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A Look At Wall Street's Shadow Market

Oct. 5, 2008

(CBS) On Friday Congress finally passed - and President Bush signed into law - a financial rescue package in which the taxpayers will buy up Wall Street's bad investments.

The numbers are staggering, but they don't begin to explain the greed and incompetence that created this mess.

It began with a terrible bet that was magnified by reckless borrowing, complex securities, and a vast, unregulated shadow market worth nearly $60 trillion that hid the risks until it was too late to do anything about them.

And as **correspondent Steve Kroft** reports, it's far from being over.

It started out 16 months ago as a mortgage crisis, and then slowly evolved into a credit crisis. Now it's something entirely different and much more serious.

What kind of crisis it is today?

"This is a full-blown financial storm and one that comes around perhaps once every 50 or 100 years. This is the real thing," says Jim Grant, the editor of "Grant's Interest Rate Observer."

Grant is one of the country's foremost experts on credit markets. He says it didn't have to happen, that this disaster was created entirely by Wall Street itself, during a time of relative prosperity. And they did it by placing a trillion dollar bet, with mostly borrowed money, that the riskiest mortgages in the country could be turned into gold-plated investments.

"If you look at how this started with the subprime crisis, it doesn't seem to be a good bet to put your money behind the idea that people with the lowest income and the poorest credit ratings are gonna be able to pay off their mortgages," Kroft points out.

"The idea that you could lend money to someone who couldn't pay it back is not an inherently attractive idea to the layman, right. However, it seemed to fly with people who were making $10 million a year," Grant says.

With its clients clamoring for safe investments with above average return, the big Wall Street investment houses bought up millions of the least dependable mortgages, chopped them up into tiny bits and pieces, and repackaged them as exotic investment securities that hardly anyone could understand.

60 Minutes looked at one of the selling documents of such a security with Frank Partnoy, a former derivatives broker and corporate securities attorney, who now teaches law at the University of San Diego.

"It's hundreds and hundreds of pages of very small print, a lot of detail here," Partnoy explains.

Asked if he thinks anyone ever reads all this fine-print, Partnoy says, "I doubt many people read it."

These complex financial instruments were actually designed by mathematicians and physicists, who used algorithms and computer models to reconstitute the unreliable loans in a way that was supposed to eliminate most of the risk.

"Obviously they turned out to be wrong," Partnoy says.

Asked why, he says, "Because you can't model human behavior with math."

"How much of this catastrophe had to do with the instruments that Wall Street created and chose to buy…and sell?" Kroft asks Jim Grant.

"The instruments themselves are at the heart of this mess," Grant says. "They are complex, in effect, mortgage science projects devised by these Nobel-tracked physicists who came to work on Wall Street for the very purpose of creating complex instruments with all manner of detailed protocols, and who gets paid when and how much. And the complexity of the structures is at the very center of the crisis of credit today."

"People don't know what they're made up of, how they're gonna behave," Kroft remarks.

"Right," Grant replies.

But it didn't stop ratings agencies, like Standard & Poor's and Moody's, from certifying the dodgy securities investment grade, and it didn't stop Wall Street from making billions of dollars selling them to banks, pension funds, and other institutional investors all over the world. But that was just the beginning of the crisis.

What most people outside of Wall Street and Washington don't know is that a lot of people who bought these risky mortgage securities also went out and bought even more arcane investments that Wall Street was peddling called "credit default swaps." And they have turned out to be a much bigger problem.

They are private and largely undisclosed contracts that mortgage investors entered into to protect themselves against losses if the investments went bad. And they are part of a huge unregulated market that has already helped bring down three of the largest firms on Wall Street, and still threaten the ones that are left.

Before your eyes glaze over, Michael Greenberger, a law professor at the University of Maryland and a former director of trading and markets for the Commodities Futures Trading Commission, says they are much simpler than they sound. "A credit default swap is a contract between two people, one of whom is giving insurance to the other that he will be paid in the event that a financial institution, or a financial instrument, fails," he explains.

"It is an insurance contract, but they've been very careful not to call it that because if it were insurance, it would be regulated. So they use a magic substitute word called a 'swap,' which by virtue of federal law is deregulated," Greenberger adds.

"So anybody who was nervous about buying these mortgage-backed securities, these CDOs, they would be sold a credit default swap as sort of an insurance policy?" Kroft asks.

"A credit default swap was available to them, marketed to them as a risk-saving device for buying a risky financial instrument," Greenberger says.

But he says there was a big problem. "The problem was that if it were insurance, or called what it really is, the person who sold the policy would have to have capital reserves to be able to pay in the case the insurance was called upon or triggered. But because it was a swap, and not insurance, there was no requirement that adequate capital reserves be put to the side."

"Now, who was selling these credit default swaps?" Kroft asks.

