jimmy,

"But what about my house" says Michael, "Can't you use that as collateral?" "Yeah, about that house" responds Jimmy, it's not worth what you paid for it, because they've built so many other Mansions around here. We can't even sell the ones we have on the market now. I just can't get a bank to refinance someone like you with depreciating assets and bad credit. I'm sorry, guy. I just can't help you, Have a good day."

# Harry the investor in Lehman's Hedge Funds

Michael is now stuck, his house is worth nearly \$300,000. He is not alone, either. In 2007, a large number of sub-prime loans begin to default. Suddenly, Lehman in New York is holding millions of mortgage shares since in the process it could not sell or got greedy for higher yields, and now these are worth much less than what was paid for them.



Linda gets a phone call from Harry, who is a big-time investor in the Lehman Brothers' hedge fund. I got my statement today and have lost \$135 million in this quarter. "Well, you see, we invested money in mortgage shares and they're not doing so well right now, the market goes up and down....and they'll come back, says Linda. But "you told me that they were safe investment with the best rating and were also insured. Ok Harry don't you worry. Says Linda I will lodge a claim on AIG". You do that, but I am pulling out my money from Lehman. As people like Harry pull their money from Lehman, investor confidence crashes and with sudden withdrawal Lehman ran out of cash.

# Lehman Claims on AIG

Desperate, Linda calls AIG where Hank tells her that look girl, we have a little issue here, you are like the millionth person that called today asking for an insurance payout. Someone from Goldman Sachs just asked me for \$1 billion cash 2 minutes ago over this subprime stuff. Thing is, I just don't know if we can pay you all, because we never anticipated all of you asking for insurance payouts at the same time.



# Lehman seeking help from Citibank

Despondent, Linda calls Citibank and asks for a loan. "We need some cash because everyone is bailing on us! Loan us a couple of billion, please. You know, we pioneered this subprime business; we lost all that money on mortgage shares not to mention the money we lent to other investment banks, says George from Citibank, but we got out first, I mean FIFO, first in first out. Our Arab brothers have rescued us, and my bosses have told me not to lend money to anyone. Besides, since your credit rating is now of junk bond status, you're just too much of a risk, sorry, Linda."



# Lehman Brothers Bankruptcy & \$ 700 Billion Bail Out

Lehman Brothers goes bankrupt Linda is fired. Bill and Jimmy are enjoying their new life styles in Santa Monica since they made millions in commissions. Michael after foreclosure of his Mansion is at his momma's house eating pizza.



After Lehman's bankruptcy, panicked investors began to sell shares and as the selling gathered momentum, suddenly, the federal government realized that if it didn't step in to calm the markets, the entire banking system would face total collapse. With no more loans and credit & AIG's inability to pay claims, the entire U.S. and World economy would face not just recession but full-blown depression, thus nationalization of AIG and \$700 billion of bailout package.

# Who is to Blame

The blame is so large that it encompasses everyone, not just greedy Wall Street 'fat cats'.

- The Federal Reserve (Greenspan) for keeping interest rates unnaturally low, thus enticing people who could not afford buying houses as well as not providing reasonable yield to investors.
- The public (Michael) for buying above their means, planning poorly for the future, and spending money wastefully.
- The mortgage industry (Jimmy and Bill) for lending money irresponsibly to people they knew were terrible credit risks.
- Wall Street (such as Linda) for buying mortgage backed securities under the idiotic premise that they would never lose value, thus enticing the mortgage industry to lend without standards.

# Who is to Blame

- Investors (like Harry) who in greed of higher yields did not care to read in between the wording of these bonds.
- Insurers (like AIG) for blind underwriting of mortgage backed securities that they knew they couldn't pay for.
- Auditors for certifying the accounts of Banks and Insurers, without going deep into the quality of credit risks and the claim reserves thereby avoided qualifying their accounts.
- Credit agencies for not investigating the viability to the mortgage backed security shares before issuing them high credit ratings.
- Finally, regulators for failing to properly monitor lending and insurance underwriting standards.

# What Americans Say

- If you had purchased \$1,000 of AIG stock a year ago, you would have \$14 left, with Lehman \$3 & with Fannie or Freddie \$ 5.
- But... if you had purchased \$1,000 worth of beer one year ago, drank all of it and then turned in the cans for the aluminum recycling in REFUND, you would still have \$21.
- Based on the above, the best current investment advice is to drink heavily and recycle.

# **Thank you for your time**

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