Failing banks, toxic bonds and mortgage laundering

by Mike Whitney via rialator - ICH *Monday, Sep 17 2007, 8:03pm*
international / social/political / other press

The Triumph of Structured Finance

> "The entire global financial structure is becoming uncontrollable in crucial ways that its nominal leaders never expected, and instability is its hallmark. The scope and operation of international financial markets, their "architecture", as establishment experts describe it, has evolved haphazardly and its regulation is inefficient — indeed, almost nonexistent. Banks do not understand the chain of exposure and who owns what: senior financial regulators and bankers now admit this." Gabriel Kolko "An Economy of Buccaneers and Fantacists"

"Ben Bernanke, the Federal Reserve chairman, is like a man who, after spending a lifetime playing with train sets, finally gets to drive the real thing - only to find it hurtling towards the edge of a cliff." U.K. Observer

By now, you've probably seen the photos of the angry customers queued up outside of Northern Rock Bank waiting to withdraw their money. http://news.bbc.co.uk/2/hi/uk_news/6998507.stm The pictures are headline news in the UK but have been stuck on the back pages of US newspapers. The reason for this is obvious---the same Force 5 economic-hurricane that just touched ground in Great Britain is headed for America and gaining strength on the way.

This is what a good old fashioned bank run looks like---the likes of which we haven't seen since the Great Depression. And, just like 1929, the bank owners are frantically trying to calm down their customers by reassuring them that their money is safe. But—human nature being what it is---people are not so easily pacified when they think their hard-earned savings are at risk. The bottom line is this: The people want their money---not excuses.

But Northern Rock doesn't have their money and, surprisingly, it is not because the bank was dabbling in risky subprime loans. Rather, NR had unwisely adopted the model of "borrowing short to go long" in financing their mortgages just like many of the major banks in the US. In other words, they depended on wholesale financing of their mortgages from eager investors in the market, instead of the traditional method of maintaining sufficient capital to back up the loans on their books.

It seemed like a nifty idea at the time and most of the big banks in the US were doing the same thing. It was a great way to avoid bothersome reserve requirements and the loan origination fees were profitable as well. Northern Rock's business soared. Now they carry a mortgage book totaling $200 billion dollars.

$200 billion! So why can't they pay out a paltry $4 or $5 billion to their customers without a government bailout?

It's because they don't have the reserves---and, because the bank's business model is hopelessly flawed and no longer viable. Their assets are illiquid and (presumably) "marked to model"---which means they have no discernible market value. They might as well have been "marked to fantasy"---it amounts to the same thing. Investors don't want them. So Northern Rock is stuck with a $200 billion albatross that's dragging them under.

A more powerful fiscal-tsunami is about to descend on the United States where many of the banks have been engaged in the same practices and are using the same business-model as Northern Rock. Investors are no longer buying CDOs, MBSs, or anything else related to real estate. No one wants them whether they're subprime or not. That means that US banks will soon undergo the same type of economic gale that is battering the UK right now. The only difference is that the US economy is already listing from the downturn in housing and an increasingly-jittery stock market.

That's why Treasury Secretary Henry Paulson rushed off to England yesterday to see if he could figure out a way to keep the contagion from spreading.

Good luck, Hank.

It would interesting to know if Paulson still believes that "This is far and away the strongest global economy I've seen in my business lifetime", or if he has adjusted his thinking as troubles in subprime, commercial paper, private equity, and credit continue to mount?

SECURITIZATION: Is it really just Mortgage laundering?

For weeks we've been saying that the banks are in trouble and do not have the reserves to cover their losses. This notion was originally pooh-poohed by nearly everyone. But it's becoming more and more apparent that it is true. We expect to see many bank failures in the months to come. Prepare yourself. The banking system is mired in fraud and chicanery. Now the schemes and swindles are unwinding and the bodies will soon be floating to the surface.

