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October 11, 2008
Washington Lawmakers and Treasury
By Fax

Dear Sirs:

I write again to urge you to consider alternatives to the TARP/ESSA, specifically the plan outlined in the pages below called "The Genesis Plan[1]", which you have previously had faxed to you in the preceding weeks.

We have continuing evidence that credit is freezing up across America. There are already anecdotal signs that this freeze is extending to cross-border shipments of goods and delivery of goods inside America, as short-term commercial credit is essential to these functions (Letters of Credit and commercial credit systems for fuel purchases, for example.) Should this freeze deepen to any material degree severe or even critical disruption of the flow of essential goods such as fuel and food may occur in America.

While this may sound "tinfoil hat" crazy, it is in fact not. There have already been reports of this occurring with goods intended for Christmas (and grains!) that are sitting on docks in Asia but are refused loading due to the lack of acceptable Letters of Credit. No foreign shipper is going to risk having to sue an American company for payment. Reports from persons who live near and work on the docks are that freight volumes have essentially collapsed. Anecdotal evidence of disruption in credit systems for fuel are appearing in various online forums, including mine. Iceland's banking and credit system has collapsed, along with their currency, with the Kronor losing more than 60% of its value overnight. This has tripled the cost of essential imports.

To believe that "it cannot happen here" is incredibly naïve; I urge you to consider that it both can and might.

There is no time to "wait for things to work"; if you remember, you were sold ESSA/TARP as a bill that must be passed **right now** or economic calamity would strike. You were told by Secretary Paulson and Chairman Bernanke that absent this legislation economic deterioration might even reach levels requiring the imposition of Martial Law.

You passed their bill over the objections of the American People and in fact the "rot" in our credit system has continued – ESSA/TARP has not instilled confidence, it has instead instilled further panic!

ESSA/TARP is not and cannot function as designed. It fails to address the underlying systemic cause of the credit freeze, which is a lack of confidence, or more succinctly, trust.

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[1] http://www.denninger.net/letters/genesis.pdf

ESSA must be immediately repealed on an emergency basis and/or replaced/supplemented with a plan that will in fact restore trust. To analyze what must happen, we must return to the underlying fundamental issue, which is illustrated by the decision process that goes on in the consumer credit space every day.

If you go to purchase a car, and wish to finance it with the dealer, there is only one consideration in regards to whether or not the loan will be made – *will you be able to pay it back?*

The same applies to interbank and commercial lending; there is in fact no difference at all.

ESSA does not and cannot ease the crunch because it does not go to the underlying cause of the problem, which is in fact threefold:

1. Excessive balance sheet leverage. All five firms that have failed had more than the 12:1 leverage that was capped by rule until the SEC repealed it in 2004. *Henry Paulson, while CEO of Goldman Sachs, was among those who lobbied for repeal of this rule.* He has not taken responsibility for the **fact** that all five of the failed firms – AIG, Lehman, Bear Stearns, Fannie and Freddie – had dramatically more leverage, twice or more, than was previously permitted under this rule for investment banks. **Had this rule been uniformly applied across all financial institutions all five of these firms would still be in operation.** Excessive leverage **remains** in the system and trust cannot return until it is known that it has been extinguished.

2. Lack of balance sheet transparency. Banks and investment banks alike are under extraordinary pressure because it is **<u>impossible</u>** to value the "assets" claimed on their balance sheets in a dispassionate, objective fashion. This is not an accident, it is an **intentional act** committed by these firms' management teams. ESSA does nothing to address this. If an investor cannot value a firm based on its balance sheet, that investor has no means of determining whether the investment they are about to make is sound.

3. OTC derivatives. Chris Cox and others are addressing this matter; this needs to be rushed to completion so a structure substantially identical to that which we have for listed PUTs and CALLs on equities is in place, including most especially margin supervision. It appears that this process is going forward.

Lehman's CDS auction and clearance demonstrates that my preferred plan to resolve failed institutions, once the three points above are undertaken, **<u>will work</u>** and will involve zero taxpayer funds for most firms.

Firms and their "friends" (including Henry Paulson, ex-CEO of Goldman Sachs) undoubtedly object to plans such as *The Genesis Plan* because institutions exposed as insolvent by it will be forcibly crammed down and recapitalized, and this will wipe out all of the executive options and restricted stock which they believe they are "entitled to keep" even as they have run their firms into the ground. This, however, is not a reason to back off from a solution that will actually resolve the crisis; in fact, it is a reason to press forward with it, as taxpayers are (rightfully) calling for blood from those who created this mess.

