

The Looting of America

How Wall Street's Game
of Fantasy Finance
Destroyed Our Jobs,
Pensions, and Prosperity—
and What We Can Do about It

Les Leopold

Chelsea Green Publishing
White River Junction, Vermont

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Not a Wall Street insider?

A guide to the economic crisis for the rest of us.

How could the best and brightest in finance crash the global economy and then get us to bail them out? What caused this mess? And what can Main Street do about it?

In *The Looting of America*, Les Leopold debunks the prevailing myths that blame low-income homebuyers, credit-card debtors, and government interference. Instead, readers will discover how Wall Street undermined itself and the rest of the economy by playing and losing a highly lucrative and dangerous game of fantasy finance.

He also asks some tough questions:

- Why did Americans let the gap between workers' and executives' pay grow so large?
- Why did we fail to realize that the excess money in those executives' pockets was fueling casino-style investment schemes?
- Why did we buy the notion that financial products that no one could even understand would somehow form the backbone of America's new economy?
- And how can we get our money back and never give it away to gamblers again?

In this page-turning, plain-speaking narrative, Leopold tells us how everyone from individual investors to school districts to institutions around the world fell victim to Wall Street's "innovative" financial products—like collateralized debt obligations, better known as CDOs, which sucked trillions of dollars from the global economy when they failed.

As the country teeters on the brink of a depression, he warns we should be especially wary of advice from the so-called financial experts who got us here and then conveniently got themselves out. So far, it appears they've won the battle, but *The Looting of America* refuses to let them write the history—or plan its aftermath.

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Media Inquiries contact:

Taylor Haynes at:
thaynes@chelseagreen.com

For more information go to:

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“Les Leopold’s account of the economic crisis is the clearest and most accessible that I have seen. It gives a reader with little economics or financial background a riveting description of how Wall Street tore down our economy and what we can do about it. It’s a page turner we all should read.”—Leo Gerard, International President of the United Steelworkers

“Les Leopold has given an entertaining account of the growth of the derivative market that supported the housing bubble during the last decade, and offers useful recommendations for avoiding the next bubble-and-bust. He is one of the few observers to have understood how today’s crisis has roots going back three decades, and to have seen how it connects to the upward redistribution of income over this period.”—Dean Baker, Co-Director of the Center for Economic and Policy Research and author of *Plunder and Blunder: The Rise and Fall of the Bubble Economy*

“Finally, here’s a book that really lays out in plain English how Wall Street’s fictional financial engineering caused the current crisis and what needs to be changed. This compelling and highly entertaining story will both anger and animate you. It takes us into the most lucrative casino ever created and shows how it laid waste to our jobs and our savings—and it provides strong remedies to repay and protect Main Street from the damage done.”—Carolyn Mugar, Executive Director of Farm Aid

“Les Leopold’s book is a cogent, clear, and compelling explanation of how Wall Street’s Big Casino wrecked the economy. I might not agree with all of his provocative proposals, but so what? This book is a fun read, despite the sickening scenario it describes.”—Jonathan Alter, Senior Editor and Columnist at *Newsweek* and author of *The Defining Moment: FDR’s Hundred Days and The Triumph of Hope*

“Because the financial collapse was built on with so many intricate scams, regular Americans often find themselves intimidated by the sheer complexity. But at bottom, it was a case of insiders taking advantage. Les Leopold has performed a virtuoso service by explaining the economic mess in terms that ordinary people can grasp, in this wonderful and terrifying book.”—Robert Kuttner, Co-Editor of *The American Prospect* and author of *Obama’s Challenge*



credit: Lilah Leopold

Les Leopold cofounded and currently directs two nonprofit organizations, the Labor Institute and the Public Health Institute, and is the author of the award-winning *The Man Who Hated Work and Loved Labor: The Life and Times of Tony Mazzocchi*. Leopold designs research and educational programs on occupational safety and health, the environment, and economics and helped form an alliance between the United Steel Workers Union and the Sierra Club. He attended Oberlin College and Princeton University’s Woodrow Wilson School of Public and International Affairs.

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Developmental Editor: Jonathan Teller-Elsberg
Copy Editor: Cannon Labrie
Proofreader: TK
Indexer: TK
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Introduction

Okay, you got this far, which means you already know something important: that you don't know enough about the financial toxic waste Wall Street has foisted upon us. Sure, you've heard there are piles of bad mortgages taken out by people who couldn't afford them. You've also heard that all of us, consumers and bankers alike, are too deeply in debt and that it's time to tighten our belts. But you suspect that's not really the entire story. It isn't.

Like most of us, you are praying that the stimulus package and the Wall Street bailouts will resurrect the economy (although you're probably dubious about helping wealthy bankers, and furious with their bloated bonuses). You're also worried that as the economy crashes your hopes and dreams for our country—like universal health care or alternative energy investments or renewed support for public education—are slipping out of reach. And you no doubt fear the country will be crushed under the mountain of debt that we are accumulating. It's all a muddle, and you'd like some straight answers. Same here.

