

MAKING SENSE OF THE BUILDING AND PROPERTY MARKET IN THE AGE OF THE UNTHINKABLE THE SUBRIME CRISIS, PROPERTY BUBBLE AND THE EXAMPLE OF ICELAND.

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There are four leadership capabilities that all organisations need:

- 1. Sensemaking - interpreting developments in the industry environment;**
- 2. Relating - building trusting relationships;**
- 3. Visioning - communicating a compelling image of the future;**
- 4. Inventing - coming up with new ways of doing things. (HBR's 10 must reads on leadership: In praise of the incomplete leader: Peter Senge et al: February 2007)**

In our Strategic Forums we always focus on contributing to inform these capabilities.

It is always important to try and make sense of the environment using whatever information comes to hand. Particularly useful are strategic conversations with diverse people of various background, expertise, connections and world views. Our Strategic Forum is such a place of assembly for strategic conversations. Our views are routinely challenged and uncomfortable questions are asked, which require analysis and research and invariably culminates in paradigm reinvention and a rich learning experience.

Another way to challenge mindsets is by reading books by writers that think outside the box. There are many such books but they must be read with an open mind in order to see how it can inform, or be applied to a better understanding of the environment or industry.

A classic book in this category is *“The Age of the Unthinkable”* by Joshua Cooper Ramo (2009). In his book Ramo puts forth a revolutionary new model for thinking about – and thriving in – this world of the unpredictable. After all, great historical shifts don't only produce losers. They also create a whole new cast of historical champions, new fortunes and ideas that can endure for centuries. Ramo explains precisely why our current way of thinking, and the policies that result, backfire. Drawing upon history, economics, complexity theory, psychology, human immunology and the science of networks, Ramo describes a landscape of inherent unpredictability – and remarkable possibility. Finding surprising lessons from people as diverse as Silicon Valley titans, relentless Islamic terrorists, legendary spymasters, unconventional physicists and innovative game designers. *The Age of the Unthinkable* reveals a breathtaking new framework for facing the challenges ahead. At a time of change and perpetual surprise, *The Age of the Unthinkable* offers both clarity and hope – hope that the most unthinkable thing of all may be that each of us has the power to save the world.

Fundamental to this way of thinking is the ability to see early and weak signals of change and to translate them to your own environment.

Early on in the book Ramo asks the question:

- ***If we had to think about the nature of our global financial markets all over again, how would we change what we did and did not do?*** (Ramo: 2009: 205).

This question is bound to challenge paradigm blind spots. The Yale historian and political scientist John Lewis Gaddis once observed that the end of the Cold War *“was of such importance that no*

approach to the study of international relations claiming both foresight and competence should have failed to see it coming. None actually did so though.”

And it wasn't just the PhD's who missed the clues. All those Generals, all those spies, all those diplomats – they were just as blind.

The collapse of the USSR is useful for us to study of how the wrong way of seeing can hide the real dynamics of the world, why the end of the USSR stunned the same minds who would later be stunned by 9/11 or **the financial collapse of 2008** and who, I assure you, will be stunned again before long.

Many of our best minds, blinded by optimism and confusion, are using out-of-date and unrealistic models of the world. (Ramo: 2009: 66,67)

