# A Root Cause of Credit Crisis explained in plain Language

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### The Two Trillion Dollar Black Hole

> Purge your mind for a moment about everything you've heard and read in the last decade about investing on Wall Street and think about the following business model:

***White collar criminal elite home free!***

You take your hard earned retirement savings to a Wall Street firm and they tell you that as long as you "stay invested for the long haul" you can expect double digit annual returns. You never really know what your money is invested in because it's pooled with other investors and comes with incomprehensible but legal looking prospectuses. The heads of these Wall Street firms have been taking massive payouts for themselves, ranging from $160 million to $1 billion per CEO over a number of years. As long as new money keeps flooding in from newfangled accounts called 401(k)s, Roth IRAs, 529 plans for education savings, and hedge funds (each carrying ever greater restrictions for withdrawing your money and ever greater opacity) everything appears fine on the surface. And then, suddenly, you learn that many of these Wall Street firms don't have any assets that anybody wants to buy. Because these firms are both managing your money as well as having their own shares constitute a large percentage of your pooled investments, your funds begin to plummet as confidence drains from the scheme.

Now consider how Wikipedia describes a Ponzi scheme:

> "A Ponzi scheme is a fraudulent investment operation that involves promising or paying abnormally high returns ('profits') to investors out of the money paid in by subsequent investors, rather than from net revenues generated by any real business. It is named after Charles Ponzi...One reason that the scheme initially works so well is that early investors – those who actually got paid the large returns – quite commonly reinvest (keep) their money in the scheme (it does, after all, pay out much better than any alternative investment). Thus those running the scheme do not actually have to pay out very much (net) – they simply have to send statements to investors that show how much the investors have earned by keeping the money in what looks like a great place to get a high return. They also try to minimize withdrawals by offering new plans to investors, often where money is frozen for a longer period of time...The catch is that at some point one of three things will happen:

> (1) the promoters will vanish, taking all the investment money (less payouts) with them;
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> (2) the scheme will collapse of its own weight, as investment slows and the promoters start having problems paying out the promised returns (and when they start having problems, the word spreads and more people start asking for their money, similar to a bank run);
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> (3) the scheme is exposed, because when legal authorities begin examining accounting records of the so-called enterprise they find that many of the 'assets' that should exist do not."

Looking at outcomes 1, 2, and 3 above, here's where we are today. The promoters have clearly not vanished as in outcome 1. In fact, they are behaving as if they know they have nothing to fear. As over $2 trillion of taxpayer money is rapidly infused through Federal Reserve loans and over $125 Billion in U.S. Treasury equity purchases to keep these firms from collapsing, the promoters are standing at the elbow of the President-Elect in press conferences (Citigroup promoter, Robert Rubin); they are served up as business gurus on the business channel CNBC (former AIG CEO and promoter, Maurice "Hank" Greenberg); they are put in charge of nationalized zombie firms like Fannie Mae (Herbert Allison, former President of Merrill Lynch); they are paying $26 million and $42 million, respectively, for new digs at 15 Central Park West in Manhattan, where their chauffeurs have their own waiting room (Lloyd Blankfein, CEO of Goldman Sachs; Sanford "Sandy" Weill, former CEO of Citigroup, who put his penthouse in the name of his wife's trust, perhaps smelling a few pesky questions ahead over the $1 billion he sucked out of Citigroup before the Fed had to implant a feeding tube).

We are definitely seeing all the signs of outcome 2: the scheme is collapsing under its own weight; there are panic runs around the globe wherever Wall Street has left its footprint.

But outcome 3 is the most fascinating area of departure from the classic Ponzi scheme. Legal authorities have, indeed, examined the books of these firms, except for one area we'll discuss later. They found worthless assets along with debts hidden off the balance sheet instead of real depositor funds. Instead of arresting the perpetrators and shutting down the schemes, Federal authorities have developed their own new schemes and pumped over $2 trillion of taxpayer money into propping up the firms while leaving the schemers in place. Equally astonishing, Congress has not held any meaningful investigations. This has left many Wall Street veterans wondering if the problem isn't that the firms are "too big to fail" but rather "too Ponzi-like to prosecute." Imagine the worldwide reaction to learning that all the claptrap coming from U.S. think-tanks and ivy-league academics over the last decade about efficient market theory and deregulation and trickle down was merely a ruse for a Ponzi scheme now being propped up by a U.S. Treasury Department bailout and loans from our central bank, the Federal Reserve.

