EVIL WALL STREET EXPORTS BOOMED WITH 'FOOLS' BORN TO BUY DEBT

By Mark Pittman

Oct. 27 (Bloomberg) -- Tom Bosh lowered the telephone receiver into its cradle, making a decision on the way down. "We're not buying any more," he told his traders at Bank of New York Co. "Nothing."

It was May 2007, and Bosh, who managed $25 billion from the bank's 13th-floor trading room above Times Square, had just hung up on Ralph Cioffi at Bear Stearns Cos. a dozen blocks away. Bosh had invested $50 million in notes from an issuer Cioffi controlled, and he was ready to pull the plug.

"I had a bad feeling," Bosh, 45, recalled. "Cioffi was just bulldogging everyone. He was saying, 'These assets are good, the collateral is paying down, and I know more than you.' That type of attitude."

Bosh's premonition, a month before two of Cioffi's funds blew up, struck a death knell for structured finance, the system Wall Street banks devised to fuel more than two decades of unprecedented borrowing. The system allowed financial companies to lend beyond their capacity and outside the reach of regulators -- until it crashed this year.

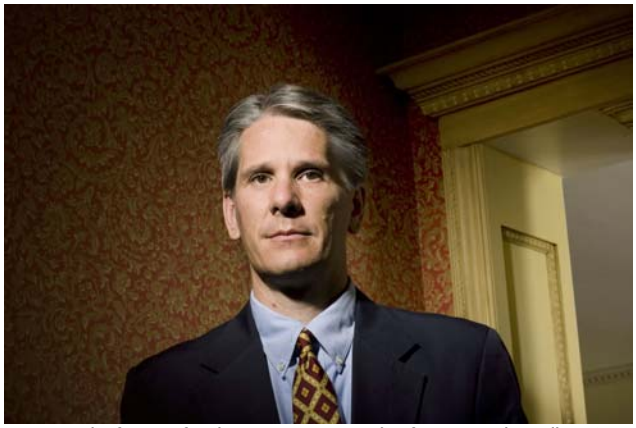
While the collapse was most visible in the stock markets, the cause was the loss of confidence in the world's biggest bond market, structured finance. So far, it has led to the worst financial crisis since the Great Depression, the disappearance or takeover of more than a dozen banks, including three storied Wall Street firms, and almost $3 trillion in government expenditures and guarantees to contain the contagion.

Biggest U.S. Export

The bundling of consumer loans and home mortgages into packages of securities -- a process known as securitization -- was the biggest U.S. export business of the 21st century. More than $27 trillion of these securities have been sold since 2001, according to the Securities Industry Financial Markets Association, an industry trade group. That's almost twice last year's U.S. gross domestic product of $13.8 trillion.

The growth over the past decade was made possible by overseas banks, which saw the profits U.S. financial institutions were making and coveted the made-in-America technology, much as consumers around the world craved other emblems of American ingenuity from Coca-Cola to Hollywood movies. Wall Street obliged, with disastrous results: two-thirds of a trillion dollars in bank losses, about 40 percent of them outside the U.S.

"Securitization was based on the premise that a fool was born every minute," Joseph Stiglitz, a professor of economics at Columbia University in New York, told a congressional committee on Oct. 21. "Globalization meant that there was a global landscape on which they could search for those fools -- and they found them everywhere."



Tom Bosh, former fund manager at Bank of New York Mellon Corp. poses at his home in Ramsey, New Jersey, U.S., on Monday, Sept. 15, 2008. Photographer: Emile Wamsteker/Bloomberg News

Eager Adopters

European banks, in particular, were eager adopters. Securitizations in Europe increased almost sixfold between 2000 and 2007, from 78 billion euros ($98 billion) to 453 billion euros, according to the European Securitization Forum, a trade organization.

Three Icelandic banks borrowed enough to buy $228 billion of assets, most of them securitizations, turning the country's financial system into a hedge fund. All three banks have been nationalized by the government, leading Prime Minister Geir Haarde to advise citizens to switch from finance to fishing.

In Germany, one bank, Landesbank Sachsen Girozentrale, bought $26 billion worth of subprime-backed investments, putting the state of Saxony on the hook for $4.1 billion.

In Japan, Mizuho Financial Group Inc., the nation's third- largest bank, acquired an entire structured-finance team, which proceeded to lose $6 billion issuing mortgage-backed securities.

Former Bear Stearns Cos. hedge fund manager Ralph Cioffi leaves Federal Court after a hearing in Brooklyn, New York, U.S., on Friday, July 18, 2008. Photographer: Ramin Talaie/Bloomberg News

Shadow Banking

The damage reaches all the way to Australia, where the town council of Wingecarribee, a municipality outside Sydney with a population of 42,000, bought $20 million of securities from Lehman Brothers Holdings Inc. Now, Lehman is in bankruptcy, the town council is in court and the securities are worth about 15 cents on the dollar.

Securitization is a shadow banking system that funds most of the world's credit cards, car purchases, leveraged buyouts and, for a while, subprime mortgages. The system, which pools loans and slices up the risk of default, made borrowing cheaper for everyone, creating a debt culture that put credit cards in wallets from Seoul to Sao Paolo and enabled people to buy luxury cars and homes. It also pumped out record profits for banks, accounting for as much as one-fifth of their revenue over the last decade.

Beginning about three years ago, investment banks revved the system's engine to boost earnings. They raised revenue by funding more subprime mortgages and cut costs by relying increasingly on the $4.2 trillion sitting in U.S. money-market funds. As it turned out, those decisions would prove fatal.

'Powerful Technology'

"It's a powerful technology that has been driven beyond the speed limit," said Juan Ocampo, a former consultant at New York-based advisory firm McKinsey & Co. who wrote a 1988 book popularizing structured finance. "For the last five years, instead of going 65 mph, they've been gunning it to 140 mph, 150 mph."

Before the invention of securitization, banks loaned money, received payments and profited from the difference between what the borrower paid and the bank's funding cost.

During the mid-1980s, mortgage-bond traders at Salomon Brothers devised a method of lending without using capital, a technique at the heart of securitization. It works by taking anything that has regular payments -- mortgages, car loans, aircraft leases, music royalties -- and channeling the money to a trust that pays bondholders principal and interest.

Off-Balance-Sheet

The word "securitization" implies safety. Investors with less appetite for risk buy higher-rated securities and get paid first at lower interest rates. Those with a bigger appetite get paid later and receive more interest.

Securitization's biggest innovation was the use of off-balance-sheet accounting. If a bank couldn't sell a bond or didn't want to, the asset could be sold to a trust within a so-called special-purpose entity, incorporated in a place such as the Cayman Islands or Dublin, and shifted off the books. Lending expanded, and banks still booked profits.

With this new technology, a bank could originate $100 million in loans, sell off some to investors, transfer the rest to a special-purpose entity and not have to hold any capital. The profit could be as much as 1.25 percentage points of the amount loaned, or $1.25 million for every $100 million issued.

"The banks could turn a low return-on-equity business into one that doesn't use any equity, which was the motivation for this," said Brad Hintz, a Sanford C. Bernstein & Co. analyst and former chief financial officer at Lehman. "It becomes almost like a fee business because it requires no capital."

‘Capture the Prize’

Like most new products, securitization found a market at home before going abroad. Bankers at Salomon and First Boston Inc. raced from bank to bank to convince issuers it was the wave of the future.

William Haley remembers a 10 a.m. meeting in 1987 at Imperial Thrift & Loan Association in Glendale, California. As Haley, at the time a 33-year-old Salomon banker, and his team walked into the conference room to make a pitch, the First Boston team was walking out.

