Repairing the Damage of “Fraud as a Business Model”

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IMF: I'M Fantasizing

"The dispersion of credit risk by banks to a broader and more diverse set of investors, rather than warehousing such risk on their balance sheets, has helped to make the banking and overall financial system more resilient."

IMF Global Financial Stability presentation, April 13, 2006

Widespread Interconnected Ponzi Scheme

Securitization professionals at several financial institutions knowingly bundled fraud riddled loans into RMBS. New investors needed to pay-off old investors. To delay being busted, they escalated and sped up the fraud. This required more "complexity" and the involvement of more cronies.

Many CDOs and virtually every CDO-Squared were more fraud to cover-up fraud.

Stan O'Neal's OpEd

"In any system predicated on risk-taking, there are failures, sometimes spectacular failures. But for every failure to be viewed as fraudulent or even criminal bodes ill for our economic system."

"Risky Business," *WSJ* April 24, 2003.

Tavakoli on O'Neal

"It's great to have an open mind, but don't leave it so open that your brains fall out."

Dear Mr. Buffett, Wiley, January 2009.

Merrill and Ownit on O'Neal's Watch

"The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans."

– William D. Dallas, Ownit's founder and CEO

Dec 2006: Merrill, JPMorgan, and Ownit

- Merrill was part owner of Ownit.
- ML global finance head sat on Ownit’s board.
- JPMorgan yanks $500 million credit line.
- Ownit goes bankrupt December 2006; ML finance head faxes in resignation.
- Stan O’Neal and Jamie Dimon can read newspapers.

Merrill Accelerates Cover-Up

- HSBC takes $6 billion subprime write-off for 4Q 2006.
- Merrill madly *accelerates* CDO activity in first half of 2007; before securitization halts completely.
- JPMorgan closes "Squared" May 2007.

Fraud audits are in order

Tavakoli on Merrill – January 2007

- Business managers have boots on the necks of risk managers.
- Risk managers should get out now and short.

“Subprime Mortgages: The Predators’ Fall,” Tavakoli, *Risk Professional* (formerly *GARP Risk Review*) Issue 35, March/April 2007.

Merrill's 2007 "Ownit" Deal

- Package of loans including Ownit's piggyback loans.
- Around 70 percent of the borrowers had not provided full documentation of either their income or assets.
- Most loans were 100% LTV
- Home prices weak and falling.
- Deal docs omitted Merrill was Ownit's largest creditor.

"Color –Blind in a Sea of Red Flags," Floyd Norris, *New York Times*, May 16, 2008.

Merrill's 2007 "Ownit" Deal (Cont'd.)

- In early 2008, "triple-A" rated tranche downgraded to junk.
- Moody's forecast 60 percent of the original portfolio value could eventually be lost.
- Bond Fund of America was an investor.

"Color –Blind in a Sea of Red Flags," Floyd Norris, *New York Times*, May 16, 2008.

Merrill's 2007 CDOs – TSF Analysis

- Classic situation for fraud: All 30 ABS CDOs, more than $32 billion.
- By June 10, 2008, all 30 had one or more "AAA" tranches downgraded to junk by one or more rating agencies.
- Topmost "AAA" junked by one or more rating agencies for 27 of the 30.

Financial Meth Labs

- Investment banks - securities fraud
- Mortgage lenders – widespread fraud
- Rating agencies – junk science
- CDO “managers” – crash test dummies & accomplices
- Certain hedge funds – shorted CDOs they “managed”
- Bond insurers – money for nothing
- Regulators – poseurs and enablers

FUBAR Finance: CDO *Hawala*

You bury my losses; I'll bury yours.

TBTF: Trust Bernanke To Fund

- Shadow Banking
- Financial Trading Machines
- Hedge Funds / PE – Borrowed Money
- Industry Jeopardized by Financial Affiliates
- Derivatives / CDS - Swamp hedge value

15 Million Underwater Homeowners

- Four million - more than 50% underwater; $107,000 average negative equity. This alone: $428 billion.
- 7.8 million - 25% or more underwater
- Most paying higher interest rates than national average. Can't refinance. Not eligible for HAMP.

Source: Equifax, U.S. Gov't. via Moody's Analytics

Banks Held U.S. Hostage

- No money to fund revolving lines of credit.
- Payrolls and payment for deliveries.

Fed bailed out banks, failed to regulate them, failed to investigate them, and then covered up for them.

Cronies Excuse Fraud with a Lie

They thought housing prices would always go up.

No competent structured finance professional uses ever rising prices as the foundation of an analysis.

Finance pros are highly educated and paid more than 95% of the country to do their jobs.

Politics and Media Corruption

FCIC: Stunning Incompetence or Cover-up?

