

Headwaters of Disaster

"If every CDO [manager] was forced to mark to market their subprime holdings, it would be - well, I can't think of a strong enough word to describe what it would be,"

US policymaker quoted in ft.com June 28, 2007

Thomas Midgley Jr. is not a name well known to those in the world of finance. But Midgley shares a distinction with a name the paper boys do know well—Drexel Burnham Lambert—the US investment bank that sold billions of dollars of junk bonds to investors which turned out to be, after all, junk.

Midgley's fame came from inventing leaded gasoline—which raised levels of lead in our blood 625 times higher than normal and for inventing CFCs, freon gas, now known to be responsible for burning a hole in the earth's ozone layer and accelerating global warming (CFCs produce 10,000 times more greenhouse gas than carbon dioxide).

Sometimes, somebody will do something resulting in dire consequences. Rarely, however, will someone do something terrible twice. Thomas Midgley Jr.'s contribution of both leaded gasoline and CFCs is one such instance. Drexel Burnham Lambert is another.

As an investment bank, Drexel Burnham Lambert specialized in debt and debt is the very foundation of the modern banking system. Prior to the introduction of modern banking, money was not based on debt as it is today. Money was based on savings and represented a universally accepted form of value, either gold or silver.

With the advent of modern banking, debt replaced savings as the basis of money. As pointed out in my previous article—D Is For Dominance, Debt, and Depression—debt-based money gave governments an extraordinary advantage in financing their military ambitions. England, in fact, parlayed this advantage into a world empire.

The cost, however, of a debt-based money system is, of course, debt. When debt-based money is issued by a government, over time debt naturally accumulates; and, as the flow of debt-based money continues and increases, so too does the total amount of debt.

This process mirrors the body's production of free-radicals. As the body metabolizes needed energy, free-radicals are produced by the body much as carbon dioxide/greenhouse gases are produced by gasoline-powered engines.

And just as greenhouse gases pose a very real threat to the earth's ecosystem, the production of free-radicals threatens the well-being of the body—the result of a lifetime buildup of free-radicals in the body is death.

While debt is natural result of our modern banking system, debt's actual role in the modern banking economy is that of a parasite. Debt, in and of itself, cannot exist, it needs to be attached to something in order to survive; and, in modern banking, the host-body to debt is productivity and savings.

Eventually in a debt-based system, the increasing accumulation of debt, like free-radicals in the body, overwhelms the host-body and the system collapses. This is where the economy is today—the tipping point where the debt driven destruction of productivity and savings is gaining momentum.

Modern banking, i.e. capitalism, first emerged in England in the 18th century, later joined by the US and other countries whose leaders quickly recognized that today's ambitions could be funded by tomorrow's debts, leaving future taxpayers burdened with today's expenses plus tomorrow's compounding interest.

In the modern parlance of politics, this is a win-win situation because costs come due in the future to be borne by the as yet unborn; and, like the popularity of the automobile, the advantage of governmental issuance of debt-based money quickly spread, pushing aside productivity and savings-based economies.

Despite warnings, after a long congressional battle, in 1913 the US government transferred its power to coin money to a new entity, the Federal Reserve Bank, a semi - autonomous government agency owned by private banks that now had the power to issue debt-based money in the US.

Since 1913, the creation of so much debt in the US has, of course, created problems. It also created opportunities. As the amount of debt grew, the repayment of debts became a critical factor—until investment banks figured out a way to sell the fast accumulating debts to others

Investment Banks Merchants of Debt

Sellers of debt began selling repackaged debt as “investments”, hence the self-described term “investment bank”. Debts no longer had to be repaid and retired, instead they could be rolled over, reissued as new debts and sold to those needing to assure themselves of future revenues, i.e. producers and savers.

In savings-based economies, producers and savers are rewarded for producing and saving. In debt-based economies, they are penalized because in debt-based economies the value of money declines as increasing amounts of debt money are continually created; diluting and debasing the value of money held by producers and savers while benefiting those closest to credit.

While debt-based money looks and acts the same as savings based money, it is not. Debt-based money can be leveraged many times its original value by investment banks. This is

why modern banking is on the verge of collapse today. Investment banks, those closest to the spigots of credit, have leveraged their proximity to credit by such high multiples that the global economy is now vulnerable to systemic risk.

It is here the investment bank Drexel Burnham Lambert joined Thomas Midgley Jr. in contributing not once but twice to our collective detriment. Drexel Burnham Lambert not only caused conservative buyers to stampede to junk bonds in the 1980s, it invented a new debt package that twenty years later in 2007 is threatening the very stability of the global economy.

Drexel Burnham Lambert's mispricing of risk in the 1980s was an extraordinary feat of miscalculation. The investment bank had apparently discovered an anomaly in the pricing of junk bonds in regards to actual risk. But Drexel Burnham Lambert's math turned out to be fundamentally flawed.

The market's historical valuation of junk bonds eventually proved correct; but, by then, buyers of debt had succumbed to Drexel Burnham Lambert's bad math. At one point, Prudential Life Insurance - "safe as the rock of Gibraltar" - was the largest holder of junk bonds in the world.

Shortly after its mistaken undervaluation of risk catapulted Drexel Burnham Lambert to the forefront of investment banks, scandal and dwindling profits soon forced the bank into bankruptcy; but not before it was to make its most important contribution to our collective problems.

Three years prior to its demise in 1990, Drexel Burnham Lambert invented a new debt vehicle, much like the AIDS virus with whom it shares an ability to spread risk unbeknownst to others; that now in 2007 is bringing financial destruction to those it exposed.

Who Cut The Prime?

