MANAGEMENT OF CREDIT CRISIS

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ABSTRACT
As the world economy slows, the number of people who have fallen behind on loan and credit-card payments is soaring. Companies are struggling too. Banks still preferred to hold cash rather than lend it. Banks knows that it will be more difficult to offload any new loans. They are also saddled with old loans, either because they have been unable to sell them, or because they have taken structured investment vehicles onto their balance sheets to protect their reputations. When banks get more nervous about lending, that tends to have wider consequences. Bank executives have learnt that investors are often more forgiving if their peers are losing money as well.

KEYWORD*:* *subprime-mortgage, toxic asset, debt-collection, wage-price spiral, risk controlling*

What separate the winners from the losers are not models, but management. The model may have enabled traders to fund themselves too cheaply, but the bank's managers set the internal cost of capital too low. Managers should remember that no one-bank model of credit crisis offers a clean solution to the problem of credit risk.

Banks have endured a brutal in last month's since credit markets froze. Many of their best business have disappeared. In developed economies, almost all banks are facing economic and regulatory headwinds that will cut revenues and jobs.

The lapses in credit-underwriting in the subprime-mortgage market hardly reflect a wise allocation of capital. The opacity of the shadow banking system and the mind-boggling complexity of those toxic asset-backed products have raised doubts about the discipline of the market.

Bank's clients failing to pay on time the loan

As the world economy slows, the number of people who have fallen behind on loan and credit-card payments is soaring. Nevertheless, although dud consumer loans have attracted much attention, individuals are not the only ones failing to pay on time. Companies are struggling too. As sales stagnate, firms will delay paying suppliers for as long as they can.

Chaos in the American banking system is also causing managers to think twice about paying promptly. In my opinion, the biggest issue that companies are having is that banks are curtailing credit lines. By putting off payments to creditors, treasures can conserve cash and thus reduce their reliance on nervous bankers.

All this puts in-house debt-collection teams in a delicate position. A hard line with delinquent debtors risks alienating customers temporarily lacking cash. Nevertheless, if they are too soft, their own companies may run short. Most are taking a firm approach.

To help get their money, firms are calling in specialist collection agencies soon after debts turn sour.

Negative spiral of financial markets

The fear is that the financial markets have entered a negative spiral, the obverse of the kind of euphoria that drove dotcom stocks to absurd valuations in last years. Back then, investors scrambled to buy shares regardless of their price. This time round, they are being forced to sell loans, whether or not they believe the borrowers will eventually repay. The problems are exacerbated by the demise of the securitization market, and fears about counterparty risk. Both those factors are making banks less willing to lend even to worthy borrowers. Banks will become ever more cautious the deeper Romanian's economy tips into recession. If confidence can be restored in that part of the market, perhaps the negative spiral can be broken.

Debt, such an exalted financing tool a little more than a year ago, is now a four-letter word. In the boom, banks were able to lend money via loans and then unload the debts in the form of structured products. Even when yield spreads narrowed, investors simply spiced up their portfolios with more debt to produce higher returns. However, once the problems in the subprime market became clear, the appetite for structured products collapsed, and the process went into reverse.

A wage-price spiral could develop should workers and firms conclude higher inflation is here to stay and adjust wages to compensate. Nevertheless, rising unemployment and spare capacity suggest that workers who want higher wages will be hard pressed to win them. Firms will, equally, be hard pressed to raise prices enough to recover their higher input bills. A glut of empty houses and flats will restrain rents, a big chunk of the consumer price index. My opinion is that the economy will grow more slowly than its capacity could allow at least until the middle of 2010.

Bank preferring to hold cash

Banks still preferred to hold cash rather than lend it. Banks knows that it will be more difficult to offload any new loans. They are also saddled with old loans, either because they have been unable to sell them, or because they have taken structured investment vehicles onto their balance sheets to protect their reputations.

When banks get more nervous about lending, that tends to have wider consequences. Companies will find it more difficult to borrow; weaker ones will accordingly get into trouble. In my opinion, the single biggest factor influencing corporate default rates is banks' willingness to extend credit. It is likely that the full impact of tighter lending standards on consumer demand has been felt.

Oddly enough, the problem is particularly intense in an area of the market that, in theory, should have been the safest; paper given AAA- like ratings by the agencies. There are no longer end buyers for this paper. The yields on such assets are too low to make them of interest except to geared investors. In addition, there is scant lending available, even if investors wanted to gear up their portfolios in these volatile times.

Housing market is still in trouble

After the longest and biggest boom in post-revolution history, it is payback time for Romanian's ever more troubled housing market. The economy looks perilously vulnerable to falling housing wealth and the collapse in mortgage finance, residential investment and property transactions. The mortgage market has already plumbed unprecedented depths. New loans approvals are closely watched because they point the way to house-price changes. The declines that started late last year are continuing apace.

Housing was grotesquely overpriced; prices are slumping. In time, they will reach a level at which poorer young Romanian can buy themselves a home. These are painful but necessary realignments.

I think that there are three main ways in which the housing market's malaise may infect the economy. The first channel is through lower residential investment. A second way in which the housing slump will hurt the economy is by slashing the demand for consumer goods linked to property transactions. The third route is through the decline in property wealth, and this is a matter of considerable controversy.

