

A Perspective on the Credit Crisis

Or "How Wall Street pimped Larry the Loan Guy to Destroy the American Economy"

By Erik Townsend 2-8-08
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"Hi! I'm Larry the Loan Guy, and I'll get you financed no matter what! No credit? No problem! Bad credit? No problem! Even Bankruptcies aren't a problem for Larry the Loan Guy. And don't worry! I'll never ask you to document or prove your income! So call me, Larry the Loan Guy, at 1-800-EASY-MONEY! Call today!!!"

For several years, it's essentially been impossible to live in the United States without being exposed to this sort of advertising. It's been everywhere, particularly on the radio and television. And while this "easy money" advertising may have recently come to an abrupt halt, a deeper look at the history of this phenomenon reveals a telling story about current financial markets, the American economy, and what can be expected from both of them in the future.

Many years ago, mortgages and consumer loans were made by banks, which held onto those loans and suffered financial loss if they were not eventually repaid. Not surprisingly, guys like Larry weren't on the radio back in those days.

Today, mortgages and many other forms of consumer credit are packaged up into bonds and sold to institutional investors, through a process known as *securitization*. The investors in question are primarily professional institutional buyers, and are expected (in theory at least) to fully understand the risks they are taking with the money they are paid fees to manage. That's the theory, anyway. I humbly contend that the rampant success of people like Larry the Loan Guy has been a clear and present warning sign - ignored for several years now - that something in the system was seriously broken.

Something doesn't add up here: The bond traders who have been steadily buying up all the debt originated by guys like Larry were living here in the United States for the last several years too, so they were undoubtedly aware that a lot of money was being lent to obviously dubious borrowers. Surely, there's no way that professional fiduciaries for pension funds and other large institutions

would ever expose themselves to the enormous default risk being created by the predatory lending practices of Larry and his contemporaries - right?

In the book *Traders, Guns & Money*, Satyajit Das asserts a shocking hypothesis about how the derivatives business really works. Essentially, he contends that the function of the derivatives industry is to sell complex financial instruments to institutional investors who don't fully understand what they are actually buying. Das goes on to explain that the buyers are constantly getting smarter, and it is for that reason, he suggests, that the derivatives industry continues to invent new, more complex financial structures every day. His conclusion is that the collective intent of the securities dealers is to keep the products complex enough to assure that the lion's share of market participants don't really understand exactly what they are buying, but think they do. It is that false sense of security which makes them most vulnerable, and Das suggests that exploiting that vulnerability is the express goal of the securities dealers.

Das' attitude is certainly dogmatic and might seem offensive to some at first. But when one examines the current credit crisis, the evidence is compelling that the *Collateralized Debt Obligation* - an invention of the securities derivatives industry - exemplifies this phenomenon of Wall Street using the complexity of financial instruments as a tool to defraud investors into buying things they don't fully understand. And they're buying these "things" with America's pension fund savings!

At the glossy brochure level, a CDO is a wonderful invention. It rolls up a whole bunch of

mortgages or other consumer debts, and structures them in several *tranches* of bond offerings, each with different credit ratings. The idea (or the sales pitch, anyway) is that thanks to some clever financial engineering, most of the default risk is isolated in the lower “junk tranches” of debt, supposedly making it perfectly safe for pensions and other institutions to buy the higher-rated “investment grade tranches”.

Now to an ordinary citizen, it might seem that if guys like Larry are doing most of the lending, then *all* of the bonds would seem to be at risk. But ordinary citizens never saw the Powerpoint presentation from the investment bankers about all the wonderful merits of CDOs. And besides, if you’re investing in something that uses fancy words like *tranches* that aren’t even in the dictionary, surely everything must be fine. Very smart people design all this stuff, you know. And they would never mislead you on purpose. They work for a very prestigious, respectable firm. Right...

Just as Das’ dogma would predict, the markets have now figured out that in the case of subprime mortgages, at least, all those fancy tranches didn’t add up to a hill of beans when it came to insulating investors from default risk. One day there were AAA-rated investment grade bonds, then the next morning the market woke up and noticed they were actually almost worthless. Oops.

Could the credit crisis have been prevented by sending a memo to bond traders in 2002 saying “On your way to work listen to the radio, pay attention, and don’t buy bonds that are secured by loans made by guys like Larry, got it”? One might have hoped they’d have seen the writing on the wall on their own, but apparently they didn’t.

But wait, aren’t there people whose job it was to see all this coming, and warn the bond traders about the extraordinary risk guys like Larry create by loaning money to uncreditworthy borrowers? Yes, they’re called bond rating agencies. Exactly what they were doing as all this was going down bears examination.

The people who work at bond rating agencies must listen to the radio too. So they must have known about Larry, then... right? And if the idea of a CDO is to bunch together loans of different credit quality into a multi-tranch bond offering, wouldn’t it be their job to do a careful, thorough

analysis of what could go wrong, what the probability of it going wrong actually was, etc.? Yes, that was indeed their job. And this is the critical point: Not only didn’t they do it, but they are the same people who are still today rating all the other classes of securitized debt that haven’t blown up... Yet.

