

# Up In Smoke: The Abridged History of US Investment Banking

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It worked. The credit markets have begun to thaw.

Overnight Libor (London Interbank Offered Rate) dropped 27 basis points to 1.67 percent, the lowest level since September 2004. Three month Libor shed 40 basis points this week to 4.42 percent. The Libor-OIS spread and TED spread are edging downward, too. The VIX, the Chicago Board Options Exchange Volatility Index—also known as the “fear index”—has skyrocketed to 80, a new record. But that is to be expected; after all, Wall Street is in a panic.

The truth is, interbank lending is beginning to ease and the financial system has begun to function a bit more like it should.

That doesn't mean we're out of the woods by a long shot. The stock market will probably lose another 15 to 20 percent, unemployment will soar, real estate will continue to crash, and consumer spending will dry up. That's all part of the hard landing ahead. But at the end of the day, some part of the credit-distribution system will still continue to function. That wasn't always a certainty.

Before the EU finance ministers announced their plan to recapitalize the banking system, by injecting capital and guaranteeing deposits and interbank lending, the world was on its way to a complete financial meltdown. The EU, led by British Prime Minister Gordon Brown, pulled the world back from the brink of annihilation. It may be the greatest story of our generation, and very few people even know what really happened. The system was completely frozen in place. Interbank lending had stopped, major corporations were unable to meet payroll because they couldn't roll over their short term debt. Cargo ships were stuck in ports around the world because buyers couldn't get Letters of Credit. As analyst John Mauldin said,

“Just as the business world is dependent upon commercial paper as its life blood, the world of global trade depends on letters of credit (LOC). If you are a manufacturer of a product and want to sell to someone outside your borders, you typically require a letter of credit from the buyer before you load any cargo at a port. A letter of credit from a prime bank is considered to be proof of your ability to pay....There are buyer's and seller's agents who make sure these things happen seamlessly, and world commerce had grown because of it.... If you think the problems stemming from a meltdown with the commercial paper markets are threatening to the world economy, they are small potatoes when compared to a seizure in the letter of credit markets.”

The European initiative forced Secretary of the Treasury Henry Paulson to do the right thing. It is 100 percent certain now that his plan to use the \$700 billion bailout to buy-back the non-performing loans and bad mortgage-backed securities from the banks would have failed and led to disaster. Paulson stuck by his wacko plan even though more than 200 economists opposed him and the stock market tumbled 8 straight days in a row losing more than 15 percent of its value. The EU had to put a gun to his head to force him to do the right thing. Paulson's Wall Street bias is so great that he would have driven the country off the cliff just to reward his dodgy friends with lavish cash giveaways from the US taxpayer.

In fact, right after the European plan was announced, Paulson convened a meeting of the country's largest banks so he could hand out \$125 billion of freshly-minted, taxpayer-generated loot to shore up their flimsy balance sheets. Citigroup got \$25 Billion, as did JPMorgan Chase and Bank of America. Goldman Sachs and Morgan Stanley both netted \$10 Billion each. None of these banks had to submit to any type of regulatory investigation to see how much of their asset-base was held in worthless mortgage-backed slop or other structured garbage. Paulson never even tried to find out if they are even solvent! On top of that, taxpayer gets no voting rights, no position on the board of directors, and no limits on executive compensation for the \$125 billion contribution to Wall Street's biggest white-collar criminals. On Thursday, all of the aforementioned banks reported horrendous quarterly losses, multi-billion dollar write-downs, and more grim warnings on future profits. It's clear that Paulson wanted to deliver the bailout money before the public discovered the extent of the carnage.

There are no assurances that the newly-capitalized banks will use their windfall to increase lending to consumers and businesses as Paulson hopes. The banks know that they'll be facing some stiff headwinds in the near-future as the the economy contracts and as deleveraging continues. It is just as likely that they will hoard their reserves or buy distressed hard-assets rather than expand their dreary loan portfolio. That means credit will continue to tighten and the widely anticipated slowdown will only get worse.

Currently, the nation is in the grips of a deflationary downturn. Oil and gold have fallen precipitously as have the other commodities which are being dumped on the market in one massive firesale. The hedge funds are liquidating at an unprecedented pace which is causing steady price erosion while strengthening the dollar. This giant institutional margin call is what is at the heart of the recent wild gyrations in the stock market. Investors are withdrawing their money which is forcing the hedgies to sell their liquid assets to reinforce their balance sheets. It's all about "demand destruction".

Adding to the turmoil, is the fact that many of the hedge fund managers are "moving to cash" to avoid the equities crash ahead. In Susan Pullim's article in the Wall Street Journal, "Smart Money stays on the Sides", she says:

"Some hedge-fund titans have yanked most of their money out of the stock market, a bearish sign amid Monday's euphoria and an indication of how the hedge-fund business is changing amid chaos.

In recent days, Steven Cohen, the hedge-fund manager who runs the \$14 billion SAC Capital Advisors, moved about half his funds, or about \$7 billion, into money-market and other short-term securities, eliminating much of his fund's exposure to the stock market, says a person close to the fund. Mr. Cohen plans on sitting on the sidelines for the rest of the year — trading a

small portfolio himself but keeping shuttered most of the stock portfolios of his other managers.

Meanwhile, John Paulson, manager of \$35 billion Paulson & Co. — who made a spectacularly successful bet against the housing market last year — has much of his fund in cash equivalents.