Here is a point-by-point comparison of *The Genesis Plan* and the ESSA/TARP:

1. *The Genesis Plan* immediately restores trust to the credit markets as balance sheets are instantaneously exposed and remain able to be evaluated by the marketplace. EESA does nothing to guarantee the return of trust to the credit markets as it does not deal with the underlying issue at all - the lies told by executives and firms in terms of their exposure to credit risk of all types.

2. *The Genesis Plan* addresses the root cause of all of the large-firm failures since the first of 2008 - excessive leverage. TARP/EESA is silent on the root cause of these business failures.

3. *The Genesis Plan* can be represented in a half-dozen pages of legislation. The EESA required over 100 to put in proper oversight. Since there is nothing other than ministerial activity required under *The Genesis Plan* and no discretion to abuse, such oversight is not necessary as with the EESA.

4. *The Genesis Plan* uses no taxpayer money at all for most institutions, and where taxpayer money ***is*** required it is intrinsically protected since it will sit at the top of a (new and clean) capital structure. The TARP/EESA uses all taxpayer and no private funds.

5. *The Genesis Plan*, when taxpayer money is used, goes directly to Tier 1 capital and thus is "high power" money; that is, it supports lending of $10-12 for every dollar put in. TARP/EESA is ***twelve times less efficient in the use of funds*** in that by purchasing assets zero leverage is obtained for each taxpayer dollar deployed.

6. *The Genesis Plan* promotes restoration of normal lending activity as it clears the impaired firm's balance sheet debt and immediately eliminates the issue of counterparty trust. TARP/EESA does not clear (although it does help remove items from) the firm's balance sheets and does nothing to address counterparty trust.

7. *The Genesis Plan* requires no lengthy administrative or "start up" time. It can literally be "up and running" immediately, with the exception of the CDS exchange, which is already under way. TARP/EESA was claimed to be required "immediately" but now is said to not be likely to actually go into effect until November at the earliest.

8. *The Genesis Plan* uses existing agencies that are already tasked with the required functions - auditing and reporting (OTS, OCC and the FDIC) and thus has very low "parasitic" costs. TARP/EESA establishes a new government agency and thus has a high parasitic cost requirement.

9. *The Genesis Plan* exposes the taxpayer to no credit risk. EESA/TARP exposes the taxpayer to $700 billion in taxpayer risk - or more.

I urge you to consider *The Genesis Plan* as an alternative to TARP/EESA immediately, and to take steps to address the root cause of the financial crisis. Absent such steps, taken immediately, the “doomsday scenario” that Henry Paulson and Ben Bernanke have laid forth is very likely to occur.

This weekend we learned that Fannie and Freddie are “secretly” buying up to $40 billion a month in “troubled” mortgage assets – non-performing prime, subprime and ALT-A paper.[2] The lunacy of purchasing non-performing – that is, delinquent – mortgages is beyond belief. This act simply guarantees losses to the taxpayer and the attempted secrecy of the purchases – and from whom they are being made - further undermines trust in the financial system and markets.

I am the former CEO of an Internet company that operated in the 1990s (MCSNet) that was sold to Winstar Communications in 1998. The scams that were run during the housing and credit bubble years of the 2000s are precisely the same as those that were run in the Internet space during those years. During those years firms like “pets.com” operated with alleged “EBIDTA” earnings that did not reflect their real forward cash flow prospects, their balance sheet leverage, or their expected future liabilities. Large telecommunications firms were fraudulently reporting traffic growth numbers that I and thousands of others knew were intentionally overstating reality in a raw attempt to goad competitors into a build-out war in facilities that would, in fact, not be required (or produce cash flow) for over a decade. The consequence of these fraudulent practices and excessive leverage led to the implosion of Winstar Communications and nearly bankrupted Lucent by extension as that firm had an incredible amount of exposure via what amounted to “zero down Pay-Option ARM” equipment leases. Thousands of additional firms, including MCI/Worldcom, failed as the falsity of their claims and “projections” were exposed and claimed cash flow turned out to be non-existent.

We have changed the names of the actors but not their methods, nor the result. I hollered then about the fraudulent accounting and falsehoods being splayed in the media, financial reports and elsewhere, to no effect, and when the bubble burst in 2000 millions of Americans had their retirement savings wiped out.

After The Internet Bubble burst in 2000 we were promised reform and legislative activism. ENRON’s failure underlined the false accounting that had been pervasive during the previous decade. The legislative and regulatory response to these failures was not a tightening but rather further loosening of regulatory oversight, and the fraudsters “jumped ship” to the housing, commercial and consumer credit markets, igniting a furious credit bubble that has now imploded and threatens the very foundations of American commerce.