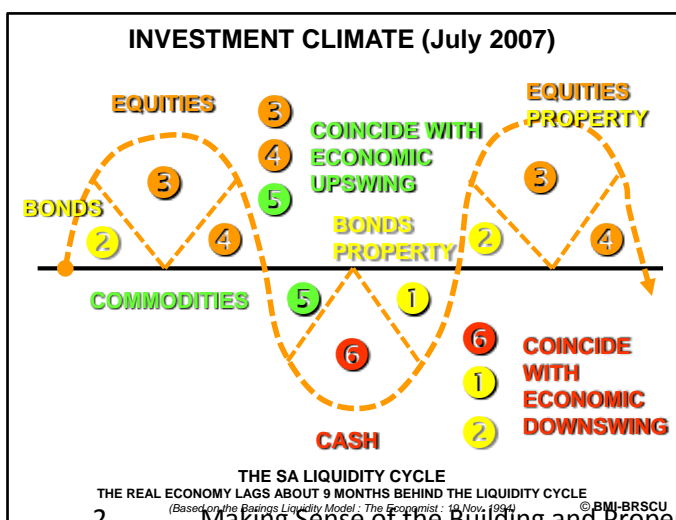
Ramo gives a fascinating account of a certain Investor who developed an acute sense of the value of weak signals of change. One morning in July 2007, the investor Bill Browder woke up in his vacation house in the south of France. It was his habit to write a letter to investors in his \$2 billion Hermitage fund once a month. Hermitage was a fund that invested in one of the most unstable markets in the world – Russia – and Browder's ups and downs there had made him a legend in the world of investing.

Browder's investment model was to buy shares in the most corrupt, worst run Russian companies and then press them to change. Working in Russia over the years had accustomed Browder to the fact that markets could snap in ways that are largely unimaginable. (Ramo: 2009: 55)

In that summer of 2007 Browder's habit of living on his toes, of looking for any sign that the landscape around him was about to avalanche away, drew his attention to a news item in the papers.

In New York an auction of debt from leveraged buy-out deals had failed to draw enough bidders and was shut down.

To most of the investing world this looked simply like a small hiccup in an otherwise well functioning financial system. But Browder recognised it for what it was: a sign that the world had run out of the ability to absorb new debt. It was the end of a Ponzi-like scheme and he knew, the start of an avalanche that might reach a historic, tragic scale.



Almost immediately he began stockpiling cash, reducing his exposure to stocks as much as he could, and moving his investor's money into any safe haven he could find. (Ramo: 2009: 56,57)

It is interesting to note that the (adapted) Barings Liquidity model (Economist: 19 November: 1994) confirms **the preference for CASH** during an economic downswing.

While studying the book of Ramo we asked a number of questions: Who in South Africa will appropriate the role to champion the cause to promote nation-building through home-ownership, property as a preferred investment and building as an engine for growth and wealth-creation?

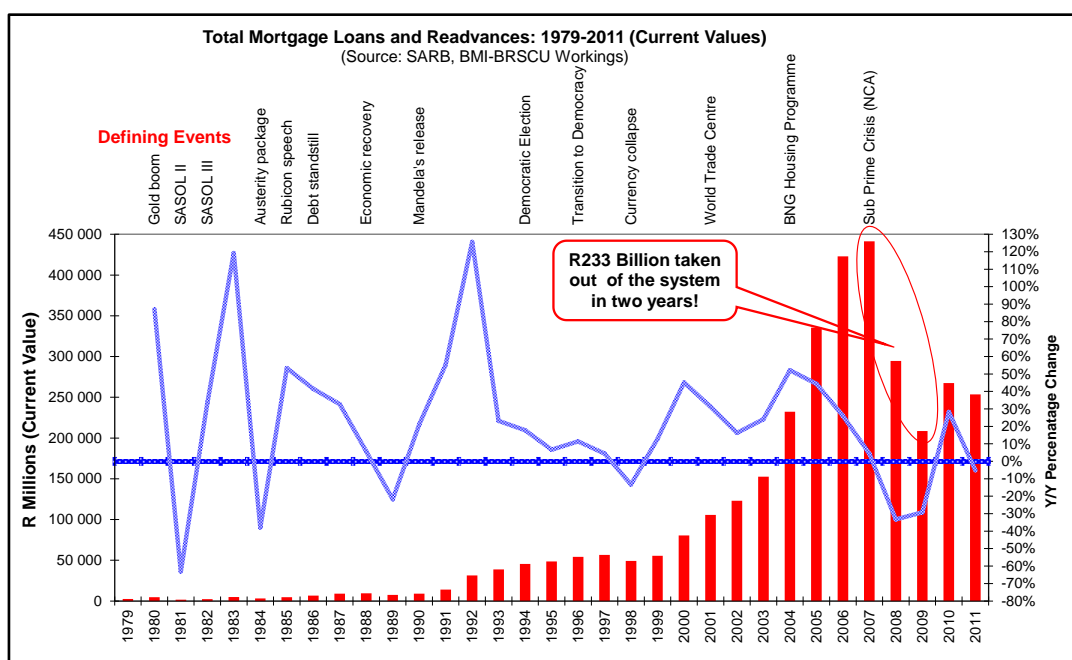
And WHO WILL ADVOCATE THE HOPES AND DREAMS of millions of current and prospective homeowners (and that of an industry that employs over one million people)? Who in the building industry is driving a vision of any description? Is there even a vision at all? Which institutional body or leaders are promoting home-ownership and nation-building and who is promoting property as a preferred investment?

