

The Subprime Primer

From Greg Mankiw's Blog

Random Observations for Students of Economics

<http://gregmankiw.blogspot.com/2008/03/subprime-primer.html>

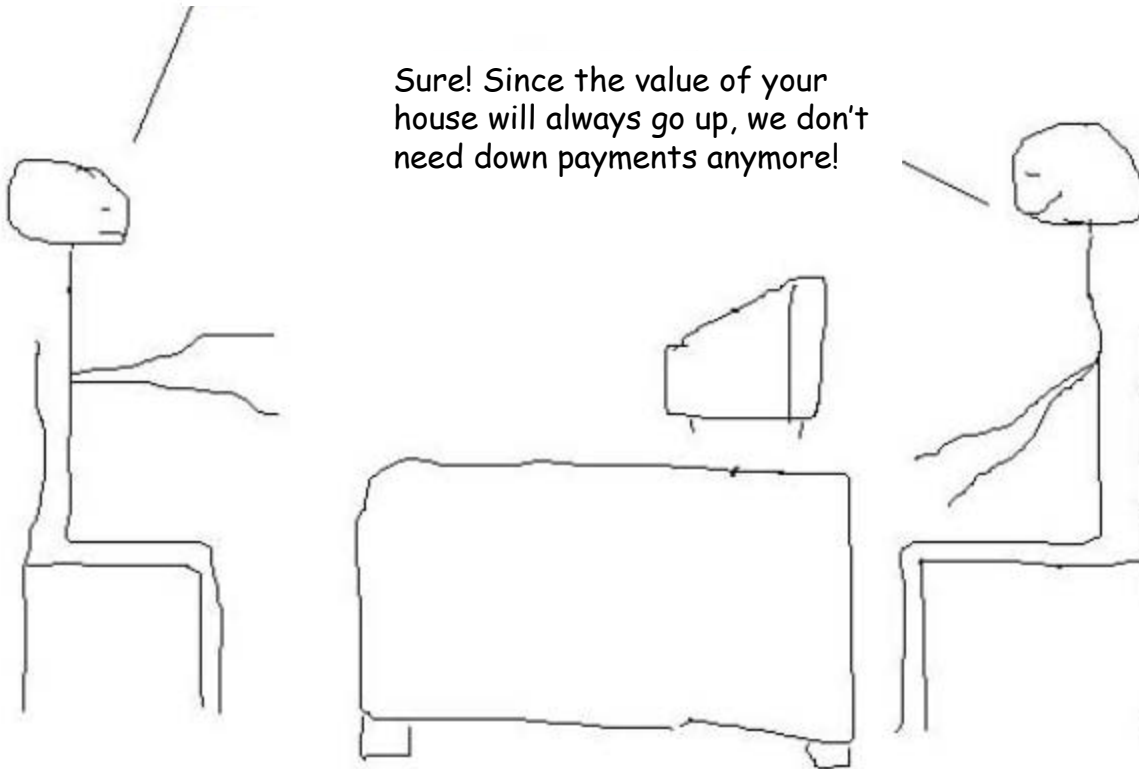
At the Mortgage Broker's ...

Ace Mortgage Brokers

We Make Your Dreams Come True

Gee, I'd like to buy a house but I haven't saved any money for a down payment and I don't think I can afford the monthly payments. Can you help me?

Sure! Since the value of your house will always go up, we don't need down payments anymore!



Ace Mortgage Brokers

We Make Your Dreams Come True

And we can give you a really low interest rate for a few years. We'll raise it later, okay?

Sure, no problem. Ummm, there's one other thing... My employer is a real prick and might not verify my employment. Would that be a problem?

Nope. We can get you a special LIAR'S LOAN and you can verify your own employment and income.



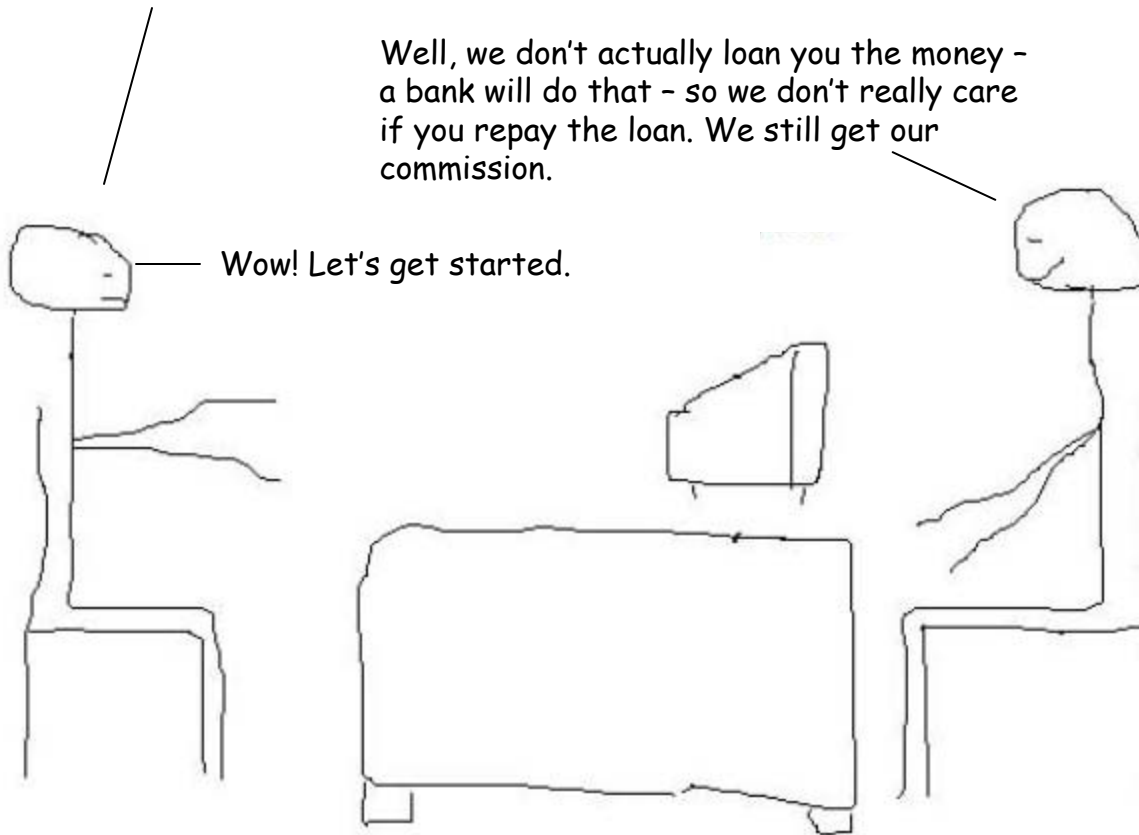
Ace Mortgage Brokers

We Make Your Dreams Come True

You guys are awesome. You are really willing to work with guys like me.

Well, we don't actually loan you the money - a bank will do that - so we don't really care if you repay the loan. We still get our commission.

Wow! Let's get started.

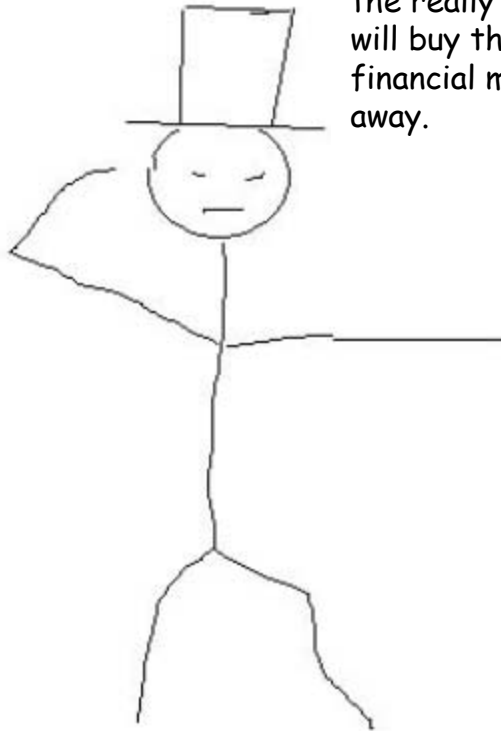


A Few Weeks Later, at the Bank ...

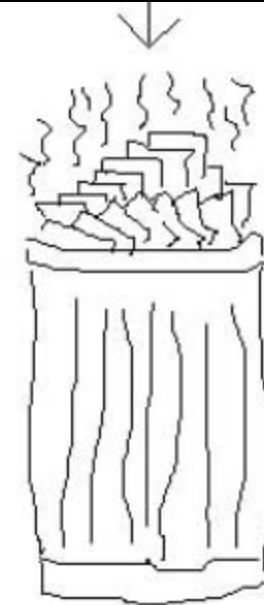
First Bank of Bankland

Open Your Christmas Club Account Today

I'd better get rid of these crappy mortgage loans. They are starting 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.



NEW MORTGAGE
FILE

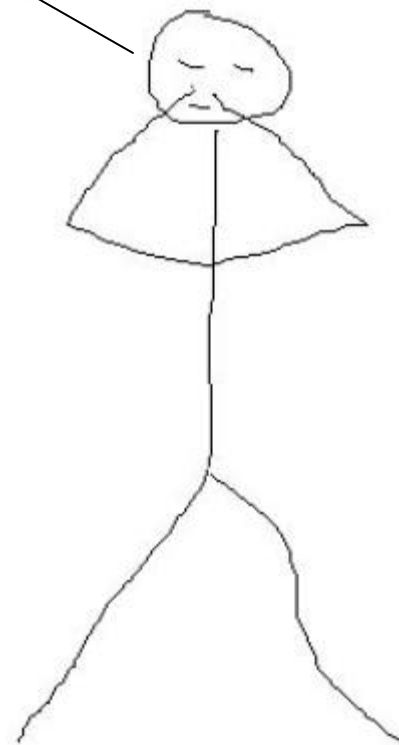
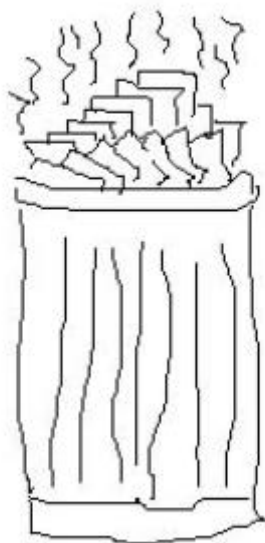
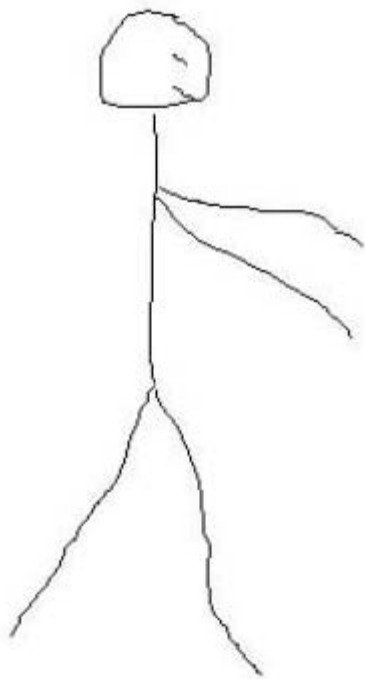


Let's See What the Smart Guys are Doing ...

