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Shadow Banking and Financial Fraud: Massive Asset Inflation, Who Really Benefits?

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Future Fast Forward

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Have you ever wondered why when over 40 million Americans are on food stamps, millions of homes foreclosed and millions more unemployed, there is hardly any social unrest in the United States?

In the European Union, the economic situation is dire as well, but again there is hardly any social unrest. Sure there were demonstrations, but it is abundantly clear that the people in these countries have no idea as to the actual culprits who have caused them to suffer such poverty and hardship and why there have been no massive bail-outs for them.

There have been hundreds of thousands of articles published on the Global Financial Tsunami and many have pointed out the scams perpetrated by the banks and other financial institutions which resulted in movements such as "Occupy Wall Street". But, such protests were not sustainable and were also largely unsupported by the very people who were affected by these financial scams.

Ask any debtor why he has not taken any action, and he would most likely say that he cannot really complain as he was in debt and could not pay off the debt and as such he must suffer the consequences, be it bankruptcy or foreclosures. This is the response of a typical brainwashed debtor!

Joe Six-Packs never even pondered that debtor-banks never had to suffer any consequences of their indebtedness as a result of their reckless speculations and other financial shenanigans! In fact, such banks were given freebies and back-stopped by the FED and other central banks. They were not allowed to fail, to be declared insolvent and liquidated. The banks were just Too Big To Fail and must be given a life-line.

That Joe Six-Packs have not started a revolution to throw out the power elites and shut down the Too Big To Fail Banks is because they are ignorant and do not understand the mechanics and the intricacies of banking in general and shadow banking in particular and how financial frauds have been perpetrated by these banks with the connivance of the FED and other central banks as well as the governing regimes. The judiciary willingly turned a blind-eye to these criminal activities.

So, I have decided to explain in as simple a language as I can muster in the hope that the Joe Six-Packs of the world would take action and put right the injustice that has been perpetrated by the global financial elites and reclaim their hard-earned money that was stolen from them.

Before explaining the reasons for the massive asset inflation engineered by the FED and other central banks, we must have some idea of banking and the securities / collaterals given to banks for the credit extended to borrowers (i.e. the Joe Six-Packs etc.)

Lesson 1

When a borrower takes out a loan, invariably he or she is required to provide collaterals in the form of a property, public quoted shares, government bonds etc. to secure the loan.

Usually, the bank will provide a loan in an amount equivalent to 80 per cent of the value of the security. So, if a house is worth US$100,000 or in Malaysia RM100,000, the bank would extend a loan of US$80,000 or RM80,000. The reason being, in a default the bank has a cushion of US$20,000 / RM20,000 to cover any fall in value of the house and or a lower price in a foreclosure sale. Thus, when there is a foreclosure there will always be more than enough money to cover the outstanding loan. Such a security is referred to as a "mortgage".

In the case of shares of a company listed in a stock exchange e.g. shares in Citibank, Wal-Mart, General Motors, Sime Darby, MMC etc., the bank would extend a loan usually not exceeding 60 per cent of the value of the shares pledged to the bank. This is the rule of thumb. But, banks in different countries and jurisdictions have different rules and regulations governing such securities. But, for the purposes of this article we shall use the 80 per cent rule for mortgages and 60 per cent rule for shares. For simplicity sake, I will not refer to other types of securities offered.

These collaterals (mortgages etc.) were then packaged and repackaged and sold to investors as "Collateralised Debt Obligations" (CDOs etc.) and or re-hypothecated many times over (the technical jargon for using the securities to secure further loans) thereby compounding the exposure and risks should there be a default.

Lesson 2

What happens when there is a financial crisis?

Malaysians will recall that during the 1997/1998 Asian Financial Crisis, shares worth RM30 or more plummeted to less than RM1. But, price of houses did not suffer as much depreciation as the property bubble was confined to commercial properties.

During the Global Financial Tsunami, Citibank shares fell to less than US$5 from a peak of US$550 in early 2007. Citigroup's market capital was US$147 Billion
on December 31, 2007, and on March 5, 2009, the market capital of Citigroup dropped to US$5 Billion, eroding over 96% of the companies' value.
When the sub-prime bubble exploded, house prices fell by as much as 30 per cent or more resulting in the outstanding loan value exceeding the value of the mortgage.

