

# 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**


Commonwealth Bank  
Group Treasury

## Slide 3

### Causes of the credit crisis

#### Two International Developments


- Deterioration in the US sub-prime mortgage sector, and resulting impact on those who took the risk by providing the funding.
- Growth in leveraged and off-balance sheet investors, often sponsored by the banks.



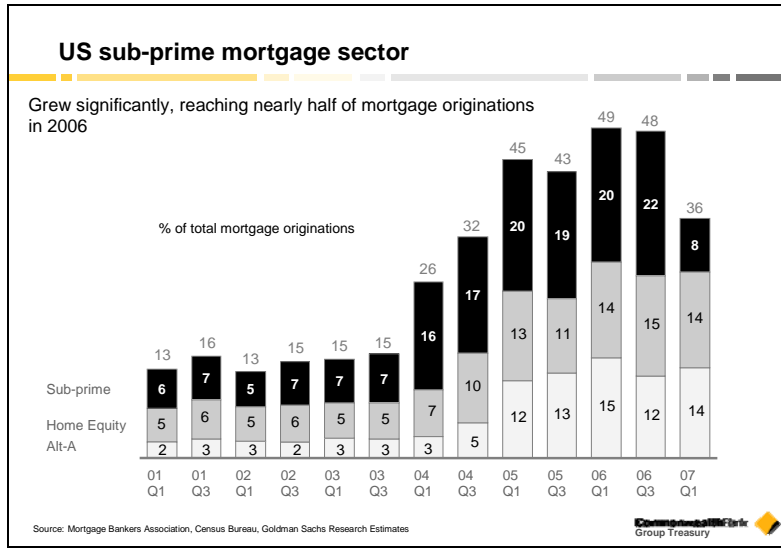
## Slide 4

### US sub-prime mortgage sector

- Grew out of excesses of a strong US housing market between 2002-2006 where there was aggressive lending in products with relaxed credit standards.
  - High loan-to-value ratios
  - Low or no doc loans
  - Adjustable rates which started at 7% and rose to 10-11%
  - Inappropriate eligibility standards – so called “NINJA” loans - no income, no job or assets.
  - Lack of understanding by many borrowers that if house prices fell, they may not be able to refinance when rates adjusted.



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

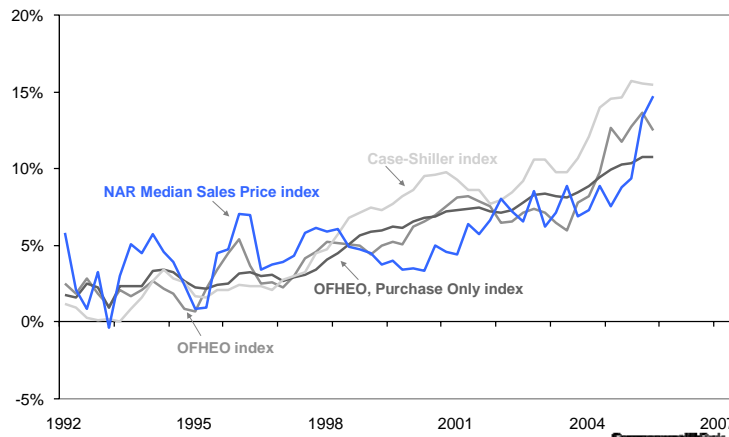
Slide 7

### The intersection

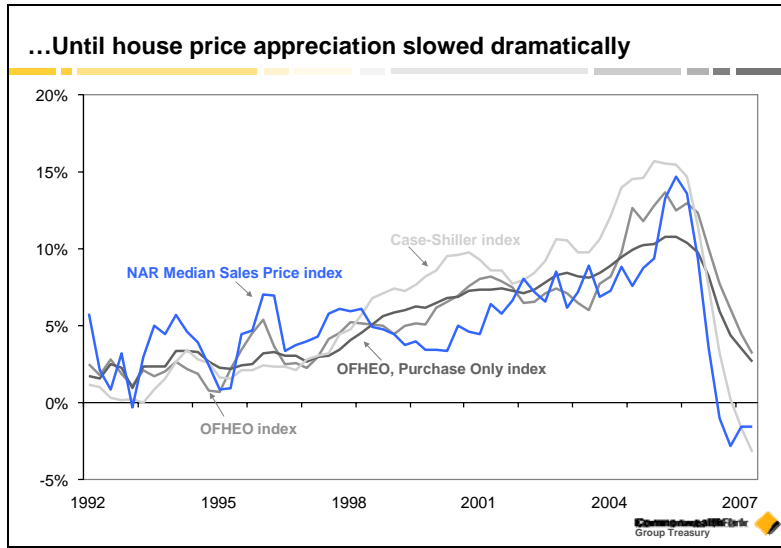
- Sub-prime mortgages mostly funded by being packaged up into structured tradeable securities and sold to investors.
- These structured securities had lots of fancy titles like 'collateralised debt obligations - "CDO", "CDO2". They were highly rated on the basis of cashflow performance over a benign 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.

Slide 8

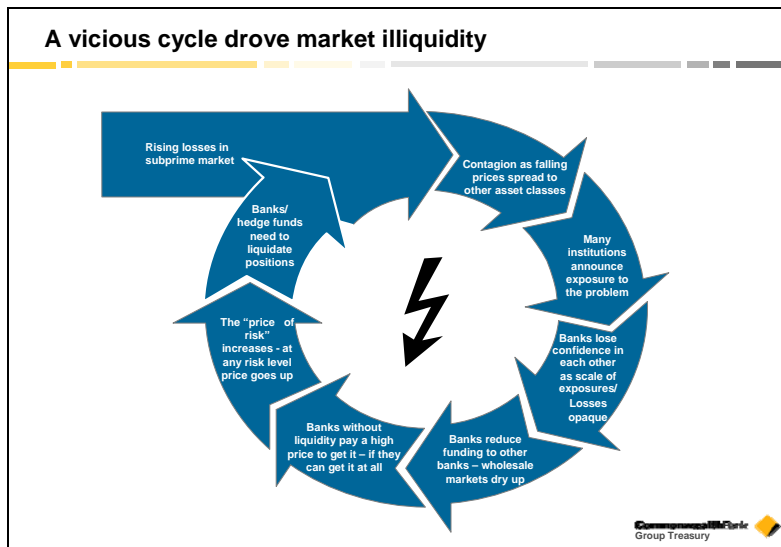
### Investors were betting on rising housing prices, not low default rates, in sub-prime mortgage loans...



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

Commerzbank  
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

Commerzbank  
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

Slide 14