RSG Investment Bank of Wall Street

“Trust the ‘Really Smart Guys’ for all Your Investment Needs”

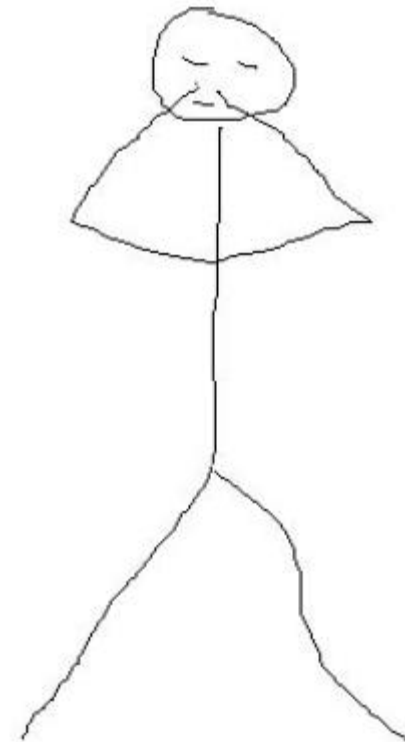
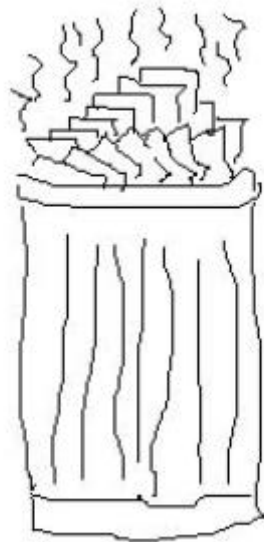
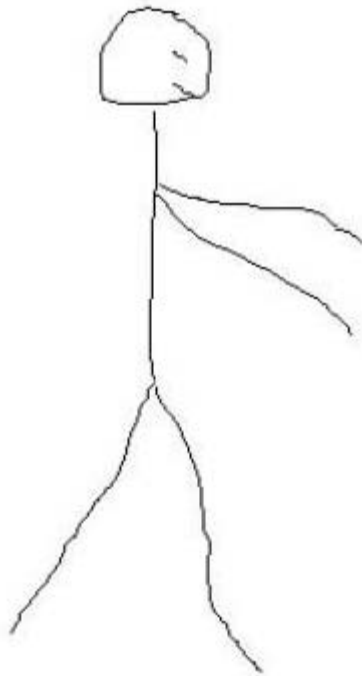
Phew!!! We'd better get rid of these shitty mortgages before they start attracting flies.



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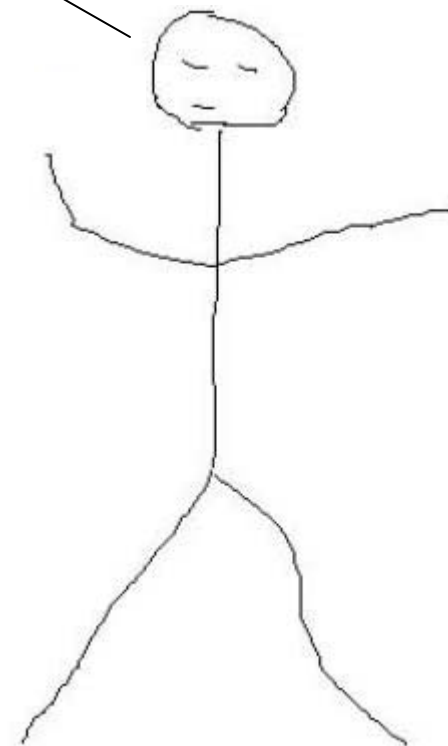
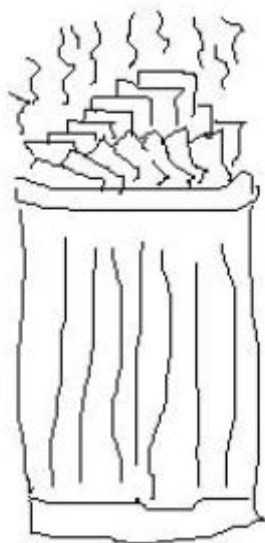
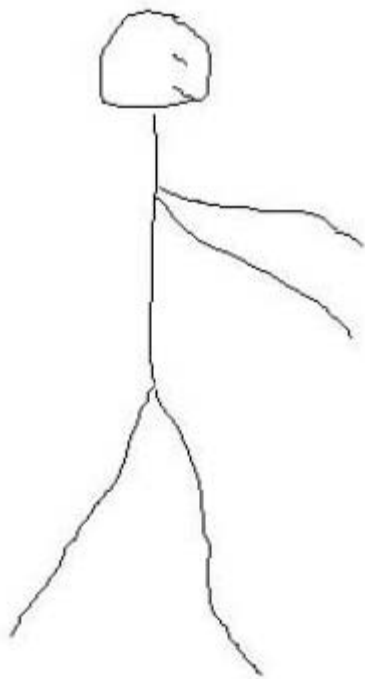
But who would buy this crap, boss?



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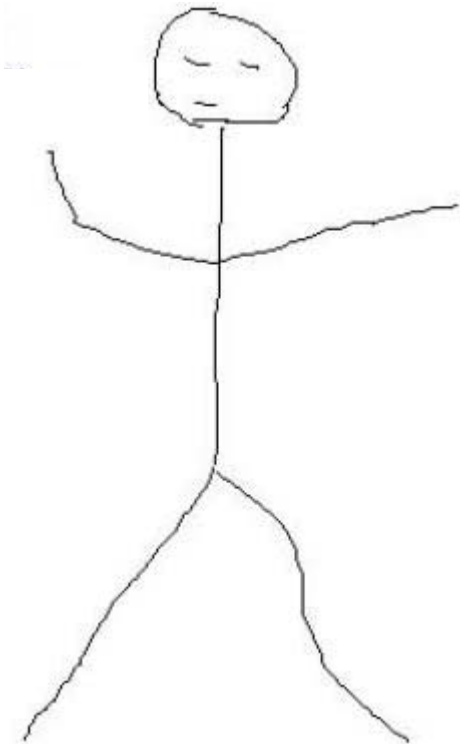
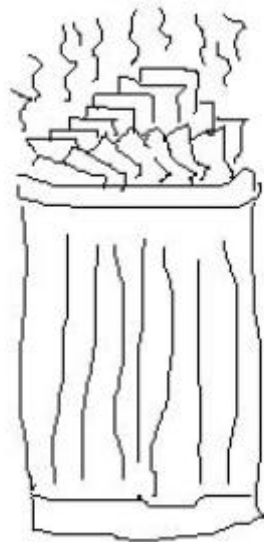
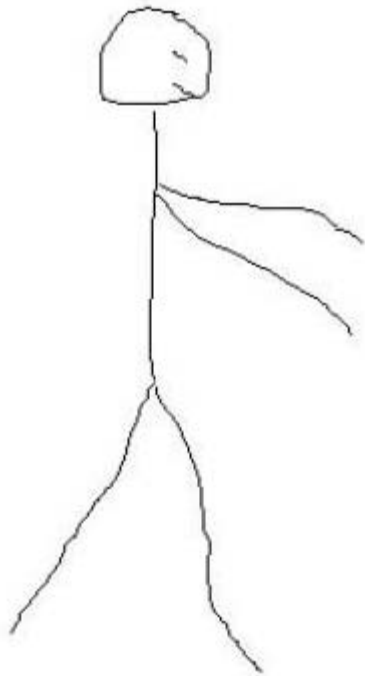
I've got it! First we'll create a new security and use these crappy mortgages as collateral. We'll call it a CDO (or maybe CMO). We can sell that CDO to investors and promise to pay them back as the mortgages are paid off.



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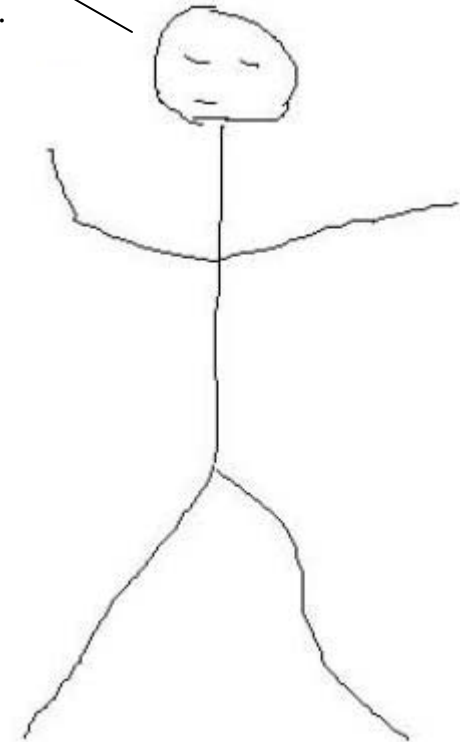
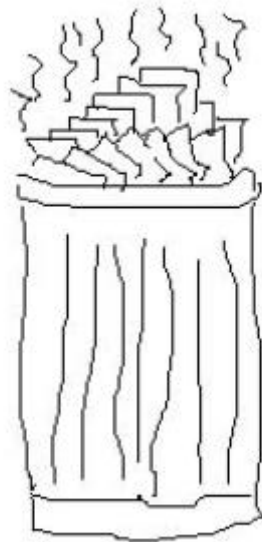
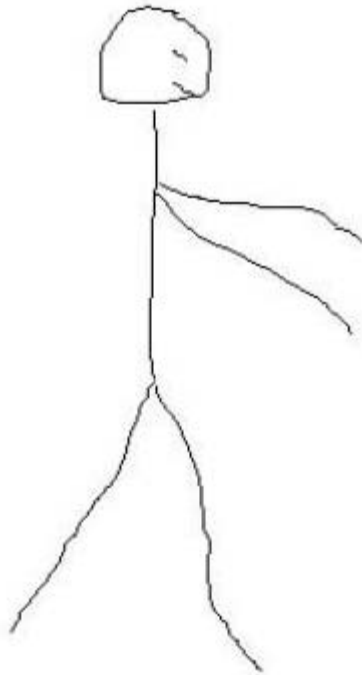
But crap is crap, isn't it? I don't get it.



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Sure, individually these 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 only go up, we really have very little to worry about.