After the housing bubble burst in 2007, I realized I didn't know enough about modern high finance. The last economics textbook I cracked open devoted 544 pages to the production of goods and services, and only one page to banking and finance. It couldn't explain why our economy was collapsing and why we had to give all that money to Wall Street to avoid an even worse collapse. I no longer felt like an informed citizen. It was time to figure some of it out and share it with my fellow ignoramuses.

I turned to the experts, the way we're supposed to. I studied the analyses of the bankers, investment analysts, scholars, and reporters who are trying to explain this mess or propose solutions to it. But too many experts are wearing ideological blinders. Many of these insiders formed the cheerleading chorus when all was rosy and billions were being made on Wall Street. Almost all promoted our bright new financial-services economy as the way forward

for America. And they considered anyone who questioned it to be an inconsequential whiner or a radical kook. What's more, most insiders seemed unable even to ask whether the new wave of "financial engineering" contributed to or harmed our society. Instead, their understanding was: "If it makes that much money, it *must* be good, useful, and productive."

It's very hard from the inside to question market fundamentalism. We have been told for decades that private-sector financial markets are, by definition, the most efficient way to allocate capital. And if they aren't working efficiently, it must mean government has interfered and messed them up. This faith-based thinking has pervaded all of our established institutions and financial reporting. It's even taught in our grade schools.

In this book, I come at the economic crisis from outside the usual professions. I aim to answer some very basic questions and share what I've learned in a way that will allow others to understand it too. As we investigate the nitty-gritty of the crisis, we'll also make sure to keep a big-picture perspective. This crisis is a good thirty years in the making, and we won't solve anything if "solutions" don't address the underlying issues.

To maintain our citizenship in a world dominated by imploding economies, we all need some basic financial literacy. I mean, take a look around you: We are teetering on the edge of a vast economic depression. The experts helped us get here. You want to let them write all the critiques as well?

For the past few years, I've had a morbid curiosity about exotic financial instruments, especially collateralized debt obligations (CDOs)—those highly profitable new financial products that supposedly made housing more affordable to marginal buyers and generated vast sums for the financial sector at almost no risk for investors. (To keep the terms straight, there's a glossary in back. I'll also be explaining the guts of CDOs in chapter 6.) Wall Streeters and their cheerleaders in the media told us that these

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CDOs were part of a wave of great new products from American financial institutions that were making our country strong and rich. As we ceased to be a manufacturing giant, we were becoming the great engine of global financial innovation, spewing forth these wondrous new inventions. In fact, these new financial instruments, the envy of the world, were said to be much more profitable than making cars or steel or refrigerators. And they produced high-paying jobs, which in turn helped increase our overall standard of living—especially in Manhattan!

It was really hard to understand how these instruments worked. I kept imagining something like a financial iPod—an elegant new device that gave people something they really wanted (or thought they had to have), and in return earning profits galore for those who produced it. But as I read more about my imaginary CDO-iPod, I soon realized that there was something fundamentally different about a financial product and a consumer product: namely, when a financial product screws up, the entire world economy could collapse.

As of this writing, several trillion dollars' worth of value—something close to half of all the world's financial wealth—has disappeared from the global economy due to, or facilitated in large part by, fundamentally flawed CDO products.¹ Our government is bailing out Wall Street firms and has taken over Fannie Mae and Freddie Mac, two companies at the heart of our mortgage system. Lehman Brothers has gone into liquidation, Merrill Lynch's bull has been gored by the Bank of America, and now Bank of America is on the verge of collapse. Along the way, the largest insurance company in the world, AIG, is essentially owned by the taxpayer, and Citigroup is not far behind. Meanwhile, banks are doing precious little lending, and the economic system is spiraling down with unemployment rising rapidly well into 2009. And the government has been forced to spend nearly \$1 trillion on financial bailouts and another \$787 billion on a public stimulus package to keep the economy from tumbling into the abyss.

These innovative financial products also are polluting local

treasuries around the globe. The town of Narvik, located at the northern tip of Norway, invested its reserve funds in supposedly supersafe CDOs: It lost \$65 million. Five Wisconsin school districts invested \$35 million and borrowed \$165 million more to purchase AA-rated securities called “synthetic” CDOs. Not only are they now on the verge of losing their entire investment, but they also owe \$200 million. That’s some financial product!

