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Citigroup collapses! Banking Shutdown Possible

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It pains me deeply to announce that, despite the massive government rescue, yesterday's collapse of Citigroup could ultimately lead to a shutdown of the global banking system.

For many years, I hoped this would never happen, and I thought we might be able to avoid it.

Indeed, that's why, my firm, Weiss Research, first began rating the safety of the nation's banks in the early 1980s, and why I later founded Weiss Ratings, a separate subsidiary dedicated exclusively to safety ratings — on thousands of banks, insurance companies, brokerage firms, mutual funds and stocks.

I subsequently sold the Weiss Ratings subsidiary to Jim Cramer's organization, TheStreet.com; and today, my former company is called TheStreet.com Ratings. I continue to own and run Weiss Research, Inc., the publisher of Money and Markets. Moreover, Weiss Research continues to review all financial institutions for their safety; and to support that effort, we acquire TheStreet.com's ratings and data for our analysts.

For you, the benefit is that you can now get these independent and accurate ratings for free on the Internet. Plus, you can check our free updated lists of the strongest and weakest bank and insurance companies on our Money and Markets website.

My philosophy was that, to find safety, your primary task was to identify the weak institutions, move your money to the strong ones, and then monitor them periodically to make sure your money was still safe. If all of us — savers, investors, bankers and banking regulators — used this kind of objective data to make rational, informed decisions, we would reward the safest institutions and help prevent the growth of the riskiest. Not only would we be safer individually, but our banking system as a whole would be more solid.

Unfortunately, however, that's not how history has unfolded.

Few people were interested in bank ratings; they blindly assumed all banks were safe. And over the years, regulators have followed a parallel path. Rather than proactively restrict or shut down the weakest, large institutions, they have encouraged their massive growth, making it very difficult for the smaller, safer institutions to compete.

More recently, in the wake of the biggest financial failures in history — Bear Stearns, Lehman Brothers, Washington Mutual, Wachovia and others — rather than liquidate the failed firms' bad assets, the authorities have been engineering shotgun mergers. The end result is that they have been sweeping most of the bad assets under the carpet of larger banks like Bank of America, Citigroup, and JPMorgan Chase, each of which already had abundant bad assets of its own. Adding insult to injury, Treasury Secretary Paulson's

decision this month — not to buy up the bad assets from many of these banks — has only heightened this concern. Rather than dispose of the toxic waste, the regulators have been rolling up the garbage to the larger banks.

And now, here we are, nearing the end of the road with the largest banks of all endangered and with no larger bank that can swallow them up. It's a day of reckoning that leaves me no choice but to issue this three-part warning:

- Despite the U.S. government's massive Citigroup bailout, it is going to be difficult for the global banking system to survive the shock to confidence for very long.
- Even if insured depositors do not pull out their funds, uninsured institutional investors are likely to run with their money, threatening to bring the system down.
- And alas, even if you have your money in a safe bank with full FDIC coverage, you could be adversely impacted.

How will the events unfold? That's a massively complex question that demands an extremely cautious and thoughtful answer. That's why, this past August, we devoted a full hour to this question in our "X" List video, naming the most likely candidates for bankruptcy. So let me review its primary conclusions and then take this discussion to the next level.

Most prominent on our August "X" List was Citigroup, America's second largest banking conglomerate with over $2 trillion in total assets. The bank was already suffering crushing losses in mortgages. But at mid-year, it still had close to $200 billion in other mortgages on its books, denoting the strong possibility of many more to come.

In addition, Citigroup had a massive portfolio of credit cards — 185 million accounts worldwide — that we felt could be the final nail in its coffin. Even before the most recent episode of the global financial crisis, Citigroup's losses on bad credit cards had surged by 67% from a year earlier. Worse, the number of credit cards 90 days past due was going through the roof, foreshadowing more large losses on the way. All of these weaknesses were detailed in Citigroup's financial statements. Not detailed, however, was …

The Highly Dangerous Derivatives

Derivatives are bets made mostly with borrowed money. They are bets on interest rates, bets on foreign currencies, bets on stocks, bets on corporate failures, even bets on bets. The bets are placed by banks with each other, banks with brokerage firms, brokers with hedge funds, hedge funds with banks, and more.

