Citizens For Financial Responsibility

There is rampant, outright fraud in our financial system. Through a number of schemes various institutions are sacrificing the markets' integrity and financial strength while undermining the credibility of The United States as the world's leading economy.

We the undersigned call upon you to address the following issues:

1. **Congress must prevent lending against unverified ("stated") income or assets, prohibit "Option" (negative amortization) mortgages, ban prepayment penalties and require conservative, proven mortgage practices be followed, including but not limited to the requirement that borrowers be qualified at the highest rate a mortgage can reset to over the life of the loan and the "back end" ratio (DTI) on all mortgages not exceed 36%. An important first step is to hold The Federal Reserve and all lenders accountable under the existing 1994 Homeownership Equity Protection Act and greatly improve consumer disclosures.** In recent years mortgage lending has become increasingly aggressive and predatory. A front-page Wall Street Journal article on October 11th documents that *fully one quarter of all mortgages made in the last three years were at "high interest rates" – in other words, subprime – and most combined multiple risky features, such as qualifying on a teaser rate and negative amortization.* This predatory practice was largely responsible for the severity of the housing bubble and, now that it has burst, is responsible for the economic pain that middle class Americans are experiencing. By causing house prices to increase at an unsustainable rate lenders have stripped trillions of dollars of real wealth from Americans for their own profit, leaving our citizens with a sea of debt, foreclosures and ruined credit. Even today banks are advertising toxic "debt bomb" Option ARM mortgage products on national cable networks. Existing laws already ban most of these risky practices – they have not been and to this day are not being enforced.

2. **Congress must amend the appropriate sections of US Code and Regulations so that all mortgage deficiency judgements can be discharged in personal bankruptcy, that all "short sale" differentials are exempt from taxation as "income", and that all GSE-backed mortgage loans are "non-recourse" loans.** Homeowners are the only ones who can be somewhat protected from what is to come, and this change will do so by allowing them to discharge mortgage debt and not be penalized for "short sales" that are undertaken to escape from "debt bomb" predatory mortgages. By making all GSE-backed loans "non-recourse" and barring short sales from being treated as "capital gains" originators will be further encouraged to apply conservative lending practices.

3. **Congress MUST NOT bail out – under any circumstances – mortgage companies and investors who voluntarily entered into risky mortgage and derivative contracts during these last several years due to lax lending standards, poor due diligence or as a matter of business policy.** *Failure must be allowed irrespective of the damage done to these firms, because only financial failure serves as an effective check and balance against excessively risky behavior and greed.* The practice of intentionally making problems "really big" in the smug knowledge that you can take ill-gotten profits and lay off the risk on society has led to a series of economic disasters that have been "charged off" on the American Taxpayer, going back to the S&L Crisis.

4. **Congress must act to ban all off-balance-sheet "conduits", SIVs and similar schemes, and require that any and all liabilities be properly and completely reported both to regulators and shareholders.** These vehicles create an intentionally-false view of firms' financial condition. In effect, these vehicles serve to fraudulently manipulate a bank's balance sheet by hiding debt. These are the same accounting tricks that were instrumental in Enron's bankruptcy. *Now, on the front page of the Wall Street Journal (October 13th) we learn that Secretary Paulson is actively involved in attempting to expand this deception!*

5. **Congress must exert its Constitutional authority to regulate the banking system and demand that the Federal Reserve immediately revoke six recently issued "23A Exemption Letters."** The Federal Reserve, in addition to "looking the other way" with the "SIVs" and "Conduits" referenced above, recently granted six large banks an exemption from one of the last pieces of Depression-Era banking regulation – "Regulation W" – which prohibits more than 10% of a bank's regulatory capital being allocated to a single affiliate. These "23A Exemption Letters", in tripling the allowed exposure, circumvented the "safety systems" intended to prevent another banking crisis caused by these irresponsible practices.

