

# CSFI

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**Dominoes in the credit crisis: a round-table, with George Magnus (UBS), Jim O'Neill (Goldman Sachs), Jon Moulton (Alchemy Partners) and Tony Jackson (FT)**  
**Held on Tuesday, May 27, 2008, at the City Club, 19 Old Broad Street, London, EC2N 1DS from 12:30-2:15pm.**

Is the worst over for banks or will they be hit by new waves of bad loans in the consumer credit and corporate loan sectors? The first speaker was definitely in the pessimists' camp: the worst is not over. This is just an intermission. Firstly the size of losses will likely grow. So far quoted banks have reported \$400bn of losses on securitised assets while including unquoted bodies such as mortgage lenders takes it to \$600bn. However including credit losses, i.e. subprime loans themselves as well as credit card debt and commercial and industrial loans, the total rises to at least \$1 trillion.

Secondly deleveraging will have a major deflationary impact in two ways, firstly via recapitalisation of the banks (\$200bn and counting) and secondly through the restructuring of household balance sheets as the combination of the credit crisis and the turn in the business cycle combine to cause personal savings to rise, which in turn has a one-for-one impact on consumption. Thirdly emerging markets will add to the problems, not through the credit crisis from which they are relatively immune, but via a homegrown inflation problem. If they tackle the problem, then it means their growth rates will slow just as rich nations' do. If they don't, then there will be a major inflation problem around the corner. For instance if China raises bank reserve requirements and allows interest and exchange rates to rise, its growth might slow to 6% from 9% - not a disaster but significant.

Overall there will not be a V-shaped recovery this year and next year depends on everything going as well as possible and US politicians taking action necessary to deal with the housing market. The speaker said Congress should do more to help bona fide borrowers stay in their homes, and taxpayer-funded capital injections should be on the agenda. One obstacle is that Congress will effectively be in recess from August to February.

The second speaker took an opposite tack. He cited data showing Chinese retail sales grew at a 10-year high of 22% in April, which mean the Chinese consumers were contributing double that of US consumers, who were becoming increasingly irrelevant. He pointed to the reduction in the US current account and trade deficits as the decline in the dollar has had a textbook impact on exports and imports. Industrial exporters were having their best time in two decades, which made it even more ludicrous for the Democrats to start talking about protectionism. In any event, the US economy has not gone into recession as the speaker had feared and the world economy would grow by 3-3.5% - below the 5% of recent years but line with the last 20. That the economy can survive the impact of a dramatic crash in US house prices is reason for optimism. Thirdly it was interesting that Japanese international bank lending is rising – perhaps they see an opportunity. Lastly the

Federal Reserve has acted swiftly after its initial dithering and as a result credit spreads have tightened.

The third speaker took the roundtable away from global economics and back to UK business. The UK was set for a slowdown after the excess of capital markets and banks. We are in the eye of the storm. Retail sales are their worst in living memory, while mortgagees are falling behind on payments. A recession is on the cards. He highlighted the \$60 trillion credit default swap market, which few understood, as the next domino. Banks that have a market cap of \$10bn might have a CDS portfolio of \$3.5 trillion. These are used to support the capital of banks and insurers in a "horrible connected circle". One member said this was a red herring as these were \$60 trillion of notional positions that would only be simultaneously triggered in the event of unforeseeable default rates. The second speaker added that he was talking about the world, rather than the UK. He too was pessimistic about the UK particularly as the Bank of England had come a poor third to the ECB and the Fed.

The fourth speaker said he was worried the credit crisis itself may contain some more dominoes of its own. It was unwise to say that just because we are beginning to get an idea of the losses that we have reached the end. The mark-to-market accounting initiative has made it harder to make sense. One member agreed saying that since the whole process was new it meant a fog had come down the financial results of institutions. The third speaker urged a return to simplicity, citing the 300-page document that supported Northern Rock's Granite securitisation. On the other hand one member feared that the idea that banks could only do what people in the street could understand would end up forming the basis for draconian regulation.

What does the future hold? The fourth speaker said the coming year would be rough for the UK with a greater than ever chance of a recession. Housing was awful; construction was terrible. Private equity is highly leveraged in the face of a weakening economy, which implies some failures. His answer – move into turnarounds and distressed debt. The third speaker said continued high interbank rates could be a harbinger of worse to come – either default levels were about to rise or the banks knew something the rest of us didn't. The first speaker said deleveraging was the real danger as it made this different from most business cycles. This will be a slow-motion contraction lasting some time. The US will soon be in recession – how severe will depend on how Americans rebuild their savings. There will be a regulatory backlash. The second speaker wrapped up, saying this was really a repricing of credit against equity. Stock markets had not been seen as extended bear market because they see the dramatic change in the world economy. Those economies that were most leveraged were in cyclical trouble but other economies will mitigate that. We can still get out of bed every day – even those in the banking industry.