Speculative Onslaught. Crisis of the World Financial System: The Financial Predators had a Ball

Financial Tsunami, Part V

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Colossal Collateral Damage

The multi-trillion dollar US-centered securitization debacle began to unravel in June 2007 with the liquidity crisis in two hedge funds owned by Bear Stearns, one of the world's largest and most successful investment banks. The funds were heavily invested in sub-prime mortgage securities. The damage soon spread across the Atlantic to a little-known German state-owned bank, IKB. In July 2007, IKB's wholly-owned conduit, Rhineland Funding, had approximately €20 billion of Asset Backed Commercial Paper (ABCP). In mid-July, investors refused to rollover part of Rhineland Funding's ABCP. That forced the European Central Bank to inject record volumes of liquidity into the market to keep the banking system liquid.

Rhineland Funding asked IKB to provide a credit line. IKB revealed it didn't have enough cash or liquid assets to meet the request of its conduit, and was only saved by an emergency €8 billion credit facility provided by its state-owned major shareholder bank, the Kreditanstalt für Wiederaufbau, ironically the bank which led the Marshall Plan reconstruction of war-torn Germany in the late 1940's. It was soon to become evident to the world that a new Marshall Plan, or some financial equivalent, was urgently needed for the United States economy; however, there were no likely donors stepping up to the plate this time.

The intervention of KfW, rather than stopping the panic, led to reserve hoarding and to a run on all commercial paper issued by international banks' off-books Structured Investment Vehicles (SIVs).

Asset Backed Commercial Paper was one of the big products of the asset securitization revolution fostered by Greenspan and the US financial establishment. They were the stand-alone creations of the major banks, set up to get risk off the bank's balance sheet.

The SIV would typically issue Commercial Paper securities backed by a flow of payments from the cash collections received from the conduit's underlying asset portfolio. The ABCP was a short-term debt, generally no more than 270 days. Crucially, they were exempt from the registration requirements of the US Securities Act of 1933. ABCPs were typically issued from pools of trade receivables, credit card receivables, auto and equipment loans and leases, and collateralized debt obligations.

In the case of IKB in Germany, the cash flow was supposed to come from its portfolio of sub-prime US home mortgages, mortgage backed Collateralized Debt Obligations (CDOs). The main risk faced by ABCP investors was asset deterioration—that the individual loans making up the security default—precisely what began to cascade through the US mortgage markets during the summer of 2007.

The problem with CDOs was that once issued, they were rarely traded. Their value, rather than being market-driven, were based on complicated theoretical models.

When CDO holders around the world last summer suddenly and urgently needed liquidity to face the market sell-off, they found the market value of their CDOs was far below book value. So, instead of generating liquidity by selling CDOs, they sold high-quality liquid blue chip stocks, government bonds, precious metals.

That simply meant the CDO crisis led to a loss of value in both CDOs and stocks. The drop in price of equities triggered contagion to hedge funds. That dramatic price collapse wasn't predicted by the theoretical models built into quantitative hedge funds and led to large losses in that part of the market, led by Bear Stearns' two in-house hedge funds. Major losses by leading hedge funds further fed increasing uncertainty and amplified the crisis.

That was the beginning of colossal collateral damage. The models all broke down.

Lack of transparency was at the root of the crisis that had finally and inevitably erupted in mid-2007. That lack of transparency was due to the fact that instead of spreading risk in a transparent way as foreseen by accepted economic theory, market operators chose ways to "securitize" risky assets by promoting high-yielding, high-risk assets, without clearly marking their risk. Additionally, credit-rating agencies turned a blind eye to the inherent risks of the products. The fact that they were rarely traded meant even the approximate value of these structured financial products was not known.

Ignoring lessons from LTCM

With that collapse of confidence among banks in the international inter-bank market, the heart of global banking and which trades in Asset Backed Commercial Paper, the banking system stared a systemic crisis in the face. A crisis now threatened of a domino collapse of banks akin to that in Europe in 1931, when the French banks for political reasons pulled the plug on the Austrian Creditanstalt. Greenspan's New Finance was at the heart of the new instability. It was his Age of Turbulence, to parody the title of his ghost-written autobiography.

The world financial system had faced a systemic crisis threat as recently as the September 1998 collapse of the Long-Term Capital Management (LTCM) hedge fund in Greenwich, Connecticut. Only extraordinary coordinated central bank intervention then, led by Greenspan's US Federal Reserve, prevented a global meltdown.