“We exchanged some knowing looks and then tried to beat the pants off them,” said Haley, who now works at RBS Greenwich Capital Markets Inc., a firm specializing in mortgage-backed securities that is owned by Royal Bank of Scotland Group Plc. “There was a fierce desire to capture the prize.”

First Boston

First Boston, housed in the same New York office tower as McKinsey, was first out of the gate in March 1985 with a $192 million computer-lease securitization for Sperry Corp., a predecessor of Unisys Corp. The bank then oversaw a series of auto-loan securitizations, including a $4 billion issue by General Motors Acceptance Corp. in October 1986, the biggest corporate debt issue at the time.

Haley’s project was a $50 million deal for Banc One Corp. called Certificates for Amortizing Revolving Debts, or CARDs. It was the first credit-card securitization and a blueprint for the $358 billion of such securities now outstanding. The transaction also gave the banks a way to securitize their own assets and get them off their balance sheets, which allowed the money to be lent all over again.

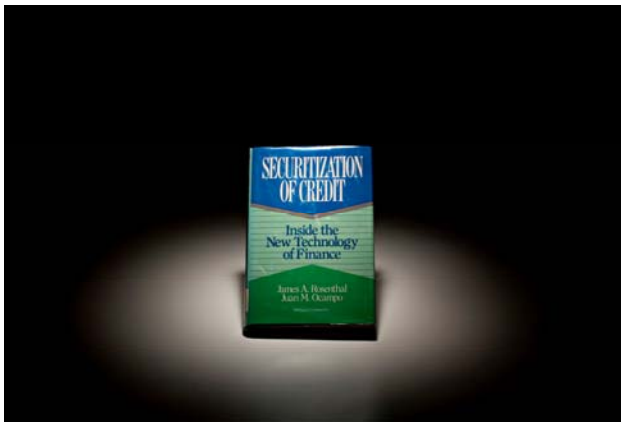
The strategy was detailed in Ocampo’s 282-page book “Securitization of Credit: Inside the New Technology of Finance,” which he co-wrote with McKinsey consultant James Rosenthal. Ocampo, who received an MBA from Harvard after graduating from the Massachusetts Institute of Technology, and Rosenthal, a Harvard Law School graduate, argued that banks could be more profitable if they used securitization.

McKinsey Book

The authors examined six of the first asset-backed transactions and gave readers a step-by-step guide for how to repeat them. They said that banks that didn’t embrace the new technology would be at a disadvantage, and they predicted it would become the dominant form of financing.

“The McKinsey book helped with credibility with issuers,” said Haley. “It wasn’t that easy in the beginning. Conferences now have thousands of people, but I remember once in Beverly Hills, I gave a speech and there were maybe 25 people in the audience. They were furiously taking notes, however.”

The new technology was spread around the world by the people who worked on the First Boston and Salomon teams. Salomon’s group was led by Patricia Jehle, who later founded Bear Stearns’s asset-backed unit. Another member, Michael Hutchins, started the first team at a European bank when he went to Zurich-based UBS AG in 1996. A third, Michael Normile, moved to Merrill Lynch & Co., where he ran its securities business, then switched to London-based HSBC Holdings Plc in 2004. Haley built similar teams at Lehman, Chase Manhattan Bank and Amsterdam-based ABN Amro Bank NV.



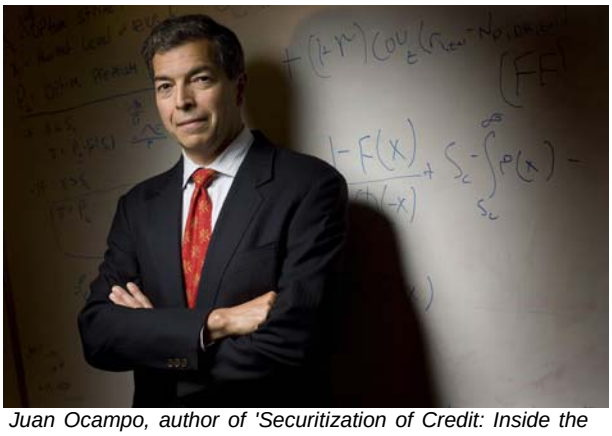
"Securitization of Credit: Inside the New Technology of Finance," a book by James Rosenthal and Juan Ocampo published in 1988, is displayed for a photograph in New York, U.S., on Thursday, August 7, 2008.
Photographer: Daniel Acker/Bloomberg News

Hard Sell

First Boston's team included Walid Chammah, 54, who went on to head debt and equity capital markets at Morgan Stanley and is now co-president of that firm. Joseph Donovan, the banker responsible for the GMAC relationship, went to Smith Barney in 1995, to Prudential Securities in 1998 and two years later took over the asset-backed group at Credit Suisse First Boston after Zurich-based Credit Suisse bought First Boston.

Donovan remembers traveling to Europe for First Boston in the early 1990s, trying to convince Volkswagen AG in Wolfsburg, Germany, and Renault SA outside Paris of the benefits of securitization. It was a hard sell. Europeans, he said, didn't take out auto loans.

"We tried over and over," Donovan recalled. "We were trying to get more issuers, and there weren't any."



Juan Ocampo, author of 'Securitization of Credit: Inside the New Technology of Finance' stands for a photo in his office in New York, U.S., on Tuesday, Sept. 23, 2008. Photographer: Robert Caplin/Bloomberg News

'50-Year Pedigree'

By the time Donovan went to work for Credit Suisse in 2000, European attitudes had changed. Home-mortgage securitizations were especially appealing, he said, because European banks didn't need a "50-year pedigree to compete."

"You don't need a whole equity-research department and relationships with CEOs and CFOs," Donovan said. "You basically needed good computers and distribution. You can always buy a Fannie, Freddie or Ginnie Mae pool. You just go online and buy it. You can't buy a Ford Motor Credit deal, because you have to know people."

CSFB went from third in underwriting structured finance in 2000, behind Lehman and Salomon Smith Barney, to first in 2001, when it issued $96.3 billion in securities. Its market share increased 50 percent to 12.7 percent. The bank fell to fourth place in 2005, although its volume soared to $144.5 billion.

Exporting Debt

As securitization caught on, borrowing increased. U.S. consumer debt tripled in the two decades after 1988 to $2.6 trillion, according to the Federal Reserve. Foreign banks used the new technology to expand lending, seeking borrowers on their home turf.

"One of the things the United States exported overseas was a debt culture," Haley said.

While consumers were snapping up credit cards, Nicholas Sossidis and Stephen Partridge-Hicks at Citibank in London were figuring out a way to sell the new bonds. Their solution: Alpha Finance Corp., the first off-balance-sheet structured investment vehicle, or SIV.

Alpha was created in 1988 as a way for Citibank, and later Citigroup Inc., to vertically integrate its business like an oil company. The raw material was found in a loan, refined into a security, then sold to a SIV at a profit.

Citigroup, formed in a merger of Citicorp and Travelers Group Inc., which owned asset-backed pioneer Salomon, also got a new product to sell: capital notes that boast returns of more than 20 percent a year. Owners of these notes receive all the excess return when borrowers pay their bills on time, though they are the last to be paid when times get hard.

Citi SIVs

In the beginning, SIVs were small and cautious. Alpha was capitalized with $100 million of equity that supported $500 million of commercial paper and medium-term notes. The SIV could hold only debt rated A- or higher and didn't take any currency or interest-rate risk, according to a 1993 Fitch Ratings report.

Alpha was followed by a slew of SIVs with names such as Beta Corp. and Five Finance. By 2007, Citigroup's SIVs had $90 billion of assets, equal to the stock market value of PepsiCo Inc., making up about one-fourth of the entire SIV industry.

