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From the Desk of Karl Denninger

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Sec. Paulson and Chmn. Bernanke
Members of Congress
Presidential Candidates
President George W. Bush
Delivery By Fax

Dear Sir or Madam:

For months now I have written to you and faxed copies of my "Tickers" found at http://market-ticker.denninger.net on various seminal matters related to our Capital Markets.

Today I write on the most serious of matters yet to come before you, and indeed, before our nation.

A growing number of people are becoming very concerned about the future of our nation, and the path you, and those before you, have set us upon and appear hell-bent to continue.

Much of this letter will sound like a scathing indictment of yourselves and in particular, the aforementioned Secretary of the Treasury and Chairman of The Fed at the head of this page.

It is.

But before you dismiss out of hand the criticisms and claims of outright complicity, I wish to revisit a bit of history for you regarding the **veracity** of the claims that these gentlemen have made over the last few years, and their predecessors before them.

You can start with *Greenspan's Bubbles*, a book that can be found in most stores or, if you prefer, via Amazon.Com, for that sets the table – a Federal Reserve and Treasury that has been focused for more than 20 years on the promulgation of one Ponzi-style asset bubble after another, all in a desperate attempt to keep the "gravy train" flowing for those in the highest of places.

But let us focus on **recent** history, that of the last year or two, because these two individuals are the ones who currently are coming hat in hand to ask, nay, demand ever more control over the lives of Americans, and over our financial future.

It is therefore important that we examine their record in an honest, forthright manner to determine whether there is any basis whatsoever for trusting either of these men with so much as the keys to your car to park it outside your favorite watering hole, say much less whether they should have control over the financial system in the United States of America.

On economic growth and the economy in general, specifically related to the "subprime" and other housing woes currently gripping America:

> Mr. Paulson said in a speech March 13th, 2007: *"The fallout in subprime mortgages is going to be painful to some lenders, **but it is largely contained**."*

Chairman Bernanke before the Congressional Joint Economic Committee on March 28th 2007, just a few days later: *"Although the turmoil in the subprime mortgage market has created severe financial problems for many individuals and families, the implications of these developments for the housing market as a whole are less clear. The ongoing tightening of lending standards, although an appropriate market response, will reduce somewhat the effective demand for housing, and foreclosed properties will add to the inventories of unsold homes. At this juncture, however, the impact on the broader economy and financial markets of the problems in the subprime market seems* ***likely to be contained****. In particular, mortgages to prime borrowers and fixed-rate mortgages to all classes of borrowers* ***continue to perform well, with low rates of delinquency****."*

Chairman Bernanke at the Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition, May 17th, 2007: "***We do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system****."*

Chairman Ben S. Bernanke speech to the 2007 International Monetary Conference, Cape Town, South Africa, June 5th: *"****The troubles in the subprime sector seem unlikely to seriously spill over to the broader economy or the financial system****."*

Mr. Paulson on Bloomberg, July 26th, 2007, just days before two Bear Stearns Hedge Funds imploded: *"****I don't think it [the subprime mess] poses any threat to the overall economy****."*

Mr. Paulson's Press Roundtable in Beijing, August 2nd, 2007, likewise, just days before the hedge fund explosion and Ben Bernanke's unprecedented "emergency" discount rate action: "*I also said I thought in an economy as diverse and healthy as this that losses may occur in a number of institutions, but that* ***overall this is contained and we have a healthy economy****.*"

Chairman Bernanke to Committee on Banking, Housing, and Urban Affairs, U.S. Senate, April 3rd, 2008: "*Clearly, the U.S. economy is going through a very difficult period. But among the great strengths of our economy is its ability to adapt and to respond to diverse challenges. Much necessary economic and financial adjustment has already taken place, and* ***monetary and fiscal policies are in train that should support a return to growth in the second half of this year and next year****.*"

And on inflation:

"*Core inflation has been relatively low in recent months* ***and longer-term inflation expectations remain contained"***.- Fed 11/1/05

"*FOMC participants project that the growth in economic activity should moderate to a pace close to that of the growth of potential both this year and next. Should that moderation occur as anticipated, it should help to limit inflation pressures over time...the economy should continue to expand at a solid and sustainable pace and core inflation* ***should decline*** *from its recent level over the medium term****...our baseline forecast is for moderating inflation*****"**. – Ben Bernanke, 7/19/06.

"*Core inflation is expected to* ***slow gradually*** *from its recent level*" – Ben Bernanke, 11/28/06

"Core inflation, which is a better measure of the underlying inflation trend than overall inflation, seems **likely to moderate gradually over time"**. – Ben Bernanke, 3/28/07

"*With long-term inflation expectations* ***contained****, futures prices suggesting that investors expect* ***energy and other commodity prices to flatten out****, and pressures in both labor and product markets likely to ease modestly, core inflation should* ***edge a bit lower****, on net, over the remainder of this year and next year*". – Ben Bernanke, 7/18/07

