How The Hell Did This Happen?

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This article was posted on http://caught.net – [Legal Misconduct Website] for the purpose of trying to help Americans understand how the financial meltdown occurred so the public can demand proper action. In a nutshell:

- This was a planned, highly sophisticated, manufactured crisis intended to benefit the few at the expense of the many.
- This “crisis” did not result from Wall Street giving to much money to the poor. It resulted from Wall Street giving too much money to the rich. Subprime loan causation is a smokescreen.
- This scam could have been accomplished irregardless of what type of government was present and with or without the Federal Reserve. All the scam needed to succeed was an **unregulated market** and **lack of oversight**.
- Not a damn thing in the bailout addressed the cause and the cause is already being lost amid the cries and proposals for a “remedy.”
- The government creating the problem and “solving” it will result in unnecessarily greater governmental control – in this case socialized business.

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A Look At Wall Street's Shadow Market

Oct. 5, 2008(CBSNews.com) On Friday Congress finally passed - and President Bush signed into law - a financial rescue package in which the taxpayers will buy up Wall Street's bad investments. The numbers are staggering, but they don't begin to explain the greed and incompetence that created this mess. It began with a terrible bet that was magnified by reckless borrowing, complex securities, and a vast, unregulated shadow market worth nearly $60 trillion that hid the risks until it was too late to do anything about them. And as correspondent Steve Kroft reports, it's far from being over. It started out 16 months ago as a mortgage crisis, and then slowly evolved into a credit crisis. Now it's something entirely different and much more serious.

What kind of crisis it is today? "This is a full-blown financial storm and one that comes around perhaps once every 50 or 100 years. This is the real thing," says Jim Grant, the editor of "Grant's Interest Rate Observer." Grant is one of the country’s foremost experts on credit markets. He says it didn't have to happen, that this disaster was created entirely by Wall Street itself, during a time of relative prosperity. And they did it by placing a trillion dollar bet, with mostly borrowed money, that

the riskiest mortgages in the country could be turned into gold-plated investments. "If you look at how this started with the sub-prime crisis, it doesn't seem to be a good bet to put your money behind the idea that people with the lowest income and the poorest credit ratings are gonna be able to pay off their mortgages," Kroft points out. "The idea that you could lend money to someone who couldn't pay it back is not an inherently attractive idea to the layman, right. However, it seemed to fly with people who were making $10 million a year," Grant says. With its clients clamoring for safe investments with above average return, the big Wall Street investment houses bought up millions of the least dependable mortgages, chopped them up into tiny bits and pieces, and repackaged them as exotic investment securities that hardly anyone could understand.

60 Minutes looked at one of the selling documents of such a security with Frank Partnoy, a former derivatives broker and corporate securities attorney, who now teaches law at the University of San Diego. "It's hundreds and hundreds of pages of very small print, a lot of detail here," Partnoy explains.

Asked if he thinks anyone ever reads all this fine-print, Partnoy says, "I doubt many people read it." These complex financial instruments were actually designed by mathematicians and physicists, who used algorithms and computer models to reconstitute the unreliable loans in a way that was supposed to eliminate most of the risk.

"Obviously they turned out to be wrong," Partnoy says. Asked why, he says, "Because you can't model human behavior with math." "How much of this catastrophe had to do with the instruments that Wall Street created and chose to buy…and sell?" Kroft asks Jim Grant. "The instruments themselves are at the heart of this mess," Grant says. "They are complex, in effect, mortgage science projects devised by these Nobel-tracked physicists who came to work on Wall Street for the very purpose of creating complex instruments with all manner of detailed protocols, and who gets paid when and how much. And the complexity of the structures is at the very center of the crisis of credit today." "People don't know what they're made up of, how they're gonna behave," Kroft remarks.

"Right," Grant replies. But it didn't stop ratings agencies, like Standard & Poor's and Moody's, from certifying the dodgy securities investment grade, and it didn't stop Wall Street from making billions of dollars selling them to banks, pension funds, and other institutional investors all over the world. But that was just the beginning of the crisis.

What most people outside of Wall Street and Washington don't know is that a lot of people who bought these risky mortgage securities also went out and bought even more arcane investments that Wall Street was peddling called "credit default swaps." And they have turned out to be a much bigger problem.

