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(Address suppressed)

From the Desk of Karl Denninger

September 21, 2008

The Honorable Senator «Last_Name»
«Address_Line_1»
«City» «State» «ZIP_Code»
By Fax: «Work_Phone»

The Honorable Senator «Last_Name»

I write to you this evening on a matter of the utmost importance – the meeting you had with Mr. Paulson and Bernanke regarding the health of our financial system.

I am absolutely certain you are being critically misled in terms of this crisis, and the actions being taken to allegedly "stabilize" it. Further, it is a fact that the record speaks for itself.

I am compelled to quote Einstein:

> "Insanity: Doing the same thing over and over again and expecting different results."

This came from a man who without question was more intelligent than any us.

We would be wise to heed his words.

First, last August, we had two hedge funds run by Bear Stearns that blew up. The solution to this was "more liquidity", injected by The Fed.

Next, Bear Stearns *itself* blew up. We once again saw not only more liquidity injected, but in addition, The Fed effectively purchased the bad assets of the company to the tune of $29 billion dollars and put it in their quasi-legal LLC "Maiden Lane".

Not to be outdone, Fannie and Freddie blew up. The "solution" to this was to once again buy up the bad assets, this time wholesale by placing the companies in conservatorship, and allocating $300 billion dollars of taxpayer money to "solve the problem."

Of course it didn't solve the problem, and we were then treated to both Lehman Brothers and AIG which blew up in a one-two staccato burst last weekend. While Lehman was "technically" allowed to explode, in truth there appears to be some "back door" liquidity out of the NY Fed that remains, as near as I can determine, unaccounted for. In the case of AIG, the "taking of bad assets" was explicit, in the form of an $80 billion credit facility (a significant part of which was immediately drawn down) along with the forcible issuance of warrants representing 79.9% ownership interest – again, the taking of ownership interest.

Now we have Hank Paulson and Ben Bernanke at your door once again, this time with a stunning $700 billion+ proposal to literally purchase all sorts of dicey assets from various financial institutions, along with a separate $50 billion guarantee for money market funds – yet more liquidity and effective asset purchases.

The important fact, Senator, is that none of these previous "fixes" in fact worked to fix a thing, and each successive "rescue" is getting more expensive, while each successive "flare up" of the crisis becomes more severe.

The **cause** of these problems has not been addressed, nor are you hearing plans to address it in the latest proposal. Let me briefly chronicle the various regulatory restraint ***removals*** and market manipulations of the last year, **all of which we, and you, were told would solve the problems in our financial system and return us to orderly markets:**

- Administrative removal of Rule 23A restrictions from certain "favored" banks (Spring 2007)
- The (Selectively Leaked) Shock and Awe Discount Rate Cut on Options Expiration (August 2007)
- The Bank Super SIV (October 2007)
- The Fed Term Auction Facility (December 2007)
- Bear Stearns/JP Morgan bailout and subsidy (March 2008)
- 325 basis points of rate cuts in less than six months and unprecedented additions of liquidity to defend them (Fall 2007 – Spring 2008)
- Primary Dealer Credit Facility (March 2008)
- Reverse MBS Swaps (April 2008)
- Fannie Mae/Freddie Mac nationalization (September 2008)
- Equity investment and collateral (September 2008)
- Administrative Repeal of 23A (September 2008)
- AIG nationalization (September 2008)
- Expansion of the Fed Balance Sheet through unprecedented Treasury refinance without appropriation by Congress (September 2008)
- Central bank dollar liquidity draws (September 2008)
- Ban on short-selling 799 financial stocks (September 2008)
- The Mother-of-all-Bailouts/Taxpayer-funded Super SIV Redux (pending)

You cannot fix a sucking chest wound with a band-aid, nor can you cure an alcoholic by giving him a bottle of whiskey. If you provide the drunk with some booze as soon as he sobers up his hand is out – demanding another bottle. Mr. Bernanke and Mr. Paulson have not only squandered the opportunity for meaningful reform they have **loosened** regulations on the banking system further as the crisis has deepened! Their response to the drunk's bleating hasn't been akin to a bottle of whiskey – it has instead been a couple of dozen **cases** of booze!