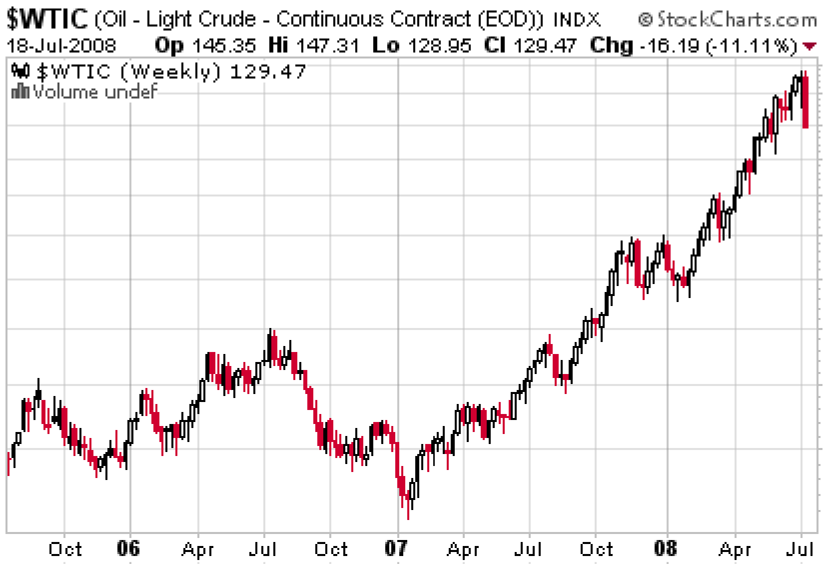
"*The Committee expects inflation to* ***moderate*** *in coming quarters*"- Fed 1/22/08 and 1/30/08

"*The Committee expects* ***inflation to moderate*** *later this year and next year*." - Fed 6/25/08

Let's deal with inflation first, because it's the easiest of the two, and will take the least amount of time and digital ink

Chairman Bernanke has, for the last three years, claimed that ***inflation will moderate*** from its present levels in the intermediate term. Has it?

I reproduce here a chart of Light Sweet Crude oil[1] for the last three years:



You will note that for the period up until September of 2007, oil fluctuated in a range from about $40/bbl to approximately $80/bbl, with a seasonal component linked to driving demand. As driving demand fell in the autumn, prices fell commensurately, and each spring, it rose.

But what happened starting in August of 2007, just a few months after Ben Bernanke said that ***"energy and other commodity prices [are expected] to flatten out"****?*

Oil began a "rocket ride" north, and while it is now correcting (as is to be expected due to seasonal demand shifts, as it has every other year) something **structural** happened to the picture.

Many say that this is simply a matter of "evil speculators" or that "China is increasing its demand", or "we have reached 'Peak Oil' output."

But did China suddenly start consuming oil where it was not before? No, although their demand is rising. And did "Peak Oil" suddenly mean that all oil supply disappeared? No, and in fact peak output likely occurred a couple of years ago.

So what was the **proximate change** that occurred around August and September of 2007, which just happens to be linked ***exactly*** to the rocket ride higher in oil prices?

Ben Bernanke, Chairman of The Fed, lowered the Fed Funds target by 325 basis points over the space of less than six months and injected over $250 billion in funds into the United States monetary system in an effort to stave off the bursting of a bubble he and his predecessor created with their own hands.

In fact, if one wants to look at the proximate cause of the rocket shot higher in oil prices, it is far

[1] http://stockcharts.com/h-sc/ui?s=%24WTIC

more important to look at not the policy rate but the "extraordinary steps" taken by Dr. Ben – specifically, the "alphabet soup" of TAF, TSLF and PDCF facilities.

You will find an ***exact correlation*** between the introduction of the TAF[2] and the latest rocket ride north in Crude. The first auction was held December 17th of last year. As the TAF has increased in size, so has the price of crude oil.

This is not a surprise. "The Slosh[3]", or total amount of market liquidity that The Fed is maintaining in the banking system, has been at a **record** since last fall with no sign of abatement.

The oil producing nations of the world are not stupid; they have seen our "Ponzi Investment" (which I will deal with later) for what it is, and now understand that we are attempting to prevent the reckoning and consolidation of the losses where they **must fall** through extraordinary actions that have and will continue to put pressure on the dollar. By putting $250 billion in additional liquidity into the system Mr. Bernanke has ***increased*** the supply of dollars, making them less valuable – simple Economics 101, "supply and demand" – and as a consequence these nations are experiencing insane rates of inflation, north of 10% annualized. They are pushing back with predictable and expected results.

Will inflation moderate? That depends on how you define "inflation", doesn't it?

If you exclude food and energy, many things are in fact **deflating**. The price of houses has deflated by about 10% on an annualized basis and by more than 30% in some "bubble" areas. But we as Americans only need one house, and once we've bought (or rented) it, we don't need another one.

On the other hand we must put food in our mouths daily and fuel in our gas tank every week if we wish to be able to get to work.

I believe the record is clear: Price inflation seen over the last year is not an accident, and it is not due to exogenous factors; it is the direct and proximate result of the policies of The Fed, of which Ben Bernanke is chair, and he has, in fact, either been hopelessly wrong in his prognostications or intentionally misleading both America and Congress.

Now let's look at the larger picture – the economic outlook in general.

Unfortunately this section will prove to be quite long, because it is simply not possible to recap what has happened, nor to expose the complicity of everyone involved, without appropriate detail.

