

THAT'S ANOTHER FINE MESS....BY SIMON
RUSSETT

At the beginning of 2008, my mood was rather sanguine concerning new opportunities, challenges, people, clients, etc. when thinking of the year ahead. Prior to and during 2008, I developed a range of international project opportunities and assisted in setting up a new Hoare Lea overseas office in Abu Dhabi. The international projects took me to many far off places, such as Russia, India, Abu Dhabi, Dubai, Bahrain, Oman, France, Turkey, Holland, and Monaco to name but a few. Business opportunities were plentiful and it appeared the near insatiable appetite for new development, particularly residential, would continue. Corporate giants were increasing in size requiring many new large headquarters buildings and I remember thinking that it had never been this good.

Stories began to emerge in the press regarding the problems associated with the sub-prime mortgage market in the USA. Not being a financial expert, the terminology both intrigued and perplexed me. What is sub-prime and how could this be a significant headache for the US economy?

Subprime lending (near-prime, non-prime, or second chance lending) is a financial term that has been popularised by the media and involves financial institutions providing credit to borrowers who do not meet prime underwriting guidelines. Subprime borrowers have a heightened perceived risk of default, such as those who have a history of loan delinquency, recorded bankruptcy or those with limited debt experience. However, subprime mortgages were not created for low income borrowers who had little or no money to put down, as commonly believed. Subprime mortgages were actually intended to be temporary loans to borrowers who expected to sell the property early or increase their income soon after purchase.

With premeditated alacrity many Financial Consultants in the American domestic residential sector used predatory lending practices, where the borrower qualified for a standard interest rate, but was sold a higher interest rate. These advisors also fraudulently misrepresented people's earnings to exaggerate the loan they could apply for and failed to notify them of exorbitant fees and hidden conditions. To compound this, people who were effectively coerced into signing up for a shiny new house, could barely sign their own name, let alone understand the small print. Very soon many of these people found that they could not afford the mortgage

repayments and properties were repossessed at an alarming rate. The sheer number of mortgages that were defaulted upon became so large, that Fanny Mae (Federal National Mortgage Association (FNMA)) and Freddie Mac (Federal Home Loan Mortgage Corporation (FHLMC)) had to apply to the Federal Housing Finance Agency (FHFA) for conservatorship to prevent systematic failure of each company. The action has been described as "one of the most sweeping US government interventions in private financial markets in decades". As we now know, these near misses were just the beginning of our woes.

The RMS Titanic is a metaphor for our ability to incorporate inherent systematic weakness in a design that appears to contain extraordinary power and strength. The banking structure has robust checks and balances, such as the FSA in the UK that regulates the industry. Bearings Bank was brought to their knees by the actions of an individual that could be likened to the fate of the RMS Titanic. The financial system is robust, but when a series of events conspire to create a previously unthought-of condition, the result can be disastrous.



RMS Titanic in dock at Belfast.



*383 Madison Avenue,
former Bear Stearns HQ.*

The first sign of problems in the UK banking network was Northern Rock. The mistake they made was to invest heavily and become the most prominent in the now virtually defunct 'buy to let' residential market. This market became saturated, prices dropped and loans defaulted upon, causing the company's financial liquidity to decrease. Whispers emerged that savings were at risk which resulted in mass withdrawal from savings accounts to deposit safely elsewhere. This further weekend Northern Rocks financial

stability and resulted in the Government having to step in and rescue it from complete collapse with nationalisation.

Of the seven deadly sins, it is greed that carries the most culpability. The Oscar winning 1980's movie 'Wall Street', directed by Oliver Stone, was loosely based on the insider trader Ivan Boesky. Michael Douglas acted the well dressed and articulate character Gordon Gekko, who during a speech uttered the immortal words "greed, for a lack of a better word, is good". That mantra has been gleefully sung in city wine bars ad infinitum and became the stalwart of many sharp suited barrow boys 'done good'. It is my opinion that these people are not to blame as individuals (the exception of course is Nick Leeson for the Bearings Bank collapse), but collectively they are a greedy bunch who for the sake of a bonus cheque, would happily part with a living family member.

