

Securitization: The Biggest Rip-off Ever

Financial Deregulation has Opened Up A Pandora's box

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Is it possible to make hundreds of billions of dollars in profits on securities that are backed by nothing more than cyber-entries into a loan book?

It's not only possible; it's been done. And now the scoundrels who cashed in on the swindle have lined up outside the Federal Reserve building to trade their garbage paper for billions of dollars of taxpayer-funded loans. Where's the justice? Meanwhile, the credit bust has left the financial system in a shambles and driven the economy into the ground like a tent stake. The unemployment lines are growing longer and consumers are cutting back on everything from nights-on-the-town to trips to the grocery store. And it's all due to a Ponzi-finance scam that was concocted on Wall Street and spread through the global system like an aggressive strain of Bird Flu. The isn't a normal recession; the financial system was blown up by greedy bankers who used "financial innovation" game the system and inflate the biggest speculative bubble of all time. And they did it all legally, using a little-known process called securitization.

Securitization—which is the conversion of pools of loans into securities that are sold in the secondary market—provides a means for massive debt-leveraging. The banks use off-balance sheet operations to create securities so they can avoid normal reserve requirements and bothersome regulatory oversight. Oddly enough, the quality of the loan makes no difference at all, since the banks make their money on loan originations and other related fees. What matters is quantity, quantity, quantity; an industrial-scale assembly line of fetid loans dumped on unsuspecting investors to fatten the bottom line. And, boy, can Wall Street grind out the rotten paper when there's no cop on the beat and the Fed is cheering from the bleachers. In an analysis written by economist Gary Gorton for the Federal Reserve Bank of Atlanta's 2009 Financial Markets Conference titled, "Slapped in the Face by the Invisible Hand; Banking and the Panic of 2007", the author shows that mortgage-related securities ballooned from \$492.6 billion in 1996 to \$3,071.1 in 2003, while asset backed securities (ABS) jumped from \$168.4 billion in 1996 to \$1,253.1 in 2006. All told, more than \$20 trillion in securitized debt was sold between 1997 to 2007. How much of that debt will turn out to be worthless as foreclosures skyrocket and the banks balance sheets come under greater and greater pressure?

Deregulation opened Pandora's box, unleashing a weird mix of shady off-book operations (SPVs, SIVs) and dodgy, odd-sounding derivatives that were used to amplify leverage and stack debt on tinier and tinier scraps of capital. It's easy to make money, when one has no skin in the game. That's how hedge fund managers and private equity sharpies get rich. Securitization gave the banks the opportunity to take substandard loans from applicants who had no way of paying them back, and magically transform them into Triple A securities.

“Abra-kadabra”. The Wall Street public relations throng boasted that securitization “democratized” credit because more people could borrow at better rates since funding came from investors rather than banks. But it was all a hoax. The real objective was to turbo-charge profits by skimming hefty salaries and bonuses on the front end, before people found out they’d been hosed. The former head of the FDIC, William Seidman, figured it all out back in 1993 when he was cleaning up after the S&L fiasco. Here’s what he said in his memoirs:

“Instruct regulators to look for the newest fad in the industry and examine it with great care. The next mistake will be a new way to make a loan that will not be repaid.” (Bloomberg)

That’s it in a nutshell. The banks never expected the loans would be paid back, which is why they issued them to ninjas; applicants with no income, no collateral, no job, and a bad credit history. It made no sense at all, especially to anyone who’s ever sat through a nerve-wracking credit check with a sneering banker. Trust me, bankers know how to get their money back, if that’s their real intention. In this case, it didn’t matter. They just wanted to keep their counterfeiting racket zooming ahead at full-throttle for as long as possible. Meanwhile, Maestro Greenspan waved pom-poms from the sidelines, extolling the virtues of the “new economy” and the permanent high plateau of prosperity that had been achieved through laissez faire capitalism.

Now that the securitization bubble has burst, 40% of the credit which had been coursing into the economy has been cut off triggering a 1930’s-type meltdown. Fed chief Bernanke has stepped into the breach and provided a \$13 trillion dollar backstop to keep the financial system from collapsing, but the broader economy has continued its historic nosedive. Bernanke is trying to fill the chasm that opened up when securitization ground to a halt and gas started exiting the credit bubble in one mighty whooosh. The deleveraging is ongoing, despite the Fed’s many programs to rev up securitization and restore speculative bubblenomics. Bernanke’s latest brainstorm, the Term Asset-backed securities Lending Facility (TALF), provides 94 percent public funding for investors willing to buy loans backed by credit card debt, student loans, auto loans or commercial real estate loans. It’s a “no lose” situation for big investors who think that securitized debt will stage a comeback. But that’s the problem; no one does. Attractive, non recourse (nearly) risk free loans have failed to entice the big brokerage houses and hedge fund managers. Bernanke has peddled less than \$30 billion in a program that’s designed to lend up to \$1 trillion. It’s been a complete bust.

