ASSET PROTECTION NEWSWIRE

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Causes of the International Credit Crisis

The first seeds for this crisis were sown nearly 100 years ago. Subsequent actions, motivated by good intentions or greed, planted more seeds. Now, the seedlings have grown into a jungle that some reporters and politicians cannot navigate.

In this discussion, J. Richard Duke reveals the significant actions that planted the seeds and nurtured the growth of this crisis.

More Details, page 2

Two Surprising Facts Every Offshore Investor Must Know

Diversifying financial portfolios with offshore investments may be an excellent hedge against the faltering U.S. Dollar. However, merely owning stock in a non-U.S. company does not in and of itself create offshore diversification.

More Details, page 5

Should One Pay Attention to Market Predictions in Newspapers?

The Black Swan includes discussions of whether predictions made by securities analysts and economists that are read almost daily in business newspapers are of any value.

More Details, page 6

Announcing ...

Richard Duke will be a guest speaker at the upcoming **Asia Offshore Association (AOA) Beijing Conference** at **The Peninsula** in Beijing, 7-9 March 2010. http://www2.asiaoffshore.org/conference/0905bj/index_n.html

Coming October 1, 2009: *Foreign Asset Protection Trust Tax Guide,* co-authored by Vernon K. Jacobs, CPA, and J. Richard Duke. For more information, see: http://www.offshorepress.com

Richard's Corner:

Recommended Reading:

The Black Swan—The Impact of the Highly Improbable, by Nassim Nicholas Taleb (Random House, 2007)

The Origin of Wealth—Evolution, Complexity, and the Radical Remaking of Economics, by Eric D. Beinhocker (Harvard Business School Press, 2006)

Causes of the International Credit Crisis

By J. Richard Duke

The following is a condensed version of the new Introduction that will soon be published in the seven-volume set of books, *International Trust Laws & Analysis*, Kluwer Law International, Ltd., Wolters Kluwer Law and Business.
http://www.aspenpublishers.com/Product.asp?catalog_name=Aspen&product_id=904119830X

The international debt crisis has caused asset protection planning to focus more on avoiding losses with respect to wealth and also to avoid loss of assets in future potential lawsuits. The focus now is on selecting proper jurisdictions to implement asset protection vehicles and selecting proper asset managers to manage assets. Asset managers must focus on investing in companies and industries that produce real items that consumers must purchase and less on companies and industries that produce discretionary items that consumers may not purchase. Asset managers must have knowledge, experience and expertise in selecting, maintaining and changing currencies in the ever-changing environment caused by actions of the central banks and governments around the world.

The U.S. government and the governments of other major countries around the world are using various legal means to find unreported offshore accounts by their citizens and residents. A prime example is the U.S. Department of Justice filing a John Doe summons in the U.S. District Court for the Southern District of Florida with respect to unreported accounts for Americans held at the Swiss bank, UBS AG. A further example is the proposed Stop Tax Haven Abuse Act that, among many other measures, will presume that a U.S. citizen or legal resident has control over any foreign accounts no matter how structured.

Asset protection planning has taken on new meaning as a result of the international credit crisis. The proper focus of asset protection currently is to attempt to minimize value—even substantial loss in value—of assets, particularly invested assets. Diversifying one’s investments not only in asset allocations but also among currencies has taken on new meaning because of the potential problems with respect to the U.S. dollar, which is the world’s reserve currency. The U.S. is the largest debtor nation in the world and the largest debtor nation in history. The Federal Reserve continues to inflate the money supply by computer entry, which will eventually result in a substantial devaluation of the dollar as the world’s reserve currency. China proposed establishing a basket of currencies to replace the dollar as the world’s reserve currency. If or when China’s proposal will be implemented is unknown; however, it is an example of concerns about the U.S. dollar.

