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Opening Extract from...

Planet Ponzi

Written by Mitch Feierstein

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Planet Ponzi

How politicians and bankers stole your future.

What happens next.

How you can survive.

Mitch Feierstein



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'*I am not a champion of lost causes, but of causes not yet won.*'
Norman Thomas, 1930

I wish my mum were still alive to enjoy and support *Planet Ponzi*. This book is for her; she'd have loved it.

A Ponzi scheme is an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors. Ponzi scheme organizers often solicit new investors by promising to invest funds in opportunities claimed to generate high returns with little or no risk. In many Ponzi schemes, the fraudsters focus on attracting new money to make promised payments to earlier-stage investors and to use for personal expenses, instead of engaging in any legitimate investment activity.
US Securities and Exchange Commission

If the maintenance of public credit, then, be truly so important, the next enquiry which suggests itself is, by what means it is to be effected? The ready answer to which question is, by good faith, by a punctual performance of contracts. States, like individuals, who observe their engagements, are respected and trusted: while the reverse is the fate of those, who pursue an opposite conduct.
Alexander Hamilton, first US Secretary of the Treasury, 1790

Either I'm dead right, or I'm crazy!
Jefferson Smith (James Stewart) in *Mr Smith Goes to Washington* (Sidney Buchman, 1939)

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Finally, a word for many of my golfing pals. Unfortunately, those golden days on the links, when I recorded slews of eagles and torrents of birdies, have largely – bar the odd flash of brilliance – passed away. I am now, it seems, 'the world's worst putter' (and thanks, Peter, for that accolade). So a word of thanks is due for the golfers. For Shar-Pei Sammy, my only room-mate: he never talks back or argues, is always well behaved,

and has a handicap lower than mine. Thanks to Leonard Fung for losing loads of money to me – 93% of the time; to Mrs F for tolerating me; to James 'Le Jambo' G, for being a true friend, great player, and accomplished hunter. Thanks to Vassar College, and thanks to its fine president, Catherine Hill, a great economist, friend, and golfer. I thank Vassar and David Kennett for arousing my now longstanding interest in macroeconomic theory, for teaching how to be different and how to be fearless in questioning authority, and for showing why we should all 'think out of the box.' Thanks also to the boys across the road: Chalky, my first English friend, you are hilarious, a true legend, and one of the biggest-hearted people on the planet. Crispin Manson, Wyke, and Evans, you're all top men. And let's not forget about Dr Johnny Gaynor – my second oldest friend in the UK with a lovely family who nobly tolerate his golf and my visits. JG, I await my invite to the Member–Guest tournament at St Andrews.

ONE

The scheme

NOT MANY MEN have left their names to history. Bill Gates's most famous product does not bear his name. Google is named after a mathematical quantity, not the names of its founders. The most valuable IT company in the world today is named after a type of fruit.

Unlike the entrepreneurs behind these companies, Italian American Charles Ponzi did not allow history to pass him by. In November 1903, equipped with just '$2.50 in cash and $1 million in hopes,' he landed in Boston.[1] He did a series of odd jobs. In one restaurant, he rose from dishwasher to waiter – only to be fired for short-changing customers. He worked for a bank that collapsed. He went to jail for forging a check. He got involved in a scheme that smuggled illegal Italian immigrants into the US and he was jailed for that too. He was a grifter, and not even a good one. He got married. He started an advertising business. The business collapsed.

Then destiny beckoned. One day, Ponzi received a letter from Spain that happened to enclose some International Reply Coupons. The purpose of these coupons – or IRCs, as they are still known today – is to allow somebody in one country to purchase postal services in another. So if you were based in Spain, you could buy IRCs in your local Correos and send them to the US, and whoever was dispatching you your goods could

use those IRCs instead of US postage stamps. To most people, this would have seemed like a neat little idea, but one of no particular significance.

But Charles Ponzi was no ordinary person. World War One had just ended. Inflation, debt, war, and flu were wreaking havoc on the old international system – and in the process the prices of these IRCs had become seriously misaligned. Ponzi found that in Italy, for example, the land of his birth, an IRC could be purchased for approximately 25% of the face value of the equivalent US stamps, implying that $10 invested in Italian IRCs would yield over $40 worth of US stamps. Thinking like a financier, Ponzi scented profit.

He quit his job. He borrowed some money. He wired that money to his relatives in Italy and told them to buy IRCs and send them to him. As soon as he received them, he sought to cash them.

And there, alas, is where his trade fell apart. Although the IRCs were technically saleable, Ponzi was thwarted by bureaucracy and red tape. Most men, at this point, would have given up. But not Ponzi. He was only just starting.