In 2003, the bank was sued by creditors of Enron Corp. for its role in setting up entities that enabled the

Houston-based company to move assets off the balance sheet for Chief Executive Officer Jeffrey Skilling. Citigroup paid $1.66 billion in March to settle the lawsuit. Skilling, a former McKinsey consultant, was convicted of accounting fraud and is serving a 24-year prison sentence.

Mismatched Funding

Starting around 2005, securitization began to rely more on short-term money-market funds for financing. This was especially true for securities made by pooling other bonds, known as collateralized debt obligations, or CDOs. Investors were loath to buy long-term debt of issuers that didn't have a track record, so new issuers sold asset-backed commercial paper that matured in less than a year. While money markets are the cheapest way to finance, they can also be the most dangerous for borrowers because they can mature as soon as the next day.

"What happened in 2005 was that because of subprime and some other changes, commercial paper and asset-backed securities offered a bigger spread than anything that had ever been in the market before," said Deborah Cunningham, chief investment officer of Federated Investors in Pittsburgh, who oversees $235 billion in commercial paper. "It was hundreds of basis points, as opposed to 10 or 20 basis points before."

SIVs, banks and CDOs sold trillions of dollars of asset- backed commercial paper between 2005 and 2007 in maturities ranging from nine months to overnight. In the U.S., the amount outstanding marched higher almost every week beginning in April 2005, peaking at $1.2 trillion for the week ending Aug. 8, 2007.

'Huge Appetite'

Once money-market funds began to be tapped for financing, Ocampo said, "it created a huge appetite for high-yield assets, far more than could be originated on a sound basis."

To accommodate the demand, banks funded more subprime mortgages, with an average life of seven years, replacing car loans with an average life of three years and credit-card bonds paid off within 18 months.

Among conservative lenders, that rang an alarm: Bankers are taught to avoid such mismatched funding, in which a lender has to pay back money before the borrower has to pay the principal.

"Most of the terrible things happening now are because of the presence of money-market assets, taking what used to be long-term funding and making it short-term," Bruce Bent, 71, who started the first money-market fund in 1970, said in an interview in July.

Reserve Funds

Bent, chairman of New York-based Reserve Funds, said he didn't buy any asset-backed commercial paper until 2007, when the market froze in the wake of the collapse of the Bear Stearns hedge funds. That's when his Reserve Primary Fund began buying castoffs of asset-backed commercial paper at cut-rate prices from other funds.

Yet asset-backed securities weren't Bent's undoing. His fund also owned $785 million in Lehman debt, bought before the firm filed for bankruptcy Sept. 15. In the two days following the bankruptcy, Reserve clients asked to pull about $40 billion from the $62.5 billion fund, and its net asset value fell to 97 cents. It was the first time that a money fund "broke the buck," or fell below $1, in 14 years. The fund is now being liquidated, and Bent hasn't given an interview since.

Reserve Primary Fund's implosion, and the subsequent seizing up of two Commonfund portfolios used by universities and endowments to hold cash, triggered a panic in U.S. money markets, cutting off this form of credit to industrial companies and banks. No one could be sure whether the banks held securitizations that had dropped in value, making them insolvent. That set off a series of bank takeovers and bailouts around the world, including a $64 billion capital injection by the U.K. government into that nation's financial institutions and 400 billion euros in loan guarantees pledged by Germany.

'Absolute Disaster'

"We've created an absolute disaster," said Nouriel Roubini, a New York University professor of economics, who predicted the failure of investment banks in a paper he wrote in February titled "Twelve Steps to Financial Disaster." "The reputation of the United States as a financial center and a leader has been tarnished significantly."

Also tarnished, if not blackened, is the securitization business itself. Sales of European asset-backed securities, including bonds for car loans and credit cards, fell by 40 percent to 12.7 billion euros in the second

quarter, and CDO sales fell by two-thirds to 10 billion euros. In the U.S., mortgage bonds issued by entities not affiliated with the government plummeted to $10.8 billion in the first half of the year, one-twentieth of the $241 billion sold in the same period in 2007.

Cioffi, Bosh

The authors of the 1988 McKinsey handbook on securitization have moved on. Rosenthal, who declined to be interviewed, became a managing director at Lehman and is now in charge of information technology at Morgan Stanley. Ocampo received a patent for risk-controlled investing and founded an institutional fund-management firm, Trajectory Asset Management. The firm doesn't have any structured-finance obligations.

Bear Stearns's Cioffi, 52, was indicted on charges of misleading investors by assuring them that his hedge funds were healthy when he knew they weren't. Cioffi, who now works out of his home in Tenafly, New Jersey, has pleaded not guilty. He declined to comment.

The Bank of New York's Bosh lost his job when his company was merged with Mellon Corp. in June 2007. He's still looking for work.

"You try to do the right thing," Bosh said in an interview this month. "And this is what happens."

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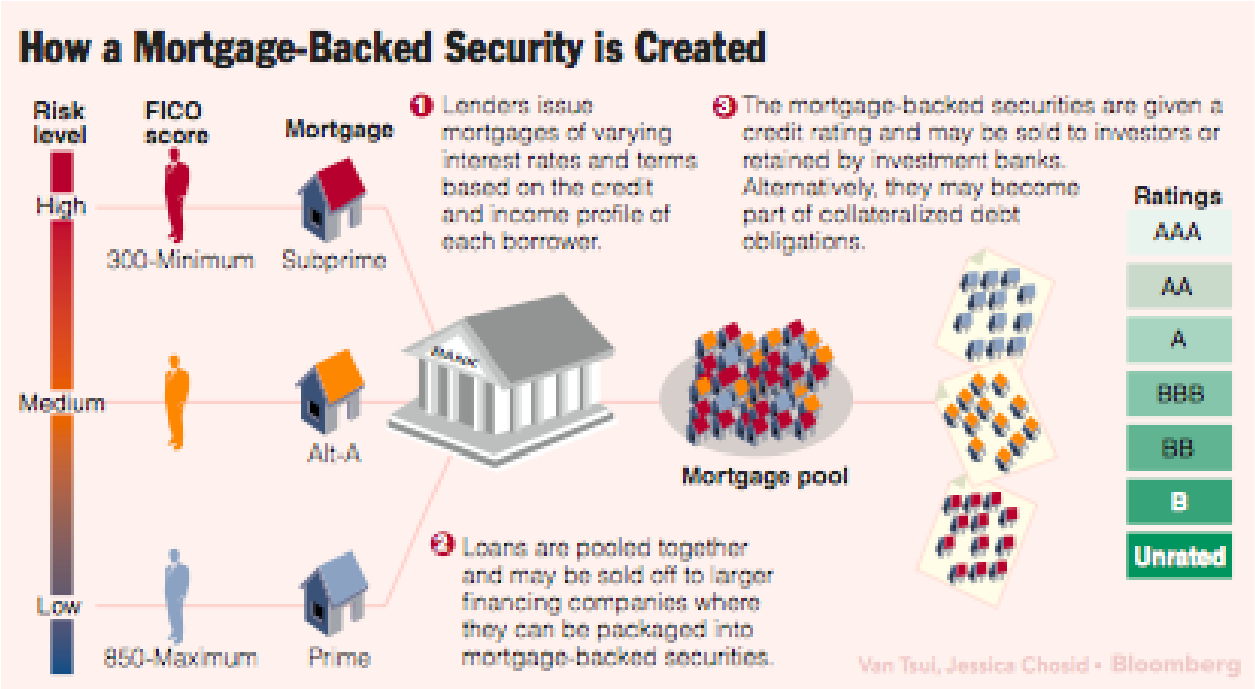

Bloomberg News

LEHMAN TOXIC DEBT ADVICE LED LEIPZIG BANK TO RUIN VIA DUBLIN

By Aaron Kirchfeld and Jacqueline Simmons

Oct. 28 (Bloomberg) -- Teachers at the Clara Zetkin Middle School in Freiberg, Germany, were counting on a budget surplus to ease staff shortages across the state of Saxony.

