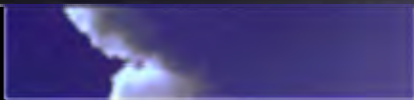


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# Après le Déluge

**From the subprime to the ridiculous**

Pat Butler, Head of Financial Services Practice, McKinsey & Co.

EUROCATALYST 2007: LIVE FROM MADRID / 5 October 2007

# ON THE BRIGHT SIDE . . . THERE ARE SEVERAL THINGS WE NO LONGER NEED TO WONDER ABOUT



- 1 Is U.S. subprime risk well understood and underwritten?
- 2 Do derivatives dampen systemic risk?
- 3 How can the AAA tranche of a MB CDO yield 100bp more than other AAA instruments?
- 4 Is monoline mortgage origination a sustainable business?
- 5 Why are so many hedge funds willing to hold 'toxic waste'?
- 6 Should Europe care about the U.S. housing market?

# CONTENTS

**Why us; why now?**

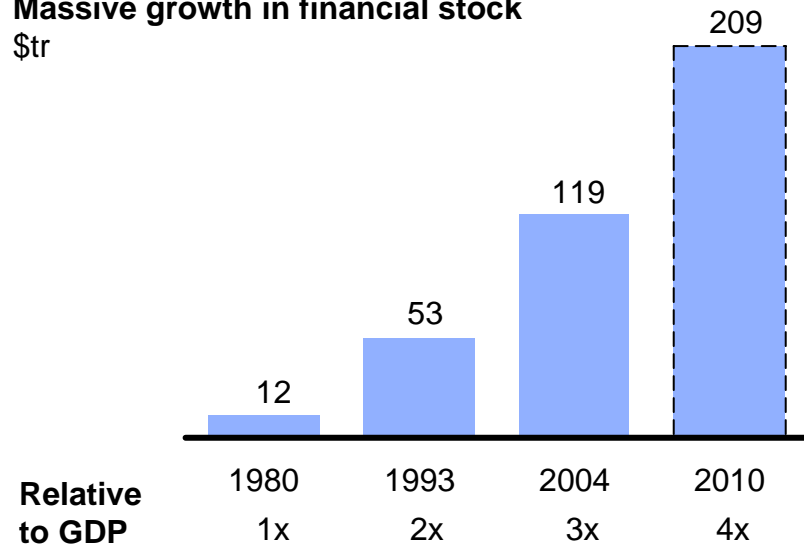
What next?

Après le Déluge

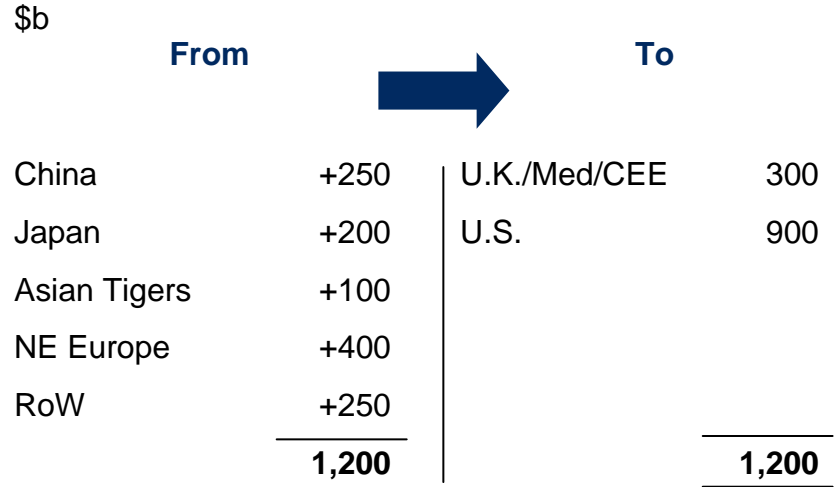


# GLOBAL FINANCIAL SYSTEM: BUILT TO BUBBLE?

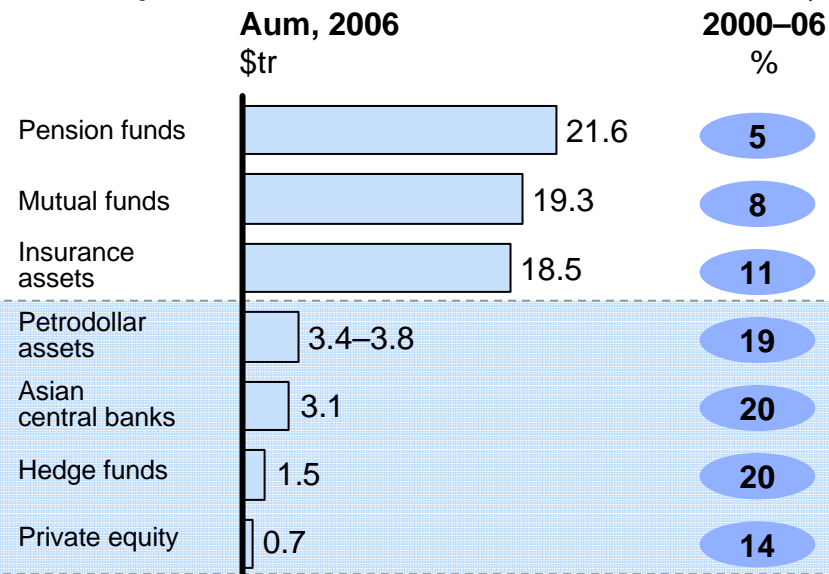
**Massive growth in financial stock**  
\$tr



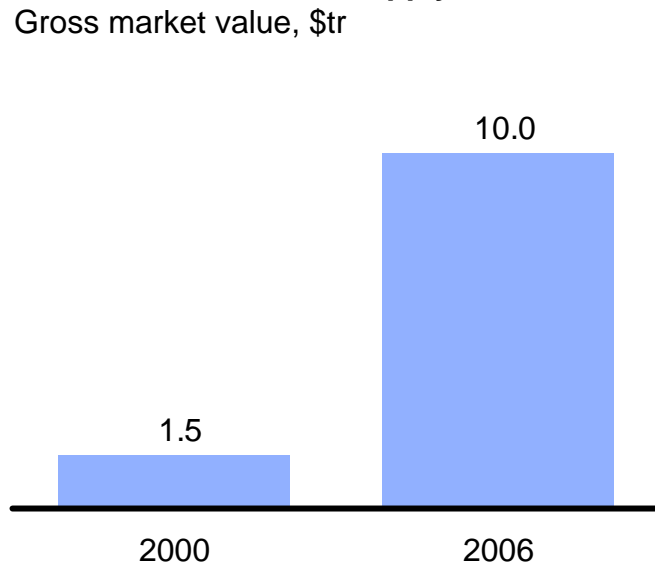
**... enormous spending and saving imbalances ...**



