

The Subprime Primer

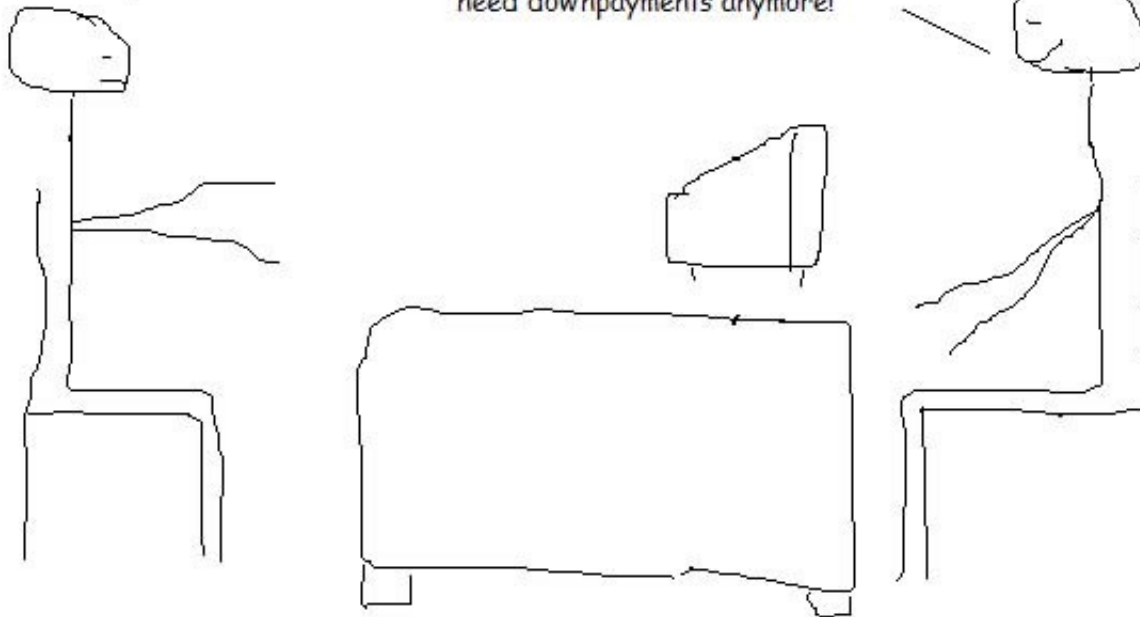
At the Mortgage Broker's

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 downpayment 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 downpayments anymore!



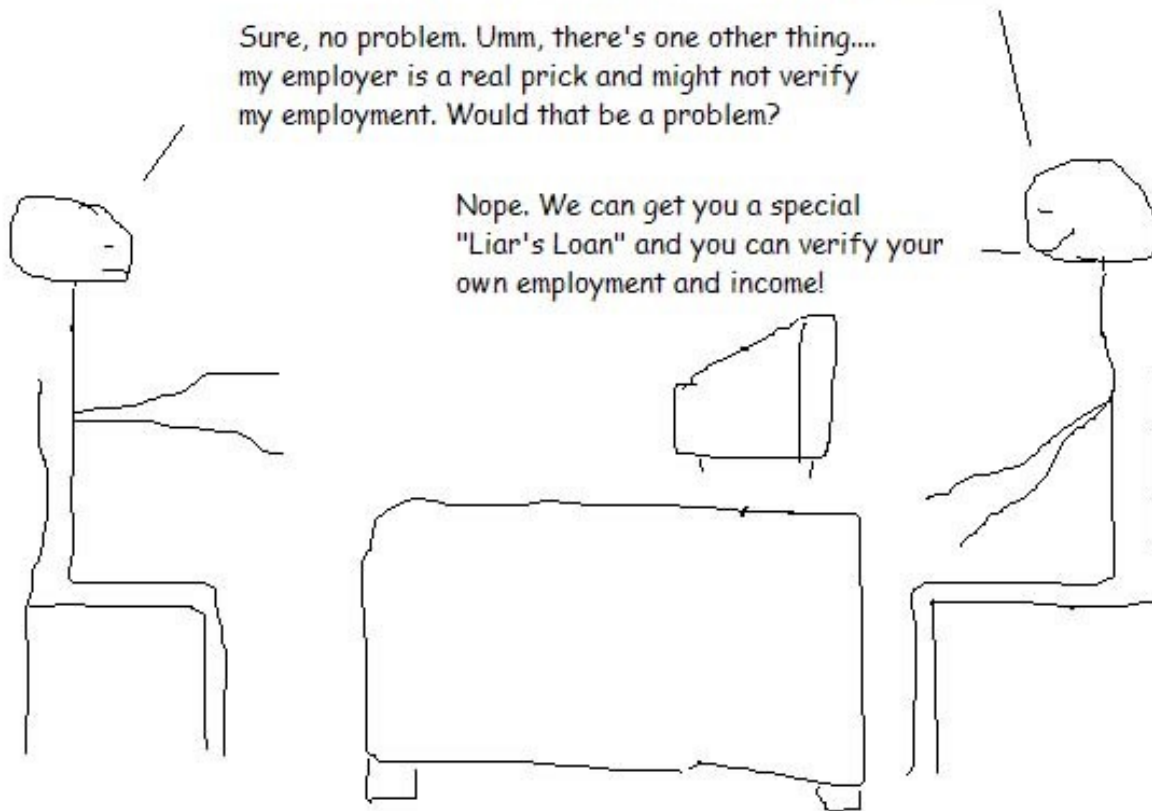
Ace Mortgage Brokers

"We Make Your Dreams Come True"

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

Sure, no problem. Umm, 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!



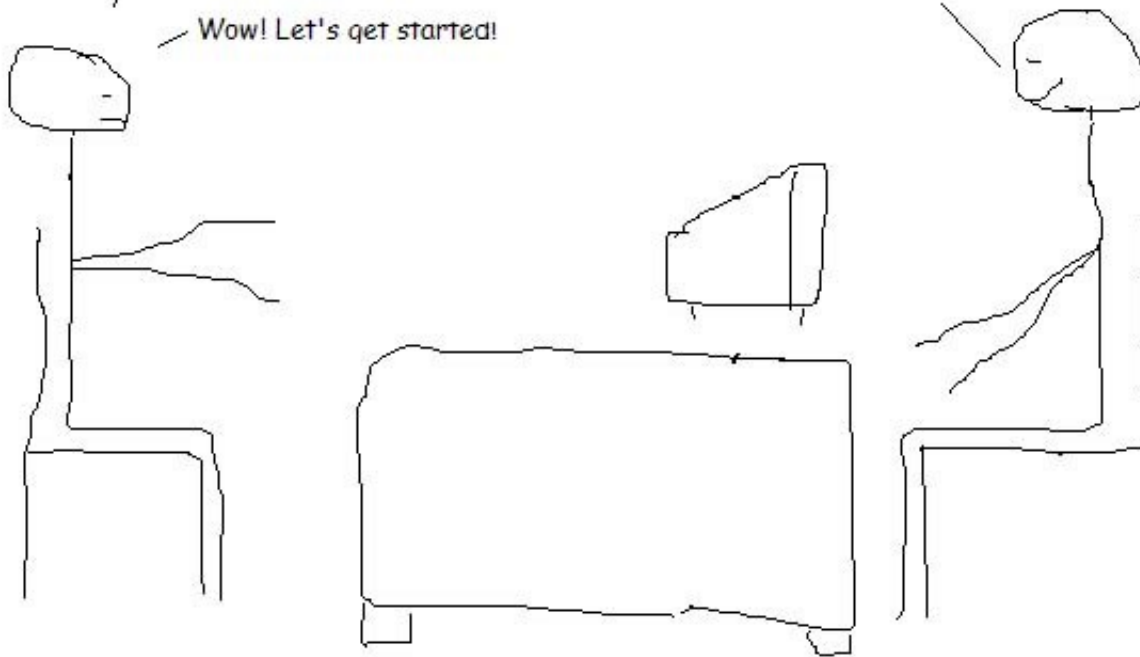
Ace Mortgage Brokers

"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 lend 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

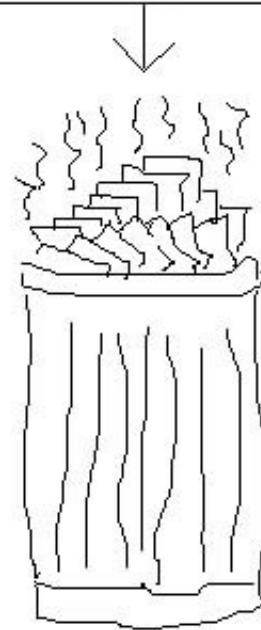
First Bank of Bankland, Inc

"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...

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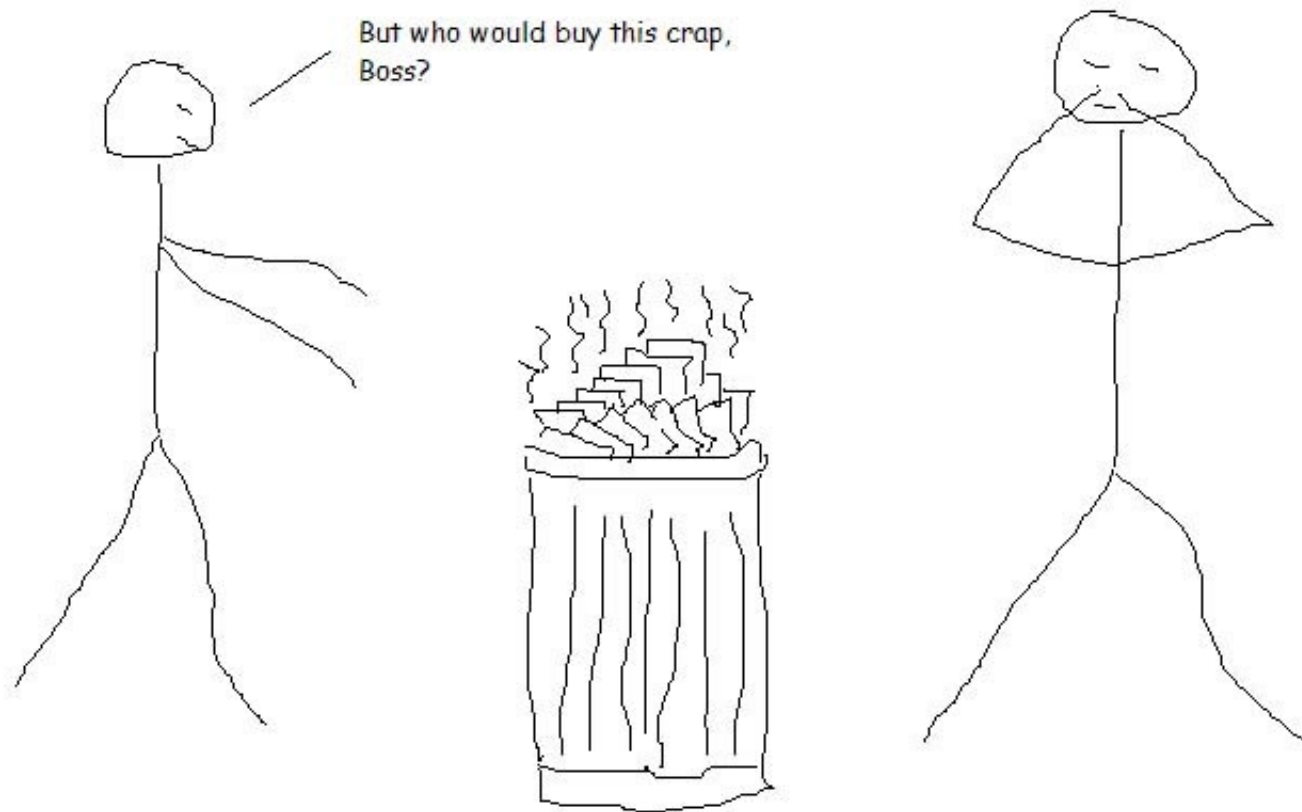
"Trust the 'Really Smart Guys' for All Your Investment Needs"

