Cass Business School
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Toxic assets were not to blame for the sub-prime fiasco and international banking crisis
Borrowing on the short term money market was the culprit according to new book

So-called "toxic assets" were not the cause of the international banking crisis, despite problems with sub-prime mortgage investments, according to a new book. It was the banks' reliance on the short term 'money markets' to finance their holdings of these securities that destabilised the global financial system.

*The Fall of the House of Credit** by Dr Alistair Milne of Cass Business School, London, examines the banking problems at the heart of the current economic crisis. In almost all cases the senior securities secured on bank loans – such as those from the Countrywide ABS-2006-19, a typical US sub-prime mortgage backed securitisation – were and remain entirely free from risk of default. But as the book reveals an initial loss of confidence in these loan backed securities was enough to trigger a damaging feedback loop, with withdrawal of funds, falling prices and a collapse of trading. This in turn led to the collapse of banks like Citigroup, Northern Rock and Bear Stearns.

Dr Milne says: "Without funding no-one could any longer buy or sell these credit assets and banks could not use them to finance their lending. When confidence in banks and credit assets collapsed so did spending and exports from China and other countries.

"Many experts are talking about the need to regulate banks, but this is not the central issue. The bigger problem is that banks and other financial institutions have the wrong business model. In the past they made profits by renting money from around the world and using this to finance a consumer spending boom. In the future their profits will have to come from collecting savings from customers and raising the long term funds needed to finance business investment. Without this change there will be no sustained recovery and the 'green shoots' will wither away."

Rebuilding the global financial system means we must overcome short term and a long term challenges. The short term challenge is healing this major wound – the lack of confidence in banks and in bank credit products. This makes it extremely difficult for banks to lend and is a heavy drag on economic activity. The long term challenge is to channel the savings needed to finance new and more productive businesses and so maintain long term growth.

* *The Fall of the House of Credit: What Went Wrong In Banking And How To Repair the Damage*, Alistair Milne, Cambridge University Press, 384 pages, hardback, £19.99 published on July 16, 2009.

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Notes to editors:

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