



## Beatrice Spreadmoore's **Financial World**

### **What Next?**

A world-wide crisis!

Okay, the housing market is in the tank, money to lend is in short supply, and the stock market is in a tailspin.

This authors opinion is that America needs a wake up call, personal debt is epidemic, poor business decisions have become the norm, and bailing out a company, AIG, that is the poster child for these symptoms will come back to haunt us.

What is written below was composed before the \$700 Billion dollar bailout was suggested, before the Washington Mutual, and **Wachovia** failed, and before the big banks gobbled up the remains and know probably have become to big to fail. However, none of this has stopped the ripple effect around the world. "Keep your eye on the ball". Credit is next up.

Can you spell the word Depression?

Put gold under your bed and stand on the sideline.

### **Bank capital**

Banks should have at least a 10% capital-to-risky assets ratio. That means, a bank needs to have at least 10% as much in capital as the amount of risky assets it invests in. A credit-grade mortgage loan will be given 50% risk weight, while a credit-grade regular consumer or corporate loan will be risk-weighted at 10%. Only investments in relatively risk-free government securities are given zero risk. The more loans the higher the capital needed which increases the costs of lending, regardless of the credit-worthiness of the borrower. This has motivated banks to find a way around the problems. re-packaging assets so they are assigned lesser risk-weights. One approach has been credit derivatives.

### **Credit cards**

The second problem is credit card debt. Regulators are focusing on credit card lenders. They did not handle the housing lenders in an effective way and now intend to make up for lost time.

Regulations will make it so prohibitive for credit card lenders to make profits that they will take **\$2 trillion** of credit off of consumer balance sheets. The credit card issuers can't raise rates, so they will cut back on all loans. Credit cards are going to have a much lower profit potential, causing the economy to take a major hit.

For example, the new regulations announced by the Fed to cut back on bad practices from credit card issuers will simply lead credit card lenders to reduce the amount they are willing to lend to consumers. We, the consumers are going to get it from every direction. Consumer spending will decline, and consumer defaults are going to increase. That will be bad news for the economy because everyone will face a higher cost of borrowing. Small business failures will explode.

There's only **\$800 billion** of credit card debt outstanding, but over **\$4.7 trillion** of unused **credit lines** outstanding. When banks cut that back you will no longer be able to manage your cash flow. This situation looks very bad for the biggest credit card issuers: *JP Morgan Chase, Bank of America, Citigroup, American Express and Capital One.*

## Credit default swaps (CDS)

A contract that enables a user, such as a bank, to better manage its credit risk. A way of transferring credit risk to another party. A *credit derivative* is designed to transfer *credit* risk from one party to another. By synthetically creating or eliminating *credit*. Credit-default swaps, contracts conceived to protect bondholders against default, pay the buyer face value in exchange for the underlying securities or the cash equivalent should a company fail to adhere to its debt agreements.

Two examples: Bond-default risk soared worldwide as the collapse of Lehman Brothers Holdings Inc. sparked concern that the \$62 trillion credit-derivatives market will unravel. Lehman, the fourth-largest securities firm until last week, has been one of the 10 largest counter parties in the market for credit-default swaps.

American International Group (AIG) expanded into the business of selling insurance against bond defaults sold banks and investors protection on \$587.5 billion of fixed-income assets. A failure by AIG would add to potentially billions in losses the markets faced from Lehman's failure (\$613 billion) and would have a world-wide impact. They are heavily involved in "credit derivatives". A failure of AIG would cause major banks around the world to **ration lending**.

Okay, what I said above is yesterdays news. Today we learn that the **Fed has bailed out AIG AN INSURANCE COMPANY!**. The spin is that we (the taxpayers) got something for our money. We now own 80% of AIG. Another point of view is that we now have our fingers in the banking pie around the world.

## What will banks try next?

Watch the banks line up for a handout. **Washington Mutual** should soon be at the head of the line. Okay, back to the point of the article.

