Mortgage Securitization 550: The Ultimate Insider Game - Observations about what happened - a time line of actions and speculation about motivation.

Symphony Music
RE: Mortgage Securitization 550: The ultimate Insider Game – Observations about what happened - a time line of actions and speculation about motivation.

Abstract: This is the story of Chase, the venerable old line bank, and how it used its dominant market influence in the decade leading up to 2012 to originate and acquire mortgage loans, how it forced individual homeowners to pay high rates, and how it ultimately began to steal the home equity away from hard-working homeowners and their families. It is also the story about how the largest US banks combined their anti-competitive behavior and took from residents in all States. As illustrated by the chain of events described below for a situation in Connecticut, Chase's attitude and actions never reflect that behavior associated with the responsibility and “public trust” that is a pre-condition for the receipt of the banking charter that allows it to serve customers in a State. This conclusion, of course, is an opinion that will ultimately have to be decided by Connecticut courts.

Caveat: Chase is mentioned and targeted in this memorandum. There is, however, no longer a difference between the actions of Chase and that of the other large banks. The largest five banks control 52% of all assets in the US economy.

When did Chase’s attitude Change?
Chase's attitude towards its customers may have shifted earlier but it certainly began to manifest itself by actions of denial and obfuscation as of October 2008. This was when Chase and the Federal Reserve Bank of New York took on a new operating relationship that effectively benefited Chase at the expense of consumers. At that time, with the CEO of Chase on the Board of Directors of the Federal Reserve Bank of New York, the Federal Reserve initiated a plan to lower interest rates, or keep them low. In a back-handed manner, this forced all borrowers who were not permitted to refinance themselves, to pay extraordinarily higher rates to Chase... these rates were higher than those the mortgage banking industry had ever been permitted to earn in the past. Once entrenched and cognizant of this benefit, Chase’s attitude with consumers took on a visceral character as Chase errors and Chase conflicts were identified and brought to Chase’s attention by Chase’s customers.

A Simplified Synopsis.
As one example of one class of customers abused by Chase behavior, many current Chase customers began their relationship with WaMu. These bank customer relationships were originally supervised by the Office of Thrift Supervision. For whatever reason, WaMu loaned mortgage money regularly to its customers based on “loan agreements” whose credit decisions were largely based on loan-to-value evaluations.

Parts of WaMu were acquired by Chase on September 25, 2008.

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1 JPMorgan Chase Bank, National Association is owned by JPMorgan Chase & Co., and operates in many jurisdictions around the world.
2 Federal Reserve Bank of Dallas 2011 annual report.
4 aka “OTS”
Chase says that WaMu and Chase were very different organizations. Nevertheless, Chase jumped at the opportunity to purchase WaMu when it was gifted the opportunity by the FDIC\(^5\). That acquisition remains a contentious ego driven regulatory action with questionable merit and the subject of legal dispute. Nevertheless, the control of WaMu by Chase is a generally accepted end-result.

Of course, Chase has publicly stated that it did not adopt WaMu's underwriting standards that it anyway maligned as “inferior.” Whether it did or did not adopt the underwriting standards, it doesn't matter. In actuality, WaMu and Chase underwriting standards and procedures were very similar. Chase and WaMu managements just say that they relied on different aspects of the same “data collection”/“underwriting” process. In the majority of cases, there is no difference in the ultimate result – the consumer/homeowner receives his loan.

Officially, however, Chase never adopted WaMu's underwriting policies. Chase did revise its own underwriting policies as of approximately October 2008.

At that time, as it is now evident after-the-fact, with the special knowledge about where interest rates were heading as a board member of the Federal Reserve Board, the “situation,”\(^6\) or Jamie Dimon,\(^7\) decided that he could have his bank benefit from its dominant market position and force consumers to pay Chase higher margins then they had ever paid in the past. These margins were significantly\(^8\) greater than what the mortgage industry ever earned in the past.

At the first level, Chase was able to do this because of its monopoly influence in the market that sets index rates.\(^9\)

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\(^5\) Federal Deposit Insurance Corporation

\(^6\) Events are described as the “situation” because trader’s representations which were thought to be “true, accurate, and complete in every material respect” at the time of the transaction turned out, with hindsight, to have missed several material realities that were never disclosed to parties that would have needed to become aware of the conflicts.