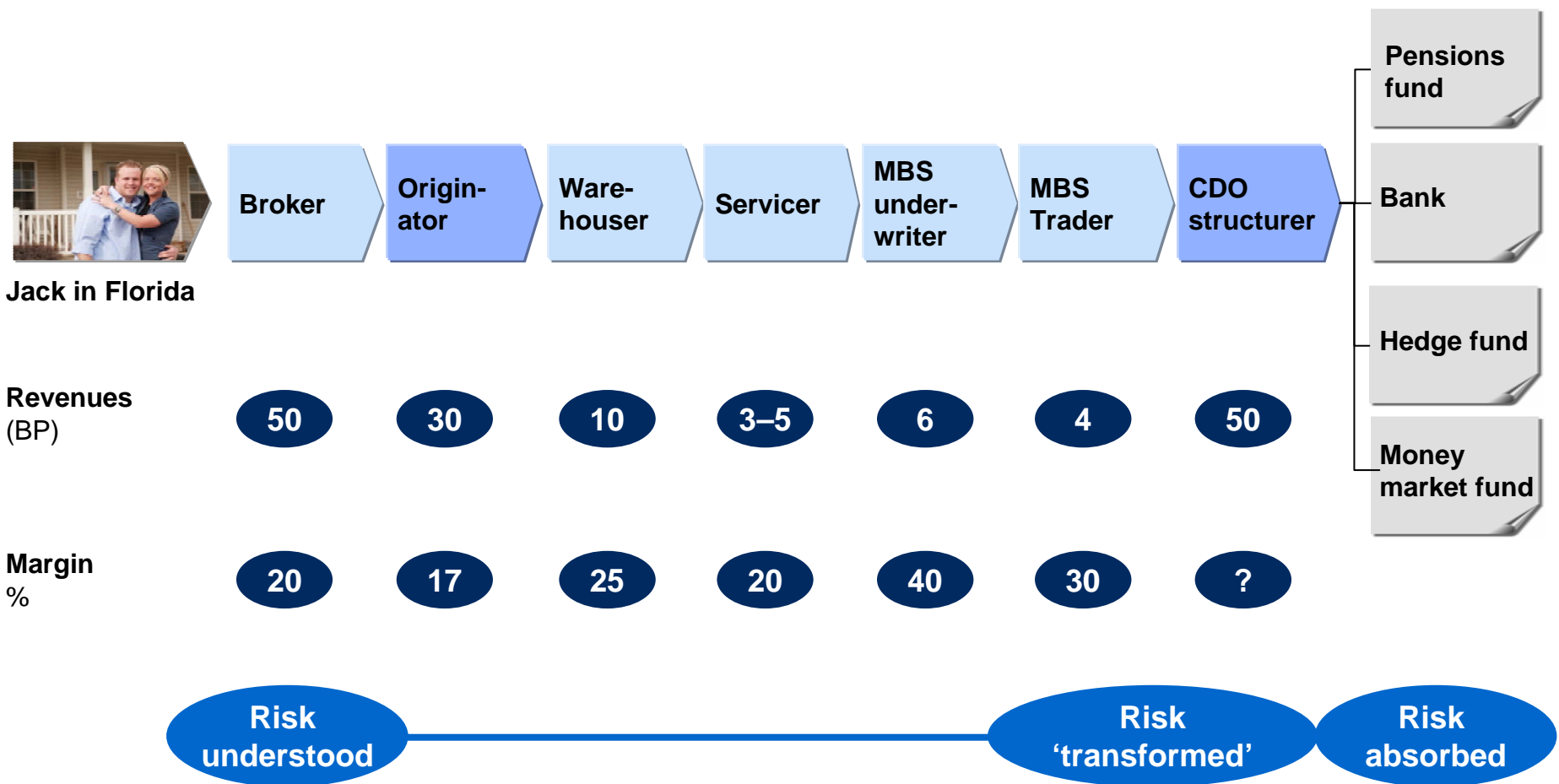
**... new power brokers ...**



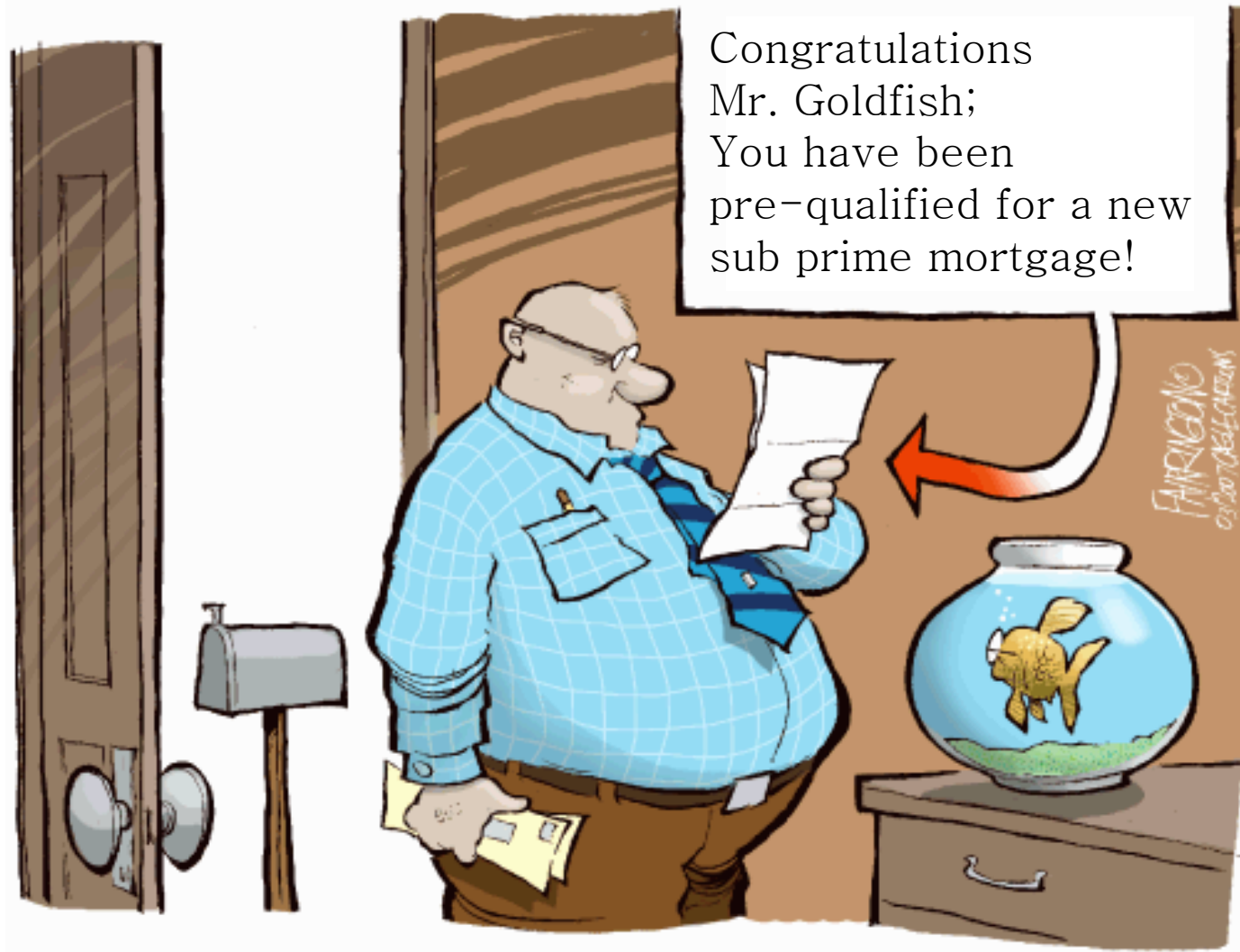
**... and derivatives to supply the octane**