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



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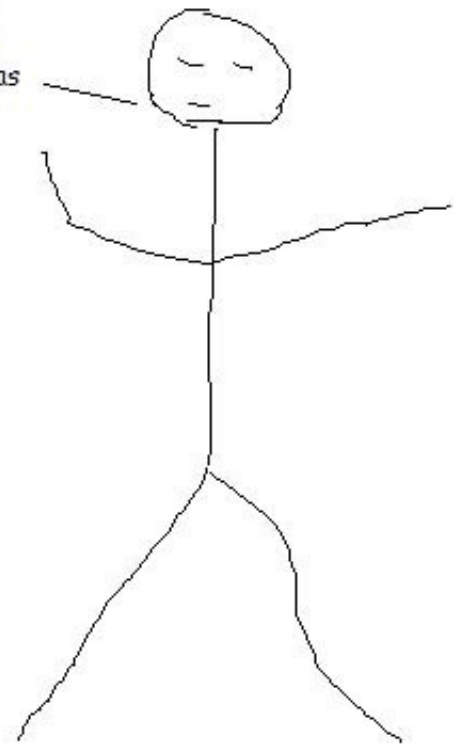
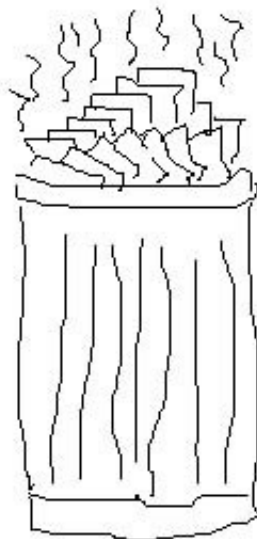
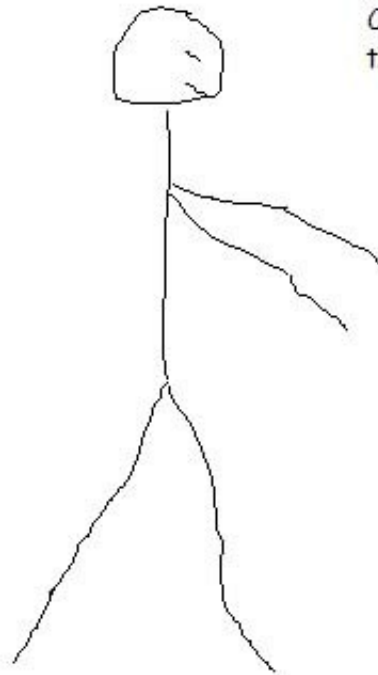
"Trust the 'Really Smart Guys' for All Your Investment Needs"



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

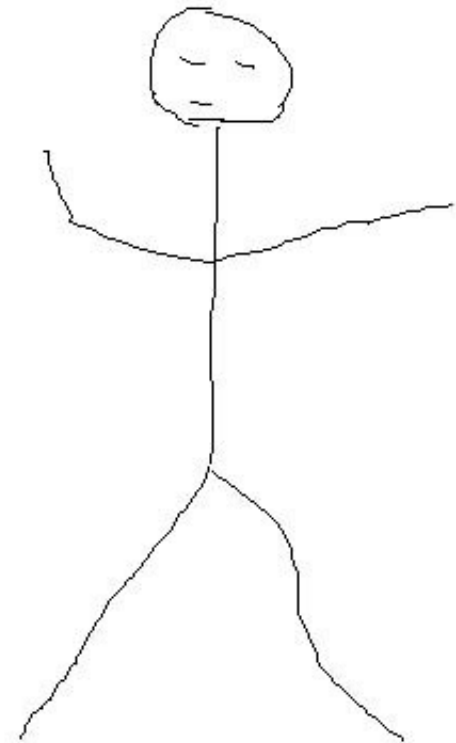
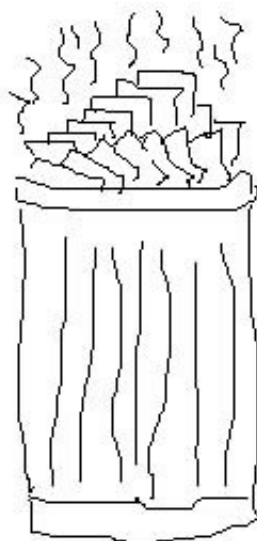
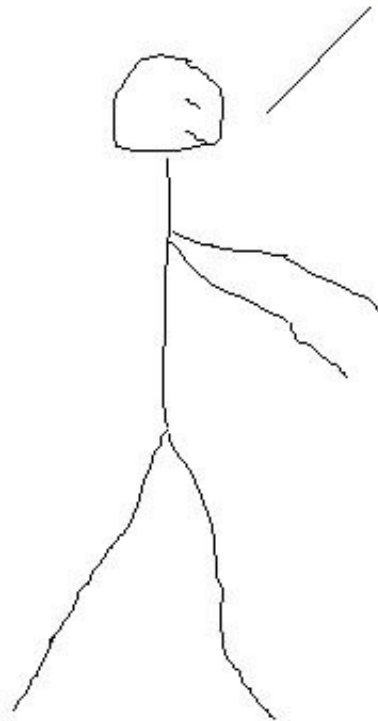
I've got it! First We'll create a new security and use these crappy mortgages as collateral. We'll call it a CDO (or maybe CMO). We can sell that CDO to investors and promise to pay them back as the mortgages are paid off.



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

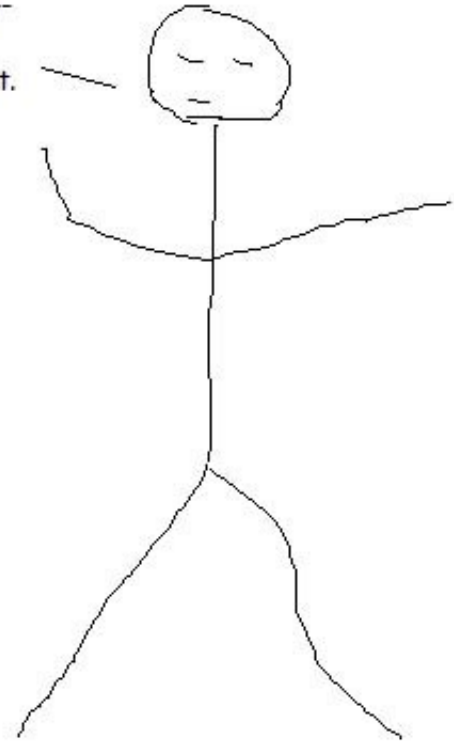
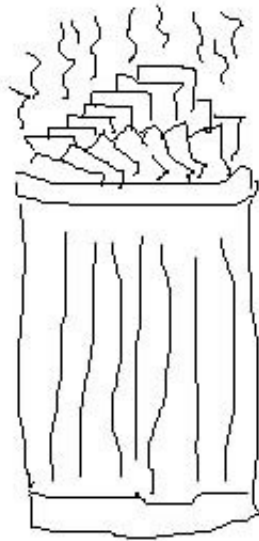
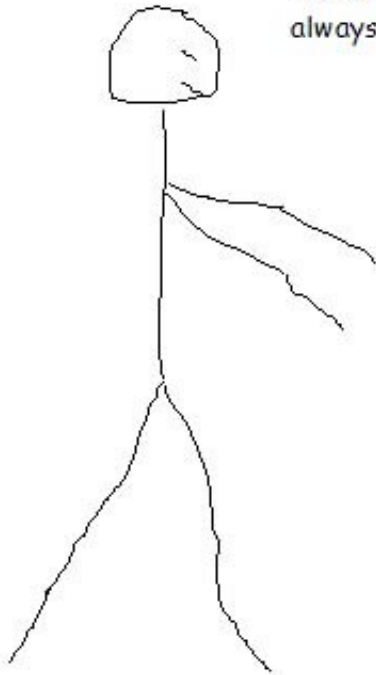
But crap is crap, isn't it? I don't get it.



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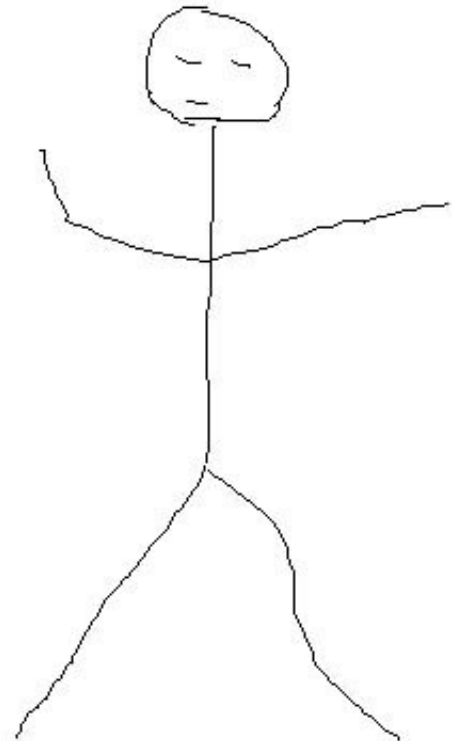
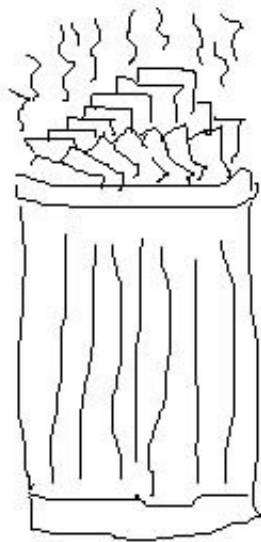
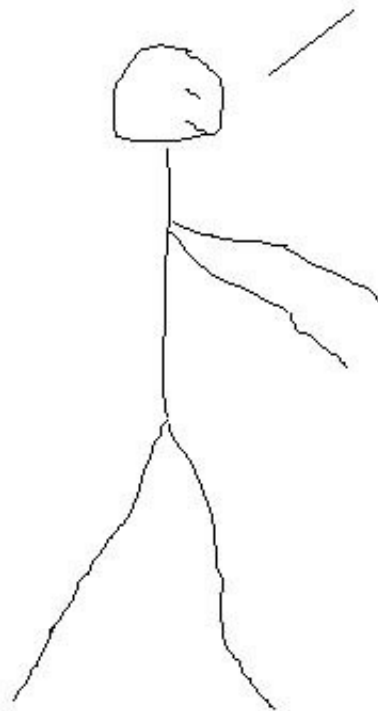
Sure, individually these are pretty crappy loans, but if we pool them together only some of them will go bad -- certainly not all of them. And since housing prices always go up, we really have very little to worry about.



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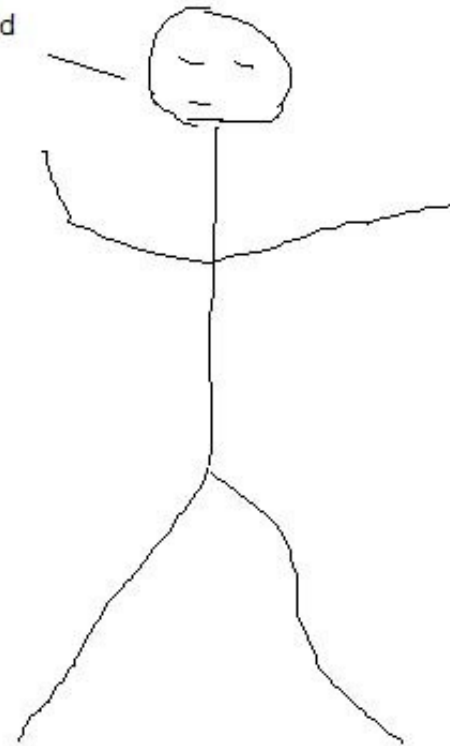
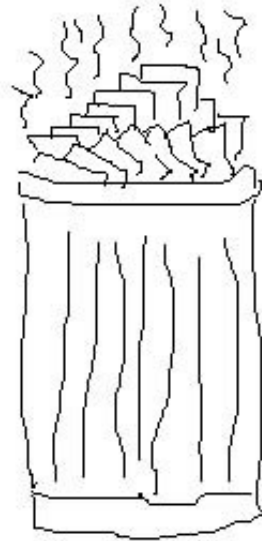
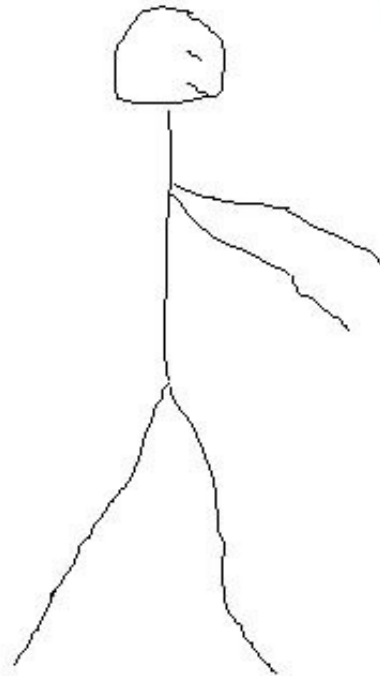
I still don't get it



