

Credit Crunch—The Blame Game

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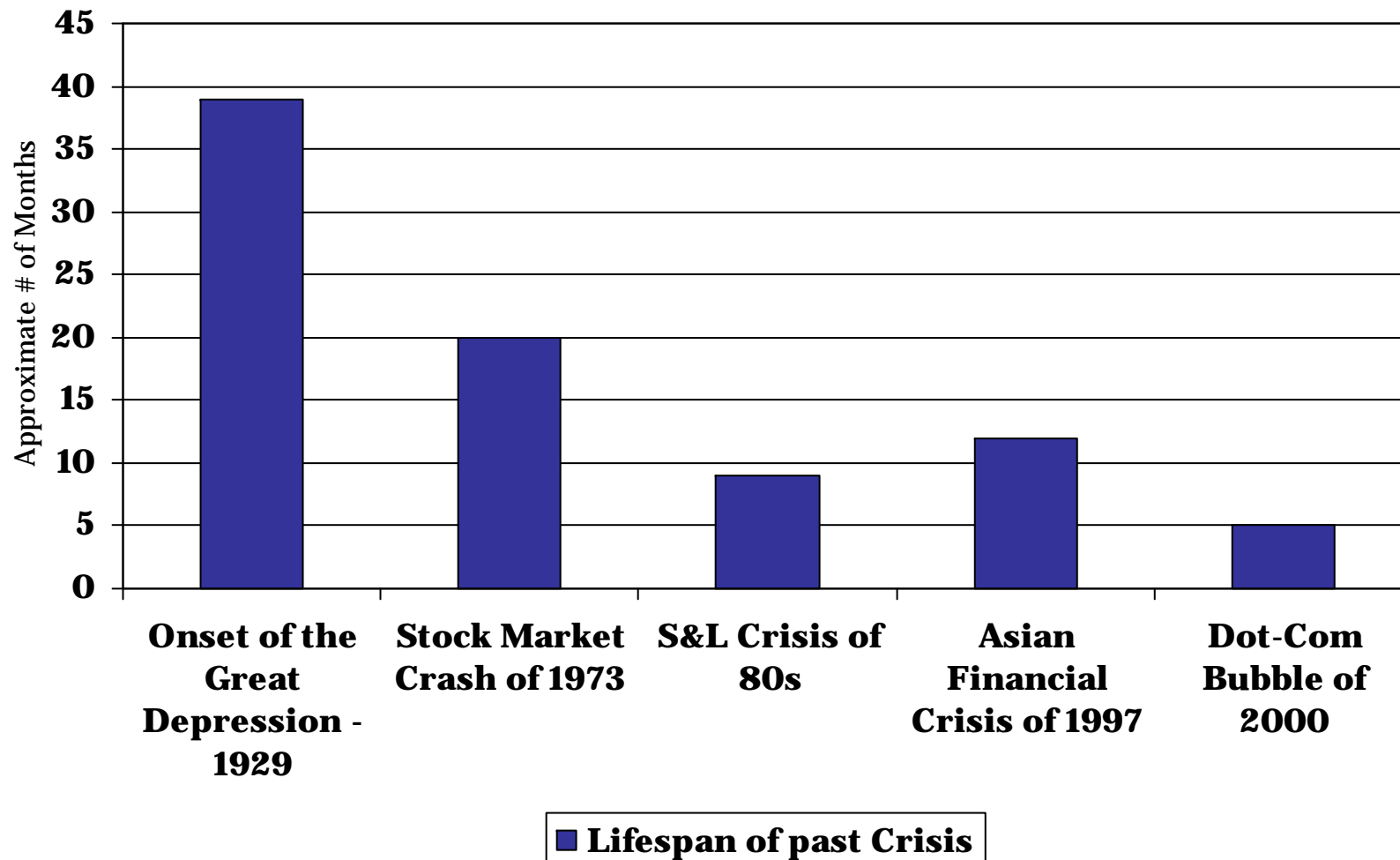
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Decreasing Lifespan of Financial Crisis



The Path to a Crisis

- Terrorist attack on September 11, 2001
- The Federal Reserve began cutting rates – 1% by 2003
- The economy began to expand in early 2002
- Real estate began looking attractive as number of houses and price they sold at increased dramatically
- Lending standards loosened with teaser rates, ARMs and IO loans with no regard for LTVs
- New financial products started entering the market
- Home values doubled and and new homes could not be built fast enough

The Path to a Crisis (contd.)

- In the middle of 2006, things started unraveling with new home sales stalling
- ARMs began to reset and default rates started increasing
- Investors started getting risk-averse and started pulling money out of SIVs
- The selling pressure snowballed and caused a sharp decline in stock markets
- Rating agencies started downgrading SIVs, which exacerbated the problem
- Monoline Insurance Companies were in troubled water due to their exposure to SIVs
- Expected loss of AAA rating of Monoline Insurance Companies put pressure in municipal market
- Auction rate securities caught in turmoil due to liquidity issues

No one was Spared

- Homeowners with mortgages
- Prospective homeowners
- Banks/Brokers/Finance Companies
- Monoline Insurance Companies
- Municipalities
- Corporations

The Players of the Current Credit Crunch (CCC)

Alan Greenspan

- Following the bursting of the dotcom bubble, September 11 and Enron troubles, the Fed lowered interest rates until they reached 1% in June 2003
- In February, 2004, Greenspan said "American consumers might benefit if lenders provided greater mortgage product alternatives to the traditional fixed-rate mortgage"

The Players of the Current Credit Crunch (CCC)

Mortgage Brokers/Originators

- Loans offered with minimal requirements and no guidance provided with regards to risk related to ARMs, IO and other forms of loans
- Since the loans would eventually be sold, originators were less concerned about credit quality
- Refinance your mortgage, get a check to buy a car or other big ticket item and cut your payments in half

The Players of the Current Credit Crunch (CCC)

Ratings Agency

- Rating agencies encouraged monoline insurance companies to diversify beyond insuring municipalities to retain triple-A rating
- Monoline insurance companies added significant risk by insuring sub-prime securitizations and SIVs
- Rating agency models failed to quantify the embedded risks as deals became more complex

The Players of the Current Credit Crunch (CCC)

Investors

- Investors' hunger for higher yields led them to chase risky products
- Investors blindly depended on ratings agencies and considered all AAA to be super safe investments

The Players of the Current Credit Crunch (CCC)

Investment Portfolio Guidelines

- Some mandated guidelines of investment portfolios have a potential of tying the investment managers to a specified ratings requirement. For e.g., all securities should have a minimum rating of BBB-/Baa3 from S&P/Moody's
- This could lead to a false sense of security, causing the managers not to perform full due diligence on every security

How & How Long?

- It took over 8 years to dig this hole...
- No magic bullet solution
- Diversification of risk, which was considered beneficial, allowed risk to be too easily hidden under many layers
- This crisis is different as we still don't know how deep it is and who or what will be the next victim
- It is easier to fix failure of an institution or a segment of the market; not easy to repair loss of confidence

What needs to be done?

Investors

- Be more realistic with their expectations
- Be a little more analytical
- Demand reliable information or refuse to invest

Ratings Agencies

- Foster and reward competition
- Address potential conflicts of interest
- Keep a scorecard on rating agencies performance
- More updated models/more transparency

What needs to be done?

Regulatory Institutions

- Regulations should not be “one size fits all”
- Monitor/quantify the impact of the use of leverage
- Bring about a change in order to be more pro-active

Financial Institutions

- Management accountability
- Long term view

Disclaimer

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