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ASIA/PACIFIC

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November 28, 2007

Downunder Daily

Less Willing, Less Able

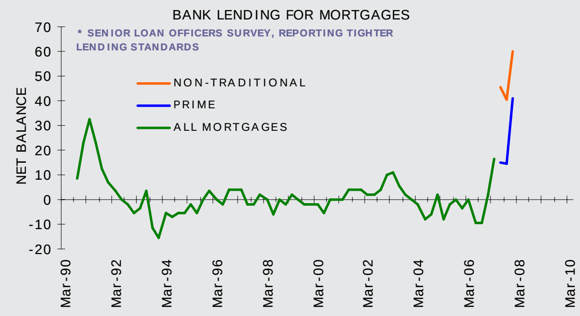
The essence of a credit crunch is lenders being less willing or less able to provide finance. We are seeing both in the US. This arguably matters more than usual, as the household sector, for the first time in 70 years, is running a cash-flow deficit – that is, it needs finance to maintain current spending.

Measuring lenders' willingness to lend is difficult, but the Fed's regular survey of senior loan officers provides a time series of bankers' reported attitudes. It's clear that the past year has witnessed a sea change in bankers' stance, at least regarding housing. Exhibit 1 shows the net balance of respondents who are tightening mortgage lending standards. This net balance measure now surpasses the restrictive readings seen in the early 1990s recession. (To be fair, this is a qualitative measure designed to capture changes; it's not clear whether lending standards in an absolute sense are tighter now than in the early 1990s.)

While banks' willingness to lend seems to be falling, their ability to lend may also be falling. As noted last week (*Accelerating Unraveling*, 23 November), recent write-downs have reduced the scope for the government-sponsored mortgage agencies to expand their lending. Commercial banks are likewise seeing balance sheet capacity eaten up by losses and reintermediation of off-balance-sheet financing. HSBC announced on Monday that it would bring US$45 billion of assets previously held in structured investment vehicles (SIVs) back onto its balance sheet.

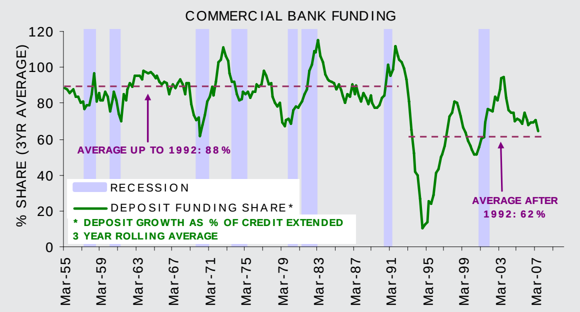
Citigroup may follow suit, according to Betsy Grasek, the head of Morgan Stanley's US banks team (*Quick Comment: SIV Impact on C Tier 1*, 26 November). (Citigroup has announced a $7.5bn capital infusion from the Abu Dhabi Investment Authority. For a comment on that, please see *ADIA Stake Reduces (but Does Not Eliminate) Investment Risk in C, EPS Outlook Still Tough*, Betsy Grasek, 27 November.)

