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The Federal Reserve is Bankrupt

How Did It Happen and What are the Ugly Consequences?

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The Federal Reserve is bankrupt for all intents and purposes. The same goes for the Bank of England!

This article will focus largely on the Fed, because the Fed is the "financial land-mine".

How long can someone who has stepped on a landmine, remain standing – hours, days? Eventually, when he is exhausted and his legs give way, the mine will just explode!

The shadow banking system has not only stepped on the land-mine, it is carrying such a heavy load (trillions of toxic wastes) that sooner or later it will tilt, give way and trigger off the land-mine![1]

In a recent article, I referred to the remarks of British Prime Minister Gordon Brown and President Obama calling for the shadow banking system to be outlawed.

Even if the call was genuine, it is too late. The land-mine has been triggered and the explosion cannot be averted under any circumstances.

The only issue is the extent of the damage to the global economy and how long it will take for the world to recover from this fiasco – a financial madness that has no precedent. The great depression is "Mary Poppins" in comparison!

The idea of a *central bank going bankrupt is not that outlandish. I am by no means the first author who has given this stark warning. What* underlies this crisis (which I initially examined in an article in December 2006) is the potential collapse of the global banking system, specifically the *Shadow Money-Lenders.*

Nouriel Roubini, the New York University professor said [2]:

> "The process of socialising the private losses from this crisis has moved many of the liabilities of the private sector onto the books of the sovereign. At some point a sovereign bank may crack, in which case, the ability of the government to credibly commit to act as a backstop for the financial system – including deposit guarantees – could come unglued."

Please read the underlined words again. "Sovereign bank" means central bank. When a central bank "cracks" i.e. becomes insolvent, "all hell breaks lose", because as the professor correctly pointed out, "*any government guarantees will ring hollow and will be useless".*

If a central bank goes belly up, it is as good as the government going bankrupt. Period!

In another article, Roubini admitted that the pressure on "the financial land-mine" is totally unbearable. He wrote: *"The US Financial system is effectively insolvent".* It follows that if the financial system is bankrupt, it is a matter of time before the "sovereign bank" goes belly up. This is a given!

He stated further that:

> "Thus, the U.S. financial system is de facto nationalized, as the Federal Reserve has become the lender of first and only resort rather than the lender of last resort, and the U.S. Treasury is the spender and guarantor of first and only resort. The only issue is whether banks and financial institutions should also be nationalized de jure.
>
> "AIG which lost $62 billion in the fourth quarter and $99 billion in all of 2008 is already 80% government-owned. With such staggering losses, it should be formally 100% government-owned. And now the Fed and Treasury commitments of public resources to the bailout of the shareholders and creditors of AIG have gone from $80 billion to $162 billion.
>
> "Given that common shareholders of AIG are already effectively wiped out (the stock has become a penny stock), the bailout of AIG is a bailout of the creditors of AIG that would now be insolvent without such a bailout. AIG sold over $500 billion of toxic credit default swap protection, and the counter-parties of this toxic insurance are major U.S. broker-dealers and banks.
>
> "News and banks analysts' reports suggested that Goldman Sachs got about $25 billion of the government bailout of AIG and that Merrill Lynch was the second largest benefactor of the government largesse. These are educated guesses, as the government is hiding the counter-party benefactors of the AIG bailout. (Maybe Bloomberg should sue the Fed and Treasury again to have them disclose this information.)
>
> "But some things are known: Goldman's Lloyd Blankfein was the only CEO of a Wall Street firm who was present at the New York Fed meeting when the AIG bailout was discussed. So let us not kid each other: The $162 billion bailout of AIG is a nontransparent, opaque and shady bailout of the AIG counter-parties: Goldman Sachs, Merrill Lynch and other domestic and foreign financial institutions.
>
> "So for the Treasury to hide behind the "systemic risk" excuse to fork out another $30 billion to AIG is a polite way to say that without such a bailout (and another half-dozen government bailout programs such as TAF, TSLF, PDCF, TARP, TALF and a program that allowed $170 billion of additional debt borrowing by banks and other broker-dealers, with a full government guarantee), Goldman Sachs and every other broker-dealer and major U.S. bank would already be fully insolvent today.
>
> "And even with the $2 trillion of government support, most of these financial institutions are insolvent, as delinquency and charge-off rates are now rising at a rate – given the macro outlook -that means expected credit losses for U.S. financial firms will peak at $3.6 trillion. So, in simple words, the U.S. financial

> system is effectively insolvent."