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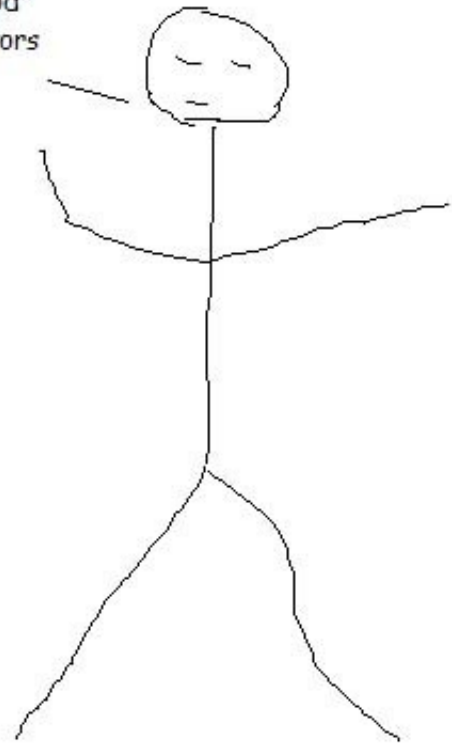
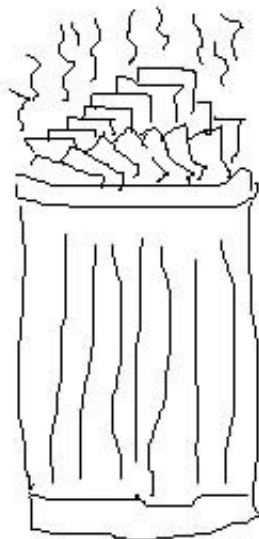
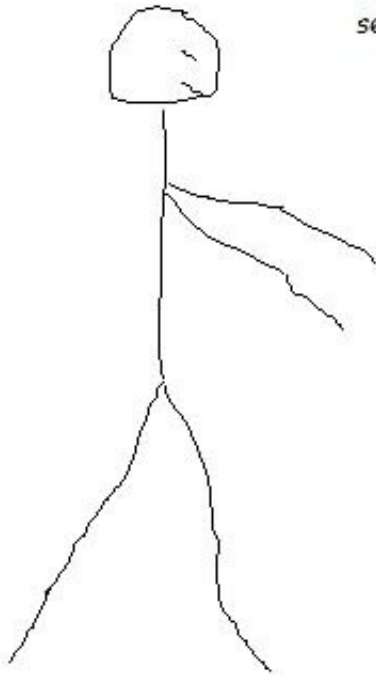
The new CDO will work like this: It will be made up of three pieces (or "tranches") and we'll call them "The Good", "The Not-So-Good" and "The Ugly".



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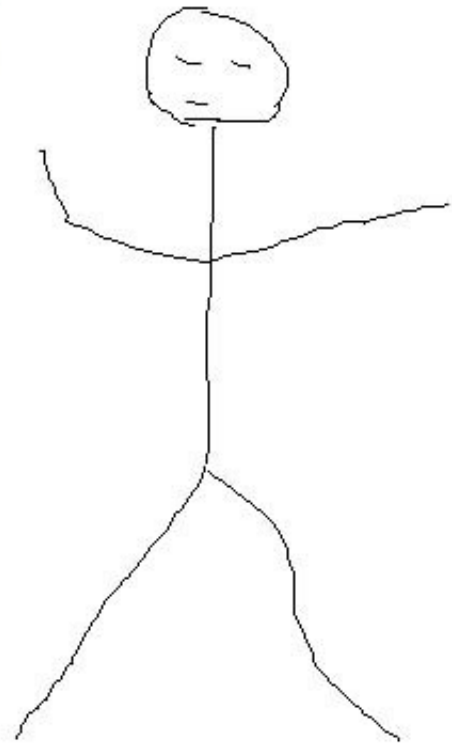
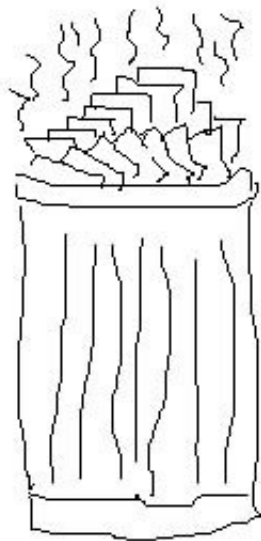
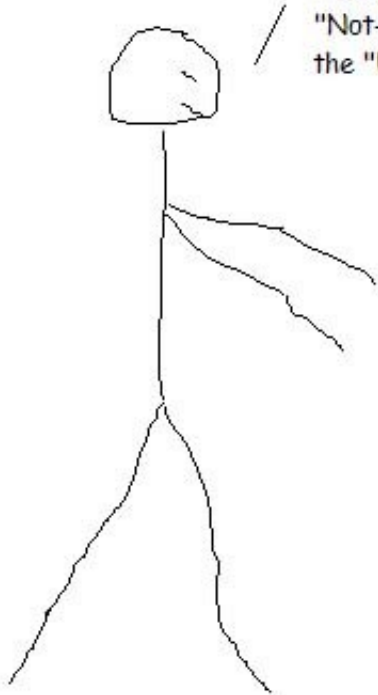
If some of the mortgages fail, as surely some might, we will promise to pay investors holding the "Good" tranch first. We'll pay the "Not-So-Good investors second, and the "Ugly" investors last.



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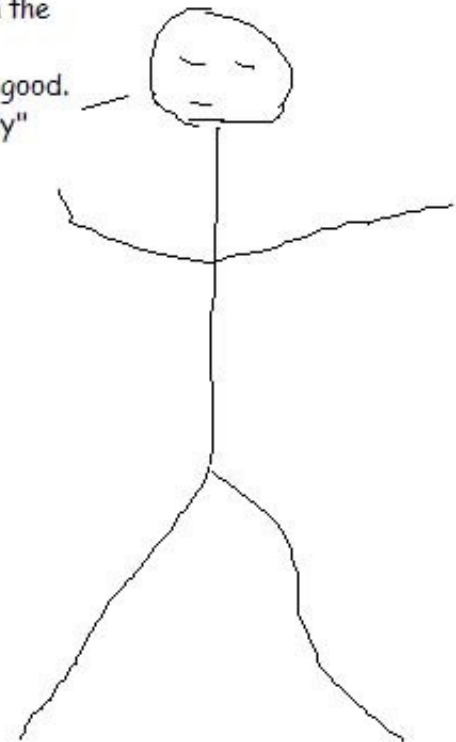
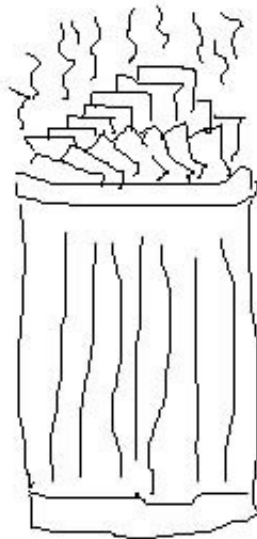
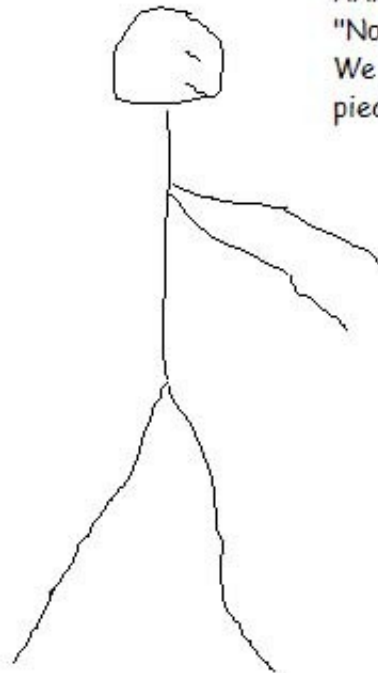
I'm starting to get it. And because the "Good" investors have the least risk, we'll pay them a lower interest rate than the other guys, right? The "Not-So-Goods" will get a better interest rate and the "Ugly" guys will get a nice fat interest rate.



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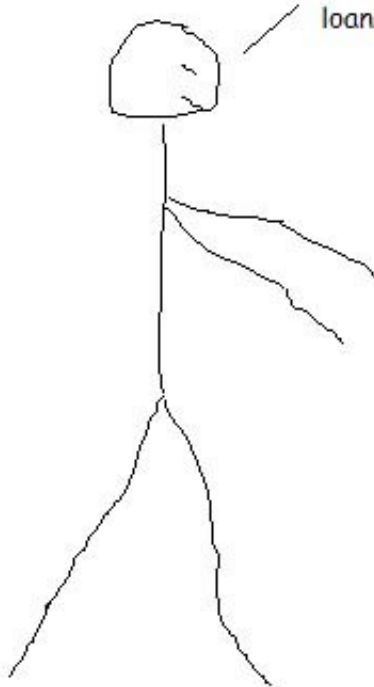
Exactly. But wait, it gets better. We will buy bond insurance for the "Good" piece. If we do that, the Rating agencies will give it a really great rating, in the AAA to A range. They will likely give the "Not-So-Good" piece a BBB to B rating, still pretty good. We won't even bother asking them to rate the "Ugly" piece.



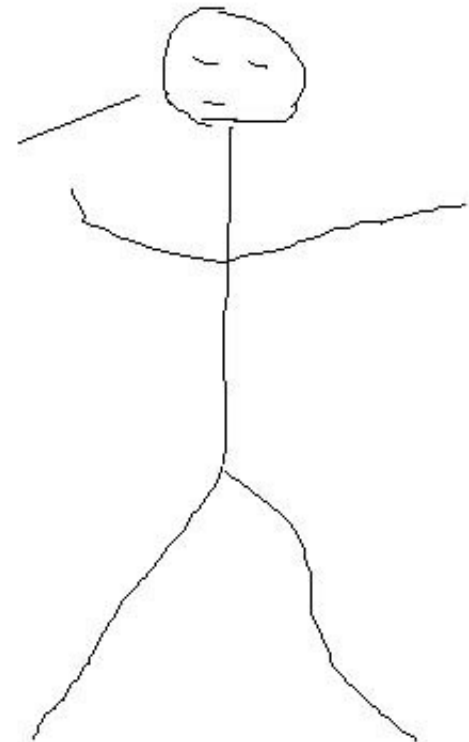
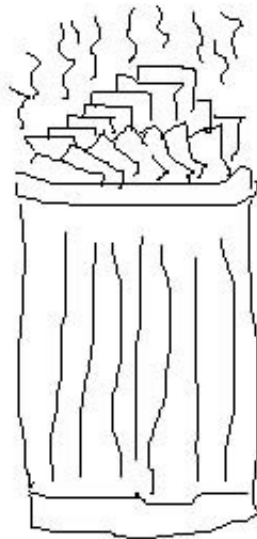
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So you have managed to create AAA and BBB securities out of a pile of stinky, risky mortgage loans. Boss, you are a genius.



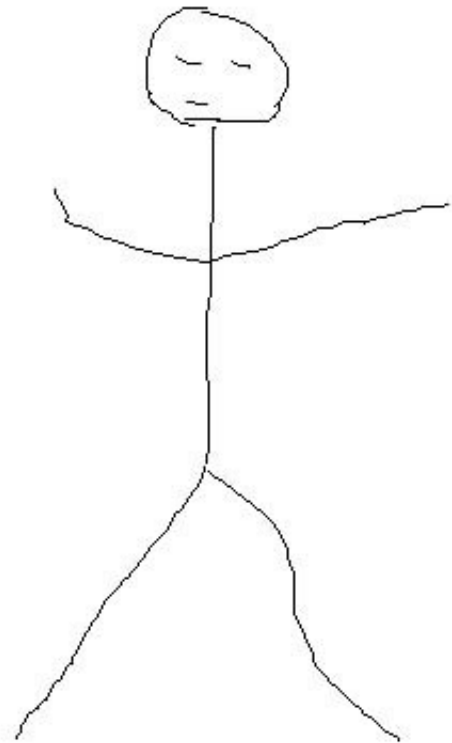
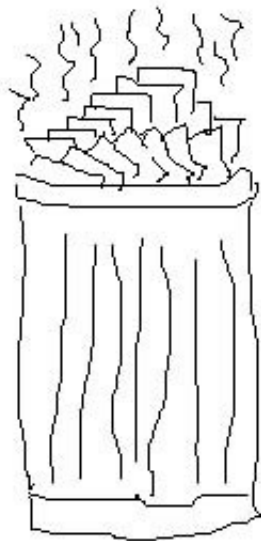
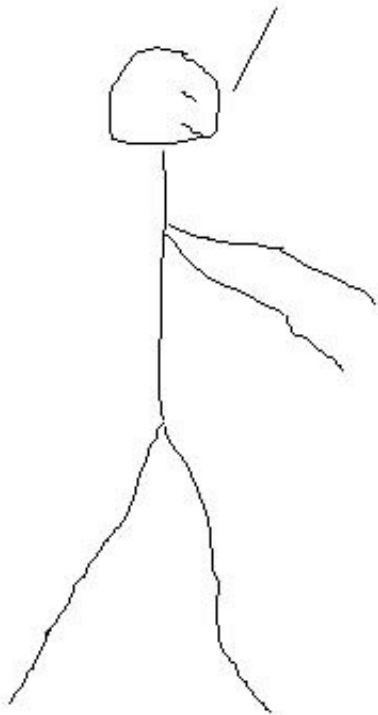
Yes, I know.



