

How the Scam Works: The “Free Market” at Work, Financial Style

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Newspaper reports seem surprised at how high banks are bidding for the junk mortgages that Mr. Geithner is now bidding for, having mobilized the FDIC and Fed to transfer yet more public funds to the banks.

Yet bank stocks are soaring: that is what is bidding up the Dow Jones Industrial Average (DJIA), as if the “financial industry” really were part of the industrial economy rather than external to it and extractive rather than productive.

I think I may have figured out why banks are engaging in what seems to be over-paying. In fact, it was obvious from the outset that this is the danger. And it explains why the very worst offenders Bank of America (now owner of Countrywide) and Citibank are the largest buyers. As the worst abusers and packagers of CDO's, 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.

Here's how I think it works: 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 ³liars¹ loan² mortgages and subprime mortgages where the mortgage brokers also have lied in filling out the forms for hapless borrowers or witting crooks 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% of \$5 million to buy this namely, \$4,250,000. The bank only needs to put up 15% 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%. So the strategy is to overpay, overpay, and overpay. Paying 15% is a small price to pay for getting the government to put in 85% to take the most toxic waste off your books.

The free market at work, financial style.

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