Exhibit 1
Less Willing to Lend



Source: Federal Reserve; Morgan Stanley Research

Exhibit 2
More Dependent on External Finance

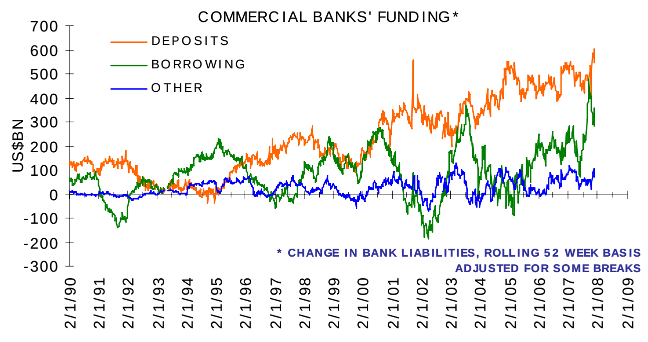


Source: Federal Reserve; Morgan Stanley Research

It's still interesting to assess the impact if Citigroup were to bring its SIV assets back onto the balance sheet. The numbers below, however, take no account of the ADIA investment, which will probably lift the Tier 1 capital ratio by around 59 basis points. If the SIV assets come on balance sheet with no loss and at a 100% risk weighting, Citigroup's tier 1 ratio would fall 44 basis points, to 6.88%, according to Betsy. If there is a 10% loss on the assets, the tier 1 ratio would fall 92 basis points, to 6.40%. At end-2005, Citigroup's tier 1 ratio stood at 9.12%. According to Betsy, Citigroup has the largest exposure to sub-prime mortgages and CDOs in her large cap-bank coverage group. In that sense, Citigroup is an extreme. But it is not unique in terms of the structural issues.

Exhibit 3

A Sharp Rise in Borrowing…



Source: Federal Reserve; Morgan Stanley Research

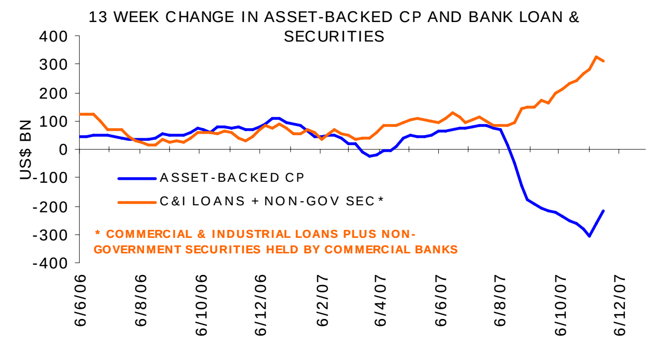
Part of the issue is Western world banks' increasing reliance on external funding to finance balance sheet (loan) expansion. Exhibit 2 shows the material trend decline in deposit funding for US commercial banks. Declining deposit funding and the pursuit of higher returns on equity made off-balance-sheet vehicles and securitization attractive. It also meant that banks have become more dependent on capital markets for finance.

What we are seeing now, however, is capital markets less willing to fund banks' off-balance-sheet vehicles and increasing spreads on loans to banks. Bank lending is accelerating at the margin (Exhibit 3), notwithstanding the higher funding cost, as assets come back (Exhibit 4). Add in write-downs, and capital ratios are being eroded.

For now, banking systems in aggregate remain fairly well capitalized, albeit less so than even a couple of quarters ago. However, it's the trend that is the concern:

Exhibit 4

Coming Back Onto the Balance Sheet



Source: Bloomberg; Morgan Stanley Research

- Funding costs have clearly increased, and are likely to stay elevated for some time, in my view. For example, ADIA is receiving an 11% yield for its investment in Citigroup. Equity capital costs will likely rise as the sector has seen a substantial PE de-rating. US financials are trading on a 12-month forward PE of 11.1, down from 12.7 at the start of the year.

- There remains the possibility of further assets coming back on balance sheet. To take one example, the stock of asset-back commercial paper now stands at $849 billion, down from the early August peak of $1,186 billion, but well above the levels of, say, three years ago (around $650 billion).

- The ongoing decline in market prices of, say, the ABX indexes points to the prospect of further asset write-downs.

Most worrying, this has all occurred against the backdrop of an economy that, US housing aside, remains broadly healthy. These trends would likely accelerate if, as seems likely, growth slows outside housing next year.

Finally, the pinch on banks' ability to lend greatly increases as capital ratios fall towards presumed 'safe' levels. For now, most banks appear willing to take the hit on their capital ratios. But as they approach a certain threshold – say, 6% on tier 1 capital – lenders are forced either to raise capital or to ration credit. A year ago, that prospect appeared very unlikely, but if the trends of the past few quarters continue, it may become an issue for some lenders next year.

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