

From the Desk of Karl Denninger

August 6, 2007

Office of Federal Housing Enterprise Oversight (OFHEO)
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By Fax: 202-414-3823
Open Letter posted at <http://www.denninger.net/ofheo.pdf>
CC: The Honorable Chris Dodd, by Fax

Dear Sirs:

I am writing to you today after reading on Bloomberg that you have received entreaties from Fannie Mae (and potentially from Freddie Mac) about lifting the GSE's limits on home loan portfolio limits that are present in force on these two GSE organizations.

I respectfully ask that you **decline** this request.

The reasons for this are many-fold; I will outline only a few of the reasons that I believe this act would be both ill-advised *and potentially dangerous to the stability of the financial markets*.

1. Fannie and Freddie have been unable to timely file audited financial statements for quite some time. *It is therefore impossible for anyone to know their exact financial condition.*
2. Both Fannie and Freddie **have tens if not hundreds of billions** of subprime exposure **already on their books**. **NONE** of this has been marked to the market via the ABX or any other transparent pricing mechanism. *As such you must assume that their balance sheets are severely impaired, but the exact degree of that impairment at this point is impossible to determine.*
3. **This entire problem in the housing and mortgage space arose due to the enabling of "animal spirits" in the securities markets; that is, making loans to people who were unlikely to be able to pay them back, relaxing front and back end ratios to proven unsafe levels, and outright fraud via permitting "stated" income and asset loans to be made to virtually anyone.**
4. This has led to an incredible speculative "bubble" in the US Housing Marketplace where the average home now sells for close to **five times** average income. **In many locales, especially in California and Florida, fewer than 10% of wage-earners can afford a home under traditional underwriting guidelines including a 20% down payment, 30 year fixed mortgage, 28-32% front end ratio and no more than a 36% back end ratio. Yet these ratios have been proven as the maximum safe limits for more than ONE HUNDRED YEARS.**
5. In order to entice people to continue "the bubble" mortgage brokers and lenders **have encouraged borrowers to "state" income which is radically in excess of their actual income. A recent HUD study showed that of "stated" loans most had fraudulently overstated levels of income claimed and of those the majority were inflated by more than** .

50%. Clearly, this will lead to a loan where the consumer **does not have a prayer of being able to make the payments.**

6. These loans were all made predicated on the idea that “Real Estate never goes down in price.” Therefore, **when** (not if!) the “homeowner” got in trouble they would be forced to come back and refinance. **This effectively reduces a homeowner to a RENTER, where the bank is the landlord, as they will NEVER be able to fully pay off the mortgage! This is a purely predatory act in that the alleged “homeowner” is actually forced by origination of the first mortgage to either refinance or sell their home at reset time! In a flat or down housing market, these consumers are doomed; mortgage issuers know this.**
7. The issuers are now asking for a bailout because the market is punishing them because the Ponzi scheme – of their own design - of “yet a bigger sucker” has now run out of “new suckers”! **You are being asked to bail out organizations who placed people into mortgages they knew they could not afford without a sale or refinance after rates reset!**

There is only **one** way in which this imbalance can be corrected, and that is to **withdraw** market support for these unsafe loans.

This **is already happening** in the marketplace, as investors have discovered that **the bonds they have been sold as allegedly “AAA” credit really are not – they are at best junk corporate debt!**

If OFHEO allows Freddie and Fannie to step in you will be **ENDORISING UNSAFE LENDING** as well as **offloading these unsafe securities onto Fannie and Freddie, who have been given a “special status” by our Government!**

This is a radically improper request **AND IT MUST BE DENIED.**

With **artificial** support for these unsafe loans removed, the market will take care of the problem on its own, as it has begun to already. House prices will correct back to historical norms over the coming months and years.

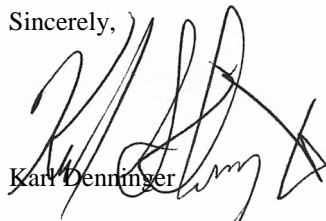
Affordability will return for the American Taxpayer and Consumer.

While there will be both consumers and firms who will undergo pain if you do not act as Fannie and others have requested **if you do act even more people will be hurt, and the damage will be far more profound.**

Simply put, there is no way to avoid the housing bubble “deflating”. ***It will happen with or without your intervention.*** However, if the housing market today is a bonfire, **you would be perpetrating a grave injustice to throw thousands of gallons of diesel fuel – more liquidity – into this toxic morass of irresponsible lending.**

I urge OFHEO to **“Just Say No”** and do the right thing – keep the caps on Freddie and Fannie, and allow the market to sort out what is, and is not, safe mortgage lending. In addition I urge you to step up efforts to force both Fannie and Freddie to file timely audited financials and mark to market **all** of the loans they currently hold (in any form).

Sincerely,



Karl Denninger