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An Ongoing Dialogue from
The Delta Group

REVENGE OF THE 1% LOAN (Part VI) Oct. 15, 2008

RIP: Indy Mac, Bear Stearns, Lehman Bros, Merrill Lynch, Washington Mutual, Wachovia

Short selling: A system that provides a trader with shares to sell at current prices, in the hope that he will profit by repurchasing them later when the price has declined.

Credit default swap (CDS): A (non-regulated) contract in which a buyer makes a series of payments to a seller, and in exchange receives the right to a payoff if a credit instrument goes into default or on the occurrence of a specified credit event, for example bankruptcy or restructuring.

The lethal game short sellers/hedge funds were playing with bank stocks was shorting shares while simultaneously buying the credit default swaps held on the bank's debt. The avalanche of shorts in a weak market drove down the prices of hopeless and helpless financial institution's shares, all the while lifting the prices of the CDS's. The rising prices of CDS's (signaling trouble) conveniently added panic to the financial shares, driving prices down further and of course, CDS prices higher. The short sell free fall was sucking the capital out of the banking institutions, and making the short sellers wealthy.

Man, the game was rigged, and our financial system was being destroyed, legally and dishonorably. And the SEC stood by and watched, and did little……

Until Tuesday. Yesterday, the Treasury stepped in and will allocate ~$250 billion of the rescue plan funds to purchase preferred common of selected banking institutions (B of A, Wells Fargo, JP Morgan, etc) to boost their capital base and secure their existence into the next decade. The Federal Government cannot be shorted out of existence. The financial shares rallied on the news Tuesday.

Not to cry a tear for these amazingly stupid institutions that convinced themselves that utilizing financially engineered risk models was a prudent tactic. These equations allowed banks to assess historical levels of risk that, with up to a 99% probability, would not lose more than a predetermined amount of capital in a worst case scenario. Using statistical analyses, banks have been assessing risk in various segments (mortgages, auto/consumer loans, lines of credit) of their lending portfolio with a flawed model because it failed to consider a significant decline in housing prices.

The housing bubble of the century was the 1% probability that nearly caused the meltdown of our financial system! They were oblivious to the obvious.

A recession is coming, and hopefully the Treasury purchase will minimize its depth and duration.

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