The Internet Bubble was bad for American investors, but this bubble literally threatens our way of life and civil order. Encouraged by the intentional acts of Congress, regulators, The Federal Reserve and their counterparts all over the world the very same scams were run in the core of the banking and credit systems worldwide. Leverage was taken to extreme levels, derivatives were traded that had no capital underpinning and purely fanciful balance sheet accounting methods were adopted, promulgated and maintained.

Now this bubble has begun to burst and we face an unprecedented crisis. The excess leverage in the system and false “capital” in fact exceeds that which existed in 1929 as a percentage of GDP and thus the risk to our way of life is more severe than at any other time in American history. The stock market crash of the previous week is a symptom and not the cause, but absent immediate and effective intervention we will follow the same path that

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[2] http://www.bloomberg.com/apps/news?pid=20601087&sid=aDjJYMSphyM0

America did in 1929 through the 1930s. Injecting "more liquidity" will, as we have seen, do exactly nothing without restoring trust.

There are only two ways to restore trust – we can either force recognition of the truth of solvency (or not) by these firms legislatively, since they have demonstrated they will not do so voluntarily, or the market will do so via bankruptcy of each firm in turn, along with many that would otherwise be solvent, until the rot is cleared from the system.

Down the second path lies an economic catastrophe worse than what we faced in the 1930s, as the leverage and fraud has in fact been more severe than at any previous time in the past two hundred years.

It is at times of true crisis that leadership is required. Thus far in this economic crisis, despite my calls, letters, faxes **and** petitions going back to October of last year, Congress has responded not with leadership but with "more of the same" and continuation of the disastrous policy decisions that have led us to this precipice.

The American People desperately need our legislators to put down the partisan sniping and "corporate largesse" and instead address the root cause of the rot in our financial, credit and economic system. We must address the intentional abuse of leverage, fraud and falsehood in financial reporting and unregulated gambling on the financial health of firms without regard to the ability to cover the bets placed.

Trust has been destroyed because more than 20 years of Congressional action and inaction has empowered this den of vipers to build a system that is in fact a house of cards without a foundation. Both political parties share equal blame for bowing to corporate interests without regard to the safety of the actions demanded by these individuals and firms. The root cause of this crisis goes back to Gramm-Leach-Billey and other legislation that repealed Glass-Steagall, the Depression-era law enacted after *the precise same game* was run in the 1920s with disastrous results. The Federal Reserve has in fact been complicit in this fraud, along with Treasury, with Alan Greenspan and Ben Bernanke both supporting a "deregulated" environment in which "principles" instead of rules are the guideposts by which we operate.

The folly of the repeal of this law and the regulatory framework that grew up around it has now been exposed for the world to see. Glass-Steagall must be re-imposed, but doing so is beyond the scope of emergency legislation.

Today, we face a crisis of confidence that threatens to upend America's way of life. You, as our representatives and Senators, must act immediately to restore trust.

There is exactly one way to accomplish this goal – the truth must be known to all, and once it is, those firms who are solvent will have the credit freeze immediately disappear. Those who are not will have to be forcibly recapitalized to maintain orderly functioning in the markets and the losses borne by the investors who foolishly purchased these instruments.

I urge you to act not in the interest of Henry Paulson and his friends, nor in the interest of Ben Bernanke and his, but rather in the interest of The American People.

It is at times like this that we discern whether or not our Congress represents us and will protect the American way of life and Constitution, or whether it will allow our nation to sink into an economic abyss in a fatally-flawed attempt to protect a few “fat cats” in Washington, New York, London, Tokyo and Shanghai.

I remain available to discuss these measures on the telephone with members of Congress and their staff, and if required I will travel to Washington DC to testify before Congressional Committees as requested. Action early in this coming week is required; it cannot wait until after the elections.

Sincerely,

Karl Denninger

How To Fix Our Banking System
The "Genesis" Plan

by Karl Denninger
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It is clear that we must act to stabilize our financial markets. What is also clear is that if we act imprudently we will destroy our financial markets and system instead of saving it, and are likely to usher in a Depression.

What Henry Paulson and Ben Bernanke have proposed will do the latter, not the former.

The root cause of the current lack of trust in our financial markets is threefold:

1. Nobody can trust a balance sheet. This is due to off-balance-sheet vehicles (which were supposed to be banned after ENRON) and "Level 3" assets, which nobody can analyze the true valuation of, as identification of the claimed assets and their valuation models are undisclosed.

2. Credit Default Swaps (CDS) are "over the counter" (OTC) transactions with no margin or capital supervision. As a consequence nobody knows if their "counterparty" can pay. In fact huge percentages of these people can't pay – but nobody knows who they are.