That LTCM crisis contained the seed crystal of all that is going wrong with the multi-trillion dollar asset securitization markets today. Curiously, Greenspan and others in positions of responsibility systematically refused to take those lessons to heart.

The nominal trigger of the LTCM crisis was an event not foreseen in the hedge fund's risk model. Its investment strategies were based on what they felt was a predictable mild range of volatility in foreign currencies and bonds based on data from historical trading experience. When Russia declared it was devaluing its rouble currency and defaulting on its Russian state bonds, the risk parameters of LTCM's risk models were literally blown out of the water, and LTCM with it. Sovereign debt default was an event that was not "normal."

Unlike the risk assumptions of every risk model used by Wall Street, the real world was also not normal, but rather highly unpredictable.

To cover their losses LTCM and its banks began a panic sell-off of anything it could liquidate, triggering panic selling by other hedge funds and banks to cover exposed positions. In response, the US stock market dropped 20%, while European markets fell 35%. Investors sought safety in US Treasury bonds, causing interest rates to drop by over a full point. As a result, LTCM's highly leveraged investments started to crumble. By the end of August 1998, it lost 50% of the value of its capital investments.

In the summer of 1997 amid the hedge fund-led attacks on the vulnerable currencies of Thailand, Indonesia, Malaysia and other Asian high-growth "Tiger" economies, Malaysia's Prime Minister Mahathir Mohamad openly called for greater international control on the murky speculation of hedge funds. He named the name of one of the largest involved in the Asian attacks, George Soros' Quantum Fund. Because of US pressure from the Treasury Department by Secretary Robert Rubin, the former head of Goldman Sachs, and from the Greenspan Fed, no oversight of opaque offshore hedge funds was ever undertaken. Instead they were let to grow into funds holding more than $1.4 trillion in assets by 2007.

Fatally flawed risk models

The point about that LTCM crisis that rocked the foundations of the global finance system, was who was involved and what economic assumptions they used—the very same fundamental assumptions used to construct the deadly-flawed risk models of the asset securitization debacle.

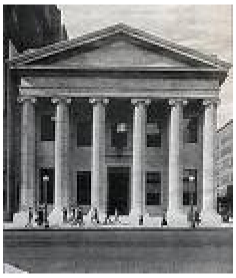
At the beginning of 1998, LTCM had capital of $4.8 billion, a portfolio of $200 billion, built from its borrowing capacity or credit lines loaned from all the major US and European banks hungry for untold gains from the successful fund. LTCM held derivatives with a notional value of $1,250 billion. That is one unregulated, offshore hedge fund held a portfolio of options and other financial derivatives nominally worth one and a quarter trillion dollars. Nothing of that scale had ever before been dreamed of. The dream rapidly turned into a nightmare.

In the argot of Wall Street, LTCM was a highly geared fund, unbelievably high. One of its investors was the Italian central bank, so awesome was the fund's reputation. The major global banks who had poured their money into LTCM hoping to coattail the success and staggering profits included Bankers Trust, Barclays, Chase, Deutsche Bank, Union Bank of Switzerland, Salomon Smith Barney, J.P.Morgan, Goldman Sachs, Merrill Lynch, Crédit Suisse, First Boston, Morgan Stanley Dean Witter; Société Générale; Crédit Agricole; Paribas, Lehman Brothers. Those were the very banks that were to emerge less than a decade later at the heart of the securitization crisis in 2007.

Speaking to press at the time, US Treasury Secretary Rubin declared, "LTCM was a single isolated instance in which the judgment was made by the Federal Reserve Bank of New York that there were possible systemic implications of a failure, and what they did was to organize or bring together a group of private sector institutions which then made a judgment of what was in their economic self interest."

The source of the awe over LTCM was the "dream team" who ran it. The fund's CEO and founder was John Meriwether, a legendary trader who had left Salomon Brothers following a scandal over purchase of US Treasury bonds. That hadn't dented his confidence. Asked whether he believed in efficient markets, he once modestly replied, "I MAKE them efficient." The fund's principal shareholders included the two eminent experts in the "science" of risk, Myron Scholes and Robert Merton. Scholes and Merton had been awarded the Nobel Prize for economics in 1997 for their work on derivatives by the Swedish Academy of Sciences. LTCM also had a dazzling array of professors of finance, doctors of mathematics and physics and other "rocket scientists" capable of inventing extremely complex, daring and profitable financial schemes.

