THE FINANCIAL CRISIS IN THE UNITED STATES

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Highly regarded within the field or bankruptcies and restructuring, Wilbur Ross is Chairman and CEO of W R Ross and Co. of New York. His successes include automotive, coal, and steel manufacturers. Now, Ross is focusing on the financial services sector.

At a recent conference, Ross provided a very sobering view of the financial black hole that American banks and consumers have dug for themselves.
Opening on a lighter note, Ross said, “I recently happened to find myself at the Federal Reserve Bank in Boston. At the reception desk hangs a carefully done sign, which informs the visitor, ‘The Federal Reserve Bank of Boston does not cash US Government Pay Checks.’” Ross continues, “someone had written in magic marker pen below, ‘what do they know that we don't know.’” That tells you a little bit about the state of confidence in the US today.”

Ross said he believes “the present financial crisis is about four(4) times as severe as the 1986-1990 S&L crisis, about two and a half times worse than the 10 year Japanese crisis, and about twice as big as the Asian crisis as 1998-1999.”

Further he says, “the IMF has forecast cumulative losses of some $945 billion, but that excludes high yield bond losses, which will add another $150 billion to that total. So, I believe the probable total damage from this crisis is something on the order of $1.1 trillion. For most financial institutions, each $1 of equity supports at least $12 of lending capability. Therefore, these losses are equivalent to removing about $13 trillion of lending power from the system,” just about the annual GDP of the US. “That's one reason why you don't hear much anymore about the worldwide liquidity excess that was supposed to save us from every imaginable financial crisis.”
Lender psychology has also changed

Says Ross, “the other important change has been in the psychology of lenders: for several years, no lender had been afraid of anything. Now, every lender is afraid of everything. Banks don't want to lend money to other businesses, and they especially don't want to lend money to each other. And, that's why the premium for interbank lending has sextupled over the past year.”

He points out that in the 3 years from June 30 2004 to June 30 2007, the top 10 European and American banks more than doubled their total assets, “partly because they had to take onto their own balance sheets the SIVs and other little pockets in which they had been hiding loans before. Now every bank wants to shrink its balance sheet.”
Another time bomb: CDs

“There's another huge but unclearly defined time bomb called credit derivative swaps, in which one party contracts to pay another party in the event that a particular debt instrument defaults. These have been growing amazingly rapidly - 37% in the second half of 2007 alone and now cover an amazing $62 trillion worth of underlying debt. The gross amount of CDs' outstanding is $455 trillion notional value of contracts.” Ross explains, “the reason that's seven (7) times the underlying amount is that an entity that wrote credit protection on a particular security at one point in time may well buy the same kind of protection to lock in the spread.” According to the International Swaps and Derivative Association (ISDA), offsetting trades means that if you netted out all of the trades against each other, the net credit extension is $2.3 trillion, still a huge amount.

“This is problematic because it's largely an unregulated global industry not conducted visibly on an exchange nor through a clearing house mechanism—and, it mainly covers corporate debt. Because it is a daisy chain, in which 37% of the players put up no collateral capital whatsoever, defaults could suddenly create a problem that is tens or even hundreds of trillions of dollars in size. So far it has not really blown up. I hope it doesn't. But, it's one of the risk factors that one should think about in evaluating US and Western European credit markets.”

How did this systemic compounding of risk happen? Says Ross, “it's three-fold. First, historical concepts of risk

management were discarded. Instead of operating on the traditional basis of ‘risk adjusted returns,’ many lenders were operating on the basis of ‘risk ignored returns.’ They were seeking returns and not really focusing on the risk component.”

Two most dangerous words: financial engineering

Second, are what Ross calls, “the two most dangerous words in the lexicon of Wall Street, ‘financial engineering.’” Brilliant young mathematicians with elaborate computer programs believed that they could forecast the probability or severity of default on newly created securitizations. And, they believed they could do it so well that they could bundle together $1 million of underlying low quality securities and slice and dice them into tranches that would create a collateralized debt obligation with a trading value of $1 million and $30,000 ” which would do to the packagers and distributors of the paper.”

Initially, originators retained the lowest tranches but as the securitizations grew so rapidly, they began to put too much of their own capital at risk. So they developed a new and extremely toxic product, called a CDO squared. This consisted of taking the lower, unwanted tranches of the initial securitizations, bundling them together, into a new CDO, selling the highest tranches of those (which turned out to be most of the whole thing), get it rated AA and AAA — and then sell it off. The same accounting magic turned the same million dollars into $1 million and $20,000—the fee again spread among the same parties.”

“What made this occur was the rating agencies acceptance of the black boxes' output. They were given a AAA rating. That generous allocation of credit rating is what created the extra trading value, because the AAA and AA tranches could trade at lower yields than the underlying securities.”

There were some inherent flaws in all this says Ross. “First, historic modeling implicitly assumed that tomorrow would look a lot like yesterday. But, the truth is, that major credit crises come about when tomorrow turns out very different from yesterday. Second, in subprime and most other forms of mortgage lending, anyone that did field due diligence would have known that the endemic deterioration of lending standards made it 100% certain that tomorrow would not look like yesterday, and instead, would look far worse. But back then, no one wanted to interrupt the party.

Turns out, says Ross, “CDOs have not performed well. During the first three months of 2008, 4,485 of these issues have been downgraded. And a 1,000 of those were previously rated AAA. Many of these AAA tranches were held by banks. These downgrades help to explain why banks have already written off $230 billion worth of their CDOs.”

Where do we go from here?

“So, that's how we got to where we are now. The scariest part of where we are now is what has happened to the American consumer. Consumer spending represents 70% of our total economy. It's really the engine that drives our economy.”

Ross points out that, “median income has dropped from $61,000 to $60,500 over the past year . It actually went down. But Americans, like people everywhere, would like to improve their standard of living. So, the solution they found to median income not going up was borrowing. So, they decided to first load up with consumer debt. For the past several years, Americans had no net savings. When that ran out, people started using their homes as a kind of ATM with a bedroom. That worked well as long as property values were going up. But, now housing prices are going down, not up.”

Wealth effect is now a poverty effect

In those years, even if people didn't take out a bigger mortgage, they felt wealthier as their house prices went up. Now, we have kind of a poverty effect as the value of the house declines. Each 5% decline in home values erases $1 trillion of American's net worth. The Federal Reserve Board estimates that for every $100 change in home values, consumer spending changes by $3.75 and many economists think the ratio is higher--$7.00 per $100. If they're right, a 5% property value decline would cut consumer spending by as much as $70 billion per year.”

“In the 12 months ended March 2008, bank repossessions of houses rose 129% from the year earlier period. And, it's not over yet. Delinquencies and foreclosures are rising rapidly; inventory is now more than 6 months supply on a nationwide basis.”

Says Ross, “Moody's estimates that by June 30, 10.6 million homeowners, 21% of all those with first mortgages outstanding, will have no or negative equity value in their homes. Meanwhile, it's very hard to get a mortgage. Lower interest rates don't help too much because it makes little difference whether you're turned down for an 8% loan or a 6% loan.”
V-shaped recovery?

“One bright spot, the weak dollar will begin to reduce our balance-of-payments deficit in the economy, albeit one that is a small fraction of consumer spending. And, one that is largely offset by the implosion of employment in real estate and mortgage industries, which created about 17% of job growth in 2006.”

“I believe we have entered a consumer and credit-driven recession that will cause at least another year or more of stagflation. But, I don't believe that it will reach the levels of the end of the world or Great Depression.

“I wish that I could agree with those who see a sharp V-Shaped recovery in the second half of the year, but I simply think that's wishful thinking.”