# THE PARTICULAR INCENTIVES AND OPACITY OF U.S. SUBPRIME MADE IT THE 'SAN ANDREAS FAULT' OF GLOBAL BANKING



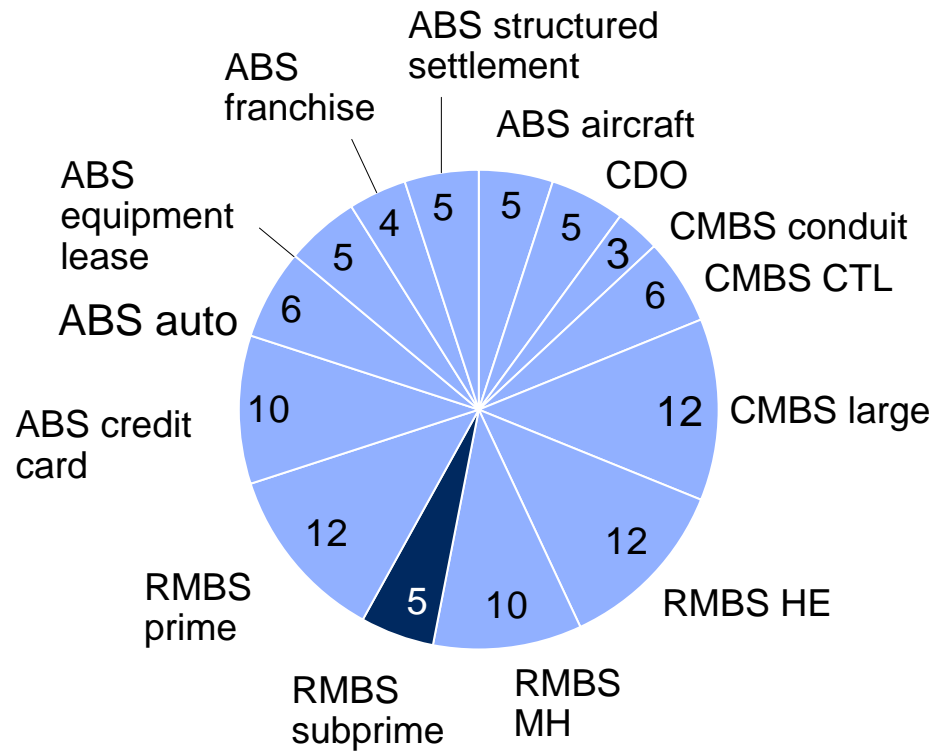
# UNDERWRITING WITH 'OPM' (OTHER PEOPLE'S MONEY) IS ALWAYS EASIER



# CDOs BECAME HIGHLY CONCENTRATED...

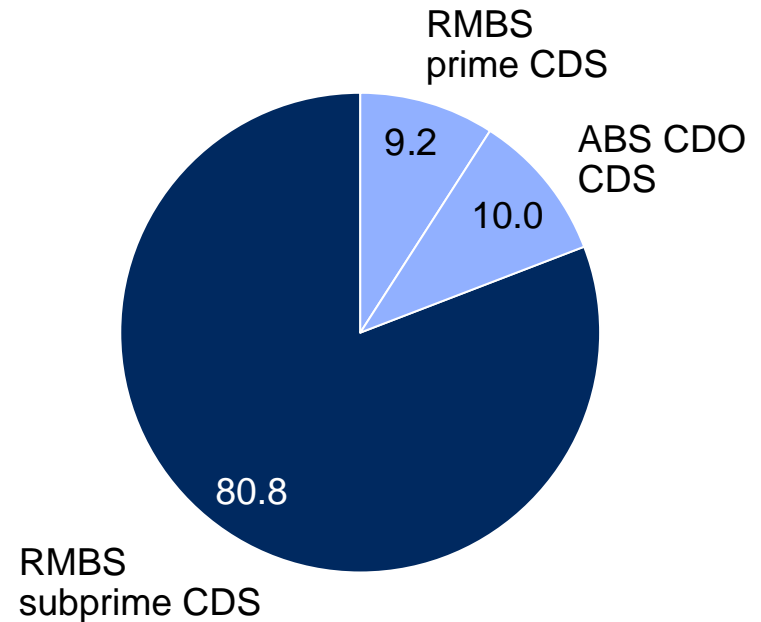
**Representative ABS CDO, 2002**

%



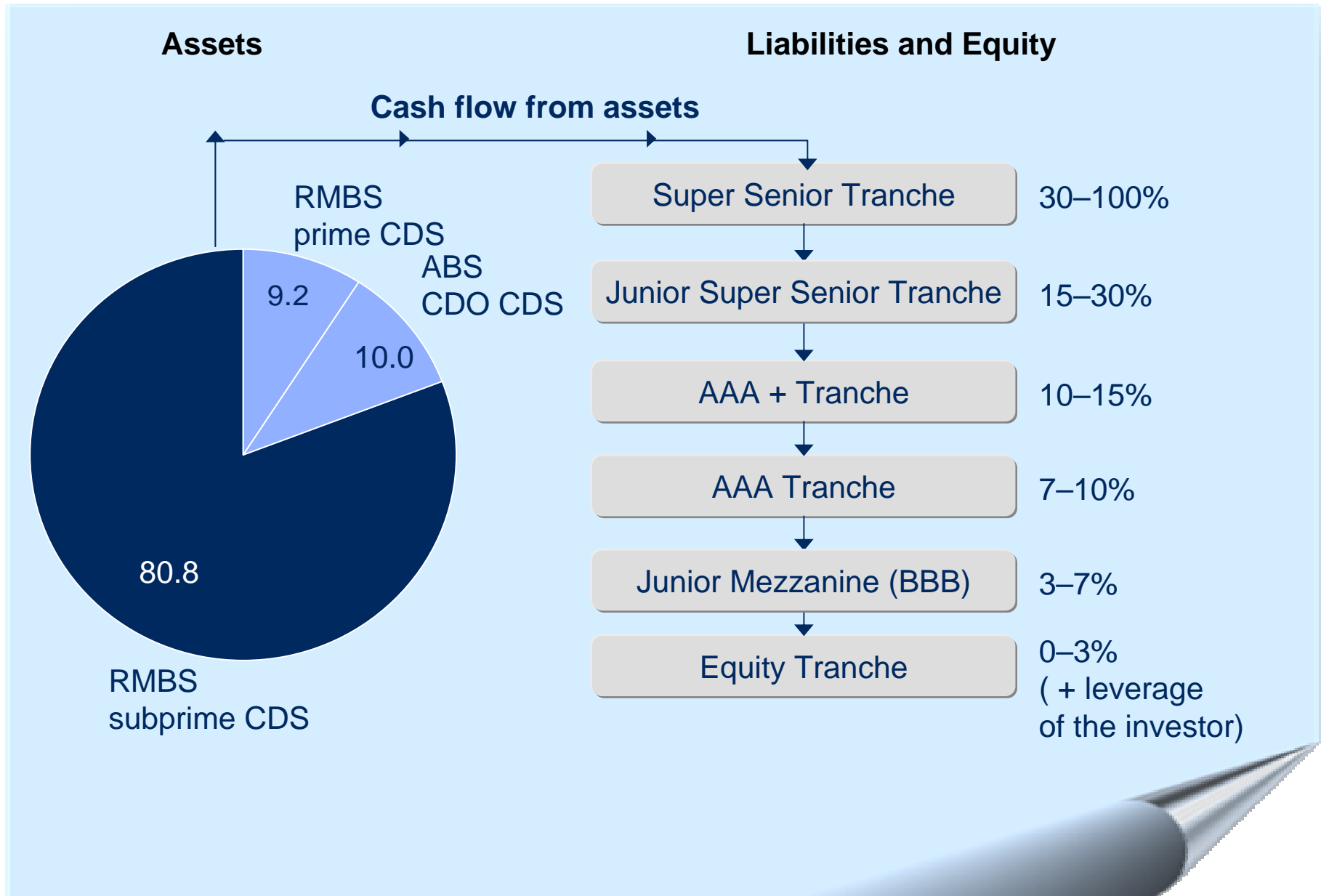
**Representative ABS CDO, 2006**

%



Note: ABS – asset-backed securities; CDO – collateralized debt obligation; CMBS – commercial mortgage-backed securities; CTL – credit tenant lease; RMBS – residential mortgage-backed securities; HE – home equity; MH – manufactured housing; RMBS – residential mortgage-backed securities; CDS – credit default swap