Black-Scholes, fundamental flaws and risk models


The Federal Reserve

There was only one flaw. Scholes' and Mertons' fundamental axioms of risk, the assumptions on which all their models were built, were wrong. They had been built on sand, fundamentally and catastrophically wrong. Their mathematical options pricing model assumed that there were Perfect Markets, markets so extremely deep that traders' actions could not affect prices. They assumed that markets and players were rational. Reality suggested the opposite—markets were fundamentally irrational in the long-term. But the risk pricing models of Black, Scholes and others over the past two or more decades had allowed banks and financial institutions to argue that traditional lending prudence was old fashioned. With suitable options insurance, risk was no longer a worry. Eat, drink and be merry…

That, of course, ignored actual market conditions in every major market panic since Black-Scholes model was introduced on the Chicago Board Options Exchange. It ignored the fundamental role of options and 'portfolio insurance' in the Crash of 1987; it ignored the causes of the panic that in 1998 brought down Long Term Capital Management – of which Scholes and Merton were both partners. Wall Street blissfully ignored the obvious along with the economists and governors in the Greenspan Fed.

Financial markets, contrary to the religious dogma taught at every business school since decades, were not smooth, well-behaved models following the Gaussian Bell-shaped Curve as if it were a law of the universe. The fact that the main architects of modern theories of financial engineering—now given the serious-sounding name 'financial economics'—all got Nobel prizes, gave the flawed models the aura of Papal infallibility. Only three years after the 1987 crash the Nobel Committee in Sweden gave Harry Markowitz and Merton Miller the prize. In 1997 amid the Asia crisis, it gave the award to Robert Merton and Myron Scholes.

The most remarkable aspect of the incompetent risk models in use since the origins of financial derivatives in the 1980's, through to the explosive growth of asset securitization in the last decade, was how little they were questioned.

LTCM had ace Wall Street investment bankers, two Nobel Prize economists who literally invented the theory of pricing derivatives on everything from stocks to currencies. To top its all-star LTCM lineup, David Mullins, the former vice-chairman of the Federal Reserve Board under Alan Greenspan quit his job with the Maestro to become a partner at LTCM. Despite all this, the traders at LTCM and those who followed them to the edge of the financial abyss in August 1998 did not have a hedge against the one thing they now confronted—systemic risk. Systemic risk was precisely what they confronted once an "impossible event," the Russian state default, had occurred.

Despite the clear lessons from the harrowing LTCM debacle—there is no derivative that insures against systemic risk—Greenspan, Rubin and the New York banks continued to build their risk models as if nothing had taken place. The Russian sovereign default was dismissed as a "once in a Century event." They were moving on to build the dot.com bubble and, in the aftermath, the greatest financial bubble in human history—the asset securitization bubble of 2002-2007.

Life is no Bell Curve

Risk and its pricing did not behave like a bell-shaped curve, not in financial markets any more than in oilfield exploitation. In 1900 an obscure French mathematician and financial speculator, Louis Bachelier, argued that price changes in bonds or stocks followed the bell-shaped curve that the German mathematician, Carl Friedrich Gauss, devised as a model to map statistical probabilities for various events. Bell curves assumed a mild form of randomness in price fluctuations, just as the standard I.Q. test by design defines 100 as "average," the center of the bell. It was a kind of useful alchemy, but still alchemy.

That assumption that financial price variations behaved fundamentally like the bell curve allowed Wall Street Rocket Scientists to roll out an unending stream of new financial products each more arcane and complex than the previous. The theories were modified. The "Law of Large Numbers" was added to say that when the number of events becomes sufficiently large, like flips of a coin or rolls of die, the value converges on a stable value over the long term. The Law of Large Numbers, which in reality was no scientific law at all, allowed banks like Citigroup or Chase to issue hundreds of millions of Visa cards without so much as a credit check, based on data showing that in "normal" times defaults on credit cards were so rare as not to be worth considering.

The problems with models based on bell curve distributions or laws of large numbers arose when times were not normal, such as a steep economic recession of the sort the United States economy today is beginning to experience, a recession comparable perhaps only to that of 1931-1939.

