Financial Toxic Waste Continues to Unravel. Loan Assets "Created Out of Thin Air"

The Circumvention of Basel Accord Capital

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DEBTCON-1 (as in DEFCON-1, the highest level of the alarm system for impending military threats/crisis) have been triggered, but the FED, global central banks and regulatory authorities are still in deep denial and treat the ongoing global financial crisis as still in the state of DEBTCON-5 (i.e. DEFCON-5, the lowest threat alert).

Before reading this article, I would like to invite you to revisit my three previous articles posted to my website, FutureFastforward.com, [1] namely:

1) Too Big To Fail Banks Will Collapse Between Now and First Quarter of 2011;

2) Basel III: The Iron Clad Confirmation That Global Banks At The Edge of The Precipice; and

3) BISTRO: Bank of International Settlements Total Rip Off.

The above three articles provide the necessary background and explanations to the issues discussed in this article.

The third article, BISTRO, exposed the banking scam of circumventing the Basel Accords' capital / asset ratios. This is only one side of the coin. To fully appreciate the global derivative casino scam, we must examine and understand the other side of the coin – how loan assets are created out of thin air, bundled and securitised and transformed into gambling bets.

The recent announcement by JP Morgan to suspend foreclosures, as much as 56,000 pending foreclosures and that Bank of America will put foreclosures on hold in 23 states, is the inevitable result of this scam – the biggest financial fraud in history.

The CDOs (mortgage-backed securities), the CDS etc. were sliced and diced, repackaged and re-invented to such an extent, that only computers could unravel their subjective values and who are the actual owners of these securities from the maze of cross-ownership. Even this admission must be taken with a pinch of salt, as toxic waste continues to unravel. The fact that the Courts have ruled that banks cannot foreclose because their ownership of the "foreclosed assets" have not been established and or are uncertain is an admission thatthe entire CDO/CDS derivative casino is a gigantic fraud – selling and buying (the suckers prefer to call it investment) of worthless papers!

This may well be the trigger (in addition to the US Treasury bubble) for the 3rd Phase of the

Global Financial Tsunami.

I am getting ahead of myself.

Let’s get back to the basics.

Banking Myths And Misnomers on Money Creation

“The study of money, above all other fields in economics, is one in which complexity is used to disguise truth or to evade truth, not to reveal it. The process by which banks create money is so simple the mind is repelled. With something so important, a deeper mystery seems only decent.”

– John Kenneth Galbraith, former professor of economics at Harvard

“It is well enough that people of the nation do not understand our banking and money system, for if they did, I believe there would be a revolution before tomorrow morning.”

– Henry Ford, founder of the Ford Motor Company

Please bear in mind the above two quotations when reading this article.

Myths and misnomers have been used by the banking elites for centuries to mislead and confuse the masses so that they will never understanding that banks and banking business of necessity is essentially fraudulent. I call it legalised fraud. This is because, judges under the payroll of the banking elites devised legal fictions to enable the banks to perpetrate the fraud. The legal tender law is but one example. We will revisit this issue later.

Another concept, that the relationship between a banker and a customer who deposits money in a bank is that of a debtor/creditor, is also responsible for the confusion. While it is true that a banker must return the money deposited on demand by the customer, the illusion and this is commonly perceived, is that the banker uses the deposits (i.e. borrow the deposits) to create loans to borrowers. This is one of the biggest myths in banking. We will expose this myth below.

Let us now analyse some banking terminology.

1.0 Deposits – Time Deposits etc. [2]

1.01 The layman assumes that the bank lends money to borrowers from the monies deposited by the customers whether as time deposits (“fixed deposits” in Malaysia) for a certain period e.g. 3 months, a year etc. or deposits in the current account. This is a myth, and this myth is further perpetuated by the banker telling customers that because they pay interest on the deposits made by the customers, the loans they extend to borrowers must of necessity be at a higher rate. [3] But, there is another kind of “deposit” in banking jargon which has caused so much confusion, even to bankers themselves and top-notch economists not well versed in banking. Let me explain.