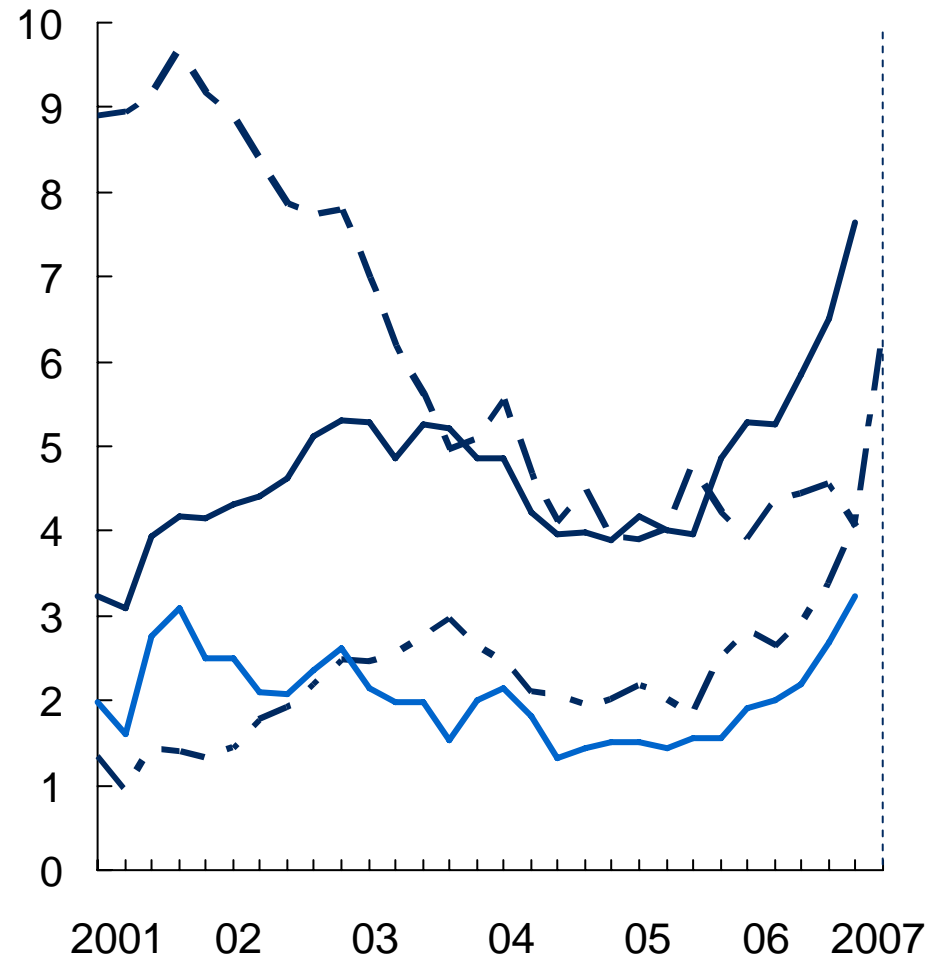
# ...AND HIGHLY LEVERAGED



# ... AND THEN THE UNDERLYING ASSETS WENT SOUR

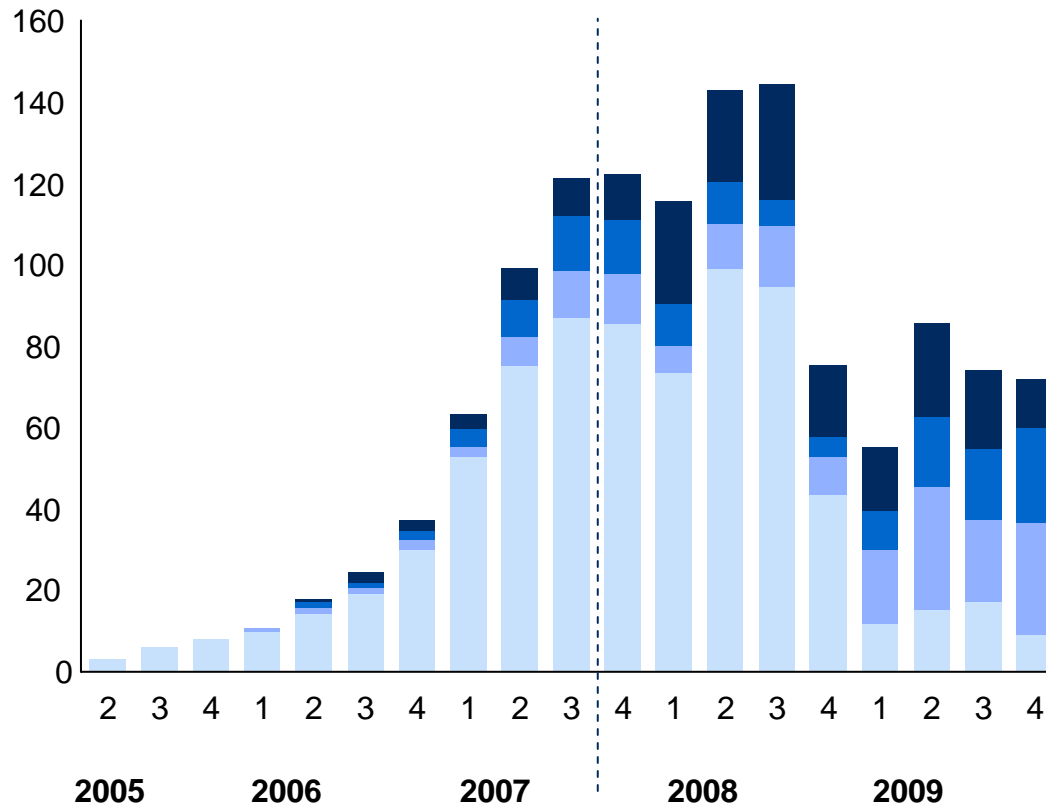
Delinquency %, of ARM loans

- <30 days past
- - 30-90 days past
- · - 90+ days past
- In foreclosure



# MUCH OF THE PAIN STILL TO COME

Adjustable rate mortgages to be reset  
\$b



- Agency
- Alt-A
- Jumbo
- Sub-prime



# FIRST ORDER IMPACT

Customers defaulting	Average mortgage size	Recovery rate
'000	\$000	%
2006 900 (A)		
2007 1,500 (E)		
2008/9 2,500 (F)		
<u>~5,000</u>	<u>200</u>	<u>70-80%</u>

~ \$200-300b



# FROM THE SUBPRIME TO THE RIDICULOUS

## On the one hand

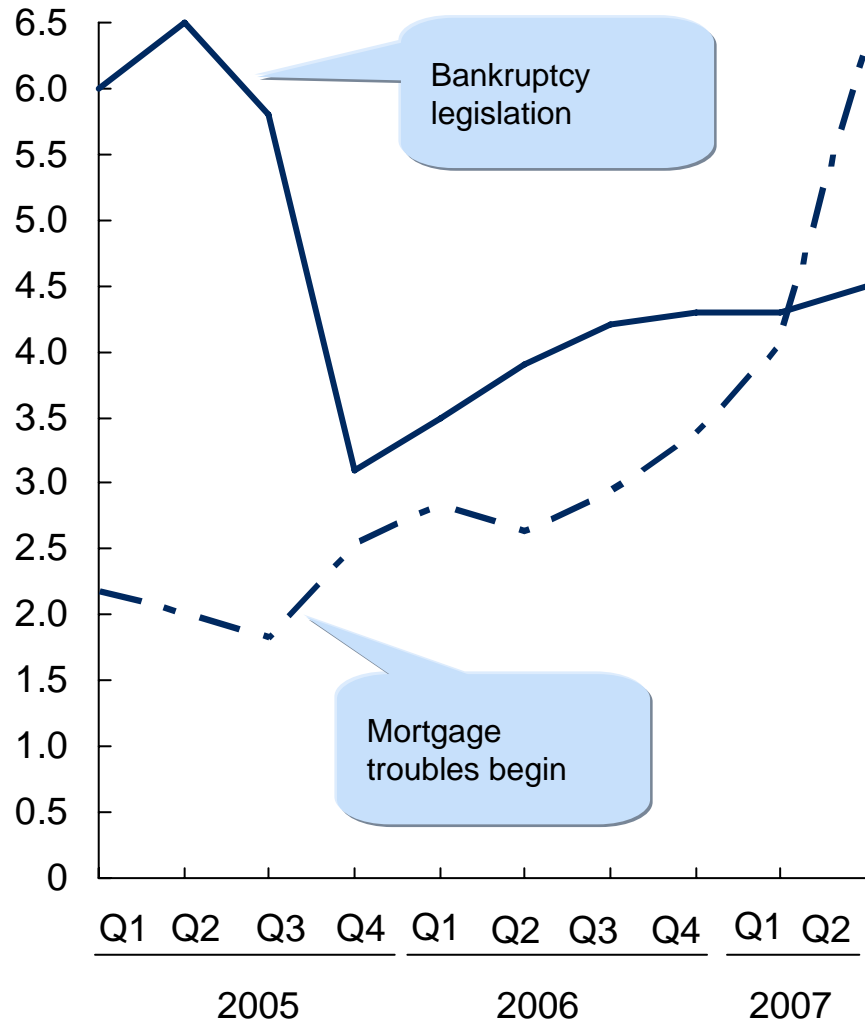
- ½% of global financial assets
- About 4–6 months of global banking profits
- Maybe 15% of capital in the banking industry
- Well spread, thanks to securitisation

## On the other hand

- Triggered a slow motion liquidity crunch
- Potential tipping point for a fragile U.S. (and global?) economy
- Seems to be resetting the price of risk globally

# EARLY SIGNS OF WIDER CREDIT PROBLEMS

- Card charge-offs
- · - Sub-prime mortgage delinquencies

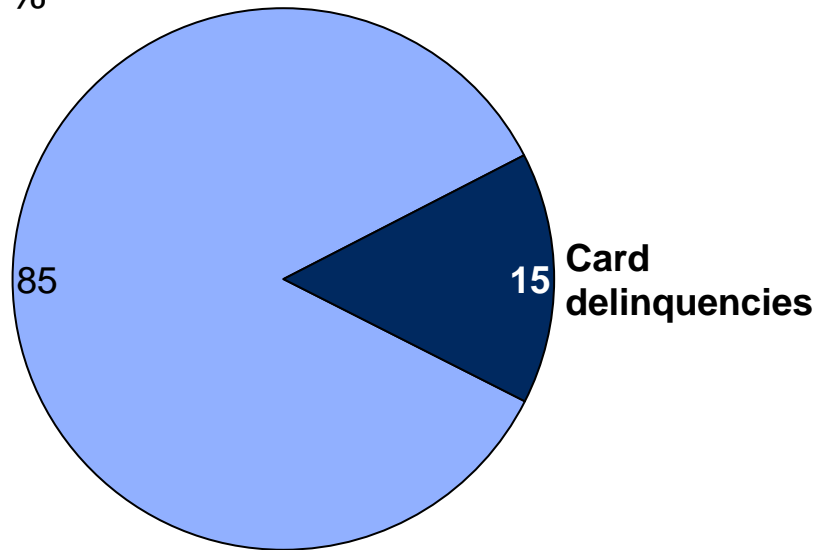


Source: Mortgage Bankers Association National Delinquency Survey; S&P

# SPREADING PERSONAL CREDIT RISK: CONTAINED OR CONTAGION?

U.S. credit card

60+ delinquent mortgage customers  
%



15% of delinquent mortgages also have a card delinquent suggesting *at least the potential* for more contagion to come



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Why us; why now?