The remarkable thing was that America's academic economists and Wall Street investment bankers, Federal Reserve governors, Treasury secretaries, Sweden's Nobel Economics Prize judges, England's Chancellors of the Exchequer, her High Street bankers, her Court of the Bank of England, to name just the leading names, all were willing to turn a blind eye to the fact that economic theory, theories of market behavior, theories of derivative risk pricing, were incapable of predicting, let alone preventing, non-linear surprises. It was incapable of predicting bursting of speculative bubbles, not in October 1987, not in February 1994, in March 2002, and most emphatically not since June 2007. It couldn't because the very model created the conditions that led to the ever larger and more destructive bubbles in the first place. Financial Economics was but another word for unbridled speculative excess.

A theory incapable of explaining such major, defining surprise events, despite Nobel prizes, was not worth the paper it was written on. Yet the US Federal Reserve Governors—above all Alan Greenspan, US Treasury secretaries, above all Robert Rubin and Lawrence Summers and Henry Paulsen—prevailed to make sure that Congress never lay a legislative or regulatory hand on the exotic financial instruments that were being created, created based on a theory that was utterly irrelevant to reality.

On September 29, 1998, Reuters reported, "any attempt to regulate derivatives, even after the collapse—and rescue—of LTCM have not met with success. The CFTC (the government agency with nominal oversight over derivatives trading-w.e.) was barred from expanding its regulation of derivatives under language approved late on Monday by the US House and Senate negotiators. Earlier this month the Republican chairmen of the House and Senate Agriculture Committees asked for the language to limit the CFTC's regulatory authority over over-the-counter derivatives echoing industry concerns." Industry of course meant the big banks.

Reuters added that "when the initial subject of regulation was broached by the CFTC both Fed chairman, Alan Greenspan, and Treasury Secretary Rubin leapt to the defense of the industry claiming that the industry did not need regulation and that to do so would drive business overseas."

The combination of relentless refusal to allow regulatory oversight of the explosive new financial instruments from Credit Default Swaps to Mortgage Backed Securities and the myriad of similar exotic "risk-diffusing" financial innovations and the 1999 final repeal of the Glass-Steagall Act strictly separating securities dealing banks from commercial lending banks opened the way for what in June 2007 began as the second Great Depression in less than a century. It began what future historians will describe as the final demise of the United States as the dominant global financial power.

Liars' Loans and NINA: Banks in an orgy of fraud

The lessons of the 1998 Russia default and the LTCM systemic crisis were forgotten within weeks by the major players of the New York financial establishment. Flanked by MBA whiz kid 'rocket scientist' analysts, bell curve models and fatally flawed risk models, the financial giants of the US banking world launched a wave of mega-mergers and began to create ingenious ways of getting lending risk off their books. That opened the doors to the greatest era of corporate and financial fraud in world history, the asset securitization bonanza.

With Glass-Steagall finally repealed in late 1999, at the urgings of Greenspan and Rubin, banks were now free to snatch up rivals across the spectrum from insurance companies to consumer credit or finance houses. The landscape of American banking underwent a drastic change. The asset securitization revolution was ready to be launched.

With Glass-Steagall gone, now only bank holding companies and subsidiary pure lending banks were directly monitored by the Federal Reserve. If Citigroup opted to close its Citibank branch in a sub-prime neighborhood and instead have a new wholly-owned subsidiary, CitiFinancial, which specialized in sub-prime lending, work the area, CitiFinancial could operate under entirely different and lax regulation.

CitiFinancial issued mortgages separately from Citibank. Consumer groups accused CitiFinancial of specializing in "predator loans" in which unscrupulous mortgage brokers or salesmen would push a loan on a family or person far beyond his comprehension or capacity to handle the risks. And Citigroup was only typical of most big banks.

On January 8, 2008 Citigroup announced with great fanfare publication of its consolidated "US residential mortgage business," including mortgage origination, servicing and securitization. Curiously, the statement omitted CitiFinancial, the subsidiary with the most risk.

Basle I loopholes

The driver pushing the banks towards securitization and the proliferation of off-balance-sheet risks including highly leveraged derivatives positions was the 1987 Basle Bank for International Settlements Capital Adequacy Accord, known today as Basle I. That agreement among the central banks of the world's largest economies required banks to set aside 8% of a normal commercial loan as reserve against possible future default. The then-new innovation of financial derivatives were not mentioned in Basle I on US insistence.

The Accord originally had been intended by Germany's ultra-conservative Bundesbank and other European central banks to rein in the more speculative Japanese and US bank lending which had led to the worst banking crisis since the 1930's. The original intent of the Basle Accord was to force banks to reduce lending risk. The actual effect for US banks was just the opposite. They soon discovered a gaping loophole—off-balance-sheet transactions, notably derivatives positions and securitization. Because they were left out of Basle I banks need not set aside any capital to cover potential losses.