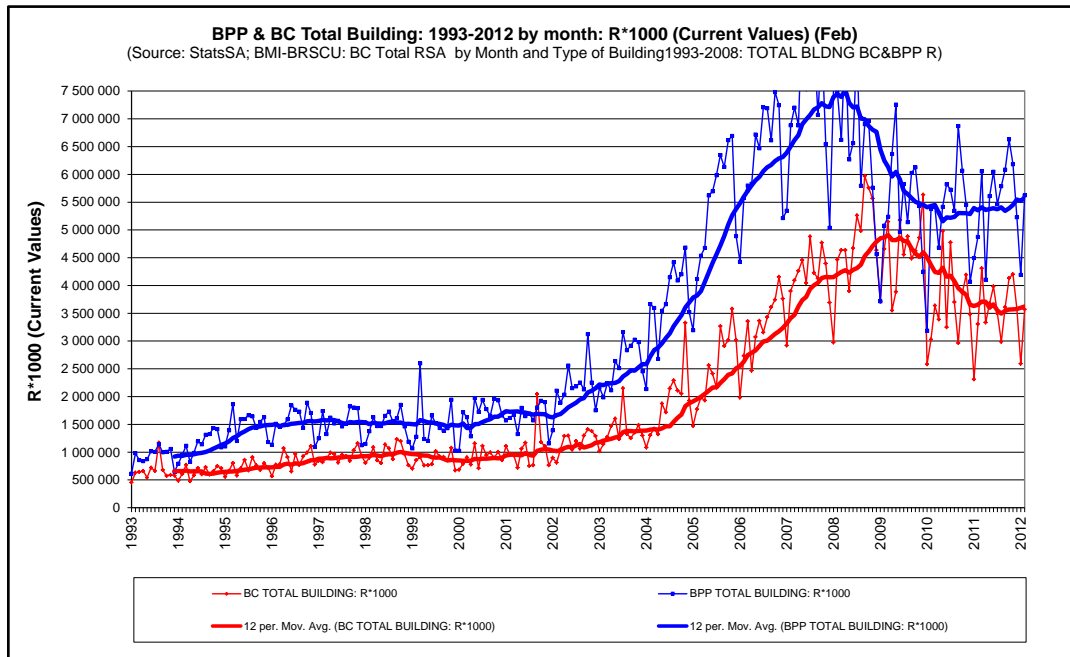
The conclusion is that it is not the Banks. In fact it almost appears as if the Financial Institutions have turned their backs on Property. Their actions since July 2007 have contributed massively to degrading the value of the one main asset of millions of ordinary homeowners. **There is a developing industry view that the Banks have lost their appetite for the Mortgage Market - for long-term investments (or, as they define it long-term debt).** This risk aversion is based on a number of unchallenged paradigm blind-spots (the beliefs and assumptions held in common and taken for granted in an organization and industry). The argument is that it is becoming too risky to finance long-term debt with short-term borrowing. What is not stated is that the average lifetime of a mortgage bond is 5-7 years, and not the 25 years or so for which it is traditionally granted.

There is also the commonly held and propagated view that a Mortgage Bond is Debt (not an investment) and that South Africans are over indebted.