Causes of the International Credit Crisis

The causes of the international credit crisis are no mystery unless one listens to the news media, politicians, the chairmen and members of the board of directors of the Federal Reserve, and mainstream economists that leave one completely confused. Thomas Jefferson wrote: “Nothing can now be believed which is seen in a newspaper. Truth itself becomes suspicious by being put into that polluted vehicle. The real extent of this state of misinformation is known only to those who are in situations to confront facts within their knowledge with the lies of the day…I will add, that the man who never looks into a newspaper is better informed than he who reads them; inasmuch as he who knows nothing is nearer to truth than he whose mind is filled with falsehoods and errors. He who reads nothing will still learn the great facts, and the details are all false.”[1]

Thomas Jefferson also wrote: “banking establishments are more dangerous than standing armies; and that the principle of spending money to be paid by posterity, under the name of funding, is but swindling futurity on a large scale.”[2] With Jefferson’s words about banking establishments, the following is a list of the substantial underlying causes of the international credit crisis:

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[1] Thomas Jefferson, THE LIFE AND SELECTED WRITINGS OF THOMAS JEFFERSON, 673, Modern Library, Random House (Adrienne Koch & William Peden Eds., 1944 and 1972).

[2] *Id.*

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The Federal Reserve and Credit Expansion

The Federal Reserve, a privately owned organization, maintained and continues to maintain interest rates at lower-than-market rates. The low interest rates, together with easy access to borrowing and the belief that values of property (such as real estate) would continue to rise caused a credit-induced boom. The factors in the foregoing sentence caused malinvestments (sometimes referred to as over-investments or improper investments not based on reality but on the fact that cheap credit was easily accessible) that at some point had to be liquidated (as all malinvestments at some point must be liquidated). Speculative manias gather speed through expansion of money and credit. Most expansions of money and credit do not lead to a mania; there are many more economic expansions than there are manias.

Fannie Mae and Freddie Mac

Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation) are government-sponsored enterprises (GSE) with a mandate to expand affordable housing in the U.S. and provide liquidity and stability to the U.S. housing and mortgage markets. Created in 1938 at the request of President Franklin Roosevelt, Fannie Mae was chartered by Congress in 1968 as a private, shareholder-owned company. Freddie Mac was chartered by Congress in 1970.

Much of the housing boom was spurred by the disproportionate increase in subprime lending, whereas borrowers had spotty credit histories or less-than-pristine credit records. Such borrowers historically found it difficult to obtain a mortgage that would enable them to purchase a home. But in 2004, the U.S. Department of Housing and Urban Development (HUD) directed Fannie Mae and Freddie Mac to purchase more loans made to subprime borrowers. This would expand the market for subprime loans and also enable the two GSEs to fulfill their affordable housing mandate in the U.S.

The Community Reinvestment Act (CRA), 1977

The CRA sought to address complaints from anti-poverty activists and housing advocates about banks allegedly discriminating against minority borrowers and "redlining" inner-city neighborhoods. The CRA decreed that banks had "an affirmative obligation to meet the credit needs of victims of discrimination in borrowing." The CRA was largely ignored until Treasury Department's 1995 regulations that made receiving a satisfactory CRA rating more difficult. The new regulations deemphasized subjective assessment measures in favor of strictly numerical ones. Bank examiners then used federal home-loan data, broken down by neighborhood, income group and race to rate banks on performance. The CRA is the underlying cause of loans to be made to individuals who could not repay those loans.

Portfolio Insurance—Black-Scholes

Professors Black and Scholes at the University of California at Berkley created a strategy known as portfolio insurance supposedly used by savvy investors. The model is based on the assumption that a trader can suck all the risk out of the market. The valuation in the securitization process and the collateralized debt obligations (CDOs) was based on an options-pricing model used by credit agencies called Black-Scholes. The model assumes that a trader can move all risk out of the market by taking a short position and increasing that position as the market falls, thus protecting against losses, no matter how deep the losses may be. The Black-Scholes glitch was discovered only after the market began crashing, leaving no buyers and the inability to sell short. As investors tried to unload stocks at the market fell, this created the very disaster they were trying to avoid. Because Black-Scholes failed, trillions of dollars of securities were mispriced without regard to the possibility of crashes and panics.[3]

Securitizations

Securitization is the process of taking an illiquid asset, or a group of assets, and through financial engineering, transforming them into a security. Structured finance is the repackaging of financial assets to allocate risk and obtain higher credit ratings. Structured finance generated great benefits for many institutions, enabling banks to repackage and apparently sell off their exposure to home mortgages, credit card loans and other assets. It is as though investors thought that somehow the securitization process had taken all the risk out of real estate financing. As the investments became more diverse, so did the pervasion of any problem into seemingly unrelated or unconnected portfolios. Investors were paid more for repackaged receivables than the amount the companies holding those receivables thought that they were worth. Why? The next two reasons for the debt crisis will answer this question.