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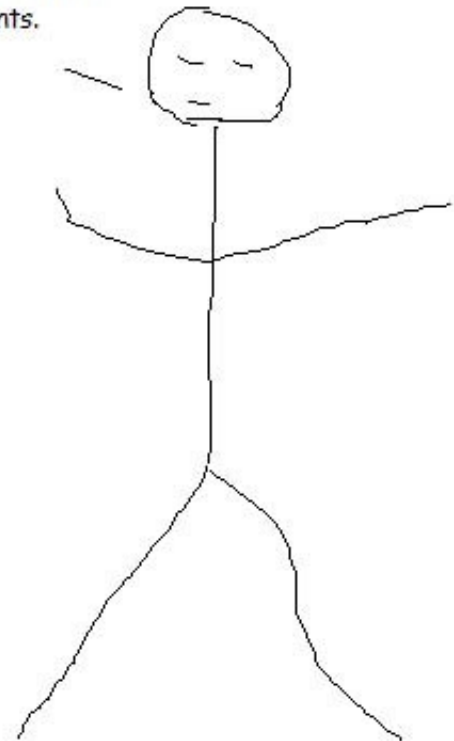
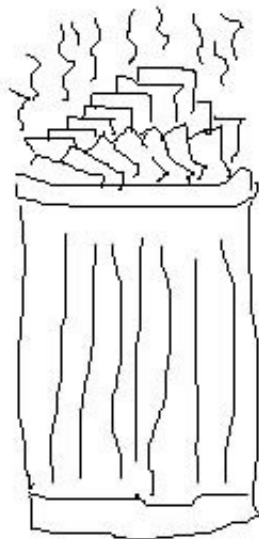
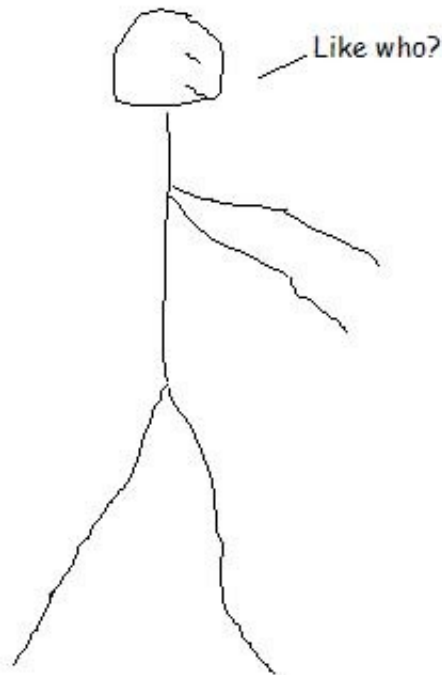
Okay, now who are we going to sell
the three pieces to?



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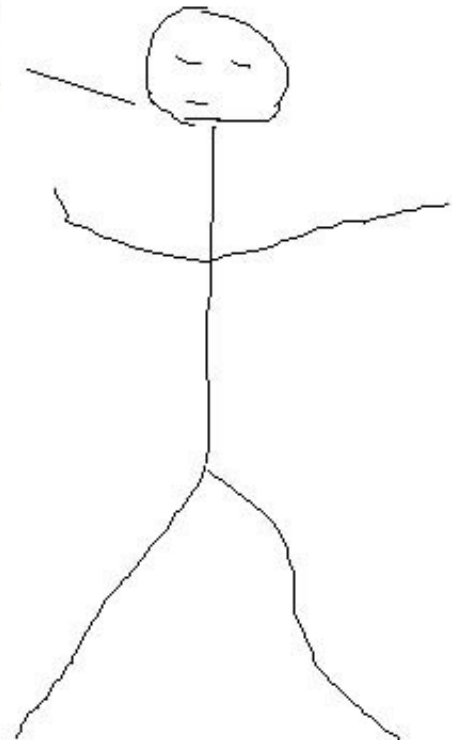
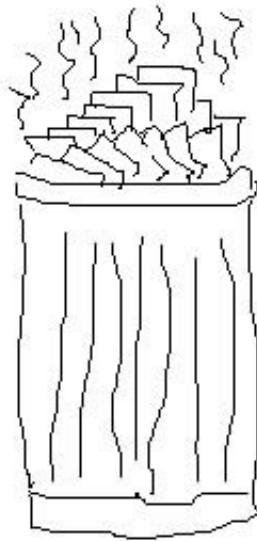
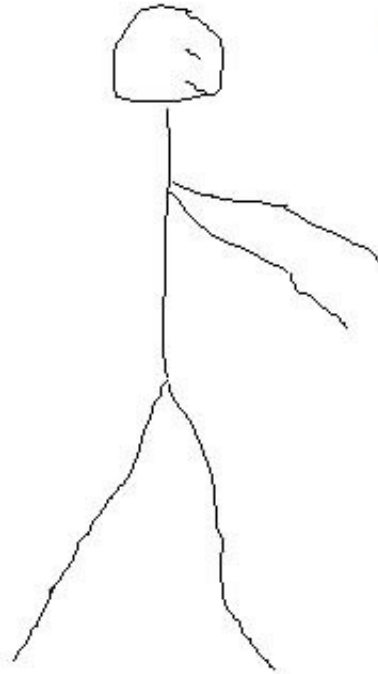
The assholes at the SEC won't let us sell this stuff to widows and orphans, so we'll sell it to our sophisticated institutional clients.



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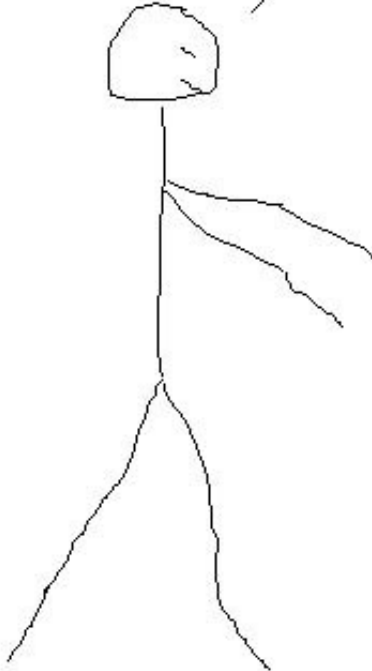
Like insurance companies, banks, small towns in Norway, school boards in Kansas -- to anyone who is looking for a high-quality safe investment.



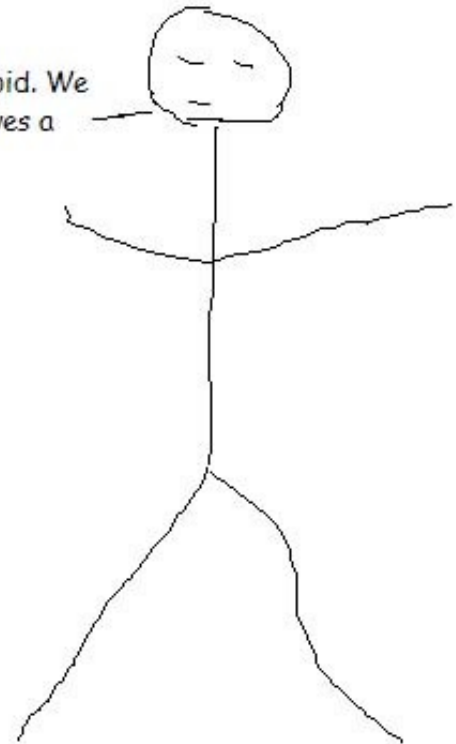
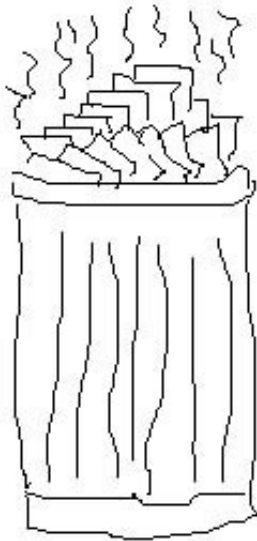
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But surely nobody would buy the "Ugly" piece, would they?



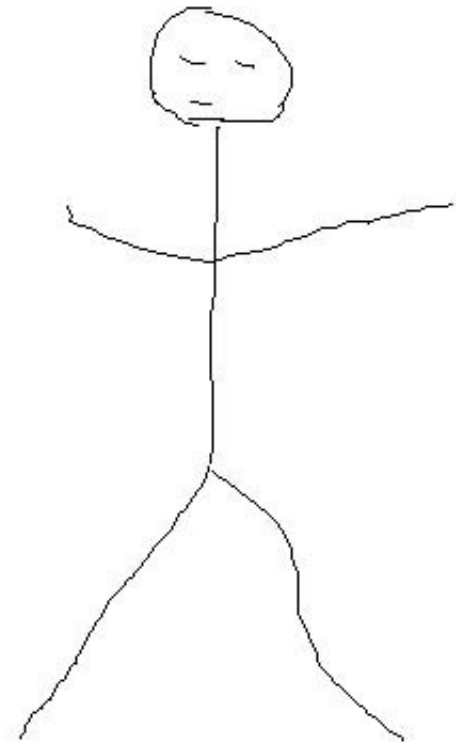
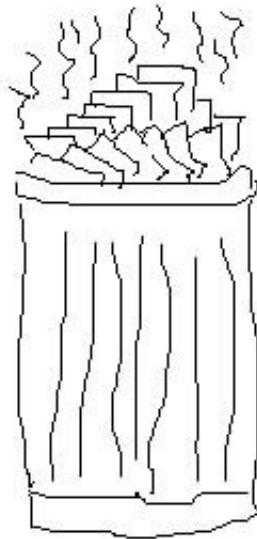
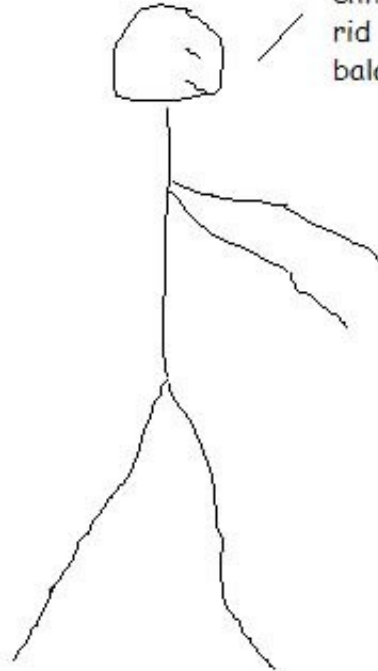
Of course not -- nobody is that stupid. We will keep that piece and pay ourselves a handsome interest rate.



