Ben Stein How Not to Ruin Your Life

Everything You Wanted to Know About the Credit Crisis But Were Afraid to Ask

http://finance.yahoo.com/expert/article/yourlife/109609;_ylt=AihYXGa_2tf9PJDeCl.2G0S7YWsA

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Posted on Monday, September 22, 2008, 12:00AM

The headlines scream doom. There are endless references to the economic situation being "the worst since The Great Depression." Immense names in finance have collapsed and sunk beneath the waves of the financial crisis. Please allow me to try to explain a bit of what's going on.

First of all, all you have to do is look around you to see that in terms of daily life, we are not anywhere near The Great Depression. Unemployment is barely about six percent. It was 25 percent at the nadir of The Great Depression. Real per capita incomes adjusted for inflation are at least five times what they were during The Great Depression. Airplanes are full. High-end restaurants are full. Prices are painfully high for food. These are not signs of a Great Depression.

On the other hand, the losses in financial products have been devastating. The Dow is off 23 percent from its high in 2007. Financial stocks even after the recent rally are off staggeringly. The biggest insurer in America has become a basket case.
Most of all, there is REAL FEAR in the air. Decent, hard working people are terribly afraid as they see their life savings melt away. Retirement has become just a forlorn dream for tens of millions of Americans.

How did it happen?

Here s one big part of the answer. First, the alert reader will notice that Ben Stein said many times that the amount of money at risk in the subprime meltdown was just not enough to sink an economy of this size. And I was right...to a point. The amount of subprime that defaulted was at most - after recovery in liquidation - about $250 billion. A huge sum but not enough to torpedo the US economy.

The crisis occurred (to greatly oversimplify) because the financial system allowed entities to place bets on whether or not those mortgages would ever be paid. You didn't have to own a mortgage to make the bets. These bets, called Credit Default Swaps, are complex. But in a nutshell, they allow someone to profit immensely - staggeringly - if large numbers of subprime mortgages are not paid off and go into default.

The profit can be wildly out of proportion to the real amount of defaults, because speculators can push down the price of instruments tied to the subprime mortgages far beyond what the real rates of loss have been. As I said, the profits here can be beyond imagining. (In fact, they can be so large that one might well wonder if the whole subprime fiasco was not set up just to allow speculators to profit wildly on its collapse...)

These Credit Default Swaps have been written (as insurance is written) as private contracts. There is nil government regulation of them. Who writes these policies? Banks. Investment banks. Insurance companies. They now owe the buyers of these Credit Default Swaps on junk mortgage debt trillions of dollars. It is this liability that is the bottomless pit of liability for the financial institutions of America.

Because these giant financial companies never dreamed that the subprime mortgage securities could fall as far as they did, they did not enter a potential liability for these CDS policies anywhere near their true liability - which again, is virtually bottomless. They do not have a countervailing asset to pay off the liability.

This is what your humble servant, moi, missed. This is what all of the big investment banks and banks and insurance companies missed. This is what the federal government totally and utterly missed. This is what the truly brilliant speculators in these instruments did not miss. They could insure a liability they could also create and control. It is as if they could insure a Cadillac for its value upon theft - but they could control what the value the insurer had to pay off was. The insurer thought it might be fifty thousand dollars - but it was manipulated into being two million.

This is the whirlpool sucking down finance.

Now, we are about to have a similar phenomenon happen with commercial mortgage debt, debt from mergers and acquisitions, credit card debt, and car loan debt. Many trillions of dollars in Credit Default Swaps have been sold on all of this, and the prices of all of them have fallen and can be made to fall more.

As I said, the pit of loss is bottomless. Warren Buffett, the smartest man of all time in the world of finance, has called financial derivatives - of which Credit Default Swaps are a prime example - "weapons of financial mass destruction." And so they are. As with the hydrogen bomb, no one thought they would ever be used to end the world. But unless someone figures a way out - and maybe the new RTC is and maybe it isn't - we are in real peril. This should never have happened. Now that it did happen, should the taxpayer pay to make the billionaire speculators whole on their bets? What the heck is to be done?