He went to friends in Boston and asked to borrow money. He explained the vast wealth available from his IRC scheme, and promised to double their money in ninety days (implying an annual interest rate of approximately 1,500%). Some people thought the offer sounded too good to be true and kept their money to themselves. Others couldn't resist and handed over their cash. Ponzi was in business.

With the money that was now flowing in, he started up the 'Securities Exchange Company' – a grand title for a venture which, after all, was only meant to be dealing in postage stamps. He promised fantastic interest rates. He paid sales agents large commissions for every new client they brought in. In the five months to May 1920, Ponzi made over $400,000 – about $20 million in today's terms. If investors wanted to get their money back, they got it. They weren't paid out because Ponzi was trading in IRCs – in fact, he never made any use of his original scheme. Instead, retiring investors were paid out from the money paid in by new investors.

Needless to say, everyone who exited the scheme having made money from it acted as a perfect advertisement to newcomers. Look at those guys, the message went, *they* made money – what the hell are *you* waiting for?

Money continued to pour in. Ponzi deposited $3 million in a Boston bank, then bought a controlling interest in it. He lived luxuriously. He had a mansion, air-con, a swimming pool. When a local writer wrote a piece claiming that there was no legal way in which Ponzi could deliver returns on the scale advertised, Ponzi sued and won. Another $500,000.

So far, everything looked OK. Ponzi was rich. Anyone who wanted to withdraw their money was able to do so, and did indeed get paid out with the promised crazy interest rate. But that's the thing about any such scheme. It looks OK. For a while, it goes all right. But under the surface, the arithmetic is catastrophic.

What were Ponzi's assets? Forget about the IRCs, the 400% profits, the whole postal angle. Those things might have sparked Ponzi's idea in the first place, but they had nothing to do with the way the scheme actually operated. In actual fact, Ponzi just took the incoming money and placed it on deposit at the local bank. Interest rates at the time paid about 5%. Given Ponzi's extravagant expenses, however, those interest rates were no more than theoretical. In fact, the assets were constantly eroded by Ponzi's lifestyle.

Think now of the other side of the balance sheet: the liability side. As the scheme matured, Ponzi was offering 50% returns every forty-five days. That meant that every forty-five days the liability side of the balance sheet expanded by 50%. The asset side, in the meantime, was shrinking as Ponzi raided it.

Naturally, this couldn't go on long – and it didn't. The whole house of cards collapsed. Many people lost their life savings. Many others, who had mortgaged their homes to raise money to invest with Ponzi, lost their money and their homes. On August 12, 1920, Ponzi surrendered to the federal authorities. He was sentenced to (a remarkably lenient) five years in prison. On being released, he was immediately re-indicted by the State

of Massachusetts. Having no money for an attorney, he defended himself and, speaking with vigor and eloquence, was almost acquitted. In the end, however, he was sentenced to seven to nine more years in prison – which he served only after a series of further adventures, including a failed escape attempt, a whole new fraud in Florida, and a Floridian jail sentence. He died in poverty, unknown, in a charity hospital in Rio de Janeiro.

His was a useless, wasted, destructive life, but he gave his name to history. A Ponzi scheme is any financial adventure in which depositors can only be paid out by using the money of new investors. As long as the scheme is expanding, everything looks fine. The financial mathematics are bad and getting worse all the time, but you can't tell how bad a Ponzi scheme is by how you experience the ride. It's not the ride that matters, it's the way it ends.

Now, you'd be right to think that Ponzi's investors were dumb. If you think you'd be smarter than them – relax, you would be. But just as investors have become shrewder over time, so Ponzi schemes have become a little smarter too. The most outrageous recent example of a Ponzi scheme was the one operated by Bernie Madoff, under the guise of a hedge fund. When his scheme hit the wall in 2008, investors had accumulated losses of $18 billion.[2] Whereas Ponzi had been sent to federal prison for just five years, Madoff was sentenced to jail for a term of 150 years, the maximum allowed. If he gets time off for good behavior, he can look forward to being released on November 14, 2139. At the time of writing, Madoff is seventy-three years old.[3]

Madoff wasn't some sleazy, undereducated, illegal immigrant. He was as well connected as they come: chairman of the board of the National Association of Securities Dealers, member of the board of the Securities Industry Association, chairman of NASDAQ. Yet though Madoff's scheme had a more polished front than Ponzi's, it was still the same dumb trick underneath. He pretended to achieve wonderful returns, while in fact simply paying any departing investors using money taken from the new ones. Madoff is said to have called his entire scheme 'one big lie.' Although

he had been investigated back in 2003, the investigators didn't even do the basics properly. In Madoff's own words, again, 'I was astonished. They never even looked at my stock records. If investigators had checked with the Depository Trust Company, a central securities depository, it would've been easy for them to see. If you're looking at a Ponzi scheme, it's the first thing you do.'[4]

And really, that's the point. The point of this whole book. Ponzi schemes are easy to spot. They're so dumb, so obvious. The asset side of the balance sheet is so full of holes, the liability side so obviously accumulating an unpayable level of debt, you'd have to be nuts not to spot them.