So we know two things for sure: One is that an enormous trend in finance has been *securitization* of all sorts of consumer and commercial debt. The second is that as proven by the subprime debacle, the people responsible for analyzing and rating the default risk associated with securitized debt instruments have failed to do their jobs adequately, so the historical valuations of these risk premia have been illusory.

Subprime risk is being very publicly repriced, with enormous consequences still being unveiled at this writing. *And all the other categories of securitized debt haven’t even been figured out yet.*

It has taken the markets 6 months just to come to terms with subprime: the extent of the losses (mostly thanks to convergence bets on those CDO bonds) was so enormous that rumors now suggest Citibank could actually be wiped out by the writeoffs! And this is just from subprime MBS trading losses alone.

Well guess what? The same process of securitizing debt has been used for myriad other forms of debt besides mortgages. And the people who led institutions to believe the upper tranches of subprime debt were safe are the very same ones now entrusted to evaluate and rate all these other forms of securitized debt instruments. We know now that all the risk analysis and bond ratings on subprime CDOs were completely worthless, and the false sense of security they gave bondholders resulted in this enormous credit crisis.

So have we taken a step back and said “Wait a minute – shouldn’t we go back and re-evaluate the true risks inherent to all those other securitized debt instruments?” No, we haven’t really done that. We’ve been too busy panicking over subprime.

So what should we expect from here? I am convinced that subprime mortgages were just the first wave of economic repercussion certain to emerge from a decade-old practice of securitizing

debt obligations so as to obscure their true risk characteristics, and then selling them at exploitive prices to naïve institutional buyers who don't understand the true risks they are taking on.

We should expect to see other classes of asset-backed securities experience dramatic repricings of risk as those risks are fully understood for the first time by the current owners of those securities. In other words, this thing is a long way from being over.

The enormous reservoir of institutional capital that stood ready to back all sorts of consumer financings has dried up permanently. In future, credit will be less available and more expensive than in the past.

But the problem goes much deeper than the financial markets. For the last 5-10 years, America has seen an unprecedented period of economic expansion and apparent prosperity. The boom in residential housing prices led the way, with typical home value appreciation of several hundred percent over the last decade in many markets. A key question is: What really caused this enormous economic expansion and appreciation in housing prices in the first place?

There are economic factors that would explain a *sustainable* increase in housing values, such as a dramatic increase in domestic product, a need for more workers, increasing wages, postwar recovery, etc. But none of those factors seem to have been in play during this swell in housing values. So if it wasn't those factors, what caused housing prices to go through the roof?

My contention is that this story is about one thing only: Easy money. When the people who securitize mortgage debt into CDOs figured out that they could sucker institutional buyers into just about anything (so long as they made it complicated enough), they laid the groundwork for a whole cottage industry of guys like Larry. The Larry's of the world suddenly had virtually unlimited amounts of capital available to loan to just about anybody, and no reason to care whether it was ever paid back.

Neither the securitization guys at the investment banks nor the Larry's of the world would ever risk losing a single penny to anyone defaulting on the bad loans they were making! Quite to the contrary, they had found a scheme where they could make a no-risk commission each time they

put another home buyer and another bond buyer into a risk situation that neither party fully understood. And what's more, they'd found a way to tap into a virtually unlimited source of institutional money to make these bad loans with!

The impact was made much worse by the fact that interest rates were falling to record lows during the same period, making the dollar amounts of monthly payments strikingly appealing in contrast to historical norms. Although a lot of things (like houses) had suddenly become quite expensive, the payments still seemed too appealing to pass up.

A sort of *perfect storm* was created when, just as interest rates were dipping to new lows and encouraging a wave of refinancings, discounted adjustable rate mortgages were also in vogue. The result of all this was that for those buyers whose purchase decision was fairly simple (*if I can afford the payments I'll take it*), they often just said yes to deals that were guaranteed to blow up at the first rate reset event.

Although the information had indeed been disclosed to them, most of the buyers never really came to terms with the reality that the payment they could "afford" was just the *teaser* payment, calculated at an interest rate discounted below an already-unprecedented low rate that was likely to increase on its own by the time of the first reset event. And as we now know, a whole bunch of those rate reset events have already led to defaults and foreclosures, and a whole bunch more will lead to more defaults and foreclosures when those future resets occur.

The dollar volume of notional principal subject to ARM resets peaked at \$50b this month and is projected to continue at unprecedented levels for several months to come. Continued downward government manipulation of interest rates will be these borrowers' only salvation.

While millions of home buyers' financing contracts were doomed for catastrophe from the outset, Larry was comfortable knowing his commission was secure no matter what happened to the borrowers or the lenders. The guys at investment banks who bundled Larry's loans up into CDOs did even better.

All it takes to make prices go up in a supply-demand system is for some of the buyers to be willing to pay more. And when the buyers were

comfortable paying any amount a lender was willing to lend them, the price they were willing to pay suddenly became more of a reflection of the borrower's access to credit than to any objective analysis (or even opinion) of fair market value. Translation: The more easy money in the system, the more quickly prices rose to artificial, unsustainable levels in what George Soros would call a self-reinforcing boom cycle.