**What next?**

Après le Déluge



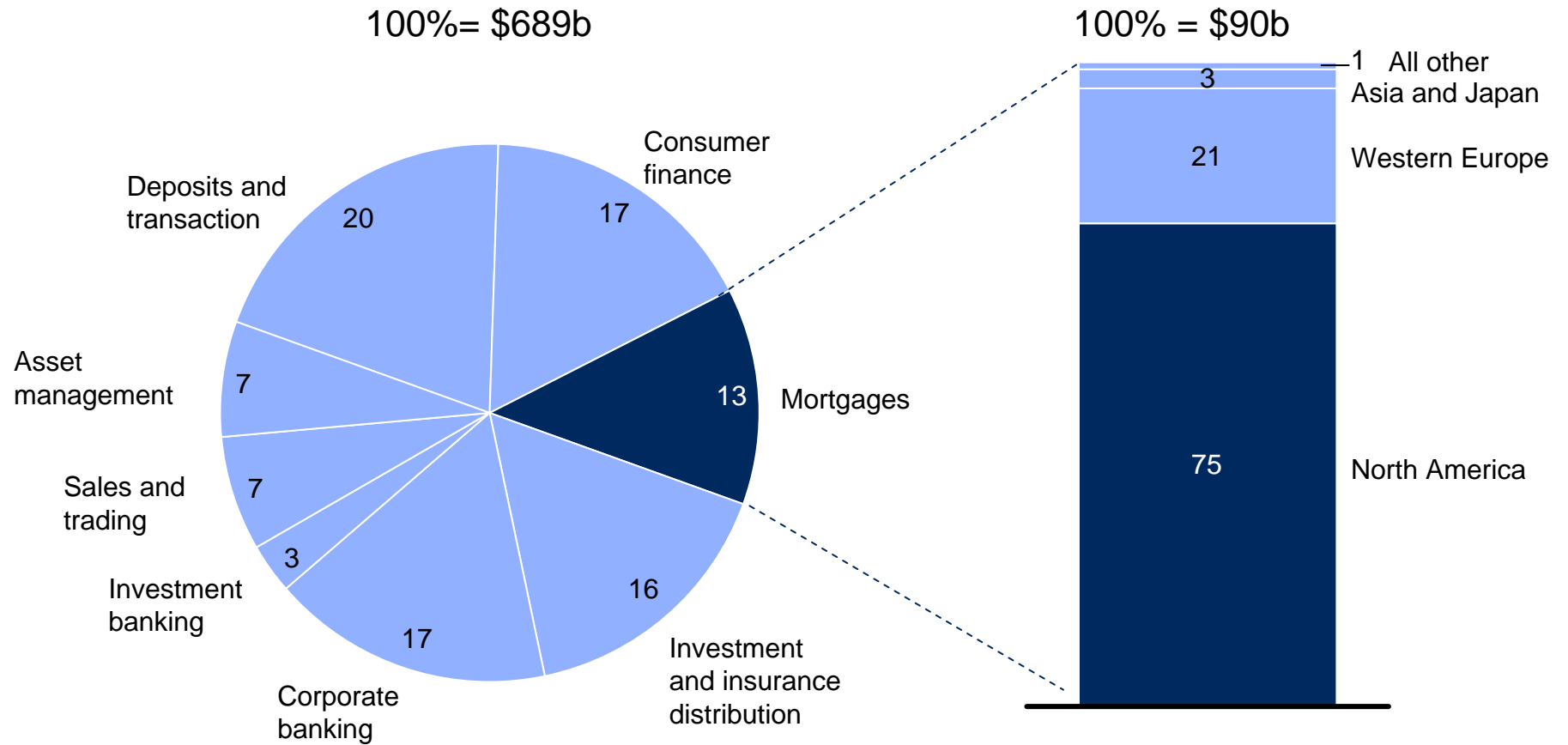
# OBVIOUSLY, SOME CLEARING UP TO BE DONE IN THE U.S. SUBPRIME INDUSTRY

- Selling practices
- Underwriting practices
- Ratings practices
- CDOs
- Regulation?

