

# The Bush Financial Bust of 2008: “It’s All Downhill From Here, Folks”

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“I just saw a picture Bernanke stripped to the waist in the boiler-room shoveling greenbacks into the furnace.” **Rob Dawg, Calculated Risk blog-site**

On January 14, 2008 the FDIC web site began posting the rules for reimbursing depositors in the event of a bank failure. The Federal Deposit Insurance Corporation (FDIC) is required to “determine the total insured amount for each depositor....as of the day of the failure” and return their money as quickly as possible. The agency is “modernizing its current business processes and procedures for determining deposit insurance coverage in the event of a failure of one of the largest insured depository institutions.”

(<http://www.fdic.gov/news/news/financial/2008/fil08002.html#body>)

The implication is clear, the FDIC has begun the “death watch” on the many banks which are currently drowning in their own red ink. The problem for the FDIC is that it has never supervised a bank failure which exceeded 175,000 accounts. So the impending financial tsunami is likely to be a crash-course in crisis management. Today some of the larger banks have more than 50 million depositors, which will make the FDIC’s job nearly impossible.

Good luck.

It’s worth noting that, due to a rule change by Congress in 1991, the FDIC is now required to use “the least costly transaction when dealing with a troubled bank. The FDIC won’t reimburse uninsured depositors if it means increasing the loss to the deposit insurance fund....As a result, uninsured depositors are protected only if a bank acquiring the failed bank will pay more for all of the deposits than it would for insured deposits only.” (MarketWatch)

Great. That’s reassuring. And there’s more, too. FDIC Chairman Sheila Bair warned that “as of Sept. 30, there were 65 institutions with assets of \$18.5 billion on its list of “problem” institutions;” although she wouldn’t give names.

So, what does it all mean?

It means there’s going to be an unprecedented wave of bank closures in the US and that people who want to hold on to their life savings are going have to be extra vigilant as the situation continues to deteriorate. And it is deteriorating very quickly.

Right now, many of the country’s largest investment banks are holding \$500 billion in

mortgage-backed securities and other structured investments that are steadily depreciating in value. As these assets wear-away the banks' capital, the likelihood of default becomes greater. This week, Fitch Ratings announced that it will (probably) cut ratings on the 5 main bond insurers (Ambac, MBIA, FGIC, CIFG, SCA) "regardless of their capital levels". This seemingly innocuous statement has roiled markets and put Wall Street in a panic. If the bond insurers lose their AAA rating (on an estimated \$2.4 trillion of bonds) then the banks could lose another \$70 billion in downgraded assets. That would increase their losses from the credit crunch—which began in August 2007—to \$200 billion with no end in sight. It would also impair their ability to issue loans to even credit worthy customers which will further dampen growth in the larger economy. Structured investments have been the banks' "cash cow" for nearly a decade, but, suddenly, the trend has shifted into reverse. Revenue streams have dried up and capital is being destroyed at an accelerating pace. The \$2 trillion market for collateralized debt obligations (CDOs) is virtually frozen leaving horrendous debts that will have to be written-down leaving the banks' either deeply scarred or insolvent. It's a mess.

There were some interesting developments in a case involving Merrill Lynch last week which sheds a bit of light on the true "market value" of these complex debt-pools called CDOs. The Massachusetts Secretary of State has charged Merrill with "fraud and misrepresentation" for selling them a CDO that was "highly risky and esoteric" and "unsuitable for the City of Springfield." (Most cities are required by law to only purchase Triple A rated bonds) The city of Springfield bought the CDO less than a year ago for \$13.9 million. It is presently valued at \$1.2 million—MORE THAN A 90% LOSS IN LESS THAN A YEAR.

Merrill has quietly settled out of court for the full amount and seems genuinely confused by the Massachusetts Secretary of State's apparent anger. A Merrill spokesman said blandly, "We are puzzled by this suit. We have been cooperating with the Secretary of State Galvin's office throughout this inquiry."

Is it really that hard to understand why people don't like getting ripped off?

