Annus horribilis

- **Ruth Williams**
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The US subprime crisis has gone from a small cloud on the financial horizon to a raging storm. Ruth Williams reports.

THINK back one year. It wasn't such a long time ago, but things were vastly different.

Mortgage interest rates were about 3 percentage points lower than now. The sharemarket was about 20% higher. The papers were full of stories about booming super returns, and the US "subprime" crisis was like a tiny dark cloud on the horizon - far away and probably harmless.

Fast forward just 12 months. Some of the sharemarket's biggest stars have been reduced to near-worthless wrecks. Most of the non-bank mortgage sector is in shutdown. The banks have increased mortgage interest rates well above the Reserve Bank's cash rate rises, while in two cases owning up to $1 billion-plus losses.

More companies are closing their doors or drastically cutting staff. In the year to May, according to Australian Securities and Investments Commission figures, more than 3200 companies entered external administration - up almost 25% on the same time last year.

In just a year, consumer confidence has fallen to its lowest in 16 years, super funds have recorded their worst quarter since 1992, and, according to Dun & Bradstreet, one in 10 businesses have a high risk of experiencing financial distress, up 11% on the same time last year. Business confidence is as low as it has been since the 1991 recession.

It is now a year since the credit crunch first ravaged the Australian sharemarket. A hiccup in the last week of July last year made way for a 3% drop on the first day of August - which became a rout through the month that stripped 12% off a market that had soared to record highs just weeks before.

It signalled the arrival of an era of hard-to-get credit and markets for which volatility is an understatement. "So much has changed in such a short period of time - it snuck up on many, many people," says Christine Christian, chief executive of credit reporting agency Dun & Bradstreet.

And, in a pernicious case of historical symmetry, this week - the week that marked the credit crunch's unofficial first birthday - has been one of the worst for bad economic and financial news. Most of it is linked, in various ways, to the US mortgage market and what has become a global crisis. The sharemarket opened with a hangover on Monday; bleary-eyed and in a bad mood after National Australia Bank's confession the Friday before of possible billion-dollar losses in securities linked to the US mortgage market.

And things got worse as the week progressed: ANZ's write-down provisions, record negative super returns, freefalling business confidence, warnings from the International Monetary Fund and, locally, hundreds of job losses in a slowing economy. Retail sales for June were the worst in seven years, and credit growth stands at 15-year lows.

Not all of this was a result of the subprime crisis. The dramatic surge in the oil price has flowed through to petrol prices, affecting household budgets across the country, and the drought and global shortages have pushed up food prices.

But the spreading impact of what began as "subprime" is clear. "The bottom line is we have an impact on the global economy, flowing through to Australia, from the credit crisis coming out of the US subprime," Prime Minister Kevin Rudd said yesterday, in an official statement of the obvious.

The outlook is so uncertain that few are willing to make predictions - except that the economy will continue to slow over the next 18 months. Talk has now turned to interest rate cuts.

And it is unclear when the liquidity crisis that sparked these issues will lift. "I don't know whether we are halfway through, or whatever," says Simon McKeon, the executive chairman of Macquarie Bank's Melbourne office. "It's a very serious problem, and the more serious the problem, the more diffi cult it is to determine how long it will last."

The background to this transition is well known. A US real estate boom became a bubble, fed by investment from the oceans of money then washing around the world from pension funds, sovereign funds and various other sources - the global savings glut. The International Monetary Fund estimated that this pool of money was worth $11 trillion in 2005.

Some of that money was parked in private equity vehicles, sparking the leveraged buy-out frenzy that saw Myer and part of the old Publishing and Broadcasting Limited - and almost Qantas - fall into private equity hands. Some of that money was also parked in the frothy US mortgage market.

Investment bankers worked out how to slice and dice millions of less-than-marginal mortgages and somehow turn them into rolled-gold AAA-rated securities.

Initially, such securities were based on loans granted to people with jobs and assets. But as the demand for the securities grew, people without jobs and assets were given loans to keep feeding the market. This process reached its peak in 2006 and, soon after, the subprime loans started defaulting on a large scale. Now loans rated above subprime are also defaulting.