As with other defective products, there’s a recall underway—the largest product recall in history. These financial instruments, which sliced and diced mortgages into securities sold and resold all over the world, have grown so toxic that they have to be carefully removed from the balance sheets of banks, investment houses, brokerages, insurance firms, and other financial entities. (I can’t help picturing bank examiners fully encapsulated in white hazmat suits and air packs, using large tweezers to pluck the toxic products from the banks’ books.) In fact, these financial hazards are turning out to be so toxic that the Bush administration, in November 2008, gave up trying to remove them and instead partially nationalized key portions of the banking system, while also providing tens of billions to other key financial institutions. Imagine that—a product so toxic that the virulently free-market Bush White House adopts socialist policies!

But this product recall is like no other. Rather than being reeled back in by their corporate producers owing to their faulty design, the federal government at first decided to use at least 700 billion of our tax dollars to buy the products from the ailing banks. (Some say we’re already up to \$1.5 trillion when you count federal guarantees, and the total will go even higher before it’s over.) Then they decided that instead of buying up the toxic waste, they would loan billions of dollars to the polluted financial companies to get them, in turn, to lend money to businesses and consumers again. (Meanwhile, the Federal Reserve was quietly insuring the toxic assets, which may cost us hundreds of billions of dollars more down the road.) Now the Obama administration is again taking up the plan to remove these hazardous assets from

the banks, which could end up requiring several *trillion* dollars on top of the money already put into this mess. Meanwhile, Wall Street's finest awarded themselves \$18.4 billion in bonuses for a job well done during the worst financial crash since the Great Depression, *after* their banks went on the federal dole.

Compare this to the failure of a more tangible product like an iPod. Let's imagine that a major electrical problem was discovered that caused iPods to burst into flames (the way some laptop-computer batteries made by Sony actually have done²). If the cost of the recall and the threat of legal action were enough to totally sink Apple, Inc.—which is pretty unlikely—about \$90 billion (as of this writing) would evaporate as the company's stock crashed to zero. That's spare change compared to a CDO going haywire. As we are learning day by day, the demise of faulty financial products can ignite a vast economic firestorm.

Another tremendous difference between a CDO financial instrument and an iPod is that, as of this writing, no one on earth really knows how much a given CDO is worth. As a result, banks, investment houses, and insurance companies—which are loaded with these products—are struggling to figure out whether or not they are solvent. And since they know that they don't know, they also know that *others* don't know. They don't trust each other, and investors don't trust them. Unlike the iPod, with its "suggested retail" sticker price, the value of many CDOs often can only be estimated through complex computer models. And no one trusts the models either. Hence a great freeze in the credit and loans our system relies upon.

How could this alleged pillar of our nation's grand financial future be so "opaque"? How is it possible that this shady instrument might damage the entire world economy? And how come so few of us have any idea how it works? Writers and policy makers are talking a good game about how people took loans they couldn't afford, and how these were put in mortgage securities that have crashed in value, and that these mysterious CDOs somehow have caused the housing market to tank (or is it the

other way around?). You hear them use the word *tranche* (the French word for “slice”) with intimate familiarity as if it were a new type of croissant. But if you listen carefully, you can sense that they have only the vaguest understanding of how these new financial instruments work . . . and don’t work.

And how many policy makers and analysts are willing to step back and look at what we’ve really become? Our nation has entrusted trillions of dollars of investment and debt to the creators and distributors of these indecipherable instruments. We’ve written rules, or eliminated rules, or failed to write rules that have encouraged the creation of wildly complex and (at one time) wildly profitable financial arrangements that turned out to be lethal. We’ve allowed a new global shadow banking system to exist totally beyond the control of any regulatory body. We’ve given the swashbuckling, gambling, high-risk alpha males and females of finance the keys to our economy and they’ve crashed it.

We have put our collective livelihoods at risk, and for what? Why have tens of thousands of our very best minds spent their energies dreaming up new money-making-money instruments that may be at best socially neutral and at worst disastrous? At this perilous moment for our planet, why are so many talented people spending their days playing this extremely risky game of fantasy finance?

I’ve tried to keep an open mind about the social utility of CDOs and other newfangled financial instruments—and the tens of thousands of truly bright people who make, sell, and profit by them. But the evidence just keeps mounting that much of the financial sector, as currently constructed, is basically a drain on our resources. Commentators everywhere point to the unproductive deployment of talent in financial engineering when we really need more minds engineering clean energy alternatives, among other things. They also are quick to slam Wall Street for its greed as if this was a freshly observed quality. Since when has greed been a sin on Wall Street or in capitalism as a whole? In fact, it’s supposed to be the very best motivator for creating efficiency in

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a market economy. Didn't Adam Smith long ago suggest that by narrowly pursuing our individual interests, society prospers?