1.02 When a bank creates a loan of $100,000 to Jack Smith, this sum ($100,000) is credited to the account of Jack Smith at the bank. The account may be his current account if an Overdraft Facility is extended to Jack Smith. Therefore, a $100,000 overdraft facility means that Jack Smith can issue checks (cheques) or withdraw cash up to the limit of

$100,000 in his current account. If the loan is a mortgage loan repayable by monthly installments over a fixed period of time, the bank will create a fixed term loan account in the sum of $100,000.

1.03 This is done electronically by an entry in the computer system of the bank. The bank does not physically transfer the cashfrom customers who have deposited the monies into their account to that of the borrower. When the bank credits the borrower's account as explained in the above two situations, the bank is said to have created a deposit i.e. the bank has deposited $100,000 in Jack Smith's account. This deposit is created out of thin air. This is a critical step in the "legalised banking fraud". This so-called deposit is not a transfer of any cash, but a mere book entry in the computer. Before there were any computers, the bank clerk would write an entry in the credit column of Jack Smith's account the sum $100,000. In the old days, money was created by a mere stroke of a pen. Today, by the mere click of a computer mouse!

1.04 Even at this basic stage, you are already confused. How can this be allowed?

This explains the oft-repeated phrase, "money is created out of thin air". The more accurate description should be "debt is created out of thin air" or alternatively "loan is created out of thin air". The law expressly allows it. This is the essence of Fractional Reserve System of Banking.

2.0 Fractional Reserve Banking

2.01 In the past, I have often been lambasted by so-called academicians and even professors of economics not well versed in banking, for promoting conspiracy theories etc. and since I am a lawyer by profession, I cannot be right. To rebut these stupid allegations, I would like you to read once more the quotations by Prof. John Kenneth Galbraith and Henry Ford cited earlier.

2.02 For the remaining doubting Thomases, I will be content to quote in extenso a passage from the booklet, Modern Money Mechanics produced and published by the Federal Reserve Bank of Chicago.

"Who Creates Money"

"… It started with goldsmiths. As early bankers, they initially provided safekeeping services, making a profit from vault storage fees for gold and coins deposited with them. People would redeem their "deposit receipts" whenever they needed gold or coins to purchase something, and physically take the gold or coins to the seller who, in turn, would deposit them for safekeeping, often with the same banker. Everyone soon found that it was a lot easier simply to use the deposit receipts directly as a means of payment. These receipts, which became known as notes, were acceptable as money since whoever held them could go to the banker and exchange them for metallic money.

"Then, bankers discovered that they could make loans merely by giving their promises to pay, or bank notes, to borrowers. In this way, banks began to create money. More notes could be issued than the gold and coin on hand because only a portion of the notes outstanding would be presented for payment at any one time. Enough metallic money had to be kept on hand, of course, to redeem whatever volume of notes was presented for payment."

2.03 Read again the underlined words. What the sentence means is that if there were 1 million gold coins held by the bankers in the vault for safe-keeping, at any one time, only a small amount of the gold coins would be redeemed by the customers. The customers who needed gold coins would surrender the receipts and take possession of the gold coins. The receipts issued by the bank for the gold coins were convenient and were used as a "replacement" for the actual gold coins. It was accepted because it was backed by gold i.e. redeemable in gold coins. In time, through usage, sufficient confidence was established to treat these "deposit receipts" as "money".

2.04 But, the devious and corrupt bankers realised that they could "create" additionally receipts (not backed by the customers' gold and coins in the vault) and no one would be the wiser, because everyone assumed that the additional receipts issued by the bank were backed by the gold and coins in the vault. In law and in fact, these receipts are counterfeit receipts. This is because genuine receiptswere issued upon a customer depositing his/her gold for safekeeping and in exchange, was given a receipt for the value of the gold and coins so deposited. But the banker's additionally receipts were issued without any deposits of gold and coins! Therefore, the additional receipts issued by the bank are not receipts issued for gold coins deposited, but self-created receipts passing off as genuine receipts backed by gold coins. Therefore, a fraud has been committed.