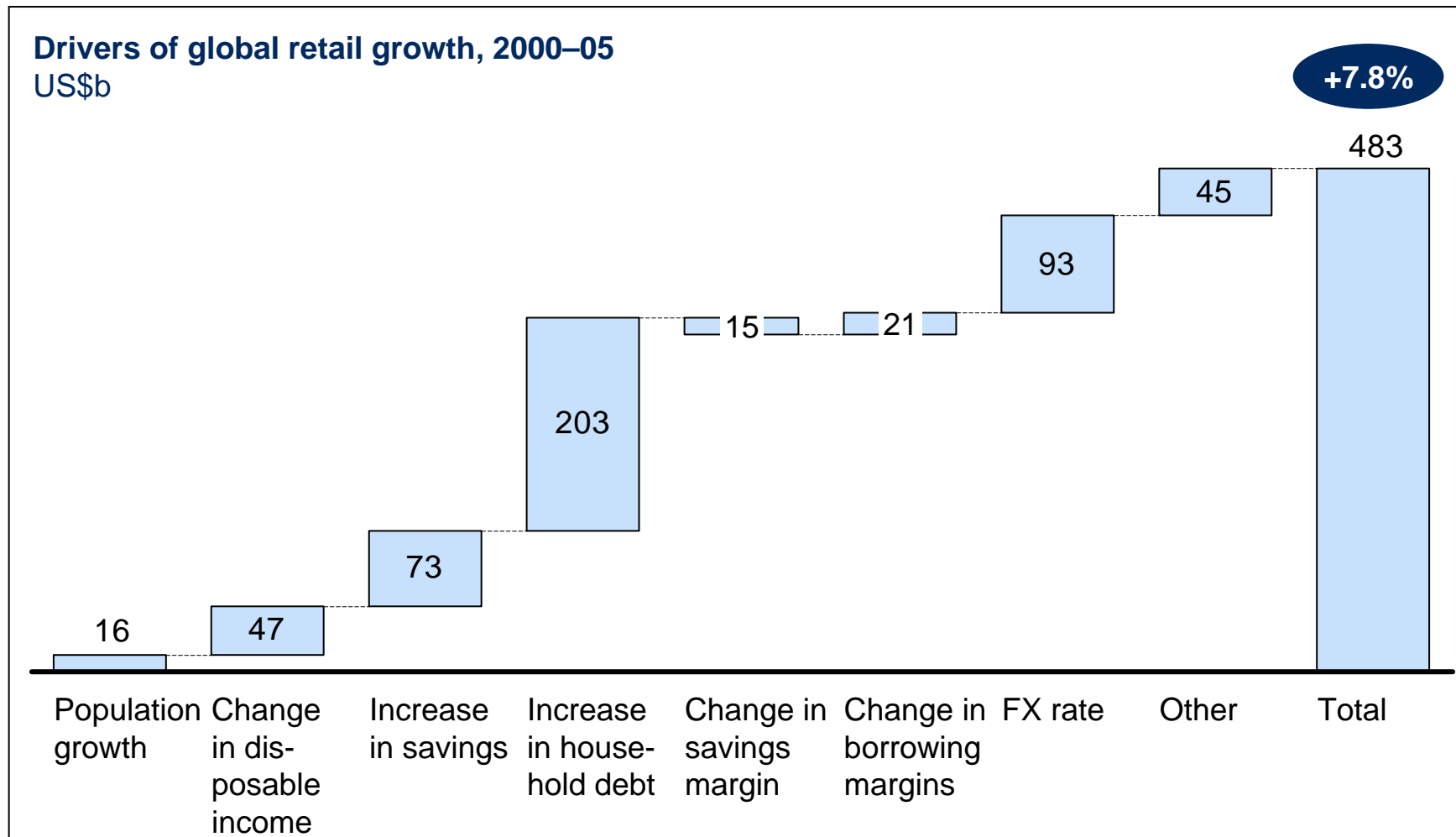


# MORTGAGE LENDING PRIMARILY A DEVELOPED MARKET SPORT

Post tax profit, 2005, %

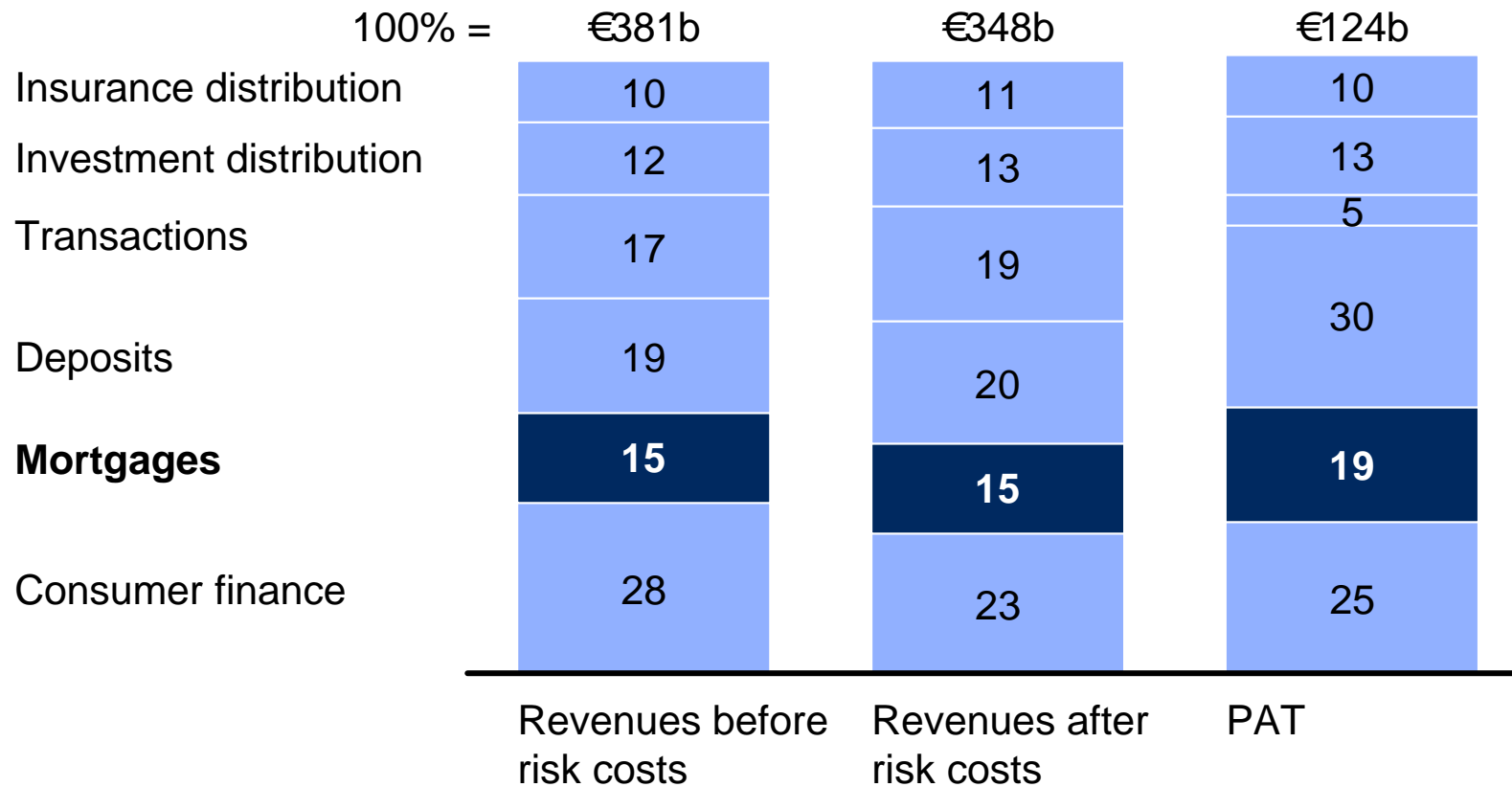


# INCREASED BORROWING THE MAIN DRIVER OF RETAIL BANKING GROWTH GLOBALLY



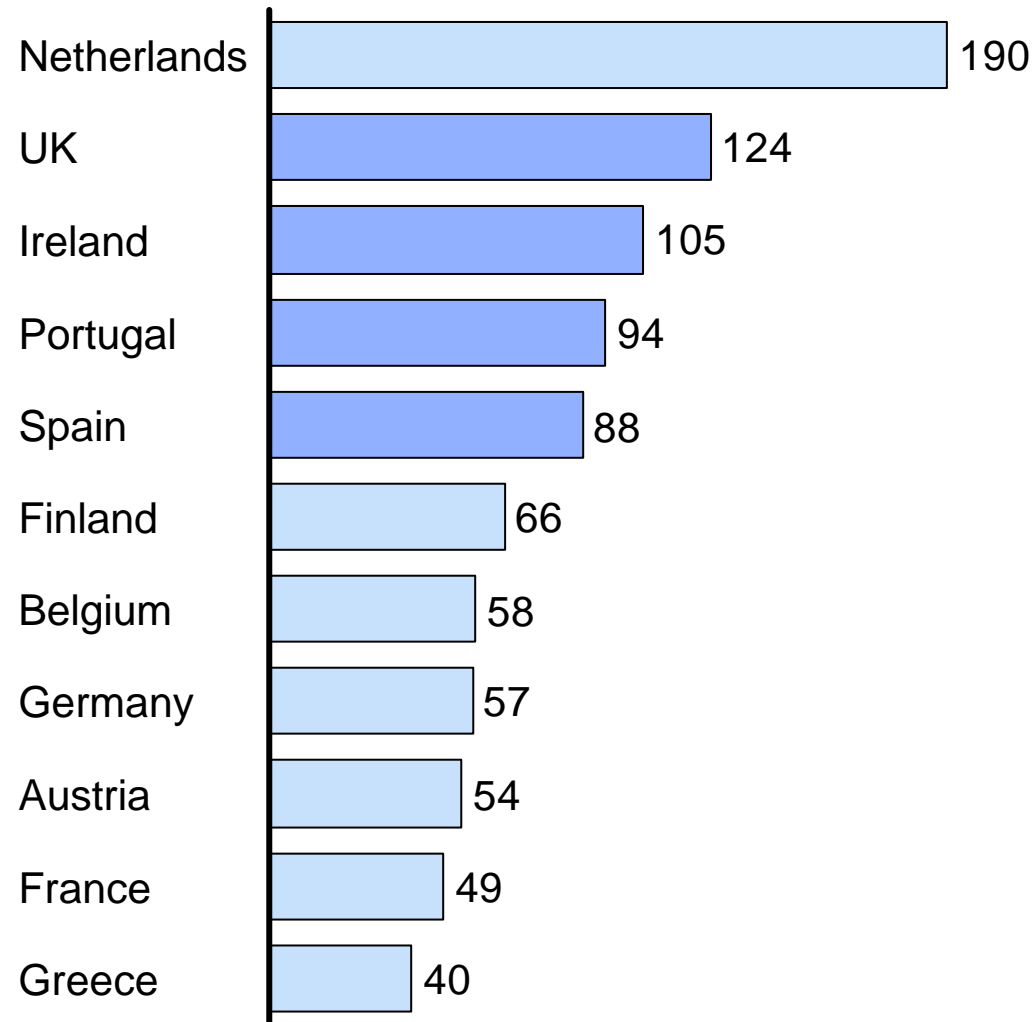
# A MAINSTAY OF RETAIL BANKING IN WESTERN EUROPE

%, 2005

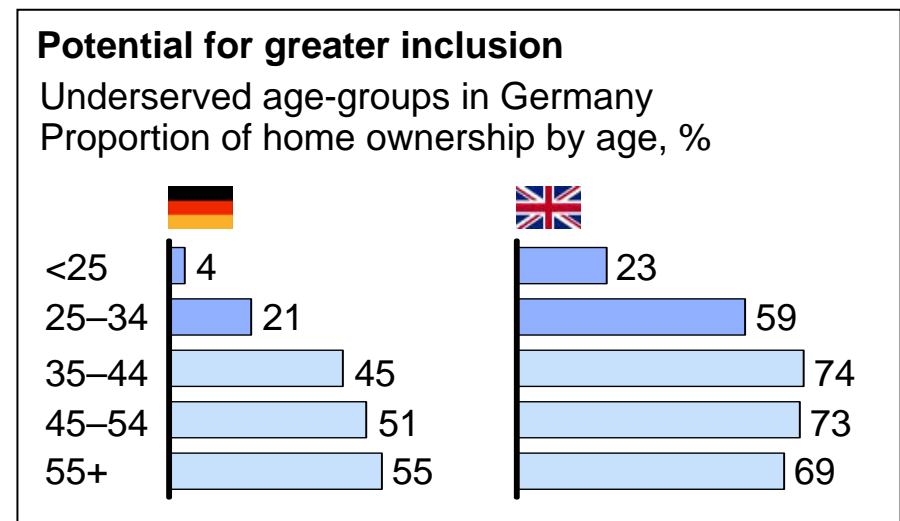
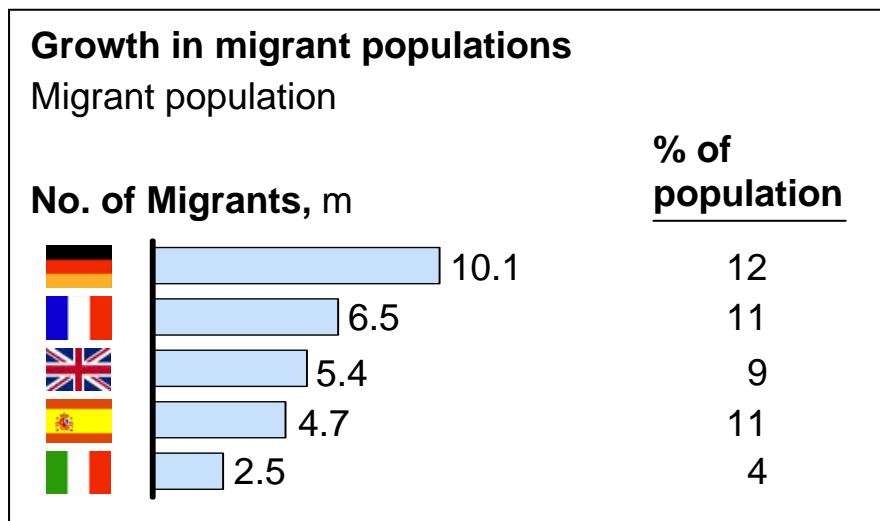
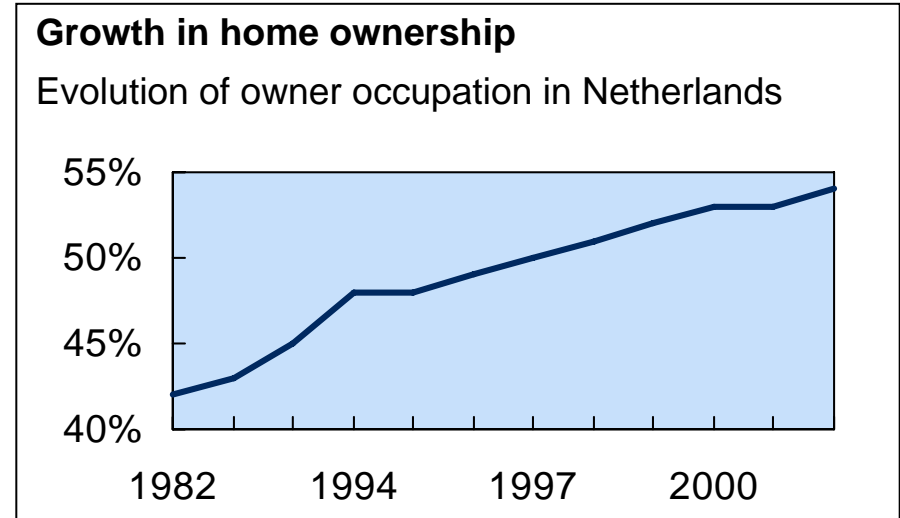
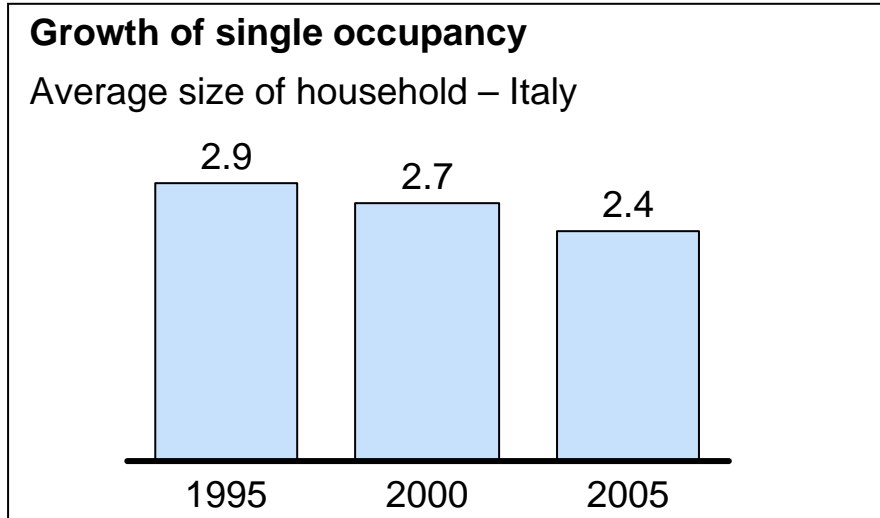