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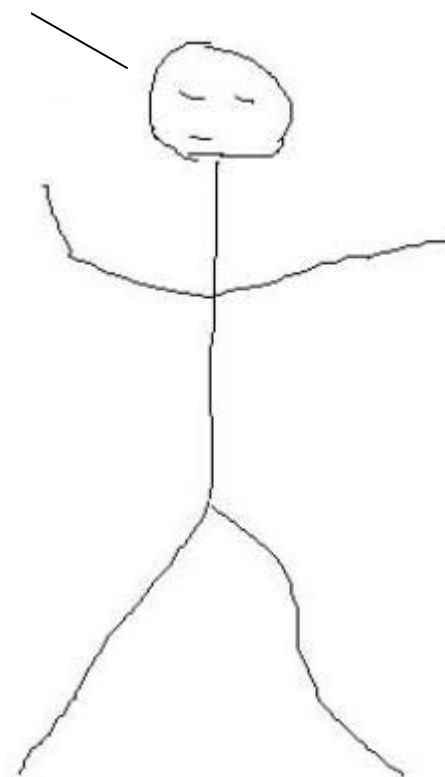
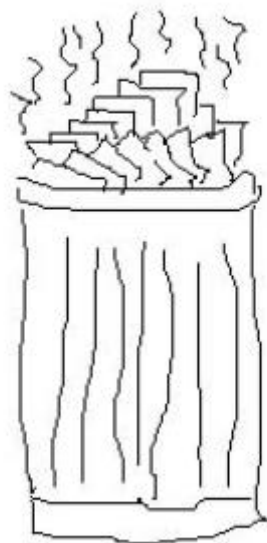
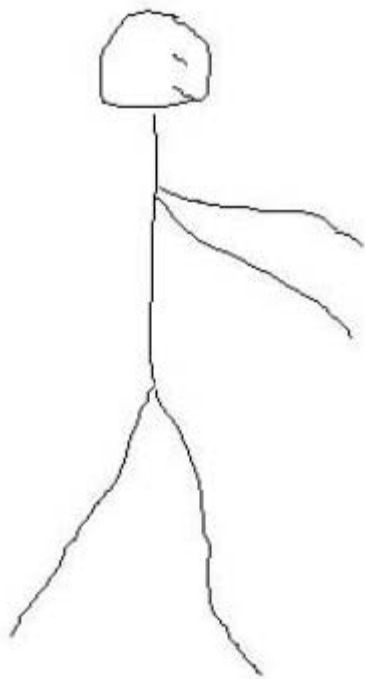
“Trust the ‘Really Smart Guys’ for all Your Investment Needs”



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"Trust the 'Really Smart Guys' for all Your Investment Needs"

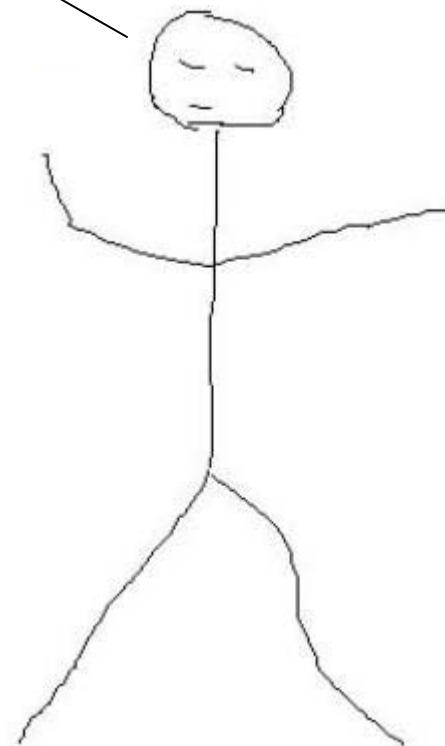
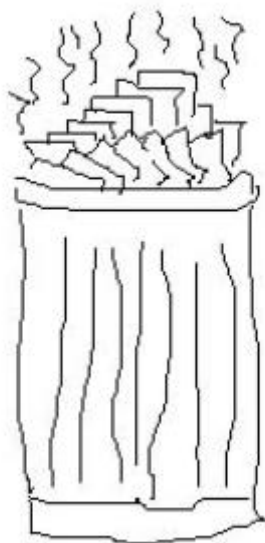
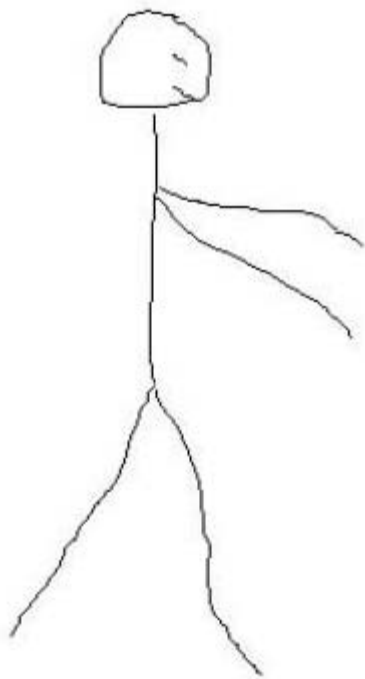
The new CDO will work like this: It will be made up of three pieces (or "tranches") and we'll call them "The Good", "The Not So Good," and "The Ugly".



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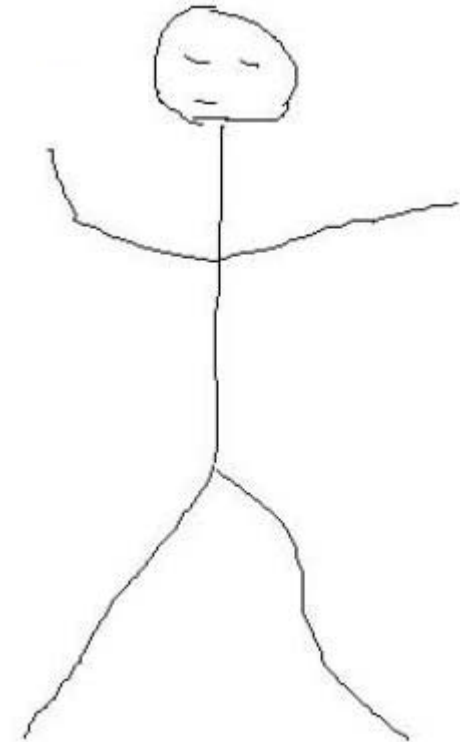
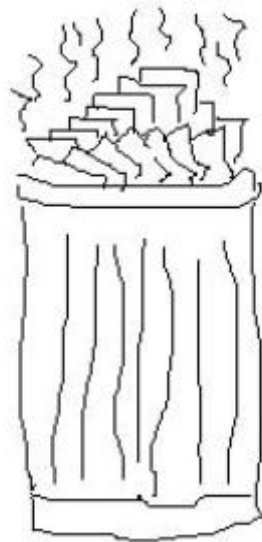
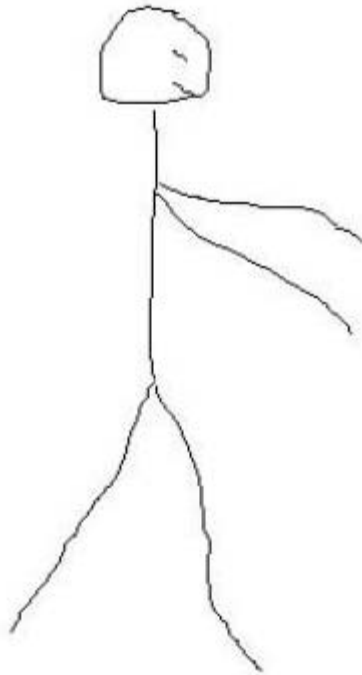
If some of the mortgages fail, as some surely might, we will promise to pay investors holding "The Good" tranche first. We'll pay the not-so-good investors second, and the Ugly investors last.



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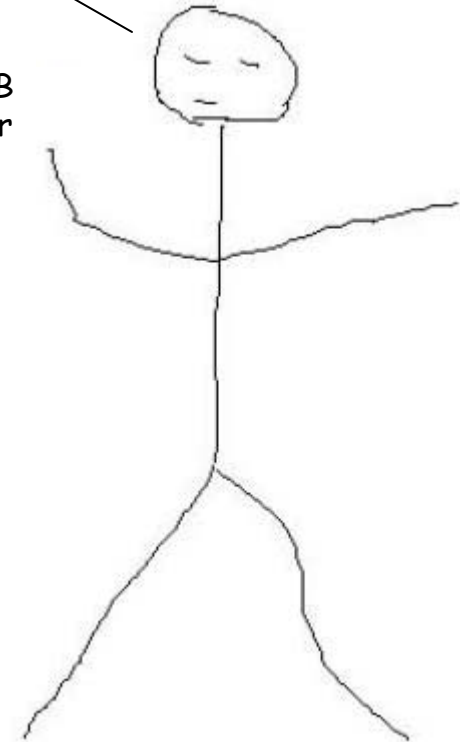
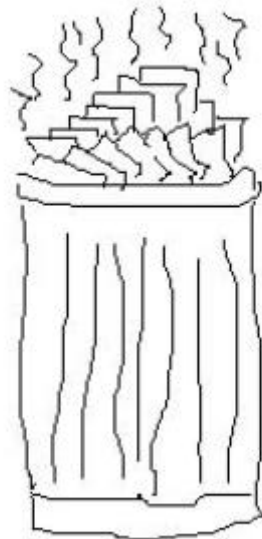
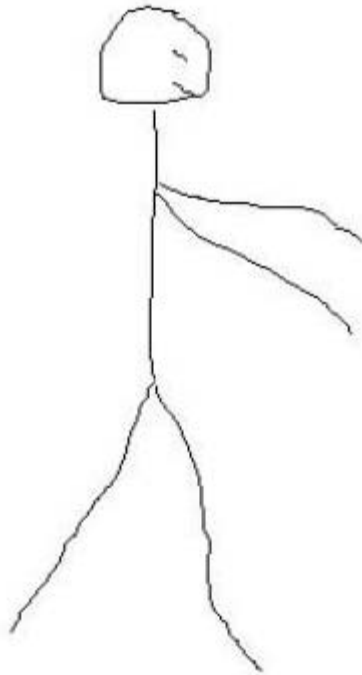
I'm starting to get it. And because the "Good" investors have the least risk, we'll pay them a lower interest rate than the other guys, right? The "Not-So-Goods" will get a better interest rate, and the "Ugly" guys will get a nice fat interest rate.



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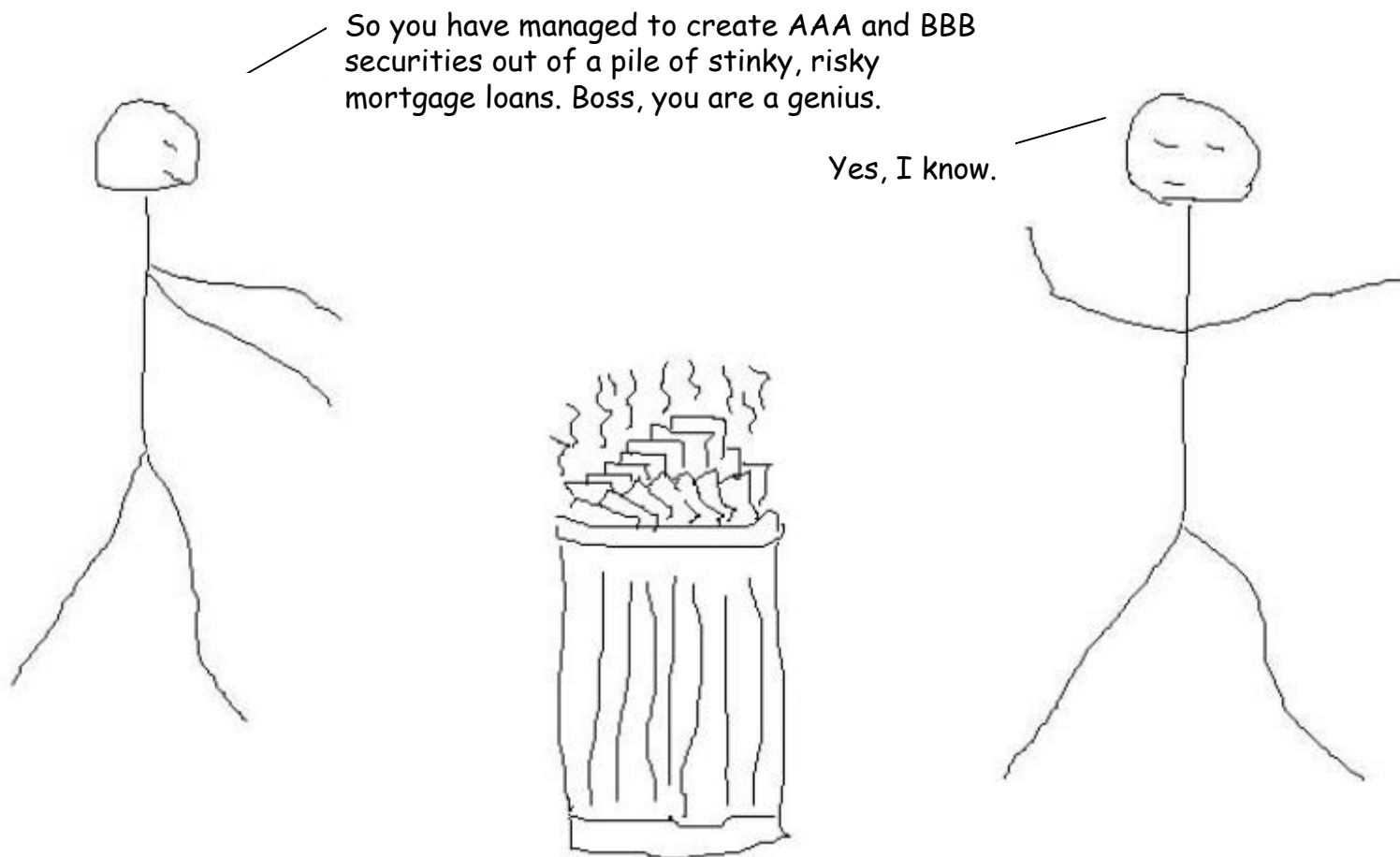
"Trust the 'Really Smart Guys' for all Your Investment Needs"