"Bear Sterns was selling them, Lehman Brothers was selling them, AIG was selling them. You know, the names we hear that are in trouble, Citigroup was selling them," Greenberger says.

"These investment banks were not only selling the securities that turned out to be terrible investments, they were selling insurance on them?" Kroft asks.

"Well, it made it easier to sell the terrible investments if you could convince the buyer that not only were they gonna get the investment, but insurance," Greenberger explains.

But when homeowners began defaulting on their mortgages, and Wall Street's high-risk mortgage backed securities also began to fail, the big investment houses and insurance companies who sold the credit default swaps hadn't set aside the money they needed to pay off their obligations.

Bear Stearns was the first to go under, selling itself to J.P. Morgan for pennies on the dollar. Then, Lehman Brothers declared bankruptcy. And when AIG, the nation's largest insurer, couldn't cover its bad debts, the government stepped in with an $85 billion rescue.

Asked what role the credit default swaps play in this financial disaster, Frank Partnoy tells Kroft, "They were the centerpiece, really. That's why the banks lost all the money. They lost all the money based on those side bets, based on the mortgages."

How big is the market for credit default swaps?

Says Partnoy, "Well, we really don't know. There's this voluntary survey that claims that the market is in the range of 50 to 60 or so trillion dollars. It's sort of alarming that, in a market that big, we don't even know how big it is to within, say, $10 trillion."

"Sixty trillion dollars. I know it seems incredible. It's four times the size of the U.S. debt. But that's the size of the market according to these voluntary reports," says Partnoy.

He says this market is almost entirely unregulated.

The result is a huge shadow market that may control our financial destiny, and yet the details of these private insurance contracts are hidden from the public, from stockholders and federal regulators. No one knows what they cover, who owns them, and whether or not they have the money to pay them off.

One of the few sources of information is the International Swaps and Derivatives Association (ISDA), a trade organization made up the largest financial institutions in the world. Many of them are the very same companies that created the vast shadow market, lobbied to keep it unregulated, and are now drowning because of unanticipated risks.

ISDA's CEO, Robert Pickel, says there is nothing wrong with credit default swaps, and that the problem was with underlying mortgage securities.

"Well, there's clearly something wrong with the system if all of these leveraged bets, hidden leveraged bets, caused a collapse in the financial system," Kroft remarks.

"It is something that we all need to look at and learn lessons from. And we all need to work together to understand that and design a structure in the future that works more effectively," Pickel says.

"My point is, the people that made these mistakes are the people you represent in your organization. And many of them sit on the board. I mean, if they didn't get it right, who would?" Kroft asks.

"These people understand the nature of these products. They understand the risks," Pickel replies.

"Well…they didn't or they wouldn't have bought them. They wouldn't have used them," Kroft says.

"These are very useful transactions. And the people do understand the nature of the risk that they're entering into…but I'm not sure that…," Pickel says.

"Useful?" Kroft interrupts. "How come they brought down the financial system?"

"Because, perhaps they didn't understand the underlying risk, and nobody really saw the effects that were going to flow through from the subprime lending situation," Pickel says.

That chapter is not over, and there is much suspense and fear on Wall Street that there are other big losses out there that have yet to be disclosed

They already dwarf what has been lost on those original risky mortgages. As bad as the mortgage crisis has been, 94 percent of all Americans are still paying off their loans. The problem is Wall Street placed its huge bets and side bets with all of those fancy securities on the 6 percent who are not.

"We wouldn't be in any of this trouble right now if we had just had underlying investments in mortgages. We wouldn't be in any trouble right now," says Partnoy.

He says it’s the side bets.

"You got Wall Street firms, Bear Stearns, Lehman Brothers. You got insurance companies like AIG. Merrill lost a ton of money on this," Kroft says. "Everybody's lost a ton of money. They're supposed to be the smartest investors in the world. And they did it themselves."

"They did it all on their own," Partnoy agrees. "That's the most incredible thing about this crisis is that they pushed the button themselves. They blew themselves up."

Asked how much of this was incompetence on the part of Wall Street and the people who ran it, Jim Grant tells Kroft, "The truth is that on Wall Street, a lot of people just weren't very good at their jobs. It's as simple as that."

"These people were being paid $50 to $100 million a year. Some of them, the guys that were running the places," Kroft remarks.

"There is no defending," Grant replies. "A trainee making 45,000 a year would have had the common sense not to bet the firm on mortgage contraptions that no one in the firm actually understood. That is not a deep point to comprehend. Somehow, through, I will call it a criminal neglect and incompetence, the people at the top of these firms chose to look away, to take more risk, to enrich themselves and to put the shareholders and, indeed, the country, itself, ultimately, the country's economy at risk. And it is truly not only a shame, it's a crime."

60 Minutes requested interviews with top executives at Bear Stearns, Lehman Brothers, Merrill Lynch , Morgan Stanley, Goldman Sachs, and AIG. They all declined.

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