They are often high risk. And they are huge. According to the U.S. Comptroller of the Currency (OCC), on June 30, 2008, U.S. commercial banks held $182.1 trillion in notional value (face value) derivatives.[1] And, according to the Bank of International Settlements (BIS), which produced a tally six months earlier for the entire world, the global pile-up of derivatives, including institutions in the U.S., Europe and Asia, was more than three times larger — $596 trillion.[2]

That was ten times the gross domestic product of the entire planet … more than 40 times the total amount of mortgages outstanding in the United States … nearly 60 times greater

than the already-huge U.S. national debt.

Defenders of derivatives claim that these giant numbers overstate the risk. They argue that most players hedge their bets and don't have nearly that much money at stake. True. But that isn't the primary risk these players are taking.

To better understand how all this works, consider a gambler who goes to Las Vegas. He wants to try his luck on the roulette wheel, but he also wants to play it safe. So instead of betting on a few random numbers, he places some bets on the red, some on the black; or some on the even and some on the odd. He rarely wins more than a fraction of what he's betting, but he rarely loses more than a fraction either. That's similar to what banks like Citigroup do with derivatives, except for a couple of key differences:

Difference #1. They don't bet against the house. In fact, there *is* no house to bet against. Instead, they bet against the equivalent of other players around the table.

Difference #2. Although they do balance their bets, they do not necessarily do so with the same player. So back to the roulette metaphor, if Citigroup bets on the red against one player, it may bet on the black against another player. Overall, its bets are balanced and hedged. But with each individual player, they're not balanced at all.

Difference #3. As I said, the amounts are huge — millions of times larger than all of the casinos of the world put together.

Now, here are the urgent questions that, as of today, remain largely unanswered:

Question #1. What happens if there is an unexpected collapse?

Question #2. What happens if that collapse is so severe it drives some of the key players into bankruptcy?

Question #3. Most important, what happens if these players can't pay up on their gambling debts?

This is the question I have asked here in Money and Markets month after month. Almost everyone said it was far-fetched, that I was overstating the risk. Yet, each of the hypothetical events I cited in the above three questions have now taken place in 2008.

First, we witnessed the unexpected collapse of the largest credit market in the world's largest economy — the U.S. mortgage market.

Second, we witnessed the bankruptcy or near-bankruptcy of three key players in the derivatives market — Bear Stearns, Lehman Brothers and Wachovia Bank.

Third, we also got the first answers to the last question: We saw the threat of a major, systemic meltdown in the entire global banking system.

What Is a Banking Meltdown
And Why Is it Possible?

On October 11, 2008, a single statement hit the international wire services that provides more specific clues:

“Intensifying solvency concerns about a number of the largest U.S.-based and European financial institutions have pushed the global financial system to the brink of systemic meltdown.”

This statement was not the random rant of a gloom-and-doomer on the fringe of society. Nor was it excerpted from a twentieth century history book about the Great Depression. It was the serious, objective assessment announced at a Washington, D.C. press conference by the Managing Director of the International Monetary Fund (IMF).

The unmistakable implication: *So many of the world’s largest banks were so close to bankruptcy, the entire banking system was vulnerable to a massive collapse.* The primary underlying cause: *Derivatives.*

The Mafia knows all about systemic meltdowns of gambling networks. In the numbers racket, for example, players place their bets through a bookie, who, in turn is part of an intricate network of bookies. Most of the time, the system works. But if just one big player fails to pay bookie A, that bookie might be forced to renege on bookie B, who, in turn stiffs bookie C, causing a chain reaction of payment failures.

The bookies go bankrupt. The losers lose. And even the winners get nothing. Worst of all, players counting on winnings from one side of their bets to cover losses in offsetting bets are also wiped out. The whole network crumbles — a systemic meltdown.

