



ÆGIS journal

Addressing threats that affect your bottom line

Volume 12 Number 6, June 2009

From the case files of

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1-212-695-1759

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This month's features:

- 1. Asset Location and Due Diligence — Organized crime**
- 2. OPSEC, Economic Espionage, and Competitive Intelligence — Landing the Boeing 747...**
- 3. Executive Protection — Security guards arming themselves**
- 4. Technical Issues — H1N1**
- 5. Real Stories from the Field — Pass the salt...**
- 6. Book and Product Reviews — *The Looting of America***
- 7. Subscription/Unsubscription/Copyright Information**

1. Asset Location and Due Diligence — Organized crime

Recently, there was a particularly interesting article in the Taipan Daily (<http://www.taipanpublishinggroup.com/taipan-daily-062309.html>) on the economic opportunity provided to organized crime as a result of the world's current economic plight.

Organized crime has a lot of cash. To put this into perspective, the article notes that Exxon Mobil booked a profit last year of about \$10 billion per quarter. The top three organized crime syndicates in Italy alone – and that is just the top three (and just in Italy) – off-booked estimated profits of \$20 billion per quarter. Tax free!

Since banks have been reluctant to lend money, this gives organized crime, which has lots of cash to be laundered, has a once-in-a-lifetime opportunity to legitimize a tremendous amount of cash. From our perspective, the issue is not that organized crime has lots of cash. We already knew that.

Rather, the issue is whether present AML programs are properly equipped to recognize, block, and capture this money. In theory, the answer is yes. In practice, however, the primary concern in many AML programs is compliance – not becoming the subject of a cease-and-desist order – and nothing more.

How resistant will these programs be to some combination of cleverness and bribery? We would be willing to bet cash money that organized crime managers expect to lose only a small amount to AML programs as they move to take advantage of this great opportunity. From their perspective, this is merely a cost of doing business.

2. OPSEC, Economic Espionage, and Competitive Intelligence — Landing the Boeing 747...

We pilots live by checklists. Sometimes the checklists are lengthy, and sometimes they are short. For the little airplanes I fly, the landing checklist – a fairly critical checklist – has four items, abbreviated as GUMP. But what about a big plane, like a 747? Are there a lot more? Not really. The reason for this is that landing is a critical time, and you only want to be distracted by having to check a few critical items. As an example, landing with the gear up is bad, big plane or little, and will make every landing checklist.

OPSEC practitioners are in a similar position. There are an unlimited number of pieces of IPCI (intellectual property and critical information) that

we would like to protect, but we really only have time and budget to protect the most critical of these. Looked at from the top, it may seem as if there are a huge number of pieces of IPCI that need to be protected. Which is true, sort of...

As an example, imagine that you are a company with ten divisions. Each division has any number of bits of information that shouldn't get out. But experience tells us that in each division there will be somewhere between ten and twenty items that are most critical, and that this is a number that can be managed. This same principle works up and down the food chain. There may be a huge number of things you would like to protect, but you can actually only focus on protecting a small portion of them. And in many cases, properly protecting one item will protect all the associated items.

However, if you have never performed a comprehensive audit of your IPCI you will have no idea of what is valuable to your adversaries and competitors, and therefore will have no idea of what actually needs to be protected.

How to protect your IPCI, is, of course, a separate issue, for which we hope you will call on our services.

3. Executive Protection — Security guards arming themselves

Recently we were strolling through the streets of Gotham and noticed a security guard carrying an ASP tactical baton. The ASP (<http://www.asp-net.com/>) is an excellent and well recognized tool (we are ASP instructors), and we are particularly fond of their 16 inch baton for pocket carry—it closes to 6.25 inches – though for duty use we prefer the 21 inch RBC (see the October 2006 issue of *ÆGIS*). However, our personal preferences aside, it is illegal for a security guard to be carrying an impact weapon in New York City.