2.05 If there were no gold "deposits" from customers, there is no way a bank can issue receipts. This is because such receipts would not be accepted as a thing of value as it cannot be redeemed for gold coins. It is mere paper! When there are deposits, the bank can create the illusion that the additional counterfeit receipts are redeemable in gold.

2.06 How did the bank utilise these counterfeit receipts to make money?

Step 1: Since the genuine receipts have been accepted as equivalent of the gold coins, they could be used to pay for goods and services. But, the public would not know the difference between the genuine receipts redeemable in gold and the counterfeit receipts. The public assumed that all the receipts issued by the bank are genuine.

Step 2: Relying on this misplaced confidence on the part of the public, the bankers would be able to entice members of the public who were in need of "money" to borrow from them. The bankers used the "additional counterfeit receipts" to create interest bearing loans.

2.07 No one ever asked the critical question – if receipts have been issued by the bank to the customers for their deposit of gold, the receipts must be in the custody and possession of the customers. So there cannot be "additional receipts" floating around. In the event, a customer surrenders his receipt to reclaim his gold deposited with the bank, the "receipt" is no longer of value, as the gold has been redeemed. The receipt would have to be canceled or destroyed. So how can there be additional receipts?

2.08 Such loans were given out as loans to borrowers at an agreed interest rate. But repayment of the principal and interest were paid in gold coins. That is how in the olden days, banks created "money" or more accurately created debts and or loans!

2.09 Let us fast forward to modern banking. Let us ask the same question in a different sort of way. As I have stated earlier, if the public believes that bank loans are dependent on the cash deposited by its customers, then it must be obvious that the dollar value of the loans must be equal to the value of the cash deposited i.e. if $10 million is deposited by customers with a bank, then the bank can lend only one single loan of $10 million or several smaller loans of $ 1 million or several smaller loans of various denominations but not exceeding $10 million.

2.10 But, this is not the case. The bank balance sheet does not show this. In fact, by law, under the system of Fractional Reserve Banking, a bank can create (extend) loans ten times the value of the cash deposited by the customers. Thus, in our example, if the bank has $10 million of customers' deposits, by law, the bank can create (extend) $100 million worth of loans by a mere entry in the accounts of the borrowers. It can be a single loan of $100 million or ten loans of $10 million each or several loans of various denominations but not exceeding $100 million!

3.0 Leverage

3.01 When a bank in the old days issued additional counterfeit receipts in excess of the amount of gold coins that would be redeemed at any one time, the bank is said to have leveraged the gold deposits by the use of the counterfeit receipts.

3.02 The inverted pyramid of a small capital base to support the huge loan assets as stipulated by the Basel Accords on capital / asset ratio is another example of leverage.

3.03 Sub-paragraph 2.09 is another example of leverage in the Fractional Reserve System of banking.

4.0 Monetary Base

4.01 The Monetary Base is the nation's total cash supply, the stock of a country's coins, notes, and bank deposits held by the central bank. As at July 2007, before the onset of the global financial crisis, the monetary base created by the FED totaled $836 billion, of which $758 billion consisted of Federal Reserve Notes and coins held by the public (i.e. the money in your wallet, in simple layman's term). The FED estimates that as much as 50% of the currency is held overseas by foreigners. The balance of the monetary base of $78 billion ($836 billion less $758 billion) represents "reserves" of banks deposited with the FED.

4.02 You will notice that the monetary base (specifically the amount of Federal Reserve Notes and coins in circulation i.e. $758 billion) is relatively small compared to the GDP of the US which was estimated to be $12 to $13 Trillion at the material time. This is, to use the layman's language, money in your wallet to effect cash purchases for goods and services.

4.03 This is the amount of money "printed" by the FED. This amount of money in circulation does not cause inflation, as it merely reflects the "cash needs" of the public at any one time.