McClatchy newspaper reported (03/08/2009) bad news affecting the banks:

> "America's five largest banks, which already have received $145 billion in taxpayer bailout dollars, still face potentially catastrophic losses from exotic investments if economic conditions substantially worsen, their latest financial reports show.
>
> "**Citibank**, **Bank of America**, **HSBC Bank USA**, **Wells Fargo Bank** and **J.P. Morgan Chase** reported that their "current" net loss risks from derivatives — insurance-like bets tied to a loan or other underlying asset — surged to $587 billion as of Dec. 31. Buried in end-of-the-year regulatory reports that McClatchy has reviewed, the figures reflect a jump of 49 percent in just 90 days.
>
> "The disclosures underscore the challenges that the banks face as they struggle to navigate through a deepening recession in which all types of loan defaults are soaring.
>
> "The government has since committed $182 billion to rescue AIG and, indirectly, investors on the other end of the firm's swap contracts. AIG posted a fourth quarter 2008 loss last week of more than $61 billion, the worst quarterly performance in U.S. corporate history.
>
> "The five major banks, which account for more than 95 percent of U.S. banks' trading in this array of complex derivatives, declined to say how much of the AIG bailout money flowed to them to make good on these contracts.
>
> "The banks' quarterly financial reports show that as of Dec. 31:
>
> — J.P. Morgan had potential current derivatives losses of $241.2 billion, outstripping its $144 billion in reserves, and future exposure of $299 billion.
>
> — Citibank had potential current losses of $140.3 billion, exceeding its $108 billion in reserves, and future losses of $161.2 billion.
>
> — Bank of America reported $80.4 billion in current exposure, below its $122.4 billion reserve, but $218 billion in total exposure.
>
> — **HSBC Bank USA** had current potential losses of $62 billion, more than triple its reserves, and potential total exposure of $95 billion.
>
> — San Francisco-based **Wells Fargo**, which agreed to take over Charlotte-based Wachovia in October, reported current potential losses totaling nearly $64 billion, below the banks' combined reserves of $104 billion, but total future risks of about $109 billion.
>
> "Kopff, the bank shareholders' expert, said that several of the big banks' risks are so large that they are "dead men walking."

Berkshire Hathaway Chairman, Warren Buffett is so livid by the sheer magnitude of the financial mess that he said:

> "These instruments [derivatives] have made it almost impossible for investors to understand and analyze our largest commercial banks and investment banks . . . When I read the pages of 'disclosure' in (annual reports) of companies that are entangled with these instruments, all I end up knowing is that I don't know what is going on in their portfolios. And then I reach for some aspirin."

The above bad news refers to the losses and potential losses that the big banks have suffered and will suffer in the near future.

But what is overlooked by many financial analysts is that these very same derivative products have *caused another financial organ failure.* And there is no way that the said organ can be resuscitated to its former state of health.

The Repo Market is gridlocked!

There has been an incestuous relationship between the traditional banking system and the shadow banking system and the *link that joined the two together is the Repo Market.[Repurchase Market]*

This is in fact the *weakest link* in the entire financial system.

This is a very technical subject and I seek your indulgence and patience when reading the remaining part of this article. The gridlock of the repo market is the basis for my assertion that over and above the aforesaid dire financial facts, *it is the major contributing factor to the bankruptcy of the Federal Reserve!*

I want to use a simple analogy. This will make the issue easier to understand.

Picture a one-inch diameter thick rope. Such a rope is made up of a few strands of narrower ropes, say 1/10th inch which are twined together to make the thick one-inch diameter rope.

Picture again that all the outer strands have been burnt away, and what remains is the middle strand, still lifting the weight. But this strand cannot on its own, lift such a weight and sooner or later, it will snap. When that happens, the weight will come crashing down!

The middle strand is the repo market.

Alternatively, you can use the analogy that the repo market is *the heart that pumps the blood (the cash flow).* The financial system is the body and it has suffered a massive heart attack!

