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How the GFC happened, and why the next one will likely be worse

Even BBC financial journalists who kowtow to big banking business are getting tired of the BS....All G20 countries have been a bit shaken by Japan's warnings...

http://www.bbc.com/news/business-35559861

Unlike the heavily populated countries of the world, we live in "fat city" (a yacht racing term for our own boat being in the most favourable conditions for the race).

But we must now give some priority to understanding and perhaps managing the rapidly growing financial risk we see.

So I am always amused by folk who think they have "money in the bank". The reason for my amusement is because the banks don't hold our money at all. What they do is to take it and use it as part of the process of lending it out. First, they convert our money into a series of digital zeros and ones, then they provide a loan to someone else, which comprises about 10% of what we put in and 90% of what comes out of thin air...creating an extra asset and debt for the bank in the form of more zeros and ones. So anything physical that we put into the bank is quickly converted into something digital that is merely a theoretical balance on our account.

This is why, when the New York Fed was hacked a month or two ago, the Bangladeshi's Central bank lost their deposit of USD81 million in one electronic heist.

This should be a warning that the notional cash in our bank accounts is only as good as the bank's solvency...and their cyber security.

Solvency, seems to be a concept that our Reserve Banks do not understand....I am sorry, I should say that remark again because they do understand it, but they only talk about capital ratio side of it, for fear of frightening the customers with unpleasant liquidity implications. Solvency is something that reflects two issues, enshrined in international law.

The first is that assets must exceed liabilities. The second is that the bank must be liquid enough to pay all claims as and when they fall due. Liabilities are fixed and legally precise. The value of all assets is subject to the vagaries of market fluctuations.

On the first solvency test, the world's major banks (and thereby central banks) have a problem. That is the "Balance Sheet Test". NO banks show all their true total liabilities and contingent liabilities on their balance sheet, because there are many contingent liabilities they don't know about. I will get to this shortly.

On the second solvency test, (the "Liquidity Test" part) because assets can lose value very quickly if a forced sale of some is required, banks must carry enough liquid cash to meet the requirements of customers. Because the cash on hand does not earn them anything, they don't carry very much at all – just a float. Try drawing out an un-forecast $50,000 from your local branch and see what happens. An event that weakens customers' faith in their banks (like them not having the cash to pay you), typically causes a run on the banks. When that happens the only option is for them to close the doors until sufficient cash can be obtained.

The banks will crunch customers who don't present sufficient extra security. So they know for instance that if there is a drop in property prices of say 30%, their customers could easily become insolvent so banks want extra security from them and in case it isn't enough, to carry a provision for doubtful debts to cover the Balance Sheet test. That provision is always based on the numbers who they know are going to pose a risk and is always small because that provision comes off their declared profits and too big a provision frightens both shareholders and depositors.

If you watch the media, you will see banks strengthening their provisions for doubtful and bad debts and that is leading to media concerns.

When the central bank sends a signal to banks that they need to raise their capital ratio, it is a signal that the central bank is concerned for either or both of the ratio of assets to liabilities and the liquidity of the banks.

This is where we need to get real.

The failure of Lehman Bros was due to a banking event (sub-prime mortgage fiasco) in the USA that then collapsed the international derivatives market at electronic speed. The derivatives market is as described by Warren Buffett as "Financial Weapons of Mass Destruction" and that derivatives market is still self-regulating. Although a bit more tightly scrutinised, IMHO it still carried the same risk exposure for the global financial system.

When the global financial crisis (aka GFC) took place, what we found was that all then existing risks contained within individual derivatives transactions were measured by an interest charge levied due to perceptions of how risky it was to deal with a certain security and with a certain counterparty. No-one of course knows who the riskiest counterparties are and if S&P and Moodys get ratings wrong for both financial products and counterparties (as they did horribly), then collapse happens from sources/counterparties that no-one can possibly forecast. If a major category of risk was triggered (like sub-prime mortgages that were thought to be prime) then the counterparty could be insolvent at electronic speed via an avenue of derivative betting (they prefer the term "hedging") called Credit Default Swaps (or "CDS"s). There were more than USD50 trillion CDSs at the time of the Lehman moment in September 2008. At that time, no-one knew which cascade of collapsing counterparties would make which huge and reputable bank insolvent within the next day or days. This was enough to freeze all international trade and commerce, because no bank could trust another to still be either liquid enough to meet obligations or even to be solvent in the short to medium term.