And prosper it did. The financial sector, up until the 2008 crash, was one of the fastest growing sectors of the economy, generating approximately 20 percent of our gross domestic product. It also accounted for 27.4 percent of all corporate profits.³ Finance grew as manufacturing declined, thereby dominating the real economy. According to the Bureau of Labor Statistics, in 1940 there were 7.1 manufacturing jobs for every job in the financial service industries. The ratio increased to 7.7 in 1950. Then the slide started, as you can see in chart 1 . By November 2008, *there were only 1.6 manufacturing jobs per financial services job*. Until the current meltdown, the financial industry produced almost 10 percent of all the wages and salaries in the country, up from 5 percent in 1975. In a few years, provided that the system doesn't collapse entirely, the finance sector is going to be larger than the manufacturing economy.

When we hear that these financial institutions are too big to fail, unfortunately it's because they are. As of 2008, Citigroup, Bank of America, JPMorgan Chase, and AIG had revenues of

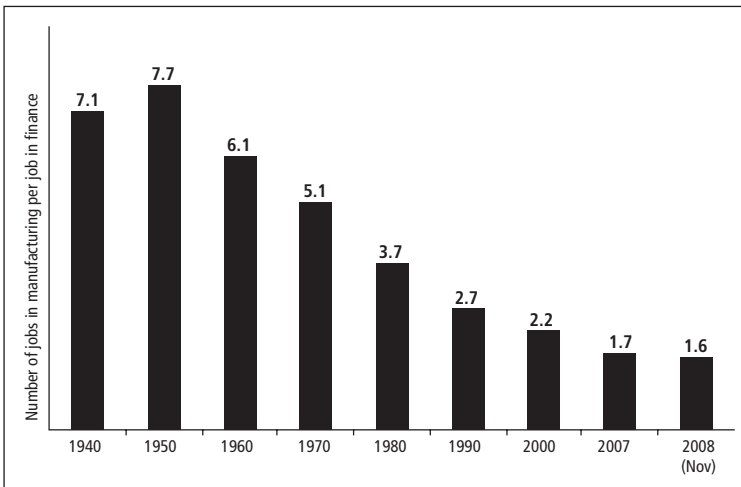


Chart 1. U.S. Job Ratio: Manufacturing to Finance Bureau of Labor Statistics

over \$100 billion each. Goldman Sachs and Morgan Stanley were not far behind, each with approximately \$80 billion in revenues.⁴ If all of them were to fail simultaneously, then all of us, as distant as we might think we are from the day-to-day operations of Wall Street, would be staring at another Great Depression.

I'm worried that Wall Street wizards have used exotic financial instruments to set up a vast game of fantasy finance . . . betting with other people's money. Is it possible that a handful of bankers and traders are making huge sums of very real money by creating, buying, and selling financial products that add little to the real economy? Is this like fantasy baseball leagues where prizes are won based on stats derived from the real game of baseball?

There are at least a couple of very obvious differences: In fantasy baseball, a few dollars exchange hands at the end of the season and no one would dare claim that make-believe baseball improves real Major League Baseball. In fantasy finance, trillions of dollars change hands and, until recently, our financial leaders—Alan Greenspan, Robert Rubin, and the like—claimed that the game actually helped to improve the real-world economy. Unfortunately for us, they were mistaken.

To be sure, fantasy finance is very real. We taxpayers are being asked to pay several trillion dollars in order to save our economy from collapse by bailing out Wall Street in large part because of their latest and greatest products—CDOs, credit default swaps, and their unholy spawn, “synthetic” CDOs. We are also paying with our jobs. The jobless rate in the private sector is rising rapidly, climbing to 8.5 percent by March 2009. And public-sector workers, from teachers to firemen, are under assault as state and local tax revenues plummet. I'm sure all of us at risk would like to know a bit more about these financial instruments and how they are wrecking our economy.

And then there's the subprime-mortgage puzzle. The financial media has all but concluded that the crash was caused by risky mortgages taken out by poor people and deadbeats who couldn't afford them, and issued by reckless lenders who should have

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known better. About \$1.3 trillion worth of such mortgages are out there. Of that about \$300 billion are in default or nearly so (divided equally between the subprime and Alt-A mortgages, the two riskiest types). Please, can someone explain how that amount, about 2 percent of household net worth, could devastate the world's financial system? To date, the taxpayer has put up about \$2 trillion in bank bailouts and loan guarantees. Why didn't that take care of the problem long ago? Like some perverse modern-day miracle of fishes and loaves, how did \$300 billion of bad debt multiply into trillions of dollars in financial toxic waste? Poor people did all that?

In this book I go after these questions—and I hope the answers will tell us a good deal about our economic woes and what to do about them. At the very least, I hope to contribute modestly to our collective financial literacy.

In short, if I can understand this crap, so can you.

The Hooking of Whitefish Bay

The great economic crash of 2008 tore right through Whitefish Bay, Wisconsin, population 13,500—though you'd never guess it from looking around town.

