Wall Street's Toxic Waste

Bear Stearn's hedge fund problems provide a glimpse of Wall Street's growing toxic waste dump.

Would you trust something called the High-Grade Structure Credit Strategies Enhanced Leverage Fund? That's the name of a hedge fund run by investment bank Bear Stearns, which took in $600 million of "investor" funds, borrowed another $6 billion, then made about $16 billion in bets. Despite the phrase "high-grade" in its name, the fund has lost about 20% this year, and halted redemptions after a run by investors threatened to pull out $300 million, or half the original stake.

Bear Stearns, advised by Blackstone, has reportedly proposed a bailout of sorts, in which the creditors of the fund would kick in some $500 million to help the fund meet its margin calls, while Bear Stearns itself would kick in $1.5 billion. The plan also called for the creditors not to make margin calls for 12 months.

The fund, along with a smaller sibling, specialized in turning subprime mortages into collateralized debt obligations, or CDOs. This is the financial equivalent of making silk from a sow's ear, in the sense that CDOs are used to turn risky paper into higher-rated assets. For example, you take a pool of subprime mortgages which by definition have low credit ratings, and use them as the basis for creating a new security, called a CDO. The CDO itself is divided into tranches (the "structure"), some with better chances of being paid than others, with the most valuable tranche often having a higher credit rating than the mortgages themselves, and the least valuable tranche often falling into the category sometimes described as "toxic waste."

This business works, or at least has the appearance of working, because the global financial system has become a giant casino, in which money is borrowed (the "leverage") at lower interest rates, and bets are placed on securities which have a higher yield. Because this is inherently risky—after all, much of what they buy has no real value—a growing market has developed in credit default swaps, a form of credit derivative (the "credit strategies") which nominally insures the values of the securities. We say nominally, because the institutions providing the credit insurance are also speculators, and will vaporize if required to make major payoffs. On top of that, the market for credit derivatives on loans is growing faster than the loans themselves, with Citigroup projecting that the size of the loan credit-default swap market will be at least twice the volume of loans traded next year. This is characteristic of the derivatives market as a whole, in which the size of the bets placed on bonds, stocks, loans, currencies, and other elements, is many times greater than the size of the underlying markets.

That means that the majority of "investments" are not purchases of bonds, stocks, or currencies, but are merely bets on the movements of those items, or on the movements of securities derived from them. This is pure gambling, not investing by any acceptable definition of the term.

As we go to press, the creditors have rejected the Bear Stearns bailout plan, and Merrill Lynch is planing to sell some $800 million of bonds it has seized as collateral for loans it made. Rumors are flying that the two funds will be shuttered, sending shockwaves through the delicate CDO markets.

This crisis is also affecting Everquest Financial, a Cayman Islands-based firm formed by Bear Stearns which is planning to go public. Everquest has been buying up the riskiest parts of the CDOs created by the Bear Stearns subprime mortgage hedge funds, based upon valuations made by Bear Stearns, and purchased with borrowed money. The Bear Stearns funds, which own a controlling interest in Everquest, have also sold the company credit derivatives to protect it from defaults on the CDOs.

The whole affair is reminiscent of the relationship between Kidder Peabody and the Granite hedge funds, both of which blew up during the mortgage-backed securities (MBS) crisis of 1994. At the time, Kidder, an old-line investment bank owned by General Electric, was the leader in the MBS market. When rising interest rates triggered a flood of mortgage refinancings, the MBS market was thrown into turmoil, and the Granite hedge funds failed. As it turned out, Kidder had been using Granite as a toxic waste dump, selling it the riskiest tranches of its MBS. This allowed Kidder to get the tranches off its books, making its business seem more profitable. Kidder also failed in 1994, but due to the deep pockets of parent GE and the scapegoating of a "loan assassin," Kidder failed more gracefully.

Things have changed since 1994, of course. The level of toxic waste hidden in the system has increased exponentially, just one of the many time bombs the bankers must defuse as they attempt to dry up the bubble without triggering a cataclysmic chain reaction.