To avert this kind of a disaster, the Mafia henchmen know exactly what they have to do, and they do it swiftly: If a gambler fails to pay once, he could find himself with broken bones in a dark alley; twice, and he could wind up in cement boots at the bottom of the East River.

Unlike the Mafia, established stock and commodity exchanges, like the NYSE and the Chicago Board of Trade, are entirely legal. But like the Mafia, they understand these dangers and have strict enforcement procedures to prevent them. When you want to purchase 100 shares of Microsoft, for example, you never buy directly from the seller. You must always go through a brokerage firm, which, in turn is a member in good standing of the exchange. The brokerage firm must keep close tabs on all its customers, and the exchange keeps close track of all its member firms. If you can’t come up with the money to pay for your shares, the broker is required to promptly liquidate your securities, literally kicking you out of the game. And if the brokerage firm as a whole runs into financial trouble, it meets a similar fate with the exchange. Very, very swiftly!

Here’s the key: For the most part, the global derivatives market has no brokerage, no exchange, and no equivalent enforcement mechanism. In fact, among the $181.2 trillion in derivative bets held by U.S. banks at mid-year 2008, only $8.2 trillion, or 4.5%, was regulated by an exchange. The balance — $173.9 trillion, or 95.5% — was bets placed directly between buyer and seller (called “over the counter”). And among the $596 trillion in global derivatives tracked by the BIS at year-end 2007, 100% were over the counter. No exchanges. No overarching enforcement mechanism.

This is not just a matter of weak or non-existent regulation. It’s far worse. It’s the equivalent of an undisciplined conglomeration of players gambling on the streets without even a casino to maintain order. Moreover, the data compiled by the OCC and BIS showed that the bets were so large and the gambling so far beyond the reach of regulators, all it would take was the bankruptcy of *one* of the lesser derivatives players — such as Lehman Brothers — to

throw the world's credit markets into paralysis.

That's why the world's highest banking officials were so panicked when Lehman Brothers failed in the fall of 2008. As the IMF managing director himself admitted, the threat was not stemming from just *one* bank in trouble; it was from *many*; and those banks weren't lesser players; they were among the *largest* in the world. Which U.S. banks placed the biggest bets? Based on mid-year 2008 data, the OCC provided some answers:

Citibank N.A., the primary banking unit of Citigroup, held $37.1 trillion in derivative bets. Moreover, only 1.7% of those bets were under the purview of any exchange. The balance — 98.3% — was direct, one-on-one bets with their trading partners outside of any exchange.

Bank of America was a somewhat bigger player, holding $39.7 trillion in derivative bets, with 93.4% traded outside of any exchange.

But JPMorgan Chase was, by far, the biggest of them all, towering over the U.S. derivatives market with more than double BofA's book of bets — $91.3 trillion worth. This meant that JPMorgan Chase controlled *half* of all derivatives in the U.S. banking system — a virtual monopoly that tied the firm's finances with the fate of the U.S. economy far beyond anything ever witnessed in modern history. Meanwhile, $87.3 trillion, or 95.7% of Morgan's derivatives, were outside the purview of any exchange.

One bank! Making bets of unknown nature and risk! Involving a dollar amount equivalent to six years of the total production of the entire U.S. economy! In contrast, Lehman Brothers, whose failure caused such a large earthquake in the global financial system, was actually small by comparison — with "only" $7.1 trillion in derivatives.

The potential havoc that might be caused by a Citigroup failure, with bets that involve *five times* more money than Lehman's — and the financial holocaust that might be caused by a JPMorgan failure with close to 13 times more than Lehman — boggles the imagination. How bad could it actually be? No one knows, and therein lies one of the primary dangers. In the absence of oversight, the regulators simply do not collect the needed who-when-what information on these bets.

In an attempt to throw some light on this dark-but-explosive scene, the OCC uses a formula for estimating how much risk each major bank is exposed to in just the one particular aspect I cited a moment ago — the risk that some of its trading partners might default and fail to pay up on their gambling debts. Bear in mind: We still don't now how much they are risking on market moves against them. All the OCC is estimating is how much they're risking by making bets with potentially shaky betting partners, regardless of the outcome on each bet — win, lose or draw.