This anecdote shows that these exotic mortgage-backed securities are real stinkers. They're worthless. The market for structured debt-instruments has evaporated overnight leaving a massive hole in the banks' balance sheets. The likely outcome will be a rash of defaults followed by greater consolidation of the major players. (re: banking monopolies) The Fed's multi-billion bailout plan; the "Temporary Auction Facility" (TAF) is a quick-fix, but not a permanent solution. The real problem is insolvency, not liquidity.

The smaller banks are dire straights, too. They're bogged down with commercial and residential loans that are defaulting faster than any time since the Great Depression. The Comptroller of the Currency, John Dugan—who is presently investigating commercial real estate loans—discovered that commercial banks "wrote off \$524 million in construction and development loans in the third quarter of 2007, almost nine times the amount of 2006". The commercial real estate market is following residential real estate off a cliff and will undoubtedly be the next shoe to drop.

Dugan found out that, "More than 60% of Florida banks have commercial real estate loans worth more than 300% of their capital, a level that automatically attracts more attention from examiners." (Wall Street Journal) He said that his office was prepared to intervene if banks with large real estate exposure maintained unreasonably low reserves for bad loans.

Dugan is forecasting a steep “increase in bank failures.”

According to Reuters: “Dozens of U.S. banks will fail in the next two years as losses from soured loans mount and regulators crack down on lenders that take too much risk, especially in real estate and construction,” predicts Gerard Cassidy, RBC Capital Markets analyst. Apart from the growing losses in commercial and residential real estate, the banks are carrying over \$150 billion of “unsyndicated” debt connected to leveraged buyout deals (LBOs) which are presently stuck in the mud. Like CDOs, there’s no market for these sketchy transactions which require billions in cheap, easily available credit. They’ve just become another anvil dragging the banks under.

On January 31, Bloomberg News reported: “Losses from securities linked to subprime mortgages may exceed \$265 billion as regional U.S. banks, credit unions and overseas financial institutions write down the value of their holdings.” Standard and Poor’s added that “it may cut or reduce ratings of \$534 billion of subprime-mortgage securities and CDOs as default rates rise.” Another blow to the banks withering balance sheets. Is it any wonder why the “new loans” spigot has been turned off?

Surprisingly, there’s an even bigger threat to the financial system than these staggering losses at the banks. A default by one of the big bond insurers could trigger a meltdown in the credit-default swaps market, which could lead to the implosion of trillions of dollars in derivatives bets. The inability of the under-capitalized monolines (bond insurers) to “make good” on their coverage is likely to set the first domino in motion by increasing the number of downgrades on bond issues and intensifying the credit-paralysis which already is spreading throughout the system.

MSN Money’s financial analyst Jim Jubak summed it up like this:

“Actually, I’m worried not so much about the junk-bond market itself as the huge market for a derivative called a credit-default swap, or CDS, built on top of that junk-bond market. Credit-default swaps are a kind of insurance against default, arranged between two parties. One party, the seller, agrees to pay the face value of the policy in case of a default by a specific company. The buyer pays a premium, a fee, to the seller for that protection.

This has grown to be a huge market: The total value of all CDS contracts is something like \$450 trillion..... Some studies have put the real credit risk at just 6% of the total, or about \$27 trillion. That puts the CDS market at somewhere between two and six times the size of the U.S. economy.

All it will take in the CDS market is enough buyers and sellers deciding they can’t rely on this insurance anymore for junk-bond prices to tumble and for companies to find it very expensive or impossible to raise money in this market.” (Jim Jubak’s Journal; “The Next Banking Crisis is on the Way”, MSN Money)

Jubak really nails it here. In fact, this is what Wall Street is really worried about. \$450 trillion in cyber-credit has been created through various off balance sheets operations which neither the Fed nor any other regulatory body can control. No one even knows how these abstruse, credit-inventions will perform in a falling market. But, so far, it doesn’t look good.