We stopped the gentleman in question and asked him about his ASP. He carried it because he was afraid of being attacked, and, illegal or not, wanted to be able to protect himself. He was, as you would expect, untrained in use of an impact weapon, which means that if he needed it, he would likely simply whack his attacker over the head. This would present him – and his employer – with a set of serious problems.

Now, the astute reader either knows or has observed that most security guards these days are unarmed. They do not carry guns, not even in banks, and they do not carry impact weapons. Their job is to deter by their presence, and to be good witnesses if a crime takes place. Their job is not to

either die or kill protecting private property or money or jewelry. Here in New York City, if there is felt to be a need for an armed guard, as in banks, the likelihood is that a uniformed officer will be arranged-for.

A security guard who chooses to arm himself has misunderstood either his function, his level of risk, or his liability (and that of his employer). But let us say that he has some special knowledge of risk, and feels the need to arm himself. An illegal impact weapon in which he is untrained is a better choice than an illegal gun for which he has received no training, but nowhere near as good a choice as an illegal misting pepper-based spray (ASR) for which he has not been trained. He is certainly far less likely to kill someone! Even better would be an ASR with training. Or at least with reading *The Seven Steps to Personal Safety* (<http://www.lubrinco.com/7steps.pdf>).

That said, we do not recommend that security guards illegally arm themselves. We do, however, recommend that those supplying security guards make sure that their employees have sufficient training to understand their role and responsibilities. And that unusual problems facing a guard are brought to the attention of management and dealt with (likely in conjunction with the police) in such a way as to preclude the need for a security officer arming himself.

4. Technical Issues — H1N1

Every year in the U.S. some 65,000 people die from what is lumped together as flu and pneumonia. This is a lot of people, and there is constant fear that should another influenza pandemic strike, it could be as devastating as the 1918-1919 pandemic, in which it is now estimated that 30 to 50 million people died, including an estimated 675,000 Americans.

From the perspective of this article, we are concerned largely with the issue of how a pandemic affects *force majeure*. While many contracts have force majeure clauses (our Memorandum of Understanding does), there is always some potential issue as to what constitutes an Act of God. Does pandemic fall into this category? We would certainly think so!

That said, we would hope your legal department either has considered or is considering this issue. And, even more, we hope that the current H1N1 variant does not become any more serious than it now is.

5. Real Stories from the Field — Pass the salt...

Some time ago one of our clients bought investment property in the southwest United States, on which they intended to build apartments. As often happens, this planned development did not bring universal joy, and it was reported that there were artifacts on the land, which would disqualify it from its intended use. A quick check revealed that there were, in fact, artifacts to be found.

What to do? Being less than trusting over the coincidence of hitherto unnoticed artifacts and antipathy to the project, the obvious answer to this question for us was to bring in an archaeologist.

The archeologist confirmed that there were, indeed, artifacts on the site. Some were indigenous, some were Egyptian, some were Greek, and some were, well, you get the picture.

Now, we think that the idea of salting the land with artifacts to remove it, at least for a while, from the construction list, was a very clever idea. Mixing artifacts was a trifle less clever. Although the perpetrators get two snaps for the idea, the buildings are up and our client is happy.

6. Book and Product Reviews

The Looting of America

Les Leopold

Chelsea Green Publishing ISBN: 9781603582056 224 pages \$14.95

<http://www.chelseagreen.com/> 1-800-639-4099

There are many theories about why we went into the current economic nosedive. One commonly heard explanation is that the *Community Reinvestment Act* (http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=635f26c4af3e2fe4327fd25ef4cb5638&tpl=/ecfrbrowse/Titl e12/12cfr228_main_02.tpl) forced banks to make bad loans to people who couldn't realistically afford their houses, and that this, in turn, took the world down. While this is an attractive theory, there are a few flaws with it.

For a start, this is the Community Reinvestment Act of **1977**, and if something were flawed with the Act, it certainly should have taken less than thirty years for this to come out.