At Bank of America, the OCC calculated that, at mid-year, the bank was exposed to the tune of 194.3% of its capital. In other words, for every $1 of capital in the kitty, BofA was risking $1.94 cents strictly on the promises made by its betting partners. If about half of its betting partners defaulted, the bank's capital would be wiped out and it would be bankrupt. And remember: This was in *addition* to the risk that the market might go the wrong way, and *on top of* the risk it was taking with its other investments and loans,

At Citibank, the risk was even greater: $2.58 cents in exposure per dollar of capital.

And if you think that's risky, consider JPMorgan Chase. Not only was it the largest player,

but, among the big three U.S. derivatives players, it also had the largest default exposure: For every dollar of capital, the bank was risking $4.30 on the credit of its betting partners.

This is why JPMorgan was so anxious to step in and grab up outstanding trades left hanging after the fall of Bear Stearns and Lehman Brothers: It could not afford to let those trades turn to dust. If it did, it would be the first and biggest victim of a chain reaction of failures that could explode all over the world.

This is why super-investor Warren Buffett once called derivatives "financial weapons of mass destruction." This is why the top leaders of the world's richest countries panicked after Lehman Brothers failed, dumping their time-honored, hands-off policy like a hot potato, jumping in to buy up shares in the world's largest banks, and transforming the world of banking literally overnight.

This is also why you must now do more than just find a strong bank.

You also must find a safe place that has the highest probability of being immune to these risks. The reason: As I warned at the outset, at some point in the not-too-distant future, governments around the world may have no other choice but to declare a global banking holiday — a shutdown of nearly every bank in the world, regardless of size, country, or financial condition.

What could happen in the banking holiday? In the past, we've seen some financial shutdowns that eventually helped resolve the crisis. And we've seen others that only made it worse. Often, savers are forced to leave their money on deposit, giving up a substantial portion of their interest income for many years. And, in other cases, the only way they can get their money back sooner is by accepting an immediate loss of principal. But no matter how it's resolved, when banks have made big blunders and suffered large losses, it's the multitude of savers that are invariably asked to make the biggest sacrifices and pay the biggest price. No one else has the money.

Are Bank Runs and National Shutdowns
Really Possible in Today's Modern Era?

Most observers think not. "If deposits are insured," they ask, "why would anyone want to pull them out?" The reason: Most bank runs are not caused by insured depositors. They're caused by the exodus of large, uninsured institutions who are usually the first to run for cover at the earliest hint of trouble. That's the main reason Washington Mutual, America's largest savings and loan, lost over $16 billion in deposits in its final eight days in 2008. That's also a major reason Wachovia Bank was forced to agree to a shotgun merger soon thereafter.

During the many banking failures of the 1980s and 1990s, the story was similar: We rarely saw a run on the bank by individuals. Rather, it was uninsured institutional investors — banks, pension funds and others — that jumped ship long before most people even realized the ship was sinking. They're the ones who hammered the last nail in the coffin of big savings and loans, banks and insurance companies that failed.

How Long Would a Global Banking Shutdown Last?
How Would It All Be Sorted Out?

No one can say with certainty. But based on other banking holidays in modern history, it's

safe to conclude that it could last for quite some time and cause severe hardship for hundreds of millions of savers around the world.

The first and most obvious hardship is that you could be denied immediate access to most or all of your money for an indefinite period. What about government agency guarantees like FDIC insurance? A large proportion of those guarantees, unfortunately, would have to be suspended in order to give banking regulators the time they need to sort out the mess.

It is simply not reasonable to expect that governments will have the resources to immediately meet the demands of thousands of institutions and millions of individuals if they all want their money back at roughly the same time.

"Your money is still safely guaranteed," banking officials will declare. "You just can't have it now."