[3] Michael Lewis, PANIC!—THE STORY OF MODERN FINANCIAL INSANITY, W.W. Morton & Co. (2009).

The Collateralized Debt Obligations and Credit Rating Agencies
The CDO was developed for the asset-backed securitization market. When a lender sells an asset, it does so to remove the asset from its balance sheet to free up capital and allow the institution to make a new loan, as well as to collect a new fee. Real estate lending went from being a portfolio business to a fee business—from a storage business to a moving business. Yet, by financing its purchaser in the sale of an asset, the loan seller is removing the asset from its balance sheet as owner but clearly reacquiring the risk of the newly pledged asset as lender. Investors misperceived and mispriced an otherwise obviously risky investment because the credit rating agencies rated the CDO transactions using the identical ratings granted to mortgage-backed security transactions and the long-standing "quality" residential and commercial mortgage-backed securities market. Continuing the discussion in the paragraph immediately above, investors misperceived and mispriced an otherwise obviously risky investment because the credit rating agencies rated the CDO transactions using the identical ratings granted to mortgage-backed security transactions and the long-standing "quality" residential and commercial mortgage-backed securities market.

The Incredible Mispricing of Risk
The problem is not with securitization, but with securitizers' and investors' almost incredible mispricing of risk. It is as though investors thought that somehow the securitization process had taken all the risk out of the real estate financing. It was definitely a very wrong conclusion—ask any B-piece buyer who does due diligence on collateral. Too much capital, lower interest rates, increased leverage, increasing values, lower cap rates, and so on, have taken down booming real estate markets before. Securitized lending was no exception. The difference was that the risk was not being assessed for the term of the loan but almost at the point of origination. Make it and sell it. *Chain of fools: hard evidence that securitization encouraged lax mortgage lending in America*, the economist, Feb. 9, 2008, available at:
www.economist.com/finance/displaystory.cfm?story_id=10641119

VaR—Value Added Risk
There aren't many widely told anecdotes about the current financial crisis, at least not yet, but there's one that made the rounds in 2007, back when the big investment banks were first starting to write down billions of dollars in mortgage-backed derivatives and other so-called toxic securities. This was well before Bear Stearns collapsed, before Fannie Mae and Freddie Mac were taken over by the federal government, before Lehman fell and Merrill Lynch was sold and A.I.G. saved, before the $700 billion bailout bill was rushed into law. Before, that is, it became obvious that the risks taken by the largest banks and investment firms in the United States—and, indeed, in much of the Western world—were so excessive and foolhardy that they threatened to bring down the financial system itself. On the contrary, this was back when the major investment firms were still assuring investors that all was well, these little speed bumps notwithstanding - assurances based, in part, on their fantastically complex mathematical models for measuring the risk in their various portfolios.

Credit Default Swap (CDS)
The buyer of a credit swap receives credit protection where the seller (apparently such as from AIG) of the swap guarantees the credit-worthiness of the product. By doing this, the risk of default is transferred from the holder of the fixed income security to the seller (such as AIG) of the swap. This gave a false sense of security to buyers of securitized instruments.

Derivatives
Derivatives are financial instruments that have no value of their own. That may sound weird, but it is the secret of what derivatives are all about. They are called "derivatives" because they derive their value from the value of some other asset, which is precisely why they serve so well to hedge the risk of unexpected price fluctuations. They hedge the risk in owning things like bushes of wheat, French francs, government bonds, and common stocks—in short, any asset whose price is volatile.

Frank Knight once remarked, "Every act of production is a speculation in the relative value of money and the goods produced."[4] Derivatives cannot reduce the risks that go with owning volatile assets, but they can determine who takes on the speculation and who avoids it.