The elegance of securitization of loans such as home mortgages for the issuing bank was that they could take the loan or mortgage and immediately sell it on to a securitizer or underwriter who bundled hundreds of such loans into a new Asset Backed Security. This seemingly genial innovation was far more dangerous than it sounded. Lending banks no longer needed to carry a mortgage loan on its books for 20-30 years as was traditional. They sold it on at a discount and used the cash to turn the next round of credit issuing.

That meant as well that the lending bank now no longer had to worry if the loan would ever be repaid.

Fraud a la mode

It didn’t take long before lending banks across the United States realized they were sitting on a bonanza bigger than the California gold rush. With no worry about whether a borrower of a home mortgage, say, would be able to service the debt for the next decades, banks realized they made money on pure loan volume and resell to securitizers.

Soon it became commonplace for banks to outsource their mortgage lending to free-lance brokers. Instead of doing their own credit checks they relied, often exclusively, on various online credit questionnaires, similar to the Visa card application where no follow-up was done. It became common practice for mortgage lenders to offer brokers bonus incentives to bring in more signed mortgage loan volume, another opportunity for massive fraud. The banks got more gain from making high volumes of loans then selling for securitization. The world of traditional banking was being turned on its head.

As the bank no longer had an incentive to assure the solidity of a borrower through minimum cash down payments and exhaustive background credit checks, many US banks, simply to churn loan volume and returns, gave what they cynically called “Liars’ Loans.” They knew the person was lying about his credit and income to get that dream home. They simply didn’t care. They sold the risk once the ink was dry on the mortgage.

A new terminology arose after 2002 for such loans, such as “NINA” mortgages—No Income, No Assets. “No problem, Mister Jones. Here’s $400,000 for your new home, enjoy.”

With Glass-Steagall no longer an obstacle, banks could set up myriad wholly-owned separate entities to process the booming home mortgage business. The giant of the process was Citigroup, the largest US bank group with over $2.4 trillion of group assets.

Citigroup included Travelers Insurance, a state-regulated insurer. It included the old Citibank, a huge retail lending bank. It included the investment bank, Smith Barney. And it included the aggressive sub-prime lender, CitiFinancial, according to numerous consumer reports, one of the most aggressive predatory lenders pushing sub-prime mortgages on often ignorant or insolvent borrowers, often in poor black or Hispanic neighborhoods. It included the Universal Financial Corp. one of the nation’s largest credit card issuers, who used the so-called Law of Large Numbers to grow its customer base among more and more dodgy credit risks.

Citigroup also included Banamex, Mexico’s second largest bank and Banco Cuscatlan, El Salvador’s largest bank. Banamex was one of the major indicted money laundering banks in Mexico. That was nothing foreign to Citigroup. In 1999 the US Congress and GAO investigated Citigroup for illicitly laundering $100 million in drug money for Raul Salinas, brother of the then-Mexican President. The investigations also found the bank had laundered money for corrupt officials from Pakistan to Gabon to Nigeria.

Citigroup, the financial behemoth was merely typical of what happened to American banking after 1999. It was a different world entirely from anything before with the possible exception of the excesses of the Roaring ‘20’s. The degree of lending fraud and abuse that ensued in the new era of asset securitization was staggering to the imagination.

The Predators had a ball

One US consumer organization documented some of the most common predatory lending practices during the real estate boom:

"In the United States in the first decade of the 21st century there are many storefronts offering such loans. Some are old — Household Finance and its sister Beneficial, for example — and some are newer-fangled, like CitiFinancial. Both offer credit at rates over thirty percent. The business is booming: the spreads, Wall Street says, are too good to pass up. Citibank pays under five percent interest on the deposits it collects. Its affiliated loan sharks charge four times that rate, even for loans secured by the borrower's home. It's a can't-miss proposition. Even if the economy goes South they can take and resell the collateral. The business is global: the Hong Kong & Shanghai Banking Corporation, now HSBC, wants to export it to the eighty-plus countries in which it has a retail presence. Institutional investors love the business model and investment banks securitize the loans. These fancy terms will be defined as we proceed. The root, however, the fodder on which the whole pyramid rests, is the solitary customer at what's called the point of sale… points and fees can be added to the money that's lent. CitiFinancial and Household Finance both suggest that insurance is needed. This they serve in a number of flavors — credit life and credit disability, credit unemployment and property insurance — but in almost all cases, it is included in the loans and interest is charged on it. It's called "single premium" — instead of paying each month for coverage, you pay in advance with money on which you pay interest. If you choose to refinance, you will not get a refund. It is money down the drain, but at the point-of-sale it often goes unnoticed.

