# Financial Risk Management: Duping the Rubes

William Leiss (October 3, 2011)

*Updated 3 October 2011: See new material at the end.*

Before 2008 financial industry professionals arranged to deceive local government officials around the world about the risks inherent in their "structured" products, costing the citizens those officials worked for huge losses they could ill afford. Much of this sad story has been told in excellent investigative journalism accounts published in *The New York Times*, some of which are referred to in my 2010 book, *The Doom Loop in the Financial Sector and Other Black Holes of Risk* (University of Ottawa Press), pages 38-43. Here I refer to developments occurring after the book was finished, as well as one other newly-reported important episode, involving school districts in the state of Wisconsin. This later story is being told by one of the first-rate financial reporters for *The New York Times*, Gretchen Morgenson; see her latest article, "Finger-Pointing in the Fog," 21 August 2011: http://tinyurl.com/3hqomna. [See also Ben Protess, "Dealbook: S.E.C. Sues Stifel Nicolaus Over Wisconsin School Investments," *NYT*, 10 August 2011: http://tinyurl.com/438ghdx.]

The U. S. Securities and Exchange Commission has sued Stifel Nicolaus & Company, a St. Louis-based brokerage firm, charging it with defrauding five Wisconsin school districts by recommending a complex financial transaction to them in 2006, involving the purchase of three financial securities. These securities only existed because Stifel arranged for them to be created by putting the job out to tender; the contract was won by The Royal Bank of Canada [RBC]. The total value of the securities was $200 million; the school districts invested $37 million of their own funds and borrowed the rest, $163 million, from DEPFA, an Irish bank. The school districts were sold by Stifel on the venture by being told that they would make profits on the investments that exceeded their interest costs by a substantial margin.

Well, the securities were a form of financial derivative called "synthetic CDOs." CDOs (collateralized debt obligations) themselves are essentially "bets" on how well a random assortment of assets – bonds secured by debts which are generating an income stream, such as home mortgages, car loans or credit card balances – will perform over a certain period of time, the key factor being the default rates (failure to pay the debts and interest on them) in the pool of debt as a whole. "Synthetic" CDOs are in effect bets on these other bets; in other words, here the investors in the securities do not have any ownership of the underlying assets [the debt pool]; rather, they simply "reference" those assets, betting on how well they will perform over a period of time. The securities sold to the school boards were synthetic CDOs.

In the case of CDOs investment banks create a corporate entity known as a "special-purpose vehicle" [SPV] to manage the collection and distribution of income flows generated by the debt. Then they would divide the pool into sections, known as "tranches," of varying riskiness: The "safest" tranches have first call on all the income

generated from the pool and are assigned the lowest interest rate, since the risk to the investor (the risk that the value of the tranche would collapse by higher-than-expected default rates on the debt) was thought to be low; and so on down the line, usually through ten tranches, where the tranche bearing the highest risk would get the highest income. In the case of synthetic CDOs, the investment banking arm of RBC advertised a "special purpose entity" program which "issued credit linked notes referencing CDO tranches." Synthetic CDOs generate income to pay investors by selling insurance against default in the referenced CDOs and are issued in tranches similar to CDOs.

[There are incredible complexities buried in these so-called "structured financial products." For an easily-accessible but technical explanation see the Wikipedia entry on CDOs: http://en.wikipedia.org/wiki/Collateralized_debt_obligation.]

The key step is to get an investment-grade "rating" on the tranches. In order to attract investors the investment bank doing the deal went to the rating agencies, in this case Standard & Poor's, for this service. The reason one can accurately refer to investing in CDOs as making a "bet" on the underlying debt pool is that the ratings agencies use complex mathematical models to rate the various tranches in the series from highest (AAA) to lowest (BBB). [See *The Doom Loop*, pages 80-83, for an account of the kinds of "games" that were played in the securities ratings business.] The investment deal that was offered by Stifel to the five Wisconsin school boards was rated AA- by S.&P; according to the board representatives, Stifel told them that these securities were as good as U. S. Treasury Bonds and that there would have to be "fifteen" Enron-type corporate collapses before anything could go wrong with their investment (this account is disputed in ongoing litigation, of course).

The value of the securities created for the Stifel/RBC deal started to collapse only a year later, and ultimately the school boards were left with tens of millions of dollars in losses on their investment. DEPFA seized the collateral for the loan from the school boards; the boards are suing Stifel (separately from the S. E. C. lawsuit against Stifel); and Stifel is suing RBC. Stifel has filed in court what is called an "amended cross claim" [hereafter Stifel ACC], a legal document filed with a court after the various sides have interrogated each other in a process called "discovery." The entire document is in the public domain, and the PDF file may be accessed at: http://tinyurl.com/456x76y.

The Stifel ACC document shows that RBC required Stifel to confirm that its client had read and understood their risk calculation. Section 41 of the claim notes that "DEPFA bank … took no action [to seize the collateral] until after the [synthetic CDO] investments had lost nearly their entire value." Does anyone think that the school board officials clearly understood that they could lose their entire investment? I doubt it very much! The public record in other such cases shows that the local officials who were persuaded to do these kinds of deals really had no idea what complex derivatives actually are, and had no way of checking the evaluation of the risks they carried that were given to them by their own longstanding financial advisors.

A pertinent twist in this case is Stifel's claim (not yet proven in court, as they say) that RBC exploited the mathematical models, used by S.& P. to generate its ratings for the

tranches of the synthetic CDOs, in order to hide the true risks in the portfolio: "In fact, the CDOs manufactured by RBC acted as a Trojan Horse, wrapped in an "AA" rating by Standard & Poor's, which carried material undisclosed profits, were riddled with conflicts, and hid risks which ultimately led to the losses suffered by the OPEB trusts" (Stifel ACC, Exhibit 1, #8). [OPEB trusts are legal entities established in Wisconsin to manage post-retirement benefits for former public-sector employees.]