We must first define the three classes of investment, and delineate their characteristics. These are, in order of favor in allocation within an economy:

1. **Productive Investment**. This is best exemplified by the purchase of a machine that makes "widgets", which are then sold to consumers. This machine has a capital cost but with the input of raw materials and energy, it produces an output that has more value than the cost of the inputs combined. Combined with adroit management and utilization, investment of this type returns more GDP to the economy than it consumes in its purchase, *even when that purchase is financed through debt.* The risk of loss in such an investment is contained in errors in calculation of utilization, input costs, and management of same by the person(s) making the investment.

2. **Speculative Investment.** This is best exemplified by the purchase of capital stock in a corporation. The investment ***itself*** produces no return, however, through the exploitation of the capital gained by the seller of the investment, a net positive rate of GDP can be obtained. There are many forms of "speculative investment", however, all share the risk of loss due to

[2] http://www.federalreserve.gov/monetarypolicy/taf.htm
[3] http://www.gmtfo.com/reporeader/OMOps.aspx

no act of malfeasance or negligence by the investor (although malfeasance by the management who sought the investment may be a factor.) This type of investment, when financed through debt, *increases the risk of loss as the carrying cost of the debt must be added to the cost basis of acquiring the investment.* Anyone who has ever bought a stock on margin and then had it decline in value is very aware of how quickly such "leverage", when applied to a speculative investment, can lead to very large losses.

3. **Ponzi Investment.** This is best exemplified by housing. A house, once built, is incapable of producing a return into GDP. Its value can only increase because someone else believes that it is of greater value than the person who originally constructed it. *This is the definition of a "Ponzi Scheme" and the claims of many Realtors in fact feed it – the fear of scarcity as epitomized in the claim "they aren't making any more land."* While Ponzi Investments have utility value in many cases, their *inherent value* frequently decreases over time and requires additional capital inputs to maintain (as in the example of a home needing a new roof.) *This type of investment, when financed through debt, is always a net drain on GDP.*

An economy is comprised of a balance of all three forms of investment. **However, only the first can form the basis for growth in an economy over time**. The third, particularly in the case of housing, is a *necessary evil*, in that people need a place to live, however, the provision of same is in effect a "tax" on that economy, in that such investment, in and of itself, produces no return to GDP.

The policies of The Fed and Congress have, in fact, discouraged **Productive Investment** and driven it offshore to places like China, Vietnam and India, while encouraging both **Speculative** and **Ponzi** investment. Global wage arbitrage, driven in no small degree by the **intentional** devaluation of the dollar, has made foreign goods inexpensive while at the same time driving up the price of imported raw materials – including oil. At the same time this devaluation has driven over 1 million high-paying software engineering jobs offshore to places like India, where our labor standards do not apply and wages are less than ¼ of what is earned in The United States.

This imbalance is unsustainable and must be encouraged to correct. A great deal of economic pain will accompany this correction, yet that pain is inescapable, and the longer we continue to try to get around the economic reality of mal-investment and its outcome, the worse the pain will be.

Now let's address one of the **root causes** of this imbalance and misallocation in **Ponzi Investment** – Freddie and Fannie.

Since the beginning of July we have seen the possibility raised of Fannie and Freddie, the "GSE"s that fund more than half of all mortgages at present in the United States, becoming insolvent. Former Fed Governor Bill Poole said recently that under fair accounting standards Freddie is insolvent *now*.

I have written for quite some time that under any rational application of accounting rules and understanding of leverage, it is not possible for these firms to operate as they are currently being run, going back to April of last year[4].

But irrespective of whether Freddie and Fannie are in fact bankrupt today, we need to examine exactly how all of this happened – who was responsible – and who's been covering it up.

In 2001, after the 9/11 attacks on America, President Bush appeared on national television and urged Americans to, in effect, "go shopping."

We were, as you're aware, in the middle of a large economic dislocation which, paradoxically, had been brought upon us by an overreliance on **Speculative Investment** in our economy, otherwise known as the "Dot COM Bubble." The bubble had burst in 2000, and was wreaking havoc among investor's portfolios worldwide.

[4] http://market-ticker.denninger.net/archives/435-More-yeah,-I-know-on-The-Housing-Crisis.html

So together with Alan Greenspan, Congress and The Administration decided to blow an even bigger bubble, this time in the area of **Ponzi Investment**, in an attempt to prevent the full extent of the losses from the previous bubble from being realized.

It was a fatal error, and one that we now **must** pay for.

During the years from 2001 to 2007, Fannie and Freddie were **allowed** to grow their leverage to somewhere between 60:1 and 200:1, depending on how you count it. That is, they have somewhere between 50 cents and $1.60 worth of actual capital – money – behind every $100 of debt they either own or guarantee.

To put this in perspective, **banks** are supposed to have their leverage limited to somewhere between 8:1 and 12:1. Bear Stearns, which **failed**, was levered up at about 30:1, or more than **double** the recognized and expected "safe" level. Investment banks across the nation have feverishly been trying to take down their leverage ratios since the summer of last year, fearful that what happened to Bear Stearns could happen to them, as debt – most of it based in **Ponzi Investment** – continues to go bad.