Those hopes have faded as a result of bets made by state-owned Landesbank Sachsen Girozentrale on structured investments backed by mortgages in the U.S. The German lender loaded up on asset-backed securities and derivatives manufactured and sold by Wall Street amounting to more than 27 times the bank's equity. Now Saxony, which pledged taxpayer money as a guarantee against losses, is on the hook for 2.8 billion euros ($3.5 billion).

"They gambled away money needed for Saxony's teachers," said Wolfgang Renner, 55, who teaches math and physics at the 106-year-old yellow-brick school in Freiberg, named for a former Communist Party leader.

It doesn't take a degree in mathematics to calculate the potential damage in nearby Leipzig, where Sachsen is based and where Gottfried Wilhelm von Leibniz, the 17th-century polymath who invented calculus, was born. Plans to replace thousands of retiring teachers and build new roads are now in jeopardy.

"As Saxony politicians, we pray every day that the guarantee won't be used," said Mario Pecher, a lawmaker in Dresden, the state capital flattened by Allied bombing in World War II. "There's a Damocles sword hanging over our heads."

Wolfgang Renner, a math and physics teacher at the Clara Zetkin Middle School, poses in a classroom at the school in Freiberg, Germany, on Thursday, Sept. 25, 2008. Photographer: Adam Berry/Bloomberg News

'Irresponsible' Loans

The bank's near collapse in August 2007 was proof of how far and wide U.S. investment banks had peddled toxic repackaged mortgages. It was also a harbinger of worse to come -- a global credit contagion that led to bailout packages from Germany to Iceland to the U.S. aimed at shoring up bank capital by partially nationalizing firms and guaranteeing lending until the storm passes.

Two days after a 50 billion-euro Oct. 5 rescue of Munich- based Hypo Real Estate Holding AG, Germany's second-largest commercial-property lender, German Chancellor Angela Merkel told an emergency session of parliament that "irresponsible" loans in the U.S. had helped destroy faith in the global financial system.

Germany's Landesbanken, whose state ownership, high credit ratings and low borrowing fees whetted their appetite for asset- backed securities earlier this decade, accounted for $22 billion of the more than $650 billion in writedowns and credit losses linked to the U.S. subprime-mortgage market. The Sept. 15 bankruptcy of Lehman Brothers Holdings Inc., the New York-based securities firm that helped set up Sachsen's biggest offshore conduit, may cost the Landesbanken half a billion euros more.

'Gambled Away Billions'

The demise of Sachsen is a story of overreaching and of how Wall Street banks exported financial technology and products whose risks were not fully understood, according to interviews with two dozen bankers, board members, credit analysts and politicians. In the end, the citizens of Saxony will probably be left holding the bag.

"They made huge bets with taxpayers' money, they gambled away billions and nobody has been held responsible," said Andreas Schmalfuss, a member of the parliamentary committee probing Sachsen's collapse.

Schmalfuss and local prosecutors are looking at whether former top executives at the bank misrepresented risks in annual reports, improperly used funds and put Sachsen in danger by setting up an off-balance-sheet conduit in Ireland to buy more asset-backed securities than it should have.

German Raids

On the morning of Aug. 12, German authorities raided the homes and offices of five former Sachsen board members. Prosecutors, police and Germany's equivalent of the FBI carted off computers and documents from 28 venues. Police in Ireland also raided Sachsen's Dublin headquarters. No criminal charges have been filed.

The searches came almost a year after a series of credit rating cuts and margin calls pushed the bank to the brink of insolvency despite a 17 billion-euro lifeline extended by other banks. Under pressure from Germany's financial authority, BaFin, which had threatened to shutter Sachsen, an emergency sale was arranged to Landesbank Baden-Wuerttemberg, the country's biggest state-owned bank, for 328 million euros.

One of the targets of the raids, according to people familiar with the investigation, is Stefan Leusder, 53, who as head of the bank's capital markets business was responsible for its principal investment vehicle, Dublin-based Ormond Quay Funding Plc, when things began to unravel.

Targeting Big League

Under Leusder's watch, investments in asset-backed securities more than doubled to almost 18 billion euros in the two years he ran the unit. Leusder, a member of Sachsen's management board, resigned on Aug. 23, 2007, three days before the bank's fire sale.

Also under investigation, the people say, are Herbert Suess, 69, the former chief executive officer of Sachsen who recruited Leusder in 2005, and former board members Yvette Bellavite-Hoevermann, Werner Eckert and Gerrit Raupach. Leusder and Suess declined to comment. Raupach didn't respond to a message left at his home, and the others couldn't be reached.

Created by regional politicians and small-town bankers in 1992 to promote economic growth in Saxony in the wake of German reunification, Sachsen was the newest and smallest of Germany's then 13 Landesbanken. That put pressure on executives to prove the bank could compete.

"The main mistake was Sachsen tried to play in a league it was way too small for," said Sebastian Scheel, a member of the committee investigating the bank's collapse.

Prague Meeting

Being small didn't stop Sachsen from thinking big. In 1999, under the direction of Claus-Harald Wilsing, a banker from Wiesbaden hired the previous year, Sachsen set up a subsidiary in Dublin to push into capital markets. The decision was made during a meeting in Prague that lasted less than 30 minutes, according to testimony Wilsing gave in January. Wilsing, who became managing director of the Dublin operation, Sachsen LB Europe Plc, declined to be interviewed.

The unit planned to take advantage of Ireland's 12.5 percent corporate tax rate -- compared with about 30 percent in Germany at the time -- as well as Dublin's proximity to Anglo- Saxon investors. Its offices were in the city's second-tallest building, in George's Quay Plaza on the Liffey River, which also housed a unit of UBS AG, the European bank that has taken the most subprime-related writedowns.

McKinsey's Proposal

At first, the Dublin unit focused on risk-averse, low-margin investments, such as European corporate and government bonds. Then, in 2000, Sachsen hired New York-based management consulting firm McKinsey & Co. to help it solve a problem. The bank was worried about what would happen after state guarantees for Landesbanken expired in July 2005 under a European Union- imposed plan designed to remove their competitive advantage. Without government backing, borrowing costs would rise, making it harder to profit in capital markets.

The McKinsey team recommended that Sachsen scale back its traditional, low-margin lending to regional firms and expand into niche businesses such as leasing, according to an October 2007 speech by Georg Milbradt, a former Saxony premier who oversaw the creation of Sachsen. McKinsey warned against an aggressive push

into capital markets, however, saying the strategy wouldn't work because the bank was going to lose its state guarantees, according to two people with direct knowledge of the situation.

Clouds are reflected in the Liffey River outside 1 Georges Quay Plaza, home of Sachsen LB Ormond Quay Funding Plc, in Dublin, Ireland, on Sunday, Sept. 28, 2008. Photographer: Tom Wagner/Bloomberg Markets via Bloomberg News

'Not Sustainable'

Despite the warnings, Sachsen management pushed ahead with plans to expand its Dublin operation, raising money by selling short-term debt so it could invest in assets backed by mortgages, credit cards and student loans. At least one board member objected, saying the bank should stay focused on loans to small and mid-size German companies. The board member, Eckhard Laible, left at the end of 2001 when his proposal was vetoed.