It took some time to have an impact on Australia. For the first six months of last year, the world nervously watched the US housing market. The sharemarket wobbled a bit, but "subprime" remained a distant threat. In late July, the sharemarket reached a then-record 6400-plus. Reality hit hard. On July 27, 2007, the Australian market lost 3% of its value in one day, following a plunge on Wall Street after shockingly low US house sales figures for June.

But the real pain came in August. "People in the capital markets talk about pre-August, post-August," says Geoff Wilson, chief executive of KPMG. "That was when subprime started to hit. You could see an earthquake coming and it played out soon after that, and it had all sorts of implications right across the markets."

Suddenly, bad news was everywhere. In early August, the RBA raised rates for the first time in nine months - the fifth time since the 2004 election.

RAMS Home Loans' profit warning came in mid-August. Non-bank lender Bluestone jacked up its interest rates above the RBA increase due to the higher cost of borrowing, and others warned that they might have to do the same. Talk had turned from subprime to "credit crunch" - meaning there was no credit. Liquidity had, well, dried up.

And a series of surveys and data revealed signs of stress in the Australian mortgage market. A Fujitsu Consulting study concluded that as many as 70,000 households in Australia were in severe danger of defaulting on their mortgage.

A Fitch Ratings report ranked Australia third in the world in terms of household debt vulnerability. And census figures indicated that 140,000 Victorians were under mortgage stress.

"Our data was telling us back in July that this just can't last forever," Christian remembers. "It felt to us like just before the introduction of the GST in 2001. Payment days started to expand out - that's generally the first sign of any financial distress. We started to see an increase in the number of defaults, particularly around mobile phone debts and credit card debts. It happened pretty suddenly."

Twelve months later, and the changes have been immense - beginning with the fallout from a severely shaken sharemarket. "Falling share prices have a big role in determining business confidence," says ANZ chief economist Saul Eslake. "We are seeing falls (in confidence), which are now very large by historical standards, which are increasingly reflected in the hard data."

And lower share prices also mean lower super returns, at least in the short term. For the June quarter, super returns were the worst since compulsory super began in 1992. It would be the first time millions of Australians would see their fund go backwards, Superannuation Minister Nick Sherry acknowledged in a

radio interview. "And this has been caused, of course, by the US subprime financial crisis, which has hit the stockmarkets worldwide, very hard," he said.

Other changes? Many non-bank mortgage lenders have all but closed for business. Wholesale funding is more expensive, and the mortgaged-backed securities market has collapsed. Last year, some $47 billion of Australian residential mortgage-backed securities were sold. In the past six months, this has shrunk to slightly less than $2 billion.

"It's had quite a devastating effect on the mortgage industry," says Joshua Gans, a professor at Melbourne Business School. "Now the big banks are the only ones who are able to loan in any significant volumes. We have lost competition."

The most high-profile victim was RAMS Home Loans, whose profit downgrade contributed to the start of the August panic. It was struggling to refinance its debt just weeks after floating at $2.50 a share. Its founder, John Klinghorn, has pinpointed the moment things changed at August 9, 2007, when French bank BNP Paribas halted withdrawals from three of its funds, saying it could not "fairly" value subprime assets held in the funds.

"Up until Thursday (August 9, 2007), life was cool for us," Klinghorn said in late August. "The market was clearly in turmoil in subprime. We are not in subprime. On Thursday, things changed. It was suddenly impacting everyone."

Westpac "rescued" RAMS by buying the group's brand name and franchise operations for $140 million.

A host of other high-profile victims have spooked investors, dragging the market down further. Hedge fund Basis Capital went under after its subprime investments became worthless. The incomprehensible structure of Centro Properties Group and its subsidiaries obscured a big hole of debt, it emerged in December. And then there were the margin lenders - Lift Capital and Opes Prime both collapsed, Tricom Equities came close.