Fannie and Freddie have actually **increased** their leverage, and The Government proposes to allow that to not only continue, but to expand. Further and far worse, Secy. Paulson proposes that he should be given carte-blanche to spend the public's money to shore up the debt issued by these two institutions ***even though they are currently operating at a leverage level that is double that of the riskiest of hedge funds, and even though in 2003 and 2004 they became mired in monstrous accounting scandals.***

Together, these firms have about five trillion dollars worth of debt either owned or guaranteed by them. That is an amount that is equal to the **entire** public float of the US Federal Debt, and about half of all federal debt.

Who owns this debt?

It is scattered around the world, literally. The Chinese own some $375 billion of it. Japan has a bunch. Foreign Central Banks took much of the recent Freddie Mac debt offering this week. All in all, about $1.5 trillion of it is owned by foreign investors.

But here's the rub – this debt has a "spread", or premium, to US Treasuries. Historically that spread has been about 50 basis points, or ½ of 1%. Lately, it has been closer to 75 basis points, or ¾ of 1%. This doesn't sound like much, but given the enormity of the debt involved, it is a huge amount of money.

This "spread" is present in all debt that has **risk** associated with it. And in fact every offering prospectus that goes with Fannie and Freddie debt has clearly stated that these securities are not backed by the US Federal Government and can, in fact, lose value.

The total amount of "extra return" that has been earned by China, Japan, other foreign Central Banks and domestic investment houses such as Bill Gross' PIMCO is about $50 billion annually. To put this in perspective, this is about ¼ of the cost of the Iraq war, each and every year.

If we are to "bail out" these people by "backstopping" Freddie and Fannie, **whether or not that backstop is ever used**, then our Congress has in fact committed theft from all of us in the amount of that "excess coupon" over the last ten years. Some $500 billion in excess spread, which should not have been earned if in fact these bonds have no more risk than Treasuries, has been extracted from you and I and given to PIMCO, China, Japan and other foreign interests.

Bluntly, Sec. Paulson and Chmn. Bernanke are proposing that Congress <u>STEAL</u> approximately $2,000 from each and every American with this legislation and give it to China, Japan, and others on the date this legislation is signed, and in addition, give them the right to steal another $20,000 from each and every American should this debt go bad and require the exercise of that "backstop."

Yes, I said **STEAL**.

See, these investors bought this debt with the full knowledge that **there was risk** associated with the purchase. It says so right in black ink in the offering prospectus. They bought it anyway and now are demanding that Congress provide to them a backstop **for their bad investment** in an amount that could be as high as $20,000 **per American.**

That's theft, pure and simple.

There are many people who claim that it will "totally destroy" the housing market if Fannie and Freddie collapse, and result in "chaos" in our markets.

They are overlooking the fact that backstopping these institutions is far worse in that we cannot stop the unwinding of the **Ponzi Investment** bubble in housing, and attempts to do so risk impairment of **the government's** ability to borrow and thus finance our way of life.

Fannie and Freddie are often said to hold only "prime" mortgage paper that is "safe." This, unfortunately, is simply not true.

Jamie Dimon, on the conference call regarding JP Morgan's recent quarter, stated that "prime loans are performing terribly."

But exactly *what* are "prime loans"?

"Prime" used to mean that you had 20% down in cash, took a 30 year fixed mortgage, and had a "back end" ratio, or total debt service to verified income, of no more than 36%.

But during the years 2003-2007, and even **today**, this is no longer true.

Countrywide Financial and *IndyMac Bank*, among others, are being investigated by the FBI for what has been described by many as "massive fraud." Many of their loans were originated via fraudulent pretense - with cooked appraisals, falsely-stated incomes or some combination. They were then sold off to Freddie and Fannie as "prime" paper based on nothing more than a good FICO score via automated approval systems maintained by both companies. *Neither of these firms has been buying only 80/20 36% DTI paper since the housing bubble began, and as the bubble proceeded the percentage of paper exposed to losses as a result of these crooked practices has dramatically increased.*

This debt is in fact quite dangerous, in that in places where home values are declining back to their true values – somewhere at or under 3x average income in a given area for an average home – there is no way to avoid these loans from going severely underwater. If the borrower then loses his job or the truth of his income – that he could never afford the loan the first place – comes home to roost, these homes will go to foreclosure *and a real capital loss will be taken as the market value is nowhere near the total outstanding on the mortgage.*

Exactly how did this happen?

Simple, really – Fannie and Freddie spent $200 million on lobbying efforts[5] intended to prevent any sort of real regulation of their leverage and actions. That $200 million "bought off" any sort of meaningful regulatory oversight, and allowed them to not only expand their leverage to manifestly unsound levels, but in addition allowed them to buy mortgage paper claimed to be "prime" which in reality had a quality more akin to that of used toilet paper.

Now we're being asked to "backstop" them because, it is claimed, if we don't the economy will collapse.

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[5] http://news.yahoo.com/s/politico/20080716/pl_politico/11781

This is pure nonsense.

Money will always be available to lend to **worthy** borrowers.

What will be cut off is lending to people who should never have obtained a loan in the first place, and were “empowered” to buy a house only because the government “had the back” of the people who wrote the mortgages.

