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Economic Commentary
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GHS Economic Commentary: A Simple View of the CDO-CDS Crisis

Event: Congress Debates Proposed \$700 Billion Debt Buyout and Causes of the Crisis

Summary: *We offer this thought piece in response to recent inquiries regarding the nature of the credit crisis.* The innovative system that became popular after 1999, collateralized debt obligations (CDO) backed by credit default swaps (CDS), remains interesting going forward and should not be dismissed. A better understanding of the relationships between local collateral conditions and global capital demand should be considered as part of a solution.

Key Considerations:

The problem is the relationship of local market conditions and local quality of collateral, and whether these can be instantly related back to the buyers of packaged securities (CDO's) such that the pricing of default swaps (CDS's) would match global demand for CDO's to local default risk.

- We believe that B2B integration has achieved extraordinary innovations, helping to create global matching of point-of-sale demand trends directly back to globally sourced procurement of raw materials and the movement of finished consumer goods. This system seems to show that transparency can be achieved, and that it could be successfully applied to this type of risk with positive benefits.
- The crisis appears to be the result of a mismatch of local market conditions of household cash flow, and global markets for reselling packaged securities. These were out of touch with each other, leading to imminent danger in early 2006.
- Despite advances in relational database technologies, apparently not much was done to bridge the details of the quality of collateral at origination to changing local market conditions, back through the conduits (also described as structured investment vehicles, or SIV's) to the complex CDO's that included many components of the original underliers.
- There existed natural, yet major lag factors between packaging of the CDO's and selling them and backing these with CDS's, and the rapidly deteriorating conditions in local U.S. housing markets. Inflation due to gas prices was probably not considered in rating agency models, thus missing out on the disastrous implications for diminished cash available for debt service within a large number of households.
- The lag factor required a higher risk premium but this did not occur due to the lack of visibility and due to the structural deficiency cited here.
- Better informational synchronization between local collateral conditions and the data elements of the CDO's would provide buyers and sellers with the ability to retrace cash flow components back to the originators and to the collateral.
- If this had occurred early on, and based upon developing trends in local U.S. consumer economics, then we believe that the cost of the CDS products would have risen sharply during early 2006, thus preventing the worst and most damaging phase of the crisis.
- The fundamental reasons to package securities appear to be valuable. The securitization methods that became popular in the late 1980's may be retained but reformed in regards to synchronization and data management.

Regulators should start with better data synchronization. Without sufficient data integration, then regulatory oversight of the structured finance market will probably be too restrictive. Visibility and transparency depend upon data synchronization and real-time networks.

- Regulatory oversight of the CDO-CDS markets should be considered immediately. Transparency should be the primary focus.
- We believe that the U.S. Commodity Futures Trading Commission (CFTC) is probably best suited to this situation.
- The CFTC's track record seems better than the SEC's in regards to regulatory oversight of complex markets that require trading liquidity. The CFTC approach would ensure trading liquidity. The SEC's recent history is less impressive in this regard.
- The SEC apparently was unable to understand the dangers lurking in the CDO-CDS complex, and evidently failed to discuss these risks earlier on, all seem to suggest that the SEC was and probably still is structurally not appropriate to this type of problem.
- Regardless of regulatory agency, the optimal solution will probably come from data visibility and transparency, and not from a regulatory culture based upon a prosecutorial model such as that executed by the SEC.
- The focus of regulators should be information and transparency, and not upon criminal intent to defraud investors. Investors are already losing plenty and they won't earn back anything if authorities arrest financial professionals. Market liquidity would help investors the most, at this time.
- Accounting must also be the subject of more substantial reforms, since the centuries-old model of double-entry accounting makes sense for transactions occurring where there are gaps in time (i.e., revenue recognition, or the time to deliver goods and services) and where there are gaps in space (i.e., delivery times for overseas shipments).
- Missing in this discussion is perhaps the greatest change that occurred while regulators focused excessively on criminal intent: that the world became hard-wired in real-time, thus removing much of the relevance of a time-and-space-based accounting system.
- A reform of the CDO-CDS system could be an invitation to improving accounting, especially as it relates to guidance for local markets that seek global capital.

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