

One Bad Bond

Jupiter V is not a spacecraft. It's a CDO—one of those financial thingamajigs at the root of the economic meltdown. How one security turns a few bad mortgages into financial disaster

BY STEPHEN GANDEL

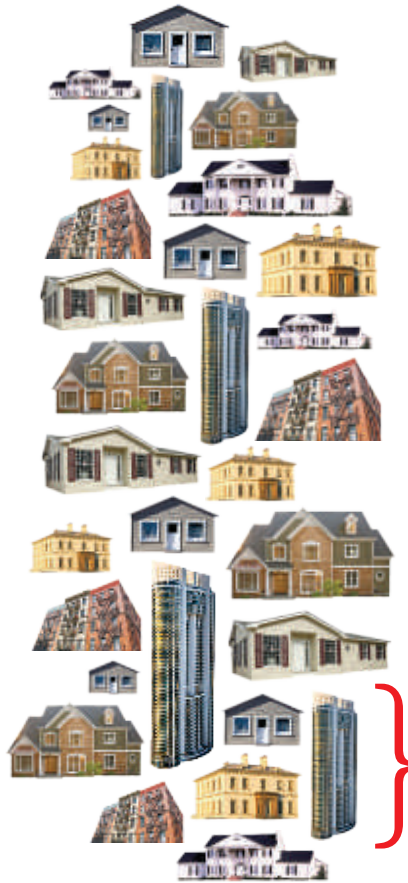
MORTGAGE BONDS USED to be the stars of finance. Home loans, after all, have a lot going for them: the vast majority of people, even today, make their mortgage payments on time. What's more, mortgage bonds are made up of thousands of home loans, giving them safety through diversity. So how did these bonds become so toxic that they've poisoned banks and threatened the entire economy?

Look under the hood of a bond called Jupiter High-Grade CDO V, and you can understand why we're in trouble. Bankers from the 1970s, when mortgage bonds first took off, would hardly recognize Jupiter. Unlike a traditional bond, Jupiter's underwriter does not buy people's mortgages,

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collect the payments and pass them on to its investors. Instead, Jupiter holds *other* mortgage bonds—and not just any. Jupiter's investments are made up of the riskiest portions of other bonds, some of which are themselves a collection of other poorly rated mortgage bonds. In a rising real estate market, such risks were deemed acceptable. When it was issued in March 2007, 93% of the Jupiter deal was rated AAA. But when things unwind—and have they ever—any default gets compounded by the chain of linked bonds. The multiplier effect works like this: while 4.4% of the typical loans tied to Jupiter's bonds are in default, nearly 59% of Jupiter's investments are now worthless. Hello, toxic asset.

The valuation of a mortgage bond like Jupiter is a white-hot argument. Most Wall Streeters agree that a large number of such bonds—amounting to hundreds of billions of dollars, perhaps trillions—are worth far less than their stated, or par, value. How much less is central to resolving the financial crisis. In early February, Treasury



The Borrowers

Just 7% of all borrowers are behind on their loans, yet hundreds of billions of dollars of mortgage bonds are nearly worthless. Here's the math behind the high finance that got us there:

HIGHEST RATED

LOWEST RATED

Mortgage Bonds

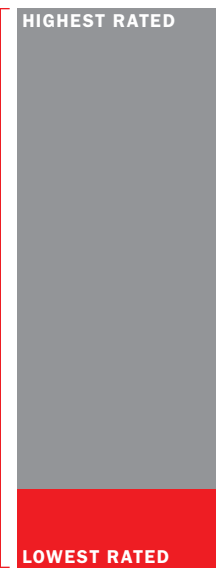
Investment bankers create these by pooling thousands of home loans—or, as in Jupiter's case, home-equity lines of credit.



LOSSES

4.4%

When loans go bad, the value of the mortgage-backed securities falls too. But since these bonds are one step removed from the loans, they have lost less than 5% of their worth.



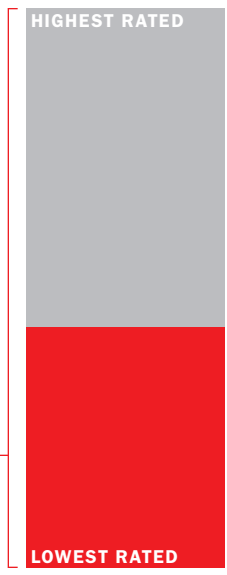
CDO No. 1

To create collateralized debt obligations (CDOs), the bankers bought the unwanted, lower-rated pieces of other mortgage bonds.



LOSSES
14%

How does the loss grow? Remember: mortgage bonds are stacked. So the bottom-rated tranches take the first loss. CDOs buy the bottom 30% of other bonds. Result: the lower 30% of the mortgage bonds become 100% of the CDO. So the losses begin to multiply. These instruments lose three times as much of their value as do the original bonds.