This was a bloody disaster for the banks!

By banking regulations, the value of the security must be written down to the actual value i.e. in the case of Citibank shares to US$5. And, in the case of houses, it had to be written down to the actual depressed price e.g. from US$100,000 to US$60,000.

Borrowers could not repay their debts and in many cases refused to pay the debt because they have purchased a house which value has depreciated to the extent that it is less than the loaned sum! There were massive defaults and as such these loans must be declared as “Non-performing Loans” (NPLs).

And by accounting standards, NPLs must be written off. If and when these NPLs are written off, the banks would be insolvent and unless the banks’ shareholders pump in more money to increase the share capital sufficient to offset the losses, the banks cannot continue doing banking business. This is so basic.

The shareholders did not have the monies to increase the share capital and neither were they in any position to borrow any money to keep the banks afloat.

The global banks were starring at a bottomless black-hole!

Lesson 3

The FED and other central banks came to the rescue of the Too Big To Fail Banks (TBTF banks) by providing loans, guarantees etc. such as the TARP program, followed later by Quantitative Easing (QE).

Remember that the TBTF banks were not allowed to be bankrupted. But, the toxic “assets” (i.e. massive undervalued securities and NPLs) cannot remain on the balance sheet of the banks if marked-to-market. The world would know that the banks were insolvent. There has to be a cover-up.

How was the cover-up implemented?

Firstly, banks need not mark-to-market these toxic assets. This is outright fraud – what was worth e.g. US$5 was declared as US$300 in the case of shares. A house worth US$60,000 was declared to be worth US$100,000.

This cover-up bought the TBTF banks and the central banks time to implement the second fraud.
Bear in mind that the losses were in the US$ Trillions.

So, there was no way for the FED and other central banks to print digitally US$ Trillions in one swoop to bail out the banks. This would result in a massive devaluation of the fiat currency be it the US dollar, the Pound Sterling or the Euro and the consequential hyperinflation. All currencies would be toilet papers overnight.

So, like the thief in the night, the FED and the other central banks did so quietly and in “batches” for want of a better term.

The FED printed digital money (i.e. virtual money) via the computer and made simple book entries.

The FED and other central banks acting in concert bought the toxic assets from the bank at book value (i.e. at or close to the original price) thereby reducing the amount of toxic assets on the TBTF banks’ balance sheets. This has been going on since 2008/2009 and will continue for a long time to come, at least a decade from 2008. So, by reducing the amount of the toxic assets on the TBTF banks’ balance sheet, the amount of share capital as well as bank reserves would likewise be reduced. In fact, the Bank of International Settlements

(BIS), the Central Bank of central banks have allowed the TBTF banks till 2019 to comply fully the Basel III Accords relating to capital requirements.

Lesson 4

The third cover-up is more subtle.

This third cover-up is to do with the scam of artificially raising the value of the shares pledged to the TBTF banks.

You will remember that these shares, pledged as securities were shares quoted in the stock exchange such as the NYSE, the London Stock Exchange etc. The value have all plummeted and are worth a fraction of the value when first pledged to the banks as illustrated above in the case of Citibank shares.

Therefore, there is a need to jack up the value of the shares quoted in the stock market. This is common sense. If the value of Citibank shares remain at US$5, the bank would not be able to cover-up this glaring black-hole if these shares have not been sold to the FED or other central banks and remained on the balance sheet.

And in the case of the FED, sooner or later, even the common man on Main Street would realise that the FED has a lot of junk on its balance sheet.
Technically, in such a circumstance, the FED would be insolvent!

Bernanke's infamous QEs were the solution. The new digital monies were applied to buy toxic assets of the TBTF banks (which in turn were converted into bank reserves) and US treasuries. The new monies were also diverted to the stock market to push up the value of the shares as well as to shore up the depressed housing market.

In the result, there was a rally in the market and the Dow rose to a record high, even higher than what was achieved in 2007 prior to the Global Financial Tsunami. Citibank shares rose by leaps and bounds as did other shares.

In technical jargon, this is "asset inflation" – the artificial rise in value of shares as a result of the FED's digital monies being diverted to the stock market.
The net effect is that the "toxic shares" on the TBTF banks' balance sheet also rose in value (albeit not to its original price) as well as those shares on the FED's balance sheet. The losses of the banks were thereby reduced.

