

**The Tale of the SPM**  
*by Michael Hey, November 2008*

**O**nce Upon a Time there was a hard working baker by the name of Miller who, with his family, lived in a simple vinyl sided house in Smallville, Ohio. They rented the house from a greedy landlord and dreamed of one day owning their own home. But however hard Miller worked and however many long hours he put in at the local bakery he could never save enough money to place a deposit down. And each year the price of houses in Smallville went up and up and up, and each year his greedy landlord would increase the rent so that any rise in pay Miller could earn vanished into the landlord's pocket.



Then one sunny Saturday morning a smart young man drove up in a shiny car on the road in front of Miller's home. He stepped out and walked confidently up and rapped on the front door.

Miller opened the door and peered at the young man; "Yes.." he said "Can Ah hep you?"

"I think I can help you!" replied the young man

"How's that?" replied Miller

"Look, I know you are renting this house and I know the landlord. In fact the landlord has asked if I know of anyone who would like to buy this house."

"Oh?" Miller's voice was filling with suspicion

"Look, if I could just come in for a moment I will explain," said the young man and with that he proffered Miller his business card. It was embossed in gold and silver – **Heronimus Clinch – Mortgage Broker** – Any Loans to Anyone – ..' it read.

"My name is Clinch." Heronimus extended his hand. Miller shook it hesitantly, then he opened the door further and within a moment the young man was seated opposite Miller in the front room.

"This house is valued at about \$100,000.00" began the young man.

"Mebbe," said Miller, "But I cannot find that much ... hell I don't even have a deposit"

"I can loan you the full value of the house, no need for a deposit" replied the young man

“Don’t you need to know somethin’ about ma earnin’s?” Said Miller  
“No!” said Clinch, laughing, “My security is in the value of the house, and as you know house values are increasing all the time, and any increase in the value becomes yours if you ever choose to sell in the future.”

“Wee...eeelll, hell, we always dreamed of owning our own home and gettin’ out of the clutches of that landlord.” Miller said.. “But lookit here, what would be the monthly repayments?”

“Here’s the statutory declaration. This is the official Federal Reg Z TIL form.. On an interest only mortgage the first two years interest would be 5% fixed, it would then adjust to 5% above the minimum bank lending rate and after three more years rise to 7%, but by then the property should have increased in value by at least 30% and you would always have the option to refinance. This line here shows the APR as it would be for the first two years and then subsequent years based on today’s minimum BLR.”

By now Miller’s wife had joined them and was sitting on the sofa, next to her husband and was squeezing his hand. Miller’s eyes had glazed over a little. “Say again.. what would be the repayments?”

“Interest only would start at \$417.00 per month – that’s for the first two years.” Clinch said

“Thet all Mr Clinch?” replied Miller incredulously.

“Yup!” Clinch said, trying with some difficulty to mimic Miller’s patios.

“You got yourself a DEAL!” said Miller and his wife squeezed his hand even harder.

“Call me Heronimus!” Clinch said with a smile.

And so another SPM (sub-prime mortgage) was born. And like a little fish Miller’s SPM slipped comfortably into the bottom of the young man’s brief case and was carried in triumph back to his downtown office where it was removed and added to a growing pile of other SPM’s and its details entered into his spreadsheet on which he calculated his commission and amongst many other figures the NPV (net present value) of the loan. And based on a minimum bank lending rate of 3% and a projected inflation rate of 2% this calculated to about \$149,500 which sum included the present day value of the property.

At the end of that month Heronimus drove down to his local bank with a cheroot smouldering in his mouth. He stepped smartly up the steps and at the entrance stubbed the cheroot out on a nearby bin and strode confidently through the double glass doors.

The real estate manager met him with a smile and a warm handshake.

“Thanks buddy,” the manager said when they were seated. “With this pile and what I have accumulated over recent months I can now put together a consolidated package of one hundred mortgages.”

“Great” said Clinch, “Just continue to transfer my commission into my usual account and I’ll be on my way.”

“Sure thing!” And with that Miller’s SPM found itself swimming with a school of ninety-nine other SPM’s in a big collateralised pond.

The real estate manager then got down to work with his analyst. They scanned the list of mortgages and loosely divided them into three sections according to a standard deviation curve. A small number were categorised as high risk and these went into the bottom drawer of the manager’s files, next to a folder entitled ‘Bank’s Obligations to Low Income and Minority Citizens’. These would provide evidence to the Federal authorities that the Bank was meeting its obligations under the Community Reinvestment Act. The bulk of the SPM’s went into a low risk category and the remainder into a very low risk category. Miller’s SPM went into the very low risk category and soon found itself with other such SPM’s that were bundled together and let loose to swim in a pond called a Collateralised Debt Obligation or CDO with very low risk. Miller’s SPM felt proud of its status and looked with some disdain at the higher risk SPM’s that had been bundled into a CDO with only a low risk category.