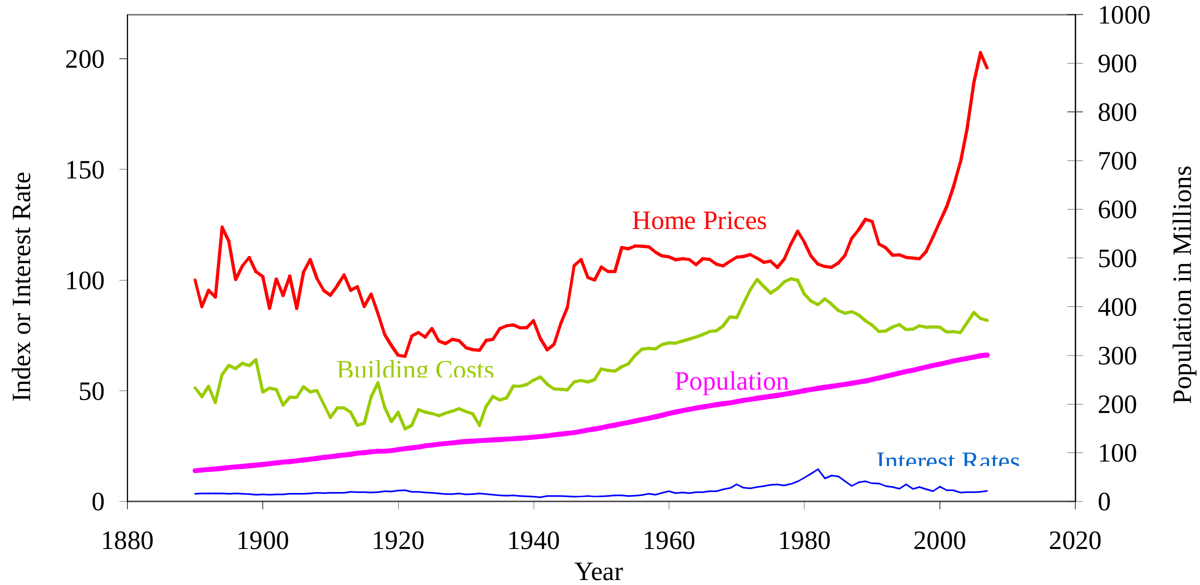
6. **Congress must exert its Constitutional authority to regulate our currency and demand that the Federal Reserve immediately reverse the recent rate cuts.** The Federal Reserve recently lowered the Federal Funds Target as well as the Discount Rate. Those who are on fixed incomes such as *Social Security* are told that they have "2% inflation" in their indexed checks, *yet their food, energy and health care costs are all rising at more than ten percent a year due to inappropriately-low interest rates.* This intentional "pushing off" of lower standards of living to people who are unable to defend against it – retirees on fixed incomes – is unconscionable. The bond market, discerning that The Fed abdicated its responsibility to control inflation, reacted by **increasing real interest rates on mortgages and other "long-term" money, the exact opposite of what consumers expected.** It is imperative that the Federal Reserve's lawful mission – monetary policy that fosters "pursuit of full employment and stable prices" – be actually adhered to.

7. **Congress must act to aggressively prosecute both those who "leak" inside information and those who trade on it. If the SEC and U.S. Attorney's offices will not start investigating these violations of the law, Congress should call for a Special Prosecutor. If we expect Americans (and the rest of the world) to trust our financial markets the defense of their integrity needs to be taken far more seriously than it has been.** One particularly outrageous example is the apparent "front-running" of the Federal Funds discount rate announcement on August 17th 2007. There is a clear and apparent pattern of trades leading up to the time of the announcement which strongly suggests that some insiders were "tipped" that an unscheduled Federal Reserve action was about to be taken. In addition, the response to a recent FOIA request appears to further suggest that the Federal Reserve did in fact have multiple conversations with market participants who likely placed trades prior to the official announcement and profited thereby.

Addressing these issues as suggested will not solve all of our impending economic problems, but they will provide a level of safety, transparency and sanity that has been sorely lacking in our economy over the last several years.

(A comprehensive explanation of details behind this petition can be found at http://financialpetition.org/petition.pdf).

The American Nightmare – **Not** "The American Dream"



(Chart above used with permission from Robert Schiller, Professor, Yale University)

The above chart shows quite clearly the result of the Mortgage and Banking Industry's action over the last seven years – and why this is likely to become the worst "credit crunch" in history.

