

The Subprime Sequel

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Where has a decade gone?

It was in 2006 that I first started reading, and then writing, about the impending problem in the [US subprime lending market](#).

While the terms 'subprime' and 'adjustable rate mortgages' (ARMs) get a knowing nod these days, back then you were greeted with a look that said 'and which planet are you from?'

Prior to detonation, subprime lending was a time-bomb ticking away in plain sight. Obviously, the lending institutions and the Federal Reserve could not — or did not want — to see what was staring them in the face.

Lending (in fact, it would be better described as 'giving') money to people who had little or no chance of ever repaying that loan was always a disaster waiting to happen.

Adjustable rate mortgage lending was the timer on the lending bomb...in the old days we called these 'sweetheart or teaser' loans.

The borrower is enticed into loan with a low (teaser) rate for a period of time (one, two or three years for example). When the sweetheart period finished, the loan rate would be adjusted to commercial terms.

To make a bad situation worse, in many cases the loans were capitalised (increased) with the difference between the teaser rate and the commercial rate. In fact, these less-than-creditworthy borrowers ended up with a higher loan amount when the rate adjusted upwards.

Back in late 2006, website [The Mortgage Lender Implode-O-Meter](#) was brought to my attention.

According to the site:

'ML-Implode.com was created in late 2006 to raise the alarm about the then-burgeoning implosion of the historically-epic housing and economic bubble. Started as a modest web page created by founder Aaron Krowne, this objective was achieved by, uniquely, tracking the in-progress implosion of independent mortgage lending companies — then being ignored by a mainstream media in denial of even the existence of the housing bubble.'

ML-Implode became regular daily reading for me.

Every week the number of insolvent lenders kept rising. As clichéd as it is, it was literally like watching an impending train wreck. Yet, at the same time, the Fed was making statements to the effect of 'Subprime crisis? What subprime crisis?'

There is no greater certainty of an event happening until it is officially denied.

This trip down memory lane was triggered by another reference I received: [Pension Tsunami](#).

This is from the site:

'The oncoming wave of public pension debt is even bigger than it seems. The purpose of this website is to provide an overview of the multiple pension crises that are about to drown America's taxpayers. Our primary focus is on California, but we also track other states, corporate pensions, social security and international trends.'

The parallels between subprime lending and US pension plans are eerily familiar.

The mathematics of the problem and official denials are echoes of 2007.

But there is one major difference.

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Subprime Lending and US Pension Problems

The impact of this problem will have long lasting and much deeper economic consequences for the global economy.

Back in the good old days of jobs for life, economic growth rates of 4% per annum, lower life expectancies, risk-free investment returns (from US government bonds) of 5% or more, government and corporate employers offered retirement pension plans to their employees.

Pensions were the 'carrot' to 'go the distance' with the employer.

The retired employee is paid a percentage of their final average salary indexed to CPI for life (and, in the event the pension recipient pre-deceases their spouse/partner, there's a pro-rata pension paid to the surviving spouse for his or her life). In these days of ultra-low interest rates, pensions are like gold.

So what's the problem?

Pension funds are mathematical nightmares.

For example, if you have a fund with 20,000 members, how do you calculate the life expectancy of each member and their spouse?

What is the long term CPI expectation?

How do you calculate what each member's likely final average salary will be?

The people who make these calculated guesses are called actuaries.

In simple terms, let's say all 20,000 members are retired and, on average, each member receives \$35,000 per annum.

That's a pension commitment of \$700 million per annum.

How much money in the plan do you need to meet this annual commitment?

Well, that depends on prevailing rates of return.

If interest rates are 7.5%, somewhere north of \$10 billion is required...because you'll need to put some money back into the fund to cover future CPI payments.

However, if rates are 2%, the fund needs at least \$35 billion.

That's a pretty big difference...\$25 billion.

This example assumes the actuaries are being conservative and using the risk-free rate of return to determine the amount needed to meet the fund's pension commitments. But that's not what's happening in the real world of official denial.

Let's say the fund does have \$10 billion. The actuaries have been using the 7.5% rate of return in their calculations to make it appear that the funds are solvent and can meet their commitments.

While the US share market has been performing well in recent years, getting this level of return has been achievable...but not sustainable. Why? Because, in spite of what industry myth-peddlers tell you, markets actually do go through cycles.

Anyway, back to the disaster in waiting.

This is a line from Reuters on 30 March 2017:

U.S. | Thu Mar 30, 2017 | 9:21pm EDT

CalSTRS unfunded liability grows under new returns expectation

[\[Click to enlarge\]](#)

This is an extract from the article:

'The California State Teachers' Retirement System (CalSTRS) announced on Thursday that its funding level had dropped and its unfunded liability had increased, following a drop in the fund's expected investment returns.'

'The public pension plan voted in February to lower its annual expected return rate from 7.5 percent to 7 percent by 2018. As a result, CalSTRS unfunded liability grew to \$97 billion from \$76 billion, and its funding level dropped from 68 percent to nearly 64 percent.'

There's the deception in plain sight...the pension plan voted to reduce the *expected* return from 7.5% to 7%. Spare me. You cannot tell the market what you *expect* the return to be...it will be what it is going to be. Talk about grand delusions.

In light of this adjustment to the *expected* return, the fund has only 64% of the amount required to meet its currently-known obligations.

What happens if the *real* and obviously *unexpected* return is well below 7%? What if it's in the negative? Markets can, and do, have that effect on portfolios.

With subprime, the rate was adjusted up; with pension plans, it needs to be adjusted down. There's a beautiful symmetry and irony in this situation.

As the Reuters article pointed out:

'Lower returns over time have a compounding effect, requiring states and cities to put more money into pension systems.'

Once you are on the slippery slope of lower returns, the funding shortfall becomes a yawning chasm.

Here's the scary part.

In 2007 it was estimated that US pension plans were unfunded by US\$292 billion. The current unfunded estimate is US\$1.9 trillion...and that's based on *expected* returns that are divorced from reality.

To come anywhere close to the expected return, pension funds have been forced to increase exposure to shares.

According to Bloomberg on 24 March 2017:

'Federal Reserve data show that in 1952, the average public pension had 96 percent of its portfolio invested in bonds and cash equivalents. Assets matched future liabilities. But a loosening of state laws in the 1980s opened the door to riskier investments. In 1992, fixed income and cash had fallen to an average of 47 percent of holdings. By 2016, these safe investments had declined to 27 percent.'

In search of returns, funds have exposed 73% to more volatile market forces.

Reuters again: *'During the financial crisis in 2008 and 2009, CalSTRS, like many funds, lost about a quarter of its total value.'*

Ouch.

The gap just gets wider.

The economic implications of this pension crisis are enormous.

After the next — and probably more serious — downturn, how do the funds bridge the unfunded gap?

Increase employer contributions? This means increasing taxes for government funds. And for corporate funds, an increase in contributions means a decrease in shareholder profits (not good for share prices). More taxes and fewer dividends are a deflationary combination.

Decrease pension obligations? Millions of boomer retirees would then need to make significant cutbacks to their life. This spells...deflation.

Or a combination of both. Again...deflation.

Just like subprime lending, this is a mathematical problem working its way to a disastrous solution. *And it's being officially denied as a problem.*

A decade later and it's a case of here we go again.

Although, in my opinion, the *expected* outcome will be far worse, and will linger for far longer, than the events of 2008–09.

Regards,

**Vern Gowdie,
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