# POCKETS OF POTENTIAL OVERHEATING

Mortgage debt/disposable income, 2006  
%



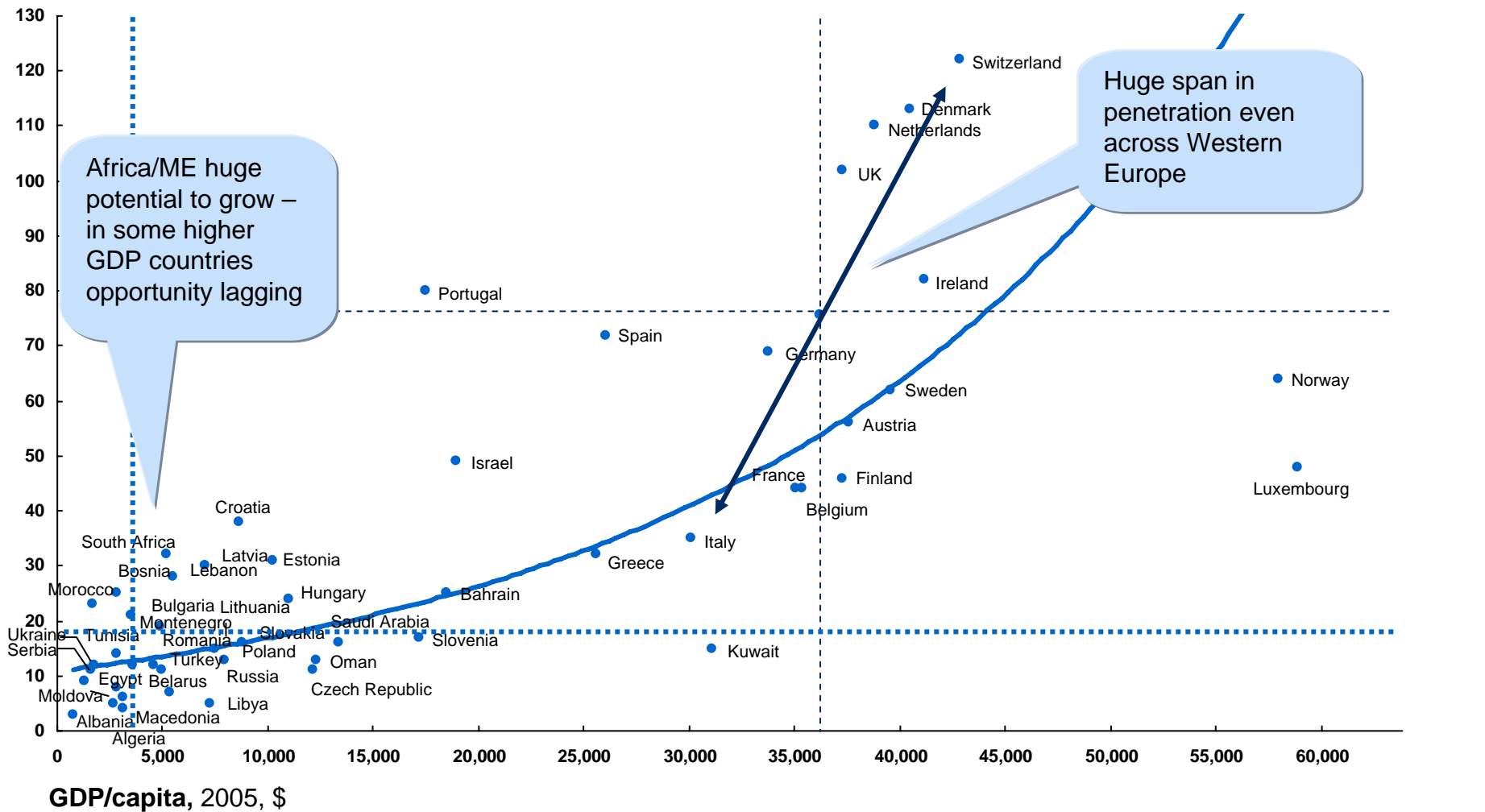
# BUT FUNDAMENTAL 'DEMAND' DRIVERS FOR MORTGAGE STILL POSITIVE IN MUCH OF EUROPE



Source: JP Morgan; OECD; CML; EFIC

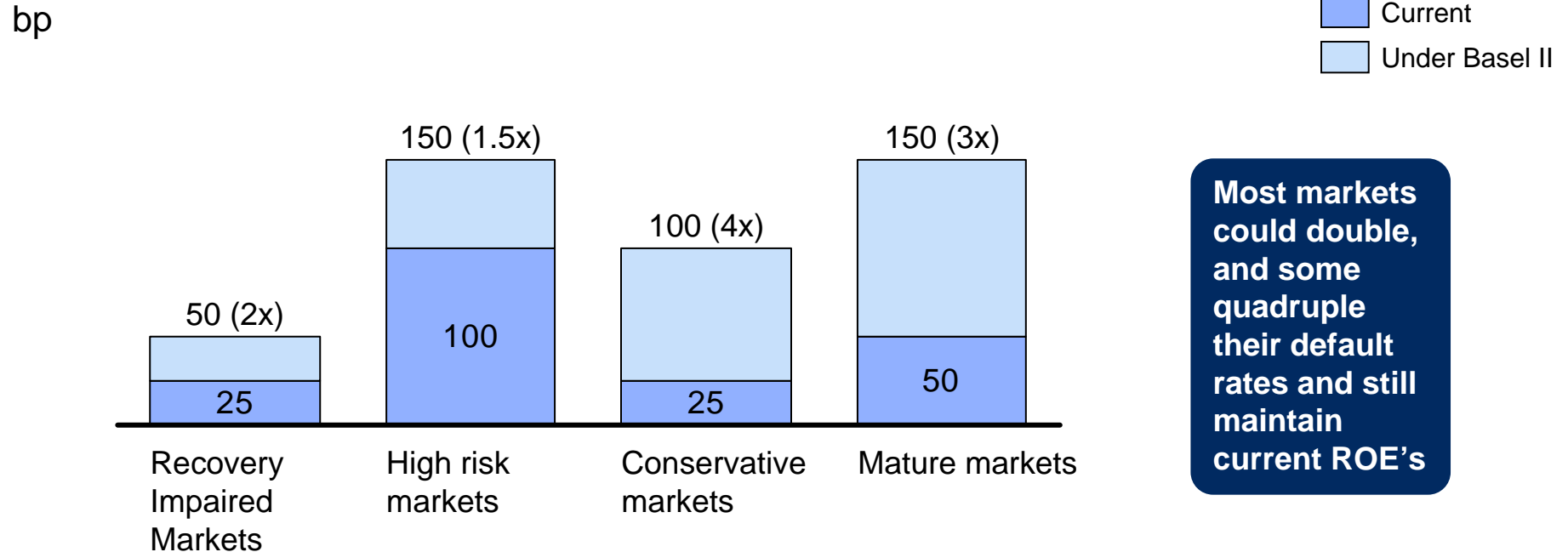
# ... AND BEYOND

**Personal financial liabilities volume/GDP, 2005, %**



## THOUGH HEADING FOR GREATER PRICE COMPETITION

Probability of default to generate current ROEs; Today vs. Basel II (IRB)