"Structured finance" is touted as the "new architecture of financial markets". It is designed to distribute capital more efficiently by allowing other market participants to fill a role which used to be left exclusively to the banks. In practice, however, structured finance is a hoax; and undoubtedly the most expensive hoax of all time. The transformation of liabilities (dodgy mortgage loans) into assets (securities) through the magic of securitization is the biggest boondoggle of all time. It is the moral equivalent of mortgage laundering. The system relies on the variable support of investors to provide the funding for pools of mortgage loans that are chopped-up into tranches and duct-taped together as CDOs (collateralized debt obligations). Its madness; but no one seemed to realize how crazy it was until Bear Stearns blew up and they couldn't find bidders for their remaining CDOs. It's been downhill ever since.

Structured Finance: The new market plumbing springs a leak

The problems with structured finance are not simply the result of shabby lending and low interest rates. The model itself is defective.

John R. Ing provides a great synopsis of structured finance in his article, “Gold: The Collapse of the Vanities”:

“The origin of the debt crisis lies with the evolution of America's financial markets using financial engineering and leverage to finance the credit expansion.... Financial institutions created a Frankenstein with the change from simply lending money and taking fees to securitizing and selling trillions of loans in every market from Iowa to Germany. Credit risk was replaced by the "slicing and dicing" of risk, enabling the banks to act as principals, spreading that risk among various financial institutions..... Securitization allowed a vast array of long term liabilities once parked away with collateral to be resold along side more traditional forms of short term assets. Wall Street created an illusion that risk was somehow disseminated among the masses. Private equity too used piles of this debt to launch ever bigger buyouts. And, awash in liquidity and very sophisticated algorithms, investment bankers found willing hedge funds around the world seeking higher yielding assets. Risk was piled upon risk. We believe that the subprime crisis is not a "one off" event but the beginning of a significant sea change in the modern-day financial markets.” (John R. Ing “Gold: The Collapse of the Vanities”)

The investment sharks who conjured up “structured finance” knew exactly what they were doing. They were hyping dog-pelts as fine mink and selling off them to anyone foolish enough to buy them. They were in bed with the ratings agencies----off-loading trillions of dollars of garbage-bonds to pension funds, hedge funds, insurance companies and foreign financial giants. It’s a swindle of epic proportions and it never would have taken place in a sufficiently regulated market.

MAKING THE CASE FOR ECONOMIC PREEMPTION

The Bush administration needs to come to grips with the “systemic” problems of the current market-model and act fast. When crowds of angry people are huddled outside the banks to get their money; the system is in real peril. Credibility must be restored quickly. This is no time for Bush’s “free market” nostrums or Paulson’s soothing bromides (We think the problem is “contained”) or Bernanke’s feeble rate cuts. This requires real leadership.

The first thing to do is take charge----alert the public to what is going on and get Congress to work on substantive changes to the system. Concrete steps must be taken to build public confidence in the markets. And there must be a presidential announcement that all bank deposits will be fully covered by government insurance.

The lights should be blinking red at all the related government agencies including the Fed, the SEC, and the Treasury Dept. They need to get ahead of the curve and stop thinking they can minimize a potential catastrophe with their usual public relations mumbo jumbo.

U.S. BANKS: Waiting for the storm-surge

Last week, an article appeared in the Wall Street Journal, “Banks Flock to Discount Window”. (9-14-07) The article chronicled the sudden up-tick in borrowing by the struggling banks via the Fed’s emergency bailout program, the “Discount Window”.

WSJ:

“Discount borrowing under the Fed’s primary credit program for banks surged to more than $7.1 billion outstanding as of Wednesday, up from $1 billion a week before.”

Again we see the same pattern developing; the banks borrowing money from the Fed because they cannot meet their minimum reserve requirements.

WSJ: “The Fed in its weekly release said average daily borrowing through Wednesday rose to $2.93 billion.”

$3 billion.

Traditionally, the “Discount Window” has only been used by banks in distress, but the Fed is trying to convince people that it’s really not a sign of distress at all. It’s “a sign of strength”.

Baloney. Banks don’t borrow $3 billion unless they need it. They don’t have the reserves. Period.

