The Hooking of Whitefish Bay

An excerpt from
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

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After attending Oberlin College and Princeton University’s Woodrow Wilson School of Public and International Affairs (MPA 1975), Les Leopold cofounded and currently directs two non-profit educational organizations: The Labor Institute (1976) and the Public Health Institute (1986). He designs research and educational programs on occupational safety and health, the environment and economics. He is now helping to form an alliance between the United Steel Workers Union and the Sierra Club. This profound work of non-fiction should be required reading for anyone who has ever had a job and everyone who believes that only fools limit their dreams for a better world.

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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.”

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 . . .”

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.” School boards repeatedly referred to him as their “financial advisor” — a label he never refuted.

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. For the schools to lose their investment, “out of the top eight hundred companies in the world, one hundred would have to go under.”

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 Noack – 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. 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.)

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.”

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. 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.
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.”

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.

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
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.” 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. Technically, Mr. Noack may have been correct when he said that the schools didn’t own any sub-prime 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

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It’s hard to blame the Wisconsinites for not understanding the transaction:

“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.”

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. They weren’t.

Les Leopold
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. 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.

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

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...”

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.
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