Thoughts on the Financial Crisis:
Fannie Mae, Freddie Mac, Bad Loans, & the Bailout
(Last modified 17 Oct 2008)

SUMMARY: There are various underlying causes of the present financial crisis, ranging from Government regulation/deregulation to the appetite of the American public for debt, both individually and nationally. Essentially, ever since the Kennedy administration, we have been living beyond our means, which gives us less of a safety cushion when things go wrong--and Murphy's Law is "Whatever can go wrong, will go wrong." This document does not deal with these underlying causes, but focuses on the two underlying policies that triggered the present financial crisis: 1) the loose monetary policies of the Federal Reserve since 1996 and 2) the "trigger" of the present crisis, what is called the "subprime" mortgage collapse. This document is VERY much oversimplified, but will give you an idea of what is going on in the financial markets today.

THE UNDERLYING POLICIES

FIRST PROBLEM--LOOSE MONETARY POLICY: The Federal Reserve was basically created to safeguard the solvency of the nation's banking system. It does this in various ways, primarily as acting as a lender of first and/or last resort to other banks and governments, and by creating "Federal Reserve Notes," which are the "dollar bills" we have in our wallets, as well as our bank accounts, etc. If the Fed creates "dollars" faster than the economy expands, then the country suffers from the effects of inflation. For example, pretend that the national economy consists entirely of 1000 apples, and there are 1000 dollars in circulation; then each apple will be "worth" one dollar. Now pretend that the Fed creates an additional 1000 dollars; you now have 2000 dollars chasing 1000 apples, with the result that each apple can now be sold for two dollars. In effect, the price of each apple has doubled; this is "inflation" of prices caused by the expansion of the money supply. "Deflation" is the opposite, when less dollars are needed to pruchase the same goods. The best recent example of deflation is the high tech toys we buy--a $500 computer today is thousands of times as capable as a $10,000,000 computer 50 years ago.

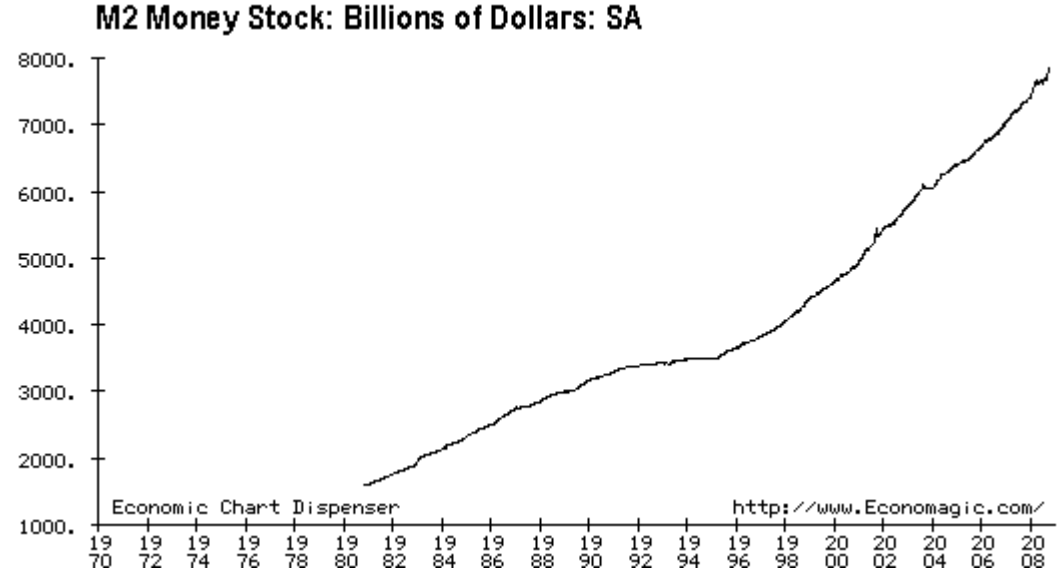
Because (in principle) money is anything that can be used in settlement of a debt, there are varying measures of money supply. Since most modern economic systems are regulated by governments through monetary policy, the supply of money is broken down into types of money based on how much of an effect monetary policy can have on that type of money, with M0 being the narrowest definition and M3 being the broadest definition. M0 is physical currency, i.e., cash held within a central bank and the amount of physical currency circulating in the economy. M1 is physical currency circulating in the economy + demand deposits (i.e. checking account deposits), which essentially measures the amount of money in circulation. M2 equals M1 + time deposits, savings deposits, and non-institutional money-market funds. M3 is M2 + large time deposits, institutional money-market funds, short-term repurchase agreements, and the like. This is the broadest measure of money commonly used and is used by economists to estimate the entire supply of money within an economy. It is interesting to note that the Fed quit reporting M3 in 2006.

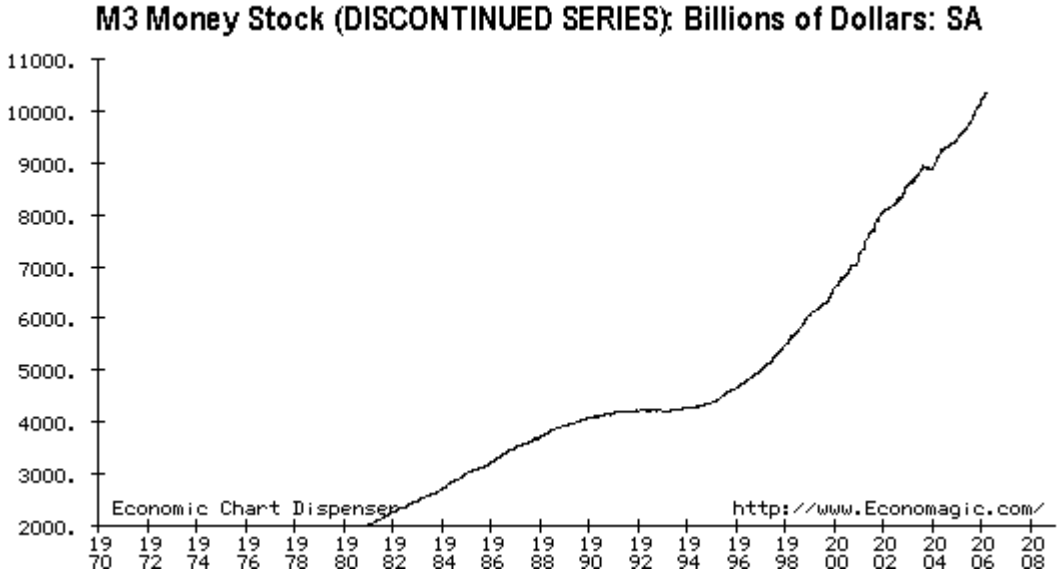
Generally, the Fed has increased the money supply (thus reducing interest rates, but potentially increasing inflation) when the economy is slow, and decreased the money supply (thus reducing the inflation rate and raising interest rates) when the economy is surging.

