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for Faith in Economic Life*

Understanding the Credit Crunch

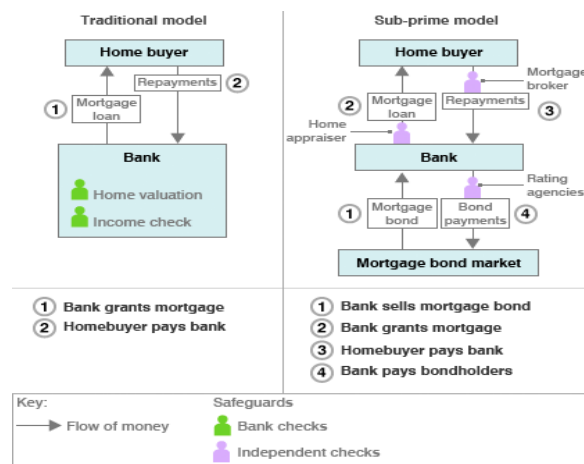
The Financial Inclusion measures you've heard about so far have been developed under extremely benign credit conditions. Interest rates have been low for some time and credit has been easy to come by. Creating wider access to cheap credit and other banking facilities has been one part of a social inclusion programme that has tried to make sure that financial inequalities in society do not result in the creation of a social underclass.

The credit crunch we have witnessed in recent months, however, has created a much harsher environment. Finance is still relatively cheap, in terms of interest rates, but it is much harder to come by, leaving people struggling to rollover the debts they already have. Some borrowers, for instance, are discovering at the end of their cheap initial fixed rate that their lender wants them to remortgage with another bank . . . if another bank wants them, which is not always the case! The credit crunch is also contributing to a developing recession which means that higher unemployment and lower incomes will cause more people to default on loans. Repossessions are therefore likely to rise. People will become more desperate - the most vulnerable more so than others. In that sort of environment, loan sharks and other predatory lenders are likely to thrive.

What is a credit crunch?

A credit crunch describes a time in the financial markets when credit dries up. The banks regard lending to each other as an inordinate risk and so refuse to do so, or do so at penal rates of interest. Other people also refuse to invest in the banks by not buying their bonds. The whole financial system, the flow of money round that system, becomes jammed up. It would result in banks defaulting on their loans to each other, or to third parties, if the central bank didn't provide liquidity to the system, which is what has been happening on a grand scale just recently. The Bank of England, The Federal Reserve and the European Central Bank have been lending to the banks because no one else will. So what's the problem?

The crisis originates with the mortgage markets. In recent years, the banks have found new ways of lending to people wishing to buy a house whilst removing the risk of a person defaulting on a mortgage from their own balance sheets. In essence it worked like this (with thanks to the BBC business website):



The new model of lending made credit both cheap and easy in such a way that people who would previously have been turned down for a mortgage were able to get one. In some senses this sub-prime lending is a sort of financial inclusion, introducing the aspirational poor to “home ownership” for the first time with the attendant feeling of wealth that emerges as house prices increase. And, of course, with demand for houses rising as a result, the housing market felt like a one way bet! It also allowed people who had previously had mortgages to borrow more than they would otherwise have done, in part because the banks had been able to set to one side the responsibility for checking whether or not their clients were good risks. Many turned a blind eye to people self-certifying their own incomes because on the new model of mortgage lending, as above, the risk would ultimately not lie with the lender. Mortgages were turned into bonds for sale to third parties with the approval of risk rating agencies which were less independent than they ought to have been since they were paid by the banks whose bonds they were issuing.

The mortgage bond market in the United States, for instance, now stands at \$6 trillion, almost 25% of the whole bond market. Investors in those bonds include other banks, pension funds and private investors. Once the housing market turned in the United States, home owners began defaulting on their mortgages and people realised that mortgage bonds were not going to be worth as much as they had thought. Because banks had also found ways of holding mortgage bonds off their balance sheets, another problem emerged - no one knew who was holding the bad bonds. The result is that banks are suspicious of each other and will not lend to each other for fear of the borrower having hidden liabilities.

