An Open Letter To United States Lawmakers

President Bush
1600 Pennsylvania Avenue
Washington, DC 20015

Transmitted by Fax

CC: Joint Economic Committee Members
House Financial Services Committee Members
Senate Banking Committee Members
Hillary Rodham Clinton, Senator New York and Presidential Candidate
Barack Obama, Senator Illinois and Presidential Candidate
John McCain, Senator Arizona and Presidential Candidate

Dear Mr. President:

It is now clear that we face a nearly-unprecedented financial crisis in this nation.

Since President Clinton signed the repeal of the last pieces of Glass-Steagall, our banking system has intentionally and willfully ignored both the letter and spirit of the law when it comes to regulatory requirements and just plain old fashioned good conduct.

The stress imposed by the collapse of the subprime lending space has exposed the truth – banks and other institutions have employed *Enron-style* financing vehicles to keep liabilities hidden and assets unvalued by the market, literally inventing valuations as they go along.

Ratings agencies, paid by the seller of securities, have admitted to using flawed computer models – specifically, the assumption that house prices would never decline – in their rating of these securities.

The Federal Reserve has been complicit in this game of "*Hide Waldo*" by first issuing "23A Exemption Letters" starting in the spring of 2007, and now, through the use of the "TAF" facility, it is preventing the investing and depositing public from learning who is under stress and to what degree.

What is clear from the market, however, is both that this stress is real and that it is dangerously close to a breaking point. The expansion of the TAF facility on March 7th, 2008 is rumored to have been prompted by a potential collapse of one or more major financial institutions. Other institutions, including Thornburg Mortgage, have disclosed that they are restating earnings for the December quarter and may have to file for bankruptcy protection. *If December's earnings are being restated, that means they were aware of – but did not disclose – the level of stress they were under when they originally filed those reports.* The secondary mortgage market, six months into this mess, remains almost completely frozen.

In addition, Hedge Funds and other unregulated entities have been met with increasingly stringent capital demands and margin calls, with the latest two to fall being Peloton and now, it appears, Carlyle. Peloton has collapsed outright while Carlyle has been suspended from the public exchanges in Europe. These margin calls, along with a lack of trust and the ability of the market to absorb forced sales, have caused spreads on Fannie and Freddie paper to rise to historic wide levels.

Mr. Bernanke and The Fed have lowered the Fed Funds Target from 5.25% to 3% over the last few months and the "slosh", or free funds available in the Fed Banking System, has nearly doubled over that time. Yet this additional liquidity has done nothing to address the problem **and won't** because the issue is not one of inadequate liquidity; *rather it is a desperate move to hide the fact that a significant number of financial institutions in our nation are, if forced to mark all their paper to the market and recognize their exposure to off balance sheet vehicles, insolvent.*

At the root of the matter, Mr. President, is a lack of trust caused by the intentional acts of these institutions, and lack of regulatory enforcement by both the Federal Reserve and other agencies such as the OTS and OCC.

As a direct consequence, those who lend money have literally taken their ball and gone home, either parking their funds in the Treasury market (irrespective of the yield being under the rate of price inflation) or sending their money outside the United States entirely.

The Fed's attempt to manage this crisis by injecting liquidity has only forced the dollar lower, which feeds a perverse cycle of price inflation in our economy. Oil is over $100 precisely because the dollar has been debased by 18% in the last two years. *But for this intentional debasement, oil would be under $80 right now. Instead, the dollar continues to decline, and all goods and services priced in other currencies continue to increase in price.*

The economic impact of these actions on American Families has been catastrophic. Food and energy price inflation has destroyed the purchasing power of those on fixed incomes and families just starting out, such as Senior Citizens and our legal immigrants. Real purchasing power of the American Family has declined for the last three years while, according to the Federal Reserve's latest documents for the 4th quarter of 2007, so has Americans' net worth.

That outcome is due to the lack of trust, which is the root of the problem – banks and others simply do not know who is bankrupt and who is not, *because nobody is able to get an honest look at these institutions' financial condition!*

I have been writing since last April in my Blog at http://market-ticker.denninger.net about this matter, and have continued to chronicle on a near-daily basis the insanity that is being allowed to continue in our financial markets. This beast was created through intentionally making unsound loans in the belief that the risk could be sold off and therefore quantity was the only metric that mattered, while quality was immaterial. This in turn drove up the price of houses to unsustainable levels. More than 100 years of history tells us that the maximum sustainable home price is approximated by a median home in a given area selling for approximately three times the median income in that same area.

Today, most markets have home prices that are well in excess of this figure with coastal areas frequently running in excess of five times incomes.

Proposals floated by various parties that attempt to prevent the correction of home prices to historical means will not work. Such price levels cannot be sustained, and it does not matter whether this is politically palatable or not.

This is a matter of mathematics, not politics.

Home prices must be allowed, and in fact encouraged, to contract until they reach economic equilibrium with household incomes. *Government must not interfere with this process!*

Today, on the 7th, we had printed the second consecutive negative jobs figure. *Since this statistic has been kept, two consecutive negative prints have, 100% of the time, indicated that a recession has begun within the last two to three months.*

We are in a recession, and it is incumbent upon our public officials to admit to our economic situation.