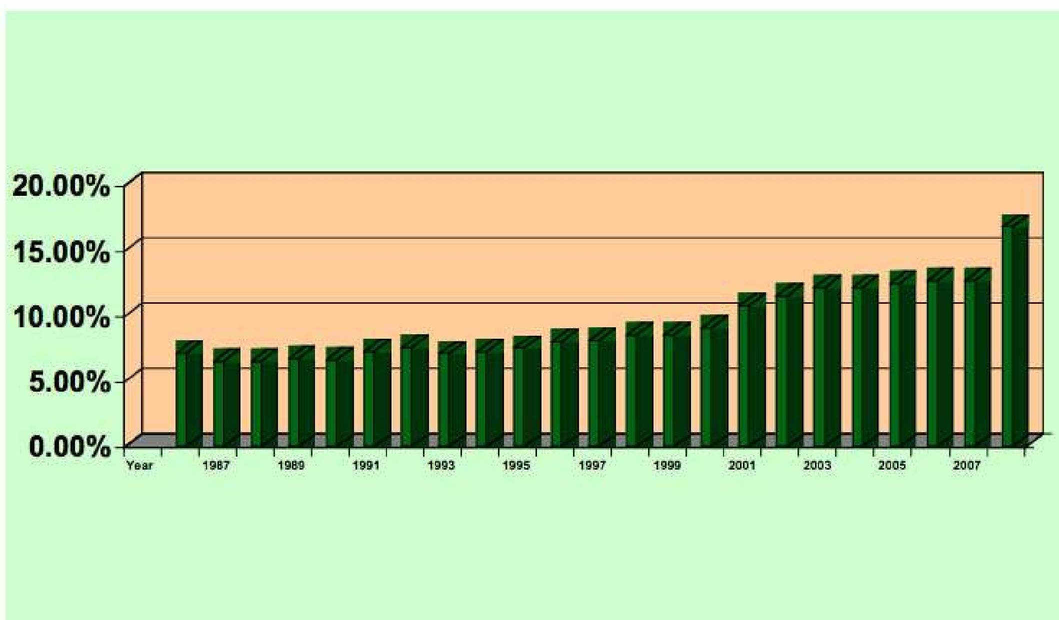
Yes, the cost of financing a home purchase will go up.

How far? The immediate impact will likely be a 200 basis point increase for qualified buyers, with a requirement to put 20% down and have no more than a 36% back end (DTI) ratio – just as it should be, and as it was for *nearly fifty years* prior to the housing bubble. Those people who want “more lenient terms” will pay more, of course. Over time the spread will relax to about 100 basis points, a quite-reasonable adjustment from where we have been for the last 10 years, assuming you truly want (and qualify for) a “conforming” mortgage and not some kind of “gimmick loan.”

Standards and rates should go up; they have been held artificially low for nearly ten years, both in rate and in terms of qualifications, on purpose; excessively-loose monetary policy is the reason we are in this economic mess!

Many also believe that The Housing Bailout Bill is a “good thing” because it will expand the FHA’s mortgage lending. Shall we take a look at how well the FHA has done controlling its risk?[6]

FHA Historical Delinquency Rate 1986 to May 2008



Historical data from 1986 through 2007 from the US Housing Market Conditions Report, 1st Quarter 2008 published by the US Department of Housing and Urban Development Office of Policy Development and Research. See Table 18 on page 79. Current delinquency data taken from the Department of Housing and Urban Development’s Neighborhood Watch Website. Delinquency and foreclosure data as of May 31, 2008 and includes all servicers. Data includes all single family insured loans with a beginning amortization date between 6/1/06 and 5/31/08.

That’s not so good eh? In fact, it’s much worse than it appears, as the following tables will show –

[6] http://whistleblower.ml-implode.com/

the delinquency rates for the ten largest FHA mortgage servicers:[7]

FHA Ten Largest Servicer Default Rates as of May 31, 2008*

* Includes all insured single family loans with a beginning amortization date between 6/1/06 and 5/31/08

Servicer	Active Portfolio	3 or More Months	Current Defaults	Foreclosure	Total Default	3 or More Month %	Current Default %	Total Default %
Wells Fargo Bank NA	1053515	69772	165435	15445	180880	6.62%	15.70%	17.17%
Countrywide Home Loans	497811	35881	86576	9843	96419	7.21%	17.39%	19.37%
Citimortgage Inc	368124	21572	64360	3861	68221	5.86%	17.48%	18.53%
Chase Home Finance	362915	17593	56331	4689	61020	4.85%	15.52%	16.81%
Midland Mtg Co	184765	15287	47125	2902	50027	8.27%	25.51%	27.08%
US Bank NA	177866	13541	31842	4003	35845	7.61%	17.90%	20.15%
National City Mtg	129220	7303	18316	2353	20669	5.65%	14.17%	16.00%
GMAC Mtg	112494	6411	29599	1958	31557	5.70%	26.31%	28.05%
Taylor Bean & Whitaker	75163	3868	15528	1145	16673	5.15%	20.66%	22.18%
First Tennessee Bank NA	60279	3152	7964	855	8819	5.23%	13.21%	14.63%
Total Top 10 Servicers	**3022152**	**194380**	**523076**	**47054**	**570130**	**6.43%**	**17.31%**	**18.87%**
Total Active FHA Portfolio	**3862391**	**239579**	**649246**	**59794**	**709040**	**6.20%**	**16.81%**	**18.36%**
% of Total FHA Portfolio:	**78.25%**	**81.13%**	**80.57%**	**78.69%**	**80.41%**			

Data taken from HUD's Neighborhood Watch site. Data is for all servicers and includes single family endorsements with beginning amortization dates between 6/1/06 and 5/31/08.