Take, for example, the purchase of furniture. A bedroom set might cost two thousand dollars. The sign says Easy Credit, sometimes spelled E-Z. The furniture man does not manage these accounts. For this he turns to CitiFinancial, to HFC or perhaps to Wells Fargo. While the Federal Reserve lends money to banks at below five percent, these bank-affiliates charge twenty or thirty or forty percent. You will have insurance on your furniture: to protect you, they say, from having it repossessed if you die or become unemployed. Before the debt is discharged, dead or alive, you will have paid more than the list-price of a luxury car or a crypt with a doorman.

Midway you'll be approached with a sweet-sounding offer: if you'll put up your home as collateral, your rate can be lowered and the term be extended. A twenty-year mortgage, fixed or adjustable. The rate will be high and the rules not disclosed. For example: if you satisfy the loan too quickly, you'll be charged a pre-payment penalty. Or, you'll pay slowly and then be asked to pay more, in what's called a balloon. If you can't, that's okay: they knew you couldn't. The goal is to refinance your loan and charge you yet more points and fees.

In prior centuries, this was called debt peonage. Today it is the fate of the so-called sub-prime serf. Fully twenty percent of American households are described as sub-prime. But half of the people who get sub-prime loans could have paid normal rates, according to Fannie Mae and Beltway authorities. Outside it's the law of the jungle; the only rule is Buyer Beware. But this is easier for some people than others.

Why would a person overpay by so much? In the nation's low-income neighborhoods, sometimes called ghettos or, in a more poetic euphemism, the inner city, there's a lack of bank branches. In the late 20th century, many financial institutions left the 'hood in the lurch. They refused to lend money; they refused to write insurance policies.

In the 1980's this author interviewed a senior Wall Street banker, at the time recovering from some kind of burnout. I asked about his bank's business in Cali, Colombia during the heyday of the Cali cocaine cartel. Speaking not for attribution, he related, "Banks would literally kill to get a slice of this business, it's so lucrative." Clearly they moved on to sub-prime lending with similar goals in mind, and profits as huge as in money laundering drug gains.

Alan Greenspan openly backed the extension of bank lending to the poorest ghetto residents. Edward M. Gramlich, a Federal Reserve governor who died in September 2007, warned nearly seven years ago that a fast-growing new breed of lenders was luring many people into risky mortgages they could not afford. When Gramlich privately urged Fed examiners to investigate mortgage lenders affiliated with national banks, he was rebuffed by Alan Greenspan. Greenspan ruled the Fed with nearly the power of an absolute monarch.

Revealing what was most certainly the tip of a very extensive iceberg of fraud, the FBI recently announced it was investigating 14 companies for possible accounting fraud, insider trading or other violations in connection with home loans made to risky borrowers. The FBI announced that the probe involved companies across the financial services industry, from mortgage lenders to investment banks that bundle home loans into securities sold to investors.

At the same time, authorities in New York and Connecticut were investigating whether Wall Street banks hid crucial information about high-risk loans bundled into securities sold to investors. Connecticut Attorney General Richard Blumenthal said he and New York Attorney General Andrew Cuomo were looking whether banks properly disclosed the high risk of default on so-called "exception" loans — considered even riskier than sub-prime loans — when selling those securities to investors. Last November, Cuomo issued subpoenas to government-sponsored mortgage companies, Fannie Mae and Freddie Mac, in his investigation into what he claimed were conflicts of interest in the mortgage industry. He said he wanted to know about billions of dollars of home loans they bought from banks, including the largest US savings and loan, Washington Mutual Inc., and how appraisals were handled.

The FBI said it was looking into the practices of sub-prime lenders, as well as potential accounting fraud committed by financial firms that hold these loans on their books or securitize them and sell them to other investors. Morgan Stanley, Goldman Sachs Group Inc. and Bear Stearns Cos. all disclosed in regulatory filings that they were cooperating with requests for information from various unspecified, regulatory and government agencies.

