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The credit bubble is just starting to unwind, a credit-derivative insider says. And while U.S. borrowers are being blamed for the mess, they were really just pawns in a global game.

By Jon Markman

Satyajit Das is laughing. It appears I have said something very funny, but I have no idea what it was. My only clue is that the laugh sounds somewhat pitying.

One of the world's leading experts on credit derivatives, Das is the author of a 4,200-page reference work on the subject, among a half-dozen other tomes.

As a developer and marketer of the exotic instruments himself over the past 30 years, he seemed like the ideal industry insider to help us get to the bottom of the recent debt crunch -- and I expected him to defend and explain the practice.

I started by asking the Calcutta-born Australian whether the credit crisis was in what Americans would call the "third inning." This was pretty amusing, it seemed, judging from the laughter.

So I tried again. "Second inning?" More laughter. "First?"

Still too optimistic. Das, who knows as much about global money flows as anyone in the world, stopped chuckling long enough to suggest that we're actually still in the middle of the national anthem before a game destined to go into extra innings. And it won't end well for the global economy.

An epic bear market

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Das is pretty droll for a math whiz, but his message is dead serious. He thinks we're on the verge of a bear market of epic proportions.

The cause: Massive levels of debt underlying the world economy system are about to unwind in a profound and persistent way.

* Talk back: Do you think a bear market is just around the corner?

He's not sure if it will play out like the 13-year decline of 90% in Japan from 1990 to 2003 that followed the bursting of a credit bubble there, or like the 15-year flat spot in the U.S. market from 1960 to 1975. But either way, he foresees hard times as an optimistic era of too much liquidity, too much leverage and too much financial engineering slowly and inevitably deflates.

Like an ex-mobster turning state's witness, Das has turned his back on his old pals in the derivatives biz to warn anyone who will listen -- mostly banks and hedge funds that pay him consulting fees -- that the jig is up.

Rather than joining the crowd that blames the mess on American slobs who took on more mortgage debt than they could afford and have endangered the world by stiffing lenders, he points a finger at three parties: regulators who stood by as U.S. banks developed ingenious but dangerous ways of shifting trillions of dollars of credit risk off their balance sheets and into the hands of unsophisticated foreign investors; hedge and pension fund managers who gorged on high-yield debt instruments they didn't understand; and financial engineers who built towers of "securitized" debt with math models that were fundamentally flawed.

Investors are abuzz over the Fed's interest-rate decision, but the Federal Reserve can't fix everything, cautions MSN Money's Jim Jubak. Lower interest rates alone won't boost confidence in the debt market.

"Defaulting middle-class U.S. homeowners are blamed, but they are merely a pawn in the game," he says. "Those loans were invented so that hedge funds would have high-yield debt to buy."

The liquidity factory

Das' view sounds cynical, but it makes sense if you stop thinking about mortgages as a way for people to finance houses and think about them instead as a way for lenders to generate cash flow and create collateral during an era of a flat interest-rate curve. Although subprime U.S. loans seem like small change in the context of the multitrillion-dollar debt market, it turns out these high-yield instruments were an important part of the machine that Das calls the global "liquidity factory."

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*****Just like a small amount of gasoline can power an entire truck given the right combination of spark plugs, pistons and transmission, subprime loans became the fuel that underlays derivative securities many, many times their size.

Here's how it worked: In olden days, like 10 years ago, banks wrote and funded their own loans. In the new game, Das points out, banks "originate" loans, "warehouse" them on their balance sheet for a brief time, then "distribute" them to investors by packaging them into derivatives called collateralized debt obligations, or CDOs, and similar instruments. In this scheme, banks don't need to tie up as much capital, so they can put more money out on loan.

The more loans that were sold, the more they could use as collateral for more loans, so credit standards were lowered to get more paper out the door — a task that was accelerated in recent years via fly-by-night brokers now accused of predatory lending practices.

Buyers of these credit risks in CDO form were insurance companies, pension funds and hedge-fund managers from Bonn to Beijing. Because money was readily available at low interest rates in Japan and the United States, these managers leveraged up their bets by buying the CDOs with borrowed funds.

