BNP PARIBAS
PRIVATE BANKING

Flash

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Subprime Crisis

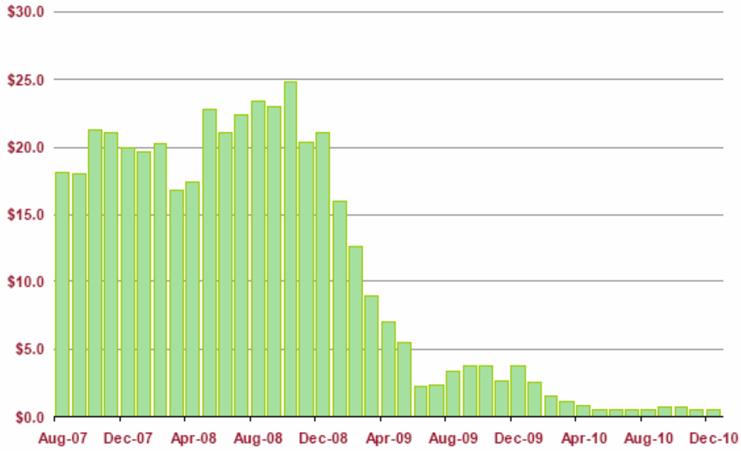
A deep-seated crisis of confidence reflected in an indiscriminate drying up of the securitisations market

The markets for securitised debt instruments are experiencing a major liquidity crisis whose origin is to be found in the insolvency of certain American mortgage borrowers, those with sub-prime mortgages to be more precise. What lies at the heart of this crisis is minor by the scale of the world economy but has nevertheless produced generalised mistrust vis-à-vis all securitised loan instruments, whose complexity often makes them poorly understood by certain operators. This mistrust, illustrated by the absence of liquidity, has spread to all securitised loan instruments, regardless of their quality, and in so doing has increased the scale of the real problem many times over and given it the dimensions of a global crisis. The leverage of the hedge funds exposed to subprime securities has also tended to amplify the tensions, as they were obliged to sell liquid assets in order to repay credit lines that were not being renewed by the banks. The larger markets were accordingly affected, with all risky assets weakening (equities and even certain segments of the money market) in favour of "safe havens" (cash, government bonds). The mistrust created by the indiscriminate drying up of the market for securitised products, the massive withdrawals by investors in funds suspected of holding American real estate and the virtual paralysis of the primary credit and securitisations markets went so far in August as to have an adverse effect on the functioning of the American and European interbank markets. However, the central banks rapidly took the measure of the risk and injected massive amounts of liquidity into the market. In addition, the Fed took action to influence the financing price of central bank liquidity by reducing its discount rate by 50 bp to 5.75% in order to facilitate the refinancing of second-rank financial establishments.

The exit from the crisis could turn out to be gradual and uneven

The exit from this crisis of confidence, which is deeper than the one seen in February, is obviously impossible to predict precisely. It is nevertheless likely to turn out to be gradual and uneven, with numerous factors of uncertainty liable to continue to weigh on the level of confidence of investors suffering from the generalised drying up of liquidity and from the impact on assets still being held in portfolios. It will in fact take time before there is a transparent evaluation of the real level of risk attaching to the various securitisation instruments and the various financial players. Uncertainty regarding upward adjustments in the interest charges on a substantial volume of subprime loans (240 billion dollars over the next 12 months, including almost 100 billion between now and the end of the year and 150 billion at the end of Q1 2008), concerning the redemptions of shares in hedge funds is and specialised investment vehicles (including conduits) and concerning the impact of the crisis on the economic situation will in all probability remain high.

Rate Reset on subprime mortgages will be spread over several quarters



Source: Crédit Suisse

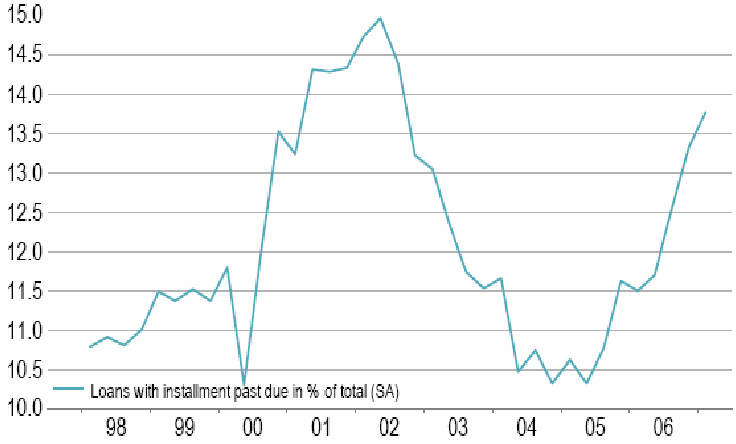
The central banks will aim at containing the contagion

Pending this exit, we are counting on even more pronounced support from the central banks, aware of the risks of contagion from the financial sphere to the real sphere. The Fed is likely to take rapid action by cutting its key rate by 25 bp as early as September. The tone of its statements is also likely to become more accommodative. The ECB, meanwhile, is likely to abandon the rate rise initially planned for September as long as tensions persist on the interbank market. It should be noted, moreover, that we do not envisage a recession in the United States and are still counting on world economic growth remaining robust, although slightly down on previous years. The American economy will remain on a below-potential growth path until such time as the wounds from the mortgage crisis are healed, while Europe should remain close to potential, as should the emerging world. Japan is also likely to pick up again towards the end of the year, following several quarters' hesitation. Our estimate of the damage related to the American housing market shows that losses will be limited on a world scale. This crisis will admittedly affect the upswing in the world economy that began in 2003 but even so should not create any major upheaval.

