Taking Stock: Subprime fiasco still sinking in

by Malcolm_Berko

Dear Mr. Berko: Is there any way you can explain the mortgage default mess so I can understand it? Please tell me why it's so much trouble.

S.T.

Louisville, Ky.

Dear S.T.: Mae West once said that: "too much of a good thing is wonderful" but in this instance, it's lethal. So read on.

Wall Street's priapic money machine is run by an overstressed culture of cocaine cowboys with MBAs who believe they can turn lead into gold. These financial alchemists, whose heads glow in the dark even when they're not on chemicals, designed, collaborated, packaged, rated and insured those subprime mortgages, turning them into a death ray severely wounding our credit system. These mad Ivy League MBAs, prodded by avaricious executives with mind-blinding bonus incentives, also designed, collaborated, packaged, rated and insured credit-card loans (potential defaults could be horrific), mezzanine financing (certainly a sticky wicket), commercial real estate loans (another bubble in the bursting) and corporate buyouts, which have dried up.

The centerpiece in this newly discovered land of Camelot is a dreadful, unfolding disaster - the collateralized debt obligation, which is now giving the financial community a serious case of the heebie-jeebies. As a friend of mine with the New York Stock Exchange recently remarked, "We think they've discovered a doomsday weapon and we're waiting for the countdown."

As you know, your mortgage is no longer owned by Home Savings or City Federal till it is paid off. Rather a whole bunch of mortgages are (counting good credits, fair credits and lousy credits) put in a huge mixing bowl by Merrill, Lehman, Bear Stearns, etc., mushed up into a batter and baked into a huge financial chocolate cake. Then Merrill and friends slice that cake, selling various sized slices to hundreds of thousand of investors all of whom get the same yield.

But that was too tame and Wall Street needed more profits. So the cowboys thought they could quadruple the firm's revenues by selling slices of those slices of tranches, at different levels of credit risk. And these slices of tranches enabled Merrill, etc. to sell the riskiest loan slices to hedge funds, which could absorb the highest risks, to junk bond funds that bought a lesser risk level and to aggressive bond funds, which wanted higher returns with lesser risk levels than the junk bond funds. Meanwhile, the safest slices with the lowest yields and highest ratings (AAA) were bought by money market funds and risk-averse investors.

So if any of these mortgages defaulted the riskiest investor (hedge funds) would take the hit till its slice became worthless; followed by the junk bond funds, till their slice became worthless; followed by the aggressive bond funds' slice.

Well, back in mid-2004, Wall Street's bosses demanded even higher earnings. Commissions from individual investors were drying up, competition for underwriting business was fierce and mutual funds were paying just $100 in commission costs to purchase $1 million of Monsanto or Merck. Now Wall Street discovered that the most difficult slices of cake to peddle were those in the middle (mezzanine tranches) with middling yields and moderate risks.

So using the same cookie cutter, they tweaked their computer models and using the same process, created new slices from the old slices, creating, once again, a new class of security. The slices of those slices also had different risk levels. Once again, the slices of tranches were divided into junk, fair-credit and good-credit and Wall Street conned Standard & Poor's as well as Moody's into a triple-A rating on the bulk of the slices.

Wow! It was happy days again as Wall Street, banks, rating agencies and the sales force earned tens of billions of new dollars selling the same paper one more time. And these slices were bought by foreign hedge funds, pension funds in Florida, mutual funds in the United Kingdom and investors in the Middle East.

Figuratively, this mortgage cake was cut into 20 slices, which was acceptable. However, Merrill and friends cut each of those slices into 20 new slices, which was really risky. But then each of those 20 new slices was cut once again into 20 more new slices and because of the enormous leverage used to purchase them (often 100 percent) a small default could cause the dominoes to collapse. Hence the "doomsday weapon." And we still have yet to face the potential credit card and commercial mortgage mess, which could implode in late 2008.

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