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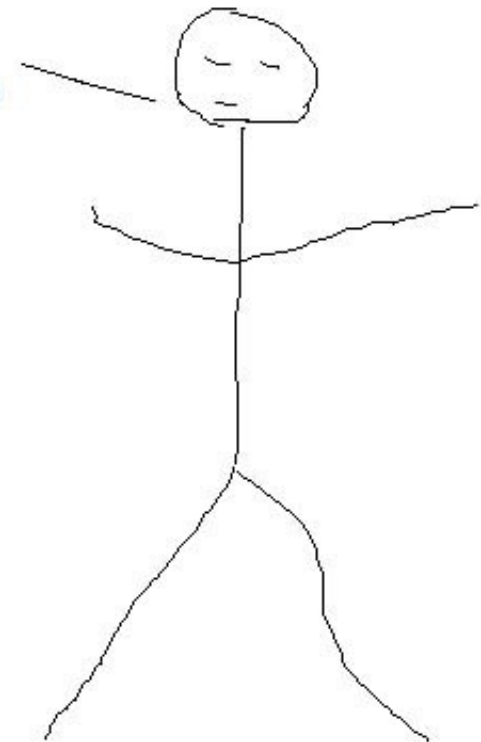
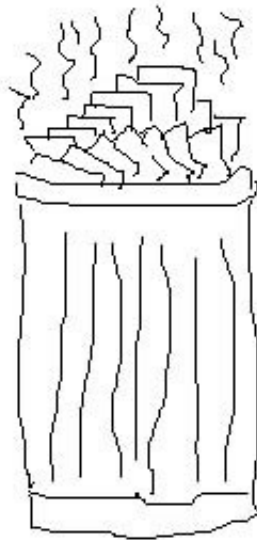
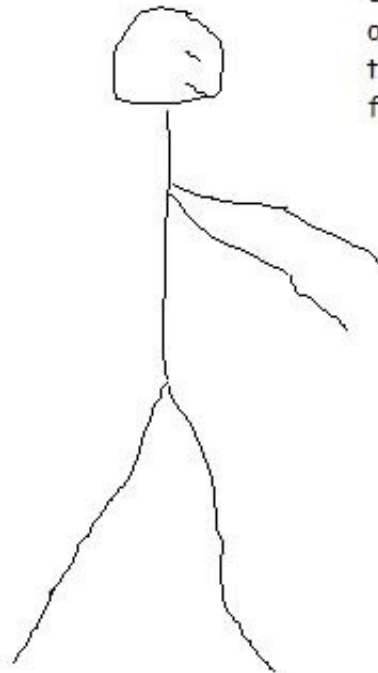
This is all great, but since we are only using the smelly mortgages as collateral on an entirely new security, we haven't really gotten rid of them. Don't we have to show them on our balance sheet?



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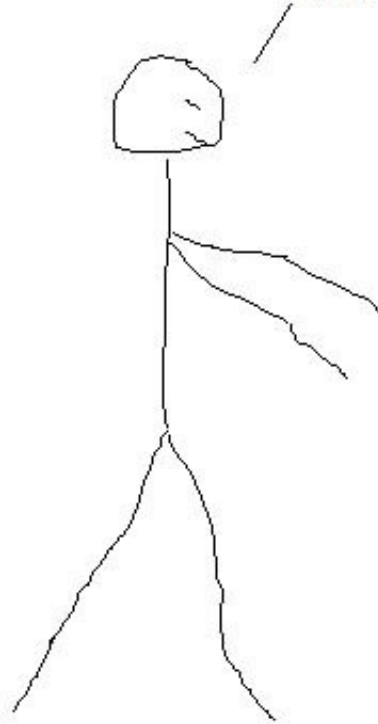
No, of course not. The guys who write the accounting rules allow us to set up a shell company in the Caymen Islands to take ownership of the mortgages. The crap goes on their balance sheet, not ours. The fancy name for it is "Special Purpose Vehicle" or SPV.



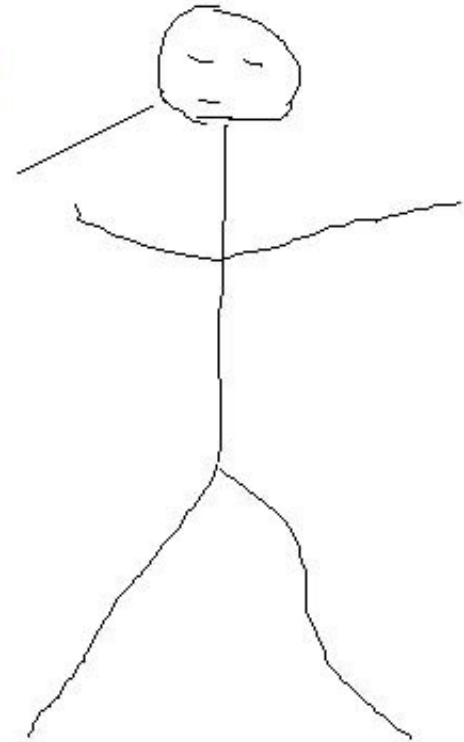
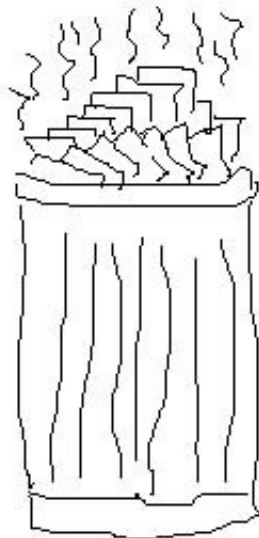
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That's great, but why would they let us do that,
aren't we just moving our own crap around?



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

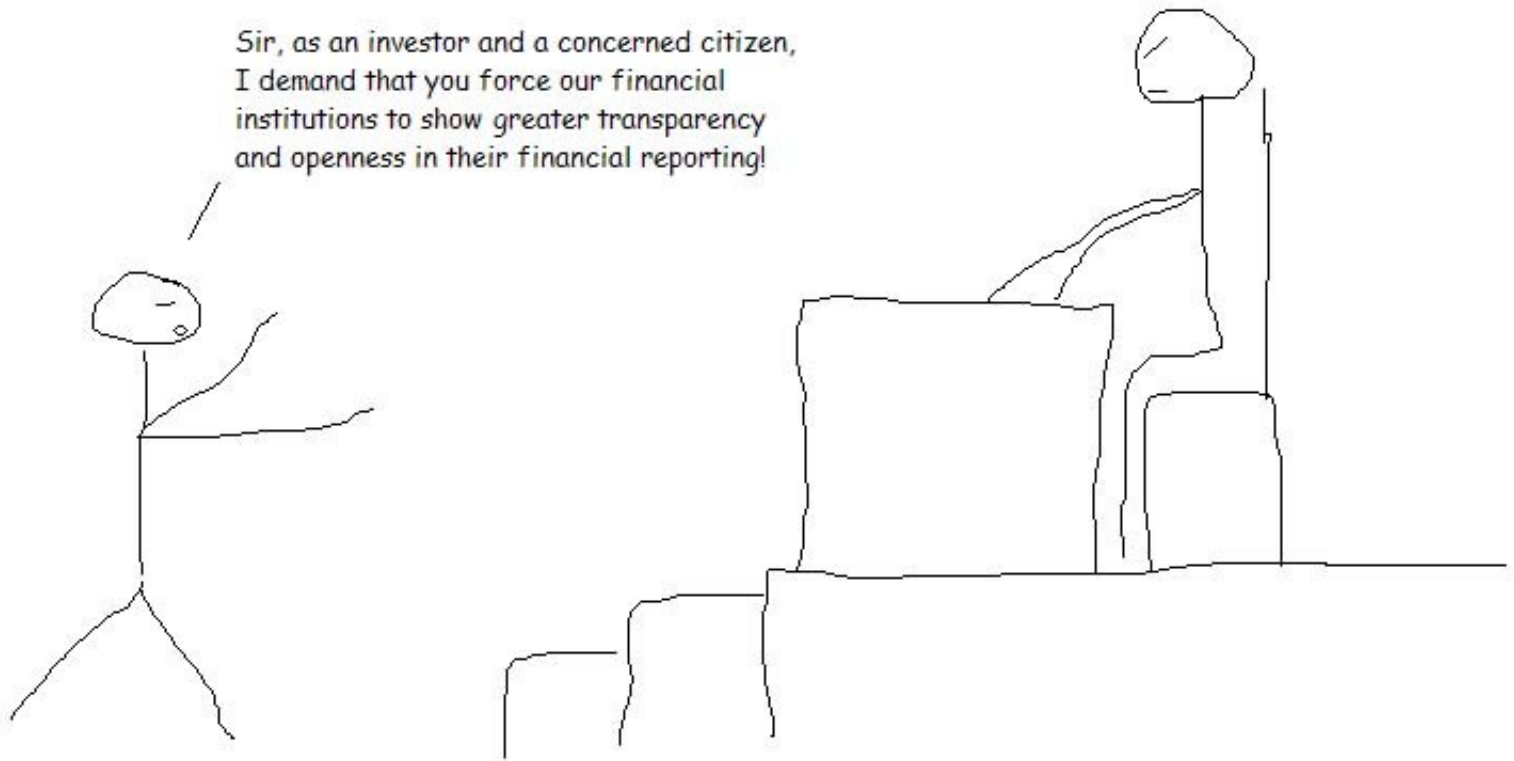


Let's drop in to see the Accountants.....

Office of the Czar of Accounting

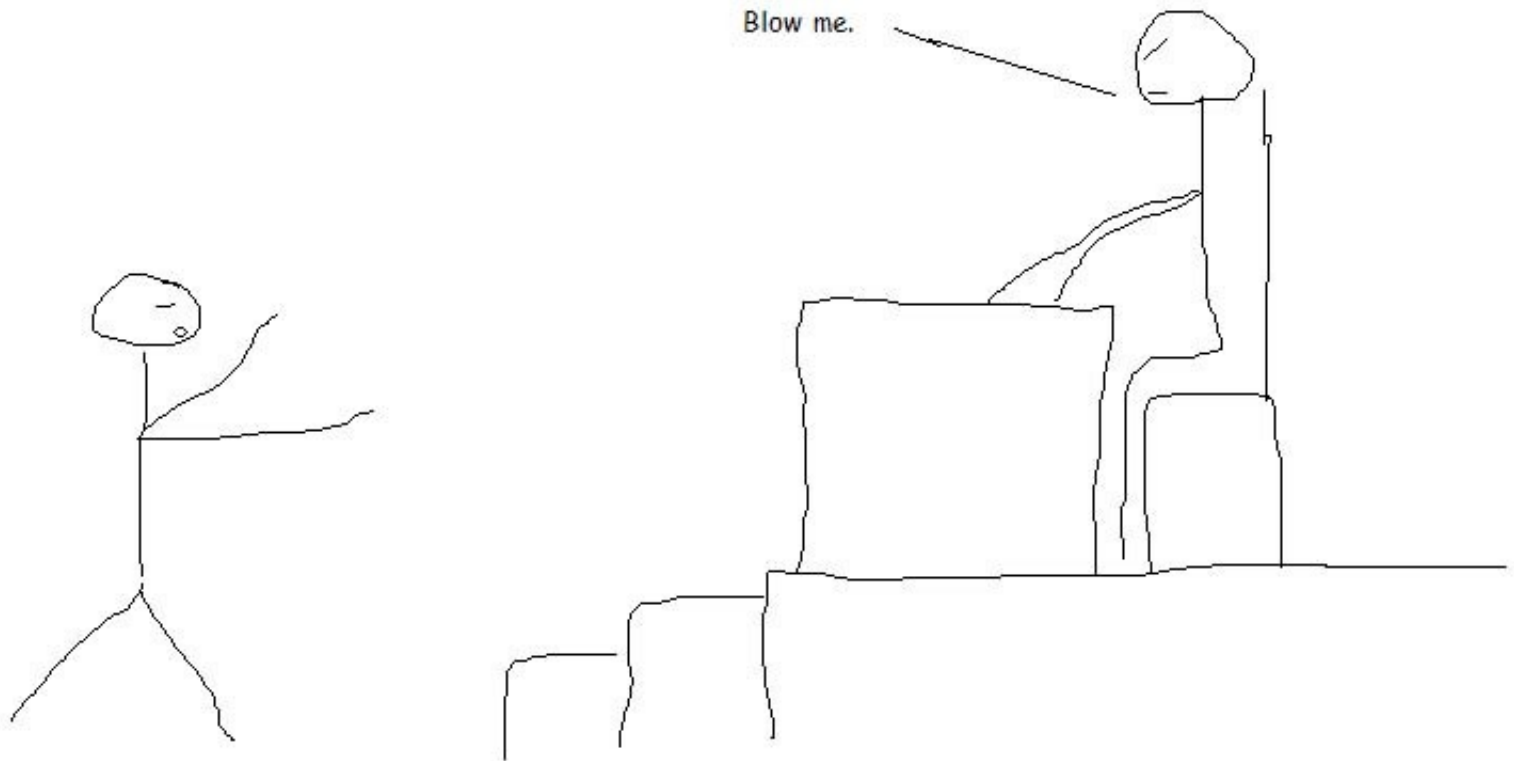
"No Nit Too Small to Pick"