They are private and largely undisclosed contracts that mortgage investors entered into to protect themselves against losses if the investments went bad. And they are part of a huge unregulated market that has already helped bring down three of the largest firms on Wall Street, and still threaten the ones that are left.

Before your eyes glaze over, Michael Greenberger, a law professor at the University of Maryland and a former director of trading and markets for the Commodities Futures Trading Commission, says they are much simpler than they sound. "A credit default swap is a contract between two people, one of whom is giving insurance to the other that he will be paid in the event that a financial institution, or a financial instrument, fails," he explains. "It is an insurance contract, but they've been very careful not to call it that because if it were insurance, it would be regulated. So they use a magic substitute word called a 'swap,' which by virtue of federal law is deregulated," Greenberger adds.

"So anybody who was nervous about buying these mortgage-backed securities, these CDOs, they

would be sold a credit default swap as sort of an insurance policy?" Kroft asks. "A credit default swap was available to them, marketed to them as a risk-saving device for buying a risky financial instrument," Greenberger says. But he says there was a big problem. "The problem was that if it were insurance, or called what it really is, the person who sold the policy would have to have capital reserves to be able to pay in the case the insurance was called upon or triggered. But because it was a swap, and not insurance, there was no requirement that adequate capital reserves be put to the side."

"Now, who was selling these credit default swaps?" Kroft asks. "Bear Sterns was selling them, Lehman Brothers was selling them, AIG (American International Group, Inc) was selling them. You know, the names we hear that are in trouble, Citigroup was selling them," Greenberger says. "These investment banks were not only selling the securities that turned out to be terrible investments, they were selling insurance on them?" Kroft asks. "Well, it made it easier to sell the terrible investments if you could convince the buyer that not only were they gonna get the investment, but insurance," Greenberger explains. But when homeowners began defaulting on their mortgages, and Wall Street's high-risk mortgage backed securities also began to fail, the big investment houses and insurance companies who sold the credit default swaps hadn't set aside the money they needed to pay off their obligations. Bear Stearns was the first to go under, selling itself to J.P. Morgan for pennies on the dollar. Then, Lehman Brothers declared bankruptcy. And when AIG (American International Group, Inc), the nation's largest insurer, couldn't cover its bad debts, the government stepped in with an $85 billion rescue. Asked what role the credit default swaps play in this financial disaster, Frank Partnoy tells Kroft, "They were the centerpiece, really. That's why the banks lost all the money. They lost all the money based on those side bets, based on the mortgages." How big is the market for credit default swaps?

Says Partnoy, "Well, we really don't know. There's this voluntary survey that claims that the market is in the range of 50 to 60 or so trillion dollars. It's sort of alarming that, in a market that big, we don't even know how big it is to within, say, $10 trillion." "Sixty trillion dollars. I know it seems incredible. It's four times the size of the U.S. debt. But that's the size of the market according to these voluntary reports," says Partnoy. He says this market is almost entirely unregulated.

The result is a huge shadow market that may control our financial destiny, and yet the details of these private insurance contracts are hidden from the public, from stockholders and federal regulators. No one knows what they cover, who owns them, and whether or not they have the money to pay them off. One of the few sources of information is the International Swaps and Derivatives Association (ISDA), a trade organization made up the largest financial institutions in the world. Many of them are the very same companies that created the vast shadow market, lobbied to keep it unregulated, and are now drowning because of unanticipated risks.

ISDA's CEO, Robert Pickel, says there is nothing wrong with credit default swaps, and that the problem was with underlying mortgage securities. "Well, there's clearly something wrong with the system if all of these leveraged bets, hidden leveraged bets, caused a collapse in the financial system," Kroft remarks. "It is something that we all need to look at and learn lessons from. And we all need to work together to understand that and design a structure in the future that works more effectively," Pickel says. "My point is, the people that made these mistakes are the people you represent in your organization. And many of them sit on the board. I mean, if they didn't get it right, who would?" Kroft asks. "These people understand the nature of these products. They understand the risks," Pickel replies. "Well…they didn't or they wouldn't have bought them. They wouldn't have used them," Kroft says.

"These are very useful transactions. And the people do understand the nature of the risk that they're entering into…but I'm not sure that…," Pickel says. "Useful?" Kroft interrupts. "How come they

brought down the financial system?" "Because, perhaps they didn't understand the underlying risk, and nobody really saw the effects that were going to flow through from the sub-prime lending situation," Pickel says.