Predatory lending and "securitization" of mortgages have pushed the price of homes to levels that are clearly unaffordable – and unsustainable. This "cheap credit" has now been shown to be a Chimera as these loans clearly cannot be repaid, and the above chart shows how far home prices are likely to fall – a return to the top of the historical range will require a **forty percent** average home price decline nationally.

The markets will surely act on their own accord to correct the present pricing imbalances, and in fact they already are. As this continues to its inevitable conclusion the resulting outcry will dwarf the current pleas and calls for action.

It is time for Congress to act as put forward in this petition to protect homeowners as well as force those who engaged in this speculative and risky behavior to suffer the justifiable losses associated with their predatory lending and fraudulent "ratings."

Mortgage Practices – Disclosure is Key, Reform is Needed!

Many “mortgages” written in the last seven years are nothing of the kind – they do not lead down a path that ends with “fee simple” clear-deed home ownership. In fact, they have been designed to do the exact opposite, trap people into what amount to long-term leases through forced serial refinancing.

When home prices were rising 5, 6, 7 or more percent a year this was a “no lose” proposition for the lenders, because if you could not refinance for some reason they just took the house – and since it was worth more than the mortgage, they suffered no loss. You, on the other hand, as a consumer, were wiped out.

Now, with prices driven to a speculative peak and affordability at unsustainably-low levels, prices are coming down – and suddenly those lenders who thought that only “you” (the consumer) were at risk are finding out that they too bear the risk when a default occurs.

To prevent this from happening in the future Congress must not only prevent all of the “features” in Petition item #1 from occurring again, but must also mandate far better disclosure.

Specifically, lenders must be required to produce their “Truth In Lending” statement *in advance of the consumers commitment to bind the loan so it can be used as a shopping tool.*

The practice of presenting this document *only at the closing table* must be barred.

In addition this document must set forth both the “base” APR *and also the “fully-blended” effective annual percentage rate, or “EPR” – the total interest rate charged against the principal amount loaned, and separately break out all fees and costs.* The inclusion of closing costs, “YSP” and points must not be stated as additional “dollars” added to the principal, *and also as an adjustment to the APR so that true comparisons can be made.*

This is the only means by which true “apples to apples” comparisons can be made. A consumer must be able to take this document from one lender and compare it to another, and see immediately not only the difference in payments but also the “effective” annual percentage rate – the true cost of the money – with all fees, costs, and “addons” included.

Current disclosures are woefully inadequate in this regard as they typically are given only at the closing table – when the borrower is in no position to shop for an alternative – and in addition typically “hide” the additional cost by rolling it into the principal amount, making it impossible to perform true “apples to apples” comparisons.

Specific Banned Mortgage Practices

On "stated income": It is simply never necessary – unless you're a drug dealer! The usual argument is that "stated income" loans are necessary for the self-employed. This is simply not true. If you can produce a tax return for your small business, you can document your income. 1099 income is still documented. So is sole proprietorship income.

Where do these people run into trouble? When they're cheating the IRS – or doing something else that is illegal. But let's be straight here with everyone – if you're doing something illegal you are a poor mortgage risk anyway, as it's very difficult to make mortgage payments from prison.

Discharge of mortgage deficiencies in bankruptcy: No, you do not get to keep your house, as some might assume. You still have the "penalty" of the bankruptcy – ruined credit, the house still gets foreclosed upon, you are still evicted and wind up renting.

So why include this?

Because with bankruptcy reform a huge number of Americans can no longer discharge their debts in a Bankruptcy – they are forced into Chapter 13, not Chapter 7. Chapter 13 forces repayment of debt, which means that even though you go "bust" the debt doesn't go away!

Point #2 in the petition serves to redress this problem – but only for mortgage debt. So if you are forced into Chapter 13 under the "new and improved" bankruptcy code, you now can discharge your mortgage – but not your other debts – during the bankruptcy process.

This is in no way a "bail out" of the borrower – it simply restores the treatment that **everyone** used to get on a mortgage before the bankruptcy law changes.