NOW you are being asked to trust the **entirety** of the taxpayer balance sheet to these same men **who have failed in every intervention in this crisis to date**, and they demand this right to once again saunter into the breach, this time without oversight, without recourse, and without limit upon their authority.

I would like to remind you that in the "white paper" I sent to all of your offices on July 22nd, I outlined the raw misunderstandings and "wrong calls" that Mr. Bernanke and Mr. Paulson have made to you and to the American Public in general.[i] In the interests of space, I will not repeat each of those falsehoods, whether by lack of understanding or intentional deception, on this page.

It is clear that "more of the same" will not solve the problem – and I believe, gentlemen, that we get only one more chance at this before there is a financial meltdown of epic proportions.

Should you undertake what Secretary Paulson and Chairman Bernanke have asked for, I firmly believe you will be responsible for precipitating the meltdown outright.

Let me be clear: if you enact this bill your legacy, written in history, will be that you caused the second Great Depression along with the institutionalized theft of at least $700 billion dollars from the taxpayers of this nation.

As I'm certain you are aware our government requires $2 billion a day in foreign purchase of Treasuries. The latest TIC data, released on September 16th, documents a precipitous decline in the purchase of those Treasuries by foreign interests, and an outright divestiture of agencies.[ii] This trend, if it continues or worse, accelerates, will force much higher borrowing costs upon the Treasury and effectively foreclose further Congressional, Treasury or Federal Reserve intervention.

The root cause of this dislocation in the economy has been three-fold:

1. The SEC, OTS, OCC and OFHEO permitted firms to "lever up" at close to unlimited degree. Fannie and Freddie were operating with an 80:1 leverage ratio on their entire book of business, while in 2004 The SEC removed the 12:1 leverage limit that formerly applied to broker/dealers.[iii] Five of the seven firms covered by these two examples have collapsed due to excessive leverage.

2. Permitting firms, including both investment and commercial banks, to hold assets in "Level 3" buckets where there is no disclosure of exactly what those assets are or how their declared values are determined. Many have called this "*mark to make-believe*"; I call it by its more common name - **fraud**. As a consequence it has become *impossible* to determine whether any particular financial institution is in fact solvent, and if so, what its true value is.

3. Unregulated, over-the-counter derivatives. There are scary numbers floated out there (in the hundreds of trillions of dollars or more) of "notional value" outstanding. The problem with these numbers is that they don't represent actual amount-at-risk, and in fact nobody seems to know what that figure actually is. The lack of a regulated exchange and central clearing means that there is no margin supervision of any sort; ergo, you have no way to know if your contract is in fact good (that is, the other guy has the money.) AIG, as an example, had $500 billion dollars of exposure outstanding in these contracts, and while this sounds somewhat reasonable when one considers they have a $1 trillion dollar balance sheet in fact it is not because most of AIG's balance sheet assets are committed to cover liabilities (e.g. insurance policies, annuities and the like.) The lack of margin and regulatory supervision is directly responsible for this. These derivatives have become nothing more than a fancy game of "pick pocket", where Broker "A" sells protection to Client "A" for $X, and then tries to find someone to buy that same protection from for "$X – something." While speculation in the marketplace is fine, speculation without being able to prove capital adequacy to back up your bets is not.

When you take these three things together you have a financial system where there is no confidence – not even overnight. This in turn leads people to be unwilling to lend, and **that** is the root of the problem.

All of the other ills – loose or non-existent lending standards, outright fraud in mortgage origination and extreme levels of excess liquidity in the system – flow from the above three sins.

