Lessons to be learnt from the consumer credit crunch

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Commentators say that the financial crisis is a global one and that it is tightening its grip on the producing economy, initially being triggered by the financial sector.
That much is true.
Commentators also say the financial crisis is a problem imported from the USA.
This is wrong.
There is no stand-alone US financial market with its own secured rules. The money- and capital markets since decades are a complex and internationally interwoven system with huge dependencies among each other. On top of that we find since approximately 15 years a steadily increasing number of investments which promise high returns and create strong leverage effects, foremost in the derivative sector.
Many commentators find that financial crisis and consumer credit crunch are two sides of the same medal.

The price to pay:
An ever increasing loss risk.

The cause:
Many presume the trigger effect derived out of the greediness of the financial institutions.
They are mistaken.
The source of the problem is the greediness for high returns on investments by institutional and private investors alike, the sky high expectations of the so-called shareholders.
It is the greediness in all of us, who were taking it as granted that a return of well above the average interest rate ratio is the normality.
It is not.

The development:
The more the Central Banks of the G10 States tried to regulate the banking- and capital markets towards the end of the 80s the more the financial institutions tried to dodge the consequences of these activities.
The Basel I agreement of 1988 led to regulations forcing banks to hold 8% equity capital in comparison to their assets. The follow up agreement Basel II ruled from 2007 on the following topics:

1. loans had to be connected to the creditworthiness of the customer according to a rigid scoring modus, meaning in effect: attractive conditions for customers of high standing and harsh conditions for the others.
2. a significant tightening of governmental control of the banking sectors dealings
3. strongly increased transparency regulations for banking strategies and dealings

For obvious reasons these criteria have never been implemented in the US. The regulatory approach didn’t fit the system. Deregulation was the credo.
Nowadays – under the impression of the financial crisis and a deep recession – governments worldwide unite in an effort to reform the financial markets globally and bring back confidence between banks and between banks and consumers. An old proverb states: ‘Once bitten, twice shy’. It proves to be very true in the current recession and its consequences hit hard.

Also interesting the activities which have been going on in the European banking community in order to evade the risk minimizing and thus also profit minimizing Basel criteria.
Exactly these fatal coincidences – the disbelief in regulations in the US and an evasion strategy in Europe – were the beginning of the end.

The core of the evasion strategy:
Financial institutions founded so-called ‘Special Purpose Companies’ , SPC’s, in off shore countries like the Cayman Islands, The Virgin Islands or tax havens like the International Financial Services Center of the Dublin Docks in Ireland.
The revenue was taxed with extremely low corporate tax rates and immediately repatriated to the mother companies tax free under the existing double taxation agreements.
What these letter box companies did was a secretive business, way off from inquisitive glances of chartered accountants and government control boards and – best of all – balance sheet neutral.

What do we find after piercing the veil:
High risk activities with evenly high win and loss positions.

Let us for a moment inspect the Asset Backed Securities, meaning property loans secured by mortgages. Millions of these secured loans – the good, the bad and the ugly – were bundled and traded as secured bonds in the financial markets.
The returns proofed to be splendid as long as no real estate crisis emerged.
Since three decades those high risk bonds were deemed as low risk because for three decades real estate knew only one way: upwards. We had a win-win-situation. House owners took loans and were rewarded with an ever growing real estate value.
Then the bubble burst. Or should we say bubbles? In reality we were talking about debts in real estate loans and credit cards debts.
Loans couldn’t be paid, house prices collapsed and our asset backed securities lost their value dramatically.
Even within the banking sector the money lending activities stalled because of a lack of mutual trust. Banks and insurance companies folded and triggered massive state interventions in the financial markets.

The first legal demand:
The creation of an internationally valid financial supervisory system to close down all gaps.

The second legal demand:
Regulations for hedge funds which currently underlie almost no control mechanisms.

Hedge funds moving trillions of dollars have done their share to deepen the crisis.

Long years ago they were initiated to hedge against interest rate and currency risks. In times of investor greed, hedge funds changed to financial monsters, speculating with the additional help of unlimited credits in the stocks-, shares- and currency markets.
In the meantime those aggressive hedge funds were called 'Vulture Funds'.
They invented the so-called 'short selling', where borrowed shares are sold to third parties, believing that they will be falling in value. The fund will buy back the shares at the lower price and return the shares to the lender, paying him a fee.
Massive short selling has brought whole countries to the verge of collapse because hedge funds act speculative and shareholder value oriented only and not any more to secure real business activities.

