

3 day old fish does smell pretty bad, regardless of where you put it

Written by ReggieMiddleton

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I'm going to try and get to this in detail today, sharing a part of my model to show how bad the earnings actually were from Morgan Stanley and Lehman last quarter. Lehman actually took a loss, while Morgan practically doubled their "real" earnings in their reported numbers. They both played "hide the sausage", shifting assets from level 2 to 3 to generate non-cash gains, as well as using FAS 159 to manufacture unreal accounting profits.

When reading the following article, consider the level 3 assets as proportion of tangible equity, and not total assets, and you will see that these companies are playing a dangerous game of chicken.

From [Dan Denning](#) at the [Daily Reckoning](#) :

A tawdry game of "hide the garbage assets" continues to play out in New York. "One look at the Goldman Sachs' numbers Wednesday should tell you the credit crunch is far from over," reports Liz Moyer at Forbes.

"Despite the Federal Reserve's dramatic efforts to shake loose the financial system, banks still can't come up with accurate prices for hundreds of billions of dollars' worth of mortgage securities, corporate loans and other assets."

These assets that can't be traded and which no one wants to buy are called Level Three assets, named for the part of the balance sheet on which they reside. The banks have stuck them there the way some people might stick a crazy Aunt in the attic to avoid being embarrassed in front of the neighbours. Shut up Aunt Tilda!

There are a lot of Aunts in the attic. "Level 3 assets now make up 13% of the \$771 billion of assets Goldman holds at fair value, according to regulatory filings. Of the \$96 billion, Goldman is on the hook itself for \$82 billion, and that 'economic exposure' is up 50% from the fourth quarter." And it's not just Goldman.

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"The increases from the fourth quarter in Level 3 exposures weren't as stark at Morgan Stanley or at Lehman Brothers. Morgan Stanley had \$78 billion of Level 3 assets, or 17% of its assets held at fair value, up 6% from last November. Lehman had \$42.5 billion in Level 3 assets, 14% of assets held at fair value, up 1% from November. The three investment banks are the first of a series of banks to file their quarterly reports detailing Level 3 exposures. The total is only expected to rise."

Well that's not good news. We were asked yesterday if the Day of Reckoning for the banks and brokers has been postponed by Fed action. The trouble is these Level Three assets aren't going away. The banks, the Fed, and the brokers hope that by letting these sleeping dogs lie, they will eventually wake up and not be any particular harm to anyone.

They hope that by stashing the loans out of sight, investors will stop worrying about them and get back to buying stocks. But three-day old fish doesn't get fresher or more appetizing just because you've hidden the refrigerator in the back room. Yet that seems to be the solution pursued by the Fed and the banks.

Instead of chucking out the garbage loans, the Fed wants to put all the garbage in a hermetically sealed room deep in the bowels of its offices in New York. But just because you can't see something doesn't mean it's stopped stinking.

Eventually, we reckon the Feds will approve of, or even create, new off-balance sheet vehicles for banks to keep these garbage loans in. The loans won't count against the bank's capital requirements. And like a bad memory, the bad loans will be forgotten, sequestered away in their own quiet little cavern like so much captured carbon dioxide.

But this unwillingness to deal directly with the bad loan problem and write down the value of level three assets does not bode well for the U.S. dollar or dollar denominated assets.

Dan Denning
The Daily Reckoning Australia

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