Exactly. 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 great rating, in the AAA to A range. They will likely give the "Not-So-Good" piece a BBB to B rating, still pretty good. We won't even bother asking them to rate the "Ugly" piece.



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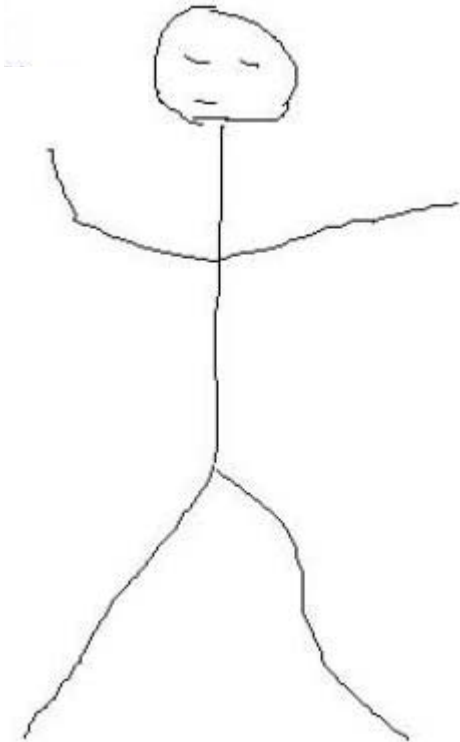
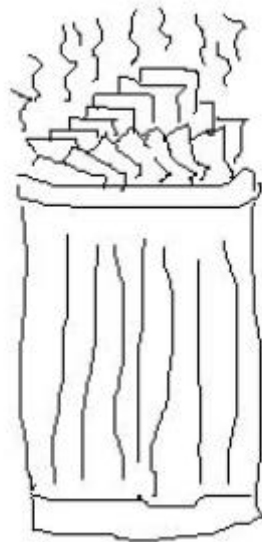
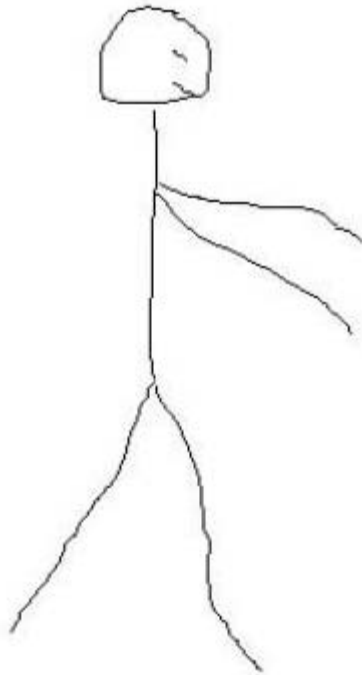
So you have managed to create AAA and BBB securities out of a pile of stinky, risky mortgage loans. Boss, you are a genius.

Yes, I know.

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Okay, now who are we going to sell the three pieces to?

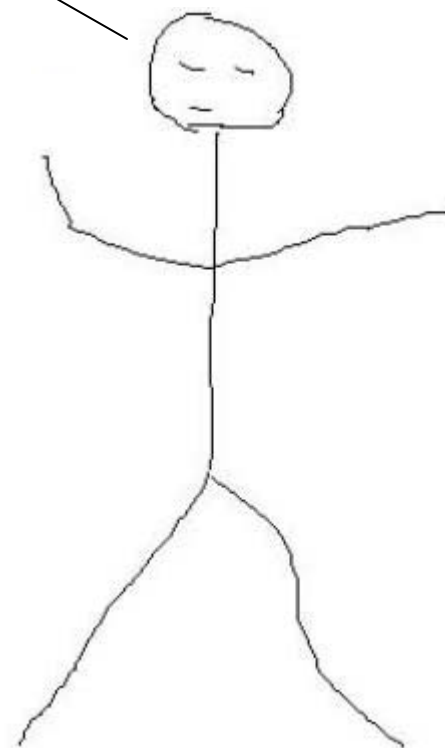
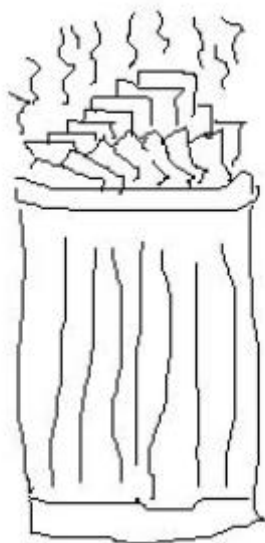
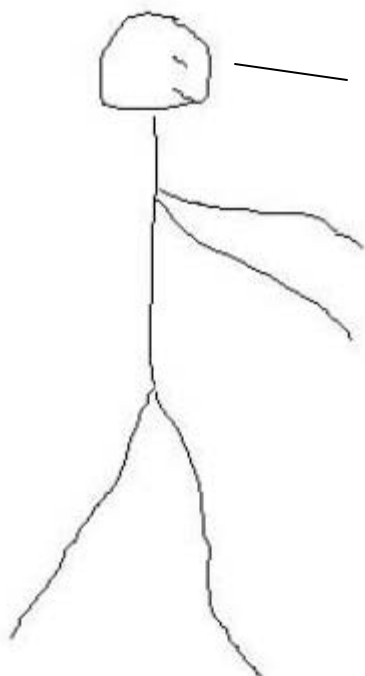


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The assholes at the SEC won't let us sell this stuff to widows and orphans, so we'll sell it to our sophisticated institutional clients.

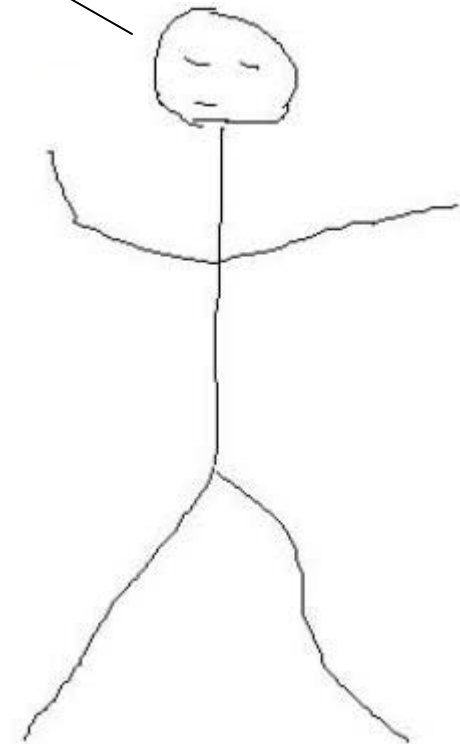
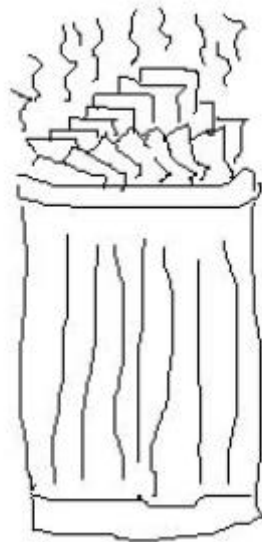
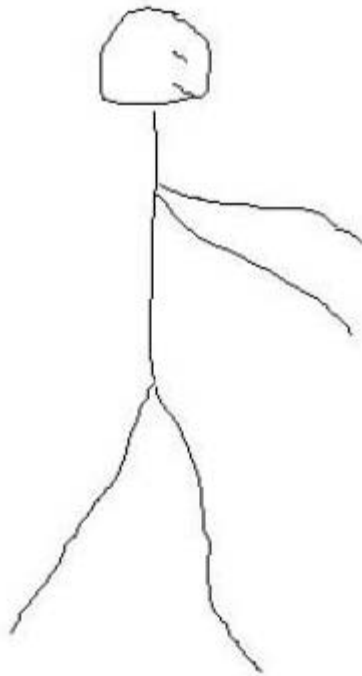
Like who?



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“Trust the ‘Really Smart Guys’ for all Your Investment Needs”

Like insurance companies, banks, small towns in Norway, school boards in Kansas - to anyone who is looking for a high-quality safe investment.