The implication is that our society should become renters rather than homeowners - taking us back to the dark ages. A very easy way to reduce the indebtedness of the nation is to curtail mortgage lending.

As a matter of fact, the reduction in mortgage advances in 2009 vs 2007 was a massive R233 Billion (in current terms), almost wiping out the entire gains of the period 2000-2007 in one fell swoop. It was like falling off a cliff - as one developer remarked.

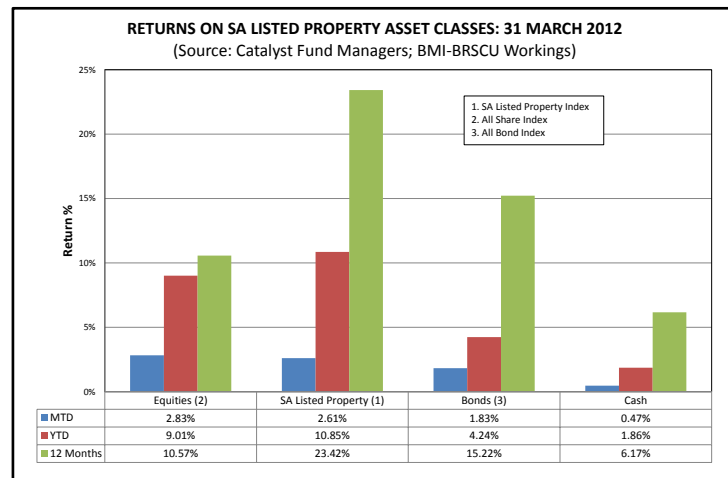




Of course it is also very evident that credit card debt, motor vehicle financing and other financing of durable goods is far more profitable than mortgages. Thus the easy target is to reduce mortgage lending and thus to reduce the outstanding debt of the nation - whilst of course "laughing all the way to the bank" in increasing other forms of profitable debt to take up the vacuum.

In South Africa the Private Sector is still hoarding cash, much to Government's frustration. Ironically it is precisely at a time when Cash is the least attractive investment of all the asset classes.

Recently Michael Lewis, an economist who has written several best-sellers released another book (Boomerang: 2011). It also focuses on an analysis of the global financial crisis informed by conversations with a diverse group of people that not many would regard as having a huge contribution to make.



What surprised again in this book are the similarities of the boom and bust cycles from different countries all over the world. The similarity with South Africa is very evident – in particular the decline in property values (and BPP, BC, Mortgage Advances et al). That there are lessons to be learnt, and applied to the sense making process is clearly evident.

According to Michael Lewis (Boomerang: 2011) a tiny handful of investors made their fortunes from the collapse of the subprime mortgage market.

Back in 2004, the biggest Wall Street Investment Banks had created the instrument of their own destruction, the **credit default swap** on the subprime mortgage bond.

The CDS enabled investors to bet against the price of any given bond – to short it. It was an **insurance policy**, but with a twist: the buyer didn't need to own the insured asset.

No insurance company can legally sell you fire protection on another person's house, but the financial markets can and will sell you default insurance on another person's investment.

Hundreds of Investors had dabbled in the CDS market – a lot of people had thought, at least in passing, that the **debt fuelled US housing boom was unsustainable** – but only fifteen or so had gone all in, and placed enormous bets that vast tracts of American finance would go up in flames.

One of them was Kyle Bass, from Hayman Capital in Dallas Texas. He made a massive wager against the subprime mortgage bond market, made a fortune and achieved a degree of fame, then warned his old friends at Bear Stearns that they were on the wrong side of a lot of stupid bets. They had no interest in what he had to say ***“You worry about your risk management. We'll worry about ours”***.

By 2008 the subprime mortgage market had collapsed taking Bear Stearns with it.

At this point Kyle Bass's opinion was that the financial crisis wasn't over. But the stakes had increased dramatically. He and his confidantes were no longer talking about the collapse of a few bonds. **They were talking about the collapse of entire countries.**

From 2002 there had been something of a false boom in much of the rich, developed world. What appeared to be economic growth was activity fuelled by people borrowing amounts they probably couldn't afford to repay: by Kyles' rough count, **worldwide debts, public and private had more than doubled since 2002**, from 84 Trillion Dollars to 195 Trillion.