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

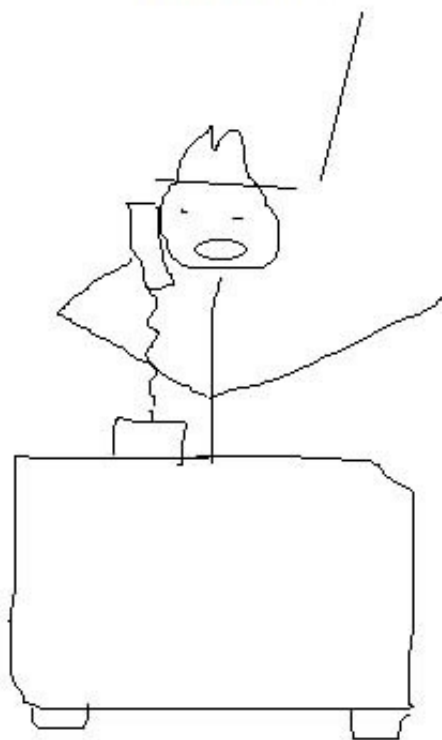
"No Nit Too Small to Pick"



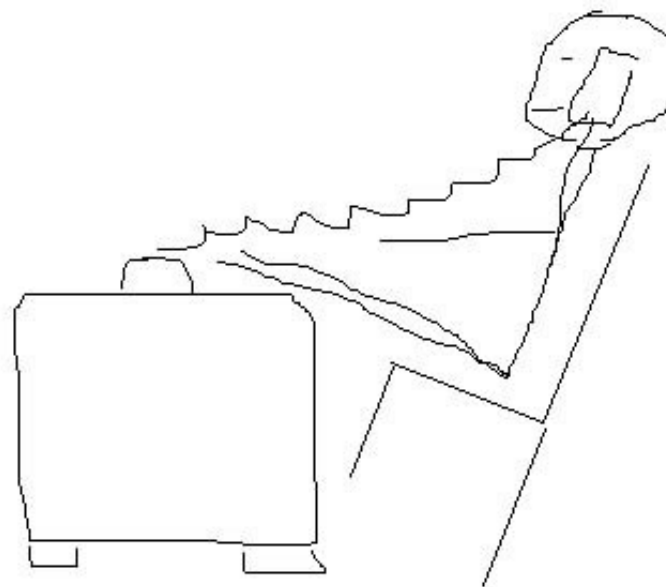
Gee, We Never Saw it Coming.....

Norwegian Village Pension Fund

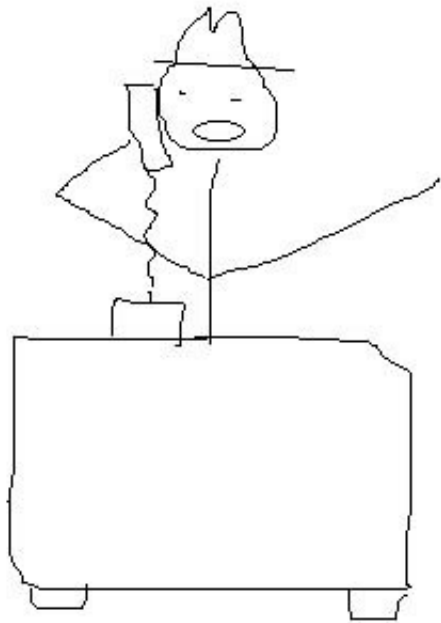
Hey man, what the hell is up?
We're not receiving our
monthly payments!



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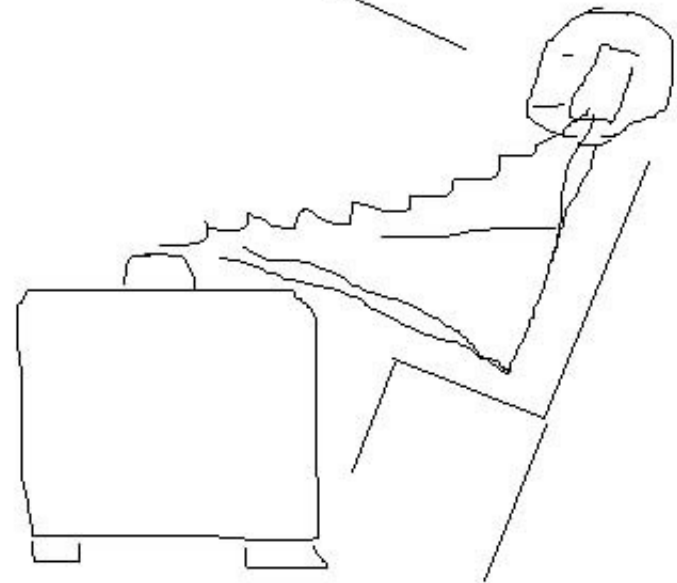


Norwegian Village Pension Fund



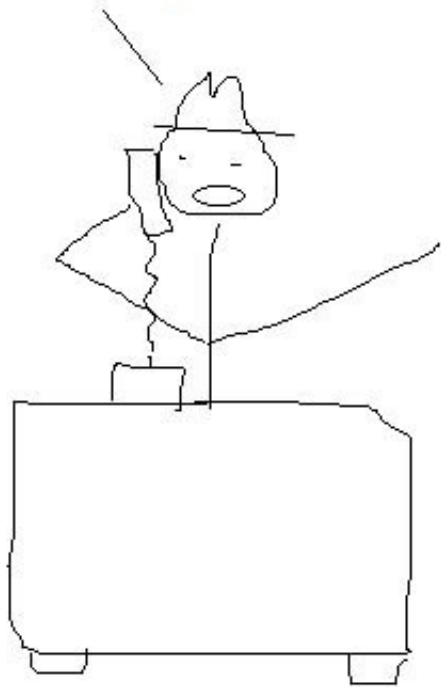
RSG Investment Bank

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

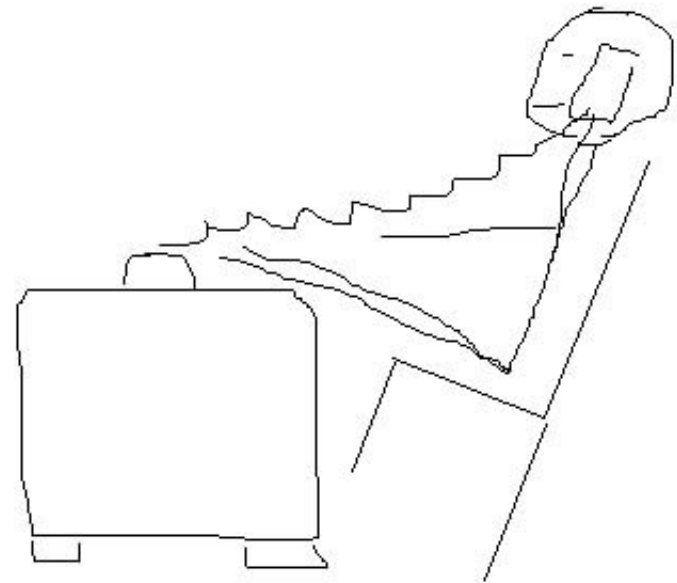


Norwegian Village Pension Fund

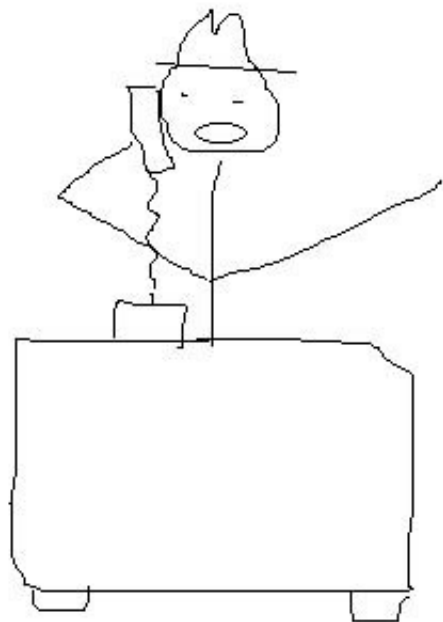
Wait a minute! We bought the AAA "Good" piece of the CDO. You know? The safe one. We're supposed to be getting paid first.



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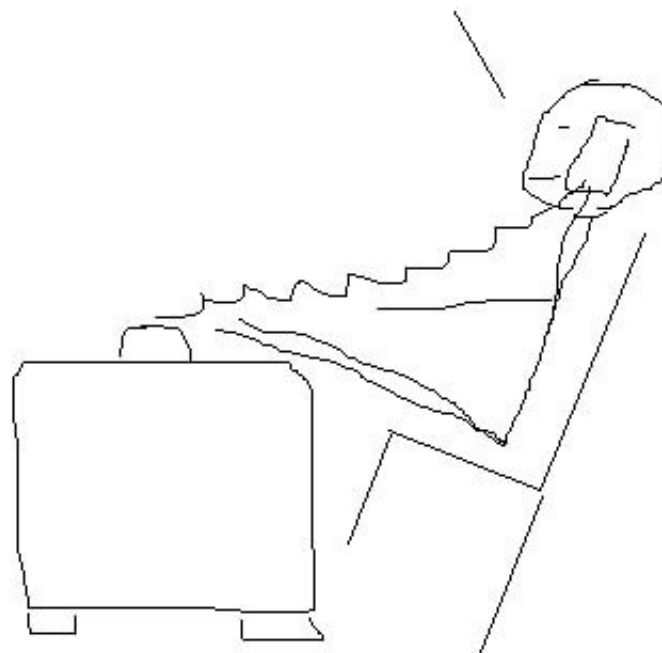


Norwegian Village Pension Fund



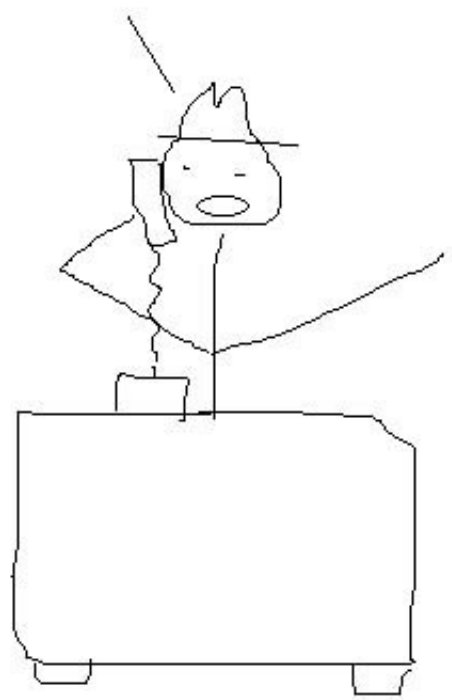
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Well unfortunately the loans were quite a bit crappier than we originally thought and there is very little cash coming in. Frankly, I assure you that we are as disappointed as you are.

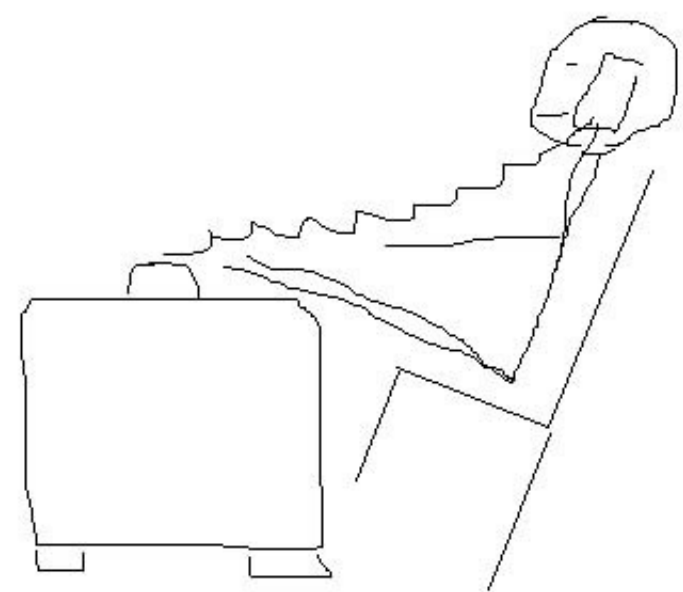
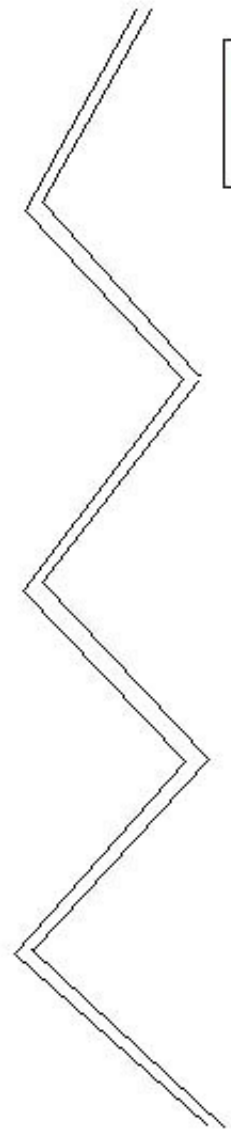


Norwegian Village Pension Fund

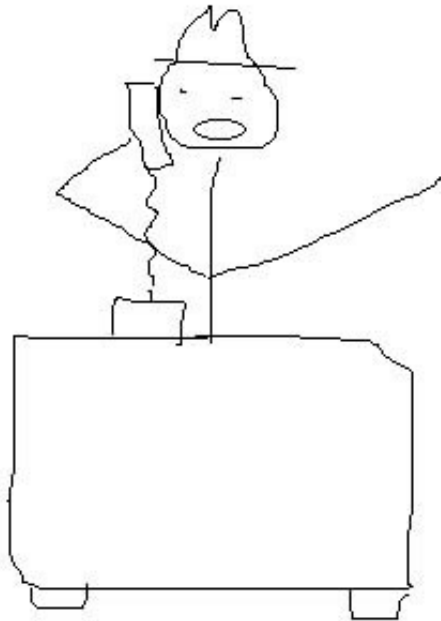
But you told me that housing prices always go up and that your borrowers could always refinance their mortgages!