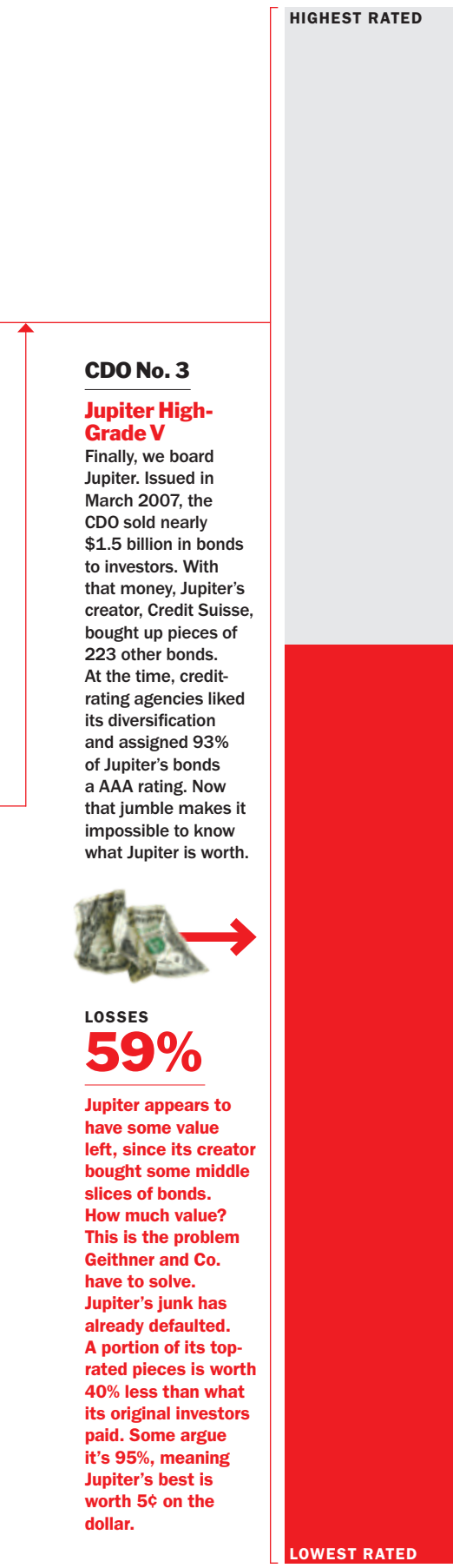
CDO No. 2

Often called CDO-squareds, they are anything but square. These bonds buy up the riskiest parts of other CDOs—lots of them.



LOSSES
36%

Here's where the small number of defaults really starts to hit the fan. CDO-squareds generally consist of pieces of the lower 40% of other bonds. So whereas a regular CDO would have losses of less than 15%, a CDO-squared would see its losses more than double.



CDO No. 3

Jupiter High-Grade V

Finally, we board Jupiter. Issued in March 2007, the CDO sold nearly \$1.5 billion in bonds to investors. With that money, Jupiter's creator, Credit Suisse, bought up pieces of 223 other bonds. At the time, credit-rating agencies liked its diversification and assigned 93% of Jupiter's bonds a AAA rating. Now that jumble makes it impossible to know what Jupiter is worth.



LOSSES
59%

Jupiter appears to have some value left, since its creator bought some middle slices of bonds. How much value? This is the problem Geithner and Co. have to solve. Jupiter's junk has already defaulted. A portion of its top-rated pieces is worth 40% less than what its original investors paid. Some argue it's 95%, meaning Jupiter's best is worth 5¢ on the dollar.

Secretary Timothy Geithner said he wanted to start a public-private partnership to buy up toxic assets. Banks hold tens of billions of dollars in mortgage bonds, and as the bonds fell in value or were wiped out completely, they erased precious capital the banks need to survive. Geithner and others believe that rescuing banks from these bonds will save them. To do that, the bonds have to be priced to sell.

A look at Jupiter shows how hard that can be. Jupiter owns 223 other mortgage bonds. One of those bonds is Mantoloking, which in turn owns 126 other bonds. Not done yet. Mantoloking's mortgage bonds own hundreds of other mortgage bonds. Those mortgage bonds are then all made up of thousands of actual loans, some of which may be current, while others may have expired. Go figure.

"It's an informational nightmare," says Andrew Lo, director of MIT's Laboratory for Financial Engineering. "It's very hard to collect all the information you need to figure out what these things are worth."

A recent Goldman Sachs report estimates that most investment banks believe bonds like Jupiter are worth 40% less than what was paid for them, or 60¢ for every dollar invested. But given how many of Jupiter's bonds have gone bad, you could just as easily guess that it is worth 41¢ on the dollar. And *that* might be generous. A top bond trader who looked at Jupiter for TIME said that on the basis of where loan defaults are headed and the loans Jupiter holds, even the best part of the bond could be worth as little as 5¢. A near total loss.

"Banks thought they could buy these bonds and lock them in their closet," says Rohan Douglas, chief executive of Quantifi, which helps investors and banks evaluate the riskiness of their portfolios. "Now those doors are being pried open, and what we are finding is one big mess." ■