Banks, Investors Are Chewed Up by The Caymans Crocodiles Called SIVs

by Richard Freeman

The meltdown, since July, of the off-balance-sheet, highly leveraged, speculative $320 billion-in-assets Structured Investment Vehicles (SIVs), which has contributed to the constriction of credit in the mortgage-backed security (MBS) and commercial paper markets, as well as the intensification of the ongoing collapse of the world financial system, has reached a decisive point. On Nov. 30, Moody's Investor Service announced that it had placed "under review for potential downgrade" $105 billion of the assets and debts of SIVs, or about one-third of those in existence, carrying implications for all SIVs. On Dec. 5, a London-based financial expert told *EIR*, that Moody's would take two to three weeks, to review whether these SIVs met the liquidity, asset-quality, and other standards that are required in their founding contracts. If they do not, then Moody's would slash their ratings from their present already inflated Aaa, down by 3-12 notches. At that point, certain "triggers" in the SIVs by-laws will be ignited, causing the banks that created the SIVs to either place the off-balance-sheet SIVs on the balance sheet, which would cause large losses and other ongoing problems; or the SIVs would be compelled to liquidate their assets at fire-sale prices.

This would throw hundreds of billions of dollars worth of "assets" that the SIVs hold—mortgage-backed securities (MBS), collateralized debt obligations (CDOs), securities backed by credit card receivables, the debt of collapsing bond insurance companies, such as MBIA Corp.—onto the market, at markdowns of 30-75%. It would crumple the MBS and CDO markets, and bankrupt tens of thousands of other institutions that hold them.

And, it has broader implications: States from Florida to Montana to Connecticut, as well as municipalities, bought billions of dollars of debt of SIVs, in the form of commercial paper and medium-term notes. The failure of the SIV paper has impaired the revenue funds of these states that hold them. In Florida, the state's Local Government Investment Fund (LGIF), which holds and invests the money of Florida's counties and municipalities, invested $2.3 billion into SIV instruments. On Dec. 12, it was learned that the LGIF will pay back only 86% of the municipalities' original investments. Some Florida cities and towns will have to slash vital services.

What's Worse Than a Collapse?

SIVs now are collapsing so fast, that many will be destroyed before Treasury Secretary Henry Paulson's so-called Master Liquidity scheme—which was supposed to save them—even gets off the ground.

The underlying axiom, upon which it was presumed that SIVs would be a runaway success, was the concept of Venetian-style usury, otherwise known as financial arbitrage. The SIV borrows funds at a lower interest rate, through the issuance its own short-term commercial paper, and invests it in other speculative financial paper that pays a higher interest rate (and has a longer maturity). Then, the SIV amplifies, by 10-12 times, the profit it supposedly is making from this interest-rate arbitrage, by using a heavy leverage (borrowed funds ratio) of 10-12:1.

But now, the SIVs have broken down on both their borrowing side, and their asset side.

In keeping with its reputation as a financial "innovator," the SIV sector—like the $2.3 trillion-assets hedge-fund pirates—was deliberately incorporated exclusively in the British Cayman Islands, the British Queen's dictatorship, run by and for the City of London's wealthy banking families. There, it is offshore and off-balance-sheet, outside the control and regulation of the United States and other sovereign nations. The policies of the SIVs, in fact, are steered from these Cayman Islands.

During the past three weeks, both in anticipation of, and reaction to Moody's Nov. 30 announcement of a "review for potential downgrade," various large bank originators of SIVs have taken their failing off-balance-sheet SIVs onto their balance sheets, or made large cash infusions, building in large losses for themselves in the process. This includes HSBC (Hongkong and Shanghai Banking Corporation) taking its $45 billion offshore Cullinan & Ascher SIV onto its balance-sheet; Standard Chartered taking on its Whistlejacket SIV, etc. The banks fantasize that they can "wait out the crisis," and the SIVs will eventually recuperate their value. This is like taking a ticking timebomb, that is sitting in the backyard, and bringing it into the living room.

At the same time, since the SIV meltdown began, starting October, Treasury Secretary Paulson has run around like Lady

Courtesy of Cayman Islands Dept. of Tourism

The SIV sector was incorporated exclusively in the British Queen's Cayman Islands, run by and for the City of London's wealthy banking families. There, it is outside the control and regulation of the United States and other sovereign nations.

Macbeth, peddling the Administration's mad scheme, called the Master Liquidity Enhancement Conduit (MLEC), which was to contain $75-80 billion, to bail out the SIVs. But, the MLEC plan is dead on arrival.