As easy credit caused home prices to skyrocket, the lenders were deceived by the illusion of safety brought to them by rapidly decreasing portfolio LTV ratios. They failed to employ Soros' theory of *reflexivity*, which would have led them to recognize that their easy credit policy was the *reason* for the price appreciation, and that a classic boom-bust situation was developing right under their noses.

Instead of recognizing the extremity of the risks they were exposed to, the institutional buyers of CDO debt tolerated "no-doc" financings, reducing transaction closure times and further accelerating the unsustainable, self-reinforcing cycle of price appreciation. All of this really was quite obvious then, as it was happening. I remember encouraging my friends to sell their homes and take profits specifically because the cycle was so obvious to me, and I'm not even a finance guy!

What we're finally starting to come to terms with – slowly – is that the whole perception of American economic prosperity between 2002 and 2006 has been an illusion. That illusion was created as a direct result of the shift in ultimate mortgage default risk exposure from lending professionals (pre-securitization) to institutional investors. The latter group now assumes the default risk of most American consumer and mortgage debt, in the form of holding bonds organized in CDOs the institutional portfolio managers thought they completely understood but really didn't.

Because these new holders of mortgage default risk were inexperienced, they allowed an insane amount of wealth to be redistributed. It might at first sound outlandish to say that billions of dollars of America's pension money was handed out to the least worthy recipients imaginable, in the form of certain-to-default subprime loans made to uncreditworthy borrowers who were *specifically targeted as uncreditworthy* in the advertising used to sell them financing! But that's exactly what happened.

In other words, the current "credit crunch" is just the first wave of evidence of a scandal of epic proportion. Wall Street defrauded America's pension funds and other institutions into putting up the money that the nation just blew on a fantasy spending spree we're only just now starting to figure out wasn't real. The spending spree came in the form of lending absurd amounts of money to unworthy borrowers, who used it to artificially bid up housing prices to unsustainable levels, causing an unprecedented level of *false* consumer confidence and thus consumer spending.

The apparently strong American consumer of the past several years is just a poor guy who got railroaded by players like Larry into believing he could safely spend well beyond his means. And that's exactly what he's been doing, helping to sustain the illusion of a healthy American economy. He's about to wake up, and his surprise awakening will come at a time when election year politics will almost certainly distort the issue and falsely assign blame to the wrong parties.

The recession we're on the precipice of at this writing will be deeper and will last longer than anyone is currently predicting, because we have to come to terms with the enormity of the spending spree the country just went on for the last 5+ years. It all happened to facilitate Wall Street's greedy desire to profit from securitization fees after perpetrating the deception of the entire mortgage lending institution of this nation. All so the securitization guys could make their fees. And those guys aren't the ones facing foreclosure of their homes, by the way.

Thanks to so-called wealth effect, a lot of American consumers have elevated themselves to the upper middle class in the last 10 years, and are now accustomed to spending more than they used to be able to afford. The shocking news is, they still can't afford their current lifestyle, and never could. They just didn't realize it because of an illusion created by Wall Street shifting the ultimate default risk of consumer debt from experienced lenders (banks) to inexperienced lenders (institutional investors).

Could the whole housing bubble really be attributable to greedy securitization bankers inventing this elaborate scheme to enable them to intentionally loan absurd amounts of money to unworthy borrowers, using the complexity of the CDO structure as a tool to persuade institutional investors to put up the money for this suicide bet?

Would they really do such a thing just so they could make fees in the process?

Now, suddenly, all those recently minted upper-middle class Americans must come to terms with two scary facts: The first is that their means are really a lot less than they thought, and the elevation of their discretionary wealth was just an illusion. The second is that they've been spending well beyond their means for years now, because they thought they made more money on their house appreciating than they did from their job. They were wrong, and now face reality.

So, what happens next in financial markets? The housing-led recession will cause consumers to not only slow spending, but eventually to come to terms with the reality of several years of excessive spending. The newly cost-conscious consumer will stop making unnecessary purchases, further retarding the economy on the whole. The government will continue to push interest rates to the lowest possible levels to contain subprime risk, and inflation is certain to result.

About the only thing the government could do to make the situation worse would be to wage an expensive, prolonged war in a foreign land that doesn't serve any useful purpose or deliver any economic value to the nation. Oh wait, we're doing that, too. ☹

Update July 18, 2008:

Sadly, the economy has been deteriorating just about exactly as I predicted in this article, and unfortunately I fear that the worst has yet to come.

I wrote this original article on a whim in February when a friend asked me to explain to them what was going on. Admittedly, it was nothing more than one guy's quick explanation of what's happening in the economy, and I'm really not an expert.

If this sort of thing interests you, I just discovered a **fantastic** web site that does a much better job of explaining all this in lay terms than I ever could have. And what's more, the format is a series of very compelling videos, rather than a boring paper like this one.

So if you care about your country and our economy, please, check out Chris Martenson's "crash course" on the economy at www.chrismartenson.com. It's free, and it's

outstanding quality. I agree with everything Chris says, and I strongly encourage all Americans to watch this outstanding video course.