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Is the U.S. Economy Safe?

What Banks And The Government Are Not Telling Us About 2009—The Next Shoes You Hear Drop May Be Very Loud Ones

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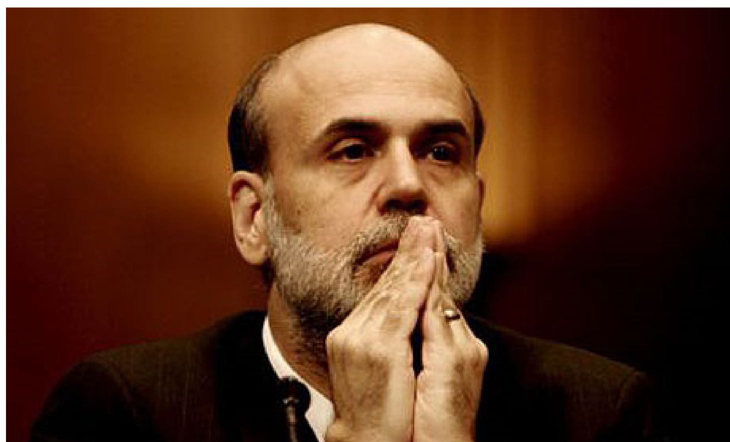
Cutting Edge News Contributor



Federal Reserve Chairman Ben Bernanke

It is time for some straight talk about what America is being told about our financial institutions. First: listen to the words or our most esteemed financial leaders.

In March of last year, Treasury Secretary Henry Paulson delivered an upbeat assessment of the economy, saying growth was healthy and the housing market was nearing a turnaround. "All the signs I look at" show "'the housing market is at or near the bottom," Paulson said in a speech to a business group in New York, adding that the U.S. economy is "very healthy" and "robust."

At about the same time last March 2007, Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve, told Congress, "At this juncture, the impact on the broader economy and financial markets of the problems in the sub-prime market seems likely to be contained."

Then, in June of 2007, Bernanke declared, "We will follow developments in the sub-prime market closely. However, fundamental factors—including solid growth in incomes and relatively low mortgage rates—should ultimately support the demand for housing, and at this point, the troubles in the sub-prime sector seem unlikely to seriously spill over to the broader economy or the financial system." He followed that up in October of last year with this statement: "It is not the responsibility of the Federal Reserve—nor would it be appropriate—to protect lenders and investors from the consequences of their financial decisions. But developments in financial markets can have broad economic effects felt by many outside the markets, and the Federal Reserve must take those effects into account when determining policy."

Just last March, 2008, Treasury Secretary Henry Paulson reassured us all with these words: "We've got strong financial institutions... Our markets are the envy of the world. They're resilient, they're... innovative, they're flexible. I think we move very quickly to address situations in this country, and, as I said, our financial institutions are strong."

What is the truth? The truth is deception. After reading the above quotes, it should be clear that politicians and government bureaucrats are lying to the public when they say that everything is all right. They do not know. Our economy and banking system is so complex and intertwined that no one knows where the next shoe will drop. Therefore, it is in our best interest to cut through all the crap and examine the facts with a skeptical eye.

Last week, bank stocks, which had been falling fast, suddenly soared higher based on earnings reports that were horrific, but not catastrophic.

Talking heads were calling a bottom in the financial crisis. The bank with the largest increase in share price was Wells Fargo. Their earnings exceeded analyst expectations and the stock went up 22% in one day. Wells Fargo owns $84 billion of home equity loans, with half of those in the two leading foreclosure states, California and Florida. Coincidently, Wells Fargo decided to extend its charge-off policy in the 2nd quarter from 120 days to 180 days in an effort to give troubled borrowers more time to reach a loan workout. Or, did they reduce their write-offs for the 2nd quarter to beat analysts expectations.

Many people are still living in houses twelve months after making their last mortgage payment. Their banks

have not started foreclosure proceedings. Is this due to incompetence by the banks, or is this a way to avoid writing off the loss? The Financial Accounting Standards Board (FASB), the little-known national agency responsible for establishing standards of financial accounting and reporting, has seemingly joined the cover-up by delaying the implementation of new rules that would have made banks stop hiding toxic waste off their balance sheets. New rules would have made banks put these questionable assets on their balance sheet and require a bigger capital cushion.

