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FCIC memo of staff interview with Yves Smith

Yves Smith

Gary Cohen

Randall Dodd

Bruce Mcwilllams

MFR

Yves Smith

Interview on November 12, 2010

FCIC: Gary Gohen
Randall Dodd
Bruce McWilliams (MFR reporter)

Roosevelt Institute

____ Massachusetts Ave.

Selected quotes from Yves Smith

"There's always going to be a tranche which constrains demand. There's always a push to work around the constraints. They began pushing structures. "

"The CDO was like a pig. What piece of the pig can't you sell? It was the tail and the hooves, so you grind those into sausage. (16:21) that was a CDO. The earlier CDOs weren't subprime only, there were other assets. But that market imploded"

"The problem with the CDOs was that ultimately, they're a ponzi [scheme] because no one wants to buy the lower tranches of the CDO. So you have to keep rolling the CDO into other CDOs into other CDOs unless the whole CDO market keeps growing, which it can't forever. Eventually, the music's going to stop."

17:00

"CDO were originally designed to solve the problem that you run into limits on a deal structure. And they tend to abuse CDOs because the CDOs an actual Ponzi."

"It's a Ponzi because it requires the market to continue to grow larger and larger."

19:11

"In 2003, when subprime market took off, real cash buyers were buying CDO's. The weird confluence of event in 2004 -2005, real cash buyers, both in subprime market and CDO market, and this might be an accident, but the ISDA in 2005 allowed for standard contracts for credit default swaps on asset backed securities. Now it was possible to do credit default swap on subprime market."

21:00

"And people like John Paulson, who had tried to short the market, but had to go to banks which took a long time, suddenly this made it easy. The firms which were leaders in this business, could have been devised by, I have a sneaky suspicion it was Deutsche Bank."

24:53

"In the 3rd quarter of 2005, it was light the turned on, you say a huge take off in really toxic loans, because the shorts wanted the actual worst possible cash bonds. The act of shorting them or placing them would distort spreads, that was actually keeping the party going. 50% to 70% of demand came for subprime came from CDOs.

The traders for European banks could earn big bonuses from negative carry trade.

Were CDOs bought or sold?

A London derivatives traders said that the only way these things were sold were to chumps with drugs, hookers, and expensive alcohol. This stuff ended up with town councils in Australia, so I would say a lot of this was sold.

1:13

So when real cash buyers got nervous in 2005, it became one that was increasingly sold.

1:23

In 2006 and 2007, CDOs were driving demand for subprime. Without lack of CDO demand, subprime would have died. The crisis would have died sooner under its own weight. In fact, CDOs kept the party going much longer and encouraged the creation of the really bad mortgages.

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