After the Jimmy Carter era, when inflation and interest rates had peaked over 20%, Federal Reserve Chairman Paul Volker generally pursued a tight money policy, reducing the growth in the money supply in an attempt to stop inflation. That policy was successful, with the result that there was approximately zero growth in the money supply and only 3% inflation by 1990. However, with the recession of 1990-1991, the Fed began to again lower interest rates and increase the money supply. From then on, particularly after 1995, through both the Greenspan and Bernanke chairmanships, we have had a relatively loose monetary policy. The inflation caused by this loose monetary policy showed up in two areas of the economy, in the stock market in the 1990s (remember the dot.com bubble?) and the residential real estate market in

the 2000s.[1] This expansion of the money supply was the major underlying cause of the present financial crisis.

Look at the following two graphs, M2 and M3, and notice the tremendous expansion of the money supply beginning in 1996:





[1] Again, let me emphasize that this is very oversimplified.

SECOND PROBLEM--LIBERAL LOAN POLICIES: the other underlying policy that caused the present financial crisis is the bad loans resulting from the real estate loan underwriting policies of Fannie Mae, Freddie Mac, and the banking sustem; and the use of "derivatives," specifically marketable securities based on these poor loans, in the financial markets.

BACKGROUND HISTORY:

Congress created the Federal National Mortgage Association (**Fannie Mae**) during the Great Depression of the 1930s to secure home mortgages by providing a secure (i.e., government backed) market for such mortgages.

From 1938 to 1968, the secondary mortgage market in the United States was monopolized by Fannie Mae, which was a government agency during that period. In 1968, to remove the activity of Fannie Mae from the annual balance sheet of the federal budget, it was converted into a private corporation. Fannie Mae thus ceased to be the guarantor of government-issued mortgages, and that responsibility was transferred to the new Government National Mortgage Association (Ginnie Mae); Fannie Mae did, however, continue to provide a secondary market for mortgages. "Secondary market" means that Fannie Mae does not originate loans itself, but buys packages of loans from the banks that originate the loans. The theoretical result is that 1) the banks do not have their money tied up for 30 years, and can use the money to make further loans; 2) Fannie Mae has a steady income stream for 30 years, which it can pass on to its stockholders; and 3) the interest payments on the loans essentially get paid out as dividends to Fannie Mae's shareholders, thus providing them with a steady income stream.

In 1970, Congress created the Federal Home Loan Mortgage Corporation (**Freddie Mac**) as a private corporation to provide competition in the secondary mortgage market. The goal for both entities was to create a secondary market for residential conventional mortgages. Both entities are known as "GSEs," or "Government Sponsored Entities."

Up to 1989, Freddie Mac was owned by the Federal Home Loan Bank System and its member thrifts, and governed by

the Federal Home Loan Bank Board, which was later reorganized into the Office of Thrift Supervision. In the Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA") of 1989, Congress revised the regulatory mechanisms for both Fannie Mae and Freddie Mac. FIRREA severed Freddie Mac's ties to the Federal Home Loan Bank System, created an 18-member board of directors to run Freddie Mac (and populated the board with well-connected political cronies--ditto for Fannie Mae), and subjected both entities HUD guidelines for loans.

As of 2008, Fannie Mae and Freddie Mac owned or guaranteed about half of the U.S.'s $12 trillion mortgage market. As a result, the corporations were particularly affected by the housing market downturn and credit crunch that began in 2007. On September 7, 2008, James Lockhart, director of the Office of Federal Housing Enterprise Overshigh (OFHEO), announced that Fannie Mae and Freddie Mac were being placed into conservatorship of the FHFA. This action is one of the most sweeping government interventions in private financial markets since the Great Depression. It was also the first step of what is becoming a "Bailout" of the entire planet's financial system.

As noted above, Fannie Mae and Freddie Mac own or guarantee almost half of all home loans in the United States; thus, they face billions of dollars in potential losses due to the rising rate of defaults (primarily on subprime adjustable rate mortgage loans), and will need to raise additional substantial amounts of new capital as the current downturn in the U.S. housing market continues.

Markets assume that the taxpayer will, if necessary, take on the burden of all Fannie/Freddie mortgages because they are GSEs that underpin the whole U.S. mortgage market. If they were to collapse, mortgages would be harder to obtain and much more expensive. U.S. Treasury Secretary Henry Paulson has said the government's primary focus is in supporting Fannie Mae and Freddie Mac in their current form and protecting the shareholders; however, this may be just political hot air--we shall see what happens as the details of the bailout emerge.

THE SUBPRIME PROBLEM:

The Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA") of 1989 and subsequent similar legislation were politically motivated economic disasters. During the 1970s and 1980s, the liberals in academia, Congress, and "community organization" (does ACORN ring a bell?) made a great deal of fuss over what they called the practice of "redlining." Redlining was, in their view, the practice of deliberately excluding minorities and the poor from home loans by taking a red pencil, drawing a boundary line on a map, and refusing to lend inside that boundary. In actuality, the banks were refusing to loan to people who had no jobs, poor credit, failure to repay loans, etc.--the effect was to loan at lower rates to minorities and the poor, but the reasons for not loaning were valid reasons. By the way, one of the things that Barack Obama did as an associate at his "public service law firm" was sue banks that refused to grant this type of subprime loans. The Clinton administration and Congressional push in the early 1990s for more home ownership impacted the mortgage industry by pushing bankers to relax standards on loans (thus, the name "subprime" loans), since Fannie Mae and Freddie Mac would either guarantee or buy these subprime loans. Result: bankers placing subprime loans win because these loans have a higher interest rate or more fees (thus, a better bottom line this quarter, leading to a higher bonus for the banker) and cannot lose, because the loans are immediately sold to the GSEs. The alternative result for bankers refusing to place subprime loans, is to have a lower profit margin, lower bonuses, and get investigated for their "unfair" hiring practices. If you were a banker, which would you do?