Let me remind you of the currency speculations of the Soros hedge fund against the British Pound some years back which led to the Pounds devaluation and a multi billion profit for Soros. The English Bank of the Exchequer with its currency and gold reserves to bolster the Pound had no chance against the financial prowess of the fund.
This is a perversion of financial tools and accelerates and deepens the crisis.

First consequences:
In the most important markets, namely the US and Europe, short selling has been stopped as a first measure and the supervision over hedge funds has been tightened. This can only be the beginning of necessary activities.

A third sector of legal hiccups in the wake of the financial crisis is the investment advisory business. By implementing a string of European Regulations in the field of Consumer Protection, consumers rights have gradually been strengthened.
In a protocolled advisory talk the advisor has to fill in a standardized risk profile of the potential investor in order to evaluate whether the investment strategy fits to the investment aims (e.g. a conservative strategy doesn't fit to aspired high returns).
The consumer has to be informed about all risks of the offered financial products and is held to separately sign that he was completely informed and has understood all information.
In future, banks will have to not only offer their own products but give correct information about competing products and their cost structure. The consumer will then be able to find an informed decision.

Which problems do we have with that:
Banks often act as distribution channels of high risk bonds for issuers which were marked with steadily lower ratings by the rating institutions during the financial crisis.
A good example are investment certificates issued by Lehman Brothers, now bankrupt.
Citibank German Branch alone sold in 2008 more than 130.000 Lehman certificates, nominal value of 10.000 € each as a secure investment.
Citibank received a significant kick-back premium from Lehman for their sales performance and each bank advisor a bonus from Citibank for selling those certificates.
This distribution system was not known outside the bank. Customers were left with the impression that their Citibank investment advisor had only their welfare in mind. Today all Lehman certificates value with 'Nil'.
Banks declare that customers were fully informed and thus aware of all risks. The signed protocols would be proof of that fact. Customers - so the banks – were especially informed that certificates were not secured by the deposit guarantee system, and that they legally were bearer bonds which stand and fall with the credit standing of the issuer, carrying the risk of a total loss.

Customers disagree. They feel they have been led astray and ripped of. A recent market survey undertaken in Germany shows that consumer confidence in the integrity of bankers is tending towards zero. Banks thus have started a campaign, called: 'Better loose profits than the consumer's confidence. How to go about it!'

The demand:
The implementation of a reversal of the burden of proof in the relevant laws, burdening the financial institution which should in the future have to proof that they correctly and completely informed their customers.

Bubbles bursting and how do we react?

In a public speech on April 3d , the night before the NATO summit, President Obama appeared on German TV and talked about the US loosing 600.000 jobs a week because of a string of bubbles bursting in the wake of the financial crisis. He said: 'These are bubbles bursting in the face of the consumer'.
Behind his statement the dire facts are

1. A two stage consumer credit crunch: first, companies extended more and more credit to increasingly risky customers without worrying about the ability of their customers to repay loans. Second, the crunch moved from customers with marginal credit ratings to the lenders themselves which started to look like bad credit risks to their financing institutions.
2. Consume now – pay later; 0 % car loans; a set of unlimited credit cards for everybody (starting with minors and ending with the unemployed); low down payments thanks to revolving credit cards; generous retailer customer cards with easy credit functions. All this triggers overborrowing with the well known effects.

What is happening now:
The subprime-mortgage crisis puts its squeeze on the consumers in the credit-card market. With home equity dried up, consumers are piling-up credit card debt resulting in a sharp rise in delinquencies.

The result:
Credit-card lines are cut dramatically. Applicants for credit cards are turned away in huge numbers. Households with a patchy credit history find themselves blacklisted. Credit card limits are reduced and cash advances are in many cases not longer possible. All this means that credit cards as cash-flow management tools are virtually rendered worthless and the new approach of 'responible lending' unintentionally harms consumer confidence, spending and the overall economy.

The way to react:
Meredith Whitney, CEO of Whitney Advisory Group summarized correctly by saying: 'While rationalizing of lending is unavoidable, what needs to be avoided is taking credit away from people who have the ability to pay their bills'.
Let us see where a responsible and balanced tightening of lending standards, a reducing of credit lines withou a hint of hysteria and enhanced collection efforts which are not choking consumers into non-existence will lead us.

Dear audience, these were just a few problem zones blossoming from the global financial and consumer credit crisis. They will pester us for some years and need to be tackled quickly.

Thank you for your attention.