4.04 This is one of the reasons for the confusion with regard to inflation. When we say that the FED "creates money out of thin air", there is an element of truth in that the FED and other central banks do "print" monies – the Dollar, Swiss Francs, Liras, Ringgit etc. This "printing" is in relation to the production of "currency" i.e. the Federal Reserve Notes in your wallet. The Ringgit in my wallet. And in 2007, it was a miniscule amount of $758 billion. Please bear this in mind!

4.05 Yet, the daily turnover of the Global Forex market is estimated to be $4 trillion and the nominal value of the derivative market before the Global Financial Crisis was estimated to be in the region of $800 trillion!

4.06 Something is not right here. It is a physical impossibility for $758 billion worth of currencies in circulation to facilitate the sale and purchase of $4 trillion in the Forex Markets and $800 trillion in the Derivative Markets. How did these "extra monies" get to be created?

4.07 Through the process of debt creation. The "extra" money was not created to enable people to make cash purchases of goods and services. The $758 billion worth of currencies took care of that function.

4.08 The "extra monies" were obtained through DEBT. People borrowed to spend on the goods and services that they desired. We finance our consumption by borrowings – housing loans, car loans, student loans, credit card loans, overdraft facility etc. We also borrow to "invest" (I prefer to call it gambling) in the stock market. It is fair to say that an average person works to pay off his debts.

4.09 The "Debt Money" (or to use the banker's preferred term "credit" [4]) and its expansion that causes inflation. The bulk of the "debt money" is transacted via checks [cheques], credit card / debit card payments, electronic transfers etc. and only a small amount is in cash (as when you cash a check [cheque] from your bank account for cash transactions).

The Debt-Based Fiat Money System

5.0 The Insidious Role of The Central Bank

5.01 I want you to read over and over again the following quotations which have puzzled me since I was a student. I did not appreciate their significance until I embarked on my research on banking as my firm had a substantial practice in this area of the law.

5.02 Do not rush. Take time to think about it. For, if it was so simple to grasp and understand the fundamental principles, the FED and central banks as presently constituted would have been abolished a long time ago and there would have been major revolutions throughout the developed world. [5]

"Let me issue and control a nation's money and I care not who writes the laws".

– Mayer Amschel Rothschild

"I am afraid the ordinary citizen will not like that the banks can and do create money. And they who control the credit of the nationdirect the policy of the Governments and hold in the hollow of their hand the destiny of the people".

– Reginald McKenna, Chairman Midland Bank, 1924

"History records that money changers have used every form of abuse, intrigue, deceit, and violent means possible to maintain their control over governments by controlling money and its issuance".

– James Madison

“When a government is dependent upon bankers for money, they and not the leaders of the government control the situation, since the hand that gives is above the hand that takes …”

– Napoleon Bonaparte

5.03 Some of you reading the quotations may say that this is history and what happened a long time ago is no longer true, as we now have a system of checks and balances in government institutions such as Congress, Parliaments etc. as well as domestic and international financial regulatory agencies. Additionally, there are laws that will prevent abuse by bankers. All well and good. But to those who continue to place such trust in the present system, please consider the following observations. Then ask – why have these outstanding leaders expressed their fears and disgust?

A few years after signing into law the 1913 Federal Reserve Act:

“I am a most unhappy man. I have unwittingly ruined my country. A great industrial nation is controlled by its system of credit. Our system of credit is concentrated. The growth of the nation, therefore, and all our activities are in the hands of a few men. We have come to be one of the worst ruled, one of the most completely controlled and dominated governments in the civilized world no longer a government by free opinion, no longer a government by conviction and the vote of the majority, but a government by the opinion and duress of a small group of dominant men”.

– President Woodrow Wilson

“The real truth of the matter is, as you and I know that a financial element in the large centers has owned the government ever since the days of Andrew Jackson”.

– President Franklin D. Roosevelt

5.04 Andrew Jackson was the President who outlawed the 2nd Bank of the United States, the predecessor of the current FED. But after his administration, the banking elites succeeded in establishing and controlling the FED. And as they say, the rest is history. Let us not be naïve anymore.