Within a week or so the Real Estate Manager was flying from his small town airport to the big city – for a meeting with a branch of the Big City Bank – Dumpitere Inc. This bank had an international presence, with branches and affiliates all over the world. It was from this bank that the local bank borrowed money to lend on to Miller and all the others in his district who had taken up mortgages.

“So, how much this lot worth?” Dumpitere’s purchaser was fingering the CDO’s that lay on his desk.

There’s eighty in the low risk category with a present value of \$11,960,000 and twenty in the very low risk category with a present value of \$2,990,000

The purchaser nodded, “OK! Keep up the good work.. we’ll get back to you” and following a pleasant lunch at the bank canteen the real estate manager returned home to Smallville.

Soon Miller's SPM found itself bundled together again with other CDO's from all over the county and was dropped into a package called an SIV (Structured Investment Vehicle).

Meanwhile eighty-five stories up in a very tall skyscraper in New York a sharp featured man with blazing eyes was shouting into a phone. His name was Rake and he was the CEO of Grabbit'n Run, a fast growing Hedge Fund.

"Git me more.. git me more.. we need to build our balance sheet, we need more assets, I got a great opportunity to short Dodg'em Motors (DM)" Rake had named one of America's largest motor manufacturers who the sharp featured man knew for sure, in advance, was about to close down ten of its factories.

Soon the phones were buzzing on the desks of Dumpitere Inc.

"Sure, we got a fresh SIV we kin let you have for about \$114,000,000 – a mixed bag of Alt-A's and AA's 'cording to Rackem Up – our internal credit rating agency. If this is OK with you we'll lend you the money to buy 'em at one half points over prime... as usual you need only put down 10% up front...

"We'll take that!" And Rake slammed down the handset and quickly dialled another number, "Hey Leech!" He shouted at his Finance Director.. "We buying a huner 'n fourteen mill SIV from Dumpitere – need you to package that into an SFP with triple A rating, shove onto our balance sheet 'n tell them analysts at Creep & Co so we can push up our share price 'cause I'm goin' heavy short on DM

Then he called the manager at Coal and Coke, the pension fund of USA's steel workers – "Nutty!" He yelled "Hey Nutty!"

"Yo Rake!"

"Nutty, Ah need to borrey two million of yore shares in DM for two/three months max, usual commission, and security is a call on our shares equivalent value.."

"You sure? Thet's about twenty mill..."

"Ah'm sure"

"Git back to you."

"Don't take long"

Then Rake called ZIT, the Zingonian Insurance Trust, that had rapidly grown to become one of the largest insurance companies in the USA.

“Hey Emo, (*his real name was Emofurieta, he was a Nigerian, naturalised US citizen, call me EMO*) I need to insure a new block of CDO’s we packaged into an SFP, they got a triple A rating, you sell us CDS’s, (Credit Default Swaps) on them, do that for us?”

“Rake, you de very devil..”

“Do it ‘n I’ll let you in on one of our deals...” (*individuals rarely got in on Grabbit’s deals unless they had at least one million dollars to invest*)

“Send dose de documents ovah Rake and we’ll look at them”

“Emo..EMO!! You know us now... say you’ll do it!”

“Hey Rake, you honkey devil! We’ll look at that paper work!”

“Emo, OK, thanks.”

And within a few days the ZIT CDS’s were issued. This ensured that the risk of default on the CDO’s that Grabbit had bought from Dumpitere was now taken by ZIT although Grabbit retained ownership of them.

So Rake had set the scene. Miller’s little SPM was now swimming with the really big fish – *don’t worry little tiddler – they said – you are insured and protected and leveraged and you are very healthy!*

And within days Rake had sold into the market every one of the DM shares he had borrowed from Coal and Coke and with the cash he made a margin call on Tobotta – a major Japanese manufacturing group who had just released a powerful but eco-friendly range of vehicles into the US Market. He paid a ten per cent deposit to give him an option to buy a block of Tobotta shares in a few months time at today’s price. He just knew the stock would rise.

Then he sat up suddenly, scratched his arse, sniffed his fingers then leaned back in his high backed leather chair and swivelled round to admire the view from his panoramic window on the eighty-fifth floor – ‘Sure Rake.. you de very devil’ he said to himself with wolfish smile and a gleam in his eyes.