You can throw all the money you want at this problem **but that won't solve a thing; there is in fact too much money in the system but nobody knows who they can trust, and thus it will not circulate normally.** Effectively, the only money circulating today is that provided by The Federal Reserve, as the lack of trust throughout the market has seized the credit system. In addition these "sneak attacks" on the markets, such as "surprise" rate cuts, "surprise" bans on short sales and other similar blatant market manipulations have resulted in people departing the market entirely, as they have no way to figure out what the rules will be tomorrow, and thus no ability to invest and trade based on their analysis of market conditions.

In order to actually solve the problem we must address all three points above.

What Ben Bernanke and Hank Paulson are recommending you do is pure folly and in fact dangerous. After **over a dozen** separate failed attempts to fix the problem by doing the "same thing", is it not time to declare the proponents of a **sixteenth** attempt insane and travel a different path?

You can address the root cause of the market's panic through the following actions, all of which can be taken today, and all of which, combined, will **restore confidence** and allow the market to clear and return to normal function:

1. Broker-dealer, insurance company and bank leverage ratios must be reduced to no more than 12:1. A change in the law to require this, with a 180 day requirement for compliance on a declining basis (e.g. from your current leverage ratio to no more than 12:1 within 180 days with "checkpoints" monthly) must be implemented immediately. In addition ongoing regulatory supervision must require that any institution that is within 10% of leverage limits must report monthly to their primary regulator, and that report must be published. This will eliminate excessive leverage in the system over the next six months and restore confidence that firms are not excessively geared.

2. "Level 3" must either be barred **or** all firms utilizing such a "bucket" for assets must disclose, to the individual CUSIP level (or equivalent) each instrument in that bucket and the full formulaic method, variables and assumptions that resulted in the derivation of its claimed value. This data must be included in each 10Q and 10K filing by these entities. This will immediately expose the "reasonableness" or lack thereof that pertains to these "marks" and remove the uncertainty – and lack of confidence – surrounding these valuations. An enormous part of the reason that short-sellers attacked Lehman and Merrill is that they simply did not believe the marks that had been taken were "real", and with Level 3 assets there was no way for anyone to independently evaluate that belief. A year ago I called for all "Level 3" assets to be barred entirely; we must still eliminate "Level 3", but doing it all at once, today, is not possible without literally detonating every large bank in America, as they have **all** taken advantage of this scheme to hide their losses. Therefore the appropriate action is to force disclosure of all marks, the securities to which they are applied, and the precise computational or observational means by which the mark was derived so market participants can form their own conclusions about the validity of that process on an individual level.

3. All OTC derivatives must be moved to an exchange or repudiated. The easiest way to do this is to mimic the OCC structure used for listed options. In the listed option world your "counterparty" is always the OCC that guarantees clearance of your trades. The OCC, being "on the hook" for the value of your position, is **very** interested in proper margin supervision with the person on the other side, and any brokers that are in the middle. ***Even during the 1987 panic option contracts did not "fail" for this reason.*** Provide through statute that ninety days hence all now-OTC derivatives must be cleared via such a central (but private) party. Any contract not so placed (by agreement of both parties) at the close of the ninety

days is declared worthless due to inability to prove capacity to pay, and therefore, failure of a primary element in any contract – ability to perform. This **conclusively** and **permanently** defuses the "derivative time bomb" and its attendant systemic risk.

Once these three steps are in place then and only then should Congress take up the issue of whether or not to create an RTC-like structure. I will note that such an enterprise must be undertaken with the greatest of care; the original estimated cost of the first RTC effort was $20 billion dollars, and yet the final total was somewhere between $140 and $160 billion, depending on who you ask, or anywhere from seven to eight times the claimed original price tag. Such a structure cannot be undertaken hastily nor is it as simple as it was with the RTC, where the assets in question belonged to already-failed institutions. Buying assets out of operating entities is fraught with extreme levels of risk, especially if competitive market prices are not used. This is especially true for complex securities where accurate valuations are nearly impossible to fix. As a consequence any such action must be taken fully "in the sunshine" of the public view and **not** at the exclusive discretion and direction of one man such as the Treasury Secretary.