6.0 The Mechanics of Money Creation

6.01 It is absolutely critical to grasp and remember that the system of money creation is based on Debt. This is fundamental.

6.02 From the above quotations, the entity that controls the creation of debt wields actual power and controls the government of the day!

6.03 It is also obvious that any entity that is given a power to create “debt-money” cannot simply use a printing machine and print the “paper money”. If it is so easy to create money, the people will have no confidence in using them. A way must be found to ensure that the people have confidence in the “paper money” created by the banks, specifically central banks.

6.04 The clue to uncovering the bankers’ secret is their declaration that the objective of having the power to create “debt-money” is tocontrol governments. So the question that needs to be posed is, “How do we control the government?”

6.05 The simple answer is to make governments indebted to the banks, not just any bank, but to the central bank and in the case of the US, to the FED. What made President Woodrow Wilson so angry, was the realisation that by approving the establishment of the Federal Reserve Bank in 1913, and granting it the absolute power to create “debt-money” he had enslaved his country.

6.06 At the material time, just like all leaders of governments, President Wilson thought that for a government to implement economic policies, it must borrow money to do so. The misunderstanding was on issues relating to money. He equated a government to that of a person. If a person has no money, he must borrow in order to purchase the goods and services that he desire. President Wilson failed to appreciate the meaning of “sovereignty”, the sovereignty of the State and government.

6.07 So, once the bankers were given the power to create “debt-money” it was the inevitable progression for the bank (the FED) to issue its Federal Reserve Notes to finance government’s expenditures. The government would in turn issue I.O.U.s (treasury bonds) to secure the borrowings. It is these borrowings that constitute the National Debt. The national debt is the public debt of the government -the obligations of the state (the US Government) to repay the loans granted by the FED.

6.08 This is the first step or the seed for the banking scam. And I want you to pause and think deeply on this issue so as to experience for yourself the “Eureka Moment”.

6.09 If you still have not uncovered the mechanics of the scam, let me give you a clue. Go to my BISTRO article and analyse Table 1, which illustrates the “risk-weighted assets” of various loans assets of a bank.

6.10 Loans to government (government securities) are rated zero risk as in cash. It is as good as cash! If that is so, why is there a need for a government to take a merry-go-round, by borrowing money from the FED and issue government bonds to secure the debt? If the FED accepts government bonds, then the public should also accept the bonds. The logical progression would be, why can’t the government issue its own currency to pay for its expenditures?

6.11 If the government can print the bonds (which is considered by the Basel Accords and Rating Agencies as good as cash), why can’t it print the currencies? Why delegate and authorise a third party (the FED) to print the currencies and then legislate that only these “paper monies” be considered “legal tenders” for the payment of goods and services and the discharge of debts!

6.12 Put it in another way – instead of allowing the FED to issue Federal Reserve Notes and declare them as “legal tenders” why can’t the government print “notes” and label them as “legal tenders”? Both are made of paper, both are affixed with a numerical value e.g. the one dollar bill, the 20 dollar bill and the 100 dollar bill. It is obvious that if the government issues its own currency, then there is no need for any borrowings! This is the scam! And the governments are so stupid to allow this to go on till today. Commit to memory the following quotation:

“There is no political or economic power more charged with the general or social interest than the power to increase or decrease the supply of money. If the sovereign authority delegates this power to a particular group or class in the community as it has done in large part of this country, it divest itself of a part of its effective sovereignty … The power to coin [6] money and to regulate the value thereof has always been an attribute of a sovereign power. It was one of the first powers given to the Federal Government by the Constitutional Convention. The development of deposit banking, however, introduced into the economy numerous private agencies which have power to create and destroy money without being recognized as creators or destroyers of money by the government or the people …”

– Marriner Eccles, Chairman of the Board of Governors of the Federal Reserve System (1935)

6.13 A bigger scam that is being perpetrated is sovereign loans – when governments borrow from foreign banks and fund managers in foreign currencies. The rationale is that if a government succeeds in borrowing foreign funds at “competitive” rates, it is a reflection of its favourable credit standing in the eyes of the foreign bankers. The United States (the biggest debtor in the world) is rated AAA and every other country plays “catch-up” and aspires for similar rating.