The real condition of the banks will be revealed sometime in the next few weeks when they report earnings and account for their massive losses in “down-graded” CDOs and MBSs.

Market analyst, Jon Markman offered these words of advice to the financial giants:

“Before they (the financial industry) take down the entire market this fall by shocking Wall Street with unexpected losses, I suggest that they brush aside their attorneys and media handlers and come clean. They need to tell the world about the reality of their home lending and loan securitization teams' failures of the past four years -- and the truth about the toxic paper that they've flushed into the world economic system, or stuffed into Enron-like off-balance sheet entities -- before the markets make them walk the plank.”….” Since government regulators and Congress have flinched from their responsibility to administer "tough love" with rules forcing financial institutions to detail the creation, securitization and disposition of every ill-conceived subprime loan, off-balance sheet "structured investment vehicle," secretive money-market "conduit" and commercial-paper-financing vehicle, the market will do it with a vengeance” (Jon Markman, “What the big banks aren't telling you – yet”)

Good advice. We’ll have to wait and see if anyone is listening. The investment banks may be waiting until Tuesday hoping that Fed-chief Ken Bernanke announces a cut to the Fed’s fund rate that could send the stock market roaring back into positive territory.

But interest rate cuts do not address the underlying problems of insolvency among homeowners, mortgage lenders, hedge funds and (potentially) banks. As market-analyst John R. Ing said, “A cut in rates will not solve the problem. This crisis was caused by excess liquidity and a deterioration of credit standards….A cut in the Fed Fund rate is simply heroin for credit junkies.”

Well put.

The cuts merely add more cheap credit to a market that that is already over-inflated from the ocean of liquidity produced by former-Fed chief Alan Greenspan. The housing bubble and the massive credit bubble are largely the result of Greenspan’s misguided monetary policies. (For which he now blames Bush!)The Fed’s job is to ensure price stability and the smooth operation of the markets—not to reflate equity bubbles and reward over-exposed market participants.

It’s better to let cash-strapped borrowers default than slash interest rates and trigger a global run on the dollar. Financial analyst Richard Bove says that lower interest rates will do nothing to bring money back into the markets. Instead, lower interest rates will send the dollar into a tailspin and wreak havoc on the job market.

“There is no liquidity problem, but a serious crisis of confidence," Bove said. "In a financial system where there is ample liquidity and a desire for higher rates to compensate for risk, the solution is not to create more liquidity and lower the rates that are available to compensate for risk. ... (The Fed) cannot reduce fear by stimulating inflation."

"It is illogical to assume that holders of cash will have a strong desire to lend money at low rates in a currency that is declining in value when they can take these same funds and lend them at high rates in a currency that is gaining in value," he said. "By lowering interest rates the Federal Reserve will not stimulate economic growth or create jobs. It will crash the currency, stimulate inflation, and weaken the economy and the job markets." CNN Money)

Bove is right. The people and businesses that cannot repay their debts should be allowed to fail. Further weakening the dollar only adds to our collective risk by feeding inflation and increasing the likelihood of capital flight from American markets. If that happens; we’re toast.

SPIRALLING INFLATION

Consider this: In 2000, when Bush took office, gold was $273 per ounce, oil was $22 per barrel and the euro was worth $.87 per dollar. Currently, gold is over $700 per ounce, oil is over $80 per barrel, and the euro is nearly $1.40 per dollar. If Bernanke cuts rates, we’re likely to see oil at $125 per barrel by next spring.

Inflation is soaring. The government statistics are thoroughly bogus. Gold, oil and the euro don’t lie. According to economist Martin Feldstein, “The falling dollar and rising food prices caused market-based consumer prices to rise by 4.6% in the most recent quarter.” (WSJ)

That’s 18.4% per year---and yet, Bernanke is still considering cutting interest rates and further fueling inflation?!?

It’s crazy!

What about the American worker whose wages have stagnated for the last 6 years? Inflation is the same as a pay-cut for him. And how about the pensioner on a fixed income? Same thing. Inflation is just a hidden tax progressively eroding his standard of living. .