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So if you follow the bouncing ball, borrowed money bought borrowed money. And then because they had the blessing of credit-ratings agencies relying on mathematical models suggesting that they would rarely default, these CDOs were in turn used as collateral to do more borrowing.

In this way, Das points out, credit risk moved from banks, where it was regulated and observable, to places where it was less regulated and difficult to identify.

Turning \$1 into \$20

The liquidity factory was self-perpetuating and seemingly unstoppable. As assets bought with borrowed money rose in value, players could borrow more money against them, and it thus seemed logical to borrow even more to increase returns. Bankers figured out how to strip money out of existing assets to do so, much as a homeowner might strip equity from his house to buy another house.

These triple-borrowed assets were then in turn increasingly used as collateral for commercial paper — the short-term borrowings of banks

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and corporations — which was purchased by supposedly low-risk money market funds.

According to Das' figures, up to 53% of the \$2.2 trillion commercial paper in the U.S. market is now asset-backed, with about 50% of that in mortgages.

****When you add it all up, according to Das' research, a single dollar of "real" capital supports \$20 to \$30 of loans. This spiral of borrowing on an increasingly thin base of real assets, writ large and in nearly infinite variety, ultimately created a world in which derivatives outstanding earlier this year stood at \$485 trillion — or eight times total global gross domestic product of \$60 trillion. ****

Without a central governmental authority keeping tabs on these cross-border flows and ensuring a standard of record-keeping and quality, investors increasingly didn't know what they were buying or what any given security was really worth.

A painful unwinding

Now here is where the U.S. mortgage holder shows up again. As subprime loan default rates doubled, in contravention of what the models forecast, the CDOs those mortgages backed began to collapse. Because they were so hard to value, banks and funds started looking at all CDOs and other paper backed by mortgages with suspicion, and refused to accept them as collateral for the sort of short-term borrowing that underpins today's money markets.

Through late last month, according to Das, as much as \$300 billion in leveraged finance loans had been "orphaned," which means that they can't be sold off or used as collateral.

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One of the wonders of leverage is that it amplifies losses on the way down just as it amplifies gains on the way up. The more an asset that is bought with borrowed money falls in value, the more you have to sell other stuff to fulfill the loan-to-value covenants. It's a vicious cycle. In this context, banks' objective was to prevent customers from selling their derivatives at a discount because they would then have to mark down the value of all the other assets in the debt chain, an event that would lead to the need to make margin calls on customers already thin on cash.

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Now it may seem hard to believe, but much of the past few years' advance in the stock market was underwritten by CDO-type instruments which go under the heading of "structured finance." I'm talking about private-equity takeovers, leveraged buyouts and corporate stock buybacks --- the works.

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So to the extent that the structured finance market is coming undone, not only will those pillars of strength for equities be knocked away, but many recent deals that were predicated on the easy availability of money will likely also go bust, Das says.

That is why he considers the current market volatility much more profound than a simple "correction" in prices. He sees it as a gigantic liquidity bubble unwinding --- a process that can take a long, long time.

While you might think that the U.S. Federal Reserve can help prevent disaster by lowering interest rates dramatically, as they did Wednesday, the evidence is not at all clear.

The problem, after all, is not the amount of money in the system but the fact that buyers are in the process of rejecting the entire new risk-transfer model and its associated leverage and counterparty risks.

Lower rates will not help that. "At best," Das says, "they help smooth the transition."

More from MSN Money

The fine print

Das notes that Japan in the 1990s lowered interest rates to zero and the country still suffered through a prolonged recession. His timetable for the start of the next serious phase of the unwinding is later this year or early 2008. . . . Das' most readable book for laypeople is "Traders, Guns & Money," an amusing exposé of high finance, published last year. Das occasionally writes a blog at his publisher's Web site. Also available are a boxed set of his reference books on derivatives and his book specifically on CDOs. . .

Perhaps the oddest line on the subject by a world leader was uttered by Luiz Inacio Lula da Silva, the president of Brazil. Asked if he was worried about the effects of the credit crunch in his country, he dismissively called it "an eminently American crisis" caused by people trying to make a lot of "third-class money." . . . CDOs were first widely used back in the late 1980s by Drexel Burnham Lambert junk-bond king Michael Milken to sell off damaged and previously unsellable debt

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in a way that was more palatable to customers.

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