What is the repo market?

The *repo market* is the market *whereby all financial institutions (regulated and unregulated) invariably go to obtain financing to meet reserve requirements, bridging finance, to lend or purchase securities, to hedge and or to invest on short-term basis.*

It used to be that mainly *US Treasuries (bear this in mind at all times)* were used as security for Repo transactions, as it is considered as most secure i.e. as good as cash since it is backed by the credit of the US government!

This requirement is no longer the case. More of this issue later.

The Nature of Repo Transactions

In repo transactions, *securities are exchanged for cash* with an agreement to repurchase the securities at a future date. The securities serve as collateral for what is effectively a cash loan. A distinguishing feature of repos is that they can be used either to obtain funds or to obtain securities. As repos are short-maturity collateralized instruments, repo markets *have strong linkages with securities markets, derivative markets and other short term markets such as inter-bank and money markets. [3]*

Like other financial markets, repo markets are subject to credit risks, operational risks and liquidity risks. However, what distinguishes the credit risks on repos from that associated with uncollateralized instruments is that repos credit exposures arise from volatility (or market risk) in the value of collateral. *Bear this in mind at all times.*

Repos allow institutions to use leverage to take larger positions in financial markets which could add to systemic risks. *Bear this in mind at all times.*

And because of the close linkages between repo markets and securities markets, any shocks will be transmitted quickly, resulting in a gridlock. *Bear this in mind at all times.*

Transactions covered by definition of repos are as follows:

(A) Repurchase Agreement

A repurchase agreement involves the sale of an asset under an agreement to repurchase the asset from the same counter-party. Interest is paid on the repurchase agreement by adjusting the sale and purchase price. *A reverse repo* is the purchase of an asset with an agreement to re-sell the same or a similar asset.

A hold-in-custody repurchase agreement is a trade whereby the repoer (the borrower of cash) continues to hold the collateralizing securities in custody for the lender of cash. The risks are obvious!

A deliver-out repurchase agreement is where securities are delivered to the cash lender for custody in exchange for cash.

A tri-party repurchase agreement is similar to a deliver-out repurchase agreement, except that the security is placed in the custody of a third-party entity. The third-party ensures that the security meets the cash lender’s requirements and provides valuation and margining services. *This is the primary form of repurchase agreement for securities dealers in the*

United States. Bank of New York and JP Morgan Chase are the two main custodians or clearing banks in the US and supervise the vast majority of the tri-party repos. *Bear this in mind at all times.*

(B) Sell/Buy-Back Agreement

A sell buy-back is two distinct outright cash market trades, one for forward settlement. The forward price is set relative to the spot price to yield a market rate of return.

(C) Securities Lending

This is where the owner of the security lends them to another person in return for a fee. The borrower of the security is contractually obliged to redeliver *a like quantity* of the same securities, or *return precisely* the same securities.

Repos can be of any duration but are *most commonly over-night loans.* Repos longer than over-night are called *Term Repos.* There are also *Open Repos* which are transactions which can be terminated by both parties on a day’s notice.

The largest players of repos and reverses are the *dealers* in government securities. There are about 20 primary dealers recognised by the Fed which are authorised to bid for new-issued treasury securities for resale in the market. The dealers are highly leveraged, 50 to 100 times their own capital. To finance the purchase of treasury securities, the dealers need to have repo monies in large amounts on a continuing basis. The institutions that supply such huge funds in the repo market are *money funds, large corporations, state and local governments and foreign central banks.*

The Repo Market and the Financial Crisis

As stated earlier when the repo market first started, US treasuries were the preferred security. But when financial engineering exploded and many financial products (i.e. CDOs) were rated AAA by rating agencies, **these securities were also traded as described above in the repo market. This was when problems started.**

According to Gary Gorton [4], the repo market before the crisis was estimated to be worth a whopping $12 trillion as compared to the total assets in the entire US banking system of $10 trillion.

