VOLUME X No. 210 F R I D A Y November 7, 2008

MAKE NO MISTAKE:
THE RECAPITALISATION OF BANKS IS ONLY A TEMPORARY BAND-AID

The Structural Problems Continue To Remain With Us

The banking crisis that has rocked the world has not been solved.

The recapitalisation of lending institutions by central banks, around the world, is not the solution to what ails most banks.

What central banks have done is, at most, cosmetic.

Granted, these acts are very important, but they are, at best, nevertheless, cosmetic.

They are buying time, to be sure, but they are not curing the root cause of the problems that brought about the international banking crisis, a crisis which has grown into a worldwide phenomenon and has spawned an international crisis of confidence.

Central banks' actions are, as the world has come to realise, very useful, at least in the short term, but they are not the medicine to cure the chronic sickness that caused this international dilemma.

The challenging structural problems remain; they have yet to be tackled, effectively.

Securitised mortgages – those were among the financial instruments, used by banks, such as Lehman Brothers Holdings Incorporated, that bundled collections of mortgages together and sold them as securities and/or derivatives – were actively marketed around the world at the time that house prices were rising and interest rates were relatively low.

Due to the rapidly rising prices of houses, condominiums, etc, these financial instruments masked the inherent risks, attached to the underlying loans.

In fact, as is well known, today, even bank officers and employees of financial entities, selling these instruments, were not fully apprised, or were even cognisant of what they were marketing, concentrating more on the commission that they could earn by getting customers to take up the instruments with promises of greater interest than banks were willing to offer at the time.

Today, the penny has dropped and investors and speculators, who were either duped, were stupid, or were instilled with insatiable greed, are blaming banks/financial entities and their employees for their problems.

For certain, in many cases, bank officers and/or their salesmen/saleswomen will have to face the music for their lack of fidelity to customers.

But not in all cases.

Because one must take responsibility for one's own actions and one should not blame the messenger for the bad news that he carries.

The securitisation of mortgages permitted banks to transform liquidity on their books.

Wholesale borrowing permitted these banks to finance the securitisation of mortgages, at least in the short term.

When things started to go wrong, however, with the number of defaulters, rising rapidly, as home prices dropped even more rapidly, first in the US and, then, around the world, a reassessment of the risks, involved in the securitisation of mortgages, was made out of necessity.

And, to the horror of many a bank and, today, the investor/speculator who bought into these instruments/derivatives, the truth was discovered: There was a very material shortfall in the market value of the collateral on which these instruments had been marketed.

This, to the dismay of many Hongkong investors/speculators, is the situation that they face, today, in respect of many, if not most, of the instruments, sold via banks, prior to and, to their shame, after the bankruptcy of Lehman Brothers Holdings Incorporated.

Securitisation of mortgages dwindled on the realisation that the market value of real property was continuing to fall and, at the same time, defaulters were growing at a near record pace.

While the liabilities of most banks remained unchanged, it was noted that the value of the assets, held by banks, was being eroded, day, after day, after day.

Magnification of the problem was made apparent when balanced against the high level of bank borrowings, relative, that is, to the capital with which the banks were operating.

At the same time, many banks were appalled to learn that they had, on their books, material quantities of securitised financial instruments, the values of which were highly questionable.

In addition to the very difficult task of trying to value the securitised financial instruments and the even more-complex financial instruments, there was the question of the distribution of the losses from these instruments, losses that, surely, must become apparent by year’s end when the books of the banks are scheduled to be audited.

Eventually, as all of the above came to be widely known, the share prices of the scrip of publicly listed banks fell.

And, rightly so, too.

And, with the fall in the market value of the bank scrip, capital was squeezed.

The end result: Confidence in the banking system, from one end of the world to another, was shaken – and it has yet to recover.

Which bank may one trust?

Which Vice President or Account Manager at which bank is more interested in his/her commission, or meeting her/his quarterly quota, than assisting customers?

These were just some of the questions that were being asked by investors and bank customers from New York to Hongkong to Tokyo.

And these same questions are being asked today – sadly.

It was the admission by Lehman Brothers Holdings Incorporated about its financial problems that was the catalyst that led to the present problems, but, if it had not been this bank, it would have been some other financial entity.

It is a given that, sooner or later, inadequate capital at banks would have become only too apparent; and, a crisis, of one kind or another, would have been made manifest.

Today's Situation

The recapitalisation of banks is having a telling effect; there are positive signs of a partial restoration of confidence.

A full recovery of confidence will be when the concerns of the viability of banks recede into history.

This may be faster than one may imagine.

It will, no doubt, take some time before bank recapitalisation leads to a resumption of normal lending levels by the banking system, normal, that is, prior to August of 2007.

Meanwhile, the world is on the brink of a recession.

Unemployment in the Western World continues to rise and, in the United Kingdom, it is running at a 17-year high.

House prices in the United Kingdom fell by about 5 percent in the third quarter of this year and there is no sign of it bottoming out.

Year-On-Year, the prices of houses in the United Kingdom are down about 13 percent.

It is a similar story in the US and in eurozone.

The squeeze on credit has taken place while real disposable incomes have fallen due, in large part, to the increases in the prices of energy and foodstuffs.

The combination of the above-mentioned factors suggests, strongly, that the risk of a rapid and lengthy slowdown in domestic demand is imminent.

The full force of the slowdown will, likely, be felt mostly in 2009.

Turning to the matter of inflation, it is known that, in the US, inflation is running at the rate of about 5.60 percent per annum; and, it is gathering momentum.

In eurozone, inflation is running at the rate of about 4 percent per annum.

Inflationary tendencies are worrying on both sides of the Atlantic.

One of the mandates of the US Federal Reserve is the containment of inflation.

The same mandate holds true of The European Central Bank and The Bank of England.

Oil prices have retreated from their peak of about $US147 per barrel of light sweet crude oil in July, this year, and this has resulted in petrol prices at the pump, retreating in line with the fall in the price of crude oil.

This is a positive sign and it will, no doubt, support the growth of real incomes as well as help to contain, to a small extent, at least, inflationary tendencies.

However, it is also noted that the cost to support banks, financially, from East to West, will raise the level of national debt of nearly every country.

The path to financial health, round the world, is strewn with rocks and boulders; one must negotiate this path with a great deal of care because to stumble is only too easy.

With bank recapitalisation plans now a reality, from one corner of the world to another, the restoration of lending, leading once again to economic growth, will be long and not without difficulties.

The bank recapitalisation plans were never envisaged to save banks or, for that matter, to nationalise banks, but they are envisaged to protect economies from the banks.

TARGET () notes that the Government of the People's Republic of China is, probably, one of the leaders of the world in this regard; and, its actions of late are bound to bear fruit, sooner than later.

Please Read Next Wednesday's Lead Story:
What The World Requires.

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