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**How The Economy In  
The US Became Less  
Than Prime**

SFU Engineering  
October 3<sup>rd</sup>, 2007  
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THIS KIND NEVER MISSES.

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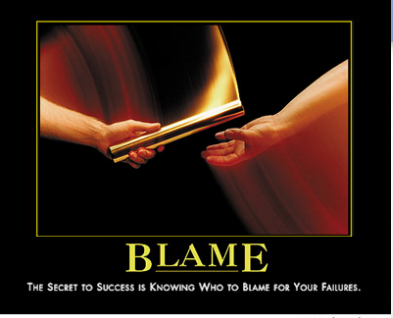
August 2007 – Evidence That Something Is Wrong

- Dow Jones Closes July 19<sup>th</sup> at 14,001 and August 16<sup>th</sup> at 12,845
- A drop of almost 10%!
- Blame immediately heaped on Sub-prime Mortgage Lenders and their mounting defaults

▪ What does that really mean? How does that translate into a 10% drop in the value of the biggest companies in the US? They don't take out mortgages?




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**BLAME**

THE SECRET TO SUCCESS IS KNOWING WHO TO BLAME FOR YOUR FAILURES.

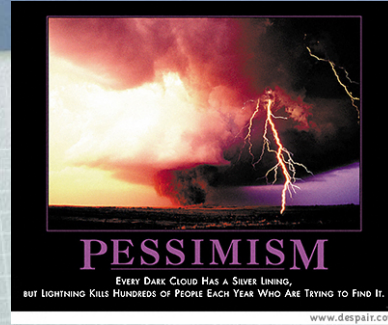
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## What is a Sub-Prime Mortgage Anyway?

- \$400,000 mortgage at 3.0% (less than prime) over 25 years
  - \$1850 monthly payment for first year
- At current rates for a 4 yr term, interest rate jumps to 6.2%
  - \$2600 monthly payment for next four years
- Ouch! \$800 more after tax is a lot every month
- When interest rates were low, this was a way for people who don't own homes to get a mortgage



## Financial Markets as a Casino

- UBC Financial Professor Emeritus, Maurice Levy
- Complicated web of very smart people creating more complicated ways to make money
  - Derivatives
  - Hedge funds
- Rocket Scientists on Wall Street and Bay Street
- Make the complicated web into a simple metaphor
  - Never precise, but fun to try



## The Characters

- Pinstripe Pete
  - The banker with the big banks (think Citibank)
  - Controls the lending of money from the largest hundred million dollar loans to the smallest \$10K loans
  - Lends to businesses direct, but mostly lends through financial engineers (private equity, hedge funds)
  - Very conservative, looking for prime rates of return (5%) in safe bets
  - Use large amounts of money and don't default on loans
  - Driven by fear of default, not successful upside returns



## The Characters

- Ernie Equity
  - Private Equity fund manager
  - Controls hundreds of millions of dollars given to him by pension funds, insurance companies and banks
  - Looking to invest in takeovers mainly, but will take large ownership positions in private companies or utilities
  - Equity investor, not debt
  - The consummate financial engineer... always looking to deal and make his stock worth more and sell the position
  - Leverage up his money with Pinstripe Pete
    - Buy 51% of company for \$200M
    - Invest \$50M of equity and \$150M of debt
    - Company can afford the interest + principal payments



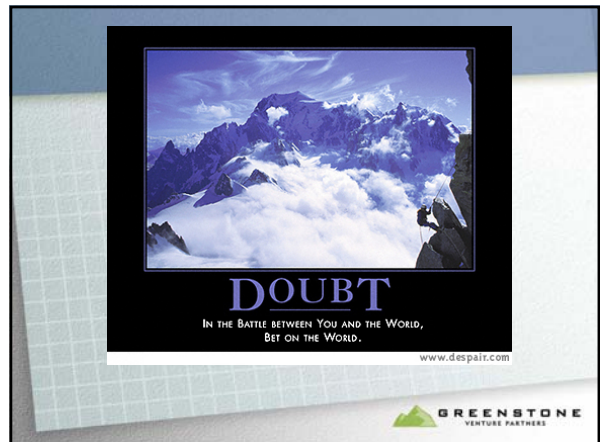
## The Characters

- Corporate Carol
  - Either in a company or representing a company (advisor)
  - Issues company debt (think Telus, for example)
  - Friends of hers then trade the debt moving the price around
  - Can alter return rate of the paper to achieve successful raise of capital and price
  - Higher rate of return needed (junk bonds)
  - More risky than Pete and Ernie
  - Less interested in returns as she is in fees
  - As an advisor, might also buy and hold personal mortgages



