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THE LESSONS OF THE PAST: WILL THEY BE LEARNED BY THE GENERATIONS ?

The Music Has Stopped: Now, Who Does Not Have A Chair ?

Nearly every week, one learns of this bank or that bank, this finance company or that finance company, having to sell some *'family jewels'*, seek investors to bolster balance sheets with urgently needed cash, agree to repurchase the company's own *'paper'*, that *'paper'*, having been sold a year or so ago to gullible, unsuspecting investors or other finance institutions, domestic and foreign, and/or come into an agreement(s) with legal departments of various governments in order to escape long and costly lawsuits – which the banking/finance companies are, just about, guaranteed to lose.

If Mr P.C. Wren, the author of the 1924 novel, Beau Geste, were alive, today, he may well consider writing another novel, based on the subject matter of today's Code of Conduct/Honour – or the lack of them.

For **TARGET** () Subscribers, not familiar with the story of Beau Geste – *'a gracious gesture'* – it is the story of the *'theft'* of a priceless family jewel, the jewel, representing the family's main asset.

The *'theft'* was perpetrated by a member of the family in order to save the honour of the family.

English, upper-class values and attitudes, prior to World War I (1914 – 1918) are dominant in the novel and it could be held that it is a pity that a number of such values seem to have been lost, almost completely, in today's world.

Certainly, a great deal of skulduggery has been unearthed since the middle of 2006, skulduggery, perpetrated by some of the biggest banks and finance houses in the world.

Since the middle of 2006, the following banks and finance houses have written down or written off their books at least the following massive amounts of money, and the figures continue to rise:

Citigroup Incorporated	$US46.40 billion
Merrill Lynch and Company Incorporated	$US36.80 billion
UBS AG	$US36.70 billion
American International Group Incorporated	$US20.23 billion
HSBC Holdings plc	$US18.70 billion
The Royal Bank of Scotland plc	$US16.50 billion

IKB Deutsche Industriebank AG	$US14.73 billion
Bank of America Corporation	$US14.60 billion
Morgan Stanley	$US11.70 billion
Deutsche Bank AG	$US11.40 billion
Ambac Financial Group Incorporated	$US9.22 billion
Barclays plc	$US9.20 billion
Wachovia Corporation	$US8.90 billion
MBIA Incorporated	$US8.41 billion
The Credit Suisse Group	$US8.13 billion
Washington Mutual Incorporated	$US8.10 billion
HBOS plc	$US7.50 billion
TOTAL:	**$US287.22 BILLION**

The above calculations were only up to the beginning of August.

Since that date, other worms have crawled out of many a bank's/finance company's woodwork.

Missing from the above **TARGET** list is, of course, IndyMac Bankcorp Incorporated, a Pasadena, California, bank, which was the second-largest banking failure in the history of the US.

The bank's 33 branches were closed over the weekend of July 12-13 by the US Federal Government.

The failure of this, primarily, mortgage-lending institution, which, today, is being operated by the US Government's Federal Deposit Insurance Corporation under the name of IndyMac Federal Bank FSB, will cost about $US9 billion when all of the confirmed losses are tallied.

Since the beginning of this year, not less than 9, US banks have failed.

It should be stated, at this point, that the matter of the write-downs/write-offs of banks and finance houses were never a matter of honour, but a matter of legal requirement or force-majeure situations.

Also, it should be mentioned, at this point, that, in the case of Merrill Lynch and Company Incorporated, it was required that this stockbrokerage house and bank reach an agreement with the Attorney General of New York to compensate certain of its (former) investors … or suffer the consequences of a long and expensive lawsuit.

Merrill Lynch announced, officially, on August 20, 2008, inter alia:

> *'Merrill Lynch will compensate individual clients who purchased ARS* (**A**uction **R**ate **S**ecurities) *through the firm prior to February 13, 2008, and sold such securities at a loss between that date and the date of this announcement.*
>
> *'Merrill Lynch will participate in a special arbitration process for individual clients who incurred consequential damages from the loss of liquidity in their ARS holdings.*
>
> *'Merrill Lynch will pay a $*(US)*125 million penalty…'*

The above settlement will cost Merrill Lynch and Company Incorporated not less than $US10 billion at the end of the day and that figure could rise to $US12 billion, according to some pundits.

Merrill Lynch and Company Incorporated was not the only bank/strockbrokerage house in the US nobbled by the US Government's financial watchdogs:

a. Deutsche Bank AG was hit with a fine of $US15 million and ordered to repurchase about $US1-billion of its Auction-Rate Securities; and,

b. The Goldman Sachs Group Incorporated was fined $US1.50 billion and ordered to repurchase about $US22.50-billion worth of its securities.

More cases are known to be in the US Government's pipeline and will become manifest later this year, no doubt.

