

Financial Crisis Update: October 1, 2008

The previous report about the forthcoming financial crisis was written in early July. In late September, the crisis really began shaking America as well as the world field. A number of friends have asked that I provide an update, which will add more to what I wrote earlier, plus some information on what you might do at this time.

THE CRISIS IN AMERICA AT THIS TIME

The whole rickety credit and loan scheme began to unravel in 2006, when overpriced homes began to fall in value and refinancing became much more difficult. The foreclosures skyrocketed, and mortgage-backed securities began to crash.

The crisis began with losses in the \$1.3 trillion market for house mortgages, which should not have been made. These, in turn, were “securitized,” that is, bundled into bonds and sold to still more investors. This was done to spread the risk. But, because it was such an immense risk, many banks throughout the world became involved.

Unlike commercial banks, **investment banks hold very little cash. Instead, they borrow much of the money they invest.** Lehman Brothers, for instance, had as little as \$1 in cash on hand for every \$30 it borrowed (some say it was 35 to 1)!

Even though Lehman had a 158-year-old name, it was actually a 14-year-old company that was spun off by American Express in 1994. To compensate for its small size and poor assets, Lehman took risks that proved too large. To keep profits growing, it borrowed huge sums relative to its size—and it plunged into real estate ventures that later collapsed.

Investors, particularly foreign investors seeking higher yields, demanded new ways that they could make more money. So *collateralized debt obligations* (CDOs) were invented. These are complicated securities based on pools of many mortgages. These papers were often absurdly rated “AA” and “AAA” as though they were as safe as U.S. Treasury bonds. But because these “pools” involved so many banks and securities organizations,—the debts were spread around the entire world!

But then, to make the situation worse, the CDOs were leveraged, in order to get even more money returns out of them. When things go well, as they did until nearly the end of 2006, the financial firms found them immensely profitable. If you borrow 30 times your capital and those investments rise only 1%, you have made 30% on your money. But if they drop—even 1% or 2%—the company stands in serious risk of collapse. What these men were doing was

very, very dangerous! Yet they are the very men and organizations which the U.S. government now wants to help.

To make matters worse, the *Glass-Steagall Act*, enacted in the 1930s, was repealed by Congress in 1999. This enabled investment banks to merge with commercial banks—and use ordinary bank deposits in their risky loan schemes.

Consumers were given big mortgages with little documentation being made out. Many people bought homes who would not be able to pay for them. Sometimes no money down was acceptable. But then, as you would expect, they began to default on loans that should never have been given to them.

To add to the problem, speculators glutted the housing market by building many additional homes for sale. But soon housing values fell in overbuilt markets like Miami, Las Vegas, California, and Florida. The supply overwhelmed the demand.

Many subprime borrowers discovered that their homes had become worth less than their mortgages. Defaults increased, and these sent the prices of homes down even farther. A downward spiral intensified. It began in earnest at the beginning of 2006.

Rising delinquencies, by borrowers unable to make payments on loans, caused the CDOs to lose value. This forced the banks to sell new stock to raise capital. But, by this time, no one wanted to buy their CDOs. As a result, Bear Stears, on the verge of collapse was taken over by JP Morgan Chase. Lehman Brothers filed for bankruptcy.

While Lehman worked with CDOs, American International Group (AIG) was busily selling something else that was very risky: *Credit Default Swaps* (CDSs). These were derivatives which were supposed to provide a kind of insurance package to investors to protect them from failures. But then when the failures suddenly arrived—AIG was in serious trouble.

These CDS contracts obligated AIG to cover other investors' losses. In 2008, AIG's mounting loss on its CDS contracts resulted in a downgrade in late September of its credit rating, and a need to provide more collateral (money) to its CDS co-investors. But AIG did not have the cash, and could not get it. By that time, no one would lend to it.

Then, near the end of September, the U.S. government purchased 100,000 shares (nearly 80%) of preferred stock in AIG in order to keep it from collapsing. Although it cost \$85 billion, this is said by some to have been a good decision because the shares are “preferred.” Therefore the government will be paid first out of AIG's assets if it later goes down—

2 and AIG has many solid insurance and aircraft leasing accounts which are not in danger. This action prevented a worldwide crisis, and may probably earn money for the government when the shares later go up in value and are sold. But is this what the government should be doing?

