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Commentary by Patrick Brown

Sub-prime fraud made simple

House-building is a major driver of the US consumer economy. In fact, as much of the economy deteriorates, it becomes increasingly important (along with the war business, which is completely financed by government debt).

George Bush needed domestic economic expansion to compensate for the extensive export of manufacturing work from US domestic labour to China-based labour; the transfer of the incomes of Americans to the incomes of Chinese.

There is almost no regulation of the home mortgage business in the US—'let the markets rule.' Greenspan and the Federal Reserve maintained very low interest rates in the US for the first few years of the Bush era.

The Federal Reserve does not control the 'money supply' and in fact gave up trying to keep track of it. There is almost no regulation of the issuance and trading of securities either.

Sub-Prime Mortgage Market

Mortgage companies and brokers competed for business by offering 'teaser' terms on home mortgages, awarding mortgages to individuals without the incomes to pay the payments when the 'teaser' rates expired. At that point a more realistic interest rate would be assessed, and monthly payments could more than double. Mortgage companies were also complicit by overvaluing the houses which were being mortgaged.

The term 'sub-prime' refers to the quality of the mortgages written, as measured by the percentage of the house value mortgaged (particularly if it was fraudulently appraised) and the percentage of the borrower's income committed (particularly after the 'teaser' deal expired) or if the borrower's income was fraudulently described, or both. There was, needless to say, a great deal of fraud in the granting of mortgages.

Not only that, mortgages were granted on an 'interest-only' payment plan, on which the borrower paid nothing on the principal, only interest (only for an initial term, and sometimes at a ridiculously low rate). The expectation was that the owner would build up equity in his/her house through a general rise in market prices. In the meantime, mortgage interest is deductible in the calculation of US income tax.

Rising For a Fall

House prices did rise, and new building continued at a rapid rate. Everyone who had title to a house felt richer, no matter what the amount or terms of their mortgage were. The mortgage industry now also granted 'home equity loans' on the basis of the inflated house prices, once again with 'teaser' rates.

One would have expected that this would be self-limiting. When the banks and financial corporations ran out of money to lend, they would start to insist on higher quality mortgages. It used to be, after all, that banks and financial institutions were required by law to maintain reserves equal to a certain percentage of the loans they had made—a requirement known as 'fractional reserve banking.'

However the US has all but abandoned (or privatized) the regulation of financial markets. So, banks did not carry the mortgage debt on their books, but resorted to 'securitization'. They issued bonds which purported to be backed by large collections of mortgages, and which purported to pay high interest rates. Some bonds mixed the mortgages with commercial loans called 'Asset backed commercial paper' (ABCPs).

Some mortgages would be divided among different bonds, or even different types of bonds, on the assumption that the risk would be lowered because not everything would go bad at the same time (everyone seems to have made the assumption that the foreclosure or failure rate of the debt would stay at its historical levels, which of course were low). Even the *Wall Street Journal* described this as 'sliced and diced.'

Some bonds were, in whole or in part, backed by banks or large brokerage companies. Some bonds were not backed by anything but the original collection of mortgages and ABCPs.

There was a great deal of money to be made in the issuing and trading of these securities. On the face of it, they carried high interest rates, and the risk was low because it was spread over many different types of debt. The securities were sold to many types of institutional and individual investors, sometimes 'on margin' (ie. with borrowed money, which debt could be again securitized, and kept off the bank's books).

The result was that the banks and brokerage companies made out like gangbusters without having to carry the debt—or the risk—or reporting it except as 'profits on securities trading.'

The securities offered on the face of it such attractive risk/return ratios that some banks and brokers went as far as buying and trading them for their own account! Drinking their own bathwater.

Securitization & Disclosure

The securitization of debt, through the issuance of bonds, has been going on since the Middle Ages. What has gone wrong here is that there has been no regulation of disclosure of the debt that is being securitized. This would not be a problem where the debt is easy to understand and its risk can be easily evaluated, for instance the long-term payables of a company.

But where a bond represents a package of debts, such as residential mortgages of varied and doubtful reliability; and where the package is so complicated that it cannot be evaluated by the bond buyer, the buyer must rely on the reputation of the packager for his evaluation.

But where the packager is not intending to carry the bond on his books, it seems possible that he may be a little optimistic in expressing the risk. The potential for fraud thus lies in this temptation, facilitated by the reluctance of the (US) government to regulate disclosure.

The reluctance to regulate disclosure is both philosophical, and also one of implementation; it would be difficult to know where to draw the line. Nevertheless, I would hold the government complicit in the frauds that undoubtedly underlie this meltdown.

Knocking Out the Bottom Card

During the past year, the first of the 'teaser' rates expired, and homeowners started to realize what the new higher payments would be. There was a trickle of foreclosures, but a lot more rumours, and trading in these securities started to become 'sticky,' particularly those not backed by banks (bear in mind that some banks and brokers held securities that were not backed by banks and brokers). The securities were widely and internationally held, but there was no regulatory requirement that anyone disclose what they held.

Gradually, the market for these securities (clearly a house of cards) became unstable. House prices started to drop, accelerating the foreclosure rate. Securities not backed by well-financed institutions became untradeable. Share prices of some institutions showed signs of dropping. Bailout packages in the billions were negotiated, leading to part ownership of major financial institutions, both in the US and abroad, by hedge funds and sovereign investment funds. The US dollar, in which most of these securities are denominated, dropped further. Many financial institutions are still reluctant to declare their exposure to Securitized Debt Obligations. Uncertainty reigned.

The Chinese revalued the Yuan upwards against the US$ in the last week of December.

The Emperor Has No Clothes

The sums of money involved are in the trillions. The Bush administration has initiated a program to assist people who hold home mortgages they cannot pay, but this is a political band-aid.

Much of the US Gross National Product of the last few years is an apparent fraud, though because there is no regulation and no disclosure, nobody knows how much. And it is on the basis of this fraudulent GNP that the US government has borrowed billions to finance its military adventures abroad.

Specific frauds are upon:

1. the people who took out mortgages (generally the poor, whose increasing numbers result from the export of US jobs), who expected that the increase in the apparent selling price of their homes would build equity and make them wealthy. They also expected that a 'booming' economy would increase their earnings to the point they could afford the increased payments when their 'teaser' arrangements expired (about now).
2. the people who bought houses at inflated prices, and who are now losing equity.
3. everyone who purchased or traded in these fraudulent securities.
4. owners of common stock in US financial institutions.
5. holders of US securities (including government bonds) and US$ worldwide (including the Chinese and Japanese).

A Fraud Well Beyond the 1929 Stock Market Crash

This has been, in fact, a massive economic fraud, probably well beyond the 1929 stock market crash. The result will be increasing foreign ownership of the big US banks & brokers; this will have some interesting future consequences!

The lessons to be learned are that if your national economy depends too much on trading in imaginary values (and not enough on the creation of real 'value added' for which capitalism should provides ample opportunity), then sooner or later the house of cards will collapse. Secondly that the object of government regulation is to control fraud and prevent a collapse where everyone gets hurt. ✐

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