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STAND BY: THERE IS MORE BAD NEWS COMING !

This Does Not Appear To Be The Time To Invest In Banks

The world's banks and finance houses are looking at provisions, write-downs and outright losses of just a little more than $US120 billion in the subprime, mortgage-lending industry, according to latest estimates.

Knowledge that this huge amount of money may, still, only be a gestimate rather than an accurate estimate of plus or minus a few percentage points, hangs over many an investor of nearly every equity market, around the world, as a modern-day Sword of Damocles: Dionysius the Elder, feasting at a luxurious banquet, while a sharp sword hangs by a horsehair above him.

The presence of this vast sum of money, awaiting the pleasure of bank examiners and, in some cases, government Central Banks, has, already, been felt on equity markets from Wall Street, New York, to Wellington Street, Wellington, New Zealand.

What has yet to materialise, with any real certainty, are the effects that the subprime, mortgage-lending industry's problems will have on the merger-and-acquisition activity, around the world.

It is, now, historical fact that nearly every bank and most financial institutions in the world has had to log in provisions and/or write-downs or, in some cases, write off completely, huge sums of money due to their exposures in the subprime, mortgage-lending industry, directly or indirectly.

Increases in risk provisions are required and more transparency on balance sheets is being demanded in order for banking authorities to know the extent of potential (and very real) loss problems.

But that is that which is known; what the near-term future will hold is, completely, unknown.

Will there be a requirement for further provisions, write-downs and write-offs?

On Monday, in New York, the merchant banking group of The Goldman Sachs Group Incorporated let go of its latest investigations into the affairs of HSBC Holdings plc () (Code: 5, The Main Board, The Stock Exchange of Hongkong Ltd).

In short, The Goldman Sachs Group Incorporated estimates that HSBC Holdings plc, a giant bank by any standards and being the largest such institution in Europe, will have to make provisions of about $US12 billion for its exposure in the subprime, mortgage-lending industry.

As soon as the Goldman Sachs news made the rounds on European bourses, it pulled down the key indices in a shot.

It does appear likely, in **TARGET**'s view, that there is a great deal more that has yet to be learned with regard to many tens of banks around the world as to these institutions' financial exposures to the subprime, mortgage-lending industry.

As the snowball winds its way down a steep slope, so it gathers quantities of the loose snow on the ground, causing it to grow in both size and weight.

So it is likely to be with many banks and finance houses that have yet to make admissions as to their problems, those potential problems perceived, and those problems, known to be hanging over the banks' bottom lines.

So banks will, as the months pass, have to own up to their problems: It is just a matter of time.

Structured Credit Products

Thus far, banks around the world are known to have written off more than $US30 billion in structured credit products, backed by US dollar-denominated, subprime mortgages.

Current accounting guidelines, in the Hongkong Special Administrative Region (HKSAR) of the People's Republic of China (PRC) and in most other jurisdictions, require that the extent to which the value of a structured credit product has been compromised must be reflected in a provision and/or a write-down and/or a write-off.

(**TARGET** is not certain how the banks in the PRC, proper, being distinct from the HKSAR, deal with such matters, if at all, and, as such, this medium cannot comment.)

In addition to that which is known, definitively, there are those bank *'products'* for which provisions, write-downs and write-offs are yet to be considered due to hedging strategies, employed by those banks, holding the products, among other things.

These non-transparent bank products, no doubt, are unlikely to find cash in a hurry in the marketplace and, as a result, the banks, beneficially owning the products, will have to inject cash into them or, alternatively, bite the bullet and take the products into their balance sheets – obviously reluctantly.

While the gurus of Wall Street are only too quick to point out that the US subprime, mortgage-lending industry accounts for only a small percentage of the total US, mortgage-lending industry, that *'small'* percentage amounts to about $US1.20 trillion.

That amount of money is equal to about 14 percent of all US mortgages.

It is estimated that about $US700 million of those US subprime mortgages were bundled, a few years ago, into structured credit products, known familiarly as residential, mortgage-backed securities.

Sticking a new feather on an old hat in order to spruce it up a little, many of these residential, mortgage-backed securities were further packaged into what is known as collateralised debt obligations.

It is confirmed that about 15 percent of subprime borrowers are in default, today, with regard to their payments.

These defaults are set to rise – not fall.

The reason for this is that, when the original residential mortgages were negotiated, back in 2005 and 2006, interest rates were much lower than those of today.

The current situation is that many borrowers of yesteryear are unable to front up with sufficient money to meet monthly debt service due to the higher carrying costs.

In short, these less affluent borrowers can no longer afford the costs of keeping their homes.

The present estimate of new defaults, already in the pipeline, at about 30 percent of the current volume of activity in the mortgage market of about $US1,200 billion, is about $US360 billion.

As house prices in the US continue to fall, more negative equity is looming on the financial horizon, suggesting strongly that about 33 percent of the defaulters will just give up the ghost and walk away from their financial obligations.

They will have little alternative in the matter.

That adds another $US118 billion to the expanding pot of mortgage defaults, resulting in even more provisions and/or write-downs and/or write-offs, being required by banks and finance houses.

The estimated amount for which banks still have to make provisions in respect of bad loans, associated with the US mortgage market, is about $US188 billion.

Of that amount of money, the estimated write-offs are about 50 percent – that is about $US94 billion.

Again, that which is not known are which banks are holding onto which screaming *'babies'*.

Within the next 6 months or so, things will become clearer as banks make known, out of legal necessity rather than any innate propensity to be transparent to shareholders and banking examiners and/or government Central Banks, all of the horrors of the current situation.

Adding to this situation are other problems, such as credit lines, formerly afforded to leverage buyouts, etc.

These could well balloon the total amount that banks will have to write off to about $US124 billion.

There are, also, other potential credit problems that many a bank and finance house is known to be facing, such as credit lines, given to customers to purchase motor vehicles, defaults in respect of credit-cards, and so on.

Conclusion: This does not appear to be the time to make new investments in banks and other financial institutions because, among other things, one does not know how safe is any particular bank or financial institution.

On Monday, on The New York Stock Exchange, the share price of Citigroup Incorporated, the largest bank in the US, slid about 6 percent to $US29.80.

This is not to suggest that banks and finance houses could go belly up – although some might well have to face the reality of the situation – but it seems apparent that banks and finance houses will have to start to tighten belts as their earnings drop, resulting in dividend payments, being reduced … or suspended.

One thing is absolutely certain: Wall Street gurus are holding onto the short end of the stick.

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