The retrenchment by Wall Street's "smart money" crowd is part of a larger effort by hedge funds that have put a total of as much as \$400 billion into cash equivalents recently, according to David Kostin, an analyst at Goldman Sachs Group Inc." (Wall Street Journal)

The vultures are collecting on the telephone wires waiting for the first bloodied antelope to plop to the ground. As the stock market rout continues, they shouldn't have to wait too long. Many pundits are predicting the greatest slump since the 1930s. Already, manufacturing has slowed faster than anytime in the last 20 years, jobless claims jumped 461,000 to 3.7 million, housing starts are at a 17 year low, and consumer confidence fell through the floor. Even worse, Paulson's bailout does nothing to stop the hemorrhaging of foreclosures which is the source of the disequilibrium in the financial markets. Congress needs to pass emergency legislation to write down the face-value of distressed mortgages (and provide low interest "fixed rate" loans for the first 25 percent of the revised value) to create an incentive for homeowners to stay put. This massive relief effort will have the added benefit of stabilizing the financial markets by putting a floor under housing prices. Struggling homeowners should be given a helping-hand before the banks.

As the former chairman of Goldman Sachs, Henry Paulson's motives have been suspect from the very beginning of this fiasco. He made sure that the US taxpayer got a shellacking on the purchase of preferred shares in the banks. And, he even faked like he was forcing the banks to take the capital they needed to stay afloat. ("Please, don't make me take that \$25 billion Mr. Secretary". What a complete farce!) These are his best buddies and he treats them well. He hasn't demanded that they bring their off-book operations back onto their balance sheets, or limit their derivatives exposure, or reduce their leverage to 12 to 1, or come clean with the amount they are holding in Level 3 assets (illiquid, complex mortgage-backed securities) Wall Street veteran Pam Marten summed it up like this:

"What most Americans do not understand, because mainstream media rarely explains it, is the incestuous relationship between the U.S. Treasury and this small band of financial marauders who busted the entire financial system with insane levels of leveraged derivative bets." Amen.

Author F. William Engdahl sees a more nefarious motive behind Paulson's maneuvering and he lays it out in his article, "Behind the Panic: Financial Warfare and the Future of Global Bank Power":

"It now would appear that the Paulson strategy was to use a crisis... to panic the more conservative European Union governments into rushing to the rescue of US toxic waste assets.

Were that to have happened, it would in the process destroy what was left of sound EU banking and financial institutions, bringing the world one step closer to a global money market controlled by Paulson's cronies—US-style Crony Capitalism. Crony Capitalism is certainly appropriate here. Paulson's predecessor at both Goldman Sachs and at Treasury, Robert Rubin, liked to

accuse the Asian bankers of Thailand, Indonesia and other lands hit with the speculative attacks of US-financed hedge funds in 1997 of 'crony capitalism,' leaving the impression the crisis was home grown in Asia and not the result of a deliberate executed attack by US-financed financial institutions to eliminate the Asia Tiger model among other goals, and turn Asia into the funder of US debt.

Interesting to note is that Rubin is now a Director of Citigroup, obviously one of Paulson's crony bank 'survivors,' and the bank which to date has had to write off the largest sum in toxic waste securitized assets.

The Paulson plan is now clearly part of a project to create three colossal global financial giants—Citigroup, JP Morgan Chase and, of course, Paulson's own Goldman Sachs, now conveniently enough a bank. Having successfully used fear and panic to wrestle a \$700 billion bailout from the US taxpayers, now the big three will try to use their unprecedented muscle to ravage European banks in the years ahead. So long as the world's largest financial credit rating agencies—Moody's and Standard & Poors—are untouched by the scandals and Congressional hearings, the reorganized US financial power of Goldman Sachs, Citigroup and JP Morgan Chase could potentially regroup and advance their global agenda over the coming several years, walking over the ashes of a bankrupt American economy made bankrupt by their follies.... This is a fight for the survival of the American Century which has been built since 1939 on the twin pillars of American financial dominance and American military dominance—Full Spectrum, Dominance." (F. William Engdahl, "Behind the Panic: Financial Warfare and the Future of Global Bank Power" Global Research)

Engdahl may be on to something here. Not only will the present crisis lead to further consolidation in the US by crushing local and regional banks which do not have an umbilical chord connecting them directly to the vault at the US Treasury; it could also throw the European financial system into an "every man for himself" frenzy ultimately leading to the breakup of the EU (a prospect that is now widely considered) which would allow the US banking cartel to extend its tentacles to the continent as it has with its equities markets.

The damage that the investment banks and their non-bank counterparts (Hedge funds, broker dealers, SIVs etc) have done to the broader economy and the lives of hundreds of millions of people around the world is incalculable. Still, the remedy is simple and straightforward.

The banks in question should be forced to establish their solvency according to "mark to market" evaluations (Triple A MBS=\$.22 on the dollar) and if they cannot meet minimal capital standards; they should be taken into receivership, their equity shareholders wiped out, their leading executives removed, and they should be transformed into public utilities under the supervision of the Congress of the United States. Once the banks are entrusted to our elected officials, we can move on to the Federal Reserve. The "price fixing" and manipulation of interest rates by privately-owned banks is a failed experiment. It's time to move on. Abolish the Fed.

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