[4] Quoted in *Unemployment and Mr. Keynes's Revolution in Economic Thought*, CANADIAN JOURNAL OF ECONOMICS AND POLITICAL SCIENCE, Vol. 3 (1977), at 113.

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Greed

In the mid-to-late 1990s, major changes in financial markets took a new turn. The financial virus spreading through the markets, which previously involved primarily new risk, broke through a significant barrier and began to involve new methods of deceit.[5] Even Alan Greenspan told a Senate bank committee in 2002: “An infectious greed seemed to grip much of our business community. The executives would be consumed with their company’s appearance, and they would doubtless enlist a network of well-paid professionals—accountants, analysts, and even lawyers—to buttress the corporate image. Through praise as exemplars of shareholder value, these executives would in fact be single-mindedly obsessed with their own enrichment. They would be at first indifferent, and later with the confidence wrought by success, arrogant about their disregard for legal and ethical norms.”[6]

Misunderstanding of the Definition of Inflation

The definition of inflation has been distorted, which results in focusing on the consequence, not the cause. Inflation is defined as the creation of money and credit out of thin air (modern times: computer entries). Inflation is “an increase in the amount of currency in circulation, resulting in a relatively sharp and sudden fall in its value and rise in prices; it may be caused by an increase in the volume of paper money issued or of gold mined, or a relative increase in expenditures, as when the supply of goods fails to meet the demand.”[7] The consequence of inflation is a general rise in prices. It is not possible to have a general rise in prices without first inflating the money supply through increased money or credit. Focusing on the consequences of inflation is similar to going to a physician for an infection caused by a splinter, and the physician gives you antibiotics to cure that infection; but the infection is caused by a splinter. Remove the splinter and the infection will go away. Remove the lower-than-market interest rates by the Federal Reserve, and the credit-induced booms will either go away or are lessened.

U.S. Investors Wanting Non-U.S. Dollar Investments

By John M. Walker, Of Counsel, Duke Law Firm

If a U.S. citizen purchases stock directly in a Swiss company, such as Nestle, this purchase does not automatically diversify the citizen’s investment portfolio with an offshore investment. First, the U.S. resident typically buys the Swiss company’s stock using U.S. dollars. The financial infrastructure supporting investment transactions by U.S. banks and broker/dealers is captive to the U.S. dollar. Transactions that involve using any other currency typically require additional steps and several business days to the execution of the transaction. As a result, purchases of non-U.S. securities through U.S. financial institutions are almost invariably made with U.S. dollars. Second, once the foreign stock is purchased, the owner holds the stock in his or her U.S. investment or brokerage account, not in an offshore account. For investors who intend to diversify their portfolio with some offshore holdings, purchasing and owning a foreign stock in the traditional manner may not accomplish their goals of diversification.

In order to accomplish offshore diversification, two scenarios present themselves. In the first scenario, the U.S. citizen deposits money into an offshore bank that converts the U.S. dollars into other currencies. The investment arm of the bank (or a third party asset manager) purchases stock in a non-U.S. company for the offshore bank account using the non-U.S. currency. Hence, the non-U.S. stock has been purchased with non-U.S. currency and is owned offshore. The second scenario is a bit more versatile. Like the first scenario, a U.S. citizen deposits money into an offshore bank that converts the U.S. dollars into another currency. The bank, or asset manager, purchases the stock for the account using this foreign currency. However, the asset manager can also purchase U.S. stock for the offshore bank account using the foreign currency. Under this scenario, a U.S. citizen can duplicate his U.S. investment portfolio using non-U.S. currency and own it offshore, thus diversifying the portfolio into an offshore portfolio.

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[5] Frank Partnoy, Infectious Greed—How Deceit and Risk Corrupted the Financial Markets, 190 Henry Holt & Company, Incorporated (2004).

[6] Roger Lowenstein, Origins of the Crash—The Great Bubble and Its Undoing, 127 (The Penguin Press) (2004).

[7] Simon and Schuster, Webster’s New Universal Unabridged Dictionary, 2nd Edition (1972).