Ergo the GFC.

At that time gross derivative assets stood at about USD1.2 Quadrillion (that is 1,200 trillion or 20 times global annual GDP - but we will never know the figure for certain because no-one probably knew it then, or even knows it today). I forget what BIS (the Bank of International Settlements) declared what they thought the total was, but IIRC thought it was something over USD800 trillion. So it may be somewhere in between 800 and 1,200. What is a few trillion here or there when it is covered by the unwitting taxpayers?

Very little of the contingent derivative assets and liabilities were shown on bank balance sheets then (or now!). So when the fix was agreed in New York by the US Fed and a small number of huge banks were forcibly merged over the weekend with those even bigger ones that were thought to be more solvent, the new mega banks suddenly found out they had taken over really sick cot cases. Bank of America took over Merrill Lynch which had on its own more than USD70 trillion in derivative liabilities.

What was made public was what the Governments could risk making public without totally destroying the global financial system – so only about USD5 trillion in fixes for banks were authorised by global politicians.

In the USA, Michael Bloomberg took the US Fed to the US Supreme Court to find out how much had been issued in loans to get confidence back into the global financial system. The answer was revealed in early 2011 as being over USD22 trillion. My bank, Westpac (they never admitted it, but it was published by the US Supreme Court order anyway) even needed to borrow some of that stuff to tide them over.

When that knowledge became public in the USA, the shareholders in Bank of America learned they had taken over Merrill Lynch with approx. USD75 trillion in contingent liabilities, the share price dropped from approx. USD35 per share to about USD7.50 per share.

Now, remember we are talking trillions in the world's reserve currency – the US dollar. Huge numbers of zeros and ones that were created overnight and then eliminated when the loans were eventually repaid and left that extra USD5 trillion or so was washing around in the world's financial markets.

Before the Lehman Bros event, what was coming was predictable. US economists predicted it, the more intelligent financial analysts predicted it, but the major players knew (whether they confessed to knowing or not) that they were too big to fail. I think it was Chuck Prince who said, "We had to keep dancing until the music stopped".

I realised that the crash was coming and how it would unfold giving the calamity a 35% probability in my emails around October 2007 when I published my book, "Flag KiwiSaver, there is a better way". By February 2008, I pulled my book from sale out of fear for what was coming, and by March 2008 in one email, gave a 65% probability to global financial collapse. I could never have believed what the world's governments would do, though with hindsight it was predictable. They rewarded the bankers and the bank shareholders in technically insolvent banks with huge bailouts. The cost was sheeted home to taxpayers.

They did (to use Dr Mario Draghi's later words) "whatever it takes".

The next move was to try to crash start the global economy with money printing, credit expansion and zero or less interest rates. They also socialised the banks' losses where necessary, by introducing "bail-ins" – the theft of the depositors' zeros and ones that could easily have comprised yours and my bank balances in order to prop up the banks' shareholders' funds and thereby their supposed capital ratio. In New Zealand we call it "Open Bank Resolution", which means banks can fix their poor capital ratio by issuing more shares ....or if they cannot get folk to buy the shares, still fix their capital ratio by unilaterally taking a proportion of the money we have on deposit (zeros and ones) and converting it to shareholders' equity. So far it hasn't cost us, but sooner or later it may, if we leave our money in the bank. Each bank has also examined its deposits and recently tightened up on the advance notice that now must be given for breaking a term deposit, so as to cut down on the possibility of sizeable future bank runs.

The effect of the extra money over five years did not stimulate growth at all. The big overseas banks held most of the interest free money they got from the Feds, made profits and paid themselves huge bonuses with it, and to compensate for the increased money supply, the velocity of money moving around the global economy fell like a stone.

