

The Free Market, Financial Style

How the Scam Works

By MICHAEL HUDSON

Newspaper reports seem surprised at how high banks are bidding for the junk mortgages that Treasury Secretary Geithner is now bidding for, having mobilized the FDIC and Fed to transfer yet more public funds to the banks. Bank stocks are soaring – thereby bidding up the Dow Jones Industrial Average, as if the “financial industry” really were part of the industrial economy.

Why are the very worst offenders – Bank of America (now owner of the Countrywide crooks) and Citibank the largest buyers? As the worst abusers and packagers of CDOs, shouldn't they be in the best position to see how worthless their junk mortgages are?

That turns out to be the key! Obviously, the government has failed to protect itself – deliberately, intentionally failed to do so – in order to let the banks pull off the following scam.

Suppose a bank is sitting on a \$10 million package of collateralized debt obligations (CDOs) that was put together by, say, Countrywide out of junk mortgages. Given the high proportion of fraud (and a recent Fitch study found that every package it examined was rife with financial fraud), this package may be worth at most only \$2 million as defaults loom on Alt-A “liars' loan” mortgages and subprime mortgages where the mortgage brokers also have lied in filling out the forms for hapless borrowers or witting operators taking out mortgages at far more than properties were worth and pocketing the excess.

The bank now offers \$3 million to buy back this mortgage. What the hell, the more they bid, the more they get from the government. So why not bid \$5 million. (In practice, friendly banks may bid for each other's junk CDOs.) The government – that is, the hapless FDIC – puts up 85 per cent of \$5 million to buy this – namely, \$4,250,000. The bank only needs to put up 15 per cent – namely, \$750,000.

Here's the rip-off as I see it. For an outlay of \$750,000, the bank rids its books of a mortgage worth \$2 million, for which it receives \$4,250,000. It gets twice as much as the junk is worth.

The more the banks holding junk mortgages pay for this toxic waste, the more the government will pay as part of its 85 per cent. So the strategy is to overpay, overpay, and overpay. Paying 15 per cent is a small price to pay for getting the government to put in 85 per cent to take the most toxic waste off your books.

The free market at work, financial style.

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