While modern science is unable to pinpoint the exact genesis of the AIDS virus, the provenance of the collateralized debt obligation, the CDO, is clear. It was invented in 1987 by Drexel Burnham Lambert as a way of selling risky substandard debt as safe highly rated debt. The collateral for the CDO was to be a mixture of both risky and safe debt labeled as the latter.

This is akin to mixing USDA cutter or canner (lowest grade) ground beef with USDA prime, and selling the whole package as USDA prime ground beef. How much USDA cutter or canner grade was allowed to be mixed with prime if the ground beef was to be sold as prime?

The answer: The percentage of subprime debt in AAA rated CDOs sold in 2005-2006 is believed to be as high as 45 %.

Subprime Debt The E-Coli of Collateral Why Would Anyone Buy It?

For years, Drexel Burnham Lambert's CDOs languished, generating little interest among investors. It was clear the CDO's higher yield carried a higher level of risk, even if the rating given by credit rating agencies implied otherwise.

In 2002, however, the debt markets changed dramatically. From \$84 billion of CDOs issued in 2002, sales sextupled to \$503 billion in 2006, and in the 1st quarter of 2007 reached \$251 billion—an annualized rate of \$1 trillion.

In 2002, a crisis in the US debt-based economy had forced normally conservative buyers of debt to abandon traditional investments and turn to Drexel Burnham Lambert's misleadingly packaged CDOs for returns they were unable to achieve elsewhere.

The Squeeze Was On Liquidity Leads to Liquefaction

In 2001, the US Federal Reserve Bank, the spigot of credit in America's debt-based economy, drastically slashed its interest rates 84 %, from 6.5 % in 2001 down to 1 % in 2002. The Fed did so because the collapse of the dot.com bubble in 2000 had so damaged US financial markets (the NASDAQ fell by 80 %) the Fed feared a depression could result.

The dot.com collapse in 2000 was the largest collapse of a financial bubble since 1929, the collapse which led to the Great Depression of the 1930s. A similar collapse in Japan in 1990 had plunged Japan into a deflationary spiral so severe Japan slashed interest rates in 1999 to 0 % with little positive effect.

The 2000 collapse of the US markets threatened a repeat of the 1930s depression and the Fed responded by liquefying the markets with, in effect, free money at 1 % (real inflation was running higher than 1 %).

The sudden availability of 1 % money had two effects: (1) It created the largest real estate bubble in history, and (2) with US Treasury debt yielding only 1 %, high yielding AAA and AA CDOs now appeared suddenly attractive.

Given the requisite cover of AAA and AA ratings granted by credit rating agencies, buyers of debt—pension funds, banks, and insurance companies—flocked to CDOs; and, although the AAA assurance of credit ratings was as false as the credit worthiness of the underlying mortgages, the credit markets were desperate for returns.

When the Fed flooded the markets with money from 2002-2005 most of it was converted into subprime mortgages which fueled the US real estate bubble. This, however, led to a

problem: What were the investment banks going to do with all the risky subprime loans they created?

This was the perfect time for Drexel Burnham Lambert's CDOs. At the height of the CDO frenzy, over a trillion dollars of subprime debt was mixed in with high grade debt and sold as high rated debt to pension funds, insurance companies, banks, and mutual funds. Do you know where your bank, insurance company, pension fund or mutual fund's money is invested today?

Death In The Tranches

The risk in CDOs is split among "tranches", the riskiest tranches returning the highest returns. But with subprime foreclosures running at historic highs, hoped for returns are being increasingly replaced by outright losses.

Among those purchasing CDO equity tranches, the tranches most vulnerable to loss, are the California Public Employees Retirement System, the Teachers Retirement System of Texas, the European Insurance conglomerate AXA, and some of the largest banks in the world, in Asia, Europe, and the US.

And Now Ladies & Gentlemen The Losers Are...

Those who purchased equity tranches lost more than an opportunity to increase returns. In many cases, they will lose their investments as well. Adjustable rate mortgage resets, the trigger event for subprime foreclosures, will continue through 2011; and in the interim as more subprime CDOs fail, financial losses will rise.

The real losers, however, are not the pension funds, banks, insurance companies or mutual funds that invested in CDOs; the real losers are you, the investors, producers, and savers that use banks, pension funds, insurance companies, and mutual funds to protect your savings against the erosion in the value of money that occurs in debt-based economies.

Your losses are now paper losses but this will soon change. Should those now owning CDOs (banks, pension funds, insurance companies, mutual funds, etc) be forced to mark to market their CDOs (value their CDOs at market value, not seller ascribed value), your losses would become readily apparent. But, it will not be so. The smoke and mirrors that intentionally creates opacity in place of transparency is designed to aid investment banks, not those who buy their investments.

But as your losses from CDOs become more significant and America's banks, pension funds and insurance companies begin to falter, investors and savers will look to the government for help. Look no further. Save your breath. You're too late.

The fox is already in the henhouse. The current head of the US Treasury is none other than investment banker Henry Paulson, the former head of Goldman Sachs, the large US investment bank and major player in today's debt markets.

And although in the 1990s, US taxpayers gave Goldman Sachs \$4 billion *gratis* to cover their losses on Mexican bonds, do not expect the favor to be returned. Investment banks live off of producers and savers, not the other way around.

If the forces of anti-globalization were to take aim at today's global economic edifice, they could not have aimed as well, or have created a more effective time bomb than Drexel Burnham Lambert's CDOs.

One of the world's top financial strategists predicted that today's largely unregulated financial markets are going to come to an abrupt end. That self-regulation is no more possible with bankers seeking billions in bonuses than with teenagers seeking sex in the back seat of cars.

He predicted that America would react with swift vengeance and draconian regulations when they woke up and realized their past savings and future dreams have been bet and lost by the boys on Wall Street.

Here in 2007, the bets have been made and the losses are coming. America has yet to wake up.

It will. Be prepared. It's going to get ugly.

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