<u>Some Lessons To Be Learned</u>

The most-important lessons that should have been learned since the middle of 2006 ought to have been:

1. The lack of crises management arrangements by certain governments, allowing flexibility in providing emergency funding to financial institutions in times of stress, including the restructuring for banks/financial institutions in times of their near collapse;

2. The maintenance of the essential ingredient of any and all banks: Liquidity;

3. The importance of being able to ascertain valuations of structured products (derivates and what-have-you), such as Auction Rate Securities and the reams of *'paper'*, issued by banks/finance companies, involved in the sub-prime, mortgage-lending industry crisis; and,

4. The importance of disclosure to risk.

<u>Some History</u>

The turmoil on the world's credit markets is unique in a number of ways, to be sure, but, at the same time, there is that same flavour of the past credit crises.

Where the current situation appears to differ greatly from past crises' situations are that the excesses, brought about by the prolific issuance of structured credit products, based on unsustainably high, real-estate valuations, have not been seen in such numbers in the past.

This situation came about due to low interest rates, strong economic growth, and the rapid increases in real-estate prices in the US.

This, in turn, led to over-confidence, the building of many more homes, then, more building, and even more building.

And, to top it off, officials of banks and finance companies became completely irresponsible and sloppy with regard to tried-and-true banking policies.

Bad lending practices followed in the wake.

Until the balloon went: Pop!

The balloon went *'Pop'* when the US housing market collapsed.

The US housing market collapsed with such speed and in such intensity that it took many a banker completely off guard.

At first, the US housing markets' declines in value were considered just a hiccough that would go away as quickly as it came.

But that hiccough cascaded to the credit markets, first in the US and, then, it spread to just about every credit market of the world.

Today, it is accepted that the collapse of the US housing market and its knock-on effect on international credit markets is among the biggest financial horror stories since The Great Depression of 1929-1939.

With inflation in check in the US and most of Europe, with the very pleasant situation of 5 years of low interest rates, with consumer demand in The Land of The Free and The Home of The Brave, hitting historic highs – everybody should be financially able to own their own homes – it was a time of stability for the world's largest and most-important economy.

Banks sought to consolidate their positions by purchasing what they thought were secure, Grade AAA, fixed-income products.

Then, widespread speculation on the subprime, mortgage-lending industry followed.

Even HSBC Holdings plc, Europe's largest bank, joined the throng.

At the same time, investors sought to find ways to make money from the loose credit conditions: Banks were awash with cash and ready to lend it at the proverbial drop of a hat.

The question for many investors was, simply put: How may I take advantage of this situation in order to line my own pockets – at the expense of the loose credit conditions?

Many investors were very successful in this quest and walked away with full pockets.

But, then, the penny dropped.

That, simply put, is the situation, today.

During, what is now seen as the chaos of just one year ago, there was the development of ingenious new derivate instruments that were sold to banks and finance houses, around the world.

It mattered little who or what purchased these new instruments of investment just so long as the risk could be passed on from Mr A to Mr B, from Bank X to Finance Company Y and so on.

In a word, it was unfettered greed, unseen for many a decade that helped to bring about the current situation.

The urgent search for higher yields in the US subprime, mortgage-lending industry was the undoing of many a bank/finance house, around the world.

The irresistibility of high yields, coupled with high credit ratings, was too much for many investors who succumbed to temptation.

A major problem was that the high credit ratings had been created by the previous sellers of the engineers of the structured, derivative products that were sold down the line.

It was along the lines of children, playing musical chairs: When the music stops, the child without a chair is deemed the loser.

For many a bank and finance house, during those halcyon days, it was a movement away from lending money to customers and holding the line, to creating the derivative and, then, selling it on, taking a turn along the way.

This resulted in even more credit, being created.

It, also, led to a long line of banks, finance companies and individuals, holding onto *'paper'*, much of which was depreciating in value with every passing day.

When it was recognised that the game was up, the value of the *'paper'* was seen for what it, really, was: Worthless instruments that were devoid of any backing or financial backbone.

Strangely, as it transpired, it was discovered that investors, who ended up with this *'paper'* as the buyer of last resort (*en dernier resort*), had little to no information with regard to the underlying quality of the loans on which the *'paper'* was, supposedly, backed.

Rating agencies had stated, at the beginning of the chain sales of the derivatives, that the *'paper'* had a rating of this or that.

It looked good and the documentation, supporting the valuations of the investments in the derivatives, indicated the seeming logic of putting the money on the table.

Suddenly, there was a reversal of the former enthusiasm, which had led to the establishment of the value of the derivatives.

Too late: The music had stopped.

And, then, government agencies were forced to enter: Stage Centre.

Banks failed and, on investigation, it was seen that skullduggery had been, in part, a dominant theme in the chaos with which, today, the world is faced.

The situation is far from over, as this medium has stated on a number of occasions.

The chaos may persist for some years to come – sadly.

What were the words of that 1950s song, again:

'I didn't know the gun was loaded and I'm so sorry my friends …'.

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