Negative Amortization: You'll never own your house if you can't pay it off. The ruse that you are "buying" something that has a never-ending cycle of refinances is simply fraud. By banning negative amortization the "toxic exploding debt bomb" cycle is prevented before it starts.

Prepayment Penalties: One of the major problems facing homeowners now are penalty clauses that are frequently 2% or more of the principal value of the mortgage, and in force for 2 or 3 years. These clauses force you to come up with $20,000, 30,000, 40,000 or more simply to refinance your loan. When faced with a reset or recast, one of the means of escape is thus cut off.

Back End (DTI) Ratios: There is a more-than-100 year history showing that 36% Debt-To-Income is the maximum "safe" total debt to total gross income ratio. Remember, after you make your house payment and other debt service you still must cover taxes, food, heat, electrical and other ordinary living expenses out of your monthly cash flow, and you need an "emergency fund" in the event that your roof needs repair, your car drops its transmission or you lose your job. The practice of qualifying people at 40%, 50% or even higher means that even the smallest disruption in your ordinary cash flow patterns places you at immediate risk of foreclosure.

SIVs, Conduits, and Why You Should Care

This is an attempt to explain how SIVs work, in simplified terms – and why these "vehicles" are a blatantly fraudulent accounting trick when carried "off balance sheet" that must be banned.

Let's say that you have a son who just got married. He and his lovely wife want to buy a house, but their credit stinks. Yours, on the other hand, is excellent. They want you to cosign the mortgage but that would cause the mortgage to show up on your credit report.

So you figure you'll work around this problem. How? You set up a "SIV".

We will posit that you have a dog named "Mutt". Mutt's a friendly dog. He gets named as the sole shareholder of your SIV called "MI" (for "Mutt Inc.")

Then you write the mortgage on your son's house yourself, and now have a $300,000 hole in your bank balance. To replenish it you "sell" the debt to this "SIV". MI "pays" you with a few licks on the face. That SIV then goes out and borrows money at a cheaper rate of interest in order to fund the $300,000 it owes you, and gives you your money back. How? You promise that you'll "backstop" the SIV – that is, if there is a loss, you will cover it. Thus the "SIV" has **your** credit profile, even though the "asset" in it – this mortgage debt - in fact is very high risk. In return for the "backstop" you are entitled to half the interest rate spread.

With that great credit profile the SIV is able to sell "commercial paper" – almost completely-unregulated short-term debt – to a Money Market fund. The fund has money from its depositors and lends it out for a very short period of time (usually 30-90 days) and gets an interest payment in return. Normally, this debt is "rolled over" every 30-90 days, but the Money Market reserves the right not to do so on any of these boundaries.

So your son has a mortgage that he pays 9% interest on, and you have a "SIV" that borrows the money at 7%. The Money Market fund pays its depositors 5% but made 7%. They make 2% a year and so do you. There's no real money in the SIV – your son makes a mortgage payment, you make an interest payment. The SIV has almost zero cash balance in it at any time but it is a **very profitable** deal for you and a good deal for him, because his best "regular" mortgage with trashed credit would cost him 11%. He gets a lower rate and your effective return on investment is nearly infinite (you've got your $300,000 back, so the interest "spread" is free money!)

By shoving off that $300,000 you have effectively made that debt **disappear.** What's better, you have turned a liability into an asset and one that pays you something too! That the SIV exists is disclosed but exactly what sort of liability it may be to you doesn't have to be under current accounting rules.

Now if you were go to get a mortgage for your house with this sort of game being played you'd probably go to jail for mortgage fraud. The reason is obvious - what happens if your son doesn't make the payments? The people who you borrowed that $300,000 from are going to want it back, aren't they? Suddenly that debt will "boomerang" back onto your personal balance sheet with disastrous results. When you fill out your mortgage paperwork you must disclose all your liabilities and assets, and the bank would count that SIV as a "liability."

If you're a public company, however, you don't have to disclose the form and amount of that liability in **your** SIVs – just that they exist. So for the shareholders of a bank, there is no way for them to know what kind of risk is out there in terms of these "conduits" and "SIVs".