Many of these firms are currently seeing default rates ***in excess of twenty percent***.

Congress wants to **expand** the role of FHA? Who is going to eat these losses? FHA is, of course, *The Government*, which means that the losses will be eaten by…….you and I.

Can we afford this? No, we cannot.

Should we find a way to pay for this? **No, we must not.**

Unfortunately the problem does not stop with Fannie, Freddie and the FHA. It has infested our banking system from top to bottom. IndyMac's collapse has been blamed on Chuck Schumer's open letter to regulators, **but in fact blowing the whistle on intentional, willful blindness of those regulators is part of Mr. Schumer's job!**

The real question is ***why did it take him so long to do it?***

The fact of the matter is that there are dozens, if not hundreds, of similar banks, including, quite possibly, some of the nation's largest banks in similar if not worse condition. As I documented back in April of 2007, Washington Mutual **doubled** their "Capitalized Interest" (that is, "earnings" from PayOption ARM negative amortization interest) on a year/over/year basis from 2006-2007[8].

Where were the regulators? Where was the OTS and OCC? This sort of nonsense was going on all

[7] Ibid.
[8] http://market-ticker.denninger.net/archives/392-WaMu-Option-Arm-Capitalized-Interest-And-Why-Its-DANGEROUS.html

throughout banking land from 2003-2007, **and yet nobody put a stop to it.** In fact, government cheered how we were "opening homeownership to minorities" and similar bits of tripe.

Now we are expected to believe that The FDIC, OTS and OCC have all of this under control? Even though IndyMac is being investigated for fraud by the FBI[9]? We're supposed to believe that the FDIC and other regulators know the scope of the problem and are able to deal with it, when there is fraud involved and nobody has identified – as of yet – how bad that is?

$4 to $8 billion in losses to the FDIC, they say. Should I believe that? I think not; remember, when the S&L crisis began we were told it was a $20 billion problem – relatively small potatoes.

It ended up being a $150 billion boondoggle.

My best estimate has been since 2007 that the total economic loss in value in the credit markets – direct loss, not "derivatives games" – would be somewhere between $2.5 and $3 trillion before this was all said and done, and that's for US assets only. I'm not counting the furball over in Europe, which may be at least as bad as ours is.

I've seen $200 billion in write-downs thus far.

Where's the rest?

It's hidden – so far.

But as you discovered with IndyMac, it won't **remain** hidden. Nor should the people, given the current posture of the government and regulators, believe a word that comes out of your mouths. You have a documented and irrefutable record that says believing your words on matters economic is a nearly-100% losing bet – every time, all the time.

Next, and finally, I wish to address the entire "CDS Mess", otherwise known as Credit Default Swaps, or as Warren Buffett called them, "*Financial Weapons of Mass Destruction.*"

He was being kind.

Here are some facts on "Credit Default Swaps" directly from our own Office of the Comptroller of the Currency's Quarterly Report[10]:

- The top 25 banks are party to $16 **trillion** in "notional" value of credit derivatives, or bets on credit events. However, ***these banks only have total assets of $7 trillion dollars between them.***

- ***Of that $16 trillion in exposure, $15 trillion of this exposure has been added recently.*** How much of this would "net out" if these contracts had to be liquidated? **<u>Nobody knows</u>**.

Recent evidence indicates that at least some of these contracts were entered into ***with full knowledge that they could not be fulfilled –*** that is, that they were fraudulent in the first instance![11] If this is true then these contracts were not used as legitimate hedging instruments – they were and are being used as a means of not having to recognize deterioration in underlying credit quality through intentional deception.

This sort of game is almost identical to Jeff Skilling of Enron's "asset lite" management concepts, which appeared to work brilliantly – up until the last few days when it all fell apart and the firm collapsed.

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9 http://news.yahoo.com/s/ap/20080716/ap_on_go_ca_st_pe/mortgage_investigation_1
10 http://www.occ.treas.gov/ftp/release/2008-74a.pdf
11 http://market-ticker.denninger.net/archives/508-The-Looting-Of-America-Continues.html

We are told that it is better for the taxpayer to fund bailouts, such as happened with Bear Stearns, in order to prevent "systemic risk", rather than expose the fraudulent accounting and intentionally false claims of "insurance coverage" against default when the purchaser (and the seller!) of the policy are well-aware that the seller cannot come up with the money.

Pray tell, why is this "better"? Is it really in the best interest of our economy to continue a charade that sinks us ever deeper towards the event horizon of national insolvency by allowing intentionally false accounting to obscure the fact that many of these firms have insufficient capital to meet the liabilities that *with certainty* lie ahead of them?

While there are a few people now calling for formal margin maintenance requirements along with forcing all such contracts onto exchanges, the voices of resistance remain strong.