Only people don't. Maybe it's that people don't like to face uncomfortable truths. Maybe it's that people can't imagine anyone could be so crooked, so unsubtle. Maybe they imagine that what looks bad to us really can't be as bad as all that – that policymakers in Washington must be on top of things, that the international financial community must have learned some lessons.

I'm not a psychologist, so I won't extend these speculations. Truth is, I just don't know how people delude themselves. It's not a trick I've ever mastered.

In any case, Charles Ponzi and Bernard Madoff were small fry. Cheap crooks who got what they deserved. They never threatened the financial system. They made some of their investors a whole lot poorer, but the world didn't come crashing down as a result.

For that – for a Ponzi scheme that would threaten to bankrupt capitalism across the entire Western world – you need people much smarter than Ponzi or Madoff. You need time, you need energy, you need motivation. In a word, you need Wall Street. But Wall Street alone doesn't have the strength to deliver a truly cataclysmic outcome. If your ambition is to create havoc on the largest possible scale, you need access to a balance sheet running into the tens of trillions. You need power. You need prestige. You need a remarkable willingness to deceive. In a word, you need Washington.

This book begins with the story of how the politicians in Washington

and the bankers on Wall Street jointly created the largest Ponzi scheme in history. The origins of that scheme go way back – at least three decades, if you think only of Wall Street, but arguably as much as sixty years if you think of the federal government.

Naturally, I'm aware that my claim sounds implausible, but I hope it doesn't strike readers as *entirely* implausible. After all, just a few years ago in 2008–9, part of the Ponzi scheme was laid bare for all to see in the shape of the subprime mortgage bust and the consequent banking crisis. That crisis was already the largest Ponzi scheme in history, so the track record is there. As for what's happening today, this book will attempt a patient accounting of the scheme, its debts, its losses, its strategies of concealment. In particular, we'll find ourselves, again and again, running across the following ingredients, key to any Ponzi scheme:

- ❏ exponentially increasing liabilities – or, in plain English, rapidly mounting debt;
- ❏ crappy, nonexistent, or inadequate assets;
- ❏ deceitful or nonexistent accounting;
- ❏ feeble, inert, or toothless regulators;
- ❏ a get-rich-quick culture, for preference salted with a whole array of inappropriate incentives;
- ❏ stupid, ignorant, lazy investors – the greedier, the better; and
- ❏ an astonishing capacity for self-delusion.

Those things are the bricks from which Washington and Wall Street constructed their castle of debt, and constructed it in plain view of all, and on a colossal scale.

If that edifice hadn't been so utterly destructive, you'd have to admire the ambition and creativity – the whole Dr Evil, death-ray megalomania

of it. And sure, Wall Street and Washington have had help. Ordinary Main Street banks did their bit. Households did more than their bit. So too did voters and media companies. The City of London was Wall Street's most willing helper, its evil Mini-Me. Poorly managed states in Europe and the Far East got in on the act. Dumb European savings banks participated. Slothful insurance companies. Crazily inept corporations who felt they had to play poker with Wall Street, not knowing or caring that the dice were loaded against them.

As we've already seen, no Ponzi scheme can last for ever. You can defy financial gravity for months (if you're Charles Ponzi) or for years (if you're Bernie Madoff), but gravity will always claim you in the end.

The first phase of the collapse of our global Ponzi scheme came on September 15, 2008, when Lehman Brothers filed for bankruptcy protection under Chapter 11 of the US Bankruptcy Code. (The earlier failure of Bear Stearns was a warning of cataclysm, but not yet the cataclysm itself.) In Lehman's filing, the bank reported assets worth $639 billion. It owed $768 billion. The bank was insolvent to the tune of approximately $130 billion. In the weeks and months that followed, horrified newspaper readers became inured to ever-greater shocks, ever greater oceans of red ink. General Motors went bust. Goldman Sachs was seeking emergency funding. Citigroup was crippled. Merrill Lynch was in crisis merger talks. The financial giant AIG was so massively bankrupt that it required $183 billion of government money to bail it out.

Across the world, the story was the same. The British government acquired most of the stock in Royal Bank of Scotland (RBS) and further holdings in various other institutions, thereby accumulating debts about equal to the UK's GDP. The Irish government undertook to guarantee its bank debt, thereby destroying its own creditworthiness. And so on.

The private sector Ponzi scheme had stopped being able to bear the weight of its own creation. Round the world, governments – a cute way of saying you, the taxpayer – were faced with the collapse of capitalism. A system no longer able to pay its way.