Subprime mortgages, often called "lair loans," come in three main categories: no-doc loans (loans given without any documentation of income, job history, or value of the property); full equity loans (where the bank loans 100% or more of the assumed value of the property--i.e., the loan recipient has none of his own money invested and, thus, no incentive to repay the loan if the value of the property drops); and ARMs (adjustable rate mortgages, which begin with a low "teaser" rate at which an individual can qualify for a loan, but then reset to a higher rate after a year or so, resulting in a greatly increased payment which the

individual is unable to pay). Many subprime mortgages have elements of all three categories.

Although numbers are fuzzy and nobody really knows the exact amount, the actual subprime mortgage exposure is apparently only about $250 Billion of total subprime loans. The default rate for prime mortgages is currently about .34%; the default rate for subprime adjustable rate mortgages is above 6% (or 20 times as great). Nevertheless, as near as can be determined, the total subprime exposure, even if all subprime loans went completely bust (which they won't, because actual houses exist--in other words, the asset value is above zero), is not enough to sink the financial system. However, there are two more problems which greatly magnify the effect of the subprime exposure: mark-to-market and derivatives (primarily credit default swaps).

The **"mark-to-market"** accounting rules are designed to make a company's balance sheet reflect the true value of assets.[2] If, for example, the bank owns a non-recourse loan on a house valued at $100,000 and the house burns down with no insurance, then the value of the underlying collateral is no longer $100,000; it is the value of the lot, less the cleanup expense, or, say $40,000. Thus, the bank would be required to mark the value of the loan on its books down to $40,000, resulting in a reduction of the bank's assets by $60,000. The mark-to-market rules are fairly easy to understand and apply when there is one specific asset as collateral to one specific loan, but they get complicated in the real world.

In the real world, banks make thousands of loans every day, then "package" these loans into lots of 1000+ loans "worth" (i.e., face value of), say, $100,000,000, and then sell the package of loans in the secondary market, typically to Fannie Mae or Freddie Mac. Thus, it is almost impossible to determine which loans are "good" and which loans are "bad" unless there is an actual investigation into each separate loan. In normal business practice, this is never done.[3] Instead, the financial world relies on 1)

[2] There are three tiers of assets under mark-to-market. The third tier involves assets which have questionable value, and makes up most of the mark-to-market problem.

[3] This is never done in "normal" financial conditions. However, during the S&L debacle, some smart people made a great deal of money by

rating agencies such as Standard and Poor and 2) models estimating value.

This reliance proved misplaced in the present financial crisis, first, because the rating agencies did not do their jobs, and second, because the models did not reflect reality (for some irrational reason, they essentially assumed that prior default rate experience in prime loans would also apply to subprime loans and derivatives--BAD, BAD assumption!).

"**Derivatives**" are financial instruments whose value changes in response to the changes in underlying variables. They are not "assets," in and of themselves, but "bets" on the future value of some underlying asset. The main types of derivatives are futures, forwards, options, and swaps.

The main use of derivatives is to reduce risk for one party, while simultaneously allowing another party to bet on a future profit. For example, assume that IBM stock is presently selling at $80 and is presently owned by Party A, who believes that $80 is the price IBM will sell for this entire year. Party B believes that it will go up to $90, and Party C believes that it will go down to $70. Party A can sell Party B an option for, say $1, which will allow Party B to buy the stock at $80 three months hence. Party A has thus locked in $1 of profit, now. If the stock goes up to over $81, Party B exercises his option and makes a gain on his purchase. If the stock stays under $81, then Party B has lost the $1 he paid for the option. Notice the leverage effect here--if the stock goes to $100, then Party B will have paid $1 for the option and will realize $20 on the exercise of the option and sale of the IBM stock. In reality, the leverage is much greater, since each option represents 100 shares of stock; thus, in our example, the $1 paid for the option to buy 100 shares of IBM stock would yield a gain of $2,000 if the shares went up from $80 to $90. (The same rationale applies in the other direction-if A grants an option to C and the price falls to $70, A can potentially lose $2,000 for the option price he received of

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sending teams of low-paid students to go through the loan files of "packages" being sold by the Resolution Trust Corporation. They found that many of the "bad" loans had uncashed checks for mortgage payments sitting in the files. The smart people immediately bought those loans up at pennies on the dollar and cashed the checks, thus paying for the purchase of the loan; any payments received thereafter were free money!

$1.) Option traders gamble on short-term changes in the market, rather than invest for the long haul and either make or lose a lot of money very quickly.

These derivatives can be based on different types of assets such as commodities, equities (stocks), bonds, mortgages, interest rates, exchange rates, or indexes (such as a stock market index, consumer price index (inflation derivatives) or even an index of weather conditions. The performance of the underlying asset can determine both the amount and the timing of the pay-offs, and will, because of the leverage effect, be magnified many times--for bad or for good--upon the ultimate disposition of the derivative. It appears that most of the problems in the mortgage industry, so far as we know at the present time, are due to derivatives called "swaps." Swaps generally arrange a trade of a fixed-rate security for a variable rate security. Thus, if X holds a note paying a fixed rate of 5% and thinks that rates will go up, he may swap his right to receive interest under that note for Y's variable rate note of 4%, based on his belief that Y's note will ultimately reset to 6% or more. This is an example of an interest rate swap. The value of each "leg" (X's 5% fixed rate and Y's 4% variable rate) of the swap depends on numerous factors, including the amounts, interest rates, time periods, etc. involved. The standard practice has been to value these swaps by "quantitative analysis," generally based on the Black-Scholes option pricing model. The problem with models is that, when the underlying assumptions are invalid, the valuations are also invalid.

One particularly nasty type of interest rate swap is the credit default swap (CDS). This is a contract between two parties, whereby the buyer (or "fixed rate payer") pays periodic payments to the seller (or "floating rate payer") in exchange for the right to a payoff if there is a default by a third party. Thus, the credit default swap is essentially a bet on what happens to some third party, over which the two contracting parties have no control.