"I left because the strategy wasn't sustainable," said Laible, now retired and tending a farm near Stuttgart, Germany.

In 2001, Wilsing recruited Adrian Fitzgibbon, an Irishman with capital markets expertise garnered from stints at JPMorgan Chase & Co. and Lehman Brothers. There he had specialized in credit and structured products, according to the Web site of AC Capital Partners Ltd., the Dublin fund management firm he and Wilsing created with backing from the Leipzig bank.

By 2002, according to the bank's annual report, the Dublin unit was managing 11 billion euros of synthetic assets -- those in which risk is taken in the form of a derivative -- an amount 77 times the value of its shareholder equity. The Dublin unit was a boon for Sachsen: Profits nearly doubled in 2003 to 29 million euros, accounting for more than two-thirds of the bank's net income of 42 million euros that year.

'The Green Isle'

Executives in Leipzig characterized the Dublin operations as being "in the black on the green isle," Schmalfuss said.

Then Sachsen overreached. The bank's owners, including state and local governments and regional savings banks, laid out plans in the 2003 annual report to generate a 15 percent pretax return on equity by 2007. Bigger, better-capitalized banks at the time, such as Frankfurt-based Deutsche Bank AG, Germany's largest lender, had returns of about 13 percent.

"We had the problem that the pressure from the management board side, in other words from Leipzig, was very, very strong that we generate more earnings," Wilsing, now a management board member at Dusseldorf-based Deutsche Apotheker-und Aerztebank eG, a niche bank for the medical industry, testified on Jan. 21. Sachsen turned to Lehman Brothers for help. Together they created Ormond Quay Funding in early 2004, a move that would ultimately lead to the bank's demise.

Ormond Quay

Named after a wharf on the Liffey River, Ormond Quay's raison d'etre was raising money by selling commercial paper to cities, companies, money market funds and bank treasuries. The off-balance-sheet entity then bought asset-backed securities with a minimum rating of AA- from major investment banks. Among the sellers were Lehman, once the biggest U.S. underwriter of mortgage-backed bonds, Deutsche Bank and London-based Barclays Plc.

Sachsen worked with Lehman on a plan for locking in Ormond Quay's top credit ratings before the July 2005 EU deadline, people familiar with the bank's operations say. Without that government backing, Sachsen would have had the weakest rating of any Landesbank, in turn hurting Ormond Quay's rating, according to a May 2005 report by Standard & Poor's.

The solution was an agreement for Sachsen to cover all of Ormond Quay's risks until 2015, in effect extending the state's guarantee for another decade.

Ormond Quay got a line of liquidity of about 4 percent of the financing from Sachsen, which would have amounted to at least 200 million euros. The remaining 96 percent was covered by Dublin unit Sachsen LB Europe, which, as a wholly owned subsidiary of Sachsen, benefited from its state backing.

‘Bankruptcy-Remote’

That meant buyers of the vehicle’s commercial paper got paid if Ormond Quay’s assets declined in value or funding ran out. The guarantee covered sales made after 2005, since Ormond Quay was launched prior to the deadline. The agreement also kept Sachsen from having to set aside equity capital to cover Ormond Quay’s risks. A spokesman for Lehman in New York declined to comment.

S&P gave Ormond Quay an A-1+ rating in a June 2004 report, its highest for short-term debt, pointing to support for the fund from the state of Saxony. It called the conduit a “bankruptcy-remote entity” and a “novel structure.”

The table was set for Ormond Quay to feast. It grew to 8.3 billion euros of investments in asset-backed debt securities by the end of 2005 from 1 billion euros in June 2004, government documents show. That year, the Dublin unit was the bank’s best performer, reporting a profit of 44.2 million euros, offsetting losses in Leipzig and enabling Sachsen to report a net income of 17 million euros, according to the annual report.

‘Cash Cow’

“Dublin was the cash cow, and they thought it could be milked for profit,” said Karl Nolle, a Dresden lawmaker on the investigative committee. “It was like a gambling addiction.”

As the EU deadline approached, Sachsen’s credit committee, composed of Leipzig executives and politicians, stepped up its push into capital markets. In June 2005, it voted to boost Ormond Quay’s 4 percent liquidity line to allow for a maximum investment of 43 billion euros by 2010, about the size of Croatia’s annual gross domestic product.

The jump in profits at the Irish arm caught the attention of financial services regulator BaFin, which asked the accounting firm KPMG LLP to review the situation in 2004. KPMG found, according to testimony given to the committee, that Sachsen’s administrative board was unaware of the level of investments made at the subsidiary or the potential losses they posed.

Barclays Capital

By the end of 2005, the key architects of the Irish operation were gone. Michael Weiss, the bank’s CEO, and board member Rainer Fuchs, who joined the bank in 1993 and backed Wilsing’s push into Dublin, both resigned in connection with an unrelated fraud investigation at a leasing unit. No charges were filed in that case. Weiss was not available for comment.

Then Wilsing left, frustrated, he told investigators, that the board wouldn’t let him sell the unit to a larger, better- capitalized partner.

The KPMG report led Sachsen to review its risk management system. Yet over the next two years, under the direction of Suess, a former savings bank executive, and Leusder, a bearded chain smoker who replaced Fuchs, the bank accelerated its investments.

Warning Signs

In the spring of 2007, Leusder turned to Barclays Capital, Barclays’s investment banking arm, to set up a new type of structured-investment vehicle called a SIV-Lite, dedicated to residential mortgages. SIVs make money by selling commercial paper in order to invest in longer-term bonds, usually asset- backed securities and bank debt. SIV-Lites differ because they invest more heavily in mortgage-backed securities.

The timing couldn’t have been worse. In February, Sachsen’s Dublin unit boasted in a press release that it was one of Ireland’s most profitable banks, just weeks before data emerged showing that U.S. subprime-mortgage defaults had risen to a seven-year high, forcing more than two dozen lenders to close or sell operations. The warning signs prompted Germany’s central bank, the Bundesbank, which helps regulate financial firms, to ask Sachsen and others about their investments in mortgages to American homeowners with dubious credit histories.

Still, Sachsen pressed ahead.

“The bank at first initiated no noticeable measures to limit the volume or risk,” an Ernst & Young LLP report concluded a year later. “Quite the opposite: The businesses were expanded.”

‘Successful Axis’

The Dublin-based SIV-Lite, called Sachsen Funding I, garnered a P-1 rating from Moody’s Investors Service in May 2007, the highest grade for short-term debt. It invested all of the $2.5 billion it raised in mortgage-backed securities, including subprime assets, according to government documents as well as Moody’s and Ernst & Young reports.

Sachsen was so gung-ho it featured a two-page color photo in its 2006 annual report, published in May 2007, featuring Jane Privett, then a Barclays Capital director, sitting in a London cab above a caption praising the bank’s “successful Dublin- London-Leipzig axis.” Privett, who recently left Cheyne Capital Management Ltd., a London hedge fund firm, declined to comment.

In July 2007, two Bear Stearns Cos. hedge funds heavily invested in subprime assets collapsed, triggering a global credit crisis. As fears about collateral damage spread abroad, Sachsen said on Aug. 10, 2007, that it had “sufficient liquidity” and didn’t expect Ormond Quay’s asset-backed securities to default.

“The mistrust of the market cut off our liquidity,” Sven Petersen, who replaced Wilsing as head of the Dublin unit, told a parliamentary hearing.

Time Runs Out

On Aug. 16, Fitch put Sachsen’s credit rating on “watch negative,” citing concerns about cash commitments to Ormond Quay. The next day, the bank obtained a 17 billion-euro credit line from other state-owned banks to repay debt sold by its Dublin unit.