The former CEO of Federal Reserve Bank of New York (NYFRB) and now the US Treasury Secretary, Tim Geithner observed in 2008:

> “The structure of the financial system changed fundamentally during the boom, with dramatic growth in the share of assets outside the traditional banking system. This non-bank financial system grew to be very large, particularly in money and funding markets.
>
> “This parallel system financed some of these very assets on a very short term basis in the bilateral or tri-party repo markets. As the volume of activity in repo markets grew, the variety of assets financed in this manner expanded beyond the most highly liquid securities to include less liquid securities, as well.

> Nonetheless, these assets were assumed to be readily sellable at fair values, in part because assets with similar credit ratings had generally been tradable during past periods of financial stress. And the liquidity supporting them was assumed to be continuous and essentially frictionless, because it had been so for a long time.
>
> "The scale of long term risky and relatively illiquid assets financed by very short-term liabilities made many of the vehicles and institutions in this parallel financial system vulnerable to a classic type run, but without the protection such as deposit insurance that the banking system has in place to reduce such risks."

Economic historians will argue for another century as to the cause for *the run on the repo market.* The collapse of Bear Stearns is as good a starting point as any. When the market discovered that its securities were duds, pure junk, shock waves ripped through the system.

Recall that I had mentioned earlier that Federal Bank of New York and JP Morgan Chase were the primary clearing banks for repos.

The Fed's rescue of Bear Stearns through JP Morgan was not so much to save the former but rather to shore up the "clearing system" of the repos for which JP Morgan Chase and the Bank of New York were the main pillars. One of the functions of a "clearing bank" for repos is to value and match securities tendered for cash borrowings. *If Bear Stearns securities are now valued as junks, the integrity of JP Morgan and Federal Bank of New York as clearing banks in this market is as good as zero!* And bearing in mind that the five major investment banks in the US rely heavily on the repo market for their funding, any gridlock in this part of the shadow banking system would tear wide open the entire banking system, including the traditional counter-part.

Hence, the FED intervention by the creation of the Primary Dealer Credit Facility *(PDCF)* which was in effect the backstop for all investment banking using tri-party repos!

This was what Bernanke said:

> "We have been working with market participants to develop a contingency plan should there ever occur a loss of confidence in either of the two clearing banks that facilitate the settlement of tri-party repos."

Louis Crandall, economist at Wrightson ICAP observed:

> "The vulnerability of the tri-party repo system has been a recurring theme among Federal Reserve and Treasury officials in recent weeks."

The inherent weakness of tri-party repos is that the counter-party risks of billions worth of funding agreements are shouldered by essentially two players – Federal Bank of New York and JP Morgan Chase.

Yet, way back then, they were held up as rock solid. It is almost hilarious to read the then advert of the Federal Bank of New York as to their expertise and service:

> "Sophisticated collateral selection: enforce diversification and credit quality; control adequacy, volatility & liquidity.
>
> "Cutting edge infrastructure: economies of scale facilitate extensive data warehousing, access to more asset classes and markets, auto-substitution, auto-allocation & optimisation technology, same day reporting.
>
> "Introduction to new counterparts: A Global Collateral Clearing House."

Panic swept across the entire repo market.

No securities were considered safe enough for repos except US treasuries.

Fundings in the repo market grind to a halt.

Market players withdrew funds and began hoarding treasuries.

The rest who own structured products were slaughtered.

I would like to quote Gary Gorton again:

> "Imagine a firm that is levered 30:1, by borrowing in the repo market. If the haircut [5] doubles, or goes from zero to a positive amount, the required deleveraging is massive! Most investment banks were levered 30:1, equivalent to about a 3 per cent haircut. If the haircut rises to 6 per cent, at least half the assets will have to be sold.
>
> "Another sign of trouble is a 'repo fail'. A 'repo fail' occurs when one side of the agreement fails to abide by the contract. [Fail to deliver the security under the repurchase agreement.]
>
> "Dealer banks would not accept collateral because they rightly believed that if they had to seize the collateral should the counter-party fail, then there would be no market in which to sell it. This was due to the absence of buyers because of the deleveraging. This led to an absence of prices for these securities. If the value cannot be determined because there is no market – no liquidity or there is the concern that if the asset is seized by the lender, it will not be saleable at all, then the dealer will not engage in repo. Repo dealers report that there was uncertainty about whether to believe the ratings on these structured products, and in a very fast moving environment, the response was to pull back from accepting anything structured. If no one would accept structured products for repo, then these bonds could not be traded – and then no one would want to accept them in repo transactions."