Second, the Act was designed not to encourage loans to the unqualified, but to stop redlining, the practice of arbitrarily denying or limiting financial services to specific neighborhoods (draw a red line around the area),

generally because its residents are people of color or poor. In fact, the Act specifically says:

“Safe and sound operations. This part and the CRA do not require a bank to make loans or investments or to provide services that are inconsistent with safe and sound operations. To the contrary, the Board anticipates banks can meet the standards of this part with safe and sound loans, investments, and services on which the banks expect to make a profit. Banks are permitted and encouraged to develop and apply flexible underwriting standards for loans that benefit low- or moderate-income geographies or individuals, only if consistent with safe and sound operations.”

Third, as chance has it, only twenty percent of the sub-prime loans were issued by institutions subject to regular examination or supervision. Eighty percent of the sub-prime loans were made by institutions not subject to regular examination or supervision.

Finally, losses attributed to sub-prime loans and Alt-A loans from *all* sources were less than \$300 billion.

So if the CRA isn't responsible, what is?

In *The Looting of America*, Les Leopold presents an alternative theory, which we will try to summarize here, without commentary. This will be a longer than usual review, because the subject matter requires some elucidation.

Leopold says that in the past it was believed by economists that real wages were tied to productivity: As productivity rises, wages rise. This held true until the mid-1970s, at which point the two diverged, with productivity roughly doubling in the last three decades, and real wages falling almost twenty percent from a high of \$746 per week in 1973 to \$612 in 2007.

So if productivity indicated that wages should be \$1,171 but were only \$612, where did the extra \$559 per week per wage-earner go? It went to what we will refer to as the investor class. In 1973, when productivity and wages were roughly in synch, the top one percent of earners took in eight percent of the nation's income. By 2006 the top one percent of earners took in almost twenty-three percent of the nation's income.

So, what did the investor class do with this money, which, were it in the hands of employees, would have been spent on goods and services? They invested it.

There is a limited investment market for existing tangible goods and services. While investment in *new* tangible goods and services is certainly possible, an attractive alternative was presented by investment bankers in the form of high-return exotic financial instruments like swaps and derivatives (by coincidence, this editor worked for UBS in Swaps and Derivatives), which may have no real connection to the real economy of tangible goods and services. Let us simply say that derivatives are financial instruments derived from something else, but not owning the something else. Thus, you could buy derivatives based on the Dow Jones Index or the Franc, but no stocks or Francs underlie the security. While these financial instruments can provide hedging (which can be good), they are unregulated and can allow casino-like speculation (which, as recent events indicate, can be bad).

So how could a \$300 billion loss in the sub-prime mortgage market trigger a worldwide economic collapse? To understand this, we need to start with mortgage backed securities, in which the Government National Mortgage Association buys bunches of mortgages from banks (so the banks have more money to lend). They then bundle these into securities guaranteed by the government at a set interest rate. The downside is that if homeowners pay back their mortgages (possibly by refinancing if interest rates fell) these mortgages disappear from the pool, and the investor might be given his investment back early, making the income stream unsure.

But sub-prime mortgages didn't qualify for federally guaranteed repurchase, because they were so risky. But that made them good candidates for investment banks because higher risk means higher interest rates. The problem was that the underlying mortgages were junk, and wouldn't be able to get good ratings, limiting their market. Enter the *Collateralized Debt Obligation* or *CDO* (an offspring of the Credit Default Obligation, created according to the book, by Michael Milliken). What the financial institution does is buy a bunch of sub-prime and Alt-A mortgages and securitize them. But unlike what is done by Ginny Mae, instead of there being one class of security there will be three. The top level gets first dibs on all the interest payments coming out of the pool, and has a lower rate of interest. The middle level gets dibs on anything not used by the top level. It is riskier, and so has a higher interest rate. The bottom group therefore has the highest risk – there may be no interest money left – and the highest interest rates. The folks putting these deals together were able to convince the rating agencies (see our article on rating agencies in the February 2008 issue of *ÆGIS*) that the top tier deserved an AAA rating, making them investment grade, and

purchasable by pension funds, insurance companies, banks, and the like, who would otherwise be prohibited from buying them.