The use of the word "manufactured" just above is especially interesting. We think of manufacturing, say, a widget or other device that we can see and take into our hands. Something manufactured is constructed out of materials in factories or workshops. CDOs too are indeed constructed, but out of whole cloth, as it were, and it is important to realize just how different these products are from those that we ordinarily think of as manufactured products. Financial derivatives such as CDOs, like other financial instruments of a more familiar nature, such as bonds, must be given an investment grade in order to be marketed and sold to investors. CDOs are rated through the use of complex mathematical models; but synthetic CDOs – which reference pure CDOs – need a second round of mathematical modeling; in other words, a modeling of another model. This gives them a rather ethereal character. It would be difficult to say, in ordinary language, just what kind of widget they really are. Which is why the kinds of people who make up local school boards probably shouldn't be touching them.

So far no one in this particular case is suing S.&P., although last week it was revealed that the U.S. justice department has been quietly investigating the ratings agency practices (Louise Story, "U.S. inquiry said to focus on S.&P. ratings," *NYT*, 17 August 2011: http://tinyurl.com/3br4xoo). But as yet no government is suing the investment banks who – some would say – are the real authors of the wicked little games involving derivatives that played a big role in triggering the global financial crisis, resulting in staggering losses to individuals and governments and the accumulation of the massive amounts of public debt that are once again, right now, shaking the global economy.

This may be about to change: On the day this piece was first drafted, *The New York Times* carried a late-breaking story by Susanne Craig and Peter Lattman, "Goldman's shares tumble as Blankfein hires top lawyer," 22 August 2011 [referring to Lloyd Blankfein, CEO of Goldman, Sachs]: http://tinyurl.com/43ftg3t. Apparently there are moves afoot by agencies of the U.S. government that may lead to charges being filed against Goldman and perhaps other major investment banks for fraudulently misleading clients about the derivatives securities they packaged and sold to clients.

*Note on subsequent developments in Jefferson County, Alabama:*

See Campbell Robertson and Mary Williams Walsh, "Debt Crisis? Bankruptcy Fears? See Jefferson County, Ala." *NYT*, 29 July 2011: http://tinyurl.com/3vwtenp. They write: "The complicated bond-and-derivative structures failed during the financial turmoil of 2008, leaving the county with a $3.2 billion debt to pay, faster than planned. Sewer revenues that were pledged to pay the debt cannot keep up." The county is facing a law that says that the interest on the bonds they issued must be paid even if the county declares bankruptcy. See also Joe Nocera, "Sewers, Swaps and Bachus," *NYT*, 22 April 2011: http://tinyurl.com/3wecuek.

Local officials across the USA and in Europe from Norway to Italy are involved in lawsuits and recriminations after being cajoled into entering the dark and treacherous waters where complex financial derivatives swim freely and seek to feed on the unsuspecting. Only strong and intelligent regulation of financial markets can protect the rest of us from these kinds of entirely legal depredations. But as Joe Nocera shows in his column cited above, in the U.S. at least financial industry lobbyists and their Congressional enablers are still fighting tooth and nail against such regulation (and, if the past is any guide, they will succeed). *Caveat emptor.*

*Update 3 October 2011 on the Wisconsin school boards:*

The U. S. Securities and Exchange Commission [SEC] has found the parties which marketed the "investments" to the Wisconsin school boards guilty of misconduct and has required them to make payments equivalent to the entire losses suffered by the boards. (See Jeff Gray and Grant Robertson, "RBC settles SEC 'misconduct' allegations," *The Globe and Mail,* 27 September 2011, http://tinyurl.com/42bq77e). RBC paid $30.4 million and Stifel bought back the $162.5 million debt from DEPFA.

The entire text of the SEC's cease-and-desist order against RBC Capital Markets on 27 September 2011 is at: http://www.sec.gov/litigation/admin/2011/33-9262.pdf. The SEC document describes the transaction as follows: "These proceedings arise out of the sale of $200 million of credit-linked notes that were tied to the performance of synthetic collateralized debt obligations holding a portfolio of 100+ credit default swaps referencing corporate bond obligations (the "CDO Investments")." [A footnote explains that "the notes were a means of simulating an investment in a CDO."] Further: "In essence, an investment in a tranche of a synthetic CDO is the economic equivalent of selling insurance on a portfolio of corporate bonds. The purchaser receives payments at an agreed-upon rate, as long as the losses within the underlying corporate credit portfolio do not reach an agreed-upon level. If losses reach agreed-upon benchmarks, the investments in that synthetic CDO tranche are eroded or, potentially, wiped out. When losses reach an "attachment" level, the investor begins to lose its principal. When losses reach a "detachment" level, the investor loses its entire investment."

The SEC found: "These CDO Investments were unsuitable for the School Districts. RBCCM's marketing materials also failed to explain adequately the risks associated with the CDO Investments. The School Districts lacked sufficient knowledge and sophistication to appreciate the nature of such investments." On the leverage in the transaction, the SEC said: "The CDO Investments' structure was incompatible with the School Districts' inability to suffer a catastrophic loss in that the School Districts would suffer a total loss if the CDO Portfolio suffered losses of merely 5% to 6%."

[*Author's Note:* The use of the word "rube" (referring to an unsophisticated person from a small rural town) in this piece is meant affectionately, since I am one of them and, in a modest way, I too got caught up in the mess discussed here.]