Wall Street Hustlers Built a $100 Trillion House of Cards and Stuck You with the Fallout

By Joshua Holland
Global Research, October 23, 2008
AlterNet 23 October 2008

Region: USA
Theme: Global Economy

Debate over who is most to blame for the financial meltdown rages on against a backdrop of economic pain and anxiety that's unprecedented in the post-war era.

The bottom line: There was a feeding frenzy that drove housing prices far beyond what the fundamental laws of supply and demand would dictate. People certainly got in over their heads, but the ultimate responsibility for that lies with the investment bankers who cooked up exotic new ways to make risky investments look more secure than they actually were (I wrote about it recently here).

While the U.S. housing market is worth somewhere in the neighborhood of $10 trillion, it was Wall Street's wheeler-dealers — and their lobbyists and allies who kept regulators out of their business — who built a house of cards out of "exotic" mortgage-backed securities and other "derivatives" worth as much as *60 times* that figure — paper wealth backed by little more than the irrational belief that what goes up will never come down.

It was the investment bankers who pushed those debt-backed securities *hard* to investors who were looking for huge returns on their dollars — much better than they could get putting their money in old-school investments like stocks and bonds. Their hard sell created so much demand that it encouraged lenders to write loans to just about anybody for just about anything; loans, after all, were the raw material for the alphabet soup of "exotic" investment vehicles — the "collateralized debt obligations," "credit default swaps" and other innovative products that have now turned "toxic."

That gets to one of the hardest pieces of this whole mess to understand — why would Wall Street want lenders to push out billions of dollars worth of loans that were inherently risky?

Here, a bit of context is crucial. The financial industry first started churning out derivatives in the early 1980s. As I've written before, that was part of a larger move away from traditional investments — manufacturing, agriculture and (long-term) commodities — and into the speculative economy as the returns on money put into the "nuts and bolts" economies of the advanced world began to dwindle in the 1970s.

At first, investors mostly gambled that interest or currency exchange rates would go up or down. Then, during the 1990s, when interest rates were low around the world, the demand for more exotic "structured" investments — including various derivatives and swaps based on debt — skyrocketed.

This brings us to a key issue in the banking mess, one that has serious ramifications for how we move forward in the future. Obscured by the finger-pointing is a simple question: How could a drop in the value of the American housing market — even a 20 percent drop in home prices — threaten to bring down the entire global economy?

Part of the answer is "leveraging" — using a limited amount of cash to buy a much larger position in an investment. Leveraging is a common investment tool, but there are rules in effect in *regulated* markets like the major stock and bond markets that limit the amount that an investor can leverage — for example, the SEC says you have to put up at least 50 percent of the cost to buy a stock on American stock exchanges. But these fancy debt-backed investments are contracts between two gamblers and are not subject to those rules. They're traded "over the counter" — in an opaque and largely unregulated exchange.

Business reporter Andrew Leonard scoffed at the idea that at the heart of the crisis were either borrowers getting in over their heads or lenders writing sketchy loans. Beginning in the 1990s, he wrote, "the incentive for everyone to behave this way came from Wall Street … where the demand for (securities based on subprime loans) simply couldn't be satisfied. Wall Street was begging the mortgage industry to reach out to the riskiest borrowers it could find, because it thought it had figured out a way to make any level of risk palatable." He added: "Wall Street traders, hungry for more risk, fixed the real economy to deliver more risk, by essentially bribing the mortgage originators and ratings agencies to … make bad loans on purpose. That supplied (Wall Street) speculators the raw material they needed for their bets, but as a consequence threw the integrity of the whole housing sector into question."

Nobel Laureate Joseph Stiglitz neatly summed up the environment in which this took place:

The mortgage brokers loved these new products because they ensured an endless stream of fees. They maximized their profits by originating as many mortgages as possible, with frequent refinancing. Their allies in investment banking bought them, sliced and diced the risk and then passed them on — or at least as much as they could. Our bankers forgot that their job was to prudently manage risk and allocate capital. They became gambling casinos — gambling with other people's money, knowing that the taxpayer would step in if the losses were too great.

They wouldn't have been able to do it without reckless deregulation for deregulation's sake — a bipartisan affair. Human greed and the herd mentality are constants, after all.

As financial reporter Gillian Tett detailed in the *Financial Times*, a crucial moment in the development of the crisis occurred back in the mid-1990s, when JP Morgan was struggling to deal with the huge number of loans on its books and needed large reserves of cash in case those loans went belly-up. It was then that two groups of young Wall Street hotshots — one that was creating those exotic new investments and another that was knee-deep in "subprime" loans — started talking with one another and realized they could essentially launder risk by slicing and dicing bundles of sketchy home loans.

As others have noted, that discussion could not have come to fruition without the demise of the Glass-Steagall Act — which forced firms to choose between writing loans and investment banking — in 1999. But there has been less discussion of the massive lobbying effort that investment banks undertook after the last time one of these bubbles of national wealth popped.