If a default ("credit event") occurs, the typical contract either settles by delivery by the buyer to the seller of the (usually defaulted) debt obligation of the third party and the payment by the seller of the par value ("physical settlement"). Alternatively, the seller pays the buyer the difference between the par value and the

market price of a specified debt obligation, typically determined in an auction ("cash settlement"). As is obvious, the market price of a defaulted obligation is FAR less than face value.

A credit default swap resembles an insurance policy, as it can be used by a debt holder to insure against a default under the debt instrument. However, because there is no requirement to actually hold any asset or suffer a loss, a credit default swap can also be used for speculative purposes. Furthermore, since these instruments are not defined as "insurance," they re not regulated, as an insurance company's product would be. Speculation--which leads to a "bubble"--in credit default swaps is widespread.

How much are we talking about? The Bank for International Settlements (BIS) publishes statistics on the notional amounts outstanding in the OTC Derivatives market. At the end of 2006, this was $415.2 Trillion, more than 8.5 times the 2006 gross world product. Of the $415 Trillion total, $292 Trillion is attributable to interest rate swaps. In 2000, the total derivatives market was $48.8 Trillion, so you see that the growth has been astronomical. It is also phony money, because it is not based on any assets whose value can be accurately quantified.[4]

Now, let us pretend that the derivative at issue is based on mortgages, and that Fannie Mae (or AIG or whatever) has purchased $100 Billion of credit default swaps. The subprime market default rate goes up, which makes the subprime loans more risky, which makes them less valuable. The derivatives also become less valuable, and the potential loss is magnified 20 times because of the leverage effect. Fannie Mae then has to mark the swap down to market, thus reducing Fannie Mae's asset base. Its buyers and investors get nervous, fearing that they will not be paid, and demand either cash for their notes or that Fannie Mae have sufficient liquid (i.e., cash) assets to pay them. Fannie Mae then has to sell off some of its assets to raise the cash. But guess what--the assets have

[4] Three is an old joke about three bankers stranded on a desert island with nothing but their hats. When they were rescued a year later, they were all millionaires, due to the trading of those hats back and forth.

to be sold at fire sale prices. This, in turn, reduces the market value of the rest of the asset Fannie Mae owns. Which means that, tomorrow when Fannie Mae marks its assets to market again, their value is less, which reduces its asset base--and the whole cycle begins again. On October 9, 2008, OFHEO announced that it was suspending the capital requirements for Fannie & Freddie for the duration of the conservatorship, i.e., it was suspending the mark-to-market rules so as to protect the remaining capital of the entities.

Since the total US GDP is only about $15 Trillion and the total value of the World GDP is only about $50-$100 Trillion, you can see that the potential default of $415 Trillion in derivatives is of concern to the financiers. It is also of concern to Main Street because any default of any such magnitude would completely dry up credit. Consumer credit has been driving the US economy since the 1990s and the US consumer has been driving the world economy. Furthermore, most small businesses rely on lines of credit to operate, and small businesses have generated essentially all US job growth over the last 30 years. No credit, no jobs, no purchases = depression.

Let me be blunt about this--all this money is Monopoly money, it does not represent "real" assets. However, it has all been reported to the public on corporate balance sheets as "real" and when it disappears, it shows up as a loss and the bank becomes insolvent and cannot continue to loan to either individuals or businesses. And since the economy runs on credit (specifically, cheap credit), this creates a crisis for the economy. It is as if you were playing Monopoly and landed on Boardwalk--and then had to sell your actual residence to pay the rent called for in the game!

The evidence is very solid that the triggering event of the present crisis is the collapse of Fannie Mae and Freddie Mac. This came about because of 1) fraud and mismanagement on the part of the Fannie/Freddie executives in lending and in artifically inflating financial results so as to obtain large (enormous!) bonuses; 2) the Fed's action since summer of 2007 in trying to reign in credit and 3) the subsequent resetting of adjustable rate mortgages, primarily in the subprime loan area.

At this point, you should look at a Youtube video that was made showing specific newspaper articles from the 90s dealing with the underlying problems with bad loans, going back to the mid-90s:
http://www.youtube.com/watch?v=NU6fuFrdC…
(If this doesn't work, go to Google and type in the search "Fannie Mae Eases Credit To Aid Mortgage Lending" and "New York Times" and "September 30, 1999")

You should also look at a YouTube video showing what happened in the Congressional hearings when McCain and the Republicans tried to rein in Fannie and Freddie in 2004: http://www.youtube.com/watch?v=_MGT_cSi7… (If this doesn't work, Google "Fannie Mae Congressional Hearings 2004 Barney Frank")

You should also read an article at
http://www.usatoday.com/money/economy/2008-10-12-congress-meltdown_N.htm
dealing with the failure to regulate both derivatives and Fannie/Freddie. (If this doesn't work, Google "How Congress set the stage for a fiscal meltdown" and "USA Today")

I mentioned adjustable rate mortgages or "ARMs." These typically have a low "teaser" rate (say, 2% or 3%) for the first two years, then reset to a higher rate once or several times at the end of the introductory period. The higher rate will be at least double the introductory rate (because the people getting these loans have generally poor credit), which will at least double the monthly loan payment. Then the loan will reset again in subsequent years and the mortgage payments will double again. Most ARMs have a maximum rate of about 16%, so you can see that they will end up being too high for the borrower to pay, and the house will go into foreclosure. Not only is this a problem for the borrower, it also adversely affects the solvency of the lender. When enough houses go into foreclosure, then the lender becomes insolvent.