One former real estate broker from the Pacific Northwest, who quit the business in disgust at the pressures to push mortgages on unqualified borrowers, described some of the more typical practices of predatory brokers in a memo to this author:

The sub-prime fiasco is a nightmare alright, but the prime ARMs hold potential for overwhelming disaster. The first "hiccup" occurred in July/August 2007 – this was the "Sub-prime Fiasco," but in November 2007 the hiccup was more than that. It was in November 2007, that the prime ARMs adjusted upwards.

What this means is that upon the "anniversary date of the loan" the Adjustable Rate Mortgage adjusts up into a higher payment. This happens because the ARM was “purchased” at a teaser rate, usually one or one and one half percent. Payments made at that rate, while very attractive, do nothing to reduce principal and even generate some unpaid interest which is tacked onto the loan. Borrowers are permitted to make the teaser rate payments for the entire first year, even though the rate is good only for the first month.

Concerns about “negative amortization,” whereby the indebtedness on the loan becomes more than the market value of the property, were allayed by reference to the growth in property values due to the bank-created bubble, which it was said was normal and could be relied upon to continue. All that was promoted by the lenders who sent armies of account executives, i.e., salesmen, around to the mortgage brokers to explain how it would work.

Adjustable interest rates on home loans were the sum of the bank’s profit – the margin – and some objective predictor of the cost of the borrowed funds to the bank, known as the index. Indexes generated by various economic activities – what the banks around the country were paying for 90 day CD’s or what the banks in the London Interbank Exchange (LIBOR) were paying for dollars – were used. Adding the margin to the index produces the true interest rate on the loan – the rate at which, after 30 years of payments, the loan will be completely paid off (“amortized”). It is called the “fully indexed rate.”

I am going to pick an arbitrary 6% as the “real” interest rate (3% margin + 3% index). With a loan amount of $250,000.00 the monthly payment at 1% would be $804.10; that is the “teaser rate” payment, exclusive of taxes and insurance. This would adjust with changes in the index, but the margin remains static for the life of the loan.

This loan is structured so that payment adjustments only occur once per year and are capped at 7.5 % of the previous year’s payment. That can go on, stair stepping, for a period of 5 years (or 10 years in the case of one lender) without regard to what is happening in the real world. Then, at the end of the 5 years, the caps come off and everything adjusts to payments under the “fully indexed rate.”

If the borrower has been making only the minimum required payments the whole time, this can result in a payment shock in the thousands. If the value of the home has decreased twenty-five percent, the borrower, this time someone with stellar credit, is encouraged to give it back to the bank, which devalues it at least another twenty-five percent and that spreads to the surrounding properties.

According to a Chicago banking insider, during the first week of February 2008, bankers in the U.S. were made aware of the following:

- Chase Manhattan Bank (“CMB”) has sent out an unlimited number of statements to its customers about Lines of Credit (“LOC’s”. The terms of its LOC’s, which, have been popular in the past, are now being manipulated and the values of the properties securing them are being unilaterally adjusted down, sometimes as much as 50 percent. This means homeowners are faced with making payments on a loan to buy an asset that is apparently worth half of the principal amount of the loan and paying interest on top of that. The only sensible thing to do in many cases is walk away, which results in a major loss in equity, reducing the value of all surrounding properties and adding to the avalanche of foreclosures.

- This is especially aggravated in cases of “Creative Financing” LOCs – those that were drawn on equal to between ninety and one hundred percent of the value of the property before the bubble burst…

- CMB has automatically closed credit lines that have “open” credit on them – meaning that the borrower left some money in the LOC for the future – over an 80% ratio of the amount of the loan to the value (“LTV”) of the property. This has been done on a mass basis without any reference to the “property owners.”

Loan to Value limits mean that the amount of money which the lender is willing to loan cannot exceed the stated percentage of the property value. In common practice, an appraiser would be hired to assess the value of the property. The appraisal is informed by comparable sales of other properties which have sold in an area that, with a few exceptions, must be no more than one mile away from the subject property. That was merely the tip of the mortgage fraud bonanza that preceded the present unfolding Tsunami.

The Tsumani is only beginning

The nature of the fatally flawed risk models used by Wall Street, by Moody’s, by the securities Monoline insurers and by the economists of the US Government and Federal Reserve was such that they all assumed recessions were no longer possible, as risk could be indefinitely diffused and spread across the globe.