Meanwhile back at Smallville Miller’s employers were running into very hard times. The lay-off’s that had long been rumoured at the nearby motor plant belonging to DM were happening. The Trade Unions were powerless, the factory gates were closed, the workers beginning to drift away from Smallville to seek work elsewhere and so the demand for the baker’s special bagels and sticky donuts plummeted.

“Sorry son” Miller’s employer said, “I’ve no choice to but to lay you off, ‘n soon ah will hav’ to close mah little bakery altogether.”

Miller shrugged, resigned, his boss had been good and always straight with him. He returned to his new home and told his wife. She hugged him and then they sat out on the porch and stared at the sky as the sun slowly set behind the rooftops.

“Honey,” he said, with a slow Midwestern drawl that always reached deep into her, “We’re gonna’ struggle. No income until I cin fin’ another job.. gonna be difficult to meet our monthly payments.”

His wife nodded silently. Then, “Think that Mistah Heronimus ken hep us?”

“No Honey. We mus’ hep ourselves.”

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The phone rang on Clinch’s desk. “Hey!” it was the estate manager from the local bank – “Hey that’s the fifth default this week we’ve clocked up on those mortgages you’ve been selling, ‘n already several family’s dumped the house keys with us – what’s going down?”

“The DM factory has closed, the market is droppin’ I reckon we’re entering into a little local difficulty..” came the reply

“You put me in a real difficult position – don’ bring me any more deals you hear?”

“Hey, that’s a little harsh.”

“You ain’t seen harsh yet sonny.”

And up in the offices of Dumpitere Inc. Bankers to the State and Nation red lines were appearing across the screen of the purchaser. He called his supervisor. “Got a small problem with some of them CDO’s from Smallville – hope this is not a trend..”

“Ah.. know about that – local difficulty is all – keep a watch.”

But it was more than a little local difficulty. All across the Midwest dozens of low wage earners like the Miller began to default on their mortgage payments.

And then, on the desk of Leech, Grabbit’s Financial Director, the ‘phone rang with a shrill, insistent call.

“I have Stickler on the line for you” his secretary said.. “seems important..”

“Mr Stickler?” Leech said, as always very correct when speaking to the head of the largest independent rating agency in the USA and the one that above all others was most respected and listened to by the Federal Reserve.

“Leech, this is a forewarning, we are looking at down-rating your stock from triple-A.”

“WHAAAT???” We just posted record profits.. what is this nonsense?” Leech could not contain himself.

“Have you been watching the housing market recently?”

“Sure, but we don’t buy real estate..”

“Well you’ll shortly own plenty of it, and at bottom value.... Those fancy instruments you fellows have been buying are built on SPM’s - sub-prime mortgages - and the buyers are defaulting across the Mid-West, hell some of those mortgages were even sold to Ninja’s...”

“Ninjas? What are you talking about Stickler? What’s martial arts to do with this?”

“Ninjas Leech...Ninjas... No **i**ncome, no **j**ob, no **s**ecurity.. clients to whom mortgages were sold..”

“Ahhhh...” and Leech let out a sigh, he knew within himself that the whole business was a house of cards, but the bonuses, the rush, the pace had blinded him.

“Stickler, you did not need to call us and I appreciate it.”

“Mmm..” then the phone went dead.

*Rake was daydreaming. In his mind time had passed, the DM shares had fallen and he was able to buy them back at half the price he had sold them for, Tobbotta shares had risen in value and he had called in his option and realised an eighty per cent gain on his margin. He would keep twenty percent of the gains for himself, take two per cent to cover his overhead and return the balance to his treasury to pay back investors at the next dividend call. Time to refurbish the yacht... order a Porsche for his daughter..*

Rake came to with a start. He called Leech.. “Hey! The stock in our lil’ ol’ company must be rising! Them bastards at Gobble-it are never going to buy us!”

Leech did not reply immediately. Gobble-it were one of the biggest Financial Advisory and Investment Banking companies in the world who prided themselves on their aggressive strategy combined with old world shrewdness. “Just keep those deals coming in Rake” he said, “There could be chilly times ahead.”

“Chilly times? CHILLY TIMES? What are you talking about?” Rake flinched as though a jug of cold water had been emptied onto him.

“I had Stickler on the ‘phone...” Then Leech relayed the message to Rake.

“Crap,” said Rake, hanging up the ‘phone. But Rake was no fool and within moments he had made some discreet calls. His mouth tightened, then he contacted his personal brokerage firm. They were based in the Virgin Islands. “Shift some eighty per cent of my holdings in Grabbit across to securities in -----.” he instructed. Then he sat back and waited.

The monitor on his desk flashed warnings. The price of Grabbit stock had begun to fall. By the end of the day’s trading it had lost three per cent.