Is anyone surprised that bank regulators, the Treasury and Federal Reserve urged a delay in implementation of new FASB rules. They can manipulate the facts because the average American doesn't understand or care.

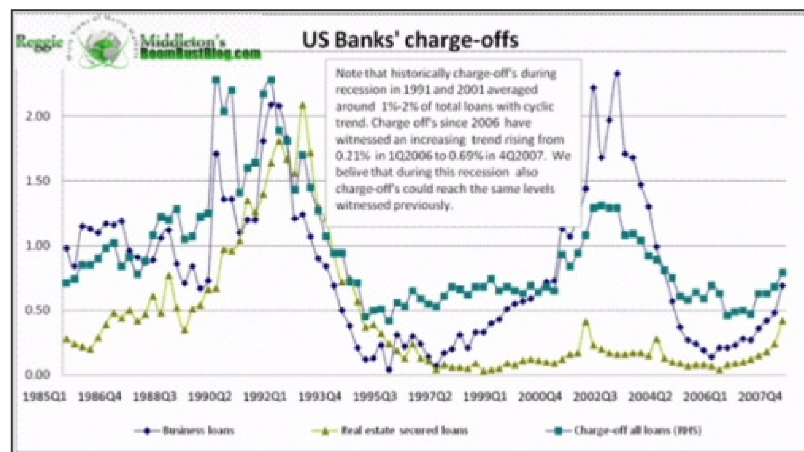
Is an FDIC Bailout in Our Future?

During the S&L crisis in the early 1990s, 1,500 banks failed. So far, seven banks have failed in 2008, the largest being IndyMac. The FDIC has about $53 billion in funds to handle future bank failures. The IndyMac failure is expected to use $4 to $8 billion of those funds. Average Americans will lose $500 million in uninsured deposits in this failure. The FDIC says that they have 90 banks on their "watch list." They do not reveal the banks on the list, so little old ladies with their life savings in local banks will be surprised when they go belly up. Based on the fact that IndyMac was not on their "watch list." I wouldn't put too much faith in their analysis.

Some 8,500 banks operate in the U.S. Based on an independent analysis by Chris Whalen from Institutional Risk Analytics, 8 percent of all banks, or around 700 banks have been identified as "troubled." This is quite a divergence from the FDIC estimate. Should you believe a governmental agency that wants the public to remain in the dark to avoid bank runs, or an independent analysis based upon balance sheet analysis? The implications of 700 institutions failing are huge.

U.S. banks hold roughly $6.84 trillion in bank deposits. Almost $2.6 trillion of these deposits are uninsured. There is only $274 billion of the $6.84 trillion as cash on hand at banks. This means that $6.5 trillion has been loaned to consumers, businesses, developers, etc. The FDIC has $53 billion to cover $6.84 trillion of deposits. Does that give you a warm feeling?

Based on historical trends, some experts estimate that we are only in the early innings of bank write-offs. The write-offs will at least equal the previous peaks reached in the early 1990s. If several more large banks such as Washington Mutual or Wachovia were to fail, it might wipe out the FDIC fund. If the FDIC fund is depleted, guess who will pay? Right again, another taxpayer bailout.



What is a Level 3 Asset?

Other banks have been moving assets to Level 2 and Level 3 in order to put off the inevitable losses. The definitions are as follows: Level 1 Assets that have observable market prices. Level 2 Assets that don't have observable prices, but they have inputs that are based upon them.

Level 3 Assets are where one or more of the inputs don't have observable prices. Their value relies on management estimates, often based on computer modeling. In other words, the banks do their own "no doc" asset valuation.

Warren Buffet's view on the financial institution practice of valuing sub-prime assets on the basis of a computer model rather than the free market price states: "In one way, I'm sympathetic to the institutional reluctance to face the music. I'd give a lot to mark my weight to 'model' rather than to market."

So, the managements of the banks that loaned money to people who could never pay them back are now responsible for estimating what these assets are worth. According to analyst and commentator Bill Fleckenstein: "Recently, the portfolio of Cheyne Finance, one of the more infamous structured-investment vehicles, or SIVs, was sold at 44 cents on the dollar. I suspect that similar assets are not marked anywhere near that valuation on financial institutions' balance sheets. So, the game of 'everything's contained' continues, albeit in a different form."

The mountain of Level 3 assets clogging up America's economic arteries is massive.