All the securitized assets, the trillions of dollars worth, were priced on such flawed assumption. All the trillions of dollars of Credit Default Swaps—the illusion that loan default could be cheaply insured against with derivatives—all these were set to explode in a cascading series of domino-like crises as the crisis in the US housing market unraveled. The more home prices fell, the more mortgages facing sharply higher interest rate resets, the more unemployment spread across America from Ohio to Michigan to California to Pennsylvania to Colorado and Arizona. That process set off a vicious self-feeding spiral of asset price deflation.

The sub-prime sector was merely the first manifestation of what was to unravel. The process will take years to wind down. The damaged products of Asset Backed Securities were used in turn as collateral for yet further bank loans, for leveraged buyouts by private equity firms, by corporations, even by municipalities. The pyramid of debt built on assets securitized began to go into reverse leverage as reality dawned in global markets that no one knew the worth of the securitized paper they held.

In what would be a laughable admission were the consequences of their criminal negligence not so tragic for millions of Americans, Standard & Poors, the second largest rating agency in the world stated in October 2007 that they “underestimated the extent of fraud in the US mortgage industry.” Alan Greenspan feebly tried to exonerate himself by claiming that lending to sub-prime borrowers was not wrong, only the later securitization of the loans. The very system they worked over decades to create was premised on fraud and non-transparency.

Credit Default Swap crisis next

As of this writing, the next ratchet down in the US financial Tsunami was the monocline insurers where, short of a US government nationalization, no solution was feasible as the unknown risks were so staggering. That problem was discussed in the previous Part IV.

Next to explode will be the imminent probability of meltdown in the $45 trillion market in Over-the-Counter Credit Default Swaps (CDS), the brainchild of J.P. Morgan.

As Greenspan made certain, the CDS market remained unregulated and opaque, so that no one knew what the scale of the risks in a falling economy were. Because it is unregulated it often was the case that one party to a CDS resold to another financial institution without informing the original counterparty. That means it is not obvious that were an investor to try to cash in his CDS he could track down its payer of the claim. The CDS market was overwhelmingly concentrated in New York banks who held swaps at the end of 2007 worth nominally $14 trillion. The most exposed were J.P. Morgan Chase with $7.8 trillion and Citigroup and Bank of America with $3 trillion each.

The problem had been exacerbated by the fact that of the $45 trillions of credit default swaps, some 16% or $7.2 trillion worth were written to protect holders of Collateralized Debt Obligations where the mortgage collateral problems were concentrated. The CDS market was a ticking time bomb with an atomic detonator. As the credit crisis spreads in coming months, corporations will be forced to default on their bonds and writers of CDS insurance will face exploding claims and non-transparent rules. A claims settlement procedure for a market nominally worth $45 trillion did not exist as of February 2008.

As hundreds of thousands of Americans over the coming months find their monthly mortgage payments dramatically reset according to their Adjustable Rate Mortgage terms, another $690 billion in home mortgage debt will become prime candidates for default. That in turn will lead to a snowball effect in terms of job losses, credit card defaults and another wave of securitization crisis in the huge market for securitized credit card debt. The remarkable thing about this crisis is that so much of the sinews of the entire American financial system were tied in to it. There has never been a crisis of this magnitude in American history.

At the end of February the *Financial Times* of London revealed that US banks had “quietly” borrowed $50 billion in funds from a special new Fed credit facility to ease their cash crisis. Losses at all the major banks from Citigroup to J.P.Morgan Chase to most other major US bank groups continued to mount as the economy sank deeper into a recession that clearly would turn in coming months into a genuine depression. No Presidential candidate had dared utter a serious word about their proposals to deal with what was becoming the greatest financial and economic meltdown in American history.

By the early days of 2008 it was becoming clear that Financial Securitization would be the Last Tango for the United States as the global financial superpower.

The question now was posed what new center or centers of financial power could conceivably replace New York as the global nexus. That we will examine in Part VI.

Endnotes:

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3. Schroy, John Oswin, *Fallacies of the Nobel Gods: Essay on Financial Economics and Nobel Laureates*, in http://www.capital-flow-analysis.com/investment-essays/nobel_gods.html.

4. For a fascinating treatment of the fundamental theoretical flaws of economic and financial market models used today, and what he calls the high odds of catastrophic price changes, I recommend the book by the Yale mathematician and inventor of fractal geometry, Benoit Mandelbrot, in Mandelbrot, Benoit and Hudson, Richard L., *The (mis) Behavior of Markets: A Fractal View of Risk, Ruin and Reward*, Profile Books Ltd, London, 2004.

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