That chapter is not over, and there is much suspense and fear on Wall Street that there are other big losses out there that have yet to be disclosed. They already dwarf what has been lost on those original risky mortgages. As bad as the mortgage crisis has been, 94 percent of all Americans are still paying off their loans. The problem is Wall Street placed its huge bets and side bets with all of those fancy securities on the 6 percent who are not. "We wouldn't be in any of this trouble right now if we had just had underlying investments in mortgages. We wouldn't be in any trouble right now," says Partnoy. He says it's the side bets. "You got Wall Street firms, Bear Stearns, Lehman Brothers. You got insurance companies like AIG (American International Group, Inc). Merrill lost a ton of money on this," Kroft says. "Everybody's lost a ton of money. They're supposed to be the smartest investors in the world. And they did it themselves." "They did it all on their own," Partnoy agrees. "That's the most incredible thing about this crisis is that they pushed the button themselves. They blew themselves up."

Asked how much of this was incompetence on the part of Wall Street and the people who ran it, Jim Grant tells Kroft, "The truth is that on Wall Street, a lot of people just weren't very good at their jobs. It's as simple as that." "These people were being paid $50 to $100 million a year. Some of them, the guys that were running the places," Kroft remarks. "There is no defending," Grant replies. "A trainee making 45,000 a year would have had the common sense not to bet the firm on mortgage contraptions that no one in the firm actually understood. That is not a deep point to comprehend. Somehow, through, I will call it a criminal neglect and incompetence, the people at the top of these firms chose to look away, to take more risk, to enrich themselves and to put the shareholders and, indeed, the country, itself, ultimately, the country's economy at risk. And it is truly not only a shame, it's a crime." 60 Minutes requested interviews with top executives at Bear Stearns, Lehman Brothers, Merrill Lynch , Morgan Stanley, Goldman Sachs, and AIG (American International Group, Inc). . They all declined. Produced by L. Franklin Devine © MMVIII, CBS Interactive Inc. All Rights Reserved. For additional information on derivatives, see Warren Buffet's 2002 warning – http://caught.net/warrenbuffet.pdf.

Now a little history from http://nadar.org Behind The Deregulatory Curtain

The current finger pointing by the deregulation crowd in Congress and their ideological soul mates in the media reminds me of the 1939 film classic The Wizard of Oz. It is as though these spin masters want us to pay no attention to the government officials behind the deregulation curtain.

Indeed, the right-wing pundits and the revisionists in Congress are spending an inordinate amount of time falsely claiming that our nation's current financial disaster stems from the Community Reinvestment Act, a law passed by Congress and signed into law by President Jimmy Carter in 1977. The primary purpose of this modest law is to require banks to report on where and to whom they are making loans. Community organizations have used the data produced as a result of this law to determine if banks were meeting their lending obligations in the minority and lower-income communities in which they do business. Congress passed this law because too many lenders were discriminating against minority borrowers. "Redlining" was the name given to the practice by banks of literally drawing a red line around minority areas and then proceeding to deny people within the red border home loans – even if they were otherwise qualified. **The law has been in place for 30 years, but the right-wing fringe claims it somehow is responsible for predatory lending practices that date back just to the beginning of this decade.**

Notice what these revisionists are not mentioning.

- No “thank you” to former Senator Phil Gramm for pushing the repeal of the Glass-Steagall Act. This law was passed in the wake of the stock market crash of 1929 - and designed to separate banking from securities activities. **In 1999, when Congress passed the Gramm-Leach-Bliley Act and in so doing repealed Glass-Steagall the banks strayed into rough waters by looking for fast money from risky investments in securities and derivatives. See note on Phil Gramm below.**
- As predatory lending mushroomed out of control, the regulators -- key among them, **the Federal Reserve and the Office of Comptroller of Currency -- sat on their hands.** The Federal Reserve took exactly three formal actions against subprime lenders from 2002 to 2007. Bloomberg news service found that the Office of Comptroller of the Currency, which has authority over almost 1,800 banks, took three consumer-protection enforcement actions from 2004 to 2006.
- No “tip of the hat” to the Bush Administration for preempting state regulators and Attorneys General from using state consumer laws to crack down on predatory and sub-prime lending by national banks.
- And, let us not forget the folks at Fannie Mae and Freddie Mac. Imagine allowing these two government sponsored enterprises--that were weakly regulated by HUD--to claim they were meeting the national housing goals by counting the purchase of subprime loans. Back in May of 2000, our associate Jonathan Brown warned that it would be inappropriate and counterproductive to encourage Fannie and Freddie to meet the housing goals by purchasing subprime loans. Too bad our members of Congress and the regulators at HUD were infected with deregulatory zeal. Former Texas Senator and current giant swiss bank [UBS] executive Phil Gramm -- would-be President John McCain's Treasury Secretary-in-waiting -- pushed through the Commodities Futures Modernization Act of 2000, which deregulated the derivatives market. **With help from his wife, Wendy, the former head of the Commodity Futures Trading Commission who went on to a post on the Enron board of directors, Gramm removed the controls on Wall Street so it could innovate all sorts of exotic financial instruments. Instruments far riskier than advertised, and now at the core of the financial meltdown. [Note: exotic instruments like the derivatives and swaps mentioned in the first article. Also see note on Phil Gramm below.]**