The SIV blowout has sent convulsions through the world banking system, but the concerted push by the world's central banks and by Paulson, for a super bailout of the system, is infinitely worse. This has triggered a hyperinflationary process that mimics, but is worse than, the one which struck Weimar Germany with full force during the second half of 1923.

On Dec. 8, Lyndon LaRouche proposed: "Quarantine the SIVs; put them into bankruptcy," because a number of institutions which bought faltering SIV paper have already become "SIV-positive," i.e., contracted a terminal disease. LaRouche's Homeowners and Bank Protection Act (HBPA) would ultimately put the bankrupt world financial system, which is already finished, through bankruptcy reorganization, and clear the grounds for sovereign, cheap, productive credit issuance to foster world economic reconstruction.

Any attempt to preserve the SIVs in their present form, will only produce immense damage, as will be manifest once the functioning and operations of the SIVs is understood.

Venetian-Modelled Looting

Various participants in the SIV market, including the cofounder of the first SIV in 1988, Stephen Partridge-Hicks—who has written a book about SIVs and securitization in general, entitled *Synthetic Securities*—try to portray SIVs as extremely advanced instruments that "appeal to the sophisticated investor." In fact, SIVs are primitive instruments for gambling and gouging the world economy, of the type which trace back to 14th-Century Venice.

The banks set up the SIVs offshore. They appoint the SIV's trustee and/or administrator; its directors; its servicing agents, etc. They control the SIV, but lie that it is an "arm's-length vehicle." From the start, SIVs are built with immense, super-charged 10:1 to 14:1 leverage ratios; they borrowed money short-term, but invested it in long-term instruments, a violation of a cardinal rule of banking; they bought the most highly speculative assets. The SIVs' downfall was predetermined by the usurious principles on which they were based.

Let us create an example of a bank-operated SIV, a hypothetical First Predators' SIV, that has a leverage of 10:1, to see what guides it. First, the SIV issues $1 billion in equity/stock. The investors who buy it, including members of the bank's coterie, by virtue of owning all the capital of the SIV, own the SIV. They are entitled to the entirety of the SIV's profit. Against this, the SIV issues $10 billion of debt, normally in the form of SIV commercial paper, which is 30-270-day debt. So, the ratio of the SIV's debt/borrowings, to its equity—its leverage ratio—is 10:1.

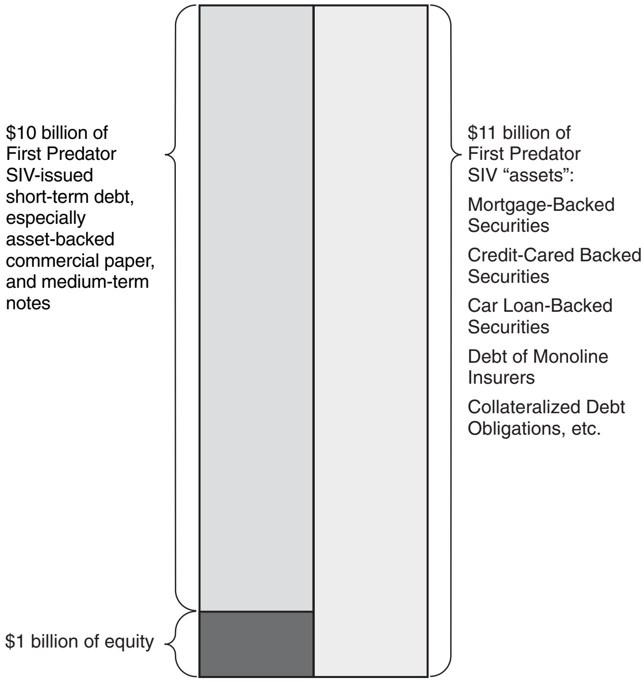
Let us assume, for illustration, that the SIV borrowed all of its debt at a rate that is 5 basis points (5/100ths of a percentage point) below the London Interbank Offered Rate (LIBOR), which we assume to be 5.50%. The SIV thus borrowed at a 5.45% interest rate.

With the pool of $11 billion ($1 billion in equity; $10 billion in debt), assume that the SIV buys various medium- to long-term assets (which because they have a longer maturity, also offer higher yield): mortgage-backed securities; asset-backed securities issued against car loans, or credit card payments; speculative collateralized debt obligations; the debt of monoline insurers, such as the now-impaired MBIA and FGIC, etc. These are the instruments that are normally bought by SIVs. It should be stressed, that the SIV does not have a single productive asset: It holds the worthless debt of other entities, and counts them as assets.