Still, on Aug. 20, S&P cut its assessment of Sachsen debt to BBB+ from A-, saying the bank “needs to restore investor confidence.”

It had no time to do so. A few days later, Barclays warned it would make a margin call on two funds that Sachsen had invested in, according to Ernst & Young and four people with direct knowledge of the matter. Sachsen realized on Aug. 22 that the Leipzig bank could incur 250 million euros in losses from a sale of those assets. When politicians balked at a fresh bailout, the bank sought a buyer.

‘So Dangerous’

“An insolvency of Sachsen would have had far-reaching consequences for the entire banking landscape in Europe,” Milbradt said in what has since become a common refrain around the world.

Emergency talks were held, and at 2:30 a.m. on Sunday, Aug. 26, the bank agreed to sell itself to Stuttgart-based LBBW. Siegfried Jaschinski, LBBW’s chief executive officer, stunned Sachsen employees when he said the Irish funds accounted for about half of the bank’s income.

“It’s not that they didn’t know the business was there, but that it was so dangerous,” Jaschinski said in a telephone interview in May.

When LBBW got cold feet four months later, Saxony agreed to provide guarantees of up to 2.8 billion euros to cover losses on a new fund, into which 16 billion euros of assets from Ormond Quay and Sachsen Funding were placed. Jaschinski signaled at a Sept. 10 banking conference that he would be interested in merging LBBW and what is now its Sachsen Bank unit with Bayerische Landesbank in Munich in a further consolidation of the seven remaining state-owned banks.

How Much?

Whether Saxony’s taxpayers can avoid covering losses and afford to hire new teachers next year depends on whether the homeowners backing the securities default and at what price those assets can be disposed of. Saxony’s Finance Ministry said on Sept. 19 that the guarantee hadn’t been tapped and that it had set aside about 825 million euros for possible defaults.

“We expect defaults, but how much and when we can’t say,” Finance Ministry spokesman Stephan Goessl said.

In July, Saxony and LBBW hired an outside bank to help them clean up the mess. The firm they selected was the asset management arm of Lehman Brothers, the bank that advised Sachsen on setting up Ormond Quay in 2004.

Now, with Lehman in bankruptcy, LBBW and Saxony may need to find a new adviser. And Germany will need to find a way to stop the contagion from spreading.

Following an agreement to bail out Hypo Real Estate, which came after its Dublin-based Depfa Bank Plc unit failed to get short-term funding, Germany announced plans to provide up to 500 billion euros in loan guarantees and capital to bolster the banking system, the government's biggest intervention since the Berlin Wall came down in 1989.

'Poison' Debt

The rescue, which will amount to about 20 percent of the GDP of Europe's largest economy, faced opposition from some state governments unhappy at the share of the bailout they are expected to bear. Saxony's Finance Ministry said in a statement on Oct. 14 that the state had already made a "substantial contribution" to overcoming the financial crisis with its 2.8 billion-euro guarantee for Sachsen.

Only now are European regulators getting around to addressing the lax oversight of banking activities. On Oct. 1, the European Commission published a proposal to enhance the authority of national regulators to police banks' foreign subsidiaries. The Basel, Switzerland-based Financial Stability Forum, an international group of regulators and finance officials, has put forward measures requiring banks to report off-balance-sheet exposure and raising capital requirements for liquidity facilities such as Sachsen's Dublin conduit.

That won't help the citizens of Saxony. In Leipzig, where Johann Sebastian Bach composed some of his most beautiful music, there is no shortage of discordant voices.

"The poison was the off-balance-sheet vehicles that far outweighed the amount of risk the bank could shoulder," former board member Laible said. "The bank might have survived had it invested within the scope of its own capital."

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With reporting by Neil Unmack in London, Karin Matussek in Berlin and Mark Pittman in New York.

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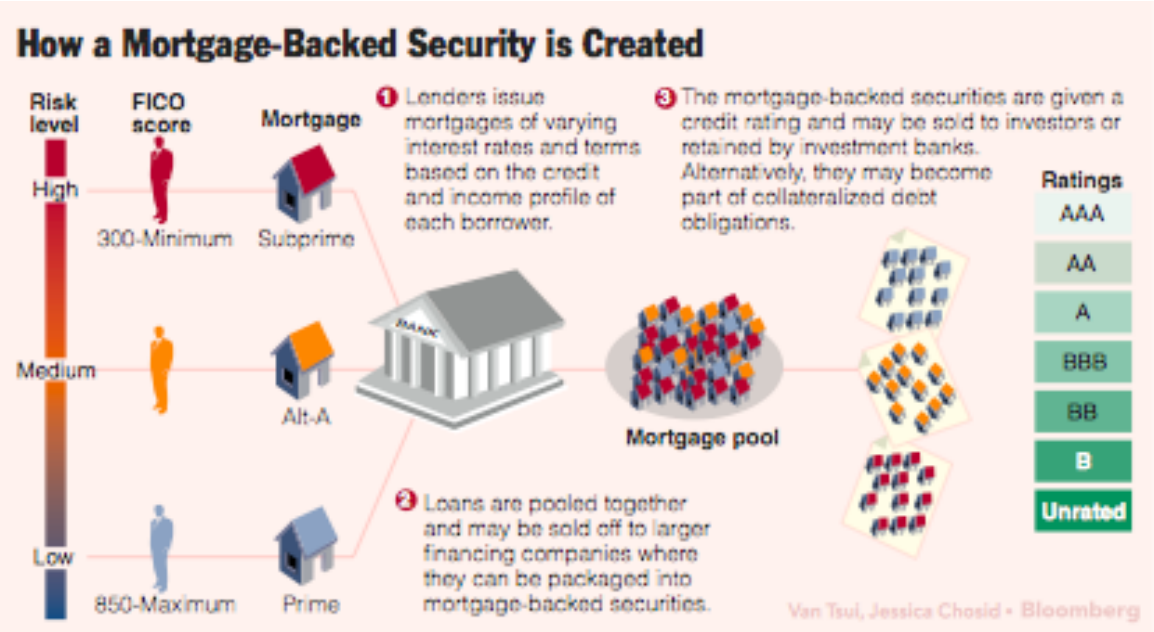


Bloomberg News

MIZUHO $7 BILLION LOSS TURNED ON TOXIC AARDVARK MADE IN AMERICA

By Finbarr Flynn

Oct. 29 (Bloomberg) -- Alexander Rekeda, a 34-year-old Ukrainian-born math whiz, turned in his BlackBerry and security card and sent an e-mail to his bosses at Calyon, the investment- banking unit of Credit Agricole SA. Then, along with ten colleagues from the New York structured-finance team, who fired off similar messages, he walked two blocks down the Avenue of the Americas to Mizuho Financial Group Inc.

It was Dec. 8, 2006, and Rekeda's arrival was a coup for Mizuho, Japan's second-largest bank by revenue. A month earlier, it became the first Japanese lender to list on the New York Stock Exchange since 1989 -- a move hailed by John Thain, then chief executive officer of the bourse, as a sign that Mizuho was taking "its place among the world's leading companies."

The hires would prove a costly blunder. Rekeda, who became head of structured credit in the Americas, and his team led Mizuho into a business it knew little about, securities backed by U.S. subprime mortgages, where it lost 672 billion yen ($7.1 billion), more than any bank in Asia. Most of the losses were related to defaults on collateralized debt obligations.