He tried to quantify the debt in relation to Government tax revenues and found:

- Ireland 25 X
- Spain and France > 10 X

He looked for an expert who knew about sovereign defaults and found the leading expert on the subject, Prof Kenneth Rogoff at Harvard University who looked at the numbers and said: ***“I can hardly believe it's this bad!”***

Bass said: ***“Wait a minute. You're the World's foremost expert on sovereign balance sheets. You are the go-to guy for sovereign trouble. You taught at Princeton with Ben Bernanke. You introduced Larry Summers to his second wife. If you don't know this, who does? Who is paying attention?”***

That's when Kyle Bass moved from betting against subprime mortgages to **betting against countries**: In his sights were Greece, Ireland, Italy, Switzerland, Portugal, Spain (and France and Japan)

The Sub-Prime crisis is the name for what is a historic turning point in our economy and culture. It is at its core, the result of a speculative bubble in the housing market that began to burst in the United States in 2006 and has now caused ruptures across many other countries in the form of financial failure and a global credit crunch. (Shiller, Robert J: 2008: 1)

His Investors said: ***“Yeah you got subprime right. But you’re always out there looking for these extremely rare events and so you think they happen more often than they do”***. But said Bass, he didn’t go out looking for these events, he was trying to understand how the world was working. **Once he understood he couldn’t see how any sane person could do anything but prepare for another, bigger catastrophe.**

The irony is that here was an essentially provincial hedge fund manager in Dallas Texas, whose entire adult life has been lived within a few miles of this place. He speaks no foreign languages. He seldom travels abroad. He is deeply patriotic and his biggest philanthropic cause is wounded veterans. He hardly knows anyone who isn’t American.

How did it ever occur to him to start spinning theories about the financial future of these distant countries?

“It was Iceland that got me going. I’ve always been interested in Iceland.”

Even as a young boy, Kyle Bass was interested in Iceland, because of a type of board game called Risk, he used to play. He explained that in the game you could attack any country in the world from Iceland, because of its strategic position. Therefore he tried to find out everything he could about this remote country, and to pay special attention when something happened in Iceland. He discovered that Iceland had a long history of survival against long environmental odds. They kept saying ***“these banks (in Iceland) are out of business”*** and the government kept saving the banks. And right in the midst of this Iceland went broke, and Bass thought ***“Wow that’s interesting. How, after 1000 years of getting things right and overcoming all these natural obstacles, did they get it so wrong?”***

Just after October 6th 2008, Iceland effectively became bankrupt. Lewis spoke to a man from the IMF who had been sent to Reikjavik, to determine if money might be responsibly lent to such a spectacularly bankrupt nation. He had never been to Iceland, knew nothing about the place, and said he needed a map to find it. He had spent his life dealing with famously distressed countries, usually in Africa, perpetually in one kind of financial trouble or another.

Iceland was entirely new to his experience: a nation of extremely well to do (Number 1 in the United Nations’ 2008 Human Development Index), well educated, historically rational human beings who had organised themselves to commit one of the single greatest acts of madness in financial history. ***“You have to understand,”*** he said, ***“Iceland is no longer a Country. It is a hedge fund.”***

In a Nation without the necessary experience of high finance they had looked at Wall Street and thought they could emulate it. For a brief period it looked like they could. In 2003 Iceland’s three biggest banks had assets of only a few Billion dollars, about 100% of the Country’s GDP. Over the next three and a half years the banking assets grew to over 140 billion dollars and were so much more than Iceland’s GDP that it made no sense to calculate the percentage they accounted for. It was, as one economist put it ***“the greatest rapid expansion of a banking system in the history of mankind.”***

At the same time, in part because the banks were also lending Icelanders money to buy stocks and real estate, the value of Icelandic stocks and real estate went through the roof. From 2003 to 2007, while the value of US stock market was doubling, the value of the Icelandic stock market multiplied 9

times. Reikjavik real estate prices tripled. In 2006 the average Icelandic family was 3 times as wealthy as the average Icelandic family had been in 2003, and virtually all of his new wealth was, in one way or another, tied to the new investment banking industry. In the end, Icelanders amassed debts amounting to 850% of their GDP. (The debt-drowned United States has just reached 350%).