What we do know is that the financial sector has already written off \$500bn of losses as mortgage bonds have fallen in value, that it has only managed to raise two thirds of that figure in new capital from shareholders, and that there may be another \$1trillion of losses to account for. That shortfall is another reason why the banks cannot lend to other people - they need whatever spare money they can find to shore up their own finances.

In addition to providing liquidity to the system, Central Banks have also recently had to act to stop financial institutions going bankrupt for fear that the whole financial system will collapse. (Remember that the United States and the United Kingdom both have their economies heavily

constructed round finance). The Fed and the Bank of England are having to work out whether simply to give loans to institutions that are essentially reasonably profitable, as with the insurer AIG (whose problem was insuring mortgage bonds against default), and on what terms. Or whether to let a bank go bust, as with Lehman Brothers. Or whether to persuade a more solid bank to take over a more vulnerable one, as with Lloyds TSB merging with HBOS. Or effectively nationalising a bank - as with Northern Rock, and in the US with Freddie Mac and Fannie Mae.

What are the implications for Leeds?

Ultimately these global issues are affecting life in little Leeds, West Yorkshire. Like the UK as a whole, our local economy is heavily dependent on financial services. We only have to think of HBOS, Yorkshire Bank, Yorkshire Building Society, Skipton Building Society, and Bradford and Bingley. The credit boom inflated not just house prices, but the finance industry itself which is now too big to be profitable. It will have to become smaller quite quickly in order to make profits in the future. Inevitably jobs will be lost in the financial sector. Employment in finance in Leeds is not of a high value technical order, but is of a low end processing / operational nature - which is where the cuts tend to come.

In addition, there is a knock on for other businesses closely linked to finance - some of the legal services offered in Leeds specialise in finance. And since the roots of the financial crisis are in property, construction also will suffer, which again has been a major employer in Leeds.

The consensus is that the UK economy will now suffer a fully fledged recession, in part built around the credit crunch. Unemployment, one feature of recession, is already running at 5.5%, its highest level for nine years - a fact that has gone relatively unnoticed with everything else that's been taking place. But the trend is upwards and unemployment is one of the more earthed ways of assessing the health of the economy.

So how bad are things likely to be? Most people do not take seriously Alistair Darling's suggestion that the situation is worse than any for sixty years, though things have worsened since he said it. It is difficult to envisage a return to rationing as in the 1940s, a 3 day working week as in the 1970s, or 25% inflation and 3 million unemployed as in the 1980s. That said, even before the most recent bout of instability in the markets, the UK was the only one of the major seven economies reckoned to be heading for recession. In addition, the pound is down 15% in the last year and inflation will be twice its permitted target by Christmas at 5%. House prices have declined by 11% in a year and, as I indicated earlier, unemployment is heading upwards at increasing pace. Things are not good.

Ordinary people in Leeds will find it harder in coming months to keep up their mortgage payments, pay off their credit card bills and keep up payments on their personal loans because of stagnating incomes and rising prices. Unemployment will make those things even more difficult. And because the banks are tightening up their practices, there will not be any easy options for people who are struggling. If credit is hard to come by and people are desperate, the door stands open to predatory lenders taking advantage.

The news is not necessarily all gloom and doom. Once the Bank of England is convinced that inflation is under control, it's likely that interest rates and thus mortgage rates will come down, making monthly payments on houses more affordable. But even then, on a longer view, one of the outcomes of a scaled down finance sector is less banks, less competition and less competitive rates. And while we are looking to the more distant future, the crisis is also likely to adversely affect all our pension funds, the majority of which are likely to be holding at least some mortgage bonds. Even the least risky mortgage bonds have lost 20-40% of their value in recent months. Our elderly may well end up retiring on less than they thought, have to work longer, or may have to top up their provision for retirement in other ways.

It all sounds a little bleak. But this is the environment in which we will increasingly be working over the coming months, even years, and these are some of the issues that members of our communities are likely to be facing. It is possible that some of these problems are beginning to surface for the agencies that are working most directly with vulnerable people. We may find out more from Dianne who heads up the Leeds Citizens' Advice Bureau and from Susan Docherty at St Vincent's Support Centre...