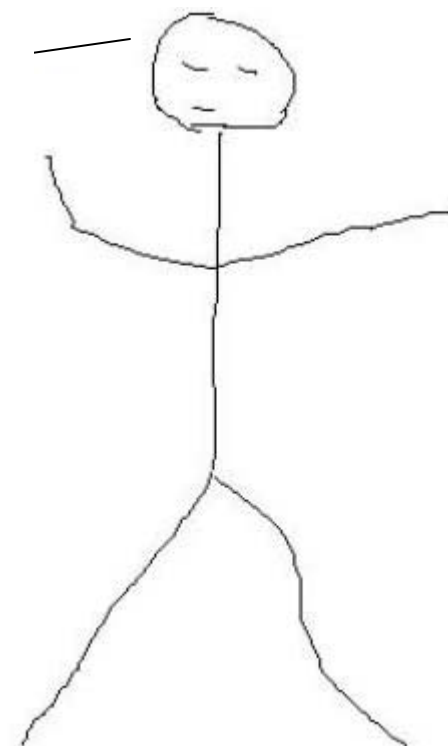
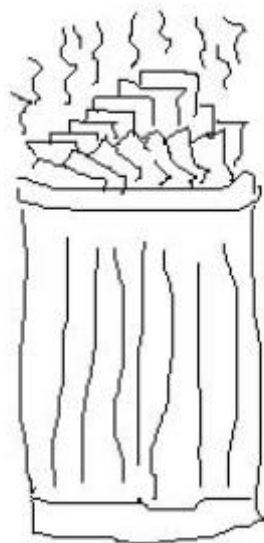
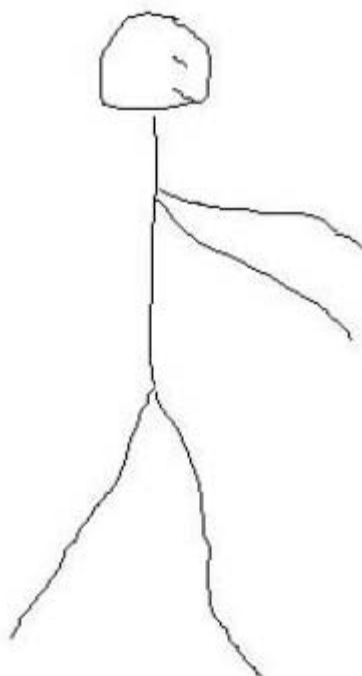


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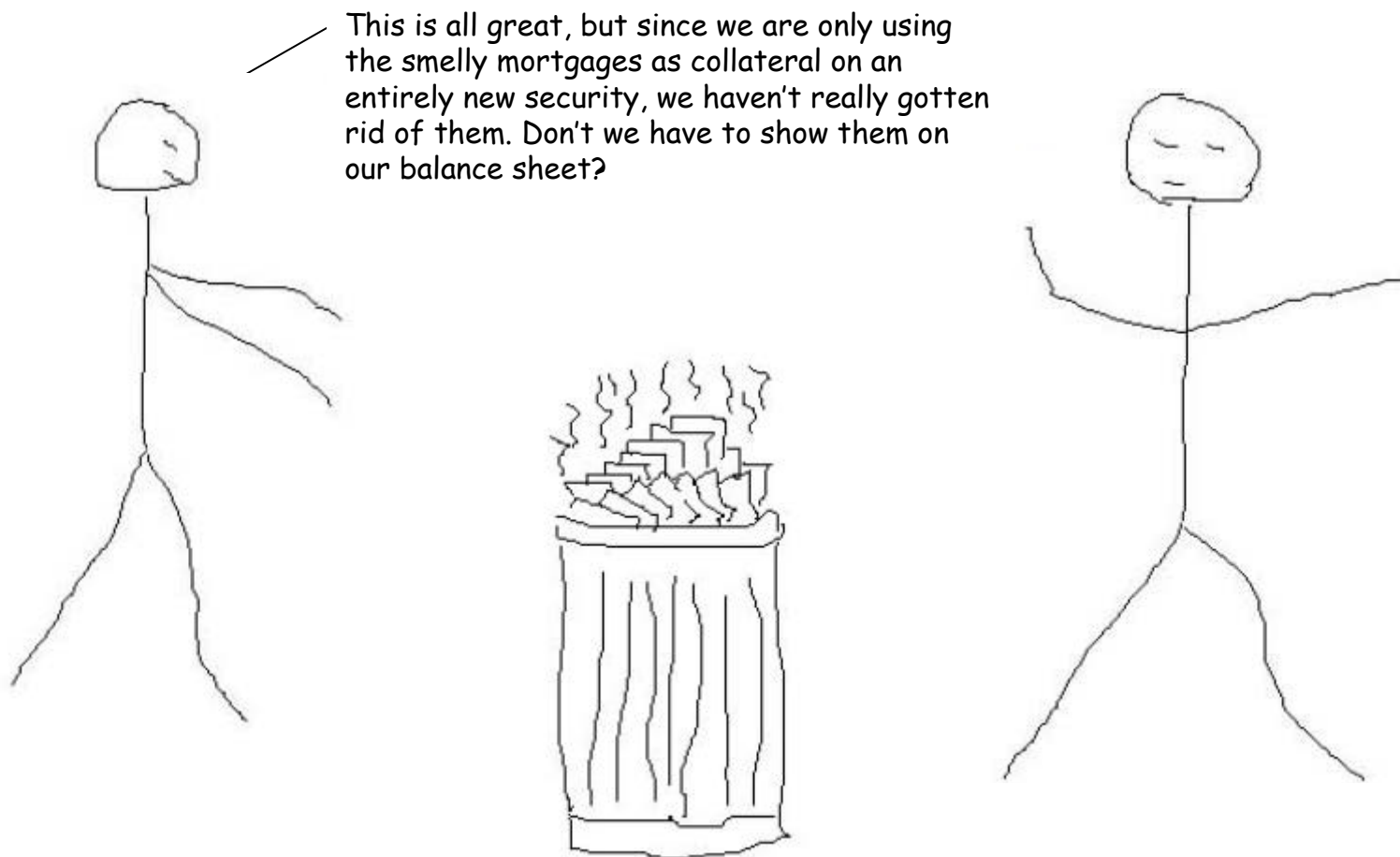
But surely nobody would buy the "Ugly" piece, would they?

Of course not - nobody is that stupid. We will keep that piece and pay ourselves a handsome interest rate.



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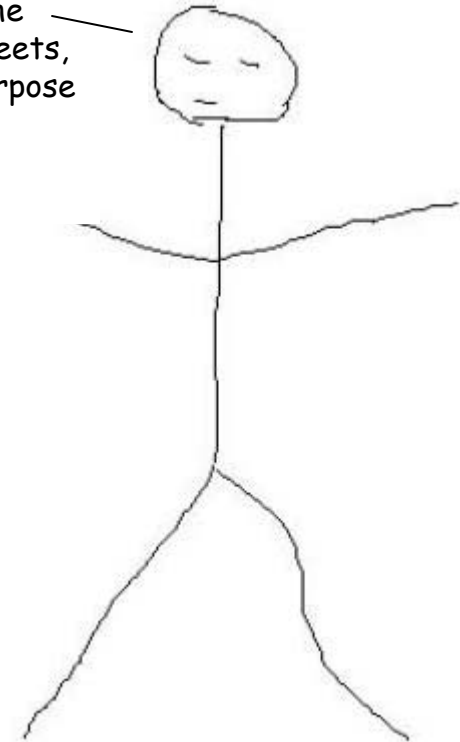
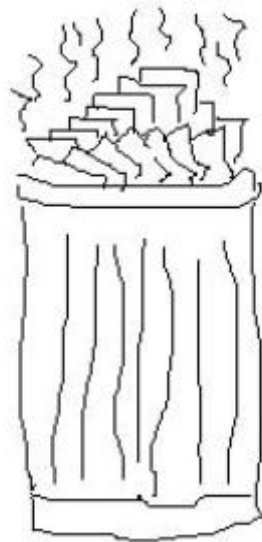
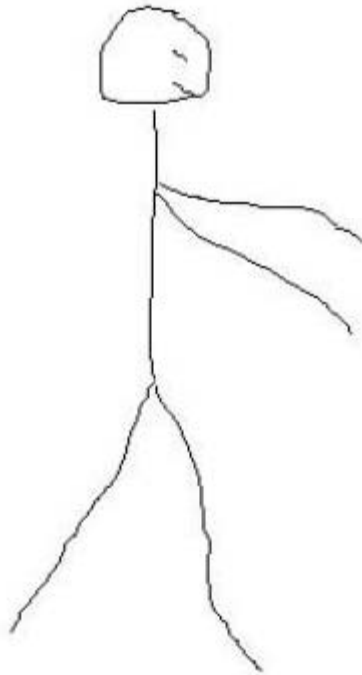
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"Trust the 'Really Smart Guys' for all Your Investment Needs"

No, of course not. The guys who write the accounting rules allow us to set up a shell company in the Cayman Islands to take ownership of the mortgages. The crap goes on their balance sheets, not ours. The fancy name for it is "Special Purpose Vehicle" or SPV.

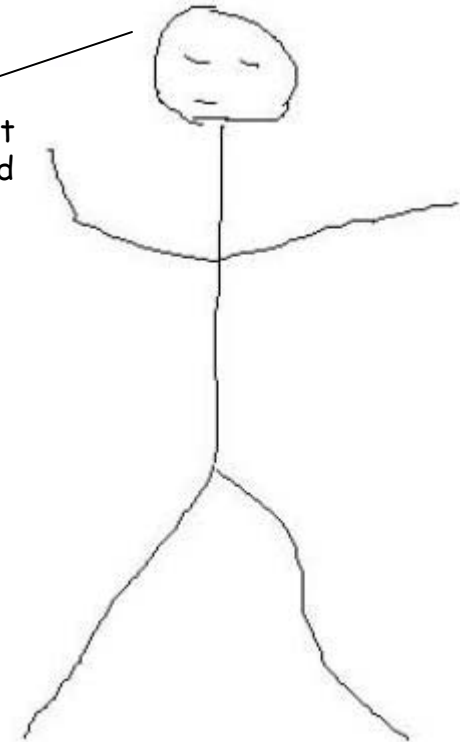
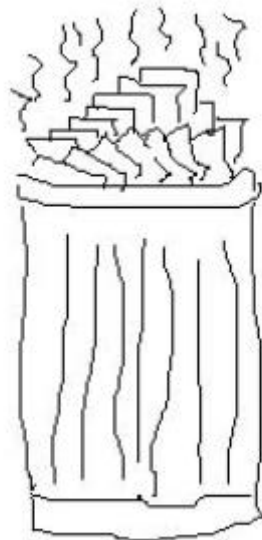
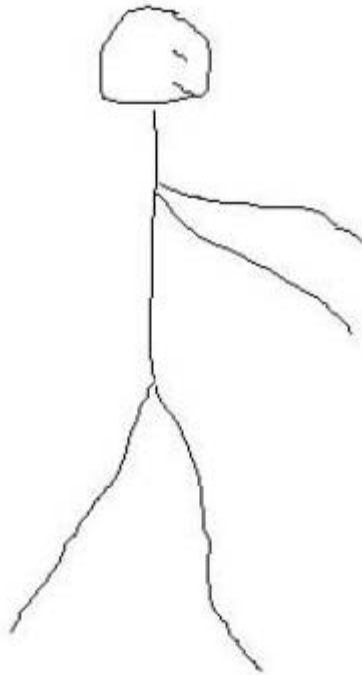


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“Trust the ‘Really Smart Guys’ for all Your Investment Needs”

That's great. But why would they let us do that. Aren't we just moving our own crap around?

