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Credit Derivatives and the Current Crisis

One of the issues sure to come before the Treasury Department as it embarks upon the operation of the Troubled Asset Relief Program will be to define the specific troubled assets that it will be willing to purchase from qualifying financial institutions. As Treasury begins to attempt to untie the knot of securitizations that plague the balance sheets of those institutions, it is important to take a high level view of the incredible complexities and interconnections that characterize the troubled portfolios themselves. Further, it becomes apparent that the best way to attack the problem may lie in the mundane roots of the crisis, at the mortgage holder level.

Although mortgage loans and the rising level of defaults in those loans lie at the base of the mortgage crisis, the entire structure that sits on top of those loans can be imagined as a large inverted pyramid. The packaging and selling of the original loans by the companies that originated them was only a first step, one that was followed by a series of further securitizations of derivatives tied to the loans themselves. An incredible multiplier effect was created, as collateralized debt obligations (CDOs) and credit default swaps (CDSs) were packaged and sold, sliced and resold as hedges and investments to the ultimate holders of these derivatives, which turned out in most cases to be the institutions that are now being addressed by the TARP. In essence, an enormous chain letter was written and passed along, multiplying in magnitude with each delivery.

If this incredible multiplier effect had not been created, the losses that would reasonably be tied to the level of defaults in the original loans would have been contained a long time ago. In round numbers, the total value of the non-prime mortgage market stands at around \$2 trillion. Assuming very large default rates of 25% in that pool of loans, the total write downs that would be required would stand at around \$500 billion. At this point, over \$300 billion of losses have been realized, and yet no end is in sight. This is the power of the multiplier effect, as the proliferation of credit derivatives has created a wildly amplified mountain of securitized mortgage-backed securities whose creditworthiness has been called into question because of the rising default rates at the bottom of the pyramid. This is why Warren Buffet referred to these complex credit derivatives as "financial weapons of mass destruction" in 2003, and warned that they could threaten the entire economic system. His greatest fear, stated at the time, was that companies could easily book revenues and profits off of these instruments, even though no money changed hands. This is exactly what took place.

Two things strike us about the market that grew up around credit derivatives. First and foremost, market participants created a product whose value and therefore pricing was purposefully opaque. Not only were these instruments incredibly complex, but their construction was designed in such a way that no comprehensible system of classification could be used to value them consistently. At this point, Treasury faces a universe of various subprime instruments that represent over 250,000 CUSIPS, or unique identifiers. The rating agencies have proven woefully inadequate in terms of qualifying the creditworthiness of these instruments, a critical element in the spreading wildfire on Wall Street. The imprimatur of the monoline insurers provided a false sense of security for the ratings agencies, who misunderstood how quickly the insurer's balance sheets could dissipate, thereby removing the illusion of a safety net that led to the misplaced credit ratings.

Perhaps more troubling, the government made the error of exempting this exploding market from regulation, aggressively moving to "protect financial institutions from overregulation" and "position our financial services industries to be world leaders into the new century." The result was the Commodities Futures Modernization Act, slipped into the 2000 omnibus spending bill, which specifically exempted the swaps market from regulation by either the SEC or the Commodities Futures Trading Commission. Swaps became the vehicle of choice that the purchasers and sellers of mortgage-backed securities used to either hedge or speculate on this market, and their proliferation provided the incredible leverage that has led to the multiplier effect.

How then, should we approach the knot of troubled assets? With over 250,000 various instruments, opaquely priced and erroneously rated, the question is not an easy one. In our earlier paper, we proposed the notion of addressing the troubled loans themselves, the bottom of the inverted pyramid, through a debt for equity swap that would create an equity security based upon the principle of fractional equity ownership, essentially bringing the institutional equity investors into the mortgage market. We feel that this approach is sound, as the underlying loans themselves must be addressed in order to begin to reverse the multiplier that runs throughout the system. After that, it makes sense to attack the highest end of the troubled portfolios, offering to purchase the soundest mortgage-backed securities, creating a market where opacity currently reigns.

Beginning with the most creditworthy instruments makes logical sense because if a price can be established there, that information can begin to flow through the marketplace, establishing criteria for true market valuation as the process unfolds. If we create a clearing price for the most highly rated securities, those about which there is little argument as to the underlying instruments, we can begin to determine the categories of securities that will fall below this level. Institutional investors have tools that can evaluate the data that exist in these securities, but need to have a market price established from which they can begin. The creation of that first clearing price becomes the jam cracker that will allow the market to begin to set criteria for the flow of market pricing into the system.

Clearly the Treasury has an enormous task in undoing this incredibly complex situation, and there is no guarantee that it can be undone in such a way that no further bank failures occur. That said, we continue to believe that the principle of transparency in the pricing and trading of these instruments is critical to the restoration of confidence in the market that is so sorely needed. A transparent market with integrity in pricing and counterparty risk is essential to the overall soundness of the system, and towards that end, the introduction of true price discovery through an auction process will be an important first step.

Sincerely,



William R. Hambrecht
Chairman and CEO