To understand securitization, one must think like a banker. Bankers believe that profits are constrained by reserve requirements. So, what they really want is to expand credit with no reserves; the equivalent of spinning flax into gold. Securitization and derivatives contracts achieve that objective. They create a confusing netherworld of odd-sounding instruments and bizarre processes which obscure the simple fact that they are creating money out of thin air. That’s what securitization really is; undercapitalized junk masquerading as precious jewels. Here’s how economist Henry CK Liu sums it up in his article “Mark-to-Market vs. Mark-to-Model”:

“The shadow banking system has deviously evaded the reserve requirements of the traditional regulated banking regime and institutions and has promoted a chain-letter-like inverted pyramid scheme of escalating leverage, based in many cases on nonexistent reserve cushion. This was revealed by the AIG

collapse in 2008 caused by its insurance on financial derivatives known as credit default swaps (CDS).....

The Office of the Comptroller of the Currency and the Federal Reserve jointly allowed banks with credit default swaps (CDS) insurance to keep super-senior risk assets on their books without adding capital because the risk was insured. Normally, if the banks held the super-senior risk on their books, they would need to post capital at 8% of the liability. But capital could be reduced to one-fifth the normal amount (20% of 8%, meaning \$160 for every \$10,000 of risk on the books) if banks could prove to the regulators that the risk of default on the super-senior portion of the deals was truly negligible, and if the securities being issued via a collateral debt obligation (CDO) structure carried a Triple-A credit rating from a "nationally recognized credit rating agency", such as Standard and Poor's rating on AIG.

With CDS insurance, banks then could cut the normal \$800 million capital for every \$10 billion of corporate loans on their books to just \$160 million, meaning banks with CDS insurance can loan up to five times more on the same capital. The CDS-insured CDO deals could then bypass international banking rules on capital. (Henry CK Liu, "Mark-to-Market vs. Mark-to-Model" <http://www.henryckliu.com/page191.html>)

The same rule applies to derivatives (CDS) as securitized instruments; neither is sufficiently capitalized because setting aside reserves impairs one's ability to maximize profits. It's all about the bottom line. The reason credit default swaps are so cheap, compared to conventional insurance, is that there's no way of knowing whether the dealer has the ability to pay claims. It's fraud, on a gigantic scale, which is why the financial system went into full-blown paralysis when Lehman Bros defaulted. No one knew whether trillions of dollars in counterparty contracts would be paid out or not. There are simply more claims on wealth than there is money in the system. Bogus mortgages and phony counterparty promises mean nothing. "Show me the money". The system is underwater, and it cannot be fixed by more of the Fed's presto liquidity. Here's what Gary Gorton says later in the same article:

"A banking panic means that the banking system is insolvent. The banking system cannot honor contractual demands; there are no private agents who can buy the amount of assets necessary to recapitalize the banking system, even if they knew the value of the assets, because of the sheer size of the banking system. When the banking system is insolvent, many markets stop functioning and this leads to very significant effects on the real economy...."

Indeed. The shadow banking system has collapsed, not because the market is "frozen" or because investors are in a state of panic after Lehman, but because derivatives and securitization have been exposed as a fraud propped up on insufficient capital. It's snake oil sold by charlatans. That's why European policymakers are resisting the Fed's requests to create a facility similar to the TALF to start up securitization again. Here's a revealing clip from the Wall Street Journal which explains what's going on behind the scenes:

"Bankers are pushing European policy makers to consider a U.S.-style program to aid the region's economy by reviving the moribund market for bundled consumer loans. Officials at the European Securitisation Forum, a trade group representing banks and other market participants, said Tuesday that central bankers should consider stepping in with a program similar to the U.S. Federal Reserve's Term Asset-Backed Securities Loan Facility, or TALF, which provides loans to private investors who buy new securities tied to consumer loans...

After suffering heavy losses on securities stuffed with poorly made loans, investors are reluctant to wade back in, and Europe lacks big players like the Pacific Investment Management Co. in the U.S., whose buying can mobilize other investors....The market also faces uncertainty over how European regulators will change the rules of the game, in part by imposing tougher capital requirements on banks, the main buyers of securitized assets in Europe.

One European Commission proposal would dramatically hike the capital required of banks holding a securitized asset if the originator allowed its share of that asset to fall below a 5% threshold....

Paul Sharma of Britain's Financial Services Authority said regulatory action is likely to shrink the investor base for ABS, in part by increasing the capital cushions banks will have to hold against ABS holdings in their trading books. He also argued that ABS were inappropriate for banks to hold as liquid assets, because they have proven difficult to sell in a market crisis.

"There is very much a query in the minds of regulators as to whether there is a significant future for securitization," said Mr. Sharma, though he added his own view was that the market did have a future role." ("In Europe, a U.S. Way To Fix ABS Market?" Neil Shah and Stephen Fidler, Wall Street Journal)

See? In Europe regulators still do their jobs and make sure that financial institutions have money before they create trillions of dollars in credit. They don't stick with their heads in the sand while crooked bankers fleece the public. Bernanke's job is to step in and put an end to the hanky-panky, not add to the problems by restoring a credit-generating regime that transferred hundreds of billions of dollars from hard-working people to fatcat bankers and Wall Street flim-flammers.

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