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

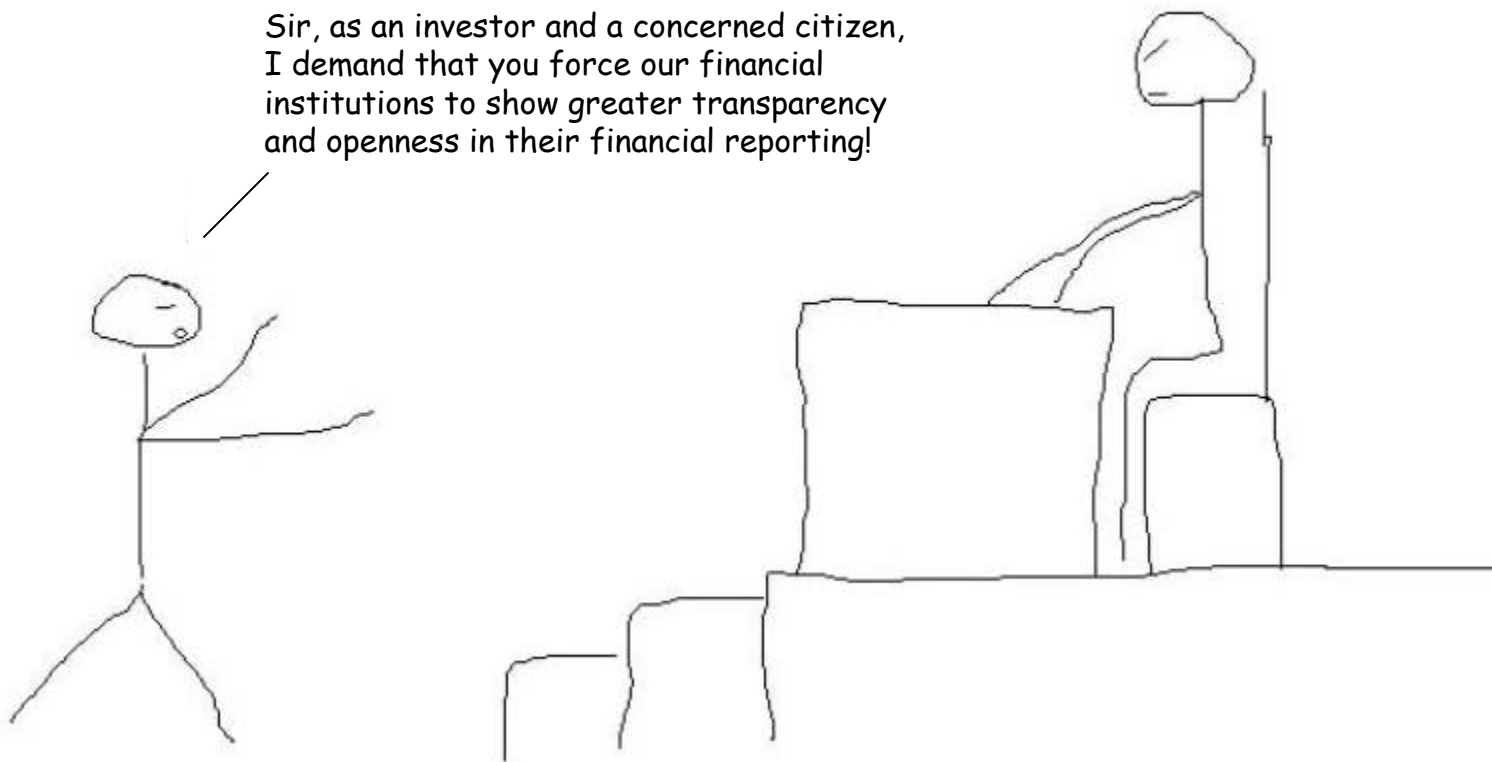


Let's Drop in to see the Accountants ...

Office of the Czar of Accounting

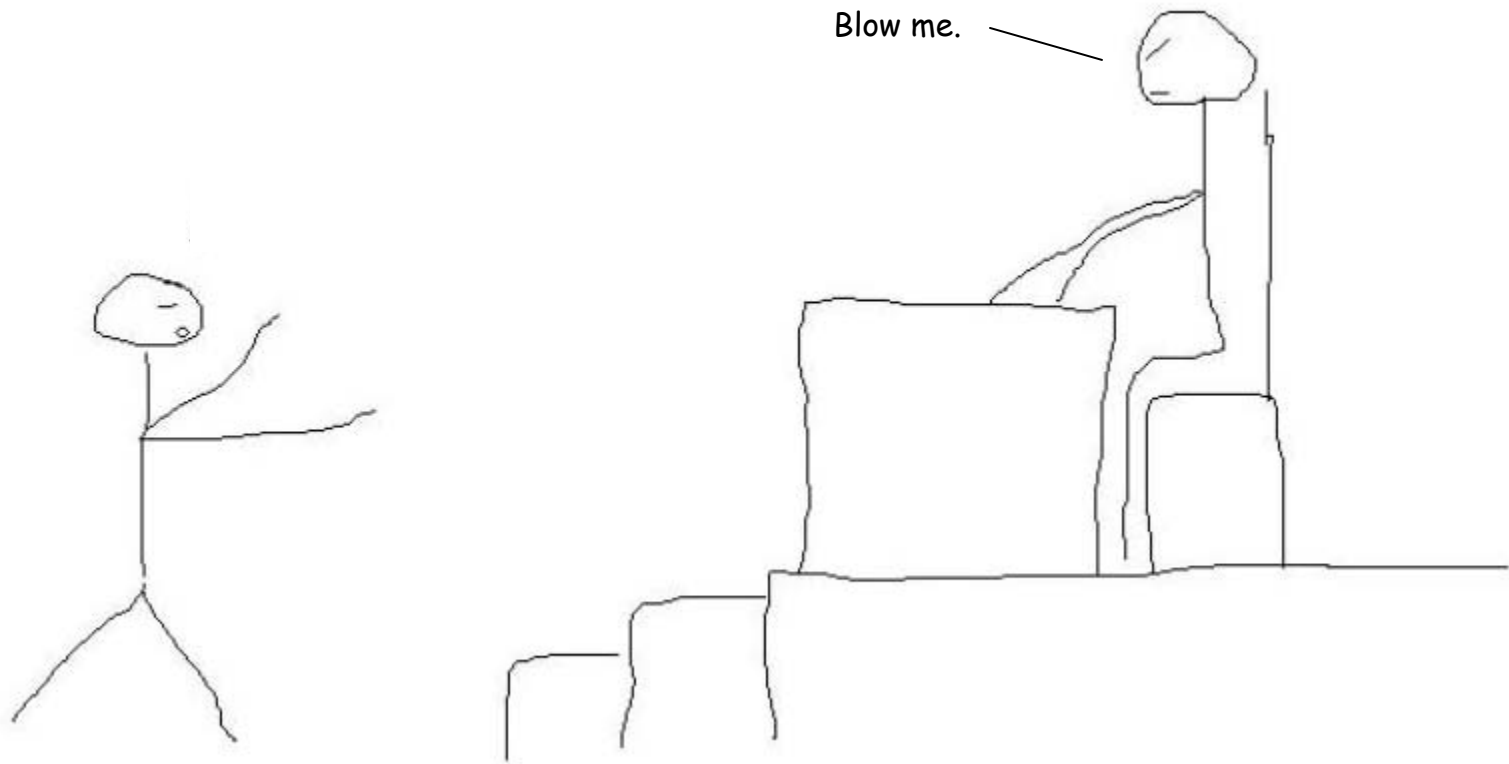
"No Nit Too Small to Pick"

Sir, as an investor and a concerned citizen,
I demand that you force our financial
institutions to show greater transparency
and openness in their financial reporting!



Office of the Czar of Accounting

"No Nit Too Small to Pick"



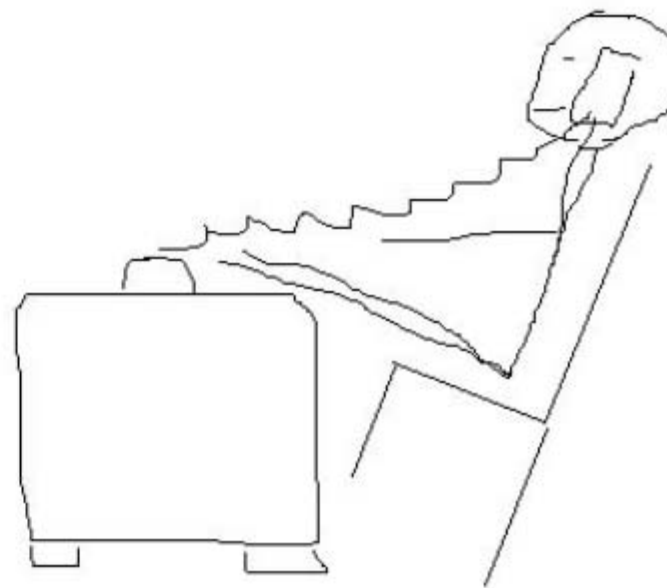
Gee, We Never Saw it Coming ...

Norwegian Village Pension Fund

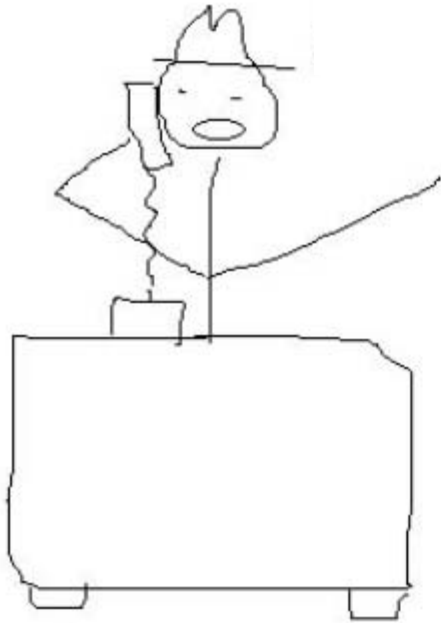
Hey, man, what the hell is up? We're not receiving our monthly payments.



RSG Investment Bank

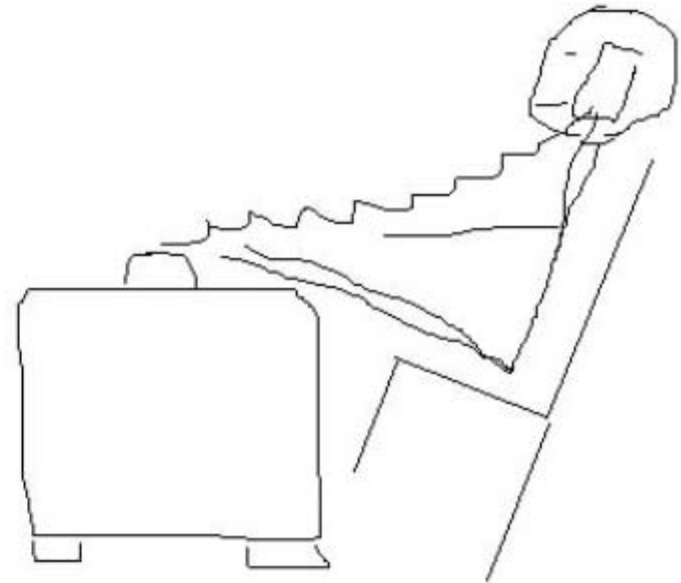


Norwegian Village
Pension Fund



RSG Investment Bank

Yeah, I meant to call you but it's been really crazy around here. It seems the assholes who took out the mortgages backing your CDO aren't able to pay them off.