Can there be any doubt that part of the desire to prevent such a change is driven by the knowledge that were these contracts forced into a tri-party model such as is used for listed options, where an intermediary such as the OCC was responsible for settlement (and thus had a very strong incentive to pay close attention to the adequacy of posted margin against open positions), that many of the writers of these "credit default swaps" would be forcibly liquidated?

Such an event would of course cause the underlying credit quality of these instruments to immediately "shine through" the veil of claimed "insurance." This in turn would result in the immediate insolvency of many of these firms.

Do we really do a service to America, and Americans, by allowing bankers and fund managers to claim "value" in assets that does not exist?

Add all this up and you have quite the mess. But is not the risk to our way of life – and to our financial system - even more severe than the risk of firms going bankrupt within our own borders?

What happens if foreign governments, who currently finance our **Ponzi Investment** games (not to mention the US Government's profligate entitlement spending) to the tune of $2 billion **a day**, decide they will no longer play along and say "No mas"?

If that was to occur, and it very well might, we would suffer an immediate and severe dislocation in both the dollar and the US Treasury market, *effectively cutting off, without warning, our ability to finance our spending.*

We cannot afford to take this risk.

The simple fact of the matter is that Paulson and Bernanke, along with their predecessors, regulatory agencies and both houses of Congress, either intentionally looked the other way while all of this occurred or they have been complicit in it.

In either case, the prognostications coming from all of you - Secretary Paulson, Chairman Bernanke, and nearly all members of Congress - have been flatly incorrect, and whether that has been due to intentional misconduct or simple bad judgment, the fact remains that entrusting you with **any** further authority, until you all come clean and force the bad actors into the sunlight, is a mistake.

So what do we do from here?

I believe that we, as Americans, must demand all of the following – some of which you have heard before, and some of which is new, but all of which needs to happen right here and now.

Restore Fiscal Sanity In America

1. The "Housing Bailout Bill", H.R.3221 (and its Senate counterpart), **must NOT** pass. *There is no way to fix Fannie and Freddie in their present form*, and the concept of "prudential regulation" of an enterprise that is operating with a leverage ratio of 60:1 to 200:1 is certifiably insane. There are too many problems with this legislation; the essence of the legislation, an attempt to extend the **Ponzi Investment** boom of the last eight years, **cannot be realized, sustained or countenanced.**

2. Fannie and Freddie must be **explicitly** cut off from Federal Government backstop. This will force them to deleverage as the bond market will in due course refuse to fund further expansion of their balance sheet. This is a **necessary action** because those who have purchased this debt, including the Chinese and Japanese who between them hold **nearly thirty percent of all Fannie and Freddie outstanding paper**, were paid to take additional risk over Treasuries **and we must not "cover" that risk at taxpayer expense.** "Adding" to H.R. 3221 **is exactly backwards** and amounts to **giving the Chinese, Japanese and other foreign interests over $100 billion in taxpayer money – immediately – with a "call option" on another $1.3 trillion! That's <u>outrageous</u>.** The executives of both Fannie and Freddie were all over CNBC and elsewhere last week claiming **they do not need a bailout. <u>We must force them to live to their word</u>.**

3. The Fed **must be directed** to drain the liquidity swamp and expose those who have improperly marked their assets "to fantasy." This action will make dollars **scarcer** and thus increase their value, deflating commodity prices, **most importantly food and oil.** This action will **also** make production of goods inside the United States for domestic consumption more attractive, thereby beginning to address the global wage arbitrage **that has been fueled by The Fed's 20 year history of loose-money policy.** If The Fed refuses to undertake this action then Congress must revise The Fed's authority and mission to be focused on the stability of prices, directing The Fed to use actual price statistics with no "hedonic" or other adjustments in the setting of policy rates, along with other actions to compel prudent performance of their duty in defense of the nation's currency. *Inflation expectations are already unhinged and will get <u>much worse</u> if we do not get this problem under control now.*

4. Due to the incredible default spiral gripping FHA loans, and to prevent a fiscal disaster being dealt to America as a consequence, the FHA must be forced to revise its approval standards to insure that:

    a. Actual cash down payments are made by all purchasers, and no form of "assistance" is permitted by any party, with emphasis on "third party" DPA organizations that are in fact nothing more than a conduit to inflate purchase prices via "seller assisted down payments."

    b. Down payment requirements are ***raised*** to at least ten percent (10%).

    c. The back end debt ratio maximum (DTI) is set at 36%, in conformance with one hundred years of experience in prudent mortgage underwriting.

    d. Risk-based premiums are charged in accordance with the borrower's credit experience, history and capacity to pay.

