

The Subprime Primer

Branny Frank and his friends in Government decide that it is not fair that the poor folks can't own a home. So they pressure Fanny and Freddie to pressure the banks to make their loan portfolio more equitable. This pressure flows down to the loan broker.

At the Mortgage Broker's

ACE Mortgage Brokers

We make your dreams come true

Borrower - "Gee, I would like to buy a nice house but I haven't saved a dime for a down-payment and I don't think I can afford the monthly payments. Can you help?"

Broker - "Sure! Since the value of your house will always go up, we don't need a down-payment anymore! We will give you a really low interest rate for a few years. We will raise it later. OK?"

Borrower - "Sure, no problem. Umm, There's one other thing.... My employer hates me and is probably not going to verify my employment. Would that be a problem?"

Broker - "Nope, we can get you a special 'Liar's Loan' and you can verify your own employment and income!"

Borrower - "You guys are awesome! You are really willing to work with guys like me!"

Broker - "Well, we don't actually lend you the money, the banks do that. - So we don't really care if you repay the load - we still get our commission anyway."

Borrower - "Wow - lets get started!"

A few weeks later, at the Bank

First Bank of Bankland, Inc.

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Banker – “I’d better get rid of these crappy mortgage loans. They are beginning to stink up my office. Thankfully the really smart guys in New York will buy them and perform their financial magic. I’ll call them right away.”

Lets see what the smart guys are doing

RSG Investment Bank of Wall Street

Trust the Really Smart Guys for all your Investment Needs

RSG – “Phew!!! We’d better get rid of these stinky mortgage loans before they start attracting flies.”

RSG-it (RSG in training) – “But who would buy this crap? Boss.”

RSG – “I’ve got it. First we’ll create a new security and use these crap mortgages as collateral. We’ll call it a CDO (or maybe a CMO). We can sell that CDO to investors and promise to pay them back as the mortgages are paid off.”

RSG-it – “But crap is crap – isn’t it? I don’t get it.”

RSG – “Sure, individually they are pretty crappy loans, but if we pool them together only some of them will go bad – certainly not all of them. And since housing prices always go up, we really have very little to worry about.”

RSG-it – “I still don’t get it!”

RSG – “The CDO will work like this: It will be made up of three pieces (or tranches) and we will call them THE GOOD, THE NOT SO GOOD, and THE UGLY. If some of the mortgages fail, as surely some might, we will promise to pay the investors holding the GOOD tranche first, we will pay the NOT SO GOOD investor second and the UGLY investor last.”

RSG-it – “I’m starting to get it. Because the GOOD investors have the least risk we will pay them lower interest rates than the other guys right? The NOT SO GOOD will get better rates and the UGLY will get nice fat interest rates.”

RSG – “Right! But wait, it gets better. We will buy bond insurance for the GOOD piece. If we do that, the rating agencies will give it a really good rating – in the

AAA to A range. The NOT SO GOOD piece will get BBB to B ratings. We won't bother asking them to rate the UGLY."

RSG-it –"So you have managed to make AAA and BBB securities out of these stinky mortgage loans. Boss, you are a genius."

RGS –"Yes, I know. ☺"

RSG-it –"OK. Now who are we going to sell this crap to?"

RSG –"Well, the S.E.C. won't let us sell them to widows and orphans so, we will sell it to the sophisticated institutions clients. "

RSG-it –"Like who?"

RSG –" Like insurance companies, banks, small towns in Norway, school boards in Kansas – to anyone looking for a high quality safe investment."

RSG-it –"but surely no one will buy the UGLY part, would they?"

RSG –"Of course not – nobody is that stupid. We will keep that piece and pay ourselves a very handsome interest rate!"

RSG-it –"This is all great, but since we are only using the really stinky mortgages as collateral on an entirely new security, we haven't really gotten rid of them. Don't we have to show them on our balance sheet?"

RSG –"Of course not. The guys who write the accounting rules allow us to set up a shell company in the Canary Islands to take ownership of the mortgages. The crap goes on their balance sheet, not ours. The fancy name for it is ""Special Purpose Vehicle"" or SPV.

RSG-it –"That's great, but why would they let us do that, aren't we just moving our own crap around?"

RSG –"Sure, but we have convinced them that this is vitally important to the health of the US financial system that investors not know about these complex transactions and what is behind them."

Lets drop in and see the Accountants

Office of the Czar of Accounting

No nit too small to pick

The investor to the Czar –“Sir, as an investor and concerned citizen, I demand that you force our investment institutions to show greater transparency and openness in their financial reporting”

The Czar –“Go Pound Sand”

Gee – We never saw it coming

Norway Village Pension Fund manager –“Hay man – what the heck happened? We are not receiving our monthly payments!”

RSG Investment Bank –“ --- Yeah, I meant to call you but it seems really crazy around here. It seem the flaky guys who took out the mortgages that are backing your CDO aren't able to pay them off.”

Norway Village Pension Fund manager –“Wait a minute! I bought the AAA GOOD piece of the CDO. You know the safe one. We are supposed to be getting paid first.”

RSG Investment Bank –“Well unfortunately the loans were quite a bit crappier they we originally though and there is very little cash coming in. Frankly, I assure you that we are as disappointed as you are. ☺”

Norway Village Pension Fund manager –“But you told me that housing prices always go up and that the borrower could always refinance the mortgage.”

RSG Investment Bank –“Yeah, that was a bad assumption. We screwed up. Sorry ☺.”

Norway Village Pension Fund manager –“Bad assumption my frozen Norwegian butt! What about the AAA rating from the agencies?”

RSG Investment Bank –“They screwed up too! ☺”

Norway Village Pension Fund manager –“But the security was insured! What about the insurance?”

RSG Investment Bank –“Are you kidding? There’s no way they have enough money set aside to cover this mess! They screwed up! ☺ “

Norway Village Pension Fund manager –“Vell tis is yust great you idiot! What am I suppose to tell the willagers?”

RSG Investment Bank –“Tell them you screwed up! ☺”

Norway Village Pension Fund manager –“ %\$^☹*##* you. ”

There you have the mess!!