Since August 2007, when the crisis first broke, the Federal Reserve (Fed) has done three things in an attempt to solve the problem. First it cut interest rates from 5.25% to 2%. This was done to promote lending.

But the second and third things were new: The head of the Fed, **Ben Bernanke, created several new “lending facilities” that allowed banks and investment banks to borrow from the Fed.** They received cash and safe U.S. Treasury securities in return for sending their junk “securitized” mortgages and other bonds to the Fed. For this one project alone, the Fed has already lent more than \$300 billion.

The third thing was to try to prevent bankruptcies by getting some institutions to buy others ready to collapse. Bear Stearns was merged into JP Morgan Chase (with the government providing \$29 billion to help them successfully merge), and Fannie Mae and Freddie Mac, the mortgage giants, were taken over by the government. The latest is the rescue of AIG by the government. Already an immense amount of money has been spent by the government.

—Then Treasury Secretary Paulson announced that he wants Congress to hand over \$700 billion to spend as he pleases on more bailouts. He wants authority to purchase all kinds of banks and other firms—instead of loaning money at a good rate of interest. I am writing this on October 1, so whether or not he gets it may be decided by the end of this week. But this is even more risky. In addition, Paulson’s plan rescues the very ones who caused the problems in the first place. Some investors (no one knows how many) bought subprime securities at huge discounts and would reap massive profits by reselling them to our government.

Then there is the fact that Paulson was formerly head of Goldman Sachs. So he is a close friend to Wall Street and the high-risk financial firms which caused all these problems. (Because Goldman Sachs was not deeply involved in the risky mortgages, it is in an excellent position to greatly profit from Paulson’s plan.)

But now the U.S. public are demanding that the little people be helped, instead of wealthy investors on Wall Street. Whatever is decided, it will eventually have to be paid for by U.S. taxpayers.

The final plan could be greatly improved if an AIG-type of bailout was done instead. The Fed is charging AIG a high interest rate and expects to be repaid from the sale of the firm’s many subsidiary businesses.

So instead of regulating financial houses (which the Fed had not been doing properly), it is now becoming a lending and ownership company. All this could greatly strengthen the federal government’s control over the nation. **This would place it in an even more powerful position of control when the National Sunday Law is enacted.**

The Fed says that this is the right thing to do in this massive emergency, since securities would otherwise be dumped on markets, prices would drop, companies could not borrow or lend, and the entire economy would collapse.

But the more that the Fed tries to solve the problem, the worse the situation seems to get. No one knows the extent of the worthless loans. They could be in the trillions of dollars. No one knows!

So far, the Fed has financed its lending program by reducing its massive holdings of U.S. Treasury securities. But it cannot do this indefinitely. When that source is exhausted, then the Fed will have to make more money—and immense inflation will add to the economic collapse.

One suggestion is to do what was done in the late 1980s when the *Resolution and Trust Corporation* was created to salvage the savings and loan companies. It was generally considered successful; for it eventually helped dispose of more than 1,000 troubled savings and thrift companies, while protecting most of the depositors.

Paulson wants Congress to let the Fed buy subprime mortgage securities to stabilize the financial system. But which securities should be purchased? No one still knows this. What about credit card securities, and U.S. securities held by foreigners? One buyout leads to another.

Paulson, himself, has admitted that the Fed might have to spend “hundreds of billions” before solving the crisis. But he says it is better to do that than to let the crash worsen.

On August 22, 2008, Chris Whalen, managing director of *Institutional Risk Analytics* announced that **he expects 100 banks to fail between now and July 2009. Most will be small, but some large.** Total assets of those banks is estimated at \$850 billion. FDIC will have to cover depositor assets when it takes them over. **FDIC only has \$50 billion in assets,** built up over years from deposit insurance paid by banks. **It will need \$20 billion just to cover the failure of Indy Mac alone!** But only part of the bank assets will have to be covered; others will still be good. Yet even if only 10% has to be covered, that would require \$50 billion by itself. Whalen thinks 20%-25% coverage will be more likely. **That would bring it up to \$100-\$150 billion.** Congress or the President will have to provide the money for this, or the public may do a run on the banks. (However, individual bank deposits are now insured up to \$100,000.)