Assume also, that the SIV's assets earn 35 basis points above LIBOR, or 5.85%. So, over the course of a year, the SIV will take in $644 million ($11 billion times 5.85%) in interest income; and pay out $545 million on its debt ($10 billion times 5.45%); yielding a profit of $99 million.

The first impulse would be to calculate the rate of profit, by dividing the profit level of $99 million, by the total funds employed of $11 billion, which would yield a small rate of

FIGURE 1
'First Predator' SIV



0.9%. But this is where leverage expressly comes into play. The investors who are the equity purchasers reap all the profit, even through they only put up $1 billion of their own money into the SIV equity, while borrowing $10 billion. Thus, the First Predator SIV profit rate is considered the profit, divided by the actual equity; that is, is $99 million divided by $1 billion or a profit rate of 9.9%—a tenfold increase.

The banks and the hedge funds, which were the creators and controllers of the SIVs, were quite satisfied with the racket. By late 2006, there were 30 SIVs worldwide, and their total assets had swelled to $400 billion. But related to the world financial breakdown, serious problems were materializing in both the SIVs' assets and debts.

Cayman Islands: The Origin of the SIV Virus

During the SIVs' formative period, there was one other defining characteristic of their functioning: they were all created outside the control and regulation of sovereign nations, in the Anglo-Dutch stronghold of the Cayman Islands. From this bridgehead, they were used to undercut industrial development, and feed speculation, in alliance with their kissing cousins, the hedge funds, which are also incorporated in this jurisdiction, and which the British used as a pirate cove for marauding raids during the 17th through 19th centuries. The Cayman Islands is a British Crown colony, ruled by the Queen, through her appointed governor-general, Stuart Duncan Jack, on behalf of a core of wealthy families.

SIVs, whether of American, French, or Swiss banks, incorporated and domiciled in the Caymans, are guided by British law, banking rules, and policy. From the Caymans, British policy governs everything

A Feb. 13, 2003 article, entitled, "Structured Investment Vehicles: The Cayman Perspective," appearing in the securitization.net web magazine, and written by a leading member of Cayman's top law firm Maples & Calder, laid out the strategy:

> The use of the Cayman Islands for the incorporation of SIVs can be traced back to the emergence of the Cayman Islands as the dominant jurisdiction for offshore capital market transactions.....
>
> The 1980s brought enormous diversification in the type of capital market projects utilising Cayman Islands vehicles with the development of various securitisation and structured finance techniques, [and] the use of repackaging and derivatives.... The late 1980s also saw the development of SIVs as investment managers sought to take advantage of market arbitrage with the first SIV launched in 1988.

The article boasts that in the Caymans, for the SIV, there are no taxes, only "light," i.e., no regulation exists, and there is no public disclosure about anything dealing with the SIV's records or transactions. Then, the article offered the assurance that should an SIV incorporated in the Caymans become involved in a legal case, the "ultimate court of appeal is the Privy Council in the United Kingdom," which reports to the Queen.

But the British financier oligarchy considered the creation of the SIVs such a strategic issue, that it tasked the U.K. law firm of Allen & Overy to oversee the matter of the SIVs' buildup. Americans may draw a blank on Allen & Overy, but it is one of Britain's "Magic Circle," its five elite law firms, whose Oxbridge members move in and out of government and corporate board rooms, and handle sensitive matters and participate in making policy.

Allen & Overy was formed in 1930. In 1936, senior partner George Allen was the personal counsel to the rabidly pro-Nazi King Edward VIII. As England found it necessary to make a policy shift toward an uneasy alliance with America, it became necessary to remove Edward VIII from the throne, through the contrived Wallis Simpson affair. It was Allen, working with higher-ups, who personally convinced Edward to abdicate. Such a highly sensitive mission, would only be entrusted to someone on the inside.

In 1988 and 1989, Citibank bankers Nicholas Sossidis and Stephen Partridge-Hicks formed the first two SIVs, Citibank's Alpha Finance Corp. and Beta Finance Corp, both incorporated, it is reported, in the Cayman Islands, or the Bahamas, the nearby British enclave. In both cases, the elite Allen & Overy oversaw the creation. Geoff Fuller, who is partner of the Capital Markets division of Allen & Overy LLP, told the authors of an Oct. 18, 2007 *Wall Street Journal* article, entitled "How London Created a Snarl in Global Markets," that, in the *Journal*'s words, "most people with the necessary skills and experience [handling SIVs] are in the United Kingdom," including law firms, accounting firms, banks, etc. Allen & Overy advised in the creation of, and continues to advise, 12 of the 30 SIVs in existence in the world. The Oct. 18 *Journal* article asserted that most direction and management of the world's SIVs, comes out of London.