Financial Institution	Level 3 Assets as a % of Capital
Bear Stearns	314%
Morgan Stanley	235%
Merrill Lynch	225%
Goldman Sachs	192%
Lehman	171%
Fannie Mae	161%
Citigroup	125%
Prudential	119%
Hartford	109%

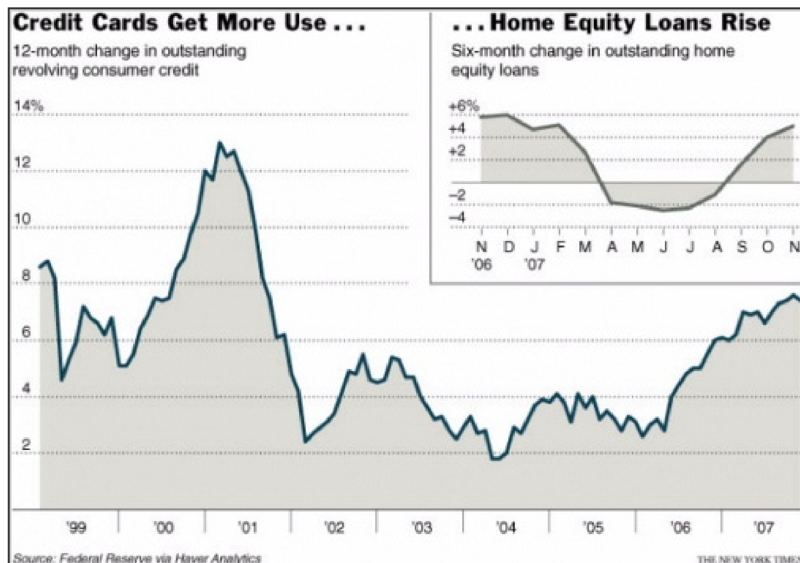
Next Shoes to Drop—How High Will the Losses Go?

Banks and security firms have reported $468 billion of losses thus far. Bridgewater Associates, a well respected analytical firm, believes things will get much worse.

According to Bridgewater, the models used have grossly underestimated the actual losses. They doubt the financial institutions will be able to generate enough capital to cover the losses. According to the report: "Lenders would have to curtail loans by roughly 10-to-one to preserve their capital ratios. This would imply a further contraction of credit by up to $12 trillion worldwide unless banks could raise fresh capital."

Not all of these losses are in the sub-prime market. According to the report, more than 90% of the losses from sub-prime loans have already been written off. Unfortunately, the losses from the prime and Alt-A loans, that is loans based primarily on high credit scores, could be much larger than we have already seen. The sizes of these shaky loan portfolios are much larger than the sub-prime portfolios. Further, Bridgewater expects about $500 billion in corporate losses that must be written off. This leads to the current estimates of keen-eyed experts such as Bill Gross, the well respected manager of the world's largest bond fund, who expects financial firms to write down $1 trillion. Gross predicted, "About 25 million U.S. homes are at risk of negative equity, which could lead to more foreclosures and a further drop in prices. The problem with writing off $1 trillion from the finance industry's cumulative balance sheet is that if not matched by capital raising, it necessitates a sale of assets, a reduction in lending or both that in turn begins to affect economic growth." NYU economist Nouriel Roubini believes that losses could reach $2 trillion.

The other shoes have begun to drop. Last week Amex reported a 40% decline in earnings as their wealthy super-prime customers are not paying their bills. So, even the well off are struggling.



CB Richard Ellis, the largest commercial real estate broker in the country has reported an 88% decline in earnings. So, commercial real estate is imploding. Bennigans and Mervyn's filed for bankruptcy this week. The consumer is being forced to cut back on eating out and shopping. The marginal players will fall by the wayside. Big box retailers, restaurants, mall developers, and commercial developers are about to find out that their

massive expansion was built upon false assumptions, a foundation of sand, and driven by excessive debt.

The U.S. banking system is essentially insolvent. The Treasury, Federal Reserve, FASB, and Congress are colluding to keep the American public in the dark for as long as possible. They are trying to buy time and prop up these banks so they can convince enough fools to give them more capital. They will continue to write off debt for many quarters to come. We could have a zombie banking system for a decade.

James Quinn is Senior Director of Strategic Planning, The Wharton School, University of Pennsylvania. This article reflects the personal views of Jim Quinn. It does not necessarily represent the views of his employer, and is not sponsored or endorsed by them.

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