EDITORIAL

The subprime crisis

The US subprime mortgage loan market is currently undergoing a sharp correction. Subprime lending, which started in the United States in the 1990s, involves granting mortgage loans to customers with a weak credit history or poor creditworthiness (as opposed to traditional customers, known as "prime" or "A-rated" borrowers). This market has expanded rapidly in recent years, with annual issuance totalling between USD 500-600 billion per year since 2004. The total volume of subprime loans written in the United States is estimated at around 13% of total outstanding mortgage loans, or USD 1,300 billion.

Over the past five months, the subprime sector has been hit by major shocks. Around 20 specialised lenders have gone bankrupt. As a result, the UK bank HSBC, active in this sector through its US subsidiary (previously Household International), had to very substantially increase its loan-loss provisions in the second half of 2006 and the first half of 2007, leading to its first ever profit warning. A number of hedge funds, including those of the US investment bank Bear Stearns, which held large-scale investments in the sector, defaulted, as they failed to meet margin calls or satisfy customer withdrawals.

Markets are now wondering what repercussions these events will have. In this respect, a number of factual observations can be made.

On the US market, subprime loans have been transferred from originators' balance sheets to special purpose vehicles (e.g. residential mortgage backed securities – RMBS), which are themselves often repackaged into collateralised debt obligations (CDOs). There is uncertainty as to whether these vehicles themselves will be impacted or whether they will be able to absorb the shock. We observe at present that CDO issuance has come to a virtual standstill and that a number of these series of securities backed by subprime loans have been downgraded or placed on negative credit watch. Investors remain very cautious on all CDO segments and in particular those whose underlyings may have similar characteristics to those of subprime paper.

As regards continental Europe, the market is different and has no equivalent of the US subprime industry. One possible way that contagion might spread would be through direct or indirect holdings by European banks and collective investment undertakings of securities backed by subprime loans. To date, available information nevertheless suggests that the amounts involved are sufficiently small so as not to pose an overall risk to the soundness of banks' balance sheets and portfolios. It is possible that the profitability of some of these institutions may be affected, as a significant

part of their income comes from market activities. However, their high level of regulatory capital and overall profitability should enable them to absorb these fluctuations.

Lastly, in terms of more general financial and economic risks, a flight to quality is currently underway along with a certain degree of market nervousness. It should nevertheless be noted that the latter is primarily affecting high-yield securities, while the spreads on investment grade companies and emerging markets remain at historically low levels. By curbing or even halting issuance of CDOs and other risk transfer products, credit market uncertainty makes it more difficult to finance LBO and M&A activity, which partly explains the equity market falls of the past ten days. Likewise, the general rise in risk aversion may have affected high-yield currencies, which are recording significant flows from the carry trade.

The current correction is chiefly hitting the riskiest instruments, whose yields had already reached levels that were too low in view of historical probabilities of default. It can therefore be seen as normal. However, on highly leveraged markets, financial dynamics must be closely monitored. That said, fundamentals remain robust, the profits of companies, banks and other financial institutions high and the outlook for world growth very favourable.