To document the Cayman Island-London overlap in dominating the world's SIVs, *EIR* assembled **Table 1**. *EIR* was able to obtain dependable information on the place of incorporation and/or registration of 15 SIVs. Of these, Table 1 shows that 12 were incorporated in the Cayman Islands; one was incorporated in the Caymans or the Bahamas; and two were incorporated in the British Jersey Island; therefore, there is 100% British control of these 15.

Observe that in the case of Citigroup, all seven of its SIVs were incorporated in the Cayman Islands, or the Bahamas. It was Britain's Allen & Overy that was assigned to directly oversee the formation of five, and possibly all seven, of Citigroup's SIVs.

The lusty embrace of Citigroup, the world's first- or second-largest bank, and other big money center banks, of SIVs, and other wildly speculative instruments, would soon send shockwaves throughout the world.

TABLE 1

SIVs: Controllers, Debt, Place of Incorporation, as of July 13, 2007

Manager-Controller	SIV	Senior Debt ($ Billions)	Place of Incorporation or Registration
Axon Asset Management	Axon Financial Funding	$11.19	Cayman Islands
Bank of Montreal	Links Finance	22.30	Cayman Islands
	Parkland Finance	3.41	NA
Banque AIG	Nightingale Finance	2.33	NA
Ceres Capital Partners	Victoria Finance	13.24	NA
Cheyne Capital Management	Cheyne Finance	9.73	Believed To Be Cayman Islands
Citigroup	Beta Finance	20.18	Bahamas or Cayman Islands
	Centauri	21.84	Cayman Islands
	Dorada	12.48	Cayman Islands
	Five Finance	12.84	Cayman Islands
	Sedna Finance	14.42	Cayman Islands
	Zela Finance	4.19	Cayman Islands
	Vetra Finance	2.62	Cayman Islands
Dresdner Kleinwort	K2	29.06	NA
Eaton Vance	Eaton Vance Variable Leveraged Fund	0.54	NA
Eiger Capital Management	Orion Finance	2.30	NA
Gordian Knot	Sigma Finance	52.64	Cayman Islands
	Theta Finance	NA	NA
HSBC	Cullinan Finance	35.14	Cayman Islands
	Asscher Finance	7.33	NA
HSH Nordbank	Carrera Capital Finance	4.28	NA
IKB	Rhinebridge	2.20	NA
IXIS/Ontario Teachers	Cortland Capital	1.34	NA
MBIA	Hudson-Thames Capital	1.77	Jersey Island
NSM Capital Management Emirates Bank	Abacas Investments	1.01	NA
Société Générale	Premier Asset Collateralised Entity	4.31	NA
Standard Chartered	Whistlejacket Capital	8.84	Jersey Island
	White Pine	7.85	
Rabobank	Tango Finance	14.04	Cayman Islands
WestLB	Harrier Finance Funding	12.34	NA
	Kestrel Funding	3.32	NA

Sources: Moody's; Standard & Poor's; Reuters; EIR.

Shockwaves

From February 2007 onward, the failure of subprime, Alt-A, and regular prime home mortgages, and the growing tsunami of home foreclosures, began to wash over the financial markets.

On March 13, New Century, the second-largest subprime lender (after Countrywide) and once a hot property, was delisted by the New York Stock Exchange, and effectively ceased to exist. New Century's market capitalization had evaporated from $1.75 billion to a mere $55 million at the point it was put out of its misery. The floodgates for crisis, in the markets for not only mortgages, but mortgage-backed securities, were now flung open.

A spotlight was shone on the SIVs because it was known that they held huge amounts of MBS. Investors began now to avoid SIV paper. It was reported earlier, that the SIVs had adopted a dangerous method to fund themselves: They bought long-term assets, such as MBS and CDOs; but they funded such purchases by issuing short-term, 90-270-day commercial paper, which must be rolled over as often as every three months. By July, investors were refusing to buy or roll over asset-backed commercial paper issued by the SIVs. It was not just the commercial paper of one SIV that investors would not buy; it was all of them.

At that time, the total commercial paper market was $2.2 trillion outstanding, of which the portion that was asset-backed commercial paper was $1.2 trillion. That latter market has contracted for 18 consecutive weeks, to a volume of $790 billion, a drop of more than one-third.

And it became undeniable that the hundreds of billions of dollars of "assets" that the SIVs held—the highly speculative MBS, CDOs, etc.—were plunging in value. Were the SIVs to sell these assets on the open market, they would be marked down by 20-70%. Thus, the SIVs, on *both sides of the balance-sheet*—the side that represents borrowing, and the side that represents valuation of assets—were collapsing. The only question was which side was deteriorating faster.