Fortunately for American taxpayers, Bloomberg News has some inquiring minds, even if our Congress and prosecutors don't. On May 20, 2008, Bloomberg News reporter, Mark Pittman, filed a Freedom of Information Act request (FOIA) with the Federal Reserve asking for detailed information relevant to whom the central bank was giving these massive loans and precisely what securities these firms were posting as collateral. Bloomberg also wanted details on "contracts with outside entities that show the employees or entities being used to price the Relevant Securities and to conduct the process of lending." Heretofore, our opaque central bank had been mum on all points.

By law, the Federal Reserve had until June 18, 2008 to answer the FOIA request. Here's what happened instead, according to the Bloomberg lawsuit: On June 19, 2008, the Fed invoked its right to extend the response time to July 3, 2008. On July 8, 2008, the Fed called Bloomberg News to say it was processing the request. The Fed rang up Bloomberg again on August 15, 2008, wherein Alison Thro, Senior Counsel and another employee, Pam Wilson, informed the business wire service that their request was going to be denied by the end of September 2008. No further response of any kind was received, including the denial. On November 7, 2008, Bloomberg News slapped a federal lawsuit on the Board of Governors of the Federal Reserve, asserting the following:

"The government documents that Bloomberg seeks are central to understanding and assessing the government's response to the most cataclysmic financial crisis in America since the Great Depression. The effect of that crisis on the American public has been and will continue to be devastating. Hundreds of corporations are announcing layoffs in response to the crisis, and the economy was the top issue for many Americans in the recent elections. In response to the crisis, the Fed has vastly expanded its lending programs to private financial institutions. To obtain access to this public money and to safeguard the taxpayers' interests, borrowers are required to post collateral. Despite the manifest public interest in such matters, however, none of the programs themselves make reference to any public disclosure of the posted collateral or of the Fed's methods in valuing it. Thus, while the taxpayers are the ultimate counterparty for the collateral, they have not been given any information regarding the kind of collateral received, how it was valued, or by whom."

As evidence that Bloomberg News is not engaging in hyperbole when it uses the word "cataclysmic" in a Federal court filing, consider the following price movements of some of these giant financial institutions. (All current prices are intraday on November 12, 2008):

> American International Group (AIG): Currently $2.16; in May 2007, $72.00
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> Bear Stearns: Absorbed into JPMorganChase to avoid bankruptcy filing; share price in April 2007, $159
>
> Fannie Mae: Currently 65 cents; in June 2007 $69.00
>
> Freddie Mac: Currently 79 cents; in May 2007 $67.00
>
> Lehman Brothers: Currently 6 cents; in February 2007, $85.00

What all of the companies in this article have in common is that they were writing secret contracts called Credit Default Swaps (CDS) on each other and/or between each other. These are not the credit default swaps recently disclosed by the Depository Trust and Clearing Corporation (DTCC). These are the contracts that still live in darkness and are at the root of why the Wall Street banks won't lend to each other and why their share prices are melting faster than a snow cone in July.

A Credit Default Swap can be used by a bank to hedge against default on loans it has made by buying a type of insurance from another party. The buyer pays a premium upfront and annually and the seller pays the face amount of the insurance in the event of default. In the last few years, however, the contracts have been increasingly used to speculate on defaults when the buyer of the CDS has no exposure to the firm or underlying debt instruments. The CDS contracts outstanding now total somewhere between $34 Trillion and $54 Trillion, depending on whose data you want to use, and it remains an unregulated market of darkness. It is also quite likely that none of the firms that agreed to pay the hundreds of billions in insurance, such as AIG, have the money to do so. It is also quite likely that were these hedges shown to be uncollectable hedges, massive amounts of new capital would be needed by the big Wall Street firms and some would be deemed insolvent.

Until Congress holds serious investigations and hearings, the U.S. taxpayer may be funding little more than Ponzi schemes while companies that provide real products and services, legitimate jobs and contributions to the economy are left to fail.



http://www.counterpunch.org/martens11132008.html

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