The enormity of the derivatives market (\$450 trillion) is the direct result of Greenspan’s easy-credit monetary policies as well as the reconfiguring of the markets according to the

“structured finance” model. The new model allows banks to run off-balance sheets operations that, in effect, create money out of thin air. Similarly, “synthetic” securitization, in the form of credit default swaps (CDS) has turned out to be another scam to avoid maintaining sufficient capital to cover a sudden rash of defaults. The bottom line is that the banks and non-bank institutions wanted to maximize their profits by keeping all their capital in play rather than maintaining the reserves they’d need in the event of a market downturn.

In a deregulated market, the Federal Reserve cannot control the creation of credit by non-bank institutions. As the massive derivatives bubble unwinds, it is likely to have real and disastrous effects on the underlying-productive economy. That’s why Jubak and many other market analysts are so concerned. The persistent rise in home foreclosures, means that the derivatives which were levered on the original assets (sometimes exceeding 25-times their value) will vanish down a black hole. As trillions of dollars in virtual-capital are extinguished by a click of the mouse; the prospects of a downward deflationary spiral become more likely.

As economist Nouriel Roubini said:

“One has to realize that there is now a rising probability of a ‘catastrophic’ financial and economic outcome, i.e. a vicious circle where a deep recession makes the financial losses more severe and where, in turn, large and growing financial losses and a financial meltdown make the recession even more severe. That is why the Fed has thrown caution to the wind and taken a very aggressive approach to risk management.” (Nouriel Roubini EconoMonitor)

“In the fourth quarter of 2007, new foreclosures averaged 2,939 a day, double the pace of a year earlier.” (RealtyTrac Inc.) The banks are presently cutting back on home equity loans which provided an additional \$600 billion to homeowners last year for personal consumption. Bush’s \$150 billion “stimulus package” will barely cover a quarter of the amount that is lost. As consumer spending slows and the banks become more constrained in their lending; businesses will face overproduction problems and will have to limit their expansion and lay off workers. This is the downside of “low interest” bubble-making; a painful descent into deflation.

Capital is now being destroyed at a faster pace than it is being created. That’s why the Fed is looking for solutions beyond mere rate cuts. Bernanke wants direct government action that will provide immediate stimulus. But that takes political consensus and there’s still debate about the gravity of the upcoming recession. The pace of the economic contraction is breathtaking. This week’s release of the Institute for Supply Management’s Non-Manufacturing Index (ISM) was a shocker. It showed steep declines in all areas of the nation’s service sector—including banks, travel companies, contractors, retail stores etc—The Business Activity Index, the New Orders Index, the Employment Index, and the Supplier Delivery Index have all contracted at a “historic” pace. Everyone took a hit.

“The numbers are so terrible, it’s beyond belief,” said Scott Anderson, senior economist at Wells Fargo & Co.

The \$2 trillion that has been wiped out from falling home prices, the slowdown in lending activity at the banks, the loss \$600 billion in home equity loans, and the faltering stock market have all contributed to a noticeable change in the

public's attitudes towards spending. Traffic to the shopping malls has slowed to a crawl. Retail shops had their worst January on record. Homeowners are hoarding their earnings to cover basic expenses and to make up for their lack of personal savings. The spending-spigot has been turned off. America's consumer culture is in full-retreat. The slowdown is here. It is now. We are likely to see the sharpest decline in consumer spending in US history. Bush's \$150 billion will be too little too late.

America's place in the world has been guaranteed not by what it produces but by what it consumes. The American consumer has been the locomotive that drives the global economy. Now that engine has been derailed by the reckless monetary policies of the Fed and by shortsighted financial innovation. When equity bubbles collapse; everybody pays. Demand for goods and services diminishes, unemployment soars, banks fold, and the economy stalls. That's when governments have to step in and provide programs and resources that keep people working and sustain business activity. Otherwise there will be anarchy. Middle class people are ill-suited for life under a freeway overpass. They need a helping hand from government. Big government. Good-bye, Reagan. Hello, F.D.R.

The Bush stimulus plan is a drop in the bucket. It'll take much, much more. And, we're not holding our breath for a New Deal from George Walker Bush.

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