The truly cute part of this is that there is really no limit to how far one can go with this sort of "disappearing act" when it comes to debt – until something goes wrong.

Let's say you did this and then a few months later your son's best friend gets married and also would like to buy a house. You do it again, and now there's $600,000 worth of "mortgages" in the SIV, your income from this scheme has doubled, but absolutely none of the $600,000 has come out of your pocket and what's better, there's still no listing on your credit report that you have this $600,000 worth of risk.

Pretty soon your son and his best friend start telling their friends about this great deal. You get approached again and again by people who want to buy houses but have crappy credit. You keep doing this time after time after time, funding them one at a time. So long as you can convince the people you're borrowing the money from (typically a money market fund) that your credit is good (in which you are helped by ratings agencies who tell you exactly what they need to see to rate your SIV "AAA" credit) you can keep on with this charade indefinitely – **IF** your Son and his friends keep paying their mortgages……

When does it stop? Well, if your son stops paying, you've got a problem. The SIV owes that $300,000 to the money market that lent it out, and suddenly there's no interest payment coming in to funnel on to the Money Market.

What's worse is that the Money Market fund might smell trouble before there are actual missed payments and simply refuse to roll over their short-term loan. That's really bad, because now they want their $300,000 back! Unfortunately the SIV only has a few thousand dollars in it – the accrued interest "spread" – and you are called on to "liquefy" the SIV – in other words, your "liquidity backstop" that you promised turns into reality. Now you need to pony up $300,000!

Banks are required to maintain a certain level of reserves – as an example, for every $1 in deposits a bank is allowed to loan out $8-10. This is called "Fractional reserve banking" and the required reserves are known as "Tier Capital." **Banks that violate Tier Capital requirements are subject to seizure by the FDIC and/or Federal Reserve.**

But by using "SIVs" and "conduits" the banks are intentionally hiding some of their liabilities – their debts – as money that is outstanding as loans! A big part of why these SIVs exist is for the purpose of **explicitly** evading regulatory and shareholder reporting requirements, and so far, it has worked quite well for them.

This game has allowed the banks engaged in it to skirt banking regulations and severely damage the safety of the banking system. If those "SIVs" default on their payments, or if the Money Market funds simply refuse to roll over their commercial paper then the full liability will "boomerang" back on to the bank's balance sheet and may render it insolvent.

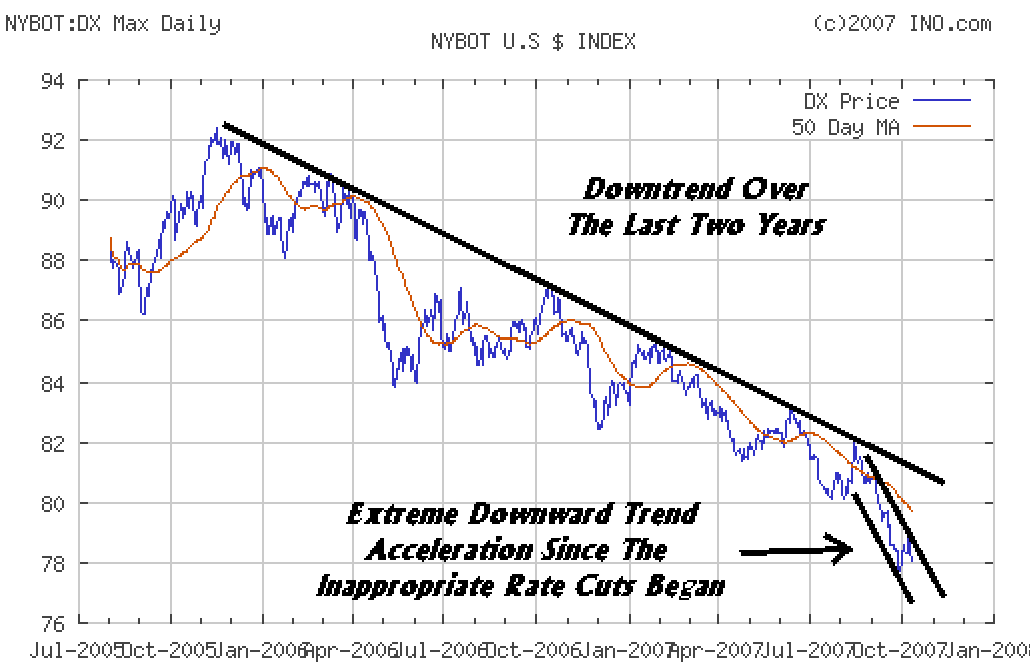
This practice of "off balance sheet" SIVs and conduits must be banned because it presents a false picture of a firm's financial condition and makes enforcement of bank reserve requirements impossible!