\(^7\) Jamie Dimon became CEO of JPMorgan Chase on 12/31/2005 and was named chairman of the board one year later. Although Jamie Dimon is maligned by many because his stewardship is the time Chase’s attitude towards its role within each State economy and society began to change, his fault seems more likely to be the fact that his stewardship did not recognize the wrong, or correct the wrong, that his overbearing organization was imposing.

\(^8\) From 9/1/1989 to 9/1/2011 the “profit/spread margin” Chase and the Securitization market earned from homeowners increased to become three standard deviation more expensive than what they had been in the past. Rates charged were one standard deviation higher than historical averages by August 2009, two by December 2009, and three standard deviations by May 2011.

In statistics, for a normal distribution, nearly all values lie within 3 standard deviations of the mean. About 68.27% of the values lie within 1 standard deviation of the mean. About 95.45% of the values lie within 2 standard deviations of the mean. Nearly all (99.73%) of the values lie within 3 standard deviations of the mean. The rates charged by the banks have been more than three times beyond the averages.

\(^9\) The Index is controlled by Chase, Bank of America and Citibank [www.wsprimerate.us/libor/index.html]. The US Department of Justice, the US Commodity Futures Trading Commission, and the UK Financial Services Authority fined Barclays bank $450,000,000 on
After determining the Index Rate, Chase then locked consumer/homeowners into higher rates on two fronts. Each front involved rates three standard deviations above historical averages. In the first case, Chase kept its margin over its cost of funds constant, despite a lower cost of funds environment. Under this scenario, Chase made three standard deviations more profit on every loan than the industry ever did in the past. In the second case, by locking consumer/homeowners into high interest rate loans, for whatever reason, using a similar statistical analysis, they fixed the rates for these consumers three standard deviations higher than what they historically received for these loans.

In each case, assuming a normal distribution to the historical rates, this represents less than 0.1% of the likely rates Chase would be able to charge in a competitive market economy.

Part of the consequence of Chase initially getting away with it is that Chase stopped loans from being made to the commercial businesses that otherwise were its main source of earning.

The ultimate result was that residents and small and medium sized businesses were completely cut off from access to working capital liquidity to continue their businesses.

Part of the larger strategy, of course, included a slander campaign and the convenient disposition of the existence of the OTS and its merger into the OCC.

All former WaMu consumers at Chase were left with no one to complain to when their original “loan agreement” understandings and customer relationships with WaMu were left hanging. Former WaMu customer were all directed to deal with the OCC, a party that had been intimately involved in deciding how WaMu customers would be treated in the first place.

**The Big Picture.**

The consequence of all these action made it such that Chase became even more of “a front.”\(^{10}\) Via the process of involvement in residential mortgage asset backed

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\(^{10}\) Without any direct economic interest in a relationship, a “front” is a legal entity that allows its corporate existence and identity to be used to advance the cause of some other organization. In the insurance world, a front is a State licensed insurance carrier that allows its policy to be issued via State laws in a State where another insurer would have no license to operate directly. The other insurer reinsures 100% of the policy of the fronting insurer. This practice is frowned upon and generally not permitted by State Insurance department. In other situations, this practice is known as using “shill,” “plant,” or “stooge.”
securitization, all homeowner /consumers – especially the “second class” customer relationships gained from WaMu - were forced to interact with, and against, accredited and sophisticated investors who were instructing their servicing agents to force the consumers to continue to pay high interest rates. The banks, as “servicing agents,” following the desires of the sophisticated accredited Tranche investors, enforced this with the simple instruction that homeowners must pay the much higher rates because these homeowners simply had the legal obligation to do so. The consumers, because of the lack of alternatives in the market, were forced to comply. The banks became visceral in the enforcement of the payment obligation.

They also started to lie.

The banks understood that it is much easier to collect payment on a credit default swap agreement than it is to go through the process of foreclosing on a home and selling a house. The banks didn’t want the expense of dealing with disputes on a State-by-State or case-by-case level and did not want to deal with all the ugly people and court hearings that would otherwise have to be addressed.

Via the pledges and representations they had made in the securitization process, a pledge that includes a statement that the information and representations they make are “true, accurate and complete in every material respect,” the banks also did not want to be considered liable for being unable to maintain the “weighted average coupons” and “weighted average maturities” of the investments they had sold to institutional tranche investors. The banks found it much easier to blame everything on the “economic hardship” of their customers. The banks illustrated this by highlighting those fraudulent egregious situations they could identify. The banks quickly painted every customer, whose credit lines they withdrew or reduced, as part of the problem. The public relations campaigns directed by the banks never identified themselves as the parties that created the problems or, of course, that Chase was benefiting from egregious prices and margins.

