Panic Is in the Air as Financial System Implodes

by John Hoefle

Panic is in the air! Jim Cramer declares on CNBC that "Armageddon" is here, and demands the Fed drop interest rates and open the discount window. Floyd Norris reports in the *New York Times* that too many people are heading for the exits at once. Michael Perry, the CEO of mortgage lender IndyMac, declares that the mortgage market is "panicked and illiquid." Headlines on Bloomberg news tout the LBO (leveraged buy-out) "freeze," and UBS analyst Daniel Stillit warns of a "significant risk of the LBO driver coming to a grinding halt." Everywhere you look there are headlines about market turmoil, credit crunches, deals falling though, hedge fund losses, and mortgage foreclosures.

Financial commentator Cramer's Aug. 3 rant on CNBC, in which he exclaimed that the Fed "has no idea how bad it is out there. None!"—is indicative of the fear which has gripped the financiers and bankers of Wall Street and beyond, as they begin to realize that their financial system is disappearing as fast as darkness exposed to light. "People are losing their jobs and these firms are going to go out of business," and the Fed does nothing, Cramer screamed. "The Fed is asleep! . . . Cut the rate. Open the discount window. Cut the rate! Relieve the pressure. Relieve the pressure! We have Armageddon! In the fixed-income market we have Armageddon. We have Armageddon. . . . 14 million people took a mortgage in the last three years. 7 million of them took teaser rates or piggy-back rates. They will lose their homes. This is crazy! . . . This is not the time to be complacent!"

The financial markets are in fact facing a form of Armageddon, though not in the way it is presented to the public. The issue is not "credit," but debt, and the games that have been played to hide the way in which debt has been used to paper over an economy—and a banking system—which is already bankrupt. The central banks have decided to let a big chunk of the system go, in the vain hope that by sacrificing some, they can save the rest.

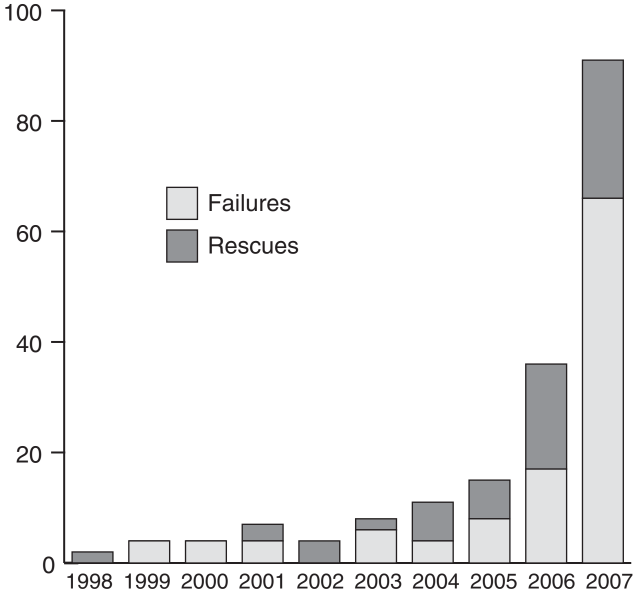
Mortgage-Backed Insecurity

If we are to believe what we read, this growing conflagration started out as a series of defaults on subprime mortgages, which blew out the subprime lenders, which then caused turmoil in the mortgage-backed securities (MBS) market, causing some private equity deals to collapse, and some hedge funds to evaporate, and finally triggering a larger credit crisis. All caused, as CNBC's Diana Olick so charmingly put it, because "American homeowners got greedy, bottom line." Once again, the little people have victimized those poor, unsuspecting international bankers, taking their money, then refusing to pay it back. How rude.

The problem with that scenario is that none of it is true: From start to finish, it is a fabrication which turns reality on its head, blaming the victims and presenting the perpetrators as the injured parties. It is the moral equivalent of the rapist claiming, "She asked for it. She made me do it."