It is very likely that there will be less bank lending. Banks will position themselves with assets that have less risk weight such as more investment in government securities, in place of the decreased lending. This will likely put more pressure on the housing market, further driving down prices. Over the last four years the average quarterly run rate was over \$200 billion in new mortgages. In the first quarter of 2008, that figure dropped to \$33 billion.

We will see less bank stock dividends. Remember, the more banks lend out, the more capital the bank needs to carry on the books. As long as the bank's assets are growing, there will be less dividends.

Lending will become more expensive for banks and they will need to cut operating costs. This means less investments in upgrading facilities, paying employee salaries and less marketing.

Banks will focus on raising capital long after the credit write downs are gone. Banks successful in growing their asset base will need to raise capital on a regular basis. This could be good for the market. Instead of looking at institutional investors as suckers to prey on, banks may look to them as potential shareholders.

To offset the higher costs we could see more bank mergers. Smaller banks will no longer be as attractive an investment so they will try to combine to make themselves a more attractive investment and stay competitive in the lending market. The need for greater capital to maintain an adequate capital ratio will make small banks unsustainable on their own. But when merged into a larger entity, the combined firm will be able to cut duplicate costs and establish a bigger market reach, the combined bank might be able to deliver a return acceptable to shareholders.

We will likely see lending concentrated in the larger banks, which are able to afford the higher lending costs, while the much smaller banks will become more skilled at investing and trading government securities.

The impact of reduced lending to small businesses could be crushing to the economy.

## **Sovereign Wealth Funds**

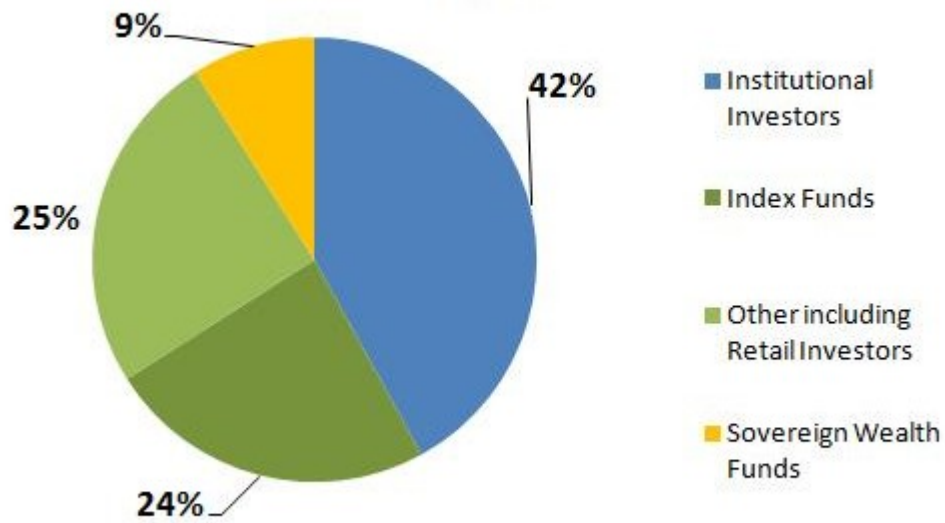
A third factor impacting the banking systems is sovereign wealth funds (SWF).

A **SWF** is a state-owned investment fund composed of financial assets such as stocks, bonds, property, precious metals or other financial instruments. Some sovereign wealth funds are held solely by central banks, who accumulate the funds in the course of their fiscal management of a nation's banking system; this type of fund is usually of major economic and fiscal importance.

Sovereign Funds (\$161,000,000) invested in the U.S. economy may decrease as they stand on the sidelines. This is having a global impact.

### \$161 billion net notional value of commodity index business in U.S. Markets

As of 6/30/2008



Source: Commodity Futures Trading Commission (CFTC), Sovereign Wealth Fund Institute

## Field Trips

[What are credit derivatives](#)

[Calculating Capital vs. Risk](#)

[Sovereign Wealth Fund details](#)

[The AIG bailout](#)

[Is what is happening Socialism?](#)

Happy Trails,

**B.S.**