The fundamental consequence of this towards consumers is that consumers have been paying three times higher rates to the Banks than the mortgage business has ever benefited from in the past. Combined with the banks’ capital allocation rules, and the actual process of shifting “ownership” away via the securitization process, the bank earns an infinitely greater amount of money from consumers than it ever did in the past.

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11 It is “infinite” because technically the divisor approaches zero as the FASB accounting rules allow the principal amount of the exposure to be recognized as an off balance sheet item. It is not actually zero because at some dollar amount, because of the bank’s ultimate buyback obligation and the degree to which the bank can pull a legitimate Promissory Note out of a securitized pool and enforce its defeased or paid off obligation against the homeowner, some accounting has to remain on the bank’s balance sheet.

The Promissory Note is defeased or paid off in full the moment it becomes owned by the Special Purpose Vehicle or Trust that also receives the funds from the tranche investors. At the moment of their agreement to invest, the tranche investors had only desired to receive the cash flow from a pool of securitized promissory notes. They may have been told that their cashflow were “secured” by mortgage liens but, in fact, as their purchase agreements tended to be silent on this matter, these obligations were only “associated” with those mortgage liens and promissory notes. The tranche investors original investments, paid to a trust that owned the Promissory Note, paid off that Promissory Note as they received the cash.
At the margin, of course, the banks' actions immediately drove the weaker credits into distress. After several years, this ultimately sucked the available cash balances from even the strongest residential credits. Combined with the lack of advances of working capital to small and medium sized commercial businesses, this drove individual State economies into distress.

The Plot Thickens.

As an undercurrent to achieving the intended end-benefit for Chase, on another side of bank operations, the residential valuation/appraisal process adopted by Chase resulted in a theft of “property equity” from homeowners.

The theft occurs via the legal process of the forced auction sale, the dampening on prices of Chase’s residential home valuation system, and the consequential lowered leverage the banks permit themselves to give towards any new home purchase based on their internal valuation system.

The statistically based residential real estate appraisal system adopted by Chase is kept secret and not disclosed to property owners. Homeowners are not given the opportunity to contest Chase’s conclusions, or to correct the situation unique to individual properties. Chase’s internal algorithmic residential valuation system necessarily ignores improvements and additions to individual homes and include a simple statistical reversion to an "average."

All these items contribute to a pricing slump and to mortgage loan defaults. It also conveniently self-justifies claims against credit-default swap counterparties that insured against events of non-payment.

Lower valuation statistics then influence the courts and determine “fair” auction prices for traders who buy homes at foreclosure sales based on Bloomberg notifications. Mass valuation appraisal algorithms justify purchases at 50% of the outstanding loan amount and thereby reward that equity to the trader (taking it from the homeowner) while also taking the homeowner’s equity that may exist in the property above the outstanding loan amount.

The delinquent homeowner loses twice.

The unregulated division of a bank, or their personnel on a personal basis, takes full advantage of the extensive information they have about a property and flip for personal gain.

In the process of doing this, Chase co-opts the potentially good business intentions of certain service providers in working to advance their cause:

1. The credit bureaus - by making them report information that is false.¹²

¹² (How can Chase be listed as a creditor prior to their purchase of parts of WaMu?)
2. The land registrars - by making them rely on information that included false and misleading information.\textsuperscript{13}

3. The court systems - by causing financial conflicts and obfuscating basic realities that are inconvenient to Chase’s objectives.\textsuperscript{14}

**The Ultimate Insider Game: “Heads I win, tails you lose.”**

With all of the above in place, the ultimate insider game then involves the proprietary trading desk of each bank buying credit default swaps on their own, self-originated, residential mortgage loans.

By positioning against itself, as a "hedging" strategy, and keeping residential mortgage interest rates high by arbitrarily changing the underwriting standards, the bank artificially assures itself that it wins, no matter what happens. This inside knowledge positioning is all at the expense of the consumer and the Public Trust.\textsuperscript{15}

Chase wins as it continues to charge the homeowner interest rates at profit margins that it historically has never earned in the mortgage business. Chase wins if the homeowner defaults because it collects from the financial guarantee or credit default swap that it purchased on the portfolio of loans it securitized.