In the early 1990s, betting on interest rates was all the rage among higher-risk investors.

But, as Tett noted, in the middle of the decade, “the interest rate climate suddenly changed, unleashing wild market turbulence and causing many of the derivatives contracts to produce huge losses — or ‘blow up,’ as traders call it.” In the aftermath, these exotic investment products had a bad name, and there were widespread calls to regulate them.

But the International Swaps and Derivatives Association fought back furiously, arguing that a regulatory clampdown would not only run counter to the spirit of capital markets, but also crush creativity. Their aggressive lobbying campaign was effective: By the mid-1990s, regulatory pressure had died away.

Then, as the new century dawned, with little public debate, a group of lawmakers — Republicans and “blue-dog” Democrats — led by John McCain’s former chief economic adviser, Phil “Nation of Whiners” Gramm, pushed through the “Commodity Futures Modernization Act of 2000,” which put the final nail in the regulatory coffin. The legislation provided us with the infamous “Enron Loophole” — which exempted most energy trading from oversight — but it also assured Wall Street’s whiz kids that their new products would be free of pesky regulation, and the popularity of those investments soon exploded.

And here we also have to give a nod to the influence of the large hedge funds that have grown like kudzu in recent decades (in 2005, hedge funds held about three-quarters of a trillion dollars in assets; by the fall of last year, that number was estimated at around $2.7 trillion). A hedge fund is like a mutual fund that allows rich investors to cover their bets by putting a little bet on the other team. But unlike a mutual fund, which has to follow a whole slew of regulations, hedge funds, because they’re only open to small numbers of “qualified investors” — people with $5 million worth of investments — are almost totally unregulated, the assumption being that the big investors are savvy enough to watch out for themselves and therefore don’t need much oversight. They can play very loose, buying into speculative, risky investments that have the potential to turn a high yield, and they can be (and generally are) highly leveraged. There are few institutions that are less transparent than hedge funds, which rely on keeping their activities under wraps to keep from getting beaten by their competitors.

So, let’s look at the chain from a shaky mortgage to a financial meltdown. First, the financiers took those mortgages and made them into mortgage-backed securities. Then, they took those securities and sliced them up into collateralized debt obligations, which got sold off and repackaged again and again.

During that process, investors’ cash gets leveraged further and further, to the point at which the whole thing is based on little more than vapor — paper wealth that can disappear in a flash with a market downturn.

NYU economist Nouriel Roubini described it like this:

Today any wealthy individual can take $1 million and go to a prime broker and leverage this amount three times; then the resulting $4 million ($1 equity and $3 debt) can be invested in a fund or funds that will in turn leverage these $4 million three or four times and invest them in a hedge fund; then the hedge fund will take these funds and leverage them three or four times and buy some very junior tranche of a CDO that is itself leveraged nine or ten times. At the end of this credit chain, the initial $1 million of equity becomes a $100 million investment out of which $99 million is debt (leverage) and only $1 million is equity. So we got an overall leverage ratio of 100 to 1. Then, even a small 1% fall in the price of the final investment (CDO) wipes out the initial capital and creates a chain of margin calls that unravel this debt house of cards.

That's precisely what's happening in today's financial markets, and the blame lies squarely at the door of the investment banks (and the deregulators who enabled their excesses). The lack of transparency in this "speculative economy" is such that nobody knows precisely who is holding onto what securities and derivatives, and the complexity of these investments means that they're almost impossible to accurately value in the real world. That combination has resulted in a kind of panic among the investor class, with everyone fearful that all these exotic bets might be called in. That has made it tough for the banks to raise cash, and has led to hoarding of whatever cash reserves they have. That has frozen the global credit market, and is spilling over into the nuts-and-bolts economy in which most of us live.

This is hardly an academic discussion, because as we navigate the crisis — which appears to be in an early stage — there is one thing that is as sure as death and taxes: Big Finance's lobbyists will again resist calls to re-regulate the financial sector. Again, we will be told that regulation will bring economic growth — the end-all and be-all for Big Business — to a grinding halt.

And when it happens this time, there will either be a powerful push-back by informed citizens who understand that the real-world pain they're experiencing is not a result of simple greed, but greed unchecked by any watchdogs, or there won't be. If there isn't, then when we emerge from this crisis we will end up simply priming the pump for the next one. As Robert Pollin, co-director of the Political Economy Research Institute at the University of Massachusetts , told me recently, "It is time to recognize that unregulated financial markets always have, and always will, cause financial crises. There are no historical exceptions to this observation at all. This point has to be grasped."

Joshua Holland is an AlterNet staff writer.

The original source of this article is AlterNet

Comment on Global Research Articles on our Facebook page

Become a Member of Global Research

Articles by: Joshua Holland