Since they paid more than a standard AAA security, but had the same AAA rating which in theory made them as safe as the government-backed mortgage backed security, they were a great deal, and nobody could be faulted for buying them. Putting aside the minor detail that the underlying commodity was junk, it therefore made more sense for an investor to put money in these high-return AAA financial instruments than to invest in lower-return tangible goods and services.

Now, here is where Leopold's story starts to get interesting. These CDOs are a great business. Certainly much better than the mortgage backed securities from institutions liable to be facing constant government scrutiny, such as those institutions for which CRA reporting is required. So there is increased demand for sub-prime and Alt-A mortgages, with riskier and riskier loans being issued. But what happens if you can't sell all of the lower-level section of your CDOs? You form a new CDO – a CDO Squared – in which you pool all the crap from your other CDOs that you couldn't sell because it was too risky. Then you get the rating agencies to bless the top level as highly safe AAA. If you can't sell all of those, you do a CDO Cubed, where you gather the s**t that didn't pass muster into a new CDO, and again get the rating agencies to say the top tier is AAA. So you have junk you are selling in a CDO as AAA, crap you are selling in a CDO Squared as AAA, and s**t you are selling in a CDO Cubed as AAA.

The problem, of course, is that the investment house still owns a lot of risky mortgages, and would like to protect itself from loss. So the financial wizards tied the CDO to *credit default swaps* CDSs are essentially taking out insurance. That is to say you as originator of the CDO put up some annual fee for the swap, and if there is a default you get paid the whole amount owed from the swap. This allows the financial institution to get rid of their risk entirely. How? Simple!

Let us say you have a pool of \$100 million of sub-prime and Alt-A mortgages. You form a new financial instrument, your swap, into which investors will pour \$100 million, which you put into interest bearing government securities. You, in turn, will make quarterly payments, partly funded by your safe investment of the investors' money, into the fund, to be distributed to the investors in the swap, the top tier of which you get blessed as AAA. Those holding top-tier notes get less than those in the middle tier,

who get less than those who own the bottom tier. If there are defaults, you simply take the money out of the SWAP.

OK, so financial institutions have sold \$300 billion of defaulting mortgages because they get points, and then move them to packagers who transmogrified a part of them to AAA. It is clear how investors in the lower-level slices lose money. But how do we go from \$300 billion to half the world's economy?

Now Leopold's story gets *really* interesting. It is a real annoyance to collect and maintain the pool of sub-prime and Alt-A mortgages, but you may recall that we said earlier that derivatives can be derived from something else to which you have no direct ownership. You will also recall that we said earlier that there was investment money looking for better returns than they would get in new tangible goods-and-services investments. So you create a *synthetic* CDO, which looks, smells, and tastes just like the real thing, only it is based on mortgages that someone else owns. You sell the covering default credit swaps, put the money in government securities, and if mortgage holders default – on someone else – you get to take the money from the swap! How cool is that! Not only that, but you can make as many of these as you wish, without the pesky annoyance of dealing with real mortgages. How often can you pull this off? Leopold offers no number, but does note that financial instruments with no connection to goods and services have a nominal value of roughly ten times the global GDP.

This takes us rather neatly from \$300 billion to about \$1.6 trillion of bank losses. Plus, of course, all the losses to investors. Plus the other losses associated with unregulated financial instruments not backed by real things like goods or services.

Note that in Leopold's view the losses are not caused by mis-pricing of the derivatives because of errors in the implementation of banks' Black-Scholes models. Nor are they caused by the over-use of consumer credit caused by the combination of below-expected wages and ready investment capital. Rather, it was caused by the simple fact that when you are gambling in unregulated markets – and unregulated financial instruments not based on owned goods and services is gambling – you sometimes lose, and unlike regulated markets, like commodities markets, where there is nightly settlement, the loss potential has little to control or limit it.

Leopold includes two final chapters in which he offers suggestions about what should be done to minimize the effect of financial markets in the future. But this is just a review, so we will leave that for your reading of the book.

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