Lesson 5

Many have moaned and groaned that the FED ought to apply QE monies to Main Street and not to Wall Street.

To the FED, what is most important to the American economy and its superpower status is that the banking system must be protected and preserved as the foundation of the entire financial edifice is global confidence in the US$ fiat money. The US$ fiat toilet paper is the fuel that drives the US economy and is the most valuable US export, an export product that does not require any manufacturing or engineering skills or technology. All it needs is a printing press (or more appropriately a digital printing press).

The above explanation is at the most basic level as the above schemes and scams are merely to shore up the first tranche of the financial rubbish that have been dumped onto Main Street. We have not even addressed the problems of those toxic assets that have been packaged and re-packaged, re-hypothecated many times over in the Shadow Banking System. Suffice to say that if the FED cannot solve the problems at the most basic level, it would be futile to address the nuclear financial waste of the Shadow Banking System.

Final Comments

Please read the extract of the article below by Chris James in 2011 entitled, “Why Citigroup Will Not Go Back to Its 2007 Highs” carefully.

In 2007, Citigroup was over $550 per share on a split adjusted basis. Investors have eagerly watched Citigroup’s stock since the March 2009 lows for it to return to its all time highs. The thing is, no matter how soon the economic recovery is, Citigroup’s stock will not return to its all time highs in the near to long term future.

Following the economic crash of 2008, Citigroup had to do multiple secondary offerings of stock to keep the company from going bankrupt. A secondary offering is when a company sells new stock to the public, diluting current shareholders. One secondary offering after another, Citigroup shareholders saw their stakes in the company diluted over and over again. Although the secondary offerings were necessary to keep Citigroup alive through the economic recession, they did permanent damage to the share value of the company.

Citigroup’s market capital was 147 Billion on December 31, 2007, and it’s share price was $294.40 on a split adjusted basis. The market capital is a measure of the value of the company, based on the sum of all the outstanding shares of a company. On March 5, 2009, the market capital of Citigroup dropped to 5 Billion, eroding over 96% of the companies’ value. Now Citigroup’s market capital ranges from 110 Billion to 145 Billion, almost back to its 2007 highs. By market capital, Citigroup is worth nearly what it was in 2007, so why is the share price only a fraction of what it was?

To do this we have to go back to dilution. In 2007, Citigroup had 5 Billion outstanding shares, and before the 1:10 reverse stock split in May 2010, there were 29 Billion outstanding shares. In other words, Investors saw their shares diluted by over 80% from secondary offerings, and as of now, their shares are still diluted. The market capital of Citigroup nearly recovered, but the share price has not, and probably will not in the near to long term future. In order for the share price to return to 2007 levels, Citigroup would have to grow to a market capital of 1.5 Trillion dollars. 1.5 Trillion! That’s assuming over a thousand percent growth. Growth like that typically takes over a decade or more for banks.

Another way Citigroup could get its historic share price back for shareholders is to introduce stock buybacks. A stock buyback is the reverse of a secondary offering. A stock buyback is when the company buys back shares on the open market and cancels them, reducing the number of shares outstanding. This creates more value per share for investors. Currently Citigroup is still recovering from the financial crisis and does not have enough cash for a stock buyback program. Therefore, Citigroup investors may have to wait much longer than they thought they would to see 2007 highs in share price again.

The point of quoting this Article written in 2011 is that after four years Citibank has yet to return to the 2007 highs for investors. The same would apply to banks who were holding these shares as collaterals.

We are now in 2013 and Citibank has yet to return to the 2007 highs for its share price.

Therefore should we be surprised that Bernanke has stated that QE would continue to 2015?

But, of course there would be some tapering as over the years, the toxic assets would have been reduced and for some of these assets, the value would have recovered somewhat though not to the 2007 high. So, instead of purchasing US$85 billion toxic assets and treasuries per month, the FED may continue with QE 4 and 5 at reduced rates i.e. US$60 billion or whatever lesser amount.

The scam will continue, the fraud will continue and Main Street will continue to suffer unless Joe Six-Packs take some drastic action through collective action to expose the fraud and the scam and shut down the ponzi scheme.

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