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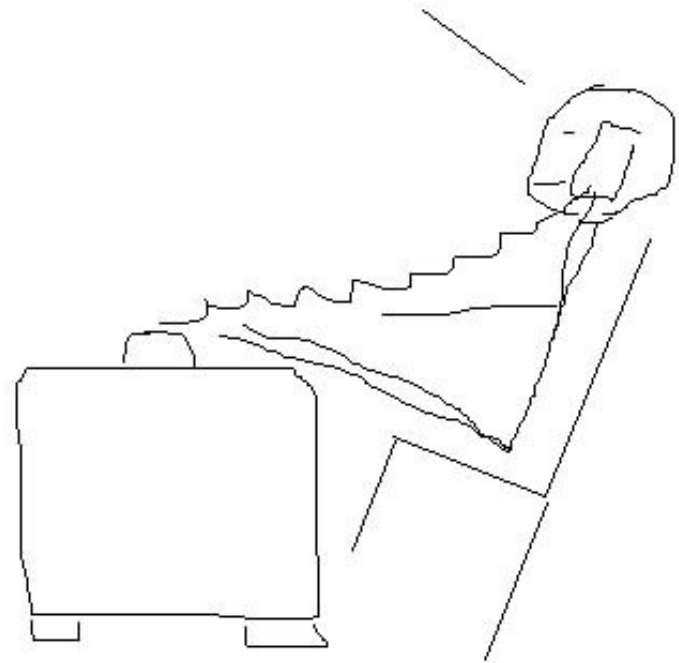


Norwegian Village Pension Fund



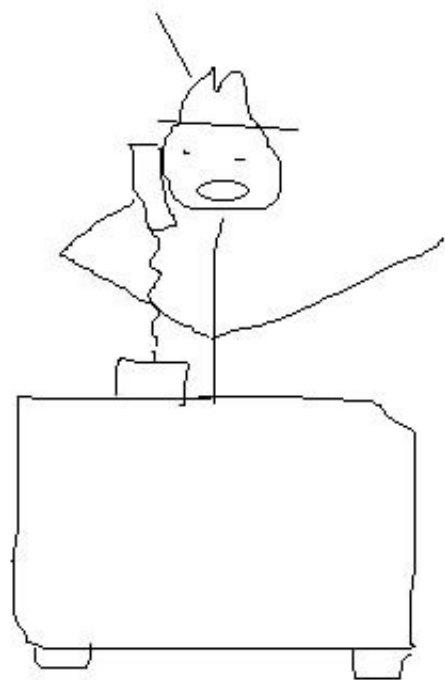
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Yeah, that was a bad assumption.
We fucked up. Sorry.

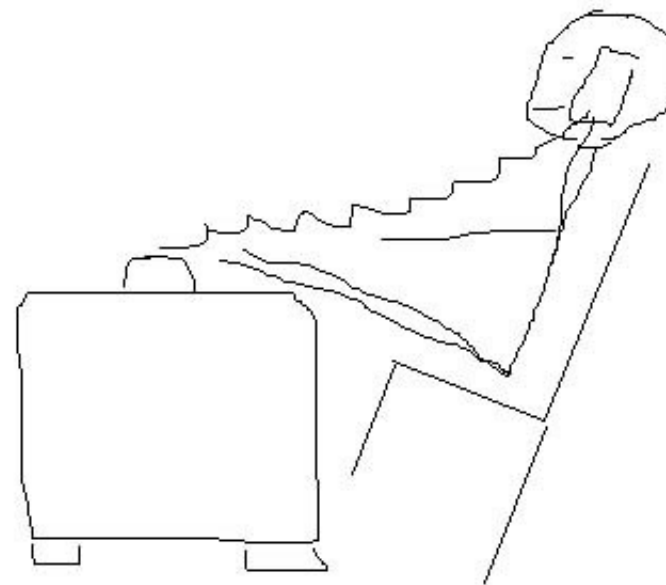
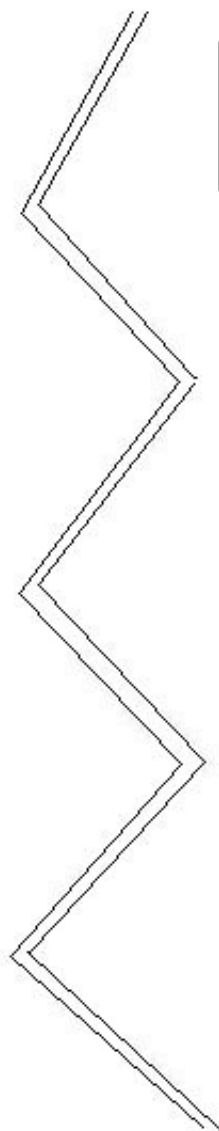


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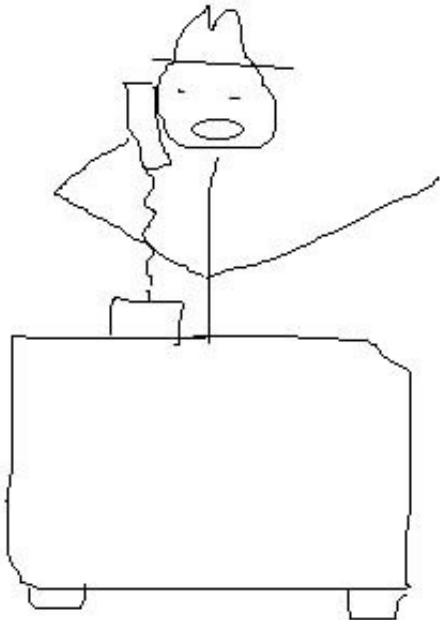
Bad assumption my frigid Norwegian ass! What about the AAA rating from the agencies?



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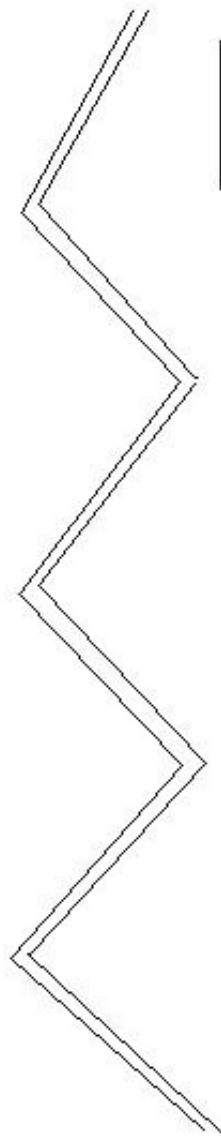
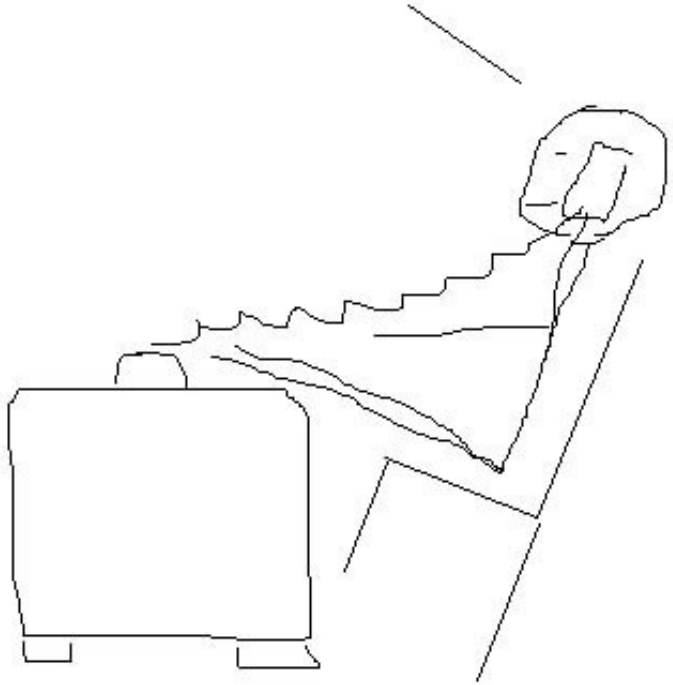


Norwegian Village Pension Fund



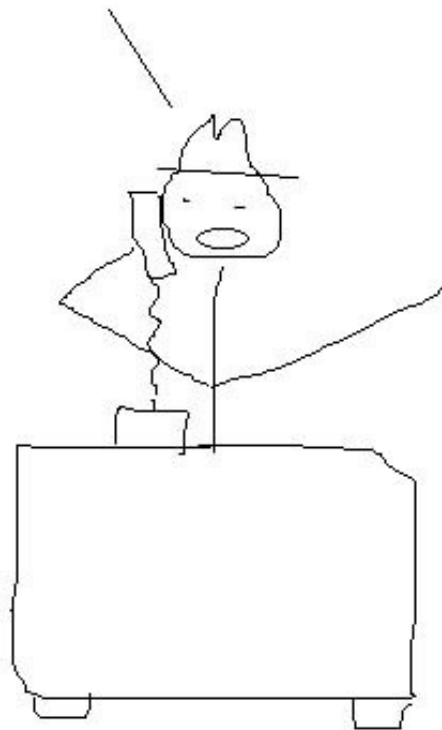
RSG Investment Bank

They fucked up too.

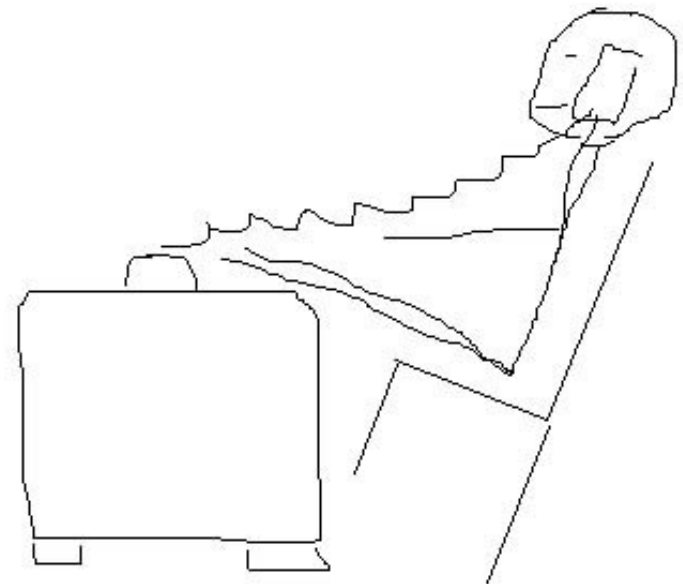
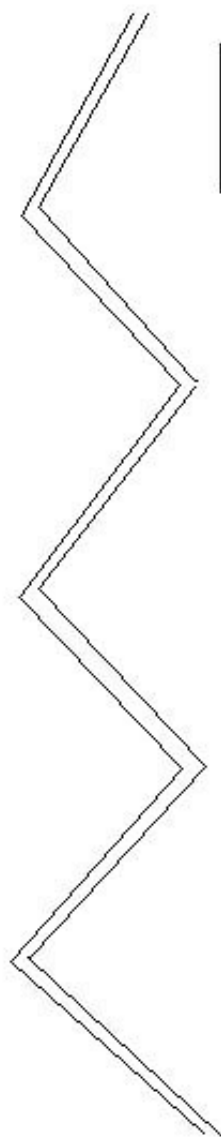


Norwegian Village Pension Fund

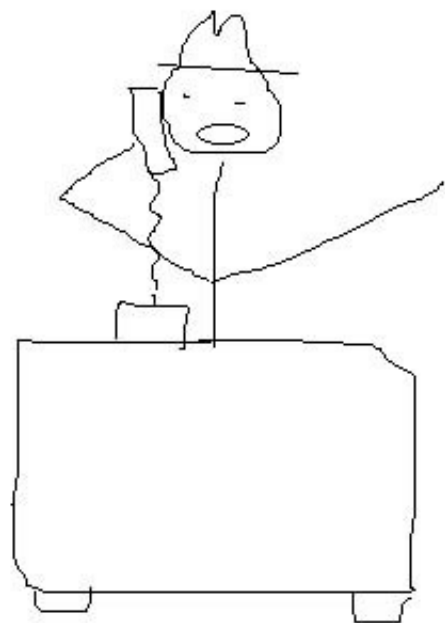
But this security was insured! What about the insurers?