*Technical economics.*

The credit default swap contract costs 1\% per year on the principal exposure and pays 100 times the premium payment in the event of a defined default (say six non-payments of interest and non-payment of property taxes). In other words, for the payment of $10,000 per year, the bank gets paid $1,000,000 for refusing to negotiate with the homeowner about the excessive, out-of-market, interest cost that homeowner is forced to pay.\textsuperscript{16}

**The Chase Realization:**

By going only against the little guy, with overwhelming force, excessive contact,\textsuperscript{17} messages, intimidation, and non-disclosure, Chase realized that it could gain the upper hand via the dizzying amount of distractions that it throws at the homeowner who just wants historical consistency and a “normal” deal.

\textsuperscript{13} (MERS undermined the integrity of basic recorded “property rights”)

\textsuperscript{14} (The banks made State employees realize that their retirement fund payments would be reduced if their posturing was not accepted. The banks also began to refuse discovery of the underlying contracts and relationships that drove the interaction with the homeowner/ consumer)

\textsuperscript{15} It is also at the expense of the Credit Default Swap counter parties who are relying on the fact that no adverse selection is taking place by the residential loan mortgage originators

\textsuperscript{16} The ISDA documents are curiously silent about the ownership of underlying mortgages associated with defaulted payments. As such, the determination of ownership is done on a case-by-case basis depending on the documentation skills of the individual traders who make a market. This documentation is very sort and determines the ultimate ownership of the underlying Promissory Note via the counterparty’s subrogation rights.

\textsuperscript{17} Most likely in violation of Fair Debt Collection Practice Act guidelines.
The Consequence:
In the event of real or fake homeowner economic hardship, nothing productive is produced by the bank side of the equation. The bank produces public relations material that wants to give the impression that they are being helpful, but Chase actually suffers from a distinct economic disincentive to do anything.

The knowledge of the history of the evil associated with monopoly power, and the existence of Federal and State antitrust laws, is lost on the operation of bank personnel and the manner through which collections are enforced. It is also lost on the bank regulators and the politicians that enforce the difficult task of making a State economy grow economically.

The Difficult Reality; the need for the Public Good.
Banks, as lenders, however, provide an essential bridge for the growth of any economy.

Institutions that provide working capital loans to allow people and smaller organizations to bridge their money needs between the conceptual creation and the sales associated with a final product are a lynchpin to any working economy, State or Federal.

Concentrating on other things distracts from this essential function.

The consequence of the banks not making residential mortgage loans available to consumers, and of not making commercial loans available, as a standard part of whatever business activity goes on in a State economy, harms everyone.

Chase and the other large banks, however, are no longer banks. Their personnel no longer know the basic principles of lending and providing credit and all underwriting has been abstracted into simplistic (and fundamentally incorrect and naïve) formulas managed by robots. This reality has resulted in automatic denials of credit where no human even sees the application. Whatever an individual State economy’s business and documentation realities happen to be, this result is anti-competitive and contrary to the public interest of each State economy.\(^{18}\)

\(^{18}\) It is also not the role of an OCC bank to determine the best practice standard of local businesses based on a non-existent “global” standard that does not exist. The bank excuse provided to their OCC regulators to impose documentation requirements that have never existed and do not exist is convenient obfuscation. To make statements to the contrary is, again, against the State’s public interest in making their State economy grow for the long term benefit of its residents.
Appendix – Disclosure As They Should Have Been Communicated:

"We" and "us" represents the Bank. We are a regulated bank. "We" and "us" also represents other parts of our organization that have nothing to do with "we" or "us" as a regulated bank. That part of the "we" and "us," when we bother to make the distinction to you, represents "we" and "us" as a "private investor," or as a vendor that can provide things such as "wealth management services," "insurance services," "investment banking services," "mortgage collection & foreclosing services," "valuation services." What "we" provide is "ours."

"You" and "yours" represents you, the Customer. You are "our" depositor, our borrower, our insurance consumer, our credit card customer, our client. We charge you for all of our services.

Although we disclose it to you in small print, we are never representing your interests when we perform these other services.

"We" or "us" do not provide "lending services." We provide no loans to small or medium sized businesses. Providing "lending services" would require us to work and think and show judgment about character. We have lost this talent. We now rely on other organizations such as rating services and credit bureaus to provide us the character judgment so that we don't need to think. You don't care about these issue because most of you think you are not affected by our decisions.

Available as Apendix 559 are the categories of items we should probably have mentioned to you but we didn't. Ooops, sorry, you’re out on the street.