Located just a few miles north of Milwaukee, this golden village exudes the hopeful self-confidence of the early 1960s. Whitefish Bay's stately mansions offer breathtaking views of Lake Michigan from cliffs that rise a hundred feet above the shoreline. As you head inland on its tree-lined streets, the houses slowly shrink back into sturdy, middle-class neighborhoods. The stores on Silver Spring Drive, its main shopping strip, have survived despite fierce competition from the nearby Bayshore Mall (a self-contained ultramodern shopping village with faux streets, a faux town square, and real condos). Whitefish Bay also supports an art deco movie theater that serves meals while you watch the show, and a top-notch supermarket, fish market, and bakery. Nothing is out of place—except you, if you happen to be brown or black. Whitefish Bay is 94 percent white and only 1 percent black. There's a reason the town's unfortunate moniker is White Folks Bay.

Yet this white-collar town voted for Obama—and has always voted for its schools, which are considered among the best in the state. Its residents' deep pockets supply the school system with all the extras: In 2007, \$700,000 in donations provided “opportunities, services and facilities for students.” The investment has paid off. An average of 94 percent of Whitefish Bay's high school graduates go on to college immediately. And the school dropout rate is less than 0.5 of 1 percent.

The school district takes its fiscal responsibilities seriously. It has set up a trust fund to pay benefits, primarily health insurance, for retired school employees. When these benefits (called “Other Post-Employment Benefits” or OPEB) were originally negotiated, the expense was modest. But then health care costs exploded. What’s more, accounting rules now require that school districts amortize these costs and post them on their books as a liability each year. Whitefish Bay, like many other school districts, became worried about how to meet these liabilities.

Whitefish Bay is a town full of financially sophisticated residents, including its school managers. They sought to pump up the OPEB trust fund quickly so they could keep their promises to retirees. As responsible guardians of the town’s resources, they looked for the highest rate of return at a minimal risk to the fund’s principal. As Shaun Yde, the school district’s director of business services, put it, the goal was to “guarantee a secure future for our employees without increasing the burden on our taxpayers or decreasing the funds available to our students to fund their education.”¹

Meanwhile, Wall Street investment houses had set their sights on school-district trust funds like Whitefish Bay’s. They hoped to persuade districts to stop stashing this money—valued at well above \$100 billion nationwide in 2006—in treasury bonds and federally insured certificates of deposit (CDs). Wall Street’s “innovative” securities could provide higher returns—not to mention more lucrative fees for the investment firms.

So an old-fashioned financial romance began: Supply (Wall Street’s hottest financial products) met Demand (school districts seeking to build up their OPEB trust funds). It looked like a perfect match.

In the Milwaukee area, Supply was represented by Stifel Nicolaus & Company, a venerable, 108-year-old financial firm, which promised to put “the welfare of clients and community first” as it pursued “excellence and a desire to exceed clients’ expectations . . .”²

As a national firm based in St. Louis, Stifel Nicolaus was fortunate to be represented in Milwaukee by David W. Noack. According to the *New York Times*, “He had been advising Wisconsin school boards for two decades, helping them borrow for new gymnasiums and classrooms. His father had taught at an area high school for 47 years. All six of his children attended Milwaukee schools.”³ School boards repeatedly referred to him as their “financial advisor”—a label he never refuted.⁴

In 2006, Mr. Noack, an avuncular, low-key salesman (he preferred to be called a banker), urged the Whitefish school board and others in Wisconsin to buy securities that offered higher returns than treasury notes but were just about as safe. He had recently attended a two-hour training session on these new financial products, so he was confident when he assured the officials that they were “safe double-A, triple-A-type investments.” None of the investments included subprime debt, he said. And the deal conformed to state statutes, so the district would be erring on the conservative side. In fact, Noack said, the risk was so low that there would have to be “15 Enrons” before the district would be affected.⁵ For the schools to lose their investment, “out of the top eight hundred companies in the world, one hundred would have to go under.”⁶

As in many romances, one party seduces and the other is seduced. Noack certainly came across as a caring, considerate suitor. He started his sales drive by inviting area school administrators and board members to tea, “with food and beverage provided by Stifel Nicolaus,” making the gathering seem more like a PTA fund-raiser than a high-powered investment pitch. He merely wanted to introduce the local officials to these new “AA-AAA” investments, as the invitation pointed out.

In a series of video- and audiotapes recorded by the Kenosha school board—which later joined forces with Whitefish Bay and three other nearby school districts to invest with Noack⁷—you could discern a pattern to his pitch. First he would stress the enormity of the financial problems the school districts faced in

meeting their long-term retiree liabilities.⁸ For example, during a seventeen-minute spiel recorded on July 24, 2006, he reminded school board members that, based on Stifel's actuarial computations, the district had an \$80-million post-retiree liability. (In an "updated" Stifel study presented a year later, the estimate rose to \$240 million.) In fact, Noack spent much more time describing the extent of the liability and how the district would have to account for it than he did explaining his proposed multimillion dollar investments and loans. Not to worry. He said that he had "spent the past four years" developing investment solutions for such liability problems.