And the reputations, profits and share prices of two of the big banks have been severely eroded. NAB, it turns out, invested heavily in on-the-nose US mortgage-backed securities, known as collateralised debt obligations (CDOs). They were triple-A rated, NAB says, but this counted for little when no one else was willing to buy the things.

Last week, NAB flagged that it would probably write off 90% of the value of those CDOs £ an amount that could reach $1.01 billion. No other institution, it is believed, has written off its CDOs to such an extent.

And ANZ's losses may exceed $1 billion over just six months. Its full-year provisions stand at $2.2 billion, including those linked to wider economic conditions in New Zealand and Australia. It lost some money through Centro, some through Bill Express and some through Opes Prime. In fact, it lost money on most of the casualties of the past year.

Ratings agencies have warned this week that NAB's debacle may push up its cost of funds even higher - costs it may have to pass on to consumers. And here is another consequence of the credit crisis: higher mortgage rates.

There was widespread shock in Australia in January when ANZ became the first bank to raise rates beyond the Reserve Bank's rises. The other banks soon followed, making dent after dent in the household budgets of millions of mortgage holders.

The banks are paying more for the portion of their funding they source from wholesale credit markets, and they say they have no choice but to pass the costs to consumers. This, with petrol, has had a major impact on consumer confidence.

But the RBA has indicated that, were it not for the banks' extra rate rises, it would have lifted the official cash rate higher to cool what was once an overheated economy. The banks have, in effect, done some of the RBA's work for it.

"The Australian economy would have been slowing anyway as a result of higher interest rates, whether

there had been a subprime market crisis or not," Eslake says. "It just would have meant more of a response from the RBA instead of the commercial banks."

But this is scant comfort for Treasurer Wayne Swan, who has pleaded for the banks to show restraint. Indeed, in another consequence, the credit crisis has coloured the first months of the Rudd Government. "This is not the greatest time to start off being in government, that's for sure," says Gans.

In response to rising mortgage rates, Swan is trying to legislate to make it easier for customers to switch lenders. In response to collapses such as Opes Prime and Lift, Sherry is shoring up market regulation. The Federal Government is moving to centralise regulation of various lending practices. First-home saver accounts will soon be launched to help those trying to break into the market.

Labor has been scrambling to tackle the effects of subprime, almost since it was sworn in. That same fate - on a much bigger scale £ awaits whoever wins the US presidential election.

There was news last month that, during the three months to June, one in every 171 US home owners lost their house to foreclosure, received a default notice or was warned of a pending auction. That's up 121% on a year ago, and 14% on the March quarter, according to US researcher RealtyTrac.

Geoffrey Garrett, chief executive of the US studies centre at the University of Sydney, says the subprime disaster has undermined the US's confidence in its own enterprising spirit - just as the dotcom collapse did eight years ago.

"The big difference between subprime and dotcom is that subprime wasn't only Wall Street, it's also Main Street.

It has hit America in its heartland," he says.

McKeon believes the world economic order is fundamentally changing. Developing countries are more economically powerful and the once-mighty US is headed for a likely recession. "In most of my time it has been the US first, daylight second," McKeon says. "We are seeing a very awkward period of adjustment as the US identifies for itself where it now belongs, and there's lots of fallout."

And what could that mean for Australia? Garrett believes the post-subprime and post-Iraq US will be more insular and more protectionist. It will be less willing to take the lead on global issues £ perhaps spelling bad news for Rudd's gamble that the US will follow Australia (and Europe) in an aggressive market-based solution to climate change.

Will things get better? Of course they will, McKeon says. He's just not sure when. "I have no doubt that we are simply in another downturn that will be followed by a period where there's much more confidence," he says.

Some believe the market meltdown has been a good thing, in some ways. "The message has got to be that we are actually back to the market environment where volatility and risk are behaving the way they should be," says Nick Kalikajaros, the head of Credit Suisse Private Banking in Australia. "The volatility we are seeing in the equity markets, even allowing for the impact of the global credit crisis, should not be viewed as unusual. We seem to have a short memory. In the last 15 years, I'm not sure people actually respected the risks they were taking for the returns being achieved in their investment portfolios, because they didn't see the downside."