3. Leverage. The SEC removed broker/dealer 12:1 leverage limits in 2004. Every firm that has failed – all five (Fannie, Freddie, Bear Stearns, Lehman and AIG) had leverage far in excess of 12:1. The draft bill is even more dangerous as it accelerates a provision intended to go into effect in 2011 that allows Ben Bernanke to **increase** financial firm leverage by dropping reserve requirements on banks to **zero** should he so choose. **It is excessive leverage that got us here in the first place, and this bill actually makes it worse.**

The solution to the trust issues in our financial system is elegant and it will work.

1. Force all off-balance sheet "assets" back onto the balance sheet, and force the valuation models and identification of individual assets out of Level 3 and into 10Qs and 10Ks. Enact this requirement beginning with the 3Q 2008 reporting period which begins next month. Total taxpayer cost: $0.00

2. Force all OTC derivatives onto a regulated exchange similar to that used by listed options in the equity markets. This permanently defuses the derivatives time bomb. Give market participants 90 days to get this done; any that are not listed in 90 days are declared void; let the participants sue each other if they can't prove capital adequacy. Total taxpayer cost: $0.00

3. Force leverage by all institutions to no more than 12:1. The SEC intentionally dropped broker/dealer leverage limits in 2004; prior to that date 12:1 was the limit. Every firm that has failed had double or more the leverage of that former 12:1 limit. Enact this with a six month time limit and require 1/6th of the excess taken down monthly. Total taxpayer cost: $0.00

Once 1-3 are put in place then send in the OTS and OCC examiners and look at every financial institution in the United States. All who are insolvent and unable to raise private capital immediately are forced through receivership where the debt is converted to equity and existing equity is wiped out.

With the CDS monster caged the systemic risk is removed, the bondholders provide the cushion for recapitalization (as it should be) and the restructured firm emerges with no debt while the former bondholders are now the owners (of the equity) in the resulting firm.

With a clean balance sheet the restructured firms remain in business and open the next morning able to raise and attract capital.

For the few firms that have an insufficient debt-holder capital cushion to successfully complete this process, we are left with two options – a capital infusion or liquidation. There will be few of these and in fact each of those firms is a regulatory failure, as we should have never permitted a firm to become so far "underwater" that the bondholder's capital is insufficient to capitalize a restructuring.

For those firms, give the FDIC (or if an insurance company, the appropriate state and federal regulatory authorities) primary control. As the CDS monster has been caged, the primary threat is now loss to state and federal guarantee programs. If these regulators deem that this firm’s liquidation would result in an unacceptable loss to the system’s guarantee programs then recapitalize the firm as follows:

- The government shall be issued senior preferred debt ahead of all other debt and equity in the capital structure, paying a floating coupon of 3 month LIBOR + 8% adjusted quarterly, in an amount sufficient to bring regulatory capital above minimum limits.

- All dividends are suspended for as long as the preferred remains outstanding, and during that period no employee of the firm may receive any form of compensation exceeding that of the President of the United States for a corporate officer, and no more than that of a United States House member for any person who is not a corporate officer. At the issue of the preferred stock all outstanding deferred compensation, including options, are deemed cancelled.

- The firm may retire the preferred at its option by repurchasing it at the issue price.

- The appropriate regulator shall have primary authority to "call" the above debt issue at any time and force bankruptcy (along with recovery of invested amounts) should the firm fail to execute an effective turn-around plan.

Finally, drop the silly shorting restrictions. Liquidity in the market stinks and this is a big part of why. Start prosecuting aggressively the rumors and other manipulation that leads to stocks **both** rising and falling.

This plan will instantaneously stabilize the credit markets as balance sheets will be transparent, the CDS monster will be permanently de-fanged, leverage will be returned to reasonable levels and the forcibly restructured firms will have no debt on their balance sheets and be able to access the capital markets. Firms that would fail once they have disclosed their true liabilities and result in unacceptable insurance program costs will be recapitalized with a reasonable expectation of the taxpayer not being stuck with the bill. Systemic risk will be removed.

Best of all, it will require zero taxpayer dollars with few exceptions, and for those instances where taxpayer dollars are required the amount of taxpayer risk would be small and well-protected.

This plan is very similar to what Janet Tavakoli proposed on September 25th in an open letter released on the web.[i] Ms. Tavakoli is an internationally recognized expert in these matters, is an adjunct professor of derivatives, and is widely published.

This and other alternatives <u>**must**</u> be examined before our nation embarks on what may be a disastrous path.

[i] http://www.tavakolistructuredfinance.com/TSF8.html