## The Characters

- Slick Dick
  - Our mortgage broker
  - Selling the consumer mortgages and turning around and selling mortgages to Carol-like folks
  - Only interested in fees, not in the well-being of his clients
  - Saw new sub-prime mortgages as way to boost business which was slowing after years of low interest rates and re-financing
  - Got very excited and started selling \$1M mortgages or so-called "Jumbo-loans", which Carol backed
  - Overselling the sub-prime is where we start our story



### The Situation 6 Months Ago

- Dick is making a fortune in fees, handing out “time-bombed” cheap mortgages
- Carol is floating corporate debt and having trouble getting great prices, because the returns stink (low rates). So she is also securitizing and selling mortgages and “jumbo-loans”
- Ernie is so busy he doesn't sleep. They are using cheap debt to fuel a historic number of buyouts
- Pete is happy that all of his lending business is improving. He doesn't fret over the price of his debt as he is the top of the debt food chain. As long as he is making the spread on lending vs. borrowing he is happy



### The Casino Rolled On...

- Dick was playing high stakes unlimited bet poker
- Carol was at the high minimum Blackjack table
- Ernie was playing the best odds at the craps table
- Pete was playing the nickel slots, but was putting in a few million nickels
- Then the interest rates went up as the economy started to slow



### Time To Fold – The Risk Has Changed

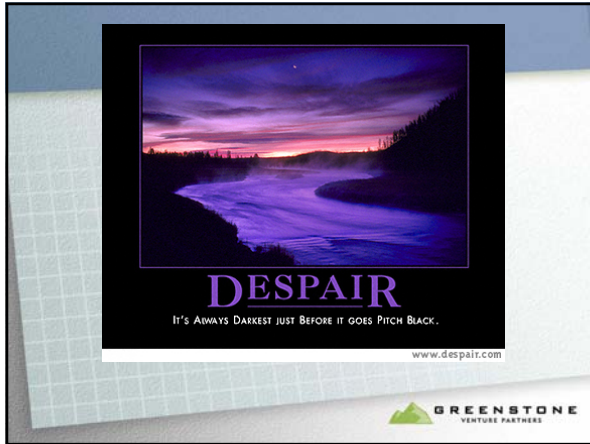
- Dick was happily playing along, oblivious to the signs of dread in interest rates
- The FBI has shown up at his office as hundreds of his customers started defaulting on their loans and started blaming him and his promises
- Dick turns pale and runs out of the casino calling his lawyer
- Carol's Blackberry starts buzzing as angry buyers of the defaulting jumbo loans see their cash flow disappearing. Her corporate customers are now suddenly weary as buyers clam up.
- Carol suddenly wants to go hide in a dark room



### Time To Fold – The Risk Has Changed

- Ernie watches Carol and Dick leave and wonders if he is OK, after all, he is an equity guy, not debt
- His iPhone rings. Deal flow is slowing. The big lenders are not leveraging their deals as they re-assess risk. The prospect of doing smaller deals means smaller returns... not good for his investors
- Pete is left alone. Suddenly he isn't putting anymore nickels in the slots. He picks up the house phone, calls the owner of the casino and says “shut it all down”. He owns the mortgage on the casino after all.
- Over in the corner, Ravi cleans up the suddenly empty casino and chuckles to himself. The US casino is closed, but there is plenty of work in India and China. He'll catch the next flight out.





### Summary

- The financial markets are so tightly linked in today's world, that a disaster in a seemingly un-related sector will ripple through the entire market
- Similarly, globalization means that all countries are affected, but not to the same extent as the troubled area
- Today we have bounced back, but the troubles remain and the casino is closed due to the lack of appetite for risk

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### Thank You

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