FINANCE

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$700 billion of taxpayer money to buy "mortgage-related securities" is simple. A Treasury official said the language is intentionally broad to give Paulson room to maneuver.

But the reality is that nothing these days is as simple as it sounds — which is part of the problem. Take the phrase "mortgage-related securities." What does that really mean, anyway? The truth is, even many Wall Street pros don't know.

"The problem is, the plan is not clear," said Gibran Nicholas, chairman and chief executive of the CMPS Institute, an Ann Arbor, Mich.-based organization that certifies and trains mortgage bankers and brokers. "No one knows what we're going to buy."

One thing is clear: The home buyer on Main Street is just one link in a very long chain. And the term mortgage-related securities could mean anything from a mortgage-backed bond — in its simplest form — to the alphabet soup of highly levered — not to mention highly inscrutable — securities and derivatives brandishing odd names like CDOs, CMOs and CDSs.

Driving the fall of financial giants such as Washington Mutual, Lehman Brothers and Fannie Mae and Freddie Mac are not just a handful of subprime mortgages gone sour, but the proliferation of all these complicated mortgage-related securities and derivatives that nobody — except the federal government — is willing to buy.

WHAT ARE CMOs?

Let's take collateralized mortgage obligations (CMOs) since they are the easiest to understand.

Wall Street banks take subprime loans and bundle them together. These loan bundles are then sliced, usually into six pieces, which have been sorted and packaged by degree of risk. These debt instruments are then sold to various investment groups such as hedge funds, insurance companies and mutual funds.

The highest rated slice is typically "Triple-A" rated. The lowest possible tranch, typically known as the "equity" portion, or the very first part to take any losses, is unrated and often referred to as "toxic waste," because it is so high-risk. In the past, investment banks kept these equity tranches on their own books.

But Wall Street got more creative. The idea was to take unrated equity slices from a whole bunch of different CMOs and pool them together and create a brand new security.

That pool would then be sliced into another six pieces and sorted again by varying degrees of risk into an entirely new security called a collateralized debt obligation, or CDO. The highest rated slice in the CDO would typically be stamped Triple AAA, and the lowest was again referred to as the equity tranch and was unrated.

So now you have an equity tranch of a CDO made up of already junky tranches of a subprime mortgage-backed security. Got that?

Now we are many, many light years removed from that tangible house someone bought on Main Street.

The issuance of global CDOs rose to $503 billion in 2007 from $157 billion just three years earlier.

"You've just made gold out of horse hair," said Brian J. Battle, vice president of Precision Trust Capital Partners in Chicago. "So they have taken all the dredge and cut it up again and now they suddenly have a triple AAA rated security and made that dredge salable."

The financial alchemy did not stop there.

BAD BETS ON CDSs

The wizards of Wall Street also fashioned other types of mortgage related securities called credit default swaps.

A credit default swap, or CDS, is like an insurance policy between two parties designed to cover credit risk. But they are unregulated and there is no central exchange for reporting or clearing, said Kenneth Kapner, president and CEO of the Global Financial Markets Institute, a New York-based training and consulting firm that specializes in derivatives, fixed income, foreign exchange and risk management.

In a typical CDS, the buyer pays a fixed fee or premium to the seller of protection for a period of time, Kapner said.

If something bad happens — a company goes bankrupt or a bond defaults or the housing market collapses and borrowers stop paying their mortgages — the companies that sell protection are forced to compensate the protection buyer, thus insulating the buyer from a financial loss, he said. That's the theory, anyway.

In a low-default environment, it worked like a charm, and those premiums fell directly to the bottom line and everyone was happy, he said.

However, as the financial crisis escalated through 2008, financial fortunes turned and companies like AIG and Lehman Brothers, both major players in the CDS market, found themselves on the hook for billions of dollars to cover all those losing bets.

And so the dominoes began to fall. Banks that could not collect on their winning bets could not afford to pay their losing bets, which caused other banks to default on their bets, and so on, explained Kapner.

Stephen Selbst, a law partner at Herrick, Feinstein in New York calls Paulson's plan to buy up all these mortgage-related securities "stunning in its opacity."

"It's incredible the Bush administration would ask for such vast and unfettered discretion to be placed in the hands of an unelected official with no legislative oversight," Selbst said.

The Securities and Exchange Commission would kick Paulson's three-page document to the corner if he tried to pass it off as a prospectus to a group of ordinary investors at Goldman Sachs, Selbst said.

And yet taxpayers are being asked to put all their money in the "Paulson fund," and take on all the risks associated with these questionable mortgage related securities, without the benefit of a prospectus that clearly outlines all the risks and rewards.

"There is no disclosure about the securities being purchased," Selbst said. "There is no disclosure about the prices being paid. There is no disclosure about how Treasury is going to set the prices."

It is not clear how much of the $700 billion bailout any of these instruments was responsible for, in part because Paulson's plan was thin on details.

In fact, it's not entirely clear if $700 billion is enough to take care of the problem when all is said and done.

During the S&L crisis, the federal government originally estimated that more than 400 thrifts with more than $200 billion in assets would be turned over to the Resolution Trust Corporation at a cost of approximately $50 billion, according to the Federal Deposit Insurance Corp. But in less than a year, the government's estimate had grown to nearly 800 thrifts with assets of more than $400 billion, and the crisis ended up costing taxpayers almost three times as much as originally projected.

"Everyone thinks the other shoe has dropped, but what if there are more shoes out there?" said Dan Gorczycki, managing director at Savills Granite, a real estate investment firm.

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