The second and more long-lasting hardship is the possibility that, by the time you do regain access to your money, you will suffer losses. In this scenario, the government would likely create a rehabilitation program for the nation's weakest banks, giving depositors two choices:

- *Opt in* to the program by leaving your funds on deposit at your bank for an extended period of time, earning below-market interest rates. The bank is then allowed to use the extra interest to recoup its losses over time — income that, by rights, should have been yours.

- *Opt out* of the program and withdraw your funds immediately, accepting a loss that approximately corresponds to the actual losses in the bank's investment and loan portfolio.

Needless to say, neither the opt in nor the opt out choice is a good one:

If you opt in, you take the chance that the government's rehab program may not work on the first attempt and that it will be replaced by another, even tougher program in the future. Moreover, even if it works out as planned, you will suffer a continuing loss of income and access to your cash over an extended period of time.

If you opt out, instead of lost income, you suffer an immediate loss of principal. Moreover, in order to discourage savers from opting out, the government would typically structure the program so that everyone demanding immediate reimbursement suffers an *additional* penalty.

Again you ask, "What about government guarantees?" By rights, in a fair plan, insured depositors would suffer less severely than uninsured depositors. And if the plan is structured properly, those in strong banks should come out whole, or almost whole, while those in weaker banks should suffer the larger losses. That's how it *should* be handled. But there's no guarantee that's how it *will* be handled.

To avoid all of these risks, I recommend seriously considering moving (a) nearly all of your bank deposits and accounts, plus (b) a modest portion of the money you currently have invested in securities to the safest and most liquid place for your money in the modern world:

Short-Term U.S. Treasury Securities

True safety has two elements. The first is *capital conservation* — no losses, no reduction in your principal. But it's the second element that most people miss: *Liquidity* — the ability to get a hold of your money and actually use it whenever you want to, without waiting, penalties, bottlenecks, shutdowns or disasters of any kind standing in your way.

Absolute perfection is not possible. But on both of those aspects — capital conservation and liquidity — the single investment in the world that's at the top of the charts is *short-term U.S. Treasury securities.* These enjoy the best, most direct, and most reliable guarantee of the U.S. government, over and above any other guarantees or promises they may have made in the past, or will make in the future.

I know you have questions. So let me do my best to anticipate them and answer them right here.

Question #1. You might ask: "The FDIC is also backed by the U.S. government. So if I have money in an FDIC-guaranteed account at my bank, what's the difference? Why should I accept a lower yield on a government-guaranteed 3-month Treasury bill when I can get a higher yield on a government-guaranteed 3-month CD?"

Without realizing it, you've answered your own question. If the yield is higher on the bank CDs, that can mean only one thing — that, according to the collective wisdom of millions of investors and thousands of institutions in the market, the *risk* is also higher. Otherwise, why would the bank have to pay so much more to attract your money? Likewise, how can the U.S. Treasury get away with paying so much less and still have interested buyers for its securities?

It's because the *risk* is higher for CDs, but much lower for Treasury securities. It's because even within the realm of government guarantees, there's a pecking order.

- The first-priority guarantee: Maturing securities that were issued by the U.S. Treasury department itself.
- The second-priority guarantee: Maturing securities that were issued by other government agencies, such as Ginnie Mae.
- Third: The Treasury's backing of the FDIC.

This is not to say the Treasury is not standing fully behind the FDIC. Rather my point is that, in the event of serious financial pressures on the government, the FDIC and FDIC guaranteed deposits will *not* be the first in line.

Question #2. You might also ask: "Isn't the United States government also having its own share of financial difficulties with huge budget deficits? If those difficulties could get a lot worse, why should I trust the government any more than I trust other investments? Why should I loan my money to Uncle Sam?"

The United States is the world's largest economy, with the most active financial markets and the strongest military in the world. Despite Uncle Sam's financial difficulties, this has never been in doubt; and even in a financial crisis, that's unlikely to change because the crisis is

global. So its immediate impact on the finances of other governments is likely to be at least as severe.