When Iceland became a tourist in global high finance and they sat down at the same table with Goldman Sachs and Morgan Stanley, they only had the roughest idea of what an investment banker did and how he behaved – most of it gleaned from young Icelanders’ experiences at various American business schools. So what they did with money probably says as much about the American soul as it does about Icelanders. They understood instantly that finance had less to do with productive enterprise than trading bits of paper among themselves. And when they lent money they didn’t simply facilitate enterprise but bankrolled friends and family, so that they might buy and own things, like real investment bankers.

That was the biggest American financial lesson that Icelanders took to heart: the importance of buying as many assets as possible with borrowed money, as asset prices only rose. By 2007, Icelanders owned roughly fifty times more assets than they had in 2002.

Far from having an innate talent for high finance, Iceland had all the markings of a giant bubble. On September 15, 2008, Lehman Brothers failed and foreigners panicked and demanded their capital back. **Iceland was ruined not by its own recklessness but by a global tsunami.**

In retrospect, there are some obvious questions an Icelander living through the past 5 years might have asked himself:

- Why should Iceland suddenly be so seemingly essential to global finance?; or
- Why do giant countries that invented modern banking suddenly need Icelandic banks to stand between their depositors and their borrowers – to decide who gets capital and who does not:
And
- If Icelanders have this incredible natural gift for finance, how did they keep it so well hidden for 1 100 years?

In South Africa there were also many early signs of change of the looming financial crisis. The July Strategic Forum meeting of BMI Building Research Unit referred to an article carried in the Business Day in early July 2007 warning about global panic following the sub-prime mortgage crisis in America.

Banking Registrar Errol Kruger also saw the crash coming early.

With borrowers starting to default on housing debts in the US, bond markets there and in Europe are trembling. More bad news about sub-prime mortgages could create global panic and our bond market would be affected. (Business Day, 6 July 2007)

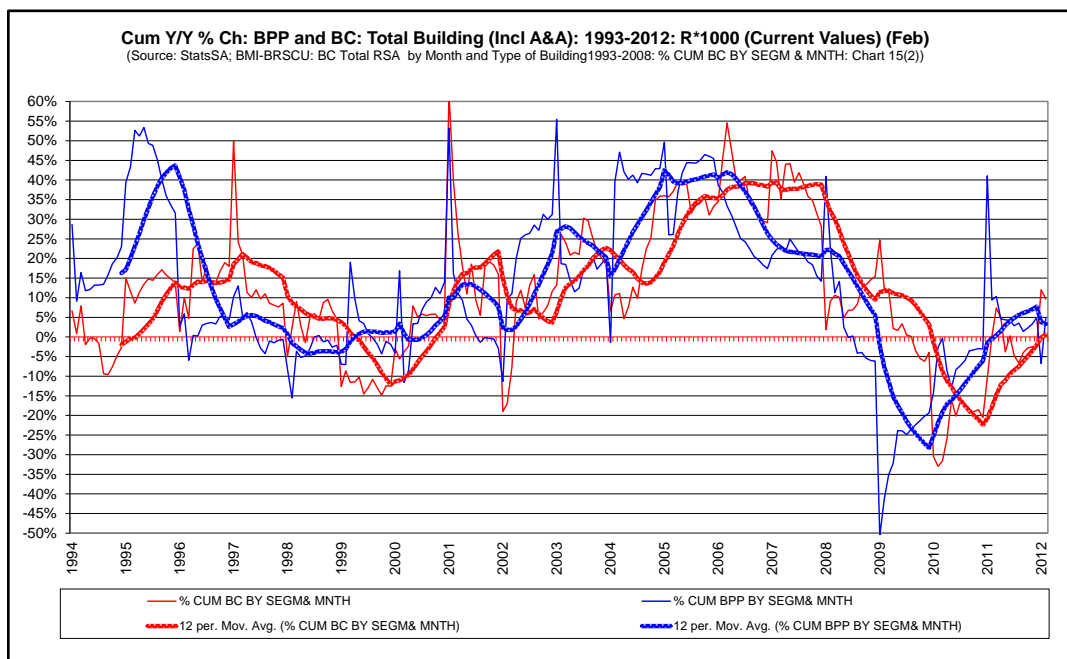
Back in July 2005, when our Banks were enjoying big profits, Kruger called up the CEO’s of the five major Institutions – ABSA, Nedbank, Standard Bank, FirstRand and Investec – and cautioned he will *be “pulling the handbrake”* on expansions and acquisitions. To him, the economy was showing early signs of overheating . . . And he warned that SA’s financial institutions were at stage 7 of the banking cycle and not stage 4 as they thought.