The SEC, through its "consolidated supervised entities" program, decided that voluntary regulation would work for the investment banking sector. Not surprisingly, this was a scheme cooked up by Wall Street itself. **The investment banks were permitted to double, triple and go 20 times (and more) down on their bets by using lots of borrowed money. They made minimal disclosures to the SEC about what they were doing, and the SEC didn't bother to review those disclosures adequately.** Too bad for the investment banks -- and the rest of us -- they made lots of bad bets. The SEC has now closed the voluntary program, though now there aren't any major investment banks left (the two remaining ones have converted themselves into conventional banks).

It is time to start paying very close attention to government officials behind the deregulation curtain. Let your Members of Congress know you are not willing to bailout the gamblers on Wall Street with a no-strings attached pile of taxpayer dollars. The time for regulation is upon us.

A Definition of Subprime Loans:

Subprime lending (near-prime, non-prime, or second chance lending) is a financial term that was popularized by the media during the "credit crunch" of 2007 and involves financial institutions providing credit to borrowers deemed "subprime" (sometimes referred to as "under-banked"). Subprime borrowers have a heightened perceived risk of default, such as those who have a history of loan delinquency or default, those with a recorded bankruptcy, or those with limited debt experience. Although there is no standardized definition, in the US subprime loans are usually classified as those where the borrower has a credit score below a certain level, e.g. a FICO score below 660. Subprime lending encompasses a variety of credit types, including mortgages, auto loans, and credit cards.

Subprime could also refer to a security for which a return above the "prime" rate is received, also known as C-paper. In the United States, mortgage lending specifically, the term "subprime" can be applied to "non conforming" loans, those that do not meet Fannie Mae or Freddie Mac guidelines, generally due to one of an array of factors including the size of the loan, income to mortgage payment ratio or the quality of the documentation provided with the loan. The phrase also refers to bank loans taken on property that cannot be sold on the primary market, including loans on certain types of investment properties and to certain types of self-employed persons.

A Note On Phil Gramm - Washington Times - Wednesday, July 9, 2008

With the economy on the top of voters' minds, former Texas senator and current giant swiss bank [UBS] executive Phil Gramm, John McCain's top economic adviser, said in an interview with the Washington Times that he expects Mr. McCain to inherit a sluggish economy if he wins the presidency, weighed down above all by the conviction of many Americans that economic conditions are the worst in two or three decades and that America is in decline.

"You've heard of mental depression; **this is a mental recession**," he said, noting that growth has held up at about 1 percent despite all the publicity over losing jobs to India, China, illegal immigration, housing and credit problems and record oil prices. "We may have a recession; we haven't had one yet."

"**We have sort of become a nation of whiners,**" he said. "You just hear this constant whining, complaining about a loss of competitiveness, America in decline" despite a major export boom that is the primary reason that growth continues in the economy, he said. "We've never been more dominant; we've never had more natural advantages than we have today," he said. "**We have benefited greatly" from the globalization of the economy in the last 30 years.**

Mr. Gramm said the constant drubbing of the media on the economy's problems is one reason people have lost confidence. Various surveys show that consumer confidence has fallen precipitously this year to the lowest levels in two to three decades, with most analysts attributing that to record high gasoline prices over $4 a gallon and big drops in the value of homes, which are consumers' biggest assets. “Misery sells newspapers," Mr. Gramm said. "**Thank God the economy is not as bad as you read in the newspaper every day.**"

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