Next Noack stressed that he was not about to take unacceptable risks with the schools' money. His recommended investments were extremely conservative, his approach cautious. As he put it in the July meeting, "our program . . . is using the trust to a certain degree [and] a small portion of the district's contribution, investing the money, making the spread in double-A, triple-A investments and funding a little bit at a time over a long period of time . . . and what we make is as risk-free as we can get. . . ."

He also nudged the school district along with a bit of peer-group pressure, describing how other Wisconsin districts were working with him on similar investments. There was power in numbers, he told them. By working together with other districts, they would "increase their purchasing power," a phrase he repeated many times.

Noack made it seem as if the districts' collective "purchasing power" had banks and investment houses lining up to compete for their business, offering them the lowest-cost loans and highest rates of return. He was soon going to be "bidding out" the districts' packages and he was sure he was going to get them the best rates.

To take the edge off the enormity of the investment Noack was pushing, he ended his pitch by asking the school board to pass resolutions to "authorize but not obligate" its financial committee or officials to make the investment if and when the rates seemed

favorable. He never asked the boards to make a final commitment then and there. Instead, he conveyed the sense that even after the vote, they weren't committed to anything.

But the seduced are rarely passive. In this affair, several key board members helped the process along. On the Kenosha videotapes, for example, one board member, Mark Hujik, a hulking, ex-Wall Street player who now owns a Wisconsin financial advisory service, repeatedly sealed the deals. The self-confident Hujik never asked a question he didn't already know the answer to. He made sure everyone knew that he knew the ins and outs of finance. At a key meeting before Kenosha signed on to its first deal, he stressed that the tens of millions in loans the board would be taking out were "moral," but not "contractual" obligations on behalf of the town. He implied that if things went wrong, the town really wasn't on the hook for \$28.5 million in loans. (Unfortunately, he didn't mention that the town could still be successfully sued and see its debt ratings plummet if it defaulted on its "moral" financial obligations. And when a town's debt rating falls, it faces higher interest rates for all its other borrowing needs, assuming anyone will ever lend to it again.⁹)

Together, Hujik and Noack wooed the parties with intimate bankerspeak that conveyed confidence and expertise. They whispered financial sweet nothings: LIBOR rates, basis points, spreads, mark to market, cost of issuance, static and managed investments, arbitrage, tranches, letters of credit, collateralization ratios, and standby-note purchase agreements. After a while the board members started using the same language. Words like "million" and "dollars" disappeared from their vocabulary; instead they referred familiarly to "twenty" and "thirty" (as in thirty million dollars). Perhaps the slang and technical lingo distracted the officials from the risky nature of their financial decisions.

Like any romance, at first everything seemed simple. There was so much trust. As one Kenosha board member said to more experienced members before a key authorization vote: "I'm not

a financial person. So if you say it should be done, I will follow your lead.”¹⁰

Listening to seven taped meetings, it’s hard not to notice the school officials’ consistent deference to Noack and their inability to ask him basic or troubling questions. No one wanted to seem dumb, though nearly all decidedly were not “financial persons.” The district officials never asked questions such as: “How will the rate of return compare to government-guaranteed securities?” Or, “If Wall Street goes into a slump, how much could we lose?” Unless you’re Woody Allen, you don’t talk about the prospect of breaking up at the beginning of a romance. When the votes were taken, no one dissented.¹¹ Demand and Supply consummated their relationship.

To the Wisconsin school districts, the deal seemed safe. They would pool their money to increase their “purchasing power.” They would borrow more money (“leverage,” as the big boys call it) and invest it in something called a “synthetic CDO” for seven years. In a handout he gave to the boards on July 24, 2006, Noack illustrated how their trust fund for retirees’ benefits could accumulate almost \$9 million in seven years by borrowing and investing \$80 million. These CDOs would pay them over 1 percent more than what it would cost to borrow the money. The more the schools borrowed, the more they would make. It was practically free money. What was not to like?

The complexity of the deal alone should have given the investors pause. Their newly purchased “Floating Rate Credit Linked Secured Notes” were a lot more complicated than federally insured CDs or treasury notes. In fact they were more convoluted than anything any of them had ever bought or sold, individually or collectively. But Noack had done his job well by making the purchases seem straightforward and prudent.

According to court documents, by the time Noack was through, the five school districts had put up \$37.3 million of their own funds (most of it raised through their towns’ general-obligation bonds) and borrowed \$165 million more from Depfa, an aggres-

sive Irish bank owned by a much larger German bank. The net investment after fees was \$200 million. With that money, the school officials bought three different bondlike CDO financial instruments from the Royal Bank of Canada—Tribune Series 30, Sentinel Series 1, and Sentinel Series 2. With a little Wall Street magic, a big payoff seemed like a sure thing.

