

Bush family private equity fund in deep trouble as Financial Tsunami rolls on

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Carlyle Capital Corp. Ltd., a subsidiary of one of the most influential USA private equity funds and closely tied to the Bush family, is in default on several of its securities. Carlyle is an offshore subsidiary of the Washington-based Carlyle Group, one of the most politically powerful private equity firms of the past two decades. The severity of its liquidity problems indicates that the unfolding financial crisis is taking major parts of the US financial and political elite down with it. Among the leading partners of the Carlyle Group in recent years have been George H.W. Bush, father of the President; James Baker III, the Bush family's attorney and 'fixer;' former UK Prime Minister John Major.

Carlyle Capital reports it is attempting to convince lenders holding \$16 billion in securities not to liquidate the company's remaining collateral. The company is a listed mortgage-bond fund managed by the Carlyle Group. The Carlyle Group already has loaned Carlyle Capital \$150 million to cover debt obligations since July 2007. In the past several days it failed to meet margin calls with four banks. The fear in the market according to informed reports is that its entire portfolio, recently valued at \$21 billion, could be sold off in a distress sale, putting major downward pressure on all mortgage bonds globally. A collapse at Carlyle would hit the value of all fixed-income securities, which have already dropped sharply as banks pull back on their lending, and force a new global round of asset sales.

Margin calls

In the past days Carlyle Capital had admitted it had received "substantial additional margin calls and additional default notices from its lenders." It said lenders are selling off securities held as collateral. Margin calls are demanded when a creditor questions the ability of the borrower to repay.

Shares in the fund, which trades on Euronext Amsterdam, have been suspended after closing down nearly 60 percent. Carlyle Capital was a prime example of the financial engineering encouraged during the Alan Greenspan era by Washington. It had leveraged \$670 million in equity by an alarmingly high 32 times to finance a \$21.7 billion portfolio of highly rated mortgage-backed securities issued by US housing agencies Freddie Mac and Fannie Mae. To finance the deals it entered into repurchase agreements with banks where it posted the mortgage securities as collateral in exchange for cash. If the value of the security held as collateral falls, the lender has the right to ask for more collateral — a "margin call" — to secure the loan.

If the borrower does not meet the margin call by putting up more collateral, the lender may sell the security.

More worrisome is the fact that the Carlyle crisis does not owe to so-called sub-prime or bad grade mortgage debt. The company held US government agency AAA-rated residential mortgage-backed securities (RMBS). Now Carlyle's lenders have issued margin calls in excess of \$400 million. At the onset of the sub-prime crisis in September 2007 Carlyle was forced to go to Abu Dhabi's sovereign wealth fund to get capital. Mubadala, the arm of Abu Dhabi which has invested in sectors as diverse as Libyan oil exploration and Ferrari, the Italian motor company, paid \$1.35bn for a 10% Carlyle stake.

And Blackstone Group too?

Carlyle is by no means the only elite US private capital group in serious trouble. Blackstone Group, manager of the world's largest buyout fund, said fourth-quarter profit plunged 89 percent after a "meltdown" in the credit markets and warned that getting loans for takeovers will be difficult in 2008. Profit declined to \$88 million from \$808.1 million a year earlier.

Blackstone decided to list the private equity company on the stock market in June 2007 in a move some date as the last gasp of the huge securitization and private equity buyout mania of the past decade. Since June its stock has fallen 53 percent. More serious, it hasn't completed a takeover of more than \$2 billion in five months and is struggling to close the \$6.6 billion buyout of Dallas-based Alliance Data Systems Corp., a credit-card processor, announced in May 2007.

Blackstone and Carlyle led the recent "locust capitalism" (Heuschrecke) hostile takeover binge which triggered a major political backlash in Germany and elsewhere. That debt-financed takeover binge came to a halt with the eruption of the sub-prime securitization crisis last fall. Blackstone has \$102 billion in assets under management at present. The value of Leveraged or debt-financed Buyout (LBO) deals announced in the second half of 2007 plunged two-thirds from the first six months, according to data by Bloomberg.

Crisis spreads to US municipal debt market

The ongoing financial market crisis whose background I have detailed in the series, The Financial Tsunami, Part I-V, was nominally triggered by a crisis of confidence in the value of the most risky securities, sub-prime home mortgages in the US, mortgages often made by banks without checking the borrowers credit history or income. Because the securitization revolution was premised on the flawed illusion that by spreading risk throughout the global financial system, risk would disappear, once the weakest part began to collapse, confidence in the multi-trillion entire edifice of securitized debt began to collapse. The process unravels over time which is why most have the illusion of a localized crisis. In reality, centered in the US economic and financial sector, what is now underway is a crisis not even comparable to the 1930's Great Depression.

Now the normally high-quality debt of US local and state governments, so-called municipal debt, is getting hit. California, New York City and the owner of the World Trade Center site will replace their floating rate debt, sharply raising costs for local governments as the economic depression is slashing their tax revenues.

In February, interest rate yields on US tax-exempt municipal debt rose to the highest ever relative to Treasuries. The market is reacting to deteriorating finances at bond insurance companies and credit rating companies. States, cities and agencies are pulling out of the

\$330 billion floating rate or auction-rate market, where costs have doubled since January and plan to sell about \$22.5 billion of fixed-rate, tax-exempt bonds to raise capital at a significant penalty price.

Bond fund managers in New York and London tell us they have never seen such troubles in the municipal bond market before.

The market for floating rate or auction-rate municipal bonds in the US, once thought safe, entered crisis as losses tied to sub-prime mortgage bonds and related securities threatened so-called monoline bond insurers' AAA ratings, causing investors to avoid the bonds they had insured. The same monoline insurers, specialized New York financial security insurance companies, had insured sub-prime mortgage securities and municipal debt. The monoline companies guarantee about half the \$2.6 trillion of outstanding state and local government debt, some \$1.2 trillion. Higher interest rate costs for states and local governments will aggravate local US fiscal crises as the depression spreads, creating a self-reinforcing downward spiral. The process is in its early stages yet.

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