6.14 How stupid can a government get – to allow money-lenders (financial rapists) and corrupt rating agencies to evaluate its credit standing! And these foreign loans invariably results in foreign exchange losses. What is amazing is that even after John Perkins has warned how such loans enslaved the people of the borrowing countries, governments continue to source for such loans. There can be only one conclusion – government leaders have been induced by corrupt means to take up such loans!

6.15 Then, there is the $ trillion dollar question – why would the governor of a central bank advise the government to seek foreign funding to finance development projects etc.? Have they been induced by corrupt means to support such loans? The rationale of bankers, as declared in the quotations cited above, is to control governments. Therefore, borrowing from foreign banks and funds would enable foreign financial elites to control our governments.

7.0 Mechanism For The Creation of Virtual Money

7.01 With the invention of computers, there is now no need for the printing of currencies (Federal Reserve Notes) other than the amount of currency needed by the public for cash transactions.

7.02 So how has technology changed the modus operandi of the FED? Mr. Lewis Douglas describes it well when he said:

“Banks, when they buy government bonds, rarely pay for them with cash that someone has deposited in the bank. Instead, theycreate a bookkeeping credit against which the Government is entitled to draw … In a country in which more than 90 percent of all business is done by the use of checks, there is no essential difference between the creation of bank deposits by fiat and the creation of printing press money. Bank deposits – not currency – constitute our chief circulating medium.”

7.03 Just to ensure you understand the phrase “bank deposits by fiat”, you will recall in our earlier discussions on “deposits” and the confusion that this word has created. The bankers, as explained by Mr. Lewis, used the term “deposit” to mean that the banker has “deposited” fiat money by the mere entry in the account books, as opposed to you and me physically going to the bank and deposit our cash (the US dollar bills or the Ringgits) with the bank teller or the ATM machines.

7.04 This is what we mean when we say that the FED can with a click of a computer mouse “create money out of thin air”. It is equally obvious, there are essentially two types of “money”:

i) Printing press money – the currencies in your wallet to use the layman’s term (paper money and coins); and

ii) Bank deposits by fiat – “money” created by bookkeeping entries. Money that is circulated through the banking system by check (cheque) payments and other electronic payment transfers.

7.05 As explained by Mr. Lewis Douglas, “bank deposits by fiat” are “monies” created by the process of a loan extended to the borrower – government borrowings or private borrowings (i.e. you and me and business entities). I call them Debt-monies, because these are “monies” created out of a debt. But, bankers prefer to call them “credits” as a loan is a credit facility extended to a borrower. To the borrower, a loan is a debt!

7.06 The confusion in terminology arises because the banker and the borrower perceive banking transactions from different perspectives. Therefore, to understand the scam, we got to think and speak like a banker.

8.0 Bank Reserves

8.01 This issue relates to the “deposits” which customers place with a bank. All banks are required by law to have “reserves” in proportion to customers’ deposits. Please revisit sub-paragraphs 1.0 and 2.0 above before proceeding further. The required reserves vary from country to country, but it is common to have a 10% reserve in proportion to the amount of deposits.

8.02 The amount of reserves are calculated based on an average held over a 14-day period and on any single day, a bank needs only enough reserves to cover its customers’ withdrawals. A bank’s reserves consist of vault cash and deposits at the FED (central bank).

8.03 A bank’s reserves are reduced whenever it pays out cash (from cash held at its vault) or effect a fund transfer – by check or other electronic means etc. (from its deposits at the FED). Reserves are also reduced when a bank advances loans (i.e. when a customer draws down on the loan). Likewise, reserves would increase when there are new deposits, as explained in sub-paragraph 8.01 above.

8.04 Let me illustrate:

Step 1:

Assuming that a bank has $10,000 of “demand deposits” (i.e. a customer has deposited $10,000).