“I didn’t want to be a pessimist, but I told them I could see a crisis coming, and they should expect a tougher stance, and increased activities from my office that are appropriate to stage 7 – activities which they might think are extremely bureaucratic.”

Errol Kruger, who has retired after eight years in the job, admits that he allows himself a wry smile when local bank executives congratulate themselves on avoiding the worst of the fallout from the global recession.

Despite projecting themselves as models of restraint and responsibility, the truth is that if they’d had their way they would have indulged in the same shenanigans that got their international counterparts into such trouble.SA would have been in it up to the eyeballs. (Errol Kruger, Moneyweb, 23 April 2011)

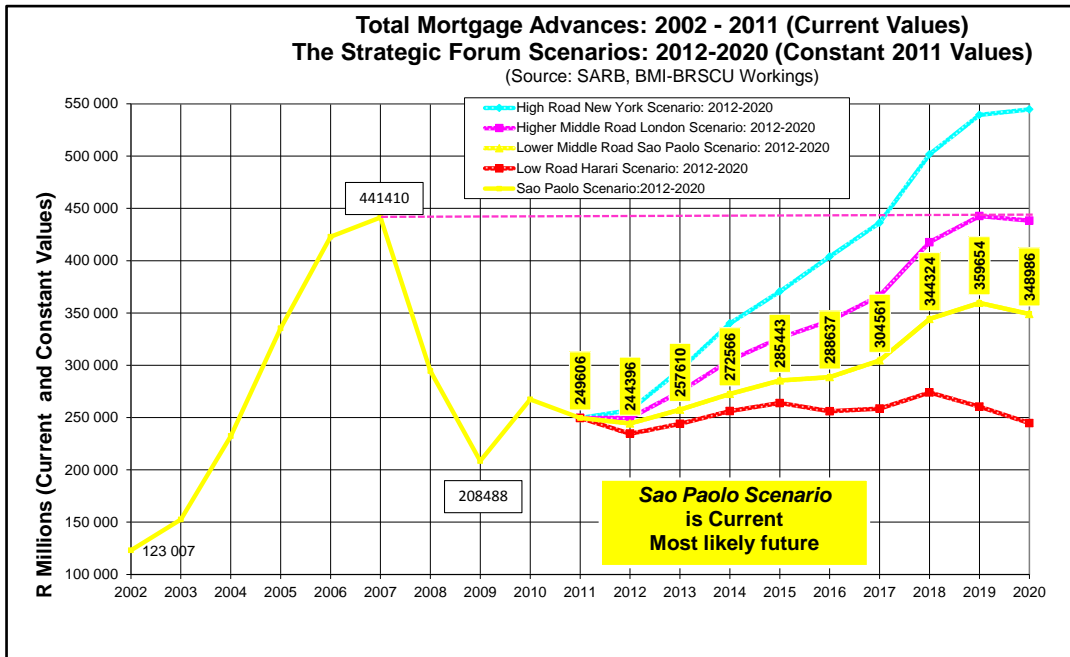
The problem was that the Building Industry was not alert to early signs of change from this quarter. The Banking Registrar was not their listening post. Whether the Banks were prepared for the financial crisis or not is a moot point. However the decision was not theirs to make. The fortuitous introduction of the National Credit Act in 2007 forced the Banks to introduce stricter credit criteria and mortgage advances dropped precipitously, from about R441,4 Billion in 2007 to R208,6 Billion in 2009, a drop of R232,8 Billion.