InvestorInsight has an interesting chart of the amount of adjustable rate mortgage resets that will be happening over 2007-2008. The real bubble begins in January of 2008. For the period of January to April expectations are that $370 million in adjustable rate loans will reset; there are many households that are going to be stressed:

Adjustable Rate Loan Resets For 2007-2008 by Month in Millions

January-07	22
February-07	25
March-07	35
April-07	37
May-07	36
June-07	42
July-07	43
August-07	52
September-07	58
October-07	55
November-07	52
December-07	58
January-08	80
February-08	88
March-08	110
April-08	92
May-08	76
June-08	75
July-08	50
August-08	35
September-08	26
October-08	20
November-08	15
December-08	17

Now look at the following graphs showing the foreclosure rates for prime and subprime mortgages:

Figure 7: Fixed and Adjustable Prime Foreclosures Started

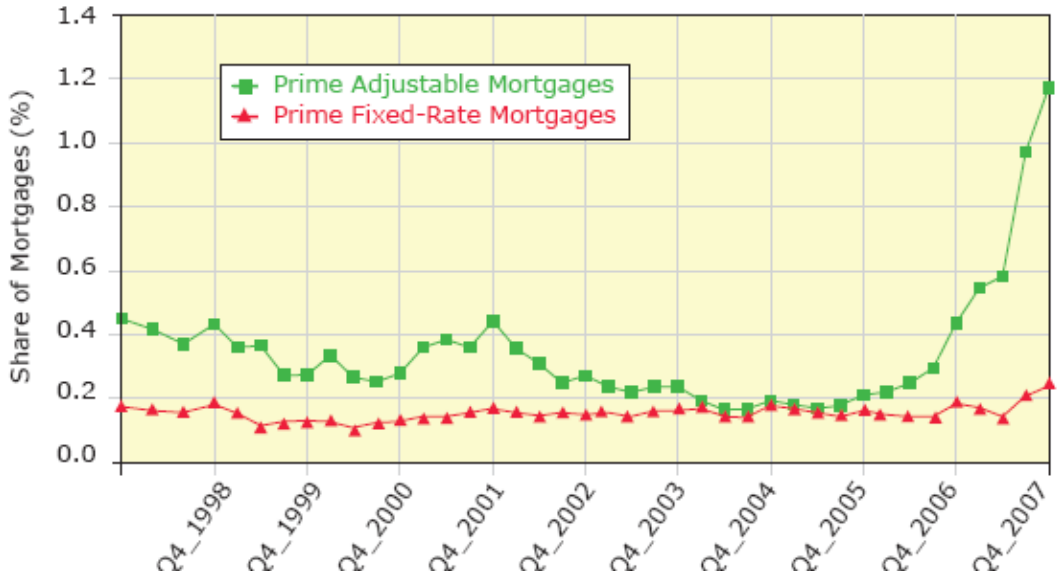
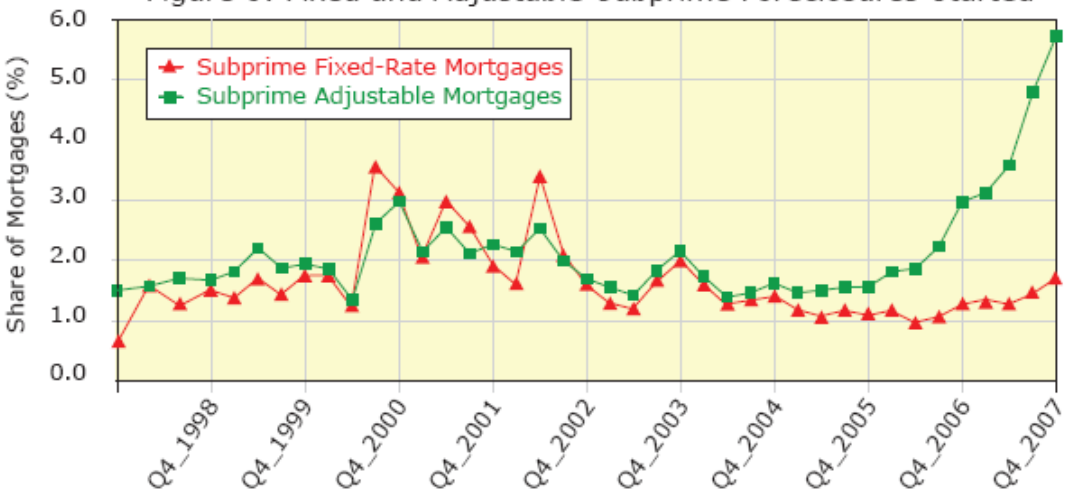


Figure 6: Fixed and Adjustable Subprime Foreclosures Started



Notice that the foreclosure rate has gone up recently for fixed rate mortgages, but is nowhere near as high as some times in the past. Now, look at the rate for adjustable rate mortgages--it has skyrocketed. This huge increase in foreclosures for adjustable rate mortgages is the triggering event underlying the present economic crisis. Now look at the next chart, which has subprime and Alt-A (typically no-document motgages that are one step up from subprime, but not as good as prime mortgages):

Defaults on Risky Mortgages

Chart Data		
	Subprime defaults	Alt-A defaults
2002	5.3 %	1.7 %
2003	4 %	1.7 %
2004	5.3 %	2.1 %
2005	7.6 %	3 %
2006	14.2 %	6.5 %
2007	19.9 %	15.6 %

Mortgages in which the value of the loan is greater than the assessed value of the home are among the riskiest mortgages. Borrowers on these mortgages are more likely to default once the real estate market starts declining because they cannot get out from under such a loan by selling their home, since a sale wouldn't yield enough money to pay off the entire loan. Above are early default rates on mortgages with a loan-to-value ration of 100% or more, so called negative equity loans, for both subprime mortgages (those made to individuals without high credit ratings) and Alt-A mortgages (no documentation loans). As housing price appreciation slowed in 2006 and home prices then began declining in some markets in 2007, defaults on these mortgages soared, according to a recent paper by economists at the Federal Reserve Bank of NY.

Now let us consider how we got to this point and the proposals to fix the problem.

HOW DID WE GET TO THIS POINT:

In a word, politics. And, although both parties have their hands in the mess, the Democratic Party political establishment is in it up to their necks, because that establishment has been using Fannie Mae as its own personal cookie jar by placing its staffers and executives (i.e., not elected or not yet elected) in executive positions in Fannie Mae for the last 30 years. Ditto Freddie Mac, but the pattern is most egregious in Fannie Mae.

At this point, you should read an article on the internet at

http://billburnham.blogs.com/burnhamsbeat/2008/07/fannie-maes-gol.html

(If this doesn't work, go to Google and type in the search "Fannie Mae's Golden Goose: A Lesson In Moral Hazard" The term moral hazard, by the way, means what happens to you, personally, if you undertake a risky investment which fails.)

