Lyn Cobley, Group Treasurer, Commonwealth Bank of Australia

The Sub Prime Crisis

Slide 1

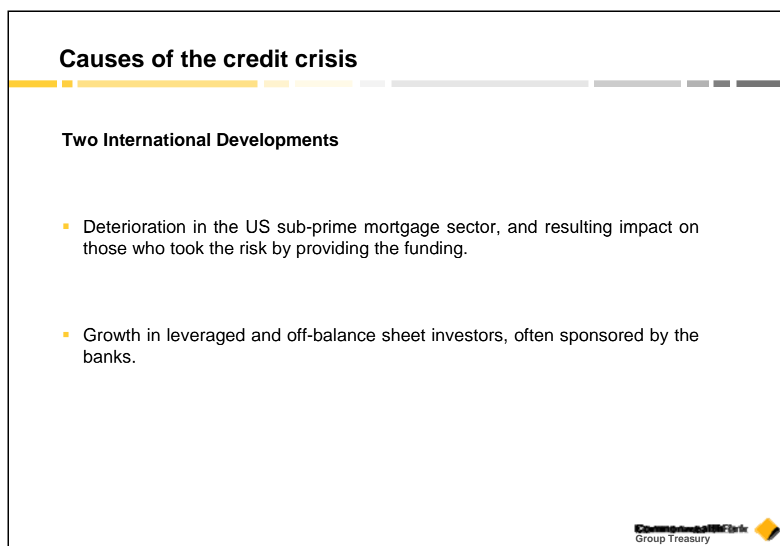
Slide 2

Contents

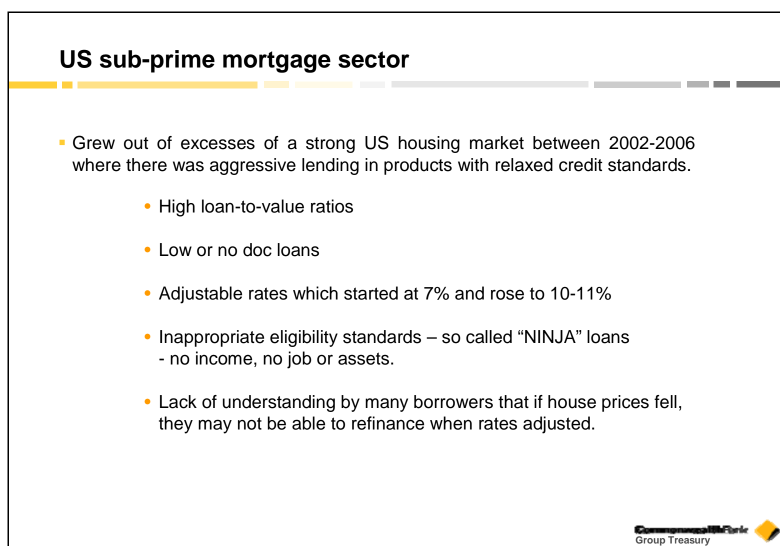
- **Causes of the credit crisis**
  - **- US sub-prime sector**
  - **- Growth of leveraged and off balance sheet investors**
- **Impact on cost of funds**

Group Treasury

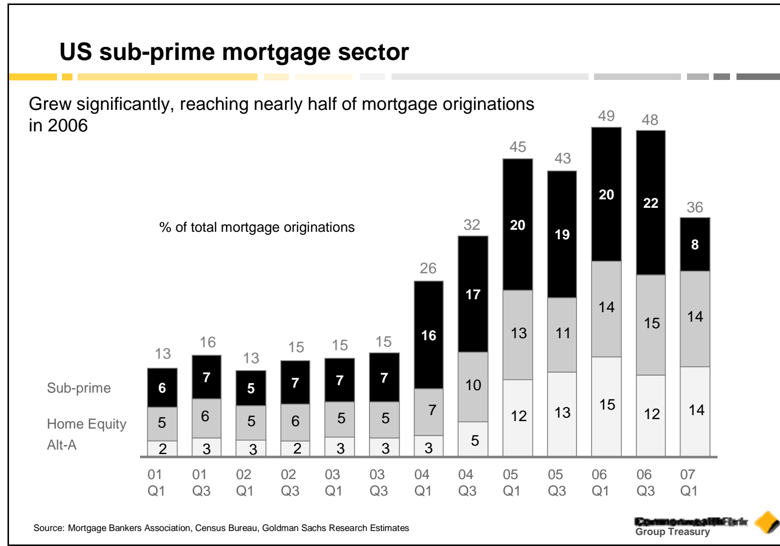
Slide 3



Slide 4



Slide 5



Slide 6

Growth in leveraged and off-balance sheet investors

- In the US, substantial disconnect between originator and funder, or ultimate risk-taker
- Exponential growth in:
  - Hedge funds that increased returns by taking higher risks through increased leverage
  - "Special Investment Vehicles" or SIV's that increased returns by investing in long term assets but funding in the short-term markets