5. We must encourage home prices to **contract** so that the average home sells for no more than three times the average income in a given market area. Policies that tend to drive prices in the other direction must be immediately dismantled. **It is of the essence** that we reduce

reliance on **Ponzi Investment** and redirect investment towards **Productive Investment** so that we can, as a nation, grow our GDP on a sustainable basis over time. ***Without the proper foundation for our economy we can never be fiscally sound and we will suffer continuing damage to our standard of living.***

6. If it is judged that Congress must provide a formal liquidity system for **conforming** mortgage loans, defined as loans originated with a 20% **cash** down payment (no seconds, "carry backs", or other games permitted), a maximum of 36% DTI ("back end" ratio), and a fixed-rate of either 15 or 30 years, then Congress should establish via separate legislation a formal government program to provide said loans, separately administered and regulated. Such a program must include felony criminal penalties for any form of fraud in the application and underwriting process and be ***strictly enforced against all who attempt to game the system,*** including Borrowers, Realtors, Appraisers, Loan Officers and Banks. Such an explicit government underwriter of loans, operated prudently, would inure to the benefit of the Government and citizens as the coupon thus earned would be at a spread to Treasury debt and provide a net tangible budgetary benefit to the United States.

7. All of those who committed fraud, whether they are borrowers, bankers, appraisers, Realtors or others, must be prosecuted to the fullest extent of the law. While some of the recent excesses were due to "animal spirits" on Wall Street and elsewhere, the **Ponzi Investment** bubble could not have grown to the size it was, nor could it have inflicted the damage it has and will, without the unlawful acts of countless individuals and firms.

8. Glass-Steagall must be reinstated and the existing "23A" letters exempting broker/dealer affiliates from the "10% limit" must be immediately rescinded. The latter can be done with the stroke of a pen by The Fed. The former must be embarked upon immediately to help prevent future bouts of **Ponzi Investment** in The United States.

9. All OTC "Credit Default Swaps" must be forced onto an exchange with an intermediary similar to the "OCC" for listed options. We simply must know who can and who can't pay.

Ladies and Gentlemen, we know the situation is bad. We can see it in $4/gallon gasoline, unemployment claimed to be 5% but is really double that (the government "ignores" anyone who has given up on getting a job), wages that have failed to make any progress in real purchasing power since 2000 and the declining values of our homes, not to mention 401ks that are now 201ks.

We know that millions of Americans participated in some form in robbing all of us, whether it be by inflating appraisals, "stating" incomes that were two, three or four times reality, claiming that "Option ARMs" were perfectly safe mortgages because "you can always refinance when the payment is going to reset", or marketing complex securities such as "ARS" bonds as "equally safe as a money market" when nothing was further from the truth.

We know that there are hundreds of insolvent banks and financial institutions, but you hid it from us in the hope that we would not panic. You've been thinking that the "housing crunch" would be over by this summer – we know, you told us that – and these firms would be "ok." Now you and we both know that the housing crunch isn't over and won't be any time soon and these firms are dead men walking. IndyMac wasn't even on the FDIC's "watch list." We're quite close to panic now, since we don't know when the lies will stop – or if they ever will. How can we trust you – or our local bank?

We know that your job is, to some extent, to "cheerlead." We even heard Phil Gramm say that we were in a "mental recession." Mr. Gramm, with all due respect, your bill to repeal Glass-Steagall is a huge part of how **Ponzi Investment** became so prominent in the United States. The only thing "mental" is you; $100 to fill our car with gasoline is in fact reality.

However, 80% of American did not participate in the fraud and theft. We gained nothing from it. Our homes may have increased in "value", but we were not foolish enough to treat our "home equity" as an ATM machine and spend our newfound "wealth" on a plasma TV, replacing it with debt.

For those of us in the 80%, we have only suffered.

Because we are honorable Americans, we pay our taxes unlike the thousands who set up offshore accounts through UBS, or the thousands more who "stated" income to, in no small part, avoid paying taxes on cash businesses. We also know our taxes will be going way up to pay for the bailouts of all these fraudsters, unless you stop it.

Because we are honorable Americans we did not lie when we went to buy a home and we bought in good faith. Now we are paying the price from the speculative **Ponzi Investment** collapse that the 20% of America who stole from all of us has brought down upon our heads, as our homes depreciate in value just like those of the fraudsters.

Because we are honorable Americans we are forced to fill our tanks with $4/gallon gasoline while watching Congress goad on even more **Ponzi Investment** through burning food in our fuel tanks – ethanol – which has translated that oil spike into food with even more ferocity than would have otherwise occurred.

And finally, because we are honorable Americans, we expect **you** to do the honorable thing.

We expect you to tell the truth.

We expect you to prosecute the wrongdoers.

We expect you to **NOT** bail out the speculators and **Ponzi Investment** Kings who have robbed us all, buying expensive retreats and yachts in *The Hamptons* with what should be **our** money.

We are the 80% of America ladies and gentlemen.

We can refuse to re-elect you, we can refuse to support you, we can refuse to be governed by you and we can refuse to pay for this charade, not that we'll have jobs or income upon which you can levy taxes at the rate we're going anyway.

If you do not have the testicular or ovarian fortitude to face the fraudsters who are, by and large, your campaign contributors, and tell them to stuff it, acting in favor of the common man, then it is time for you to step aside and allow those who can and will to come to the fore. Gentlemen like The Honorable Senator Bunning and The Honorable Representative Garrett have demonstrated that it is not impossible to do the right thing in Washington DC.

We're tired of bailouts and handouts.

We demand leadership, not lies.

We vote.

We know what happened, and who was and is responsible.

We expect you to respond, and put a stop to it.

Sincerely,

Karl Denninger