I, and those who have signed this letter, call upon you Mr. President, the members of the House and Senate Banking Committees, and the members of the Joint Economic Committee, to immediately act to address this issue before we find ourselves in a fully-developed deflationary credit collapse – that is, a re-run of either Japan's experience or worse, ours of the 1930s, *both of which were caused, at their root, by the same abuses and lack of government oversight and regulation.*

In short, if we are to avoid the worst potential outcomes, it is imperative that the following actions be announced immediately as public policy by our Government and implemented without delay:

- All securities and instruments traded and held for investment by regulated financial entities must have a CUSIP assigned and be traded on a public exchange or their value must be established by independent appraisal (in the case of a house or other real property.) All real property already has a tax appraisal available; properties carried by banks and other financial institutions must not be "marked" at values in excess of those appraisals, and appraisals must be updated whenever ownership changes hands, including via foreclosure actions. *We must stop 'mark to model' and 'mark to myth'; if you cannot obtain a bid for a thing, today, its value for today is zero!* These marks must be taken *nightly* for tradable instruments and no less often than annually for real property.
- Margin requirements must be enforced against all market participants. It is simply obscene that we have firms rated "AAA" who hold less than 1% of their exposure in actual capital. That is not "AAA" credit irrespective of what anyone tells you, and when the bond market is trading their debt at 70 cents on the dollar, the market is saying that this firm is rated "C" – or just above default – at best. In addition, the idea that a bank or hedge fund can write a credit default swap without having to prove capital adequacy for the duration and reserve commensurately is an outrage – these are forms of insurance and must be regulated as such.
- All off-balance sheet vehicles must be banned and existing ones immediately brought back onto the balance sheet of the firm involved and disclosed in full. **Enron** collapsed in no small part because these off-balance-sheet vehicles allowed them to hide their exposure until it was literally too late to do anything about it. *We cannot afford a repeat of the "Enron experience" on an even larger scale, one that threatens our banking system!*
- We must either get rid of the NRSRO label for ratings agencies, allowing free and open competition, or we must hold those certified agencies to their ratings. Hiding behind a free speech disclaimer while enjoying oligopoly protection is an outrage; either all are free to speak or there must be no protection. In addition, as BASEL sets reserve requirements for banks based solely upon ratings, the systemic risk of a "gamed" ratings system should be obvious. *That the current environment has been systemically gamed for years is now obvious for all to see. This must be cleaned up immediately.*
- All credit instruments must be subject to "Regulation FD" disclosure requirements. It is outrageous that bond rating agencies are given details on the mortgages and other instruments inside "CDOs" that are not available in the prospectus to buyers.
- Fraud must be aggressively prosecuted in all instances. There were many homeowners who lied on mortgage applications but there were also just as many financial institutions who literally made up data for their models when it was missing instead of rejecting the loans outright. The worst abuses were in the "stated income" or "liar" loans, but the problem is not limited to that area of the market. *The FBI must go after not only homeowners who lied but also the banks that deceived by omission or commission the purchasers of these securities, and those who continue to deceive with improperly booked capitalized interest earnings on homes which have declined in value below their mortgage balance.*
- Fannie and Freddie's capital adequacy must be investigated and stringently monitored. If either of these institutions were to collapse the results would be catastrophic. The Federal Government *cannot* bail them out as that would cause a rocket shot in treasury yields which in turn would greatly increase the cost of government borrowing – which we cannot afford given the national debt and current budget deficits. *Therefore, it is critical that OFHEO be extraordinarily diligent to insure that this does not happen, and that Fannie and Freddie ONLY buy fully-documented loans with no more than a 36% back end ratio and no more than an 80% LTV. This is a material tightening from current guidelines but it must be put in place immediately as it represents the benchmark of sound mortgage lending for more than 100 years.*

I recognize that these changes would cause some institutions to fail immediately. *Nonetheless, the consequence of not taking these actions will be far worse, and the probability of that outcome is extremely high.*

Mr. Thomas Hoenig, President of The Federal Reserve Bank of Kansas City, said during a speech on March 7th in Brazil (available at http://www.kc.frb.org/SpeechBio/HoenigPDF/HoenigBrazil3.7.08.pdf) the following:

> “I believe there may be merit in considering formal liquidity requirements, and perhaps loan-to-value ratios for banks and other financial institutions, especially the large institutions that provide liquidity and risk management products to other financial institutions and to financial markets. I also think that it is time that we extinguish some of the off-balance sheet fictions that have developed to excess in recent years.”
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> “In conclusion, let me stress again my belief that the response to this crisis should be fundamental reform, not Band-Aids and tourniquets. “
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> “I believe a central bank must have the legal authority to require this information from the supervisory agency on terms set by the central bank. A voluntary exchange of this important information is no more likely to be effective in a financial context than it was in the U.S. intelligence community prior to 9/11.”

This, of course, was not widely reported in our “mainstream media”, but Mr. Hoenig is correct on all points.

These actions need to be taken right here and now.

I call upon you to act today in order to prevent the economic catastrophe which looms over our nation due to the artifice and outright fraud of the last ten years.

I look forward to a public response from all recipients of this letter, addressing the points herein and announcing policy initiatives immediately. Our capital and credit markets cannot wait for the election or for long cycles of public hearing and comment. We must act now or our credit markets will remain seized as market participants cannot be forced to either lend or borrow.

Our nation is in grave economic danger and requires your immediate attention.

Sincerely,

Karl Denninger