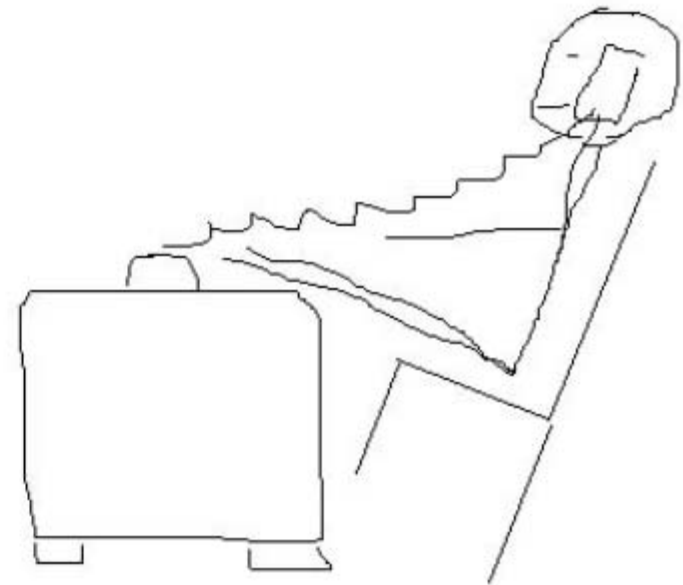


Norwegian Village Pension Fund

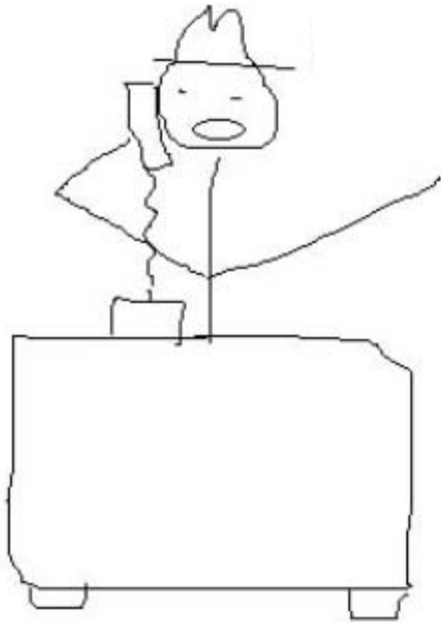
Wait a minute! We bought the AAA "Good" piece of the CDO. You know? The safe one. We're supposed to be getting paid first.



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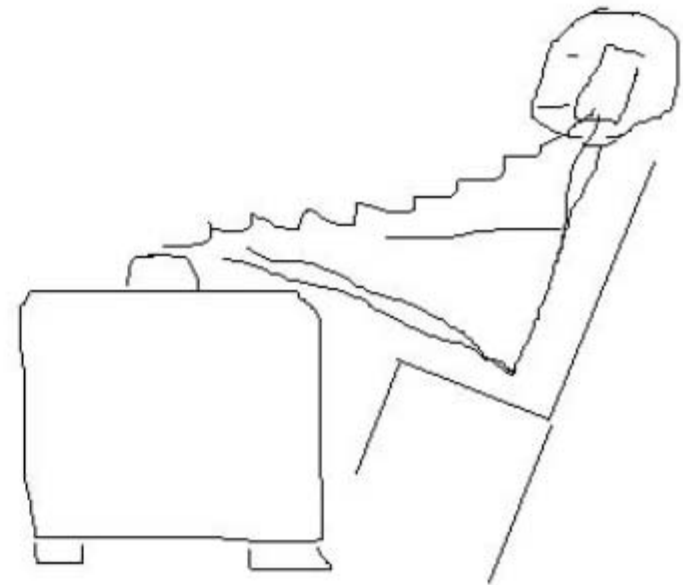


Norwegian Village Pension Fund



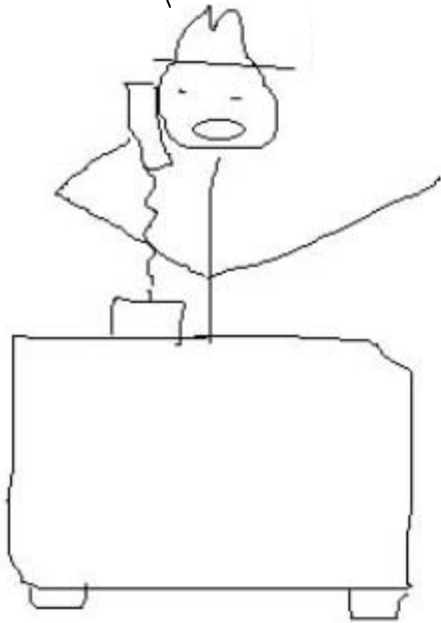
RSG Investment Bank

Well, unfortunately the loans were quite a bit crappier than we originally thought and there is very little cash coming in. Frankly, I assure you that we are as disappointed as you are.

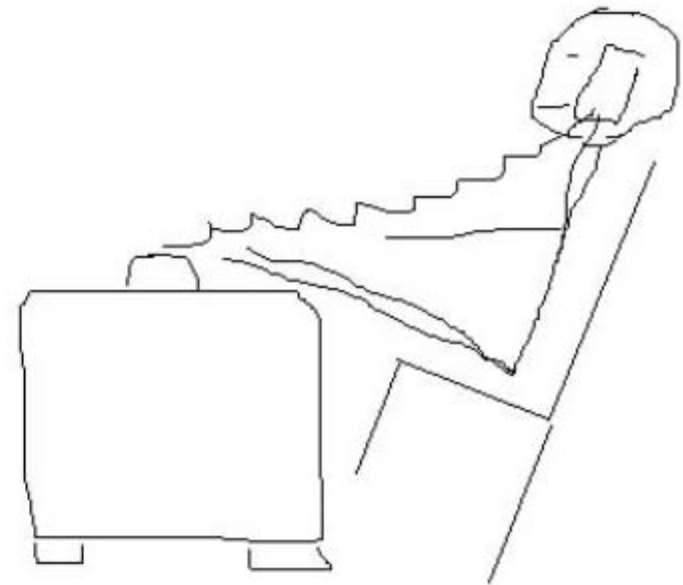


Norwegian Village Pension Fund

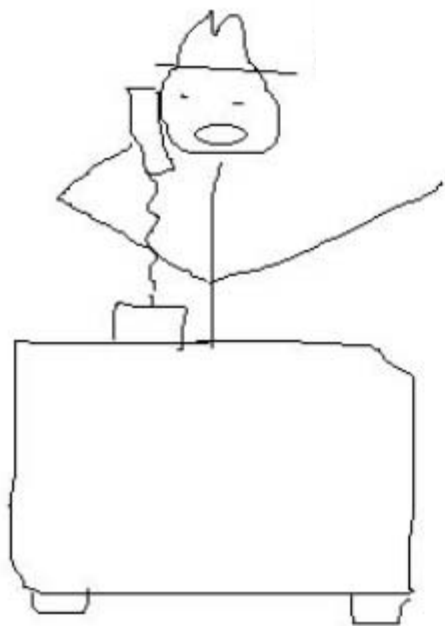
But you told me that housing prices always go up and that your borrowers could always refinance their mortgages!



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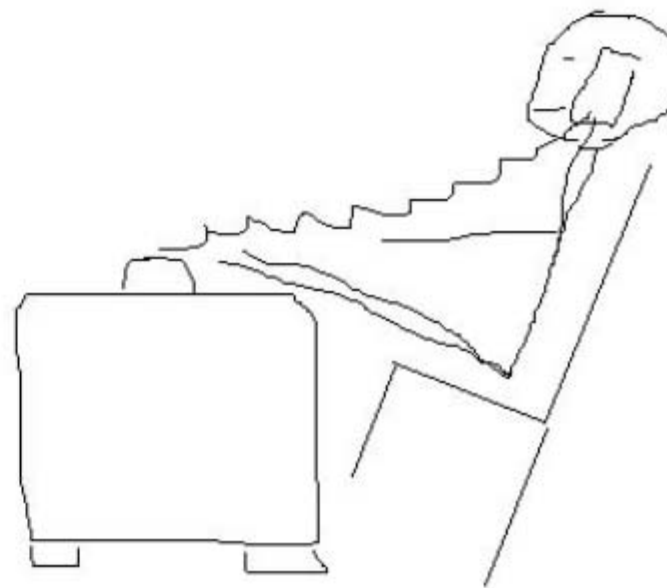


Norwegian Village
Pension Fund



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Yeah. That was a bad assumption.
We fucked up. Sorry.

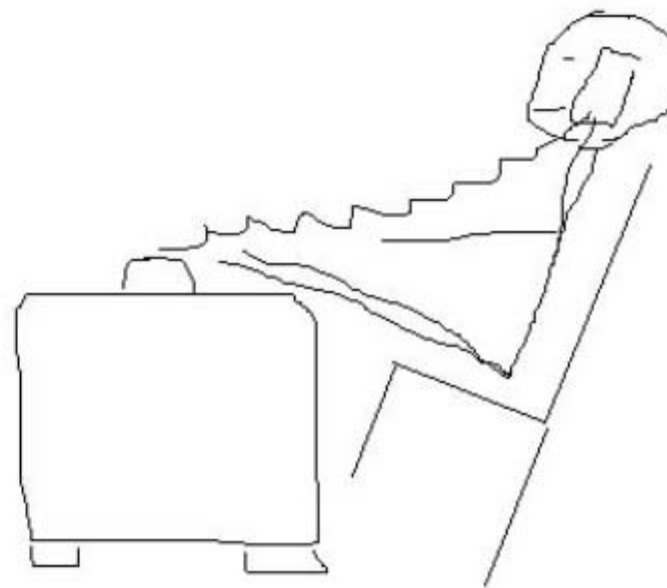


Norwegian Village Pension Fund

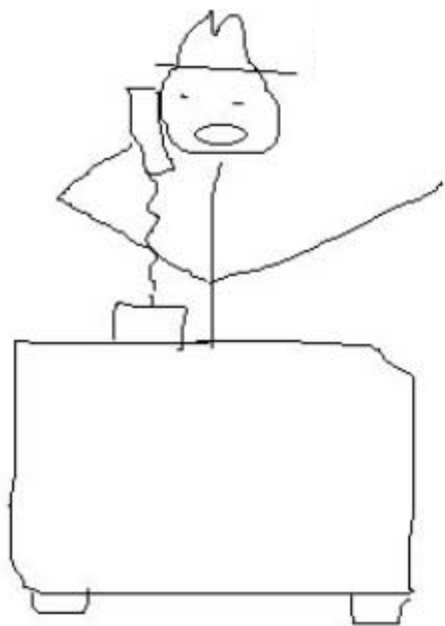
Bad assumption, my frigid Norwegian ass!
What about the AAA rating from the agencies?



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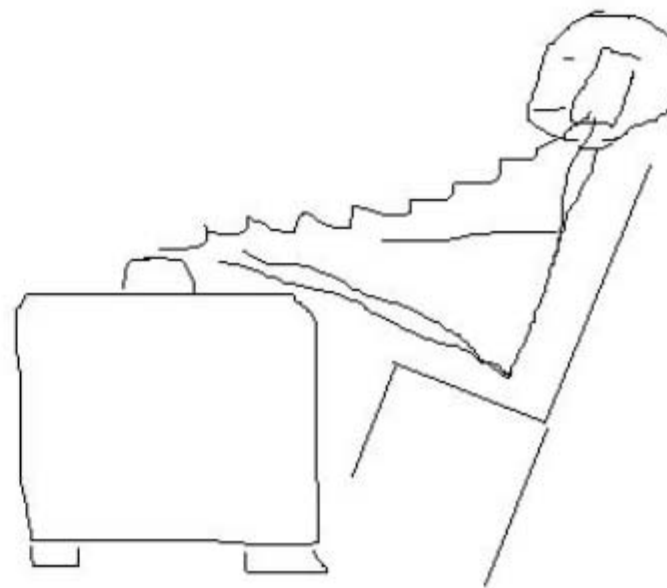


Norwegian Village
Pension Fund



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They fucked up too.