- Phil Angelides: Bear Stearns hedge funds' June 2007
- Prince and Rubin say implosion raised no concerns.
- Rubin claims problems first apparent in fall of 2007.

FCIC: Incompetence or Cover-up? (Contd.)

- Citi's $200 million credit line to Bear Stearns hedge funds to be refunded by Everquest IPO reported May 2007. IPO cancelled after bad press, in which I was quoted saying investment inappropriate for retail.
- Hedge funds invested in Citi's toxic March 2007 Octonion I CDO. EOD February 2008.
- FCIC staffers made aware of public information source by me prior to hearings.

Rubin: Media Enablers – Denial About 2007

- Rubin heads BG panel on potential U.S. state default: Ambac's pending bankruptcy, protection of Citi's toxic CDOs, and Ambac's lawsuit/settlement with Citi, never come up.
- Robert Rubin told Buttonwood Gathering, end October 2010, that no one could foresee problems in 2007.
- Editor for *The Economist* said panel showed Rubin's value. (Editor wasn't trying to be funny.)

Rubin’s Omission: Ambac and Citi’s CDOs

CDS Notionals for Citi’s CDOs

Deal Name	Closing Date	Manager	$Millions
RidgeWay Ct Fndng II	6/27/2007	CSAC	$ 1,950
Adams Square II	6/27/2007	CSAC	$ 510
AA Bespoke	TBD	TBD	$ 1,400
888 Tactical Funding	3/15/2007	Harding	$ 500
Class V Funding III	2/28/2007	CSAC	$ 500
ESP Funding I	9/7/2006	Elliott	$ 657
Ridgeway Ct Fndng I	7/26/2006	CSAC	$ 1,570
Diversey Harbor	6/1/2006	Vanderbuilt	$ 1,875

Example: Ambac alleged Citi provided false asset marks for Ridgeway Court Funding II. Sued Citi and CSAC.

Citi's Troubles Indisputable by Jan 2007

Jan 2007-October 31, 2007

- Early 2007, Jim Rogers appears on Cavuto with Meredith Whitney explains why he's *short.* Predicts $5 price. Whitney opposes view, rates it *sector perform*.

- Price is $55 on Jan 3, steadily drops to $42.25 by October 31, 2007.

Whitney's Hyped Citi Call was *Late*

- October 31, 2007 - Jim Rogers still short; $5 target. Richard Bove, Charles Peabody, and Michael Mayo already have a sell on Citi. Whitney rates Citi sector underperform; says it could trade in '30s and must cut dividend. Rogers said Citi must cut dividend, when he announced his short in Jan 2007.
- December 27, 2007, Citi is below 30 and still falling.
- Citi hits $5 in January 2009. Jim Rogers takes his profit.

Motive for Rubin's Lie about 2007?

- Citi brought suspect CDOs to market earlier in 2007.
- Citi had massive exposure to put options and serious issues with its SIVs.
- After multi-year fraud, by Jan 2007, public information about imploding mortgage lenders made need for write-offs undeniable.
- Admission of awareness makes CEOs and CFOs accountable for allowing widespread securities fraud to continue.

CNBC: Media Corruption

- Predatory Lending: Well documented fact (not opinion)
- CNBC anchors deny it on air.

SEC: Failed and Captured Regulator

- Mary Shapiro: Appalling track record at FINRA.
- Robert Khuzami's conflict of interest: Oversaw Deutsche's CDO lawyers; Deutsche entangled in others' CDOs.
- Toxic Deutsche CDO: Carina interconnected with JPM, Merrill, Morgan Stanley, Citi, Wells Fargo, Goldman, and more. Have to investigate Deutsche when investigating CDO *hawala*.

From FINRA to SEC: Caricature of Capture

- FINRA: Wall Street’s enabler.
- Schapiro's 2008 compensation: $3.3 million
- 2008: almost $700 million in FINRA portfolio losses from strategy including investments in hedge funds.
- 2009: Schapiro’s $7.3 million retirement package. Revealed by media inquiries to SEC and FINRA, pre-990 filing. Disclosure apparently wasn’t Shapiro’s priority.

TSF

SIGTARP – Questionable “Inspection”

- November 2009 presentation – Omits Goldman’s key role as underwriter (creator) of CDOs / foreign banks’ involvement. Footnoted unnamed Abacus CDOs.

- I put this information in the public domain just prior to the November 2009 release.

- SIGTARP later played catch-up and still pulled its punches.

Bank of America Home Loan Servicing

- Four million home loans before and 14 million after Countrywide acquisition
- 1.3 million customers 60 days or more delinquent – 86% are Countrywide loans

Banks (not borrowers) Broke the Law

Foreclosure Fraud (phony affidavits, i.e., perjury) is a crime.

- Delinquency is not a crime.
- Being foreclosed upon is not a crime.
- Bankruptcy is not a crime.