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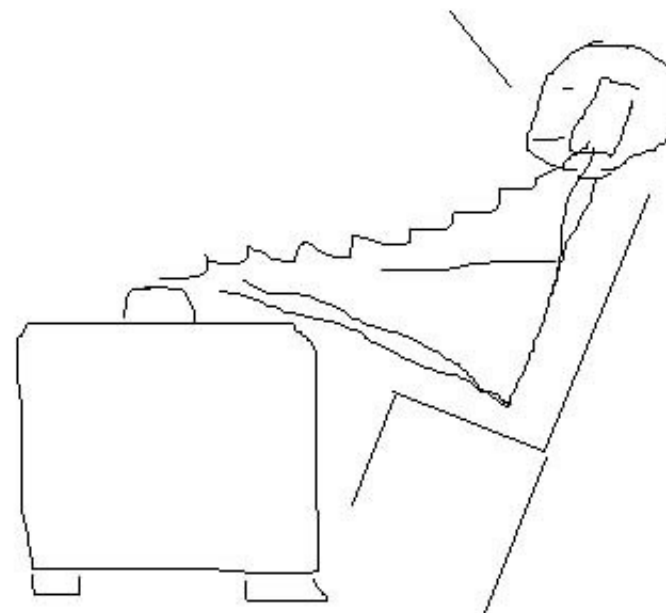


Norwegian Village Pension Fund



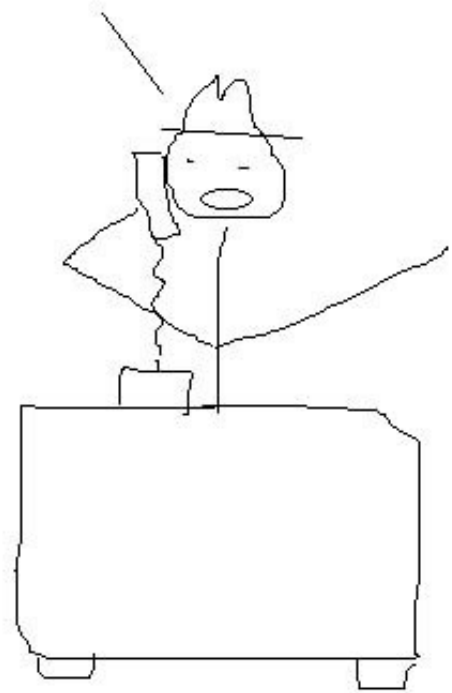
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Are you kidding? There's no way they have enough money set aside to cover this mess. They fucked up.

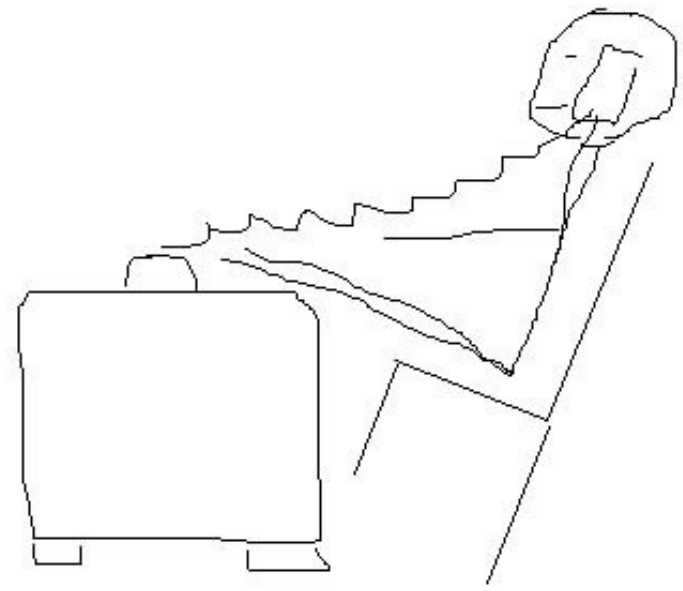
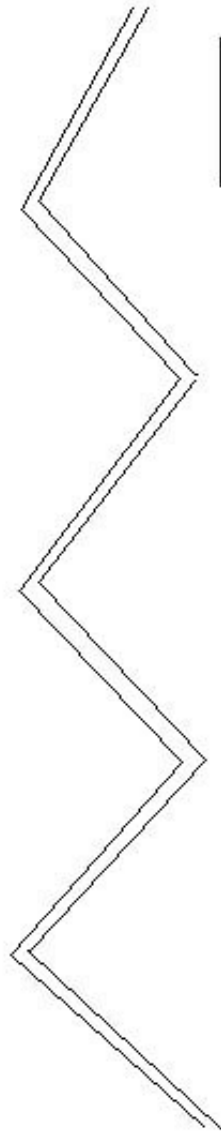


Norwegian Village Pension Fund

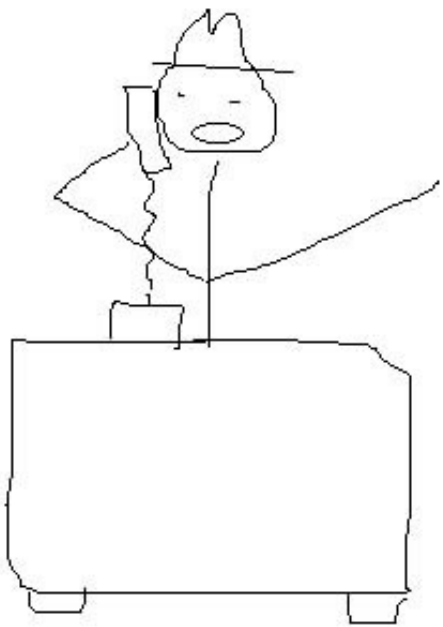
Well that's just great, asshole.
What am I supposed to tell my
villagers?



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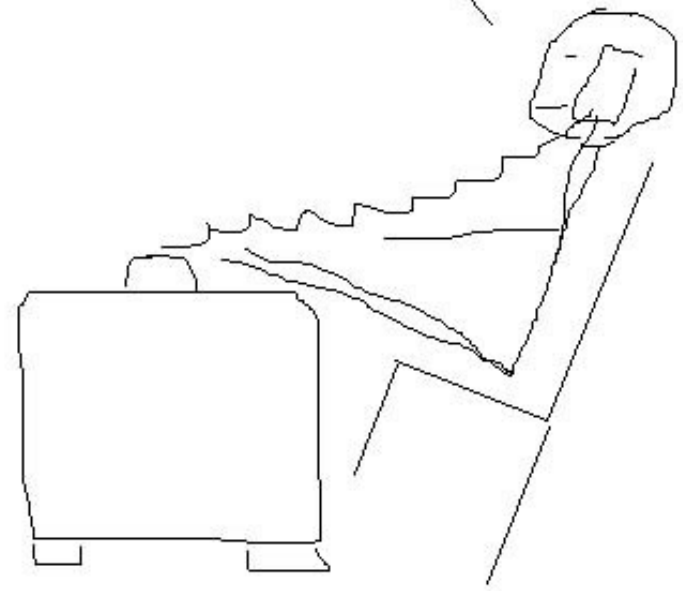


Norwegian Village Pension Fund



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Tell them you fucked up.

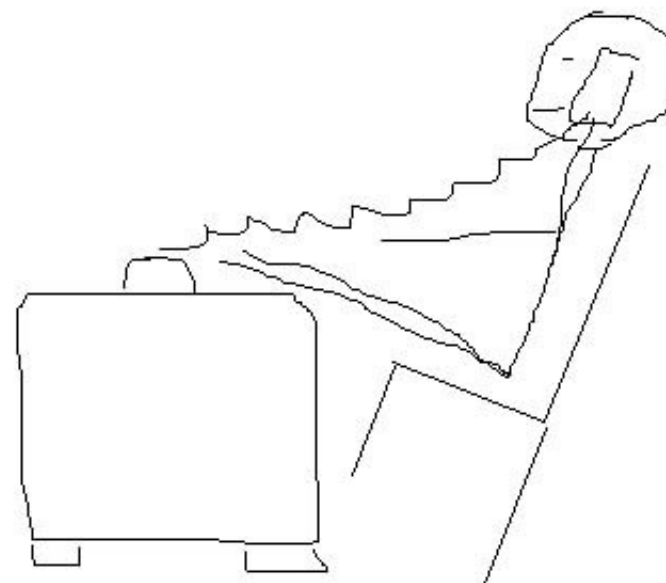


Norwegian Village Pension Fund

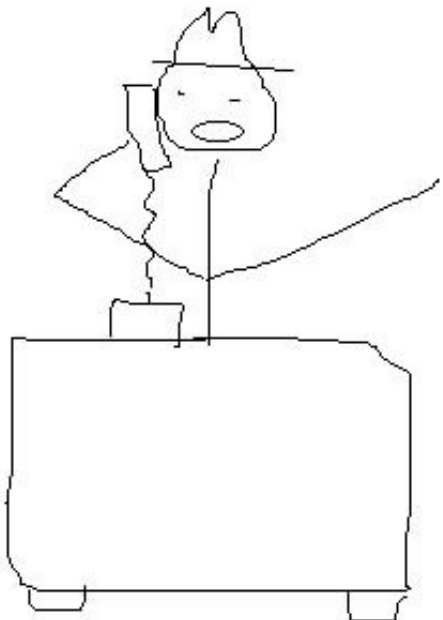
Fuck you.



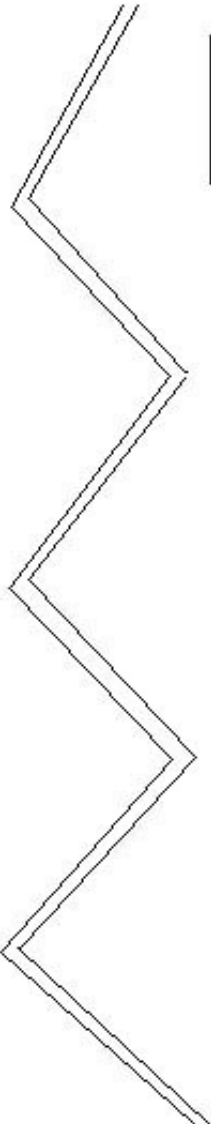
RSG Investment Bank



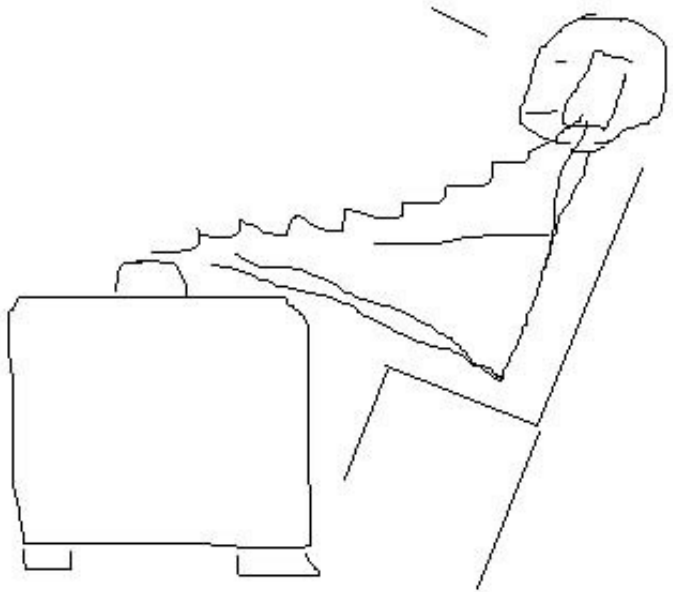
Norwegian Village Pension Fund



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Fuck you.



The End