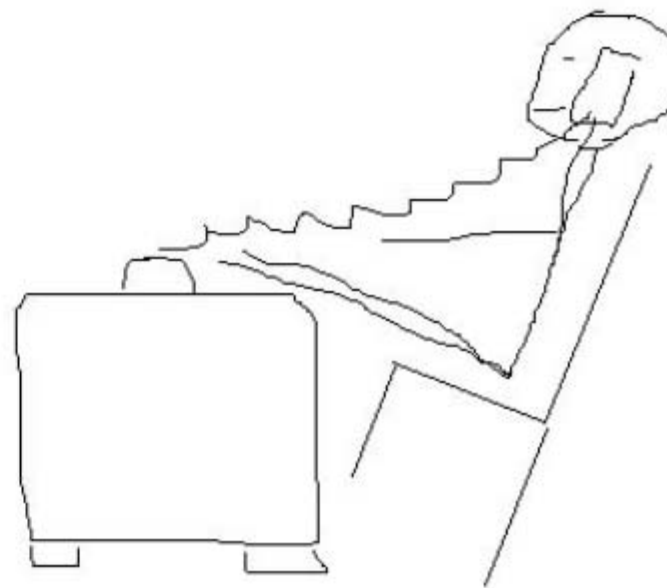


Norwegian Village Pension Fund

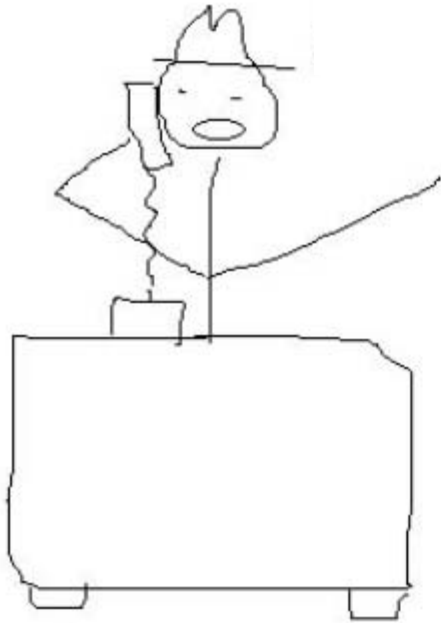
But this security was insured! What about the insurers?



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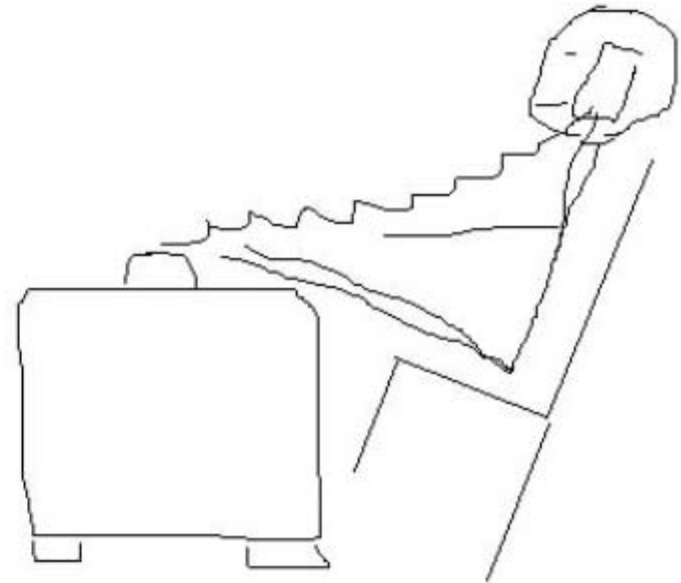


Norwegian Village Pension Fund



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Are you kidding? There's no way they have enough money set aside to cover this mess. They fucked up.

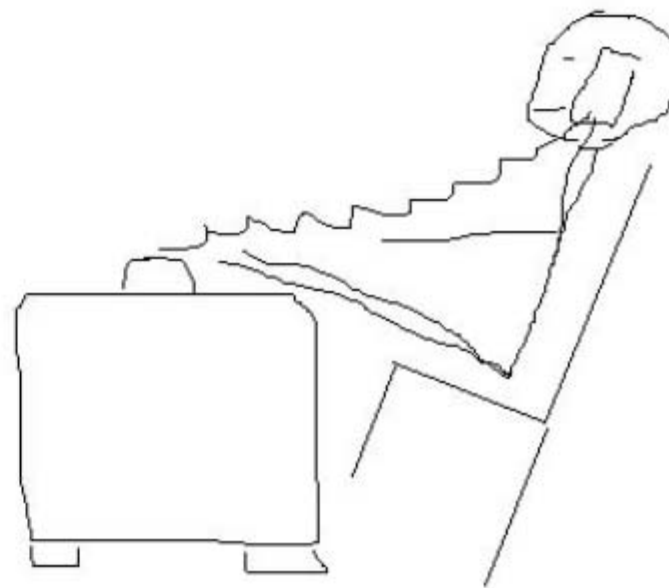


Norwegian Village Pension Fund

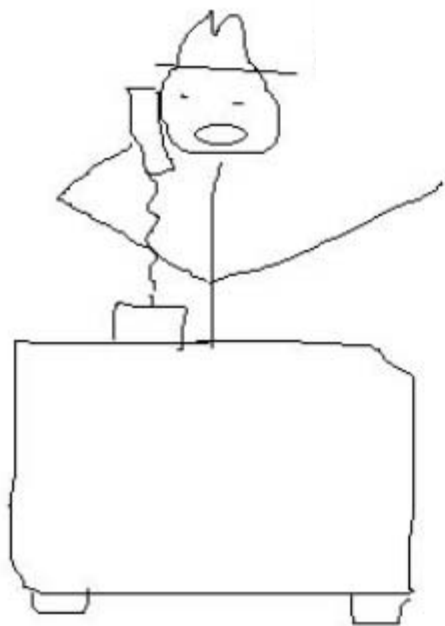
Well that's just great, asshole. What am I supposed to tell my villagers?



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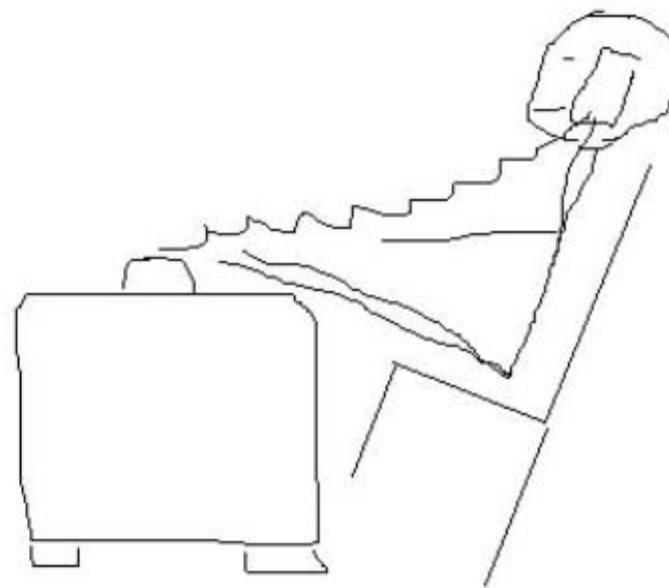


Norwegian Village
Pension Fund



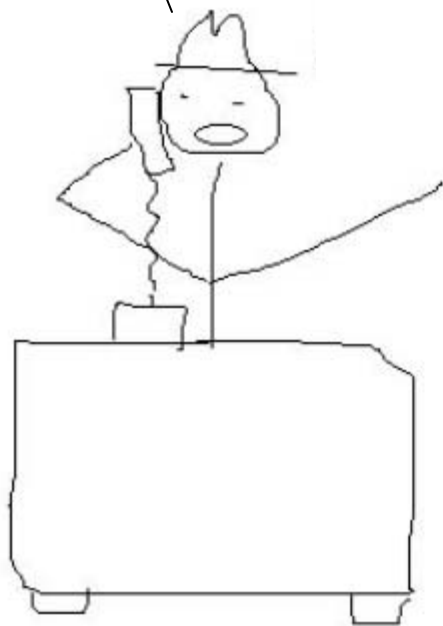
RSG Investment Bank

Tell them you fucked up.

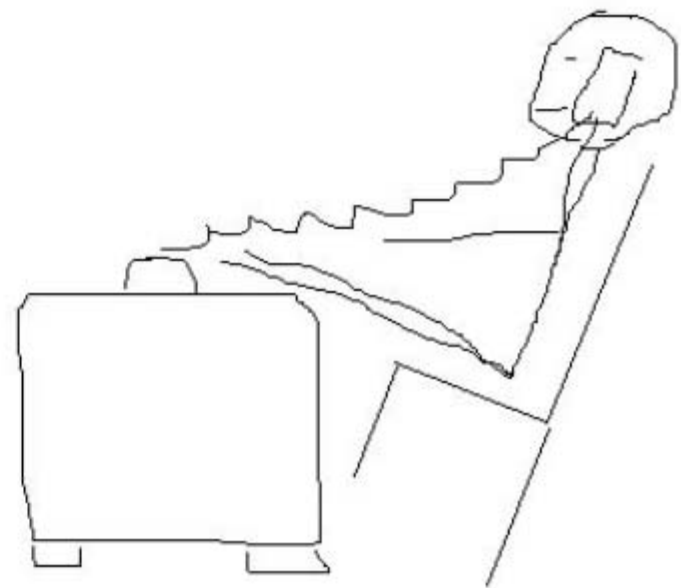


Norwegian Village
Pension Fund

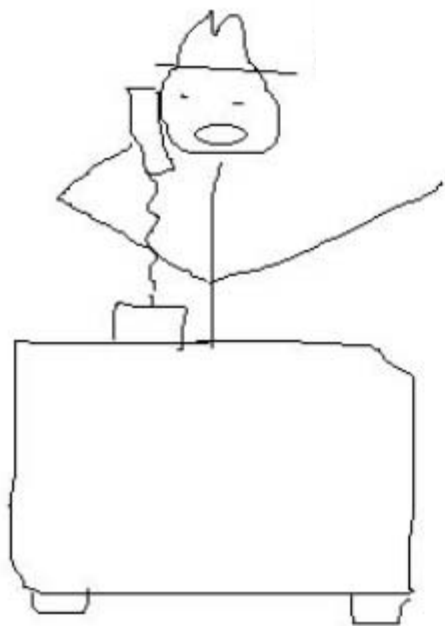
Fuck you.



RSG Investment Bank

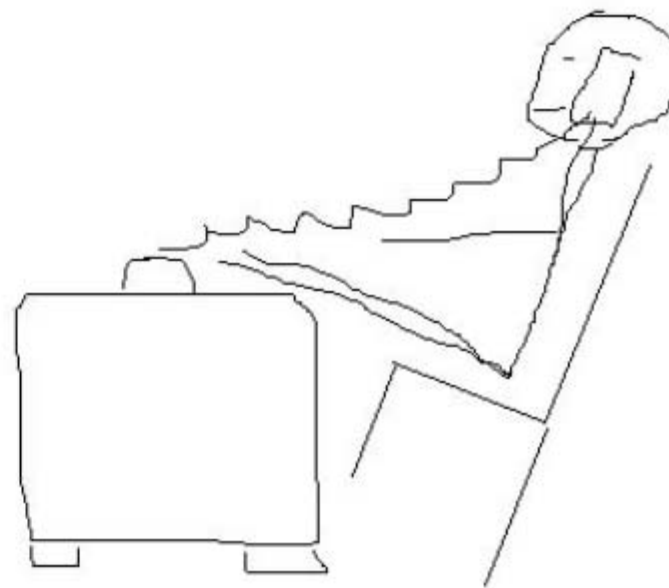


Norwegian Village
Pension Fund



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Fuck you.



The End