More importantly, the United States government's borrowing power — its ability to continue tapping the open market for cash — is, by far, it's most precious asset, more valuable than the White House and all public properties; even more valuable than all the gold in Fort Knox. Those assets are like Uncle Sam's home, land and pocket change. His borrowing power, in contrast, is like the *air he breathes to stay alive*.

Remember: The U.S. Treasury Department is directly responsible for feeding money to the utmost, mission-critical operations of this country, including defense, homeland security, and emergency response. The Treasury will do whatever it takes to *continue* providing that funding, and that means making sure they *never* default on their maturing Treasury securities.

Even in the 1930s, when a record number of Americans were unemployed, and when we had a head-spinning wave of bank failures, owners of Treasury bills never lost a penny.

Even in the Civil War, Treasuries were safe. Investors financed 65 percent of the Union's war costs by buying Treasury securities. But the war was far worse than those investors had anticipated, leaving over half of the entire economy in shambles, raising serious concerns among those investors. However, the U.S. government made the repayment of its maturing Treasuries it's number *one* priority over all other wartime obligations. Investors got back every single penny, and more.

My main point is this: The crisis ahead will not be nearly as severe as the war that tore our nation apart. If Treasury securities were safe then, we have no reason to doubt they will be safe today. Unfortunately, however, I cannot say the same for all of the money you've entrusted to a bank.

Question #3. "Suppose there's a bank holiday and I need to cash in my Treasury bills. Since the Treasury Department and the Treasury-only money market funds use banks for transfers, won't I be locked out of my money too?"

We actually have a real precedent for a similar situation. In Rhode Island in 1991, when the governor declared a state-wide bank holiday, all the state-chartered savings banks were closed down. Every single citizen with money in one of those banks was locked out.

At the time, one of our Safe Money Report subscribers happened to have a checking account in one of the closed Rhode Island banks. Thankfully, he had almost all of his money at the Treasury Department in Treasury bills, so his money was safe. But he called and asked: "The Treasury is set to wire the money straight into my bank account, which is frozen. Will the money the Treasury wires me get frozen too?"

In response, I told him to check his post office mailbox. Instead of wiring his funds, the Treasury had taken the extraordinary measure of cutting hard checks and mailing them out immediately. They wanted to make *absolutely* sure he got his money without any delay.

The moral of this story is that, even in a worst-case banking scenario, the Treasury will do whatever is necessary to get your money. We can't forecast exactly how. But they will probably send you hard Treasury checks. And they'll probably designate special bank offices in every city in every state where you can cash them in. Ditto for Treasury-only money

market funds.

Question #4. "Throughout history, many governments have defaulted on their debts in a more subtle way — by devaluing their currency. Why are you recommending Treasury bills, which are denominated purely in dollars, if one of the consequences of this disaster could be a decline in the dollar?"

The trend today is toward deflation, which means a *stronger* dollar. But even if that changes, the solution will not be to abandon the safety and liquidity of Treasury bills. It will be to separately set some money aside and buy hedges against inflation, like gold or strong foreign currencies that tend to go up in value when the dollar falls.

How to Buy Treasuries

For funds that you do not need immediate access to on a daily basis, consider the U.S. Government's Treasury Direct program. They offer a variety of choices, but I recommend you use strictly the 13-week (3-month) Treasury bills.

Meanwhile, for most of your personal or business, savings or checking, you don't need a bank, an S&L or any other financial institution. All you need is a money market fund that invests in short-term U.S. Treasury bills or equivalent. The Treasuries it buys enjoy the same U.S. government guarantee as Treasuries bought through any other venue. So deposit insurance is simply not an issue.

Moreover, the Treasury-only money fund gives you the additional advantage of immediate availability of your money. You can have your funds wired to your local bank overnight. Or you can even write checks against it, much as you'd write checks against any bank checking account.

For my family and business money, we use the Weiss Treasury Only Money Market Fund. Plus we also use the fund that was founded by James Benham, a good friend of my father's. That's Capital Preservation Fund, which Jim sold to the American Century family of funds. Use either of these or your choice of the fund in the list below.

Good luck and God bless!

Martin

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