And assuming there is $1,500 of reserves (i.e. 10% reserve ratio = $1,000 and $500 excess reserves).

One fine day, a cash check of $500 is presented to the bank for cash withdrawal.

This will be the result:

Demand deposit is reduced to $9,500 and Reserve is reduced to $1,000.

Reserve of 10% of $9,500 is $950. Therefore there is an excess reserve of $50 ($1,000 less $950).

Step 2:

The next day, another cash check of $500 is presented for payment.

The result will be:

Demand deposit is reduced to $9,000 ($9,500 less $500) and Reserve is reduced to $500 ($1,000 less $500).

Reserve of 10% of $9,000 is $900. There is therefore a shortfall of $400 in the reserves.

The bank must make good the difference of $400 either by injecting additional capital of $400 or sale of securities to realise $400 or to borrow $400 from the FED. For reasons of liquidity, the practice is to borrow in the inter-bank market or from the FED by pledging sound collateral e.g. US treasuries. Presently, US treasuries are toilet papers, shored up only by stupid foreign creditors (the biggest being China). The rest of the banks' assets are all toxic wastes. How long do you think the FED and other central banks can get away by exchanging virtual monies (created out of thin air) for toxic wastes, without endangering the credibility of the entire system?

Step 3: The Fiasco

If pending the topping up of the reserve requirement to $900, there is presented a check (cheque) for cash payment of $1,000, what will be the result?

The remaining reserves of $500 are insufficient to meet the cash demand of $1,000. There will be a crisis. When this is amplified in the billions or trillions, the result is a bank run like what happened to the Northern Rock Bank in the UK and the banks in Iceland and elsewhere.

Assuming that the bank was able to top up the reserves to $900, what will be the result?

The reserves of $900 are still insufficient to meet the cash check of $1,000.

8.05 That is why the role of the FED is so critical in the banking system. The system is such that the FED MUST BAIL OUT THE BANKS whenever the system gets clogged up.

8.06 To put it crudely and bluntly – when the banking patient is constipated, the FED's role is to flush the shit out or else the patient would literally die in its own shit (the derivative toxic waste)!

9.0 Flushing The Shit Out – How?

9.01 When there is a financial crisis, the payment system screws up big time. Cash flows get really wobbly. Recall the case of the Northern Rock Bank. And now hundreds of bank failures.

9.02 There is now in the global banking system a huge problem. Demand deposits are shrinking or drying up and with that, "bank deposits by fiat" cannot be created. Debts (loan assets) are the lifeblood of the banking system. There is an urgent need for blood transfusion. The problem is further compounded by the lack of capital to comply with the Basel Accords capital / asset ratio. If compliance has been differed till 2019 for full compliance, banks are therefore insolvent.

9.03 Should we be surprised therefore, that the FED and other central banks, via massive Quantitative Easing (QE) has purchased massive toxic assets from banks so as to inject massive liquidity and boost reserves in the global banking system?

9.04 After the first round of QE, there was talk that the Too Big To Fail Banks were flushed with excess reserves. This is pure bullshit! If it was true, the banking crisis would have been resolved. The fact that the FED and other central banks are preparing for Quantitative Easing II is indicative that the worst is yet to come. They are holding their breath for the 3rd phase of the Global Financial Tsunami.

IT IS THE INVERTED PYRAMID, STUPID!

9.05 Now that you have an understanding of how money is created by the bankers, allow me to fast forward to the present global financing crisis so as to explain why I am issuing the global alert, DEBTCON-1.

Why DEBTCON-1?

This part of the article is related to the issues raised in Sub-paragraph 9.0 above and the reason why there is a further need for QEII – massive financial blood transfusion. The arteries are clogged up with derivative toxic wastes. You must understand how the toxic wastes clogged up the system to understand why the banking patient is in intensive care and dying.

10.0 Mania for Loans & Derivative Products – Debt Monies

10.01 In 2001, following the bursting of the tech bubble, Alan Greenspan embarked on a policy of aggressive reduction of interest rates. By 2003, the prime rate has fallen to 1%. It was unprecedented. This was the desperate attempt to revive the markets, as the tech bubble wiped out more than $5 trillion.