The Burnham article, above, is written by a venture capitalist who consulted to Fannie Mae in the mid-1990s. He is very neutral and names no names, but explains clearly what happened. Here are the players . . .

Franklin Raines--Chairman and a former Chief Executive Officer at Fannie Mae. He served as President Bill Clinton's Budget Director. Raines was forced to retire from his position with Fannie Mae in December 2004 when auditing discovered severe irregularities in Fannie Mae's accounting activities. At the time of his departure The Wall Street Journal noted that Raines, who long defended the company's accounting despite mounting evidence that it wasn't proper, issued a statement late Tuesday conceding that "mistakes were made" and saying he would assume responsibility as he had earlier promised. At that point, Fannie Mae had to reduce its surplus by $9 billion. Raines left with bonuses and a golden parachute reputed to be valued at $240 Million (!!!) in benefits. During the five years Raines ran Fannie Mae, some $249 Million in bonuses went to executives. DOJ filed suit against Raines when the depth of the accounting scandal became clear, and the Court ordered Raines to return $50 Million Dollars he received in bonuses based on the mis-stated Fannie Mae profits.

Raines had been known to be working for the Obama Campaign as Chief Economic Advisor until McCain's television ad linking Obama to Raines and to the Fannie Mae collapse on September 18, 2008. After the ad came out, both Obama and Raines denied that Raines was connected with the Obama campaign. If you google Franklin Raines and Obama and Fannie Mae, there are several articles linking Raines to Obama prior to September 18, 2008, including a Wikipedia article; that article has since been changed and references to the Obama campaign deleted. At this point, it is clear that Raines held himself out to be giving Obama economic advice, but it is unclear whether he was actually talking to Obama or just the Obama staff, and it is unclear exactly what he was saying.

Tim Howard was the Chief Financial Officer of Fannie Mae. Howard was in charge of cooking the books. The Government investigation determined that "Chief Financial Officer, Tim Howard, failed to provide adequate oversight

to key control and reporting functions within Fannie Mae." Investigations by federal regulators and the company's board of directors since concluded that management did manipulate 1998 earnings to trigger bonuses. Howard resigned under pressure in late 2004. Howard's Golden Parachute was estimated at $20,000,000. Howard is a Chief Economic Advisor to Barack Obama.

Jim Johnson is a former aid to Walter Mondale, a former executive at Goldman Sachs and Lehman Brothers and later forced from his position at Fannie Mae (he was the CEO prior to Raines). He was also a Senior Obama Finance Advisor and was selected to run Obama's Vice Presidential Search Committee, the Committee that selected Joe Biden. In regard to Johnson, the Office of Federal Housing Enterprise Oversight's May 2006 report on mismanagement and corruption inside Fannie Mae found that Fannie Mae had hidden a substantial amount of Johnson's 1998 compensation from the public, reporting that it was between $6 million and $7 million when it fact it was $21 million."

Obama gave a speech on September 17, 2007 to Wall Street Bankers addressing the Financial Crisis where he called for a "reappraisal of values." and stated ""The danger with this mentality isn't just that it offends our morals, it's that it endangers our markets." Contributing to Obama's speech was Jim Johnson. Johnson also is still involved in September 2008 giving briefings for the Obama campaign. By the way, this contradicts earlier reports that Johnson had left the Campaign when he came under investigation for taking illegal loans from Country Wide Financial while serving as CEO at Fannie Mae. On September 9, 2008, Obama criticized "Golden Parachute" payments to Fannie Mae executives and is on record during the current financial crisis as being against golden parachute payments. Jim Johnson's parachute at the time he left Fannie Mae was estimated at $28 Million.

There are more people involved, of course. For example, there is Angelo Mozilo, former CEO of Countrywide Mortgage, (the now defunct major private originator of subprime mortgages, which went bust earlier in 2008). Franklin Raines and James Johnson, two Obama advisors discussed above, received preferential home loans as industry favors, apparently in deference to their executive positions heading Fannie Mae. Raines and Johnson, as

"Friends Of Angelo," were funneled millions of dollars for personal home loans. Mozilo himself made exceptions from Countrywide policy to provide the two Fannie Mae CEO's low and no-interest rate deals. Obama's outspoken criticism of Mozilo's exceptionally high compensation is fairly hypocritical in view of the preferential loans to Raines and Johnson and the degree to which Countrywide's failed sub-prime loans contributed to the government takeover of Fannie Mae and Freddie Mac and last week's mortgage-related crisis on Wall Street. Johnson earned $21 million in just his last year at Fannie Mae, where he served as CEO from 1991 to 1998. Raines earned $90 million in his five years as Fannie Mae CEO, from 1999 to 2004.

By the way, Obama later "nuanced" his position on Johnson:

> "Jim Johnson has a very discrete task," Obama continued, "as does Eric Holder[5], and that is simply to gather up information about potential vice presidential candidates. They are performing that job well, it's a volunteer, unpaid position. And they are giving me information and I will then exercise judgment in terms of who I want to select as a vice presidential candidate.
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> "So this – you know, these aren't folks who are working for me," Obama said. "They're not people you know who I have assigned to a job in a future administration and, you know, ultimately my assumption is that, you know, this is a discreet task that they're going to performing for me over the next two months." …

So, apparently, Johnson also now either does or does not "work" for Obama.

More people: Penny Pritzker, the current Finance Chair for the presidential campaign of Barack Obama, was the chair of Chicago-based Superior Bank's board for five years. Superior Bank went belly up in 2001 with over $1 billion in insured and uninsured deposits; 1,406 depositors

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[5] Eric Holder was implicated in the scandal involving Bill Clinton's granting a pardon to convicted financier ($496 million theft) Marc Rich in return for campaign contributions.

lost much of their life savings. This collapse came amid harsh criticism of how Superior's owners promoted half a billion dollars of sub-prime home mortgages and overstated the thrift's assets by $420 million. On Nov. 1, 2002, the Federal Deposit Insurance Corp. sued Ernst & Young, Superior's auditor, in a fraud suit filed two months after a group of Superior depositors accused the bank's owners and directors, including two members of the Pritzker family, of racketeering, claiming they lined their pockets with money looted from Superior savings accounts.

