Wall Street's Fraud and Solutions for Systemic Peril

TSF Opinion Commentary – September 29, 2009
By Janet Tavakoli

Last week I gave a presentation to members of the International Monetary Fund (IMF) explaining the corrosive atmosphere that allowed the largest Ponzi scheme in the history of the capital markets to flourish. The following is a brief summary.

Wall Street gave mortgage lenders large credit lines (similar to credit card debt) and packaged the loans into private-label residential mortgage backed securities (RMBS). Most of the RMBS was rated "AAA," since subordinated investors absorbed the risk of a pre-agreed amount of loan losses. But many RMBSs were backed by portfolios comprising risky fraud-riddled loans. Most of the "AAA" investment was imperiled, and subordinated "investment grade" components were worthless. Wall Street disguised these toxic "investments" with new value-destroying securitizations and derivatives.[1]

Meanwhile, collapsing mortgage lenders paid high dividends to shareholders (old investors) and interest on credit lines to Wall Street (old investors) with money raised from new investors in doomed securities. New money allowed Wall Street to temporarily hide losses and pay enormous bonuses. This is a classic Ponzi scheme.

Securities laws chiefly apply to financiers (the underwriters and traders) that create, sell, and trade securities. Underwriters are responsible for appropriate due diligence, an investigation into the risks.[2] If you know or should know that investments are overrated and overpriced when they are sold, those facts must be specifically disclosed. If you fail to disclose material information, expect to be investigated for fraud. If you have a mortgage subsidiary, expect it to be investigated, too.

Wall Street protests that it sold toxic assets to sophisticated investors obliged to perform independent due diligence, so those investors may have trouble claiming damages. But the ballgame has changed. Massive fraud damaged the U.S. economy. (Housing prices didn't just fall; they plummeted as the fraud unraveled.) U.S. taxpayers became unwilling unsophisticated investors funding Wall Street's bailout.

The Fed uses tax dollars to keep some of our largest banks—weakened by reverse-Glass-Steagall mergers with troubled entities—from collapsing under heavy loan losses.

Wall Street's huge bonus payments were based on suspect accounting. Failure should not result in fortune. Yet, Wall Street once again proposes to pay out exorbitant bonuses. Many banks' current illusion of profitability is only made possible by taxpayers' enormous subsidies including low cost borrowing, higher interest payments

360 E. RANDOLPH STREET - SUITE 3007 • CHICAGO, ILLINOIS 60601
OFFICE 312.540.0243
www.tavakolistructuredfinance.com

on bank capital deposits, a credit line for the FDIC (to be repaid with banks' subsidized profits), and continued government debt guarantees on bank debt. A large share of certain banks' tax-subsidized profits is due as reparation to unsophisticated investors, the U.S. taxpayers.

Delusional Complacency

When you leverage fraud riddled fixed income securities, there is nowhere to go but down in a hurry. Confusion after the fraud falls apart leads to a vicious cycle of selling, as investors and lenders shun both good and bad assets. The deflating debt bubble is followed by a classic liquidity crunch.

By the end of 2006, public reports of implosions of large mortgage lenders eliminated CEOs' plausible deniability. By January 2007, many (including me) publicly challenged the failure to account for losses. Instead, toxic securitization *accelerated* in the first half of 2007—classic malfeasance as a Ponzi scheme collapses. In August 2007, I projected hundreds of billions in principal losses for mortgage loans alone—not counting other troubled asset classes, derivative duplication, and leverage. Fed Chairman Ben Bernanke contemporaneously said mortgage loan losses would be $50-100 billion.

At a lunch following my presentation, a senior officer claimed the IMF had estimated global losses of $1 trillion in its April 2007 Global Financial Stability Report. I averred the IMF's Report followed a growing wave of billions in write-downs; by then *Bloomberg News* had reported potential global losses in the high hundreds of billions of dollars (Feb 2008). (Everyone's estimates were too low.) Not so, other senior IMF officers said; they were "early" and had great political "courage." But their heads were up their own hindsight bias. The IMF's estimate was in the April 2008 Report, after Bear Stearns' March 2008 implosion.[3] Blind to fraud, the IMF missed the message.[4]

The IMF is not a financial regulator. Actual regulators did worse. The SEC dropped seminal investigations and failed to investigate ongoing securities fraud. In the spring of 2007, the Fed and the U.K.'s FSA reported that the degree of leverage in the global financial system was less than at the time of Long Term Capital Management, but in reality it was much greater. They are now repeating their mistakes. Winston Churchill said we must alert somnolent authority to novel dangers; but our regulators are complacent, and the dangers are not novel.

Existing Solutions to Halt Growing Systemic Risk

An IMF official asserted: "You can't prove fraud" and insisted it was in the interest of risk managers not to let their institutions collapse. (He was unable to attend my exposition based on Chs. 5-12 of *Dear Mr. Buffett*). This IMF officer isn't just soft on crime; he's in denial. Failure to recognize fraud led to statements like the one that opened Chapter 2 of the IMF's April 2006 Global Financial Stability Report:

There is growing recognition that the dispersion of credit risk by banks to a broader and more diverse group of investors, rather than warehousing such risk on their balance sheets, has helped to make the banking and overall financial system more resilient.