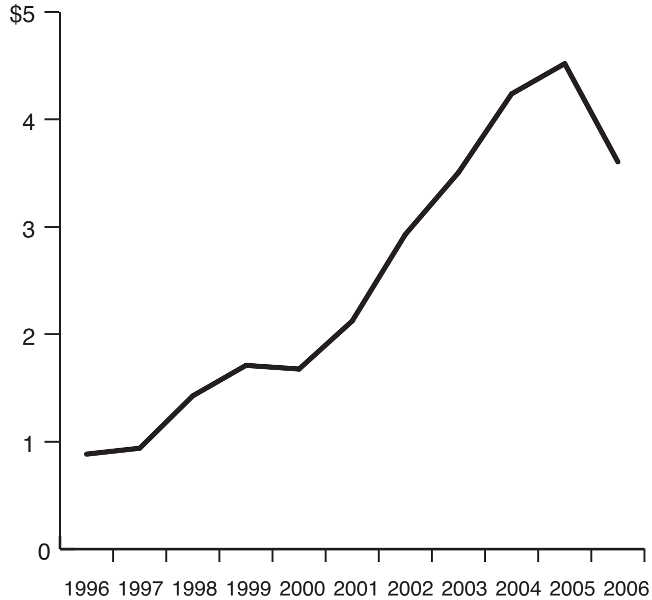
To understand what is going on in the financial markets, and to grasp why the players are so panicked, one must begin with the realization that the U.S. economy has been operating below breakeven for some four decades, as productivity has plummeted and overhead has grown. To cover the difference, we have gone into debt at an accelerating rate, creating huge amounts of debt that can never be repaid. Using a combination of deregulation, accounting trickery, and that fantasy known as the derivatives markets, the bankers magically flipped this bottomless pit of debt into a moun-

FIGURE 1
Failures and Rescues of Mortgage-Related Companies
(Number of Companies)



Source: MortgageDaily.com.

FIGURE 2
Flow of Mortgage Funds Drying Up—Net Annual Borrowing for Home Mortgages
($ Trillions)



Source: Federal Reserve Flow of Funds.

tain of assets, then borrowed even more against them, leveraging and speculating themselves into a pyramid scheme so vast, its size is almost incomprehensible.

One of the schemes the bankers used to keep the game going was the deliberate escalation of real estate prices, since rising real estate "values" created assets which could be borrowed against and speculated upon. The mechanism used was the creation of the mortgage-backed securities market, in which mortgages would be sold by the originators to big banks and financial players; these mortgages would then be combined into pools, and used as the basis for the creation of mortgage-backed securities. Whereas under the old savings and loan system, the mortgage originator would keep the loan until it was paid off, the MBS system allowed the originator to sell the mortgage quickly, and use that capital to make another mortgage. To feed the growing debt bubble being created by the banks, the home-financing system was quickly turned into a mortgage mill, in which the real objective was not to sell homes, but to sell mortgages in ever greater numbers and amounts, to feed the bubble. This "housing market" was in reality a classic pyramid-style debt-farming scheme.

Since this debt-farming scheme requires selling ever more houses at ever higher prices, at the same time that real incomes for most of the population are falling, it became necessary for the bankers to devise mortgage options to fill the growing gap: Lending standards were relaxed, lending terms were loosened to allow lower initial payments, and the sale of overpriced mortgages to people who couldn't really afford them, continued. The subprime mortgage market was created by the bankers to keep the money flowing into the bubble, and the real victims were the people forced to pay artificially high prices for housing.

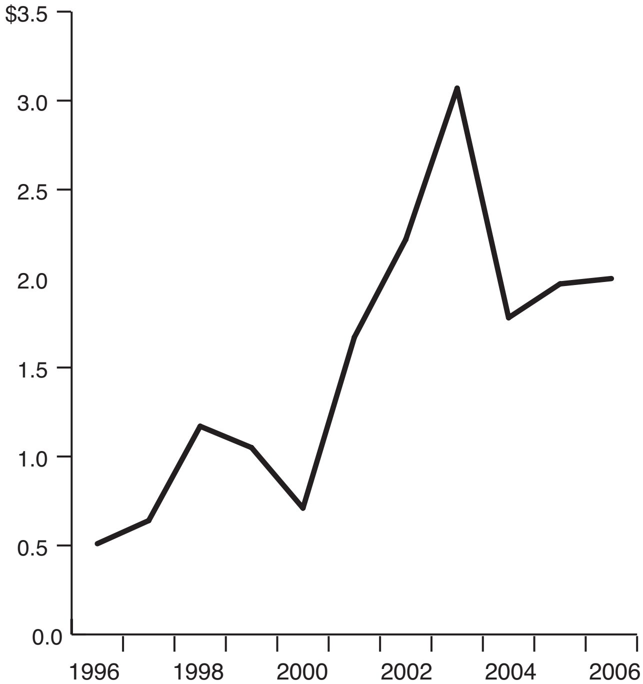
This debt-farming scheme produced a large money flow for the banks and the financial system as a whole, from the original mortgages, to the mortgage-backed securities, and the even crazier collateralized debt obligations (CDOs) and similar paper "assets," all of which could be sold, resold, and used as collateral for further borrowing, creating tens and perhaps hundreds of trillions of dollars of "wealth," extracted from phony real estate valuations and mortgages which can never be repaid.