Until this year, the former link between house prices and spending appeared to have reasserted itself. According to Peter Drucker, a 15% decline in house prices over the next two years would reduce the increase in consumer spending by one percentage point a year. The effect on GDP growth would be smaller, bringing it down by about half that amount over the next year, since much of the spending shortfall would leak out into imports.

In my opinion, what the economy really needs is to rein in wage growth and make the labor market more flexible. Cuts in corporate-tax rates have also been ruled out. Other supply-side reforms, for instance to education, will have little immediate impact.

Inflation news must be better

If the inflation will be out of its box, the central bank can do little to help, and may indeed have to raise interest rates to show its inflation-fighting resolve. Coming on top of the erosion of consumers' purchasing-power by soaring oil and food prices, the housing slump looks set to inflict some hefty collateral damage.

In the last decade, public policy has been dominated by the power of markets-flexible and resilient, harnessing self-interest for the public good, and better than any planner-in-chief. Nowhere are markets deeper and more liquid then in modern finance. Nevertheless, finance has stumbled and there are growing calls from all sides for bold re-regulation.

New rules become inevitable. It is natural and right that regulators should seek to learn lessons. The credit crisis will damage not just the reputation of the financial system but also the lives of those who lose their houses, businesses and jobs as a result of it. In my opinion before that governments set about reforming financial regulation, they need both to be clear about the causes of the crisis and to understand just how little regulators can achieve.

Control the risk

What I strongly believe is that finance was not solely to blame for the crisis. Lax monetary policy also played a starring role. Low interest rates boosted the prices of assets, especially of housing, which in turn fed into complex debt securities. This created a spiral of debt that is only now being unwound. True, monetary policy is too blunt a tool to manage asset prices with, but central banks in economies with deep mortgage markets should in future lean against the wind when houses prices are rising fast. Bold re-regulation could damage the very economies it is designed to protect. At times like this, the temptation is for tighter controls to rein in risk-takers, so that those regular, painful crashes could be avoided. It is an honorable aim, but a mistaken one.

Finance is a brain for matching labor to capital, for allowing savers and borrowers to defer consumption or bring it forward, for enabling people to share, and trade, risk. The smarter the system is, the better it will do that. A poorly functioning system will back wasteful schemes and shun worthy ones, trap people in the present, heap risk on them and slow economic growth. This puts finance in a dilemma. A sophisticated and innovative financial system is susceptible to destructive booms; but a simple, tightly regulated one will condemn an economy to grow slowly.

New regulations in place

The tempting answer is to try to wriggle free from the dilemma with a compromise that would permit innovation but exert just enough control to squeeze out financial failure. It is a nice idea; but it is a fantasy. The experience of the past year is an object lesson in the limited power of regulators.

It would be convenient to blame the regulators for all that, but the system is stacked against them. They are paid less than those they oversee. In an open economy, business can escape a regulatory squeeze in one country by skipping offshore. Once a bubble is inflating many factors conspire to discourage a regulator from pricking it.

Moreover, even if you could put all that right, regulators would still fail, because of the nature of finance itself. Financial progress is about learning to deal with strangers in more complex ways. The village moneylender, limited by his need to know those he did business with, was gradually superseded by ever broader impersonal markets that can cheaply mobilize colossal sums and sell more complex products. The remarkable thing is not that finance suffers from booms and busts, but that it works at all.

Regulators cannot know how trust will ebb and flow as new markets develop the experience and practice they need to work better. They therefore cannot predict the peril of new ideas. They have to let new markets develop, or stifle them. The system learns dangerous junk bonds are reborn as respectable high-yield debt; bankers will now be scared of extreme leverage but it is delicate, as the world learned last summer. The regulator is condemned to muddle through.

The notion that the world can just regulate its way out of crises is thus an illusion. Rather, crisis is the price of innovation, so governments face a choice. They can embrace new financial ideas by keeping markets open. Regulation will be light, but there will be busts. The state will sometimes have to clear up and regulation must be about cure as well as prevention. On the other hand, governments can aim for safety and opt for dumbed-down financial systems that hobble their economies and deprive their people of the benefits of faster growth. And even then, a crisis may strike.

Political could be the principal danger

Consumer confidence is now lower than in the past. House prices continue to fall. I do not think that the program “First house” will solve the housing market’s problems. I strongly believe that policymakers should be designing a new stimulus plan and should stand ready for another after that, and another. Getting a second stimulus plan or more debt reduction for homeowners could be difficult. Much depends on how the economy fares in the coming times. Nothing focuses politicians’ minds like an economic slowdown in an election year. The principal danger now is not economic but political.

Lesson to learn

Bank executives have learnt that investors are often more forgiving if their peers are losing money as well.

Regulators also have lesson to learn. Most of them come in two categories. The first is to take a broader view of risk. That means looking at off-balance-sheet assets and at gross exposures. For national supervisors, it requires a lead regulator with a remit to watch the system. Internationally, the global capital markets would ideally have global regulatory norms or at least more co-operation between national authorities.

Now that the investment banks know the central banks will stand behind them, they also need closer scrutiny and higher capital standards. The second change in philosophy is to bully banks to build buffers when times are good so they have stronger defenses when times are bad.

Banks' risk models have been backward-looking, so no time appeared safer than the moment before the bubble burst.

Bankers are rightly rewarded for taking risks, which by their nature cannot be entirely managed away or anticipated. However, bankers are paid, they cannot just sit out a credit boom; they have to keep dancing.

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