

INVESTMENT UPDATE

Like us, you may have been drawn, like a rubbernecking driver on the highway, to the spectacle of Goldman Sachs' grilling at the hands of a Senate committee a few days ago. It made for great television: Highly-paid Wall Streeters, accused of bringing the economy to its knees as a result of their arrogance and greed, squirming in their seats as our duly-elected public servants chastised them for their hubris and lack of conscience. The Senators were shocked—shocked!—to learn that Wall Street was populated by gamblers and hustlers (to use just two names that were thrown around), who traded against their own customers, and who sold their customers products that were “pieces of [expletive deleted].”

Great television, maybe, but not particularly enlightening for those of us who deal with Goldman Sachs and their major competitors on a daily basis. If anything, we'll confess to being a little shocked ourselves, but for an entirely different reason: namely, that anyone could think that modern Wall Street institutions have anything but their own self-interest at heart. The sad fact of the matter is that some time ago, brokerage firms realized that they could make more money by using the firm's capital to “run their own book,” rather than operating a retail sales and trading operation.

But we're getting ahead of ourselves; let's back up a bit and look at what this investigation is all about. As everyone now knows, by 2005 or so, the US housing market had been on a multi-year tear, with prices climbing at double-digit annual rates. With the full benefit of hindsight, prices were being inflated beyond what a “normal” market would support. There were many reasons for this, but a critical factor pushing prices ever higher was that home ownership had been extended to a whole new portion of the American population, a group of people whose income and credit worthiness were not up to the standards traditionally required for home ownership.

Under normal circumstances, making traditional 30- and 15-year mortgage loans to marginal (or worse) borrowers would have been foolish, but by 2005 there were additional factors that made these loans financial dynamite. First, home prices had appreciated to the point that affordability had sunk to the lowest levels since the ultra-high interest rate days of the mid-80s. Yet demand remained resilient, with potential homebuyers afraid to miss the wave. “Originate to sell” mortgage brokers moved in and exploited this demand, creating ever-more exotic and risky mortgage products (the option-ARM and the interest-only are just two of these wonders of modern finance) in order to get unsophisticated consumers into the house of their dreams. With no fear of loss

(they were simply originating the loans, not holding them) these mortgage origination factories provided financing for subprime borrowers and pushed through “low doc” (often falsified) applications for buyers who could barely make their first month's payment. Of course, this was all done with US home prices at the absolute top of the market, when continued appreciation of home prices was the only lifeline these buyers could grasp. If home prices fell, mass foreclosures were inevitable.

The pain wasn't really felt for another year or two after home prices peaked in mid-2006 (not coincidentally, when many of these junky adjustable mortgages saw their teaser rates roll off with predictable results). The real question that is now being investigated is how did the subprime market, which was, at most 10-12% of the US mortgage market, nearly take down the entire financial system?

First, a little more background. Starting in the early 1980s, Wall Street began taking mortgage loans and packaging them into CMOs (collateralized mortgage obligations), which segregated the monthly principal and interest payments into different classes, or “tranches.” This was originally done to satisfy the desire on the part of investors to have mortgage bonds that had tighter payment windows—instead of buying a FNMA pass-through, for instance, that would begin paying down principal from day one and continue paying for the next 30 years until the last payment on the last loan was made, a CMO's cash flows could be segregated into a shorter (e.g., a three year average life) bond, an intermediate bond, and a bond with a long average life; the shortest bond would get the principal payments first (until it was paid off), then the intermediate bond, and so on. Simple enough and quite effective.

But this simple loan securitization template became, over the years, increasingly complex and arcane. By the time subprime loans began to be securitized in large numbers in the last decade, mortgage bonds were created that tiered the classes not by who got the principal payments first, but who took the losses first (the so-called “senior/subordinate” structure). The bonds that took the defaults first carried a higher rate of interest in order to attract buyers, and were rated lower (but most were, remarkably, still rated “BBB,” the lowest rung of the investment grade scale). The other classes of bonds were stacked on top of the BBBs, each with higher ratings, lower yields, and more credit protection. While the lowest rated bonds might get wiped out if defaults rose to 5% to 7%, the top, AAA-rated bonds might not see any principal losses until defaults rose to 30% to 40%.



For years (at least until early 2007), these subprime bonds, even the BBB-rated bonds, performed extremely well, as home prices were rising, masking growing delinquencies. In fact, the hardest task that Wall Street had in structuring these deals was finding someone who was willing to take the “other side” of the trade—the investment banks were making a fortune structuring subprime deals, and most often wanted to keep the riskiest pieces for themselves, but they needed to be able to “short” (i.e., hedge) some of their risk while they placed all the various tranches. As incredible as it seems today, at the time it was extremely difficult to find anyone who wanted to bet against subprime! In response, the dealer community began to construct credit default swaps (a type of insurance contract that pays the holder if the reference security goes belly-up) that they could use to hedge against certain components of their subprime exposure.