Mizuho expects as much as 20 billion yen in potential further losses on bonds and bad loans related to bankrupt Lehman Brothers Holdings Inc., company spokeswoman Masako Shiono said on Sept. 16. Moody's Investors Service, citing "questions regarding the effectiveness of Mizuho's risk management and its risk appetite," continues to give the bank a negative outlook.

"Mizuho never made a penny out of subprime in the good times, they just got left holding the can in the bad," says David Threadgold, an analyst at Fox-Pitt Kelton Asia Ltd. in Tokyo who has an "underperform" rating on the stock. "They made a very poor decision to launch into the packaging of subprime products at the end of 2006."

Toxic Assets

How a Japanese bank that traces its roots to 1864 made such a bold entry into the U.S. subprime securities market, and almost choked on the toxic assets it created, is a tale of overreaching and poor timing. It also illustrates how financial technology made in the U.S. wreaked havoc on the other side of the globe.

Many of the details are spelled out in a lawsuit Calyon filed against Mizuho in U.S. federal court seeking $750 million for "covertly" inducing its employees to quit. The case was settled out of court in September 2007 for an undisclosed amount. Shiono said Mizuho wouldn't comment for this article.

Rekeda, who has a master's degree in mathematics from Kiev State University of Economics in Ukraine and an MBA from the University of Connecticut, had built Calyon's CDO business over two years. He closed six deals for the French bank in 2006, according to an affidavit in the case.

The Mizuho Financial Group Inc. logo is displayed outside a Mizuho Bank Ltd. branch in Tokyo, Japan, on Tuesday, Nov. 13, 2007. Mizuho Financial Group Inc., Japan's second-largest bank by revenue, said full-year profit fell by half as subprime losses mounted. Photographer: Tomohiro Ohsumi/Bloomberg News

Signing-On Fee

All six, including two with the celestial names Cetus and Orion, later defaulted as Paris-based Credit Agricole racked up more than 6.5 billion euros ($8.1 billion) in subprime losses. Rekeda, now 34, declined to be interviewed.

On Oct. 18, 2006, Rekeda and his team were offered an $11 million signing-on fee to defect to the Japanese bank, a Calyon lawyer said at a court hearing. Mizuho's plan to expand into the U.S. was hatched earlier that year, as Japanese lenders were recovering from a 14-year debt crisis that forced them to take $1.1 trillion in writedowns for bad loans.

Mizuho, formed in 2000 in a merger of three banks, beat out rivals Mitsubishi UFJ Financial Group Inc. and Sumitomo Mitsui Financial Group Inc. to win approval from U.S. regulators to set up a financial holding company. That enabled it to operate as a full-service investment bank.

As Mizuho President Terunobu Maeda said at a press briefing on May 15 this year, the bank had excess capital and "needed to study" the U.S. mortgage-backed securities business.

Pedestrians walk past the Mizuho Financial Group Inc. headquarters in Tokyo, Japan, on Thursday, July 31, 2008. Mizuho Financial Group Inc., the Asian bank with the largest subprime-related losses, said first- quarter profit rose 14 percent as income from lending increased and bad-loan costs fell. Photographer: Tomohiro Ohsumi/Bloomberg News

Bad Loans

Maeda, 63, a former chairman of the Japanese Bankers Association and an amateur gardener who doesn't use air conditioners at his home during Tokyo's humid summers to make an environmental point, became president of Mizuho in April 2002. The bank recorded a loss of 2.38 trillion yen that fiscal year as it wrote off bad loans accrued during three recessions in a decade. Maeda returned it to profitability the next year after reducing non-performing assets and through gains on investments in Japanese stocks.

While Mizuho was a newcomer to the CDO market in the U.S., it had experience arranging and selling similar investments in Japan and Europe. The company had ramped up its loan- securitization business, which Japanese banks were able to do without borrowers' consent after October 1998. Merrill Lynch & Co., Bear Stearns Cos. and Goldman Sachs Group Inc. all helped Japanese banks repackage and market securities backed by corporate loans and mortgages.

Rising Delinquencies

Even so, Mizuho decided it needed help in the U.S. Talks with the Calyon team began in early 2006, when Douglas Munson, a sales director for the French bank, approached golfing buddy Theodore Ake, head of fixed income for Mizuho in New York, according to two people familiar with the negotiations. The size of the group and the amount of sign-on bonuses snowballed after Rekeda was brought into the discussion, the people said. Munson and Ake declined to comment.

By the time the deal was consummated, the market was turning. On Dec. 11, 2006, the same day Mizuho announced it was setting up an office in the U.S. to create asset-backed debt securities, Fitch Ratings said the outlook for U.S. subprime mortgage bonds was "negative." It expected delinquencies on those loans to rise by 50 percent.

There was also confusion about the hiring deal. The Calyon team turned out to include more than the five people expected by Hitoshi Shimoyama, then deputy president of investment banking unit Mizuho Securities USA Inc., documents in the case allege.

"Mizuho did not even know the number or names of additional persons until shortly before they came," Shimoyama said in a March 17, 2007, affidavit.

Bonus Pool

Benjamin Lee, one of those who defected on Dec. 8, returned to the French bank five days later. He said he "had been misled by Rekeda" about the terms of employment at Mizuho, according to an affidavit he filed.

Lee said he was initially told by Rekeda that he could expect $1 million to $1.5 million from a bonus pool. He later learned there was a separate contract for him and other junior members of the group that didn't include a revenue-related bonus. Senior team members were entitled to share as much as 25 percent of revenue from completed transactions, court documents said.

Rekeda's group priced its first deal within 10 weeks, after the Mortgage Bankers Association reported that the default rate on U.S. subprime loans reached 12.6 percent, the highest level since the first quarter of 2003.

Aardvark CDO

The deal was named after a squat animal with a pig-like snout that feeds on ants and termites. Incorporated as a special- purpose company in the Cayman Islands, Aardvark ABS CDO was an ugly concoction: 31 percent of its $1.5 billion of securities were backed by subprime loans, 23 percent by residential mortgages repackaged from other CDO deals, and 33 percent by Alt- A mortgages, a category just above subprime. The remaining 13 percent were prime loans.

One reason Rekeda was able to move so fast was that the deal had already been assembled by London-based Lloyds TSB Group Plc, which pulled out before completion, said three people familiar with the transaction. HarbourView Asset Management Corp., a unit of New York-based OppenheimerFunds Inc., stayed on as manager. Spokesmen for Lloyds and HarbourView declined to comment.

Moody's assigned its highest short-term rating of P-1 to $1.3 billion of the Aardvark securities. In the prospectus, Mizuho pledged to back 87 percent of the deal, meaning that the bank, rather than investors, was on the hook for most of the potential losses.

In the Pipeline

A subsequent Mizuho offering, Tigris CDO 2007-1, valued at $902 million in March 2007, was backed by the lowest investment- grade tranches of CDO deals arranged by other Wall Street firms, including Merrill, Lehman and Citigroup Inc., according to a report that month by Fitch Ratings. More than 80 percent of the securities in the CDO had Fitch's lowest investment rating, BBB-, which is nine grades below AAA.

Rekeda planned to bring at least nine more CDO deals to market within six months, the investment newsletter Asset-Backed Alert reported on May 11, 2007. The newsletter quoted him saying the bank had "built up the pipeline." As of April 1, 2007, Mizuho Securities had amassed more than 550 billion yen in residential mortgage-backed securities and CDOs supported by home loans, according to the bank's financial statements.

One of those deals made it to market in June 2007: a special-purpose entity called Delphinus 2007-1. Although named after a constellation, its contents were hardly stellar. Three- quarters of its securities were based on subprime mortgages, according to a July 23 Fitch report.

