Cambridge University Press
978-0-521-76214-4 - The Fall of the House of Credit: What Went Wrong in Banking and What Can be Done to Repair the Damage?
Alistair Milne
Frontmatter
More information

The Fall of the House of Credit

How was it possible for problems in one relatively small sector in the global financial system – the American sub-prime mortgage market – to lead to the most serious economic crisis in living memory?

Alistair Milne untangles the complex world of modern banking and examines solutions to the crisis. He shows how the banks misused their ability to securitize loans and, by borrowing short and lending long, exposed themselves to exceptional risks when asset prices started to fall. But it has been above all a collapse in trust and confidence, rather than poor lending decisions, which has fuelled the crisis. Despite all the talk of 'toxic' assets, the book argues that most assets are sound and can be repaid. The imperative is to restore confidence through collective action involving asset purchases, guarantees and recapitalization. Failure to do so will mean that taxpayers will be carrying a crippling tax burden for generations to come.

ALISTAIR MILNE is Reader in Banking and Finance at the Cass Business School, City University, London. He has also worked for the Bank of England and HM Treasury.

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What went wrong in banking and what can be done to repair the damage?

ALISTAIR MILNE

CAMBRIDGE UNIVERSITY PRESS

To J, K, L and all the Ms

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Contents

List of figures x
List of tables xi
List of boxes xii
Acknowledgements xiii

Introduction 1

1 **Where did all the money go? An analysis of the causes and cure of the current global banking crisis** 24

Presents the argument of the book, that a policy of holding safe but illiquid long-term structured credit securities, financed using short-term borrowing, created a bank funding crisis that was the principal mechanism creating the credit crisis. Presents a key Figure 1.1, which illustrates this new feedback loop in wholesale funding markets that makes this crisis different from any others. Compares other analyses of the crisis and argues that it can be addressed through a policy of taxpayers providing insurance against extreme systemic credit losses. Considers some practical details.

2 **Build-up, meltdown and intervention** 50

The macroeconomics of the story and the role of banks in recycling global savings. The threat of a massive global economic downturn if this recycling is not maintained. An overview of bank involvement in the structured credit markets. An estimate of the amount of exposure and some projections of prospective losses, distinguishing permanent credit impairment from short-term liquidity losses. An overview of actions taken by policymakers.

3 **We have been here before, haven't we?** 83

A brief comparison of this crisis with Scandinavia, Japan and the Asian crises of 1997, Latin American lending and some other examples of financial panics.

4 **A basic funding tool – the tranched mortgage-backed security** 118

Explains the mechanics of the tranched mortgage-backed security and similar instruments. Compares them with corporate bonds. Shows how tranching is used to concentrate the risk, creating a large amount of default-risk-free paper. Looks at how Countrywide used these securities to fund its lending and at one particular sub-prime securitization in detail.

5 **Using tranching to make short-term transaction profits** 143

Examines how the basic structure was used for very different purposes, for short-term transaction deals backed by high-yield but high-risk portfolios. How these deals work well in an upturn but are no longer attractive in a downturn. Explains CDO, CLO and so on, including more suspect complex deals. Looks at one particular CLO. Quantifies both where the money went and discusses who was holding it.

6 **Borrowing short and lending long: the illusion of liquidity in structured credit** 170

Describes the fundamental failing of the new credit markets, the failure to sell the new credit instruments to long-term investors and the decision instead by banks to hold them as 'trading instruments' financed with short-term borrowing. Looks at the use of off balance sheet vehicles such as conduits and SIVs, noting that they provided only a proportion of the short-term financing, repo being much more widely used.

7 **The levees break** 195

A narrative of the first phases, from late 2006 until the rescue of Northern Rock. Documents the worldwide impact of the initial losses on US sub-prime. Structured credit markets became illiquid, resulting in write-offs of many bank portfolios. The disruption of money markets and global impact.

8 **The flood of losses** 220

The narrative continued, up to the failure of AIG. A series of case studies both discusses the major losses experienced by many individual institutions (UBS, Merrill, Citigroup, Fannie and Freddie, AIG) and provides an overview of losses across the banking sector. Discusses also many of the knock-on effects on monolines and municipal bond markets.

9 **Central banks and money markets** 257

Goes into the details of central bank monetary and liquidity operations, pointing out the limitations of central bank liquidity provision. Explains how banks use money markets to raise short-term funding. Compares orthodox and unorthodox approaches to monetary policy. Notes that there are substantial limits on the ability of central banks to provide commercial banks with new funds for lending.

10 **The run on the world's banks** 285

The failure of Lehman and the four-week run on the global banking system and government rescues that followed. An assessment of the policy measures taken, showing how they are moving in the direction of taxpayer provision of long-term systemic risk insurance.

Conclusions: repairing the house of credit 314

Explains how a global slump can be avoided and briefly considers longer-term measures to restore global prosperity.

Glossary 341

Index 357

Figures

1.1	Positive feedback loops in bank funding and loan markets	*page* 33
2.1	Schematic diagram for mortgage-backed securitization	59
2.2	Bank involvement in mortgage-backed and structured credit	61
4.1	Tranching of a $1 billion pool of mortgages	126
7.1	Housing problems spread to banks	201
9.1	Libor vs. good collateral repo rates	262

Tables

2.1	Some national current-account deficits and surpluses	*page* 53
2.2	Approximate magnitudes of the European and US structured credit market	64
2.3	Some projections of possible credit crisis losses	70
2.4	Principal responses by financial authorities to the financial crisis – before and after the Lehman failure	80
3.1	Fiscal costs of bank support (% of 1997 GDP)	102
4.1	Securities sold to investors by Countrywide ABS 2006–19	133
5.1	Interest margin on the Grosvenor Place CLO III	150
5.2	Adjusting the Grosvenor CLO III returns for expected losses and costs	151
8.1	Major bank credit losses and write-downs compared with pre-tax earnings	249

Boxes

2.1	Some further details on bank involvement in structured credit markets	*page* 60
4.1	The countrywide ABS 2006–19 securitization	131
5.1	An example of a collateralized loan obligation: Grosvenor Place CLO III	146
5.2	Declining credit spreads and CDO profits	162
6.1	How yield-based trading was carried out	175
6.2	How large were yield-based trading positions at the peak of the credit boom?	189
9.1	How central banks implement monetary policy in practice	267

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To Rudy, I apologize that while I have been able to include the financial equivalent of a car chase, I could not satisfy your other request for some steamy bedroom scenes. Let's hope that despite this the text still has some general appeal. My children have had much less of my time over the past eight months than I would have liked. My partner has been the most long-suffering of all, putting up with many weekends and evenings when I have been devoted only to the computer screen. She tells me in no uncertain terms that this has to be a one-book relationship. On my side I am determined that this will be the only book I ever write – at least on such a topical subject and to such a tight deadline.

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