



Pyramids Crumbling

My college experience dates so far back that it can only be labelled “ancient history.” Still, there are a few seminal lessons I learned at Duke University—unfortunately none of them having much to do with the classroom. “Ticket Scalping 101” and “Beginning Blackjack” probably head the list, but not far behind would be “Introduction to Pyramid Schemes.” While the first two courses may be rather unique to my own experience, the latter I assume is standard fare, and has been since the first diploma was awarded at Harvard, Yale or whichever college claims to have been the “firstest” with the “mostest.” A second semester senior who never signed up for a dorm-born chain letter cannot really claim to have received a college education at all. The chain’s lesson was that you should be the originator of the letter, not the 500th recipient. You wanted your name at the apex of this upside down pyramid not at the broadened top, which signalled the exhaustion of additional fish, tuna or whatever derogatory noun one could employ to signify the university’s last few suckers.

Wall Street and its global lookalikes, of course, are life’s largest colleges where lessons can be mighty expensive and

downright bankrupting. The last two decades alone have witnessed pyramid schemes involving savings and loans/ junk bonds, the small investor/dot.coms, and now global bonds/subprimes. I could go on and you have your own candidates to be sure, but in each and every case the originator of a surefire “can’t miss” concept collected huge premiums from a willing investment public, only to see the pyramid collapse either of its own merits or from the lack of additional gullible investors. There will be more to come, much like a regular university that welcomes a never-ending stream of new “students” who pay annual “tuition” to be “educated.”

In addition to the pyramid shape of its securitised assets and the endless chain of its letters, finance and especially modern finance is centered around banking and now, unfortunately, around shadow banking. Both, *The Economist* magazine points out in its 22 September issue, are built on a fundamental (and ever present) mismatch: they borrow short and lend longer and riskier. Recognising this flaw, governments have for over a century mandated that banks have an ample percentage of reserves in order to bridge

the liquidity and investment risks that periodically ensue. Like Jimmy Stewart in *It's a Wonderful Life*, the critical job of a traditional banker was to have enough reserves or cash on hand to prevent a run. Stewart's modern day counterpart must follow similar guidelines, although a 21st century banker now can always look skyward for a guardian angel in the form of the Fed, the ECB, or the Bank of England. Recent infusions of over a half a trillion dollars by this triumvirate point to the perennial need for reserve banking in either an earthly or a more heavenly sense.

But today's banking system as pointed out in recent *Investment Outlooks*, has morphed into something entirely different and inherently more risky. Our modern shadow banking system craftily dodges the reserve requirements of traditional institutions and promotes a chain letter, pyramid scheme of leverage, based in many cases on no reserve cushion whatsoever. Financial derivatives of all descriptions are involved but credit default swaps (CDS) are perhaps the most egregious offenders. While margin does flow periodically to balance both party's accounts, the conduits that hold CDS contracts are in effect non-regulated banks, much like their hedge fund brethren, with no requirements to hold reserves against a significant "black swan" run that might break them. Jimmy Stewart—they hardly knew ye! According to the Bank for International Settlements (BIS),

CDS totaling \$43 trillion were outstanding at year end 2007, more than half the size of the entire asset base of the global banking system. Total derivatives amount to over \$500 trillion, many of them finding their way onto the balance sheets of SIVs, CDOs and other conduits of their ilk comprising the Frankensteinian levered body of shadow banks.

Defenders might claim no harm, no foul. Theoretically, many of these trillions represent side bets between risk seeking or risk avoiding parties—both adults at a table where the calming benefits of diversification work for the systemic good of all. Originators and existing supporters of these securitised WMDs might also point out that their reserves come in the form of equity and subordinated tranches comprising 10 or 20% of the repackaged loans. They do. But as this equity/subordination shrinks due to underlying defaults, the pyramid begins to unravel. Rating servicer downgrades can and do lead to the immediate liquidation of certain CDOs. The inability to rollover asset-backed commercial paper does and has led to the liquidation of SIVs or, pray tell, a misguided attempt to restructure them as super SIVs. CDOs and even levered municipal bond conduits known as "Tender Option Bonds" have been and will be similarly vulnerable to "Jimmy Stewart-like" runs as the monoline insurers that theoretically stand behind them are themselves downgraded to less than Aaa status.