Dimon: Materially Misleading?

- No borrower has been "evicted out of a home who shouldn't have been"
- "almost no chance we made a mistake."

JPM October 2010 earnings call, "Homeowners in Limbo," *WSJ*, October 18, 2010 and *Washington Independent,* October 14, 2010.

Bonus info: Ambac sought damages ($900 protection on a 2006 CDO) from JPMorgan Investment Management for alleged inappropriate investing in risky CDOs it managed.

Washington Independent Debunks Dimon

"But the financial statement itself proved the lie. The bank said it was carefully checking 115,000 mortgage affidavits. It set aside a whopping $1.3 billion for legal costs. And it put an extra $1 billion into a now $3 billion fund for buying back bunk mortgages and mortgage products."

"Too big to fail rears its head again," Annie Lowrey, October 14, 2010.

Richard Cordray, Former Ohio AG

- Every foreclosure done with falsified affidavits was improper.
- The fact it happened repeatedly makes it worse.
- Ally (GMAC), Bank of America, and JPMorgan Chase admitted to this practice.
- Cordray: Apparently they had “fraud as a business model.”

CNBC October 15, 2010

Activist Short Seller – Convenient Patriotism

- July 2008 – Pershing Square's Ackman is short Fannie equity and Fannie and Freddie sub debt.
- Ackman proposed restructuring advantageous to his financial position.
- Called me to get involved with Fannie and Freddie issues (I was unaware of above), because it's important to the country.
- I agree with restructuring (clear from my previous public positions), and disagree with *modus operandi.* Must also consider foreign investors and greater magnitude of losses.

Banks: We’ve Seen it Before

- Continental: Oil Loans / Lytle’s fraud, kickbacks. Mid-May 1984, Japanese jerked away $2 billion O/N deposits, Europe followed. FDIC, Treasury, Fed injected $4.5 billion. Fed absorbed, later sold interest; BofA acquired 1994.
- Late ‘80s - Loans to Latin America seriously impaired. BofA and Manufacturers Hanover – losses would wipe out equity and more. Citibank would have most of its equity wiped out. Irving Trust, First Chicago, Continental…also on the ropes.
- More…

Banks 2008: Broke More Than Twice Over

Permanent losses of the top ten banks in the United States exceeded their capital, i.e., their combined net worth.

Reassessing the Portfolio

Rating Agencies: Failed NRSROs

Nationally Recognized Statistical Rating Organizations

Status Should Be Immediately Revoked for Structured Finance

Credit Risk: P(Def) and Recovery Value

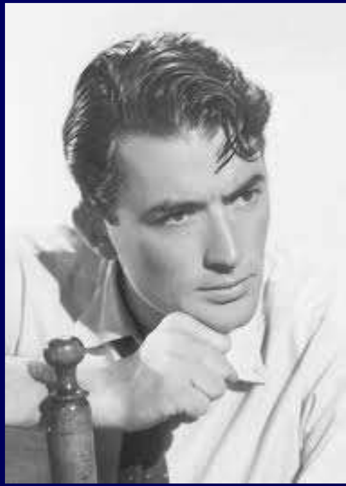
Independent and Quantitative

- Cannot be collapsed into one ordinal number such as a Moody's rating factor
- Cannot be adequately described by an ordinal letter rating.

Fixing the Rating Agencies

- Three year or more endeavor - as I said in 2007
- Thorough housecleaning of employees and methods
- Independent standard definition of ratings

GSE's Third Party Underwriting / Blind Date

Prudent	Predatory
	

Criteria	Prudent	Predatory
P(Def)/Character	Man in Grey Flannel Suit	Man Eater
Recovery/Looks	Gregory Peck in Prime	Walking Dead

Correlation: Movie Stars

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Images from peoplequiz.com and zombifiedzone.blogspot.com respectively.

Correlation: Poor Credit Risk Measure

But a great way to throw a tarp over fraud.

Credit Risk

We need two pieces of information:

- Default Probability
- Severity of Loss (Recovery)

Find Out Where You Are Now

- Portfolio fraud audit.
- Statistical sampling of portfolio.
- Put-backs where doable.
- Reality-based estimate of actual and potential losses.
- Repeat process over time.
- Estimate where you hit bottom.

Find Out Where You Are Now (Cont'd.)

- Acknowledge business model may not be viable
- Perform genuine scenario analysis – not like the sham bank "stress" tests
- Reality-based assessment of losses is different than accounting assessment
- Redo this frequently

Prepare for Restructuring

- Write-off bad loans, or at least admit true extent of permanent value destruction
- Bondholders take partial debt write-down and debt for equity swap
- Refund public funds
- Withdraw from public financial crack

Sound Underwriting

- Traditional prudent lending.
- Stand up to pressure.
- Reality-based assessment of business.

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