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The Debt Crisis Moves To Center Stage

by John Hoefle

The demise of Wall Street's securitization machine will impact the economy and the lives of people in ways that few have considered. Debt lies at the very heart of our economy; for households, businesses, and government, borrowing has become a fact of life, a way to subsidize normal operations for some, a lifeline for others. Debt, its issuance and management, has become perhaps the biggest business in the country, and it is a business that has died.

It is not the need to borrow that has died: The need for borrowing is bigger than ever, given the bankruptcy of the banking system, the soaring prices on food and energy and the like, and the falling incomes of the lower 80% of the population. What has died, is the mechanism which enabled the issue of vast amounts of debt, the ability to convert that debt into securities, and move it off into the nether world of off-balance-sheet finance. The debt machine itself has broken.

Debts as Assets

The way the debt machine worked can be seen in the case of mortgage-backed securities (MBS). Mortgage lenders would make loans to people to buy homes, then sell those loans to larger financial institutions, which would consolidate them into pools, and issue securities whose value was said to be derived from the value of the underlying mortgages. The mortgage-backed security itself is a new debt, whose repayment is said to be backed by the income stream from the payments on the mortgages in the pool. But that is not quite true, since the mortgage payments are already spoken for, as the repayment with interest of the original mortgage loan. All the buyer of the MBS really owns is a bond backed by the company which issued it.

This securitization process is presented as a way to provide more money for mortgage loans, and it does do that, but that is only the beginning, as the debt from the mortgages is used to fuel the securities machine. The relationship between the mortgages and the securities can be easily seen by comparing the volumes of each. In 2003, for example, there were just shy of $1 trillion in new mortgages issued, while just over $3 trillion in mortgage-related securities were issued. Mortgage-related securities, as defined by the Securities and Financial Markets Association trade group which provided the securities statistics, include mortgage-backed securities and collateralized mortgage obligations (CMOs) issued by both government agencies such as Ginny Mae, Fannie Mae, and Freddie Mac, and by private sector institutions such as Bear Stearns, Lehman Brothers, and Goldman Sachs.

The ability to turn $1 in mortgage debt into $3 in securities explains why residential real estate became such a speculative bubble. The name of the game was not selling houses, but selling mortgages to fuel the securities business. The real money was not in the loans themselves, but in the speculation which they enabled. With the connivance of the ratings agencies—which are actually just private companies which get paid for the ratings they issue—these mortgage-backed securities were broken up into slices, or tranches, with the top tranche often having a higher credit rating than the mortgages upon which is was nominally based. Pools of subprime mortgages were thus transformed into securities with triple-A ratings which could be sold to pension funds, money market funds, and others, as supposedly safe investments. The tranches that did not qualify as triple-A were then often pooled and resecuritized into collateralized debt obligations (CDOs), producing yet more triple-A tranches,

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and some of these CDOs were resecuritized into CDOs-squared, or CDOs containing other CDOs, which naturally had their own triple-A tranches. This process of turning sows' ears into silk purses produced a string of securities whose value began to vaporize at the first hint of trouble in the real estate markets.

This scam was repeated with all sorts of debt, from credit cards to corporate loans, creating a giant pyramid scheme of "assets" which could be bought and sold as if they had value. This securitization scheme allowed the debt in the economy to rise rapidly, and was the reason why individuals were able to get their credit limits raised when they maxed out their credit cards, and borrow the money to buy cars; the reason why private equity firms were able to borrow billions of dollars for takeovers; and the reason corporations were able to borrow billions of dollars to finance their operations. While the details vary, the overall process of the securitization of debt—the conversion of debts into assets—is what provided the illusion that the economy still functioned.

Save the Paper

With the market for MBS, CDOs, and other paper drying up, the question of rolling over the mountain of existing debt now moves to center stage. Without new credit, the debts cannot be rolled over, and thus defaults will soar, blowing out not only the debt markets but also the credit derivatives market.

The central banks are desperately trying to buy time to figure out what to do. The rescue operations so far, including the injection of $500 billion into the banking system by the European Central Bank in December, seem mainly designed to preserve the fictitious values of mortgage-related securities by reducing the need for the holders of such instruments to sell them.

The nature of this problem was revealed last Summer when Merrill Lynch and Lehman Brothers tried to sell the collateral they seized from the troubled Bear Stearns hedge funds, only to find themselves getting offers as low as 20 cents per dollar of book value. By establishing such a low market price, the banks effectively undercut the valuations of all similar instruments, triggering a vicious cycle of writedowns. As the holders of these securities write them down, their own net worth drops, prompting their creditors to issue margin calls—which in turn, prompts another round of asset sales to raise the money to pay creditors.

It appears that the central banks are trying to alleviate this problem by taking in much of this bad paper as collateral for loans, and there is talk of the central banks becoming buyers of last resort in order to protect the banks. The insolvency of the banking system is being openly discussed in the media, reflecting discussions underway between financial and political circles, with notable British spokesmen publicly floating the idea that the governments will have to step in and bail out the banks.

"Governments will almost certainly have to intervene directly to put a floor under mortgage values, thereby underwriting the solvency, as well as the liquidity, of banks. . . . Government intervention will become inevitable to underwrite the solvency, as well as the liquidity, of the banks," the London *Times*' Anatole Kaletsky wrote Dec. 17.

Kaletsky's comments came the day after former Fed chairman Sir Alan Greenspan told ABC's "This Week" that the Federal government should provide direct help to homeowners threatened by foreclosure.

John Dizard of the *Financial Times* noted on Dec. 17, that one of the key features of the Term Auction Facility set up by the Fed was the creation of inter-bank swap lines which allow the European Central Bank and other central banks to draw dollars from the Fed. Dizard suggested that as the ECB is not as restricted as the Fed in the types of collateral it could accept for loans, that the intent is to allow the central banks to buy up worthless dollar-denominated securities, to obviate the need to sell them on the open market.

The *Washington Post's* Steven Pearlstein said much the same thing Dec. 19, writing that the ECB's injection was "not only $500 billion, but $500 billion lent against almost any collateral, including a handwritten IOU from Uncle Ludwig in Dusseldorf."

The problem of preventing this vicious spiral of asset writedowns was also addressed by Bank of England markets director Paul Tucker, who called it a "vicious circle," and by New York Fed chief Tim Geithner, who warned of an "adverse self-reinforcing dynamic." These comments were reported by Ambrose Evans-Pritchard in the Dec. 23 *Sunday Telegraph.* Evans-Pritchard also said that the Fed is looking at provisions in the Federal Reserve Act which would enable it to act as a lender of last resort.

According to a 2004 Fed study, the Federal Reserve Act allows for the Fed to "lend directly to individuals, partnerships and corporations" in "unusual and exigent circumstances," when adequate credit is not available from other banking institutions.

Time for the Firewalls

The meaning of these statements is clear: the people running the financial system intend to protect their own power and as much of their money as they can, by dumping the losses on the taxpayers. Rather than admit that their system has died and take their losses—both in terms of money and power—the bankers are determined to hold on, to bankrupt the government and impose savage austerity upon the population, choosing their fictitious values over the future of humanity. The real tragedy here is not that they would make such a choice, but that the citizens would let them get away with it. They are what they are. The real question is, what will we do?