Leech knocked on the door to Rake’s office and walked in. He sat immediately in front of Rake looking at him across the expanse of polished hardwood desktop.

“I need to give you a review of our... the financial position in respect of recent undertakings.”

“D’you hav to?”

“We owe \$102,600,000 to Dumpitere for purchase of those blocks of CDO’s, the current true value of which is probably around 20% of the purchase price being about \$22,800,000 and falling. We are due to return to Coal and Coke some \$20,000,000 of DM shares, ..”

“Which will be down to \$10,000,000 so we take a profit of \$10,000,000,” interjected Rake.

“We are committed to buy \$200 m of Japanese Tobbotta stocks..”

“Which will rise at least 5% giving us a neat \$10,000,000 profit for our pains on a margin of \$20,000,000”

“Sure, but today those stocks are down by 2% and the outlook is poor”



“Piss off Leech!” Rake smiled

The next day the respected independent rating agencies dropped a bombshell. Grabbit’s credit rating was reduced from triple-A. Grabbit’s shares continued to slide. Rake issued a statement:

“Grabbit reported record profits over the last quarter. Trading remains strong and Grabbit holds some very good positions. The rating agencies are mistaken, the underlying assets of the company are sound and protected through independent insurances.”

But the reassurances fell on deaf ears.

First to get through to Rake was Dumpitere’s General Manager. “Rake, we are increasing the interest on those loans, we are permitted to do that when your credit rating is reduced.”

“I’ll refinance and you’ll have no more business from us..” Rake was defiant.

*Miller’s SPM was looking very anaemic. ‘Hey, what’s wrong with you lil’ buddy?’ the others in his SFP were swimming around, full of concern.*

*‘I’m not getting fed.. no nutrition at all..’ he replied, ‘and some of you don’t look to good either..’ he said*

*The other SPM’s in the SFP shrugged.. ‘Just a temporary problem’ they said and ‘Shit happens lil’ buddy... but it’ll sort itself out’*

By the end of that month Grabbit’s shares had collapsed. They had lost seventy per cent of their value. Nutty from Coal and Coke pension fund had begun calling on the hour, but Rake had nothing to tell him. He had gone long on Tobotta’s share value with the cash from the sale of Nutty’s DM shares that he had borrowed and now Tobotta’s shares were tanking; vehicle sales throughout the USA had dropped off by more than twenty per cent. But at least going short on DM was looking good, but the gain from that, when it came would not cover his position on Tobotta. He needed to raise cash and fast but no-one would lend to him. A rights issue was out of the question.

Then the second bombshell came and the blood drained from Rake’s features.

ZIT was going bust!

Through the issue of insurance against blocks of CDO’s that had been overrated by agencies owned by the banks that had packaged and sold them ZIT had underwritten what was rapidly becoming a huge and untenable risk. No insurance company expects more than a small

percentage of the insurance it has written to be claimed against at any one time but as the market had exposed to full public view the Emperor's Clothing around the shoals of SPM's so a landslide of customers were forced to call in claims against the value of the CDO packages they had insured.

ZIT folded!

Grabbit hit the deadline to return the DM shares it had sold short. But Grabbit could not raise the funds even to buy them at the current price being less than half the price they were sitting at two months earlier. And then the call came in to buy the Tobotta shares.

Rake had no choice. He called Gobble-it.

"Sorry Buddy. No can do!"

Rake swivelled in his chair, Leech came into the office behind him. "Congratulations boss," Leech said, "You have managed to turn an asset base with a real value of less than \$22,800,000 and dropping into a current liability of \$302,600,000. That has to be some kind of record!"

Grabbit'n Run called in the Receiver. Law suites were filed. Rake faced a Senatorial enquiry.

The contagion spread across the financial world. Banks stopped lending and stocks markets plummeted.

Finally the Government stepped in. They arranged, with taxpayers money, to buy all the SPM's that underlay the complex financial derivatives that had cloaked them in a shimmering web of deceit.

And so it came to pass that Miller's SPM shivered back to life with a healthy injection of funds from the very person who had taken him out in the first place. Miller, now back at work again in California, was paying tax and his tax dollars went cover the payments of his old SPM. But Miller and his family were back in rented accommodation with no hope of buying a home, ever..

And the bankers? The SPM's had been bought by the Federal Government using taxpayers money so at least those liabilities were off their books, but what about the overhanging debt, the dozens of Grabbit'n Runs who had multiplied a weak asset base into debt by a factor of twelve or more? The Federal Authorities glumly calculated the reality. The notional value of all the SPMS was about \$700 bn. Multiply that by twelve and the figure hit nearly \$9 trillion.

No wonder the banks had stopped lending to each other....