Bernanke’s rate cut may be boon to the “cheap credit” addicts on Wall Street, but it’s the death-knell for the average worker who is already struggling just to make ends meet.

No bailouts. No rate cuts. Let the banks and hedge funds sink or swim like everyone else. The message to Bernanke is simple: “It’s time to take away the punch bowl”.

The inflation in the stock market is just as evident as it is in the price of gold, oil or real estate. Economist and author Henry Liu demonstrates this in his article “Liquidity Boom and the Looming Crisis”:

“The conventional value paradigm is unable to explain why the market capitalization of all US stocks grew from $5.3 trillion at the end of 1994 to $17.7 trillion at the end of 1999 to $35 trillion at the end of 2006, generating a geometric increase in price earnings ratios and the like. Liquidity analysis provides a ready answer." (Asia Times)

"Market capitalization zoomed from $5.3 trillion to $35 trillion in 12 years?!?

Why?

Was it due to growth in market-share, business expansion or productivity?

No. It was because there were more dollars chasing the same number of securities; hence, inflation.

If that is the case, then we can expect the stock market to fall sharply before it reaches a sustainable level. As Liu says, "It is not possible to preserve the abnormal market prices of assets driven up by a liquidity boom if normal liquidity is to be restored." Eventually, stock prices will return to a normal range.

Bernanke should not even be contemplating a rate cut. The market needs more discipline not less. And workers need a stable dollar so they can live within their means. Besides, another rate cut would further jeopardize the greenback's position as the world's "reserve currency". That could destabilize the global economy by rapidly unwinding the US massive current account deficit.

The International Herald Tribune summed up the dollar's problems in a recent article," Dollar's Retreat Raises Fear of Collapse":

"Finance ministers and central bankers have long fretted that at some point, the rest of the world would lose its willingness to finance the United States' proclivity to consume far more than it produces - and that a potentially disastrous free-fall in the dollar's value would result.

The latest turmoil in mortgage markets has, in a single stroke, shaken faith in the resilience of American finance to a greater degree than even the bursting of the technology bubble in 2000 or the terror attacks of Sept. 11, 2001, analysts said. It has also raised prospect of a recession in the wider economy.

This is all pointing to a greatly increased risk of a fast unwinding of the U.S. current account deficit and a serious decline of the dollar."

Other experts and currency traders have expressed similar sentiments. The dollar is at historic lows in relation to the basket of currencies against which it is weighted. Bernanke can't take a chance that his effort to rescue the markets will cause a sudden sell-off of the dollar.

The Fed chief's hands are tied. Bernanke simply doesn't have the tools to fix the problems before him. Insolvency cannot be fixed with liquidity injections nor can the deeply-rooted "systemic" problems in "structured finance" be corrected by slashing interest rates. These require fiscal solutions, congressional involvement, and fundamental economic policy changes.

Rate cuts won't help to rekindle the spending spree in the housing market either. That charade is over. The banks have already tightened lending standards and inventory is larger than anytime since they began keeping records. The slowdown in housing is irreversible as is the steady decline in real estate prices. Trillions in market capitalization will be wiped out. (thanks to Greenspan) Home equity is already shrinking as is consumer spending connected to home-equity withdrawals.

The bubble has popped regardless of what Bernanke does. The same is true in the clogged Commercial Paper market where hundreds of billions of dollars in short-term debt is due to expire in the next few weeks. The banks and corporate borrowers are expected to struggle to refinance their debts but, of course, much of the debt will not roll over. There will be substantial losses and, very likely, more defaults.

BERNANKE'S LEGACY: Was he a man or a mouse?

Bernanke can either be a statesman---and tell the country the truth about our dysfunctional financial system which is breaking down from years of corruption, deregulation and manipulation---or he can take the cowards-route and “buy some time” by flooding the system with liquidity, stimulating more destructive consumerism, and condemning the nation to an avoidable cycle of double-digit inflation.

We'll know his decision on Tuesday.

http://www.informationclearinghouse.info/article18410.htm