Obviously, such a scheme cannot continue forever, as eventually the price of homes must overshoot the capability of the public to pay for them, and that is what has happened. The leading waves of foreclosures have occurred primarily in the cities of the Midwest, which have been devastated by the collapse of industry, and in places like California and Florida, where speculation on real estate has run rampant. With the reduction of the inflow of new mortgage money into the system, the issuance of mortgage-backed securities began to decline. Even more disastrous, from the bankers' point of view, was that home prices began to fall in many areas, throwing the whole leveraged mortgage bubble into reverse. Since the vi-

TABLE 1
Some of the Companies in Trouble

Company	Problem
Absolute Capital	Client withdrawals suspended; CDO/ subprime losses
Accredited Home Lenders Holding Co.	Planned sale to Lone Star Fund in jeopardy
AIG	"Mortgage-backed securities, CDO losses"
Alliance Boots	KKR-led LBO funding problems
Allison Transmission	Carlyle-led LBO funding problems
American Home Investment Mortgage	Bankrupt; specialized in Alt-A mortgages
Ameriquest Mortgage Co.	Closed all retail offices; new sales through brokers
Arcelor Finance	Bond issue put on hold
A-TEC	Bond issue put on hold
Bank of America	Various subprime/securities/loan losses
Barclays	Various subprime/securities/loan losses
Basis Capital Funds Management	Client withdrawals suspended; declared in default by lenders
Bear Stearns	Hedge fund meltdowns
Braddock Financial	Closed Galena Street Fund
Caliber Global Investment	Closed; subprime losses
Catalyst Paper	Bond sale cancelled
Caxton Associates	Margin calls from lenders
C-Bass	Margin calls after writedown; seeking capital
Citigroup	Various subprime/securities/loan losses
Commerzbank	Hit by subprime losses
Countrywide Financial	Various subprime/securities/loan losses
DAE Aviation	Barclays postpones loan
Deutsche Bank	Various subprime/securities/loan losses
Dillon Read Capital Management	Closed by UBS
Dollar General	Private equity deal; terms changed to lure buyers
ECC Capital Corp.	Sold mortgage operation to Bear Stearns
EquiFirst Holdings	Sold by Regions Financial to Barclays
First Franklin	Sold by National City to Merrill Lynch
First Gulf Bank	Bond issue put on hold
First NLC Financial Services Inc.	Closed
Fremont Investment & Loan	Shut down mortgage unit
Gazprom	Bond issue put on hold
Goldman Sachs	Global Alpha hedge fund declining
Harmony Gold	Bond issue put on hold
Harvard Management	Losses at Sowood
HSBC	Subprime losses
IKB	Hit by subprime losses
Insight Communications	Funding problems with private-equity bid
J.P. Morgan Chase	Various subprime/securities/loan losses
KfW Group	Covering losses at IKB
Lehman Brothers	Various subprime/securities/loan losses
LoanCity	Closed
Luminent Mortgage	Margin calls
Macqurie Bank	Hedge funds hit by subprime losses
Magnum Coal	Bond issue put on hold
Massachusetts state pension system	Losses at Sowood
Maxeda	LBO-related bond issue cancelled
Merrill Lynch	Various subprime/securities/loan losses
MISC BHD	Bond issue put on hold
MortgageIT Holdings Inc.	Sold to Deutsche Bank
Myers Industries	LBO put on hold
NetBank Funding Services	Shutting down
New Century Financial Corp	Bankrupt
OAC Rosneft	Bond issue put on hold
Oddo & Cie	Closing three funds
Oneida	Bank loan cancelled
Opteum Financial Services	Shut down some operations, sold the rest
Option One Mortgage Corp.	Sold by H&R Block to Cerberus
Oreck	Bond sale cancelled
Ownit Mortgage Solutions	Bankrupt
Oxygen Media	Bond sale cancelled
Quebecor	Bond sale cancelled
ResMAE Mortgage Corp.	Bankrupt; sold to Citadel
Royal Bank of Scotland	Various subprime/securities/loan losses
ServiceMaster	LBO-related bond sale cancelled
Silverton Casino	Bond sale postponed
Sowood Capital	Closed after losses
Stolle Machinery	Bank loan cancelled
Stoneridge	Bond issue put on hold
Thomson Learning	Bond sale cancelled; underwriters left holding debt
Tyco	Bond sale cancelled
U.S. Foodservice	LBO-related bond sale postponed; underwriters left holding debt
UBS	Losses at Dillon Read
Union Investment Asset Mmgt.	Client withdrawals halted on subprime fund
United Capital Asset Management	Redemptions suspended
Wells Fargo	Various subprime/securities/loan losses
Y2K Finance	Subprime losses