Now all this does not sound very good.

As of August 22, 2008, there have been about \$505 billion in bank write-offs so far. That is even

before Congress may give Paulson \$700 billion more to play with! We have not seen the write-offs that will come as consumers start defaulting on credit cards, auto loans, and other consumer debt. Neither have we seen the losses that will come from commercial real estate or corporate loans. They cannot write off something until it goes bad, but they can increase their loan loss provisions. Yet that hurts earnings and stock prices, and thus ability to raise new equity. Banks will withdraw credit and loans from them because of this.

The total write-off of all banks may ultimately be \$1 trillion. Dr. Nouriel Roubini puts it at \$2 trillion.

The result of all this: Because banks have less capital, therefore they will lend less to businesses which need the money. Without it, the businesses will be less capable of paying current loans, which, in turn, means that banks have less capital. Ultimately, this means that banks will have to raise a lot more capital than anyone who today purchases financial stocks can imagine. And it will largely be very expensive capital. This means that the door will move closer to closing on banks, brokers and others trying to raise new capital in the debt markets.

Add to all this the problem that you cannot just take someone's property (including stocks, which are property), without serious reasons. **The government has to wait until a crisis occurs to take over businesses, otherwise shareholders could sue,** saying they were experiencing unnecessary losses.

As mentioned earlier, **as of now—the first of October—the government (i.e., the taxpaying public) is responsible for more than \$300 billion in guarantees and loans.**

Swiss bank, UBS executive, Mike Dion has warned clients, "The U.S. Fed has exhausted a lot of policy initiatives. This may be the deepest crisis in 50 or 100 years, but we'll only know a couple of years from now."

That summarizes a few of the key points, to date. I never own stocks, bonds, or other securities. Some of you may. Either way, all of our many friends will want to be aware of the implications of the present situation; one which the government does not dare discuss at this time, lest there be a run on the banks.

WHAT SHOULD YOU DO?

What if I want to sell my house? You may find it very difficult to do. Prices have fallen, many houses are on the market for sale, and it has become more difficult to obtain mortgages.

What if I want to purchase property and are certain that I will hold onto it for awhile? This is a good time in which to do it. Mortgage rates have dropped. The average 30-year fixed mortgage rate fell to 5.78% by late September, from 6.52% in August.

Is this a good time to refinance my house? The experts say it is; and, because interest rates are lower, many are now doing it.

Is it time to take my money out of the bank,

and hide it in a jar in my backyard? Your money is supposed to be safe in the bank as long as you do not have more than \$100,000 in any one bank. (Just now, Congress is considering upping the FDIC on each savings deposit to \$250,000.) But keep in mind that this only covers savings accounts in banks, not checking accounts.

Frankly, although they do not yield much interest, just now bank savings accounts are far safer than many other kinds of investments.

Would my insurance policy be safe? They usually are. However, if an insurance company got into trouble, state regulators could transfer all its accounts to another insurance company. But, in general, insurance policies tend to be far safer than other kinds of financial investments.

What will happen if my mortgage lender crashes? If the company that holds your mortgage fails, your loan (along with all others) will be assets in a bankruptcy proceeding. It is likely that another bank will buy the loans and then you will have to mail your mortgage payments to a new address.

What would happen if I have a brokerage account at a firm that suddenly went bankrupt? Those are your assets, not the company's, and its creditors have no right to your money. Hopefully, the transfer to a new brokerage should go smoothly. Federal regulators will oversee the process. If it were to happen that some of your assets are missing, SIPC insurance will cover \$500,000 worth of securities, including \$100,000 in cash.

Should I invest in stocks now? Here is my position on stocks: I never have any myself; but, for those interested in acquiring them, there are two types of stock investments: *First*, there are the long-term ones. Buy when stocks are low and keep them for years. *Second*, there are the quick-in-and-quick-out type. But this is speculation. It is really gambling. Should you gamble? No! Here is a definition of gambling: *First*, they are "all devices to obtain money without value received," and consist of "the acquisition of money or property without labor." *Second*, they are "games of hazard" (*Great Controversy*, 387).

It is better to work for a living, than to spend your time trying to get someone else's money. Every time you make money on the stock market, by frequent buy/sell activity in the stock market, someone else loses the money that you make. The roulette wheel at a casino operates in the same way.