Accomplishing either scenario has become more difficult as a result of the recent actions of the IRS and the U.S. Department of Justice against UBS. Numerous offshore banks are reluctant to work with U.S. clients. However, some banks see an opportunity to accept U.S. clients so long as the banks receive the proper qualified intermediary (QI) forms, especially the Form W-9, and further know that the clients are filing the required tax returns. It appears that most banks that will accept U.S. clients prefer that accounts be opened by foreign entities, foreign trusts, etc., again so long as the proper QI forms are received.

The minimum investment required by foreign private banks varies. Some private banks will open accounts with a minimum investment of $250,000. Others that serve a different niche of high net-worth investors require minimum investments of $1million and yet others require $3million. Generally, high net-worth investors prefer private banks or foreign asset management firms where investments are geared toward conservation and preservation of wealth instead of attempting to “beat the market” or earn high rates of returns.

If you are in a financial position to diversify a portion of your investment portfolio outside the U.S. dollar, good foreign custodial private banks are available to purchase worldwide assets in foreign currencies. Good foreign private banks can serve as custodial banks for private banking departments of U.S. banks, Registered Investment Advisors and others so that investments can be held in currencies other than the U.S. dollar.

Should One Pay Attention to Market Predictions in Newspapers?

By J. Richard Duke

Under “Richard’s Corner,” you will note reference to the book *The Black Swan*, a New York Times best seller by Nassim Nicholas Taleb. The book discusses so-called experts, such as securities analysts, and points out the record of their projections with respect to the market. The following are excerpts from the book:

> A few researchers have examined the work and attitude of security analysts, with amazing results, particularly when one considers the epistemic arrogance of these operators. In a study comparing them with weather forecasters, Tadeusz Tyszka and Piotr Zielonka document that the analysts are worse at predicting, while having a greater faith in their own skills. Somehow, the analysts’ self-evaluation did not decrease their error margin after their failures to forecast.
>
> Last June I bemoaned the dearth of such published studies to Jean-Philippe Bouchaud … one of those quantitative scientists who apply methods of statistical physics to economic variables, a field that was started by Benoit Mandelbrot in the late 1950s … Unlike economists who wear suits and spin theories, they use empirical methods to observe the data and do not use the bell curve.
>
> He surprised me with a research paper that a summer intern had just finished under his supervision and that had just been accepted for publication; it scrutinized two thousand predictions by security analysts. What it showed was that these brokerage-house analysts predicted *nothing*—a naïve forecast made by someone who takes the figures from one period as predictors of the next would not do markedly worse. Yet analysts are informed about companies’ orders, forthcoming contracts, and planned expenditures, so this advanced knowledge *should* help them do considerably better than a naïve forecaster looking at the past data without further information. Worse yet, the forecasters’ errors were significantly larger than the average difference between individual forecasts, which indicates herding. Normally, forecasts should be as far from one another as they are from the predicted number. But to understand how they manage to stay in business, and why they don’t develop severe nervous breakdowns (with weight loss, erratic behavior, or acute alcoholism), we must look at the work of the psychologist Philip Tetlock.
>
> There are those people who produce forecasts uncritically. When asked why they forecast, they answer, “Well that’s what we’re paid to do here.”

> My suggestion: get another job.
>
> This suggestion is not too demanding: unless you are a slave, I assume you have some amount of control over your job selection. Otherwise this becomes a problem of ethics, and a grave one at that. People who are trapped in their jobs who forecast simply because "that's my job," knowing pretty well that their forecast is ineffectual, are not what I would call ethical. What they do is no different from repeating lies simply because "it's my job."
>
> Anyone who causes harm by forecasting should be treated as either a fool or a liar. Some forecasters cause more damage to society than criminals. Please, don't drive a school bus blindfolded.

To look at some predictions, let's look at two articles from the front page of The Wall Street Journal, Monday, September, 21, 2009.