Ratings Downgrade

About 80 percent of the deal was backed by credit-default swaps arranged by firms including JPMorgan Chase & Co., Citigroup and Wells Fargo & Co. Citing "strong demand" from investors, Mizuho increased the size of the deal that July to $1.6 billion from $1.2 billion.

That was eight days before two Bear Stearns funds were shut down, heralding the start of the subprime crisis. Less than three months later, on Sept. 27, Fitch put Delphinus on its watch list. The negative designation, Fitch analyst Kevin Kendra said at the time, was "probably the quickest I've seen" on a CDO. In other words, Mizuho struggled to find buyers for its CDOs and, as their values plummeted, the bank would have to absorb the loss.

Mizuho didn't tell investors about the extent of its exposure until November 2007, when it reported a 70 billion-yen loss on subprime-related securities in the first half ended Sept. 30. It also said it expected that figure to grow to 170 billion yen for the full year.

1251 Avenue of the Americas, where Mizuho Bank has offices, in New York, October 28, 2008. Mizuho lost 672 billion yen ($7.1 billion) on investments in U.S. subprime mortgages, more than any bank in Asia. Most of the losses were related to defaults on collateralized debt obligations. Photographer: Chip East/Bloomberg News

CDO Default

By December, Mizuho had halted its U.S. CDO business. It fired Rekeda and at least four others on the team, putting an end to the bank's one-year experiment with American financial technology.

In January, as delinquencies on loans that backed Mizuho's CDOs increased, Aardvark, Tigris and Delphinus went into default. Subsequent downgrades of all of the tranches of Tigris and Aardvark required the bank to write down the value of the CDOs.

Mizuho had to inject 150 billion yen of capital into its securities unit, shelve a planned merger with Shinko Securities Co. and axe 300 jobs. The bank's shares lost half their value in the fiscal year ended March 31.

When a record 2,474 shareholders gathered at the Tokyo International Forum on June 26 for the bank's annual meeting, they were out for blood.

"The responsibility rests at the top with Maeda," Kenjiro Endo, 66, who bought Mizuho shares when he retired from chipmaker Toshiba Corp. six years ago, said after the meeting. "If this were overseas, he'd resign."

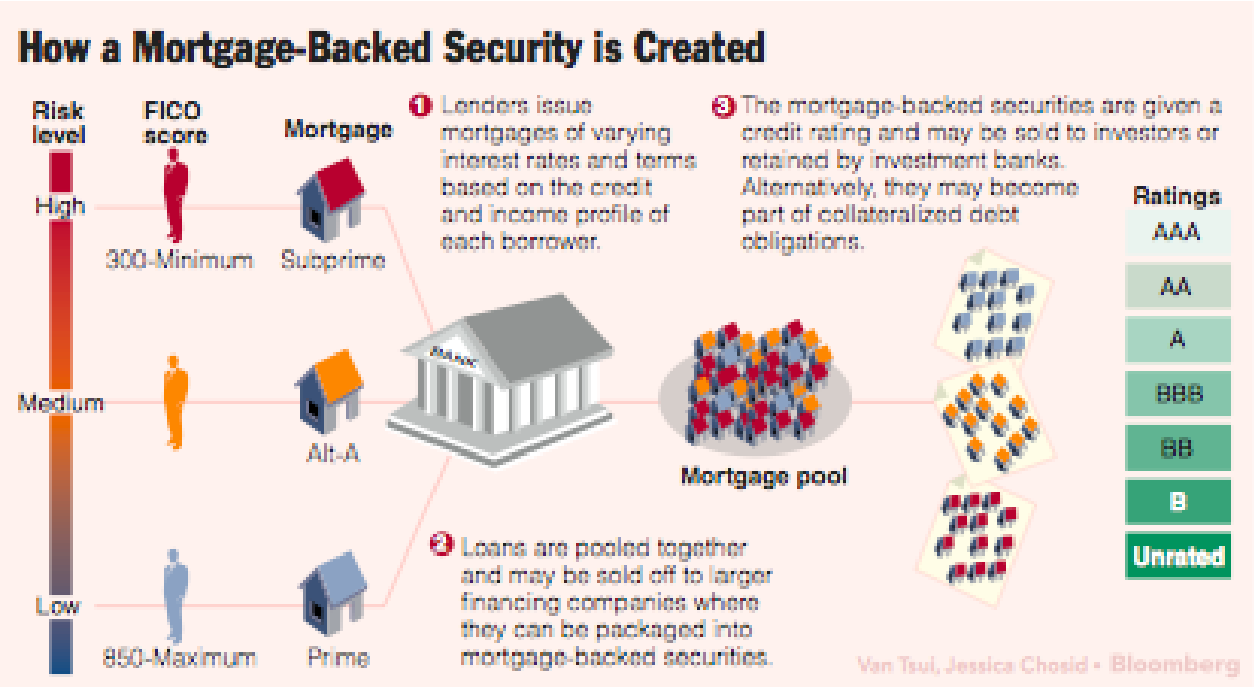
'Market Crashed'

Endo may have had a point. Citigroup CEO Charles O. "Chuck" Prince, Merrill's Stan O'Neal and Wachovia Corp.'s Kennedy Thompson were all forced to resign after significant subprime losses. In Japan, where executives often bow and apologize for their mistakes, Mizuho's Maeda stood firm.

"Unfortunately, from October, the securitized investment- product market crashed, and even if we tried to sell the investments, it wasn't possible," Maeda said at the shareholders' meeting. "When the market stops functioning, there is no measure to avoid it."

Maeda also defended the bank's decision to enter the U.S. securities market.

"It's not because of some management failure that things turned out like this," he said. "I am very sorry to tell you, doing nothing, and not taking risk, is not a bank."



Failure to Hedge

Yet Mizuho might have incurred half as many losses if it had accelerated the sale of subprime-related investments and hedged more bets with credit-default swaps, according to a person familiar with its U.S. operations. The bank, fearing it would lose as much as two-thirds of its potential profit, decided not to hedge, the person said. Mizuho declined to comment.

"The holding company was unable to grasp the size of losses at Mizuho Securities when the subprime problem emerged," said Keisuke Moriyama, a Tokyo-based analyst at Nomura Holdings Inc. "Mizuho has a governance problem. How it fixes it is the biggest issue that faces the group."

The ultimate cost to Mizuho may be greater than the 672 billion yen it wrote down. The bank, the first in Japan to put money in U.S. financials amid the credit crunch, invested $1.2 billion in Merrill in January. The Wall Street bank's shares have slumped 70 percent this year.

'Missed Out'

Now Mizuho is sidelined as other Japanese banks swoop in to buy troubled U.S. assets. Nomura purchased some of Lehman's Asian and European businesses in September, and Mitsubishi UFJ, the nation's largest bank, acquired 21 percent of Morgan Stanley for $9 billion.

"Mizuho has totally missed out," said Amir Anvarzadeh, director of Japanese equity sales at KBC Financial Products in London. "They've been very aggressive overseas, trying to grow this business organically, and some of those ambitions have come back to haunt them."

Although it was the biggest loser, Mizuho wasn't the only Japanese bank that got hurt. In all, 672 domestic banks and credit cooperatives had 1.5 trillion yen in losses from overseas securitized products, the country's financial regulator reported Sept. 4.

Rekeda, meanwhile, has moved on. He now works for Guggenheim Capital Markets LLC in New York, along with Paolo Torti and Xavier Capdepon, who both followed him from Calyon to Mizuho. Their new jobs: selling distressed CDOs at a discount.

With reporting by Christine Harper and Mark Pittman in New York.

Editors: Neil Western, Robert Friedman.