The IMF's source was a 2006 speech made by Treasury Secretary Timothy Geithner, then president and CEO of the New York Fed. The IMF gets the lion's share of its funding from the United States and the United Kingdom, its stakeholders. Geithner's views have more influence than those of former Fed Chairman Paul Volcker, who calls for a return of Glass-Steagall, a separation of traditional commercial banking from high-risk activities.

Wall Street supplies a swinging door of jobs for its financial regulators, and—in the case of many members of Congress and our Presidents—campaign contributions. This dependence is known as "capture," and the result is that instead of reigning in Wall Street, dependent thinking enables mayhem.

In the recent Ponzi scheme only the agents—mortgage lenders, rating agencies, fund managers, securitization professionals, CFOs, CEOs, and other fee or bonus beneficiaries—prospered. Controls and risk management were undermined. The financial institutions and their shareholders, for which these agents are failed stewards, collapsed. Investors in toxic securitizations lost money. Had regulators done their jobs, they would have shut down Wall Street's financial meth labs, and the Ponzi scheme would have quickly choked to death from lack of monetary oxygen.

After the Savings and Loan crisis of the late 1980's, there were more than 1,000 felony indictments of senior officers. Recent fraud is much more widespread and costly. The consequences are much greater. Congress needs to fund investigations. Regulators need to get tough on crime.

Troubled financial entities should be put into receivership and restructured. Old shareholders will be wiped out. Debt-holders will take a haircut (discount) along with a debt for new equity swap to recapitalize the entity. But the job won't be complete until we separate high risk activities from traditional banking in a return to a Glass-Steagall like structure with regulators that indict fraudsters, snuff out systemic fraud, and allow honest bankers to prosper.

The fact that many U.S. banks stuck to traditional banking and protected shareholders during this crisis is under-publicized, but their prudence worked.

We have the solutions. We need the will to implement them.

Janet Tavakoli is the president of Tavakoli Structured Finance, a Chicago-based consulting firm to financial institutions and institutional investors. She is the author of a book on the cause global financial meltdown: *Dear Mr. Buffett: What an Investor Learns 1,269 Miles from Wall Street* (Wiley, 2009).

She is also the author of *Credit Derivatives & Synthetic Structures* (Wiley, 1998, 2001), *Collateralized Debt Obligations & Structured Finance* (Wiley, 2003), *Structured Finance & Collateralized Debt Obligations* (Wiley, September 2008).

[1] Collateralized Debt Obligations (CDOs and CDO-squared), Structured Investment Vehicles (SIVs), Real Estate Mortgage Investment Conduits (REMICs and Re-REMICs), Asset Backed Commercial Paper (ABCP), and related credit derivatives.

[2] Rating agencies do not buy and sell securities, but they should have their special NRSRO designations immediately revoked as a start. One former rating agency official even suggests liquidation.

[3] I later sent the IMF official a link to the April 2007 Report, and he admitted he misspoke.

[4] In April 2005, I gave a presentation to the IMF including a discussion of flawed ratings of "super-senior" and "AAA-rated" structured products. Thereafter, loan fraud accelerated and securitization standards deteriorated, yet the IMF's April 2006 report stated: "As a practical matter, the investors who may be least likely to appreciate such nuances (e.g., smaller regional banks and retail investors) typically only purchase the most senior (least risky) credit products." In reality, many "super-senior" tranches and the "AAA" tranches subordinate to them had substantial principal risk.

Other Important Disclosures

Copyright, User Agreement and other general information related to this report: Copyright 2009 Tavakoli Structured Finance, Inc ("TSF"). All rights reserved. This report is prepared for the use of Tavakoli Structured Finance's clients and may not be redistributed, retransmitted or disclosed, in whole or in part, or in any form or manner, without the express written consent of TSF. Receipt and review of this report constitutes your agreement not to redistribute, retransmit, or disclose to others the contents, opinions, conclusion or information contained in this report. The information relied on for any opinions expressed were obtained from various sources and TSF does not guarantee its accuracy.

This report provides general information only. Neither the information nor any opinion expressed constitutes an offer, or an invitation to make an offer to buy or sell any securities or other investment or any options, futures, or derivatives related to securities or investments. It is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and particular needs of any specific person who may receive this report. Investors should seek financial advice regarding the appropriateness of investing in any securities, other investment or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Investors should note that income from such securities or other investments, if any, may fluctuate and that price or value of such securities and investments may rise or fall. Accordingly, investors may receive back less than originally invested. Past performance is not necessarily a guide to future performance.

Under no circumstances will TSF have any liability to any person or entity for (a) loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of TSF or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if TSF is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The financial reporting analysis observations and other observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. No warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any opinion or information is given or made by TSF in any form or manner whatsoever. Each opinion must be weighed solely as one factor in any investment decision made by or on behalf of any user of the information contained herein, and each user must accordingly make its own study and evaluation of each security and of each issuer and guarantor of, and each provider of credit support for, each security that it may consider purchasing, holding, or selling.