> ***Nations Ready Big Changes to Global Economic Policy—Rush to Set a Plan for Growth Ahead of G-20 Summit, But Enforcement Issues Loom***
> The Group of 20 nations is scrambling to finalize a plan before this week's Pittsburgh summit that would commit the U.S., Europe and China to make big changes in national economic policies to produce lasting growth as the world recovers from the worst recession in decades.
>
> ***Slack Attack: Fed Faces Test on Inflation***
> Similar slack—the unused portion of an economy's productive capacity—is evident across the U.S. Thousands of airplanes and hundreds of thousands of train cars sit unused, hotels report their highest vacancy rates in at least two decades, and millions of Americans are underemployed.

From the above two articles, both on the front page, the first article presupposes that the economy is recovering, and the second article shows exactly opposite facts. This makes the point of the author of *The Black Swan*, as well as the study of securities analysts' records that he cites.

In The News

Isle of Man

The Isle of Man's continuing high level of compliance with global standards of financial sector regulation and supervision - including international co-operation and the combating of money laundering - has been confirmed by the International Monetary Fund (IMF).
http://www.fsc.gov.im/ViewNews.gov?page=lib/news/cso/imfreportconfirm.xml&menuid=11570

Cook Islands

First Tax Information Exchange Agreement (TIEA) Signed
Following in the global trend to eliminate harmful tax practices the Cook Islands has signed its first Tax Information Exchange Agreement (TIEA) with New Zealand. The agreement is expected to enable the tax authorities of both countries to gain access to information about income and assets that would-be evaders try to hide in the other country. Other TIEAs are in

the pipeline and the goal of the Cook Islands is to be removed from the OECD grey list of unco-operative jurisdictions.
http://www.asiacititrust.com/en/news_and_events/latest_news/17

IRS Extends Deadline for Disclosing Hidden Offshore Accounts

IR-2009-84, Sept. 21, 2009

WASHINGTON — The Internal Revenue Service today announced a one-time extension of the deadline for special voluntary disclosures by taxpayers with unreported income from hidden offshore accounts. These taxpayers now have until Oct. 15, 2009.

Under special provisions issued in March, taxpayers with these hidden accounts originally had until Sept. 23, 2009 to come forward. Those taxpayers who do not voluntarily disclose their hidden accounts by the new deadline face much harsher civil penalties, where applicable, and possible criminal prosecution.

IRS officials decided to extend this deadline after receiving repeated requests from tax practitioners and attorneys around the country following an influx of taxpayer requests. By extending the deadline for a short period of time, the IRS is providing relief for those taxpayers who had intended to come forward prior to the deadline, but faced logistical and administrative challenges in meeting it. The extension will allow tax preparers and attorneys the necessary time to interview and advise their backlog of taxpayers with these hidden accounts, and prepare the necessary paperwork to qualify for the special penalty provisions.

The IRS also announced that there will be no further extensions.
http://www.irs.gov/newsroom/article/0,,id=213463,00.html

Estate Tax Faces Its Own Life-and-Death Struggle

Parties Are at Odds on How to Deal With a Levy Set to Disappear Entirely in 2010 Before Being Resurrected at Full Pre-Bush Level

The Wall Street Journal
September 19, 2009

Officially, Republicans in Congress would like to see it disappear on schedule. "There ought to be a full repeal," said Rep. Dave Camp of Michigan, the ranking Republican on the tax-writing Ways and Means Committee. "Death should not be a taxable event."

But very few believe that is possible. Republican leaders worry that liberal Democrats would accept a one-year repeal, then block any action in 2010 to ensure the tax returns in 2011, at 55%. That has put Republicans in the mood to compromise as well.

Senate Finance Chairman Max Baucus (D, Mont.) and House Ways and Means Chairman Charles B. Rangel (D, N.Y.).

Mr. Rangel agrees with the president that the 2009 estate tax -- a $3.5 million inheritance-tax exclusion and 45% rate -- should be locked in permanently. In March, Mr. Baucus proposed the same policy, though he added a provision indexing the exclusion to inflation.

But sharply different bills in the House and Senate could make a long-term solution elusive. With health care and routine spending bills jamming the Senate calendar, an estate-tax fight -- first on the Senate floor, then with the House -- could make passage of a bill virtually impossible this year, House and Senate aides say. Lawmakers likely [will] fall back on a one-year extension of the current rate and exemption and leave the fight to next year.

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