As the year progressed I was still upbeat about business development and plans for further group expansion were still firmly on track. The financial quagmire began to take on a more sinister form as Bear Stearns failed and was snapped up at a fraction of their true value by J P Morgan. The most valuable asset of this long standing and well respected Bank was not fund values, it was their New York City office tower, valued at \$1.0Bn, which is now the new

J P Morgan HQ. J P Morgan paid \$238M for Bear Stearns, which was \$2 a share, down from \$170 twelve months previously. Who could have foreseen the speed at which Lehman Brothers crashed globally with huge mortgage debts and 26,000 jobs losses? Merrill Lynch soon followed, being bought by Bank of America. Both Goldman Sachs and Morgan Stanley could see the writing on the wall and became traditional bank holding companies, which brought an end to the era of global investment banking. The general public has a low opinion of get rich quick whizz kid banker types and some saw this as divine intervention, almost apocalyptic. Unfortunately, these mergers and acquisitions have and will result in large numbers of people losing their jobs, with the effect this has on local communities and the economy as a whole.



Former Lehman Brothers HQ, 25 Bank Street, Canary Wharf.



Bank of America Building, 5 Canada Square, Canary Wharf.

My simple understanding of the basis of funding is primarily through investment contributions, such as pensions, that are collectively pooled together to make much larger funds. These funds are invested in global markets and provide fund vehicles for the majority of development in many countries. Western society has for decades been a buy now pay later culture, whilst China, with the largest single population on earth, have a save now spend later culture. In effect, the people of China are to some extent funding the debt of the West. This is a seismic shift in power that is here to stay. Equally Middle Eastern banking systems, while not completely unaffected have remained relatively unscathed. It is now not unusual for Developers and Architects presenting to UAE banks for funding of European projects. Some Islamic countries, where Sharia Law prevails, have banking systems that prohibit interest payments and will not invest in businesses that provide goods or services considered contrary to its principles. Isn't that a novel and rather socialist ideology!

At the beginning of 2009, I still cannot believe the calamity that has befallen practically all sectors of the global business community. What surprised me most was the shear speed at which the downturn took hold. No sector is unaffected and there is concern our savings are a risk if a major high street bank(s) fails.

An acquaintance of mine who is a financial expert put the situation into perspective "no banking system, no business community". The backbone of most business operations is the banking system. Businesses come in many shapes and forms, but have the same principles in trading mechanisms. Many products and services are bought and sold with the seller being compensated by a financial transaction, generally by electronic means. The banks then process these payments, with the buyer's money being deposited into the sellers account. All a very simple service and exactly how the general public has come to expect it.

The global financial fallout put the high street banking system under such severe pressure, that it came extremely close to failure. Most of the worlds Governments acted very quickly to stabilise the situation, with billions of taxpayer's money, which so far has averted catastrophic effects. To put it quite simply, if the banking system had failed, western culture as we know it, would have rapidly decayed, with cash being the primary method to purchase goods or services. We have all seen images of the empty supermarket shelves in Zimbabwe, where a loaf of bread costs \$10,000,000. Hyperinflation would become rife as supplies dwindled. Hospitals, schools, public transport would fail. Crime would rapidly increase and our safety placed in severe jeopardy. Let's just hope Gordon Brown's rescue package has worked.

The Icelandic Government made a clear statement that a handful of people in their financial institutions were responsible for the country being declared bankrupt. How can a handful of people have this much power



JP Morgan's new proposed site at Canary Wharf Riverside South.



to be able to do this? These people leveraged state income from gross domestic product (GDP) by up to 32 times its value! To laymen this appears an extreme multiple, but is in fact quite normal. The investments they made simply devalued with the global crisis and they were caught short. Our own Central Government advised local Councils to invest overseas and one of the best deposit interest rates on offer were with Icelandic banks. When the news broke it became apparent that nearly £1.0Bn of taxpayer's money was held in these banks and the interest was being used to fund staff salaries and other services. Gordon Brown invoked domestic terror laws to freeze £4.0Bn of Iceland's funds in the UK, in what was a tit for tat spat that resulted in the UK money being returned.

In the last four months interest rates have plummeted from 4.5% to 1.0% and there are plans to reduce this to 0% if the need arises. The Bank of England has proposed quantitative easing, which involves printing new money to inject liquidity and stimulate lending. These are emergency measures that are usually only used in post war conditions, as the interest rate drop has yet failed to stimulate the housing market. However, the side effect of quantitative easing is inflation and this is set to increase during the year, with Sterling falling against global currencies making imports more expensive. The government has recently announced that a further £200Bn of taxpayer's money

will be used to inject liquidity into the lending market and hopefully ease the lending complexities.

There is almost a wartime spirit that we will not be defeated and we will all get through this. Personally I have been through three periods of recession and whilst this one is probably the most severe, with corporate probity and strong leadership, the UK economy should emerge from this fitter, leaner and stronger. □

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