Chris Dodd has been in the Senate for 28 years. Dodd has served as Chairman of the Democratic National Committee and is Chairman of the Senate Banking Committee. As Chairman he had responsibility for acting as a "watch-dog" of Fannie Mae and Freddie Mac. He also essentially has veto power over the selection of the CEOs who run Fannie Mae and Freddie Mac. Dodd was a leading contender to be Obama's Vice Presidential selection until his receipt of VIP loans from Countywide Financial were disclosed. (It has been reported that Dodd received $7,000,000 in loans from Countywide during the time that Dodd's Committee was responsible for overseeing banks in the United States; Countrywide is presently under FBI investigation for Securities Fraud.)

The Government Watchdog Group, The Center For Responsive Politics, reports that Senator Dodd received more campaign contributions from Fannie Mae and Freddie Mac than any other Senator.

Dodd voted against two proposed laws that would have strengthened oversight of Fannie Mae and could have stopped the current crisis long before it reached this proportion. See, http://www.govtrack.us/congress/record.xpd?id=109-s20060525-16&bill=s109-190 and http://www.washingtonpost.com/ac2/wp-dyn?pagename=article&node=&contentId=A58272-2002Jul11&notFound=true

Dodd is consistent--he also opposed similar legislation that would have prevented the Enron collapse.

Barney Frank (D., Mass.) has been in Congress for 27 years and is the Chairman of the House Financial Services Committee. In 2003, Frank rejected Bush administration and

Congressional Republican efforts for the most significant regulatory overhaul in the housing finance industry since the savings and loan crisis of the 1980's. Under the plan a new agency would have been created within the Treasury Department to assume supervision of Fannie Mae and Freddie Mac, the government-sponsored companies that are the two largest players in the mortgage lending industry, see http://en.wikipedia.org/wiki/Barney_Frank As reason for opposition, he stated "These two entities, Fannie Mae and Freddie Mac, are not facing any kind of financial crisis," He added, "The more people exaggerate these problems, the more pressure there is on these companies, the less we will see in terms of affordable housing."

The legislation in question was aimed at creating additional "watchdogging" of Fannie Mae and Freddie Mac, watchdogging that would have prevented this Crisis. Frank also opposed the "watchdog" reforms presented by John McCain in 2002, 2005, and 2006. Frank has been described as "The Patron Saint of Fannie Mae".

By the way, here is a list of the top couple of dozen politicians to whom Fannie Mae contributed:

All Recipients of Fannie Mae and Freddie Mac Campaign Contributions, 1989-2008 (from OpenSecrets.org, at the Center for Responsive Politics)

Name	Office	State	Party	Grand Total	Total from PACs	Total from Individuals
Dodd, Christopher J	S	CT	D	$165,400	$48,500	$116,900
Obama, Barack	S	IL	D	$126,349	$6,000	$120,349
Kerry, John	S	MA	D	$111,000	$2,000	$109,000
Bennett, Robert F	S	UT	R	$107,999	$71,499	$36,500
Bachus, Spencer	H	AL	R	$103,300	$70,500	$32,800
Blunt, Roy	H	MO	R	$96,950	$78,500	$18,450
Kanjorski, Paul E	H	PA	D	$96,000	$57,500	$38,500
Bond, Christopher S 'Kit'	S	MO	R	$95,400	$64,000	$31,400
Shelby, Richard C	S	AL	R	$80,000	$23,000	$57,000
Reed, Jack	S	RI	D	$78,250	$43,500	$34,750
Reid, Harry	S	NV	D	$77,000	$60,500	$16,500
Clinton, Hillary	S	NY	D	$76,050	$8,000	$68,050
Davis, Tom	H	VA	R	$75,499	$13,999	$61,500
Boehner, John	H	OH	R	$67,750	$60,500	$7,250
Conrad, Kent	S	ND	D	$64,491	$22,000	$42,491
Reynolds, Tom	H	NY	R	$62,200	$53,000	$9,200
Johnson, Tim	S	SD	D	$61,000	$20,000	$41,000
Pelosi, Nancy	H	CA	D	$56,250	$47,000	$9,250

Carper, Tom	S	DE	D	$55,889	$31,350	$24,539
Hoyer, Steny H	H	MD	D	$55,500	$51,500	$4,000
Pryce, Deborah	H	OH	R	$55,500	$45,000	$10,500
Emanuel, Rahm	H	IL	D	$51,750	$16,000	$35,750
Isakson, Johnny	S	GA	R	$49,200	$35,500	$13,700
Cantor, Eric	H	VA	R	$48,500	$46,500	$2,000
Crapo, Mike	S	ID	R	$47,250	$40,500	$6,750
Frank, Barney	H	MA	D	$42,350	$30,500	$11,850

Note that Chris Dodd pulled in his $165,000 over 25 years; Obama got his $126,000 in the last 3½ years. McCain is far down the list--he got $21,600 over 20 years.

Charles Schumer, Senior Senator from New York (Hillary is the Junior Senator) has also been wonderful to Fannie Mae executives--you can follow the links on his Senate website showing him trying to force the regulators to loosen their controls on Countrywide, Fannie Mae, and Freddie Mac. He succeeded: in February 2008, they did.

Then there is Richard Syron--who took over as CEO of Freddie Mac after Raines resigned in 2003, with the promise of reforming the prior management errors. Instead, however, he expanded Freddie's exposure to subprime mortgages. His ties to the financial community come through the American Stock Exchange, where he was CEO from 1994 to 1999; he also held top posts at the Federal Reserve Bank of Boston between 1989 and 1994 and, before that, was president of the Federal Home Loan Bank Corporation. The infamous study from the Boston Federal Reserve Bank "Closing the Gap: A Guide to Equal Opportunity Lending," which was widely used to justify and encourage subprime lending practices, went out over his signature while he was President of the Federal Reserve Bank of Boston in 1992. Richard Syron, by the way, was a participant in both Democratic and Republican administrations.

These are the men who tore Wall Street down. Do you trust them to rebuild it?

