



Losses in the subprime mortgage market have sparked protests by homeowners demanding aid and a moratorium on active foreclosures. Mario Tama, Getty Images

How stage was set for meltdown

Subprime market began with talk over Chinese takeout

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Representatives of five of Wall Street's dominant investment banks gathered around a blond wood conference table on a February night almost three years ago. Their talks over takeout Chinese food led to the perfect formula for a U.S. housing collapse.

The host was Greg Lippmann, then 36, a fast-talking Deutsche Bank AG trader who aspired to make mortgage securities as big a cash cow for Wall Street as the \$12-trillion corporate credit market.

His allies included 34-year-old Rajiv Kamilla, a trader at Goldman Sachs Group Inc. with a background in nuclear physics, and 32-year-old Todd Kushman, who led a contingent from Bear Stearns Cos. Representatives from Citigroup Inc. and JPMorgan Chase & Co. were also invited. Almost 50 traders and lawyers showed up for the first meeting at Deutsche Bank's Wall Street office to help set the trading rules and design the new product.

"To tell you the truth, it's not very glamorous," Lippmann says. "Just a bunch of guys eating Chinese discussing legal arcana."

Those meetings of the "group of five," as the traders called themselves, became a turning point in the history of Wall Street and the global economy.

The new standardized contracts they created would allow firms to protect themselves from the risks of subprime mortgages, enable speculators to bet against the U.S. housing market and help meet demand from institutional investors for the high yields of loans to homeowners with poor credit.

The tools also magnified losses so much that a small number of defaulting subprime borrowers could devastate securities held by banks and pension funds globally, freeze corporate lending and bring the world's credit markets to a standstill.

For a while, the subprime boom enriched investment bankers, lenders, brokers, investors, realtors and credit-rating companies. It allowed hundreds of thousands of Americans to buy homes they never believed they could afford.

It later became clear that these homeowners couldn't keep up with their payments. Defaults on subprime mortgages have so far produced about \$80 billion in losses on securities backed by them. The market for the instruments is so opaque that many firms still aren't sure how much they've lost.

Chief executives at Citigroup, Merrill Lynch & Co. and UBS AG were replaced. To forestall a housing-led recession, the Federal Reserve has cut its benchmark rate three times since August and is injecting as much as \$40 billion into the credit system to encourage banks to lend to each other.

This is the story of how Wall Street transmitted the practices of southern California's go-go lending industry and the inflated U.S. real estate market to the global financial system.

Lippmann was a Wall Street renaissance man, with a strong appetite for sushi and an online restaurant guide so comprehensive one blogger labelled him "the Robert Parker of raw fish." He opened the kitchen of the \$2.3-million US Manhattan loft he lived in then, complete with six burners, two grills and six-metre island, to an Italian cooking class.

The goal of Lippmann's group on that winter evening in 2005: to design a new financial product that would standardize mortgage-backed securities, including those based on high-yield subprime loans, paving the way for their rapid growth. Of the firms participating that night, Lippmann's Deutsche Bank is based in Frankfurt, UBS in Zurich and the others in New York.

In February 2005, pension funds, banks and hedge funds owned fixed-income securities that were earning returns close to historic lows. AAA-rated securities based on home loans offered yields averaging a full percentage point higher than 10-year Treasuries at the time, according to Merrill.

The trouble was that most creditworthy borrowers had already refinanced their houses at 2003's record-low mortgage rates. To meet demand for mortgage-backed securities, Wall Street had to find a new source of loans. Those still available mainly involved subprime borrowers, who paid higher rates because they were



UBS was one of the participants in a 2005 meeting that led to the creation of the subprime securities market. It has since had to write off billions of dollars in subprime losses. Mario Tama, Getty Images



Bloomberg Archive
Greg Lippmann of Deutsche Bank AG is among the engineers of the mortgage derivatives market.

seen as credit risks.

The banks wanted more mortgage-backed securities to sell to clients. Creating a standardized "synthetic" instrument, or derivative, would leverage small numbers of subprime mortgages into bigger securities. In this way, the firms could produce enough to meet global demand.

Deutsche Bank sprang for the take-out food, and traders and lawyers sat down to design a new product and create what would soon become one of the hottest capital markets in the world.

The meetings were monthly, beginning at 5 p.m., after the trading day, and lasted more than three hours each. By June, the differences were sorted out,

the new contract was endorsed, and banks that hadn't been party to the group of five negotiations signed on.

Another necessary step was to create an index to represent the market and help hedge general market exposure. It was called the ABX-HE and would be similar to the indexes traders use for baskets of stocks. This, participants believed, would add to the market's liquidity, or depth, by attracting more trading.

