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From the Desk of Karl Denninger

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The Honorable Chris Dodd
United States Senate
448 Russell Building
Washington DC 20510
FAX: 202-224-1083

Dear Sir :

I am writing to you today after reading from IndyMac bank that you have had conversations with them, as well as other mortgage issuers, about "what Congress can do to help" with the liquidity freeze that is facing these issuers.

Mr. Dodd, may I respectfully suggest that the proper answer is: **NOTHING.**

Let me put forward the reasons for this:

1. Affordability of homes in the United States is at historic low levels. This ***cannot*** be corrected via any other method than ***housing price decreases.*** This is an unfortunate reality, ***but it is reality***. The housing boom and incredible price appreciation was fueled by loose lending standards, outright fraud, and underwriting that many would consider criminal in its willful blindness.

2. ***The Market*** is taking care of these problems. Bond purchasers are simply refusing to buy any more of the toxic waste that Wall Street and these issuers have foisted upon them, operating under the general structure of "Fool me once, shame on you, fool me twice, shame on **me**." This is an **appropriate** response.

3. ***The Market*** can only work when those who are "bad actors" are **punished** by the market for their foolhardy practices. **To leave the bondholders with "the bag" while not allowing the punishment to flow back uphill to the issuers is <u>VASTLY UNJUST</u>.   It will also fuel further irresponsible behavior.**

4. These banks and other institutions are **not** victims in this situation. **They are in fact part of the group of people who conspired to create this bubble and reap untold profits from it at the expense of the American Public!**

Instead, **if the Congress is to act** what it needs to do is to **bar** any agency paper from being written (e.g. Fannie, Freddie, VA or FHA) which does not conform to the following:

1. Maximum front end ratio of 32%, and back end ratio of 36%.

2. A maximum 80% CLTV, with no piggybacks permitted whatsoever, or a 90% CLTV with PMI paid for by the purchaser.

3. Only fully-amortizing loans of 30 years or less are permitted on agency paper.

4. Please ***do not*** consider raising the GSE conforming loan limit. This limit has already been raised inappropriately in the last few years and has advanced at several times the rate of inflation in the last two decades. Up until the 1990s, it was increased in a rational form; this, however, is no longer true. **Further enabling "bubble" pricing helps <u>nobody</u> and will simply lead to more financial failures by both homeowners and lenders!**

These are ***conservative*** underwriting guidelines that have held as **safe** for more than 100 years.

If lenders wish to lend ***off their own portfolios*** at higher DTI ratios, issue ARMs, and otherwise take more risk, ***that is fine***, but they must be subject to the same reserve capital requirements that any other bank or thrift might be if they are a depository institution, **and be exposed to the full risk of failure if they are not.**

If Wall Street is unwilling to buy this paper, there is a reason – **it is unsafe!** This has now been **proven** and the losses that will be ultimately taken throughout Wall Street will be **at least** $100 billion and quite possible three to four times that amount. ***It is absolutely essential that these losses <u>are</u> taken and that firms, including banks if necessary, <u>are</u> allowed to fail.*** Only through the risk of **business failure** is inappropriately-taken risk properly punished, and only through forensic evaluation after these failures do we find out if there were **criminal** acts (like fraud, for example) at the root of the problems which led to the failures.

I realize that there are one to two million American families who are at risk of losing their homes due to these practices over the last few years. However, the solution to that problem is **not** to bail out lenders **who created and profited from the problem!** That solution is found through the market, which will, absent government intervention, force a price correction in housing to take place and return affordability to historical norms, restoring the business balance. **If Congress stays out of it this adjustment will occur sooner rather than later, and the pain, while sharper, will end more quickly and equitably for everyone.**

The "Invisible Hand" of the market ***only works when people's bad decisions result in them being fully exposed to the financial penalties that accrue from these dangerous and inappropriate practices, including the issuing of debt securities that are claimed to be "AAA" credit when by any objective measurement they are no such thing.***

In short I implore you to **administer some "Tough Love"** and tell these issuers – sorry, **you must take responsibility** for what you have brought upon America. If this causes your businesses to fail, that is most unfortunate. In short what these insurers need to be told that the Government will take care of honoring the FDIC and FSLIC insurance commitments - but that's it.

Sincerely,

Karl Denninger