There has been much hay made about "stabilizing" housing prices. Senator, a material part of the underlying issue in this matter is that house prices remain too high. The definition of affordability, since The Depression, has been a 20% down payment, 36% DTI or "back end" ratio, and a 30 year fixed mortgage. For all but the wealthiest of Americans this corresponds to a house price of approximately three times annual household income. In many areas of the nation, particularly California and Florida, median home prices today are still 30-40% above median income levels by this classic measure of affordability. We should be encouraging home prices to return to affordable levels, not taking actions that will simply force more Americans into foreclosure and bankruptcy, turning them into debt slaves. "Easy" credit has not only escalated prices of home, food and energy at a ridiculous rate but has also depressed wages, giving Americans little choice but to finance their lives with ever-increasing debt.

We cannot return lending to normal, nor can we return the banking system to normal **until house prices come down to historical norms and the bad debt in the system has been defaulted, with the losses taken by those who made the bad loans.** Taking it onto the taxpayer's balance sheet will **not** fix the problem as **it is the taxpayer who doesn't have the ability to make the payments**. This proposed bill is nothing more than an elaborate asset-stripping scheme for the benefit of a few favored bankers at the expense of other market participants **and** the taxpayer, and will in fact **make the economic and systemic problems worse** by further encumbering the Government's balance sheet.

I will make a bold prediction, and remind you that my prior efforts in this vein, and predictions, have proved accurate – **if you pass this bill you will see a market meltdown worse than last week's in its wake, and you will be (justly) blamed for it**.

Finally, to address the comment that was reported to have been made in your meeting by Henry Paulson about some "financial types" wanting the market to collapse, I assure you that while there may be some people who would take great joy in such an event, I am not one of them. As an American living here, not abroad, with my investments and capital deployed here in the United States, should the market collapse I will drown in the vomit along with everyone else.

While I am semi-retired and ran an Internet Company in the 1990s, I lack the wealth necessary to be able to "ride through" such an event without catastrophic losses, and am very concerned about the potential loss of social and political order that such a collapse is likely to bring. I am in addition a single parent of a 12 year old daughter and am concerned for her future. As I write this letter I am, for all intents and purposes, flat in the markets with essentially all of my investments in either cash or short-term Treasury-linked instruments. I do speculate on a regular basis in the capital markets, but have no particular bias in either direction at present; it is just as easy for me to profit from a rise in a given market as a fall. I am willing to "open my kimono" to you in order to prove this, including showing you, in real-time, the positions that I currently hold and my total financial base.

My interest here is singular – restoring order in the capital markets and thus to Main Street USA. Like all other Americans, I have suffered greatly from the insane gyrations on Wall Street and the incredible distortions that the game-playing has caused in commodities, especially food and energy.

Only through restoring trust can we actually solve the problem, and none of what Secretary Paulson and Chairman Bernanke propose will accomplish that.

What I have outlined above will solve the problem as it addresses the underlying cause instead of attempting to flood the market with money we do not have. Many commentators have stated that the financial system is having a "heart attack", and they are correct; the circulatory system is the credit markets, and money can be thought of as blood.

You can pump in all the blood you want, but if you do not convert the heart from ventricular fibrillation to a normal sinus rhythm, the patient still dies.

It is time for us to learn something from Einstein and choose a different path before our markets expire.

I can be reached at any time at XXX-XXX-XXXX and would appreciate discussing this matter with you at your earliest convenience. I am prepared to fly to Washington DC this coming week if required and testify under oath in front of the House, Senate, or both on these matters and elaborate on the material contained herein.

Our Nation's future is at stake – don't make a horrific error.

Sincerely,

Karl Denninger

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[i] http://www.denninger.net/letters/2008-07-19-Lawmakers.pdf
[ii] http://www.ustreas.gov/press/releases/hp1138.htm
[iii] http://www.nysun.com/business/ex-sec-official-blames-agency-for-blow-up/86130/