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America's Teetering Banking System

By Mike Whitney

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Somebody goofed. When Fed chairman Ben Bernanke cut interest rates to 3 per cent yesterday, the price of a new mortgage went up. How does that help the flagging housing industry?

About an hour after Bernanke made the announcement that the Fed Funds rate would be cut by 50 basis points the yield on the 30-year Treasury nudged up a tenth of a percent to 4.42 per cent. The same thing happened to the 10 year Treasury which went from a low of 3.28 per cent to 3.73 per cent in less than a week. That means that mortgages, which are priced off long-term government bonds, will be going up too.

Is that what Bernanke had in mind; to stick another dagger into the already-moribund real estate market?

The Fed sets short-term interest rates (the Fed Funds rate) but long-term rates are market-driven. So, when investors see slow growth and inflationary pressures building up; long-term rates start to rise.

Bernanke knew that the price of a mortgage would increase if he slashed rates, but went ahead anyway.

How did he know?

Because 8 days ago, when he cut rates by 75 basis points, the ten-year didn't budge from its perch at 3.64 per cent. It just shrugged it off the cuts as meaningless. But a couple days later, when Congress passed Bush's \$150 stimulus package, the ten year spiked with a vengeance, up 20 basis points on the day. In other words, the bond market doesn't like inflation-generating government handouts. So, why did Bernanke cut rates when he knew it would just add to the housing woes?

The fact is, Bernanke had no choice. He's facing a challenge so huge and potentially catastrophic; that cutting rates must have seemed like the only option he had. The banks are "capital impaired" and borrowing at a rate unprecedented in history.

The capital that the banks do have is quickly being depleted.

Banks are forced to borrow reserves from the Fed in order to keep lending.

A careful review of these graphs should convince even the hardened skeptic that the banking system is basically underwater. The sudden and shocking depletion of bank reserves is due to the huge losses inflicted by the meltdown in subprime loans and other similar structured investments.

"When US homeowners default on their mortgages en-mass, they destroy money faster than the Fed can replace it through normal channels. The result is a liquidity crisis which deflates asset prices and reduces monetized wealth," says economist Henry Liu.

The debt-securitization process is in a state of collapse. The market for structured investments -- MBSs, CDOs, and Commercial Paper -- has evaporated, leaving the banks with astronomical losses. They are incapable of rolling over their short-term debt or finding new revenue streams to buoy them through the hard times ahead. As the foreclosure-avalanche intensifies; bank collateral continues to be down-graded which is likely to trigger bank failures.

Henry Liu sums it up like this: "Proposed government plans to bail out distressed home owners can slow down the destruction of money, but it would shift the

destruction of money as expressed by falling home prices to the destruction of wealth through inflation masking falling home value." ("The Road to Hyperinflation", Henry Liu, Asia Times) It's a vicious cycle. The Fed is caught between the dual millstones of hyperinflation and mass defaults.

The pace at which money is currently being destroyed will greatly accelerate as trillions of dollars in derivatives are consumed in the flames of a falling market. As GDP shrinks from diminishing liquidity, the Fed will have to create more credit and the government will have to provide more fiscal stimulus. But in a deflationary environment; public attitudes towards spending quickly change and the pool of worthy loan applicants dries up. Even at 0 per cent interest rates, Bernanke will be stymied by the unwillingness of under-capitalized banks to lend or over-extended consumers to borrow. He'll be frustrated in his effort to restart the sluggish consumer economy or stop the downward spiral. In fact, the slowdown has already begun and the trend is probably irreversible.

The financial markets are deteriorating at a faster pace than anyone could have imagined. Mega-billion dollar private equity deals have either been shelved or are unable to refinance. Asset-backed Commercial Paper (short-term notes backed by sketchy mortgage-backed collateral) has shrunk by \$400 billion (one-third) since August. Also, the market for corporate bonds has fallen off a cliff in a matter of months. According to the Wall Street Journal, a paltry \$850 million in high-yield debt has been issued for January, while in January 2007 that figure was \$8.5 billion---ten times bigger. That's a hefty loss of revenue for the banks. How will they make it up?

Judging by the Fed's graphs; they won't!

Bernanke's rate cuts sent stocks climbing on Wall Street, yesterday, but by early afternoon the rally fizzled on news that Financial Guaranty, one of the nation's biggest bond insurers, would be downgraded. The Dow lost 37 points by the closing bell.

The plight of other major bond insurers, MBIA and Ambac, could be known as early as today, but it is reasonable to expect that they will lose their Triple A rating. According to Bloomberg:

"MBIA Inc, the world's largest bond insurer, posted its biggest-ever quarterly loss

and said it is considering new ways to raise capital after a slump in the value of subprime-mortgage securities the company guarantee". The insurer lost \$2.3 billion in the fourth-quarter. Its downgrading from AAA will "cripple its business and throw ratings on \$652 billion of debt into doubt." Many of the investment banks have assets that will get a haircut.

The New York State Insurance Department tried to work out a bailout plan but the banks could not agree on the terms (ed note: "They don't have the money")

"Bond insurers guarantee \$2.4 trillion of debt combined and are sitting on losses of as much as \$41 billion, according to JPMorgan Chase & Co. analysts. Their downgrades could force banks to write down \$70 billion, Oppenheimer & Co. analyst Meredith Whitney said yesterday in a report." (Bloomberg)

The bond insurers were working the same scam as the investment banks. They found a loophole in the law that allowed them to deal in the risky world of derivatives; and they dove in headfirst. They set up shell companies called "transformers", (the same way the investment banks established SIVs; structured investment vehicles) which they use as "off balance" sheets operations where they sell "credit default swaps , which are derivative instruments where one party, for a fee, assumes the risk that a bond or loan will go bad". ("The Bond Transformers", Wall Street Journal) The bond insurers have written about \$100 billion of these swaps in the last few years. Now they're all blowing up at once.

Credit default swaps (CDS) have turned out to be a gold-mine for the bond insurers and they've given a boost to the banks too, by freeing up capital they use in other ventures. "The banks profited on the interest rate difference between the CDOs (collateralized debt obligations) they bought and the payments they made to transformers...The banks sometimes booked profits upfront on the streams of income they expected to receive." (WSJ)

Neat trick, eh?

Even now that the whole swindle is beginning to unravel, and tens of billions of dollars are headed for the shredder; industry spokesmen still praise credit default swaps as "financial innovation".

"It's too early to say we're going to ban all these products," said Guenther Ruch,

administrator for Wisconsin's insurance regulation and enforcement division. (WSJ)

Maybe Ruch is right. Maybe it is too early to ban all these dicey financial inventions. But he may change his tune when Wall Street gets a whiff of the billions that'll be lost in downgrades and the markets start to tumble.

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