

From Liquidity Crisis to Credit Crunch

Observations of Washington Mutual Vice Chair William A. Longbrake

In December 2007, William Longbrake the Vice Chair of Washington Mutual Incorporated offered his perspectives on the developing situation in the Capital Markets. An attentive crowd of professionals, academics, and students listened intently to his observations. Dr. Longbrake has spent over 20 years at Washington Mutual serving as the bank's CFO Chief Enterprise Risk Officer. In 2001, he was named the CFO of the Year in the Driving Revenue Growth category by CFO Magazine. Dr. Longbrake described the components of a credit cycle, as well as the aspects that may amplify its effects. From there he focused on the current liquidity crisis and the potential risks that may cause a credit crunch.

The ingredients of a credit cycle were enumerated in the following areas. Collective action as Dr. Longbrake described leads to a degradation of standards with each new entrant into the market. The availability of cheap money and leverage is also vital to the progression of a credit cycle as witnessed by the boom in hedge funds. Furthermore, changes in technology, market structure, law and regulation all have a significant effect of the duration and extent of the credit cycle. The five steps that a cycle goes through are: 1. Up cycle where supply begins to lag demand; 2. Financial Accelerator effect in which rising prices bring further demand; 3. Tipping point at which the rise in price begins to decrease demand; 4. Supply begins to exceed demand; 5. Financial accelerator exacerbates the falling prices and continues to decrease demand. These five steps are prevalent in most cycles the difference lies in how accentuated the cycles become.

In applying the aforementioned model to the Residential Housing Cycle, Dr. Longbrake mentions several particular drivers. It generally takes a house 2 years to go from the conception to the actualization stage, therefore the lag between demand and supply is fairly great. In addition, affordability in the housing market is determined by house prices and interest rates which were the predominate drivers of this cycle. Factors that amplified the housing cycle are extremely important to understanding its growth: The availability of capital from developing nations looking for returns in the U.S. in connection with a large credit deficit; The advancements in securitizations, specifically with regards to Collateralized Debt Obligations (CDOs); Basel Bank Accords incentives towards off-balance sheet vehicles for lower capital charges; and the boom in unregulated brokers driven solely by commissions on loans issued. When combined these effects drove housing prices higher and accentuated the standard credit cycle. Rate of increase on real home prices rose from a historical average 1.25% per year for the 25 years prior to this period to over 40% per year in the most recent years.

Dr. Longbrake breaks down the current liquidity crisis into several rounds, highlighting that there has been a tightening of underwriting standards not only in prime residential loans, but also in commercial business loans. This leads him to raise several risks that have the potential to aggravate the current problem. This situation will be the first true test of Sarbanes Oxley in a distressed environment and may lead to further regulation. In addition, the effects of FAS 157 and 159, regarding level three assets whose values are based on assumptions will be tested. Of particular note is the reliance

upon credit ratings and the potential effects of downgrades to guarantee companies that have wrapped approximately \$2.2 trillion in debt.

The overall message focuses on the dangers of the liquidity crisis becoming a credit crunch. In which, the availability of credit disappears and the prices for the scarcely available continue to increase. A scenario in which no one wants to be overly vulnerable to further development and becomes even more conservative with the capital they have. Dr. Longbrake raises an important conclusion regarding the housing market and potentially other credit sectors. The creation of a new model, as opposed to the old originate-to-hold model in which the risk creation and the risk bearer were always very close to each other. In the recent format, there is the appearance of an originate-to-distribute model that while currently flawed and in need of regulation is nevertheless here to stay.