10.02 With such low yields, financial institutions and investors were looking for ways to obtain higher yields. The conventional wisdom was that since risks have been more widely distributed through credit derivatives, losses through defaults were minimised. You will recall in my earlier BISTRO article, I had described how loans were bundled into CDOs and traded. But, the returns were not good enough for the punters. The rocket scientists at the big banks came up with a new product – CDO Squared.

10.03 If we use the analogy of CDOs being a single basket of loans with different categories of risks, CDO squared consists of buying up various loans from other “CDO baskets”, and reconfigure them so as to create a new CDO basket. This was obviously more risky, but the returns were higher. Such was the demand for these exotic financial products that no one – not the lawyers, the accountants, the regulators, the central bankers, compliance officers – bothered to ask how would the ownership of the mortgage loans be determined?.These financial products have been sliced and diced so many different ways, that is it any wonder that recently, JP Morgan and Bank of America have to suspend foreclosures because they could not satisfy the courts that they had legal title to foreclose?

10.04 It is not my intention to analyse and explain each and every financial product engineered by the whiz kids from Wall Street and City of London. What was important was that these products were very complicated and no one really knows how they should be evaluated. Some rating agencies devised their own models to evaluate the risk of default of these financial products, such as CDOROM by Moody’s. And as models go, they are not perfect and there are always loop-holes to be exploited. The game was to get the highest rating from these agencies. And those who could exploit the loop-holes in the models were able to obtain ratings higher than what they were entitled.

10.05 A good example was the Goldman Sachs’ CDO “GSAMP Trust 2006-S3” which had 12 tranches of securities which were all highly rated. Ten tranches were rated investment grade. [7] After the crisis, seven were rated junk, and four tranches were totally wiped out!

10.06 But, the model that was most responsible for giving a false sense of integrity of the financial products was the risk model of David Li called the “Gaussian Copula model”. It was touted to be able to forecast which basket of CDOs would default, but more importantly which loan asset (or tranche) in the basket would most likely to default. It was all about correlations and other bullshits!

10.07 As a result, the Pandora box of toxic gambling gambits was opened to satisfy the cravings of the mad financial punters. And as they say the rest is history!

10.08 The system is clogged up. $Trillions of toxic wastes remain in the system. And now, the banks have the added problem of questionable ownership of foreclosed assets. There was a slight chance, a 5% chance that if the mortgaged assets could be deposed off even in the present depressed price conditions, the cash-flow would have improved in the short term, enough to give a breathing space to the unbearable stress that has been building up on banking reserves. However, the suspension of foreclosures has piled up the pressure and may have triggered another organ failure.

End Game

There are no more chips on the table to continue with the game.

If the FED and other central banks embark on a second massive quantitative easing gambit, and the bet turns bad, which will be the most likely scenario, the end result would be the bankruptcy of the FED and the other major central banks.

Think deep about it. It is the logical consequence of the quantitative easing policy. The confidence in the Federal Reserve Notes would vaporise into thin air. How fitting, as they were also created out of thin air!

Notes

[1] Go to Archive Folder: Malaysia Updates. The three articles are all posted in September 2010.
[2] In Malaysia, time deposits are known as "Fixed Deposits".
[3] There is a slight element of truth in that interest paid on such deposits constitutes a "cost" element to the banker. But this is so miniscule when compared to the interest earned from loans created out of thin air, that it is irrelevant.
[4] i.e. a loan is a credit extended to a borrower.
[5] See the quotation in sub-paragraph 1.01 above by Henry Ford. That so few economists are familiar with the mechanics of money creation is because banking is not taught as a subject in Economics 101. Even your main street banker will have difficulty explaining how money is created, as their main focus is to make profits by extending loans to the public.
[6] The power to "coin" money means the power to issue money and not to make coins only.
[7] See page 147 of my book, The Shadow Money-Lenders.

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