This change led to a sharp increase in the demand for government securities for repo transactions, which was compounded by significantly higher safe-haven demand for US Treasuries and the increased unwillingness to lend such securities in repo transactions. As the crisis unfolded, this combination resulted in US government collateral becoming extremely scarce. [6]

I will now turn to the issue of the FED's solvency.

As has been observed, the Fed intervened aggressively to check the run on the repo market. Various measures were taken, but in my view the most dangerous was the widening of the collaterals which the Fed was willing to accept to secure funding of the players in the repo market. The Fed also intervened by lending a huge chunk of its US treasuries in exchange for junks to facilitate credit expansion.

In the result, what happened was that the Fed's present balance sheet of approximately $2 trillion is made up mostly of junk securities.

The Fed is no different from banks in that confidence in the quality of its assets is critical and that if and when the market recovers, *there is in fact a market for the junk assets that it took on to unravel the gridlock in the financial markets.*

By way of analogy, if your high street bank's balance sheet is made up of junk, what would you do? There are just not enough assets to meet its liabilities.

But of course, one can argue that the Fed is not your high street bank. It is the central bank of the mighty USA. It will always be able to "print money" or "digitalise" money and keep the markets going.

But beware that the Federal Reserve Note is mere paper, *fiat money which cannot be redeemed for anything tangible such as gold.* And although it is stated boldly in the notes issued – "In God we trust" – you and I are not actually placing our trust in God when accepting the Federal Reserve Notes as "money".

When Joe Six-Packs realises that the Federal Reserve Note is not even secured by US treasuries and or the FED has real tangible assets, but its balance sheet is littered with junks and toxic waste, *there will be a run on the Fed i.e. when Americans and foreigners no longer have faith in the Federal Reserve Notes as "money".*

If confidence could vaporise in a second and cause a stampede in what was once considered solid security, the triple A rated bonds in the repo and money markets, the same confidence that is now reposed in the Federal Reserve Notes can likewise disappear into the memory hole.

All these years, the con was maintained by the Fed that it was solid because it has on its balance sheet over $800 billion of US treasuries i.e. its notes "were so-called backed by these treasuries". It could sell its treasuries in the repo market for cash and thereby control the money flows in the economy and vice versa.

In their subconscious mind, Americans and stupid foreign central banks and their executives (brain-washed by the Chicago School of Economics) somehow believe in the infallibility of the Fed.

Now it has been exposed that the Fed's "assets" comprise of junk bonds and toxic wastes.

The Emperor has no clothes!

Paul Volcker, former Chairman of the Federal Reserve may have given the ultimate epitaph: *"The bright new financial system – for all its talented participants, for all its rich rewards – has failed the test of the market place."*

And it is any wonder that Professor Nouriel Roubini declared:

> "The process of socialising the private losses from this crisis has already moved many liabilities of the private sector onto the books of the sovereign. At some point a sovereign bank may crack, in which case the ability of the government to credibly commit to act as a backstop for the financial system – including deposit guarantees – could come unglued."

In my opinion, the Fed has already become "unglued". Whatever guarantees given to secure the indebtedness of CitiGroup and others to prevent a run on these banks are useless.

It is bankrupt!

End Notes

[1] There are two banking systems in existence today. The Traditional Banking System – i.e. High Street banks and the Shadow Banking System. But the players in both the systems overlap because, the major banks of the traditional system helped spawn the shadow banking system. In fact they are the key players in the use of the so-called "new financial products, the CDOs, CLOs, MBS" etc and which have now turned toxic – worthless, junk to be exact.
[2] See my website archives: Roubini Warns of Sovereign Bank Failure – February 20, 2009 www.theage.com.au
[3] See: *Implications of repo markets for central banks,* CGFS Publications No 10, March 1999.
[4] Gary Gorton, *Information, Liquidity, and the (Ongoing) Panic of 2007* prepared for the Jackson Hole Conference 2008
[5] "haircut" here refers to the rate payable for the cash loan or the margin.
[6] Peter Hordahl and Martin R King, *Developments in repo markets during the financial turmoil* BIS Quarterly Review, December 2008

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