The market is overestimating the impact of the subprime crisis on the financial sector

The financial institutions most affected by the subprime crisis are the American banks. According to financial analysts' estimates, the profits of those in the S&P 500 financials will feel an impact of around 5% (see, for example UBS, Investment Research – Asset Allocation Comment dated 3 August 2007). A stress test by Moody's (quoted by Bloomberg on 29 August) puts the reduction in the income of the five largest American banks at 10% as a maximum. The agency estimates that, despite the downturn, their profits are likely to remain in positive territory and that the level of profitability will remain "respectable". However, the present valuation of the financial sector suggests, taking a historic PE of 16, that the market is expecting a decline in their profits of the order of 20%. In the light of the data available at present, the market therefore seems to be overestimating the impact of the subprime crisis on the financial sector. Concerning the portion held outside the banking sector (institutional investors, hedge funds, insurance companies, etc), one must assume - and this after all is the underlying principle of securitisation - that the losses are spread over a vast number of investors. The losses dispersed in this way over the global investor community represent, for the purpose of comparison, a fall in the order of 2% in the S&P 500. The impact will admittedly be amplified by the overdone fall in bank stocks (which account for between 30 and 40% of the stock-market indices in the developed countries). However, smoothed over two years, the capital losses can be absorbed without too great difficulties by the investor community as a whole.

Subprime default rate - Proxy

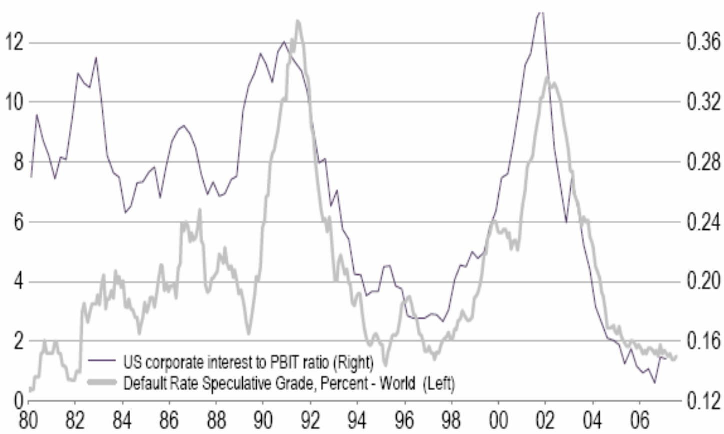


Source: American Mortgage Bank Association, Factset

Present credit spreads are denoting very pessimistic expectations

Moreover, corporate credit fundamentals remain sound, in our view. Solvency ratios are still excellent. The recent tendency for corporate borrowing to accelerate corresponded to a rational trade-off between debt and equities (buyback of undervalued shares through the issue of low-interest debt). This type of trade-off is likely to come rapidly to an end following the revaluation of the relative cost of debt versus equity financing, but without appreciably curbing investment spending, which can easily be selffinanced. Valuation levels on the high-yield market are currently exaggeratedly pessimistic regarding the future level of default rates, which are now at a historic low (see graph). A simple calculation shows that present spreads on the high yield imply an expectation of a rise in the default rate from the present level of 1.8% to over 5% on average over the next five years, which seems much too pessimistic - in the absence of a world recession, a possibility we rule out (see graph).

Corporate Credit: sound fundamentals



Source: Moody's – Federal Reserve Bank

The “growth crisis” on the securitised debt market is unlikely to derail growth

In the final analysis, we interpret the current turbulence as a "growth crisis" for the securitised debt market whose impact on the world economy, although real, must not be overestimated. The shakeout can admittedly last for several months yet. Fresh knockon selling is possible in September because of redemptions of shares in hedge funds with quarterly liquidity. But we believe that opportunist investors have already launched a movement based on more realistic repricing of the risks incurred by securitised products. The central banks, and even possibly governments, will be vigilant in seeing that the macroeconomic impact is limited. Inevitably, this crisis will lead to a tightening of world lending conditions, a curb on credit and a distinct decline in housing-related wealth effects in numerous countries in Europe as well as in the United States. However, the sound state of corporate balance sheets, the absence of major inflationary pressures, the strength of demand in the emerging countries and the abundant liquidity created by the central banks (in both developed and emerging countries) should permit a soft landing for the world economy.
