Credit crisis claims another bank

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The collapse of the market in US subprime mortgages has claimed another European victim. On Friday it was announced that SachsenLB, a bank owned by the German state of Saxony, had to be bailed out to the tune of 17.3 billion euros ($23.3 billion).

The rescue was organized by a group of Germany's most powerful savings banks after SachsenLB's investment conduit, Ormond Quay, was unable to raise funds because of its American subprime mortgage exposure.

"The ongoing market disruption in selling asset-backed commercial papers resulted in there being doubt on securing funding for the Ormond Quay conduit," SachsenLB declared in a press statement.

The SachsenLB bailout follows the financial rescue earlier this month of the 84-year-old IKB Deutsche Industriebank, after its affiliate, Rhineland Funding, was unable to sell commercial paper because of its exposure to investments based on US mortgages.

The IKB bailout was organized through the German bank regulating authority, BaFin, which warned that, had the bank gone under, Germany could have faced its worst financial crisis in 75 years. IKB is believed to have an exposure of 17.5 billion euros ($24 billion) to US subprimes and could lose up to one fifth of its investments.

The demise of the IKB and SachsenLB investment conduits is the outcome of two factors: a downturn in profitability in the German economy in the first half of this decade, and the attempt to overcome the problem through the development of new financial mechanisms based on American practices, and promoted by US-based credit rating agencies.

Five years ago, IKB was a small bank providing long-term finance to the so-called Mittelstand, a cluster of soundly based, but relatively small German companies. In 2002, at the urging of credit ratings agencies, IKB moved to counter a fall in profits by diversifying from lending to the Mittelstand firms and turning to investments in financial markets. The vehicle for these new operations was Rhineland, which was set up so that it could borrow from investors in both the US and Europe.

Rhineland's profits were derived from the difference between the interest rates it paid on its commercial paper issues and the return on its purchase of bonds. Rhineland expanded rapidly. In September 2003, it held 4.8 billion euros in debt. By January 2006, its holdings had expanded to 9 billion euros.

The credit-rating agencies were pleased. In December 2006, Moody's Investor Services praised IKB for its efforts and noted: "IKB has over the last few years been successfully diversifying its business activities by expanding outside Germany." Just nine months later it was to be at the very centre of potentially the biggest financial crisis since the dark days of 1931.

The history of SachsenLB, one of Germany's state government-owned Landesbanks, reflects the operation of the same "free market" forces. The Landesbanks pursued a business model based on their ability to secure the highest credit ratings due to their government backing.

Higher credit ratings meant they paid lower interest rates on their borrowings than their commercial rivals. So the Landesbanks were able to undercut their rivals in the issuing of loans.

Their business model, however, was undermined four years ago by the insistence of the European Union that the German government end its indirect subsidies and institute, instead, a "level playing field." The EU's decision, which came into effect last month, has forced the Landesbanks to undertake riskier ventures.

The impact was particularly hard on SachsenLB, which saw its credit rating downgraded to BBB+, the lowest of any bank. An article published on this development in the *Financial Times* on July 15 noted that bankers had emphasized at the time that “no immediate crisis is looming.” Just over one month later, SachsenLB has been bailed out, and no one can be sure it will be the last such institution.

The same concern is being expressed around the world in the wake of the turmoil that gripped global financial markets last week. Despite initial upbeat assessments following the US Federal Reserve’s intervention to cut a key interest rate on Friday, serious questions are beginning to be posed.

In a comment published in the *Washington Post* on Sunday, Edward Chancellor, an editor with the financial commentary service Breakingviews.com, took issue with the conception that the economy “will trundle along just fine, regardless of what happens on Wall Street.”

He wrote: “It’s true that some panics pass without consequence. But there are times—think October 1929—when the tremors on Wall Street anticipate a more widespread economic storm. Given the tremendous run-up of debt in recent years, there’s a good chance that today’s credit crunch will turn out to be more than just a wisp of cloud in an otherwise blue sky.”

Chancellor challenged the claim by US Treasury Secretary Henry Paulson that the recent market turbulence would have little impact—a view based on the assumption that the credit crunch was “merely a passing liquidity” event. There was a good chance the current credit panic could become something more, because it resulted from the collapse of a previous property boom.

“I believe that something profound has happened in recent weeks,” he concluded. “The credit system is losing its, well, credibility. People no longer trust the triple-A ratings that many complex debt securities carry. The risk models used by rating agencies, hedge funds and banks have also come under suspicion. The effects of subprime losses are being felt in unexpected places, including supposedly impregnable money market funds. Hedge funds and other highly leveraged investment vehicles are being forced to unwind. After years of excess, credit is beginning to contract.”

Well-known *Financial Times* columnist John Plender expressed similar views in a comment published Saturday. According to Plender, it would take more than a rate cut by the Federal Reserve to halt the crisis. Plender disagreed with the views of the “optimists” that the subprime mortgage market was too small to inflict serious damage on the financial system.

“The trouble with this cheery view,” he wrote, “is that the crisis is about much more than the subprime mortgage market. There has been a systematic deterioration in credit quality as a result of financial innovation. Banks now routinely sell their loans, which are then packaged into all manner of complex products designed to satisfy investors’ demand for income at a time when yields on virtually all investments have fallen to very low levels.”

It was “too early to say” whether the credit crisis would bring a US and global recession, but something more than Friday’s interest rates cuts by the Fed would be needed to “keep this financial show on the road.”

While it is not possible to make exact predictions, some conclusions can already be drawn from the unfolding crisis. During television coverage of the market slide, one commentator noted that a Brazilian bank seeking credit had been asked whether it held any “American debt”—the implication being that if it did, it would receive no finance. Such events are taking place around the world—a measure of both the historic decline of American capitalism and the destabilizing impact of its demise on the global capitalist economy as a whole.

Ten years ago, when the so-called Asian financial crisis was erupting, the former US Federal Reserve Board chairman Alan Greenspan hailed the virtues of the “free market” American model over the system of regulated or, as he dubbed it, “crony capitalism.” A decade on, it is precisely this American model that has precipitated a global crisis.