Group Treasury

Slide 7

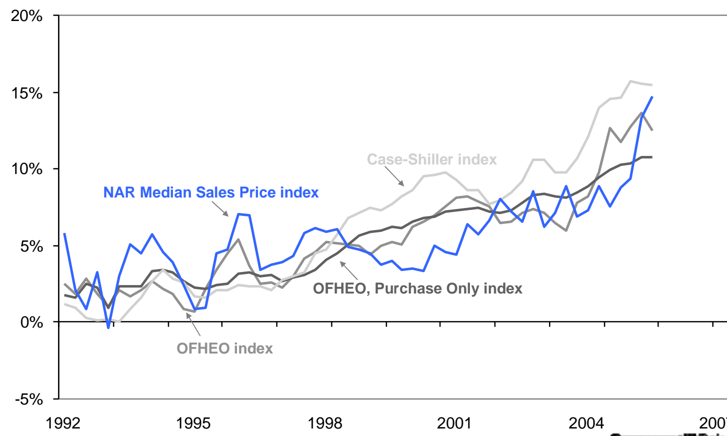
The intersection

- Sub-prime mortgages mostly funded by being packaged up into structured tradeable securities and sold to investors.
- These structured securities had lots of fancy titles like ‘collateralised debt obligations - “CDO”, “CDO2”. They were highly rated on the basis of cashflow performance over a benign period, ie; a small market that so far experienced low defaults.
- When the storm hit, it was very difficult to tell just where the failing sub-prime mortgages were, so investors simply stopped buying altogether.

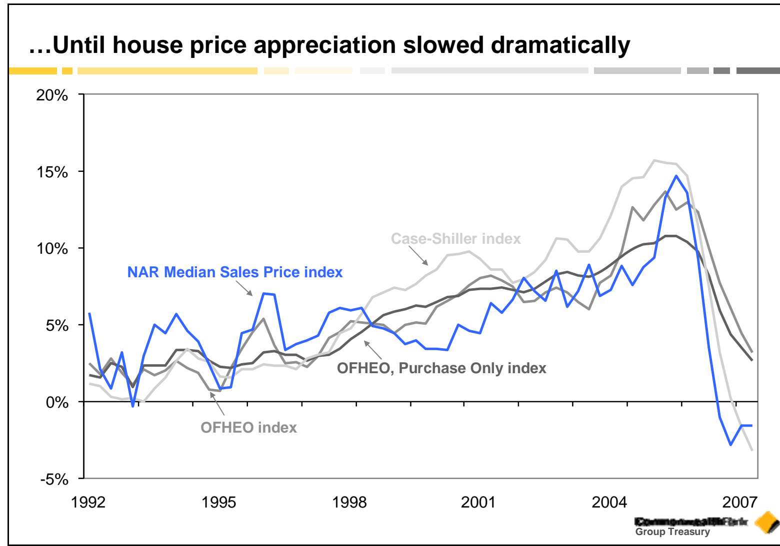
Group Treasury

Slide 8

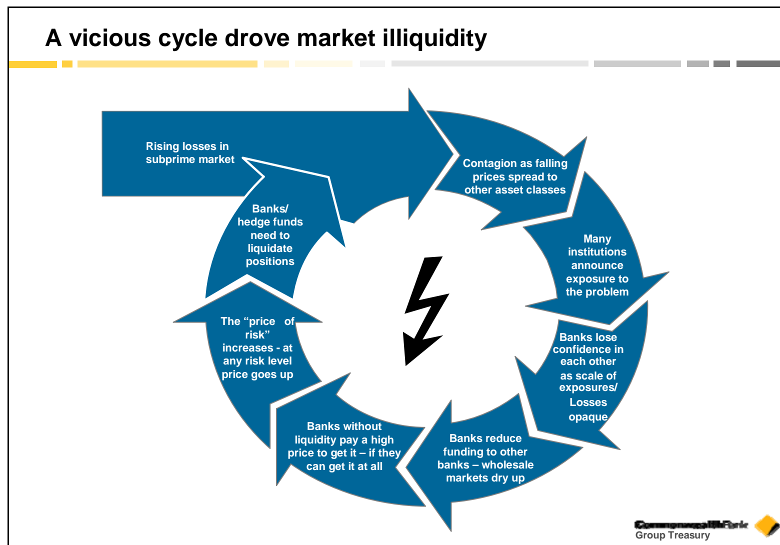
Investors were betting on rising housing prices, not low default rates, in sub-prime mortgage loans…



Slide 9



Slide 10



Slide 11

The Northern Rock story

- Suffered a major liquidity crisis resulting from its reliance on a particular type of wholesale funding…… which dried up.
- Share price fell from 1200 to ~100. Bank of England provided more than 25bn pounds of funding.
- Resulting in every banker's nightmare: a run on the bank.

Source: Company website; literature search

Group Treasury

Slide 12

There are many losers and winners

The winners

- Well-capitalised, prudently funded, highly-rated institutions that will weather the crisis and be able to make intelligent strategic investments at attractive prices
- Nimble proprietary investors that can buy assets at 'firesale' prices
- Emerging markets, which appear to have been insulated from the turmoil - so far

Group Treasury

Slide 13

There are many losers and winners

The Losers

- Owners of credit assets purchased at improbably narrow spreads. The subprime mortgage market is filled with examples, some of which are well-known
- Residential real estate owners in badly-affected markets, including Florida, Nevada, Arizona and California
- Institutions with imprudent levels of leverage and overly reliant on the availability of the securitisation markets
- Investment banks with a heavy dependence on the mortgage markets
- Rating agencies (particularly their structured credit groups)
- Mortgage guarantors and credit guarantors
- Some regulators that may have been slow to act

Group Treasury

Slide 14

Group Treasury