FIGURE 3
Pace of Mortgage-Related Securities Issuance Slows
($ Trillions per Annum)



Source: Securities Industry and Financial Markets Association (SIFMA).

ability of the MBS, CDOs, and related paper assets was dependent upon rising real estate prices, the entire edifice began to crumble. Though the failures began at the periphery, the problem was systemic; what was breaking down was not the subprime market, but the financial system itself, of which the breakdown of the subprime market was but the most visible—and highly touted—aspect.

Bare Sterns

The turmoil at Bear Stearns is illustrative. Bear Stearns had made lots of money speculating in subprime real estate, buying subprime loans and issuing mortgage-backed securities on them. As the market began to sour, Bear Stearns did what all the big banks do, namely move the failing paper off their books by selling it to captive hedge funds or other speculators. Unfortunately for Bear Stearns and its hedge funds, the losses at the hedge funds grew so great that the lenders to the funds began to seize and sell their collateral, only to find that it would not sell for anywhere near the nominal value the funds carried it at on their books. At that point, the game was over.

What that little episode revealed, was that the valuations on the books were not real, and though the amount of money involved in the Bear Stearns crisis was relatively small, the implications of the phony values sent shock waves reverberating through a system which itself is chock-full of such phony valuations, trillions upon trillions of dollars of assets which are ultimately based on unpayable debt.

The collapse of the real-estate money pump has triggered, domino-style, a cascade of failures throughout the markets. Some 80 subprime mortgage-related companies have disappeared so far this year, either going bankrupt or closing, exiting the mortgage business, or being sold. Roughly a third of those companies were located in California, with additional clusters in New Jersey, Florida, Texas, and North Carolina. As these companies fail, they spread losses to their shareholders and their lenders, on top of the damage done by the drying up of mortgage lending.

At the same time, the reduced money flow into the financial system, both from mortgage loans and the securities based upon those mortgages, combined with the vaporization of asset values, has created the "credit crunch" which is causing all the panic. Suddenly, the speculators are finding that the money they were counting on to do their deals is drying up. Hedge funds are failing left and right, others are taking heavy losses, and still others are stopping investors from withdrawing their money. Corporations are being forced to postpone bond sales, and private equity firms which announced a record $616 billion of buyouts in the first half of this year, are finding that some of those deals are now in trouble, as the money to complete the transactions is not there. The very system itself is vaporizing, because the value is not there—in fact it never was; the new financial system of Sir Alan Greenspan and Felix Rohatyn is being exposed as a complete fraud.

In all of this, it is the banking system which sits at ground zero. This is neither a "subprime crisis" nor a "credit crunch," but a banking crisis, and a collapse of the entire global financial system. The banking system has survived thus far by a combination of consolidations to disguise failures, the movement of bad assets off their books via the derivatives markets, and phony accounting—with the complicity of regulators who deliberately allow this corruption. The banks are bankrupt several times over, protected only by the illusion that the assets on their books, and the markets they serve, have value, but those illusions—which are all that keeps the banks open—are fading fast.

As the level of panic rises, the central banks will be inundated with calls to bail out the markets, to stop the losses. While these banks stated their intention to hold firm, that determination collapsed at the end of the week of Aug. 6, as the central banks turned on the spigots. As LaRouche observed, they panicked when they realized the dimension of the losses facing the system, and fearing it would all collapse, did what they knew they shouldn't. This itself is a sign of the times, because irrational fear is now calling the shots. The markets are panicked, the banks are panicked, the central banks are panicked, and the system is out of control. This game is over.