The US Dollar Index – <u>REAL PURCHASING POWER</u>

The Dollar has declined from 92 to 78 **in less than two years -** a 15% depreciation in value. **This is a real devaluation of buying power in American households by that same fifteen percent.**

Note the chart below and the precipitous downward acceleration since the Rate Cuts in August and September – a dangerously-accelerating trend.

The lower the dollar goes, the more the cost of oil, food, education and health care rises – all costs which comprise a large portion of Middle Class citizens' essential – not discretionary – purchases.



While policy makers can watch prices creep upward and claim "inflation expectations are well-anchored", the American Consumer must eat, buy his gasoline and pay his medical bills today with rapidly-shrinking actual purchasing power. The consumer bears the brunt of The Federal Reserve's mismanagement in our monetary policy right here and now. Inflation at the producer level can be, and usually is, passed on – exactly like a tax – but consumers wind up with the bill, and nobody to pass it to.

Will the dollar be at 40 in the next couple of years – perhaps before Congress stands for re-election next November? If it does, then American's purchasing power will be cut in half from today's already ridiculously-damaged levels. Gasoline will sell for more than $5/gallon, corn and wheat will double in price again, and the average American will be demanding Congressional recalls.

Congress can and must act now to protect the American Dollar.

Banking Safety And Regulations – A Bad Joke

Between the "SIV" issue and the "23A" letters – of which **two more were granted in the last few days –** our alleged "banking regulatory environment" is a complete joke.

Regulation "W", which exists **specifically to prevent a potential bank collapse due to bad bets**, is being subverted intentionally and with reckless disregard for the risk to our economic safety.

Over the last few months we have seen **SEVEN** of these exemptions granted to Wachovia, Citigroup, Bank of America, JP Morgan Chase, and just recently Deutsche Bank, Barclays and RBS!

(You can see these letters at http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2007/ and the base "Regulation W" text at http://www.bankersonline.com/regs/223/223.html)

Why is this important? Because these regulations were put in place to ***specifically*** force potentially-insolvent affiliates to go out of business if necessary, rather than risk their sponsor – a regulated and "covered" (by FDIC insurance) federally-chartered bank – becoming insolvent as the result of a default event.

By waiving these regulations – and the list of waivers continues to expand almost by the day – The Fed has removed one of the most important safety measures in our banking system. In addition these waivers do not solve the underlying problem, which is that the "securities" that are being funded via this method are in fact either worthless or nearly so.

So instead of causing these banks to do what the regulations intend – force these affiliates to either de-leverage or, in the extreme case, go out of business entirely – The Fed is instead attempting to prop up these entities **while at the same time putting the entire banking system at risk.**

Without a consistent and functional set of banking regulations that are applied evenly **there is no regulation at all!** The "credit crunch" arose precisely **because** these banks "gamed the system" of regulation by creating affiliates and "off balance sheet" vehicles to park risky securities in – a practice that **ENRON** engaged in as well, and which was partially responsible for its failure.

That we now have no fewer than **SEVEN** major money-center banks engaged in this same sort of manipulation of accounting standards and banking regulations – and that The Fed is granting these exemptions as fast as a gumball machine spits out chewy things - is an outrage. Not only does this render investors incapable of judging a proper value for these firms' shares, it makes a mockery of the entire concept of "fractional reserve banking" and the limits allegedly imposed on institutions practicing it.