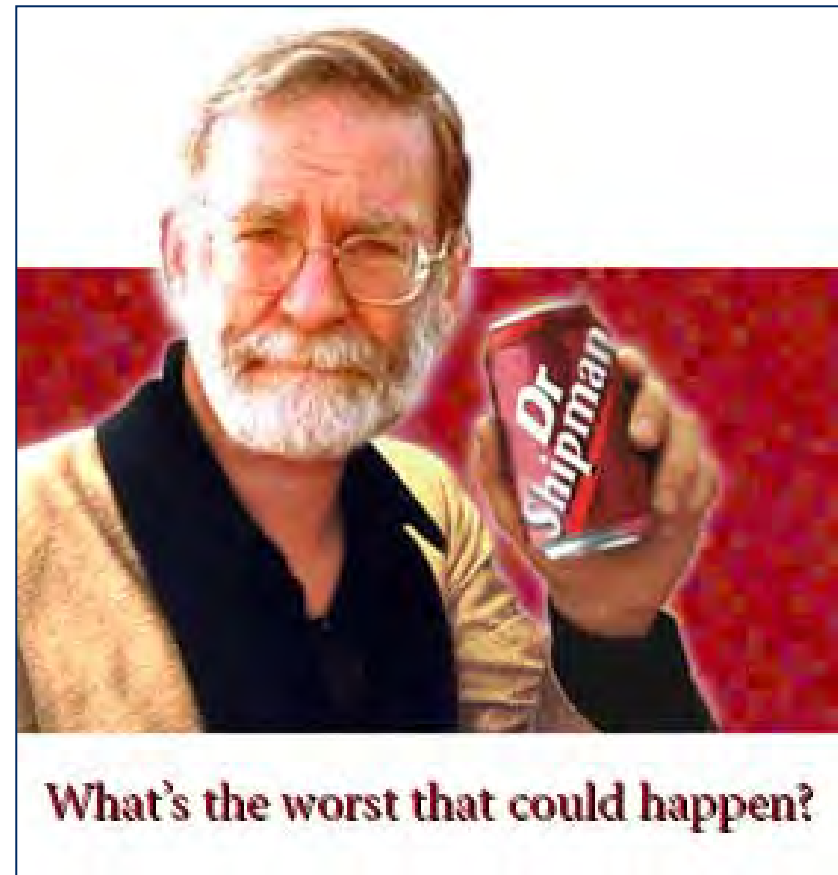
- **Recovery impaired markets** where regulatory restrictions on repossession rates loss-given defaults should be high (e.g., Italy, France)
- **High risk markets and segments**, notably non-standard segments and high LTV/income multiples
- **Conservative markets** with restricted LTV and multiples (e.g., Sweden, Belgium, Denmark)
- **Mature markets** with flexible LTVs and income multiples and high mortgage penetration (e.g., U.K., Netherlands)

Source: JP Morgan; EFIC Analysis

## ...BUT WHAT ABOUT THE NEXT 2 YEARS?

“But this ‘long run’ is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again.”

– J.M. Keynes, 1923



## CRITICAL UNCERTAINTIES

### **US and Global economic outlook**

- Benign 'soft landing' and recovery in 2008
- Early, mild recession in 2008
- Sharper recession in 2008/2009 triggered by actions to control rising inflation

### **Speed of recovery in credit markets**

- Relatively quick recovery in early 2008
- Slow recovery over 12-18 months
- No recovery in structured credit markets

### **Reaction of investors (and regulators)**

- No permanent reaction against the industry
- Irreversible trend away from opaque, complex structures ('vanilla-erisation' of the industry)

## 4 POSSIBLE SCENARIOS FOR THE FUTURE

Bounce back	Steady recovery	The long chill	Late Tackle
<ul style="list-style-type: none"> <li>• Credit and liquidity crunches resolved by end of 2007 with no lasting impact</li> <li>• Consumer confidence remains robust; no spike in default rates</li> <li>• Interest rate cuts prevent slow down without any inflationary effect</li> <li>• Capital markets keep growing in line with long-term growth momentum</li> </ul>	<ul style="list-style-type: none"> <li>• Credit problems take 9-12 months to resolve; U.S. slower to recover than Europe and Asia</li> <li>• Economic conditions remain benign; Fed and ECB steer course between slowdown and inflation</li> <li>• Emerging markets remain stable through 2010; strong growth in Asia to continue</li> <li>• Industry growth falls below trend rate in 2008, but picks in 2009</li> </ul>	<ul style="list-style-type: none"> <li>• US consumer confidence falls due to housing market downturn</li> <li>• Economy dips into a mild slowdown in 2008Q1 with negative growth for at least one quarter</li> <li>• Slight up-tick in default rates hits credit markets; LBO and M&amp;A markets shrink</li> <li>• Further interest rate cuts in 2008Q2, but market takes a year to take off again</li> </ul>	<ul style="list-style-type: none"> <li>• Liquidity supports by central banks successfully bring stability in capital markets</li> <li>• Consumers confidence boosted, and real economy stays healthy</li> <li>• But, heated economy and 'over' liquidity turn into inflation spiral in 2008, leading 2-3 quarters of recession</li> <li>• Capital markets spooked in 2008H2-09H1, then 1.5~2 years of negative revenue growth follow</li> </ul>

# IMMEDIATE PRIORITIES FOR MORTGAGE PLAYERS

1. Re-assess risk appetite; underwriting, liquidity and funding
2. Strengthen collection and recovery capabilities
3. Prepare for cost-cutting, but align with strategy
4. Get closer to your customers (including brokers)
5. Assess how to maintain strategic investments
6. Explore acquisition opportunities, but very cautiously



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**Après le Déluge**



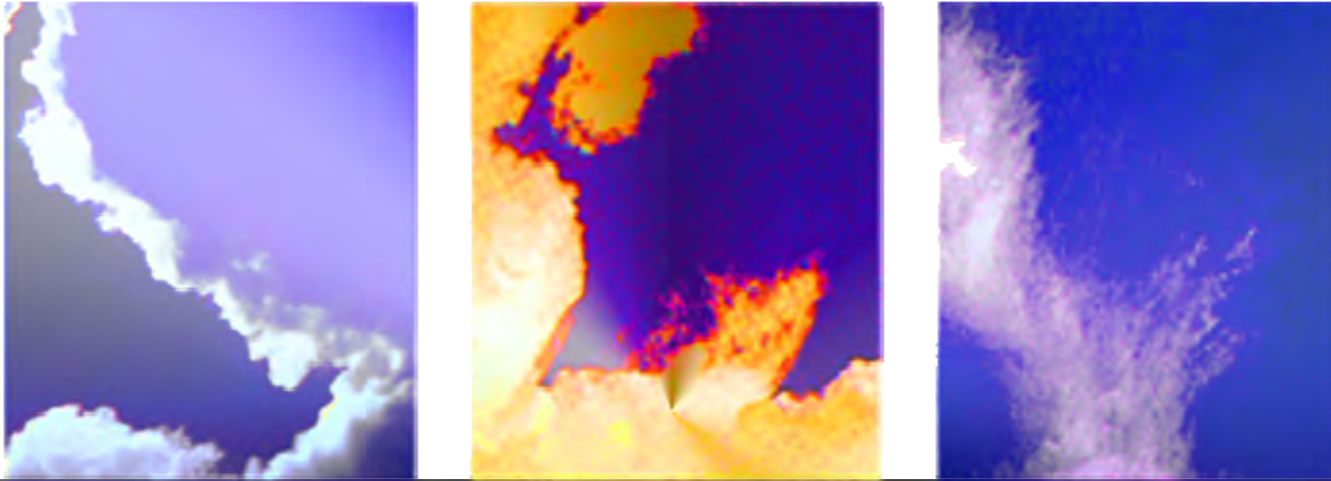
# APRÈS LE DÉLUGE

1. Get serious about operational excellence
2. Innovate around the customer, rather than the financial markets
3. Invest in wholesaling excellence
4. Exploit the convergence opportunity
5. Think cross border



**GOOD LUCK!**





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