The ABX-HE index started trading on Jan. 19, 2006, with a volume of more than \$5 billion. The cost of wagering against the securities was rising, a sign that traders saw an increased chance of default. An early warning was visible to anyone who knew where to look.

In the months to come, Deutsche Bank and at least one other member of the group of five, Goldman Sachs, began using subprime derivative contracts to bet the other way and guard against the possibility that subprime mortgages might default.

For Lippmann's part, he says, he thought the risks of a downturn were significant enough to justify the millions of dollars it would cost to "short," or wager against, subprime securities. He says he told his bosses: "If we're right, we're looking at a sixfold gain. And since a housing market slowdown is not as big a long shot as that, we

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Lippmann disputes that the derivatives the group of five helped create — which banks packaged into CDOs — caused the subprime crisis.

“The problems in subprime are what they are and derivatives did not cause them,” Lippmann says. “Derivatives enabled more CDOs (collateralized debt obligations) to be created and the stakes to be bigger. But the transparency made people realize the problem faster.”

Others see things differently. Derivatives, or “synthetics,” are “like wearing a seat belt that allows you to drive faster,” says Rod Dubitsky, director of asset-backed research for Credit Suisse. “The total dollar amount of losses, all these losses you're seeing, are from synthetics. No question, it changed the game dramatically.”

FROM E1 YEDLIN: A group hug for natural gas

Premier Campbell might also need a big order of bug spray to combat the pesky pine beetle.

For all those companies levered to natural gas — a really cold winter in the U.S. Northeast that necessitates big withdrawals from natural gas storage facilities. Ideally, this should be accompanied by equally cold weather in Europe that continues to drive up prices for natural gas. This will also buoy prices in North America because shipments of liquefied natural gas destined for the U.S. will be re-directed to Europe, where they will fetch a higher price. Failing that, a group hug.

Clive Beddoe — direct flights from Calgary to Kingston, Ont., on WestJet. Beddoe, as a result of his refusal to fly rival Air Canada, ended up on a proverbial plane, train, automobile and buses journey earlier this year while en route to Kingston. He was the featured speaker at a Queen's University dinner, arriving a couple of hours late as a result. Lucky for him, they kept his plate warm and the podium open.

CIBC — lessons in how to avoid the next financial mess and a statue of a magpie reminding management to stay away from shiny objects offering the promise of big returns. With the meltdown in the asset-backed commercial paper market, CIBC has the dubious distinction of having been caught on the wrong side of three significant events in the finance world: real estate in the 1980s, the tech meltdown in 2000 and now ABCP.

George Gosbee and Tristone Capital — a gold star for the leadership shown in the aftermath of the royalty review — despite receiving personal threats — and the comprehensive analysis done by his firm illustrating the flaws in the panel's analysis and recommendations.

Brett Wilson, co-founder of FirstEnergy Capital Corp. — a gold star for setting an example and raising awareness within his peer group of the need to give back to the community and pushing the philanthropy agenda in a constructive manner.

Ernie Sapieha, CEO of Compton Petroleum — a home gym and personal trainer to keep him busy after his company is sold so that he doesn't have to trek to the Eau Claire YMCA to pump iron.

Rick Grafton, retired vice-chairman of Canaccord Adams — enough golf games in the next 12 months so that the 30-year veteran of the investment banking business becomes a scratch golfer.

Jim Buckee, retired CEO of Talisman Energy — a quiet lunch with environmental crusader Al Gore to discuss the science of climate change.

Ben Bernanke — a week without the media looking to his predecessor, Alan Greenspan, for guidance or commentary on anything to do with the economy.

Wayne Henuset — a lesson in humility and how to rebuild credibility. Henuset might be a fine purveyor of wine, but he needs some guidance on what he can and cannot say during a news conference. When his nuclear power company, Energy Alberta, announced its plans to build a nuclear power plant in northern Alberta, Henuset claimed he had a buyer for the bulk of the power to be generated. This turned out to be untrue. He also said he had bought the land necessary to build the facilities. In fact, what he had was an option to buy the land. There's a reason why Energy Alberta was sold to Ontario-based Bruce Power in late November.

Don Lindsay, CEO of Teck-Cominco — a leap of faith that results in Teck buying Fording Canadian Coal Trust, thereby positioning Teck to become a global mining giant instead of potentially becoming a handmaiden to other big mining companies that understand that when it comes to mining, bigger is the only way to go.

Corporate Canada — a national securities regulator.