The "Too Big To Fail" banks still use shonky accounting and fail to show true assets and liabilities. They argue it isn't shonky practice, but they certainly would not tolerate that sort of "head-in-the-sand" accounting malpractice from anyone banking with them.

Seven countries have been forced to issue negative interest rates to keep the party going. That means that as of today USD10 trillion of bonds require depositors to pay for the privilege of storing their money in the form of zeros and ones with banks/governments who have no possible capability to repay...the bonds can only be sold on or recycled by the issuers. Will that end well? Will it Cocoa!!!

Low interest rates are designed to bring forward to today the purchase of goods and service that will otherwise be purchased tomorrow. So people have bought more stuff than they really need, and now need an incentive to buy something else. But what the heck, interest rates are rock bottom. So the inducement to take out more credit gets bigger and bigger until there will be a default somewhere and then all hell will break loose.

One by one, governments are starting to realise their "Social Credit" style policies won't work. When Shinzo Abe waved the flag of surrender at the G7 meeting two weeks ago, he was told not to rock the boat, because others are still trying those policies in the hope that by the time things go bust, the present leaders will no longer be in office. In the USA, if they don't raise interest rates soon all their superannuation schemes will go bust, so they know what must be done...a time of going "cold turkey"

So where are we now?

This week our reserve banks are getting twitchy about the total risk profile of banks including both the liquidity test (they must never mention) and they talk about increasing capital for prudential reasons. They can never say that if a sizeable bank in Europe (i.e Deusche Bank – which is a bit shakey to say the least) turns up its toes, the entire global financial system could "kark it"... i.e. all our banks could need to close their doors for a while to work things out. Such an event being often referred to as a "Bank Holiday".

The 2008 GFC wasn't caused by banks having too little capital, but by banks having huge undisclosed contingent liabilities that were triggered by defaults and caused a global liquidity crisis that hit at electronic speed. The default risk continues today. The problem hasn't even been swept under any carpet and the banking industry is instead living on "hopium". One thing to think on though, is that meantime global debt has increased by more than USD57 trillion since the GFC.

Where else did you think interest free credit come from for cars, TVs, holidays and happy times – or for the bogus Chinese economic miracle? Now our MSM newspapers are warning us about having too much debt? They are as guilty as the bankers, economists and politicians for selling the public down the river.

The world's entire economics profession is still in denial over the underlying causation for deteriorating economic conditions that I won't touch on here, so I will leave that for a later date. They think it is due to financial gambling by folk who should have known better, **yet the bankers were trying to compensate for a causal disaster which cannot ever be fixed, when they caused the mayhem**. Like all filed and failing business people in history, if you cannot fix it, you ignore and try to work around it.

Many markets are now in bubble territory – not just house prices. Yet I am "humming and ha'ing" about whether the total financial collapse will happen this year, or whether, and for how long the governments of the world can defer the evil day.

Since about November 2015 my estimate has been for a probability of collapse of about 55% for late 2016. But it is now harder than ever to figure out what the stoats and weasels who run our financial system will do. Don't worry, we can trust our leaders...Malcolm Turnbull (ex Goldman Sachs) and John Key (ex Merrill Lynch).....yeah right!

There is a fair chance that the next crash may be delayed for another year or so. My estimate for 2017 is – if it doesn't happen in 2016, there is a 75% probability and for 2020 a 95% probability.

In other words, crash is certain but its shape and timing is not. All I know is people should be checking how to hedge against it.

In my email "in box" I am facing a daily barrage of negativity from reasonably sensible (perhaps even "expert") folk. This sort of stuff is an example...

http://pro.portphillippublishing.com.au/s6tglimpromptmo/ETGLS603/?email=jcrofe%40xtra.co.nz&a=20&o=4727&s=8451&u=33089&l=236059&r=MC2&vid=Hn-FEU&g=0&h=true

We in Australasia need to keep it all in perspective because our countries are far better off than anyone else's. For us, we are told everything still looks rosey, so we have plenty of time to plan once the balloon goes up in the Northern hemisphere.

Fortunately, we have the luxury of time to go on enjoying ourselves. Eat, drink and be merry, for.........