The withdrawal of deposits from our new age shadow banking system has frightening potential consequences because a thinly capitalised banking system is always at risk relative to its more conservative counterpart. Visualise, as does Chart 1, in crude yet understandable form, today's shadow system versus that of two decades ago.

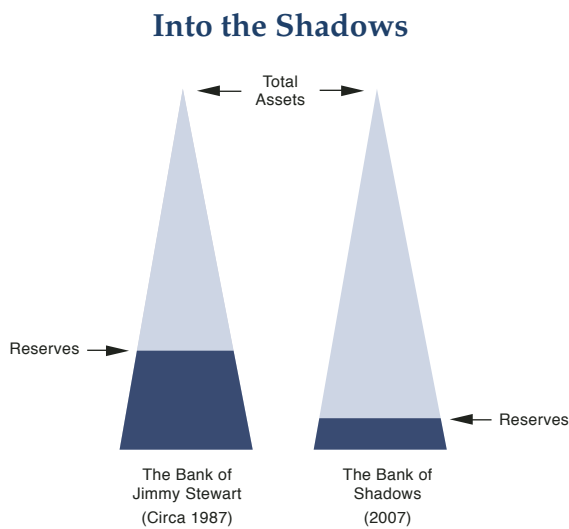


Chart 1

Source: PIMCO

While the exact amount of reserves supporting the Bank of Shadows is undeterminable, let's go back to the \$45 trillion BIS estimate of outstanding CDS for more insight. If total investment grade and junk bond defaults approach historical norms of 1¼% in 2008 (Moody's and S&P forecast something close) then \$500 billion of these default contracts will be triggered resulting in losses of \$250 billion or more to the "protection selling" party once recoveries are inserted into the equation. To put that number in perspective, many street estimates ascribe similar losses to

subprime mortgages, a derivative category substantially distinct from CDS insurance. Of course, "buyers of protection" will be on the other "winning" side, but the point is that as capital gains and capital losses slosh from one side of the shadow system's boat to the other, casualties and shipwrecks are the inevitable consequence. Goldman Sachs wins? Fine, but the losers in many cases will not be back for a return match. Much like casinos depend upon a constant stream of willing gamblers believing that this is their day, so too does Wall Street. But a trillion dollars of SIVs with their asset-backed commercial paper may be a dinosaur relic of yesterday's shadow system. They will likely not be back. And the New Century mortgage originators? The Bear Stearns hedge funds? The chastened Freddie Macs and Fannie Maes, and all of the banks and investment banks requiring fresh capital through the sale of stock? They'll be back but not in risk taking, fighting form. Throw in an embarrassed regulatory network consisting of the Fed and Congressional watchdogs asleep at their post, but are now more than willing to display their prowess, and you have a recipe for credit contraction, a run on the shadow banking system that would give Mr. Stewart shivers aplenty. The unfairly "Ben Stein pilloried" Jan Hatzius of Goldman Sachs estimates that mortgage related losses of \$200-400 billion alone might lead to a pullback of \$2 trillion of aggregate lending. Even if this occurs gradually, he writes,

“The drag on economic activity could be substantial.” Add to that my \$250 billion loss estimate from CDS, as well as prospective losses in commercial real estate and credit cards in 2008 and you have a recipe for a contraction in credit leading to a recession.

Pyramid schemes and chain letters collapse because there is no more credit to feed them. As the system of modern day levered shadow finance slows to a crawl, or even contracts at the edges, its ability to systemically fertilise economic growth must be called into question. And as the private shadow banks of the 21st century are found wanting, so then must public finance in the form of lower interest rates and increasing fiscal deficits fill the breach. The Fed will likely reduce Fed funds to 3% by midyear 2008. Congress and the Administration should, but likely won't, join hands in a tax relief program that benefits low income homeowners.

Market based, regulation-lite American style capitalism, seemingly so ascendant after the dot.com madness nearly a decade ago, has met its match with the subprimes and the poorly structured and supervised derivative conduits of today's markets. Financial innovation will inevitably march forward, if not in distinctly new forms, then into new asset markets and even unexplored continents. For now, however, its current surge is spent. Investment survivors will have to learn to live in a different world, filled with new risks, lower leverage, and at some point, hopefully greater rewards.

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