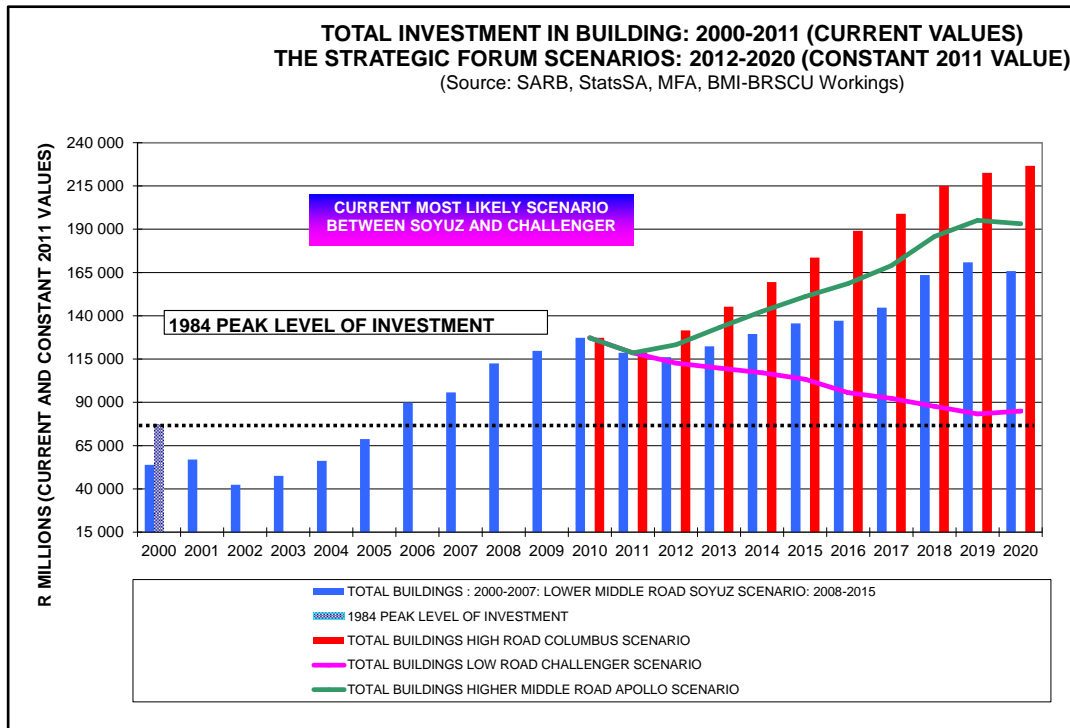
The impact on the Building Industry was equally devastating particularly on BPP and BC. It is doubtful that the Industry thought very much about the impact of the NCA on their livelihood. The strategic response was incremental and after the fact and even with the evidence against any speedy recovery becoming more evident as time passed, the industry was still hoping for better times.

The lesson to be learnt is that the industry must become much more alert to weak signals of change and must adapt their strategies in advance in turbulent times and monitor the environment more regularly.

Under the Upper Middle Road Scenario it could take a decade to get back to the 2007 level of Mortgage Advances.



Investment in Building will have a somewhat better future because only the Residential Private Sector is dependent on Bank Financing with Private Sector Non Residential dependent to a lesser extent. These two sectors together comprise less than 40% of the Total Investment in Building, with the Public Sector, Affordable Housing and unrecorded Additions an Alterations making up the rest.



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