But what if Wall Street took a tumble and the value of the school boards' investments fell below the value of their loans? The school officials didn't even ask the question, but Noack already had the answer: "If we stick to all investment-grade companies, you still got to have ten percent . . . go under. You're talking, I would assume, and I'm not an economist, but that's a depression."¹²

The districts seemed oblivious to risk, even after securing disappointing returns on their first investments. There was a huge gap between the rates Noack had expected to lock in and what they finally got. The entire point of investing in CDOs was to get a rate of return that was substantially higher than what it would cost to borrow the money. The difference is called "the spread." Every quarter of a year you were supposed to collect what you'd earned through the spread and reinvest it. Noack had predicted that the CDOs would yield the school districts about 1.5 percent above what it would cost to borrow the money. In the first purchase, Tribune Series 30 for \$25 million, the spread was 1.02 percent. However, on the next CDO purchase, Sentinel 1 for \$60 million, the spread was only 0.67 percent. In their final deal, Sentinel 2 for \$115 million, the spread was 0.82 percent. The idea was that after the seven years the districts could redeem their CDOs, like bonds, and have enough value to pay off the Depfa loan as well as the general-obligation bonds taken out by the town. Of course, this assumed that the CDOs would be safe and sound for seven years.

Unfortunately the CDOs were not the secure investment Noack had thought they would be. According to the *New York Times*' analysis:

If just 6 percent of the bonds . . . went bad, the Wisconsin educators could lose all their money. If none of the bonds defaulted, the schools would receive about \$1.8 million a year after paying off their own debt. By comparison, the CDO's offered only a modestly better return than a \$35 million investment in ultra-safe Treasury bonds, which would have paid about \$1.5 million a year, with virtually no risk.¹³

But this comparison missed the true alchemy of the deal, and its great attraction to the local school officials. Buying a safe treasury bond would have required the schools to put up \$35 million from their general-obligation borrowing—money they would have to pay back and on which they would have to pay interest to the bondholders. In fact, if the districts had made such an investment, they would have had to pay *more* in interest than the treasury bonds would have yielded. That investment would make little sense.

The CDO deal was complex but it seemed to have enormous advantages: Not only would it supposedly produce \$1.8 million a year in revenues, it would also pay for all the interest on the general-obligation bonds, as well as the debt itself, at the end of the seven years. That is, returns from the CDOs would cover the \$165 million in loans from Depfa *and* the \$35 million of collateral the schools put up through the general-obligation bonds. All in all, the deal was supposed to generate \$1.8 million a year, free and clear. Now *that's* fantasy finance.

Hujik certainly had bought into the dream. "Everyone knew New York guys were making tons of money on these kinds of deals," he said. "It wasn't implausible that we could make money, too."¹⁴

The Wisconsin officials didn't see that their quest for this pot of gold had created two insidious problems. First, town elders were now ensnared in a series of complicated financial transactions that yielded considerable fees for bankers and brokers. The districts paid fees to issue their general-obligation bonds; they

paid fees to service those payments; they paid fees to borrow the funds to buy their CDOs; they paid fees to buy their CDOs, and they paid fees to collect the loan payments and to distribute the CDO payments. Someone would be getting rich off all this, but it wasn't the five Wisconsin school districts.

Second, when little fish try to swim with big fish, they better be prepared for risk—lots of it. No one on either side of the deal, at least on the local level, had read the fine print. They couldn't have, since the detailed documents—the “drawdown prospectuses”—were delivered weeks after the securities were purchased. They wouldn't have understood them anyway. In this romance between Supply and Demand, everyone was in over their heads. The “experts” in the room (on both sides) sounded cautious, confident, and knowledgeable. But in truth, Noack had no idea what he really was selling, and school district officials like Hujik and Yde had no idea what they really were buying. It is likely that both parties truly believed they were handling the equivalent of a mutual fund made up of highly rated corporate bonds.¹⁵ They weren't.

It's hard to blame the Wisconsinites for not understanding the transaction: They were dealing with one of the most complex derivatives ever designed—a synthetic collateralized debt obligation, which is a combination of two other derivatives: a collateralized debt obligation (CDO) and a credit default swap (CDS). This is the kind of security that Federal Reserve chairman Ben Bernanke called “exotic and opaque.” Investment guru Warren Buffet called it a “financial weapon of mass destruction.”¹⁶ In other words, one of the most dazzling—and dangerous—illusions in all of fantasy finance.