Most important of all—Prepare for the crisis ahead. First, prepare an emergency preparedness list of supplies to stock up on. **You will find such information in my book, *Preparing for a Crisis*. It is absolutely FILLED with helpful information! This is a newly prepared, improved book, based on an earlier edition which is now out of print.**

There are materials and supplies which may be

4 difficult or even impossible to obtain once a crisis hits. Whether it be a terrorist attack, the dollar's collapse, martial law, or natural disasters, you need to be prepared! Everything warns us that trouble is coming!

In addition, try to move out of the city and into the country! Here are several reasons to leave all large and medium-size cities as soon as possible:

(1) If bank failures spread, it may not be financially possible to move. In the future, selling your home could become even more difficult.

(2) There is the possibility of terrorist attacks on several large or medium-size cities. They have been predicted by federal officials for several years now. For example, it would be very easy to poison the city water supply. This would cause a panic which could produce catastrophic results.

(3) After a terrorist attack, national (or state) martial law may be imposed, it could become difficult or impossible to leave large cities.

(4) Rioting, looting and violence in large cities may occur if the dollar completely collapses (especially if the welfare checks stop).

(5) Disruption or failure of utilities may occur as a result of rioting, violence, or a terrorist attack. This would be a special problem if it occurred in the winter.

(6) Inability of trucks to bring food, medicine, and other vital supplies into the cities during a time of crisis or violence.

(7) Increased difficulty in observing the Bible Sabbath in the midst of a crisis.

(8) Lastly,—we have been told to get out of the cities!

“As I consider the conditions in the cities that are so manifestly under the power of Satan, I ask myself the question, What will be the end of these things? The wickedness in many cities is increasing. Crime and iniquity are at work on every hand. New species of idolatry are continually being introduced into society. In every nation the minds of men are turning to the invention of some new thing. Rashness of deed and confusion of mind are everywhere increasing. Surely the cities of the earth are becoming like Sodom and Gomorrah.”—*Evangelism*, 29-30.

“God has been calling upon His people to leave the

cities.”—*Country Living*, 29.

“A great blessing would come to parents and to children, if they would leave the wicked, polluted cities, and go into the country . . . Believers who are now living in the cities will have to move to the country, that they may save their children from ruin.”—*Country Living*, 18-19.

“Let children no longer be exposed to the temptations of the cities that are ripe for destruction. The Lord has sent us warning and counsel to get out of the cities.”—*2 Selected Messages*, 355.

“‘Out of the cities’ is my message . . . The time is near when the large cities will be visited by the judgments of God. In a little while these cities will be terribly shaken. No matter how large or how strong their buildings, no matter how many safeguards against fire may have been provided, let God touch these buildings, and in a few minutes or a few hours they are in ruins.

“The ungodly cities of our world are to be swept away by the besom of destruction. In the calamities that are now befalling immense buildings and large portions of cities God is showing us what will come upon the whole earth.”—*7 Testimonies*, 83.

“Oh, that God’s people had a sense of the impending destruction of thousands of cities now almost given to idolatry!”—*Adventist Home*, 136.

“The time is not far distant, when, like the early disciples, we shall be forced to seek a refuge in desolate and solitary places. As the siege of Jerusalem by the Roman armies was the signal for flight to the Judean Christians, so the assumption of power on the part of our nation, in the decree enforcing the papal sabbath, will be a warning to us. It will then be time to leave the large cities, preparatory to leaving the smaller ones for retired homes in secluded places among the mountains.”—*5 Testimonies*, 464-465.

“The destruction of these cities, almost wholly given up to idolatry, is impending.”—*8 Testimonies*, 32.

Dear friends, a most terrible crisis is ahead. Draw near to God! Make sure you are right with Him! Make sure you are reading the Bible and Spirit of Prophecy and obeying Him! —*vf*

NOW—Preparing for a Crisis, a 42-page book, containing a massive amount of information which fully covers the subject. Here are the chapters:

Water, Food, Heating Fuel, Alternate Electricity Sources, Alternate Lighting, Clothing and Bedding, Preparing the House, Household Items, Sanitation, Medical Supplies, First Aid Kit, Household Equipment,

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