During October 2007, the Cayman Islands-incorporated Cheyne Finance (pronounced Chen-ey), which as of July 13, 2007, had held assets valued at $9.73 billion, became the first major SIV to effectively declare itself bankrupt. A plan was hastily slapped together, in which the giant Royal Bank of Scotland would rescue Cheyne by buying much of its assets. But after viewing Cheyne's assets up close, Royal Bank of Scotland backed away from the plan.

Pretending Solvency Is Not an Option

It is not optional for SIVs to declare bankruptcy. Upon the SIV's formation, the administrator and directors of the SIVs signed covenants which stipulated, that the SIVs must demonstrate that they have sufficient funds—through a mixture of selling off all their assets, and drawing down their equity base—to be able to pay off and retire every penny of their senior debt. Laws establish for the SIV certain triggers/thresholds, at which point, it must take certain action. Most important, when it can no longer retire all its senior debt from asset sales and its internal funds, it enters into a stage called "enforcement" or "malfeasance." That means it must be liquidated; this is irreversible.

The London-based financial expert who spoke to *EIR* Dec. 5, also emphasized that Moody's Nov. 30 announcement of a "review for potential downgrade" of SIVs' debt of $105 billion, has significance: it could trigger the procedure of "malfeasance": i.e., ultimate liquidation of the SIVs.

In this context, consider the desperate action that leading banks have taken with respect to SIVs:

- On Nov. 7, Citigroup infused an emergency $7.6 billion into its seven SIVs.
- During the last week of November, HSBC Holdings announced that it would take $45 billion of the assets and debts of its two off-balance sheet SIVs, Cullinan Finance and Asscher Finance, onto its books, and close the two SIVs. This clears up nothing, as it leaves HSBC with $45 billion of radioactive paper;
- On Dec. 3, WestLB Ag, Germany's third-largest state-owned bank, infused an emergency $11 billion credit line, to its Harrier Finance SIV;
- On Dec. 3, the Hamburg-based HSH Nordbank AG provided $3.3 billion in back-up funding to cover its Carrera Capital SIV's failed commercial paper.
- On Dec. 9, Société Générale, France's second-largest bank, took $4.3 billion of the assets of its Premier Assets SIV, onto its books.

But the SIV timebomb keeps on ticking.

Spreading Contagion

The listing of state and local governments that have revealed themselves to be "SIV-positive"—that is, have used their investment fund monies to buy toxic and failing SIVs' financial paper—is growing. This infectious state may imperil these governments' financial survival, and engender, as the case of Florida shows, the slashing of vital services.

- Orange County, Calif.—the fifth-most populous in the United States—revealed that the County's Extended Fund had invested $460 million, or 20% of its total $2.3 billion investment, into SIVs. But beyond the Extended Fund, the county has another $837 million invested in radioactive SIVs. John Moorlach, who is a former Orange County treasurer, and is now a county supervisor, uttered the lethal words on Dec. 7: "We'll find out real quick, if we have a problem."

It should be recalled that in 1994, Orange County became the first county in 60 years to go bankrupt, when its portfolio of derivatives lost $1.6 billion. It shut down critical services across the board.

- The Dec. 5 *Boston Globe*, in an article headlined, "Volatile Holdings Part of State Fund," reported that the Massachusetts Municipal Depository Trust, which holds total assets of $5.6 billion, had invested $134 million "in volatile 'structured investment vehicles.'" The MMDT fund is an investment pool meant for state and municipal entities to place their monies until they need it to pay bills.
- *The Day* in Connecticut reported Dec. 5, that officials overseeing the state's $5 billion Short-Term Investment Fund (STIF), "might soon have to dip into their reserves for the first time in the fund's 35-year history to keep cities and towns from losing their money." The STIF had invested $100 million in the London-headquartered Cheyne SIV.
- In Florida, indispensable services are on the verge of being shut down. As reported, the state's Local Government Investment Pool had invested billions of dollars into SIVs, and the fund had been frozen since Nov. 30, after it suffered a run on its funds that cut the $27 billion pool to $14 billion. The Dec. 5 *Wall Street Journal* reported that the chief financial officer for the Jefferson County school district, which has $4.1 million in the state's frozen fund, said that he had to stop payment on checks totalling $500,000 to vendors the previous week, so that teachers could be paid. Meanwhile, a whopping 95% of the Clay County Utility Authority's cash is invested in the Florida-run investment fund. "We're very concerned about the possibility of defaulting on some contracts that are already in place," said the chief operating officer. This could cause curtailment of electricity supply.