As we'll see, these investments were truly mysterious in their design and in their execution. One of the most “exotic” features was that these securities didn't give the buyer ownership of anything tangible at all. The buyer received no stake in a corporation, as they would have with a stock or bond. Instead, the school districts, without realizing it, had become part of the trillion-dollar

financial insurance industry. (It was not called insurance, however, since insurance is, by law, heavily regulated.) In fact, they had put up their millions, and had borrowed millions more, to insure \$20 billion worth of debt held (or bet upon) by the Royal Bank of Canada. And that debt included some very nasty stuff: home equity loans, leases, residential mortgage loans, commercial mortgage loans, auto finance receivables, credit card receivables, and other debt obligations.¹⁷ Technically, Mr. Noack may have been correct when he said that the schools didn't *own* any subprime debt. *They didn't own anything*. Instead, they had agreed to *insure* junk debt. The revenue they hoped to receive each quarter was like receiving insurance premiums from the Royal Bank of Canada, which was covering its bets on the junk debt.

What's more, although the synthetic CDOs had been rated AA, as Noack had touted, those ratings were bogus. The CDOs were drawn from a vast pool of junk debt that had been chopped up into slices based on risk. The top slices had the least risk and the bottom slices had the most risk. Unbeknownst to both Noack and the school districts, the districts' \$200 million of borrowed money was used to insure a slice near the bottom of the barrel! They would be on the hook for paying out claims if the default rate hit about 6 percent, a number it is fast approaching. Neither savvy Dave Noack, nor confident Mark Hujik, nor concerned Shawn Yde appeared to have any understanding of this frightening reality.

But the big fish—the CDO creators and peddlers at the top levels—knew what they were doing. The Canadian bank received \$11.2 million in up-front fees. (That's right, the bank was, in effect, buying insurance, yet the school districts were paying the bank up-front fees for the honor of insuring the bank's junk debt.) The investment sales company took \$1.2 million in commissions. We don't know precisely how much Depfa got for the loans, but it was substantial.

Whitefish Bay and the other school districts got something substantial too: nearly all of the risk. The school districts are

about to lose all of their initial \$37.3 million. They will also lose another \$165 million of the money they'd borrowed from Depfa. As soon as the default rate is reached, \$200 million will go to pay insurance claims to the Royal Bank of Canada. And the schools still will owe the full \$165-million Depfa loan, and they will still owe on the bonds they had issued to raise much of their \$37.3 million in collateral. The risk of reaching total default currently is so high that Kenosha's entire piece of the CDO investment (\$35.6 million) was valued at only \$925,000, as of January 29, 2009—a decline of in value of \$36,575,000.¹⁸ Now the school districts are paying hefty fees not just to bankers but also to lawyers, as they sue to unwind the deal and recover damages.¹⁹

“This is something I'll regret until the day I die,” said Shawn Yde of the Whitefish Bay schools.²⁰

He's not alone. As National Public Radio and the *New York Times* reported in a joint article, “Wisconsin schools were not the only ones to jump into such complicated financial products. More than \$1.2 trillion of CDOs have been sold to buyers of all kinds since 2005—including many cities and government agencies. . . .”²¹

Did these public agencies deserve any protections? A prudent rule might be to forbid investment houses to peddle such risky securities within a thousand yards of a school district. But there are no rules, since these “exotic and opaque” financial securities are still entirely unregulated. (When the Kenosha Teachers Association discovered that the securities peddled to the school districts were identical to those that sunk AIG, it requested that the Federal Reserve remove them from the school districts just as they have done for AIG—an eminently fair and reasonable request in my opinion. See chapter 8 for more on AIG.)

Whitefish Bay, Kenosha, and the other three districts made missteps and miscalculations. They were naïve. As Mark Hujik candidly said, they saw a pot of gold on Wall Street and wanted their piece. But they were had. We all were.

We know that something has gone terribly wrong not just in

Whitefish Bay but with our entire economy. There's a connection between the junk that was peddled to the "Wisconsin Five" and the crash of the global financial system. In fact, if we can understand exactly what David Noack sold to Whitefish Bay and why, we will also understand how the economy collapsed, *and* what needs to change to prevent this from happening again.

Our trail will lead to an examination of financial booms and busts, including the Great Depression. And those of us with strong stomachs will also learn more than we ever wanted to know about CDOs, CDOs-squared, synthetic CDOs, and credit default swaps—those exotic instruments that swamped Whitefish Bay.

Along the way, we will see how bankers, traders, and salespeople pocketed hundreds of millions of dollars by selling risk all over the world as if it were a collection of predictable Swiss watches. And we'll puzzle over why Alan Greenspan, Robert Rubin, and Ben Bernanke fought so hard to keep these dangerous financial instruments unregulated.

We'll tackle the "logic" of free marketeers who claim that the meltdown is the fault of low-income homebuyers who got in over their heads. We'll also marvel at how, in response to the financial meltdown, former treasury secretary Paulson and friends blew open the U.S. Treasury vault so that Wall Street could walk off with a trillion dollars . . . and counting.

And once we've put all the puzzle pieces together, we'll use our new understanding to formulate reforms that might protect us from the fantasy-finance fiasco that is harming not just Wisconsin and the rest of America, but the whole world.