Let’s talk about the ratings agencies. It is now known that these agencies—Moody’s, S&P, and Fitch—rated these bonds based on broad information provided by whichever investment bank collected the loans and structured the deal. However, the data that Wall Street provided was nearly always aggregated data, not individual loan-level data, on the mortgage loans that made up these structured bonds. This made it all too easy to “put lipstick on a pig” by constructing bonds that consisted of a lot of really crummy collateral with a few very high quality loans mixed in to bring the averages up. Banks, especially European banks, snapped up the AAA-rated tranches of these deals, since regulators treated AAAs as nearly “risk-free” for risk capital purposes. Investors had a reasonable expectation that the ratings agencies had performed their due diligence in carefully analyzing and scenario-testing these bonds before they were awarded a gilt-edged rating; unfortunately, no such analysis was performed.

But there was one final, truly hideous, layer to the rotten subprime market. It wasn’t enough for Wall Street to create these securities, and obfuscate the details of just how bad they really were; they took the extra step of re-wrapping the lowest of these low-quality tranches into new bonds, called CDOs (collateralized debt obligations). Once again, the ratings agencies dropped the ball, this time by assuming that risk would be mitigated through diversification of many different mortgage pools. Relying on models they developed for analyzing corporate bonds (where a diversified portfolio of different credits—finance companies, industrial companies, electric utilities—does lessen risk), the ratings agencies erroneously assumed that a portfolio of subordinated BBB-rated subprime tranches (the lowest of the low) could, through financial alchemy (and hungry for the fees paid by the Wall Street firm driving the deal), be transformed into AAA-rated bonds. And to make matters worse, these brokerage houses used the same subordinated tranches over and over again, in multiple new CDOs, magnifying the exposure of each junky loan many times over.

This last feature—replicating the highest risk of a pool of subprime loans in multiple deals—helped magnify the sub-

prime market’s riskiest bets to a multiple of their actual size. A \$38 million tranche in one subprime deal (Soundview 2006 OPT5-M8) showed up in 30 different CDOs (including the notorious Abacus 2007 AC-1, the deal at the heart of the SEC’s civil lawsuit against Goldman Sachs) and ultimately caused \$280 million in losses. This is precisely how seasoned bond veterans’ forecasts of losses from subprime proved to be far too conservative when losses began to be reported in mid-2007. We saw the risk of contagion from the inevitable subprime meltdown (see our August 2007 *Investment Update*), but we had no idea the extent to which those risks had been replicated many times over.

Which brings us to the main issue of the day: What remedies need to be put in place to keep this from happening again? Certain Wall Street firms have bent the rule of law and nearly all have stomped all over the capital markets’ sense of competitive fair play. And while most firms can use the excuse that they behaved rationally—maximizing profits for their shareholders by maximizing the profits of the trading desk—they have been bailed out when their risks blew up in their faces. The “heads I win, tails you (the taxpayer) lose” scenario is unacceptable; it allows these firms to take on risks they would never accept if their personal capital was on the line.

It falls on Congress to pass laws that will change this equation, and on regulators to enforce these laws. Congress will likely go too far in some cases (we’re not sold on the idea of banning proprietary trading), and not far enough in others. The reforms we’d like to see involve disclosure—making underwriters publicly disclose, both on a when-issued and ongoing (monthly) basis, all loan-level detail for structured products so that investors and ratings agencies are on equal footing with the issuer when it comes to evaluating these bonds. We need a public clearinghouse for all derivatives trades that will show the true size of all the “side bets.” Banks should be forced to disclose, in detail, what their risk positions are, including all off-balance sheet exposure. And the ratings agencies should have to publicly disclose their methodology for rating arcane bonds and disclose all potential conflicts of interest, including the fees they charge brokerage firms for rating new issues.

In addition, stricter new risk-based capital rules for investment banks, based on volatility and risk in both their assets and liabilities (and not necessarily on specious “ratings” of holdings) would also help ensure that there is a sufficiently ample financial cushion to cover potential mistakes in risk management. That, along with the elimination of the Too Big to Fail doctrine, are further steps in the right direction.

If Wall Street fails to respond, they will surely drive off their clients and business partners. In the words of Goldman Sachs shareholder Warren Buffet, “Look for three qualities: integrity, intelligence, and energy. And if you don’t have the first, the other two will kill you.” These firms have a choice: Change or die.