On the other hand, just for fun, you might want to google The Federal Housing Enterprise Regulatory Reform Act of 2005, sponsored by Chuck Hagel and co-sponsored by John McCain. Among other things, it did the following (taken from the Congressional Research Service summary):

> Federal Housing Enterprise Regulatory Reform Act of 2005 - Amends the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 to establish: (1) in lieu of the Office of Federal Housing Enterprise Oversight of the Department of Housing and Urban Development (HUD), an independent Federal Housing Enterprise Regulatory Agency which shall have authority over the Federal Home Loan Bank Finance Corporation, the Federal Home Loan Banks, the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac); and (2) the Federal Housing Enterprise Board.
> Sets forth operating, administrative, and regulatory provisions of the Agency, including provisions respecting: (1) assessment authority; (2) authority to limit nonmission-related assets; (3) minimum and critical capital levels; (4) risk-based capital test; (5) capital classifications and undercapitalized enterprises; (6) enforcement actions and penalties; (7) golden parachutes; and (8) reporting.

Franklin Raines' last appearance on the national scene (and which probably led to the McCain ad) was his editorial "Truce Time In The Fan-Fred Wars" in the Wall Street Journal on August 5, 2008, saying basically that everything was fine with Fannie Mae and Freddie Mac (and "A point of personal privilege" saying that, if there were anything wrong, it was not his fault). A month later, Fannie and Freddie were taken over by the Government.

Go back and watch, again, the interesting U Tube video with footage from the 2004 hearings showing the Democrats vociferously defending Fannie and castigating the regulatory agencies for their "high-tech lynching" of Raines.

This is not to imply that the Republicans are clean, either--look at the list above and you will see various Republicans are also on the take, including our own dear Senator Bennett (4th on the list-$108,000). Probably the most notable Republican implicated (who is not on the list, because he was not an elected official) is Rick Davis, Senator John McCain’s campaign manager, who was a senior partner in Davis Manofort, a lobbying company which was paid more than $30,000 a month for five years, apparently

ending when he left in 2008 to run McCain's campaign (i.e., assuming that the two senior partners split the monies in half, this would have given him $15,000 per month, or even more than the elected officials received). Davis acted as president of an advocacy group set up by the mortgage giants Fannie Mae and Freddie Mac to defend them against stricter regulations. Since Davis had run McCain's 2000 bid for the Presidency, the main reason for him to have been hired as a lobbyist would have been the potential influence he could exercise in a future McCain presidency. Thus, even if pro-financial-regulation McCain were to win the Presidency, there would be a voice for Fannie at the top levels of his administration--this is called "insurance, just in case."

WHAT IS THE BAILOUT?

We don't know yet--the details are unclear. The Administration and the Democrats apparently want the taxpayers to cough up $700+ Billion to buy subprime mortgages from the banks and Fannie/Freddie and the investment and insurance companies. This amount seems to be quite a lot more than the actual subprime mortgage exposure, but quite a bit less than the potential derivative exposure. The Republicans want to either have the banks (etc.) take out a Government insurance against future losses or have the Government take an equity position in the companies (probably through warrants) which it could sell at a later time for a profit. The outcome is still unclear.

First Plan: The Paulson/Bush plan is a two-page proposed law saying give Paulson $700 Billion, let him spend it as he pleases, and Congress and the courts can't look over his shoulder to see what he did with it. For some strange reason, it was DOA.

Second Plan: If the first plan was too vague, the second Paulson/Bush plan went too far the other way--it was a 300-page bill giving essentially the same $700 Billion, but divided into an immediate $250 Billion phase, a $100 Billion phase to be distributed when the President saw fit, and a final $350 phase to be distributed when Congress approved it. The money would go to buy (presumably at greater than fair market value) subprime loans from Freddie/Fannie and big banks, and thus inject liquidity

into the financial system. Since the Fed has injected about $400 billion into the system over the past year, and in view of the enormous amounts involved, I question whether this new $700 Billion would have had any positive effect or merely exacerbated the problem. Worse, it was a perpetual $700 Billion fund, thus potentially enabling banks with good political connections to dump their bad debts into the fund forever. It failed to pass the House, primarily because Republican incumbents in contested races voted it down (there were also 95 Democrat Nays).

Third Plan: It appears to be essentially the same as the second plan, but with sweeteners for disgruntled House members: 1) modify the mark-to-market rules so as to improve the banks' balance sheets (the SEC had already done this on Tuesday, but the bill would ratify the change); 2) raise the federal depository insurance protection from $100,000 per account to $250,000 per account (only a cosmetic change, for most people); 3) add a fix for the alternative minimum tax; and 4) extended various tax breaks and credits (including a zero capital gains rate for certain sales and another temporary fix for the Alt Min tax). This passed and was signed by President Bush. It apparently now includes the Government taking an equity stake (of $250 Billion?) in some or all of the banks being bailed out--details are hazy. Meanwhile, the Fed has opened the floodgates of money, inflating the money supply and dropping interest rates (which, if you have been paying attention, is one of the root causes of the problems we face.)

In my opinion, none of the plans have addressed the basic problems with the financing system--expansion of the money supply coupled with lax lending standards mandated by Congress, resulting in too much money lent out on assets whose value did not justify the loans and to people who could not repay the loans. Nor do they address derivatives. Modification of the mark-to-market rules will only allow banks to hide these overvalued assets better. Further, the bills do not address the root problem of inflation of the money supply by the Fed over the past 15 years, which is the other main contributor to the debt binge this country went on. Sooner or later, debts have to be paid. None of the bailout plans say how to do this.

PROGNOSIS:

Grim, getting much worse.

The 1960s and 1970s were the heyday of Keynesian economics in the United States. It was thought that inflation must be accepted as the price of low employment (look up "Phillips Curve"). However, the bad economy of the 1970s coupled high unemployment with high inflation, which became known as "stagflation" (economic stagnation + price inflation). Theories based on the Phillips curve said that this could not happen, and the theory came under attack from a group of economists headed by Milton Friedman, who argued that the demonstrable failure of the relationship demanded a return to non-interventionist, free market policies. The Phillips Curve idea that there was a simple, predictable, and persistent relationship between inflation and unemployment has been abandoned by most if not all economists, other than those on the left wing.

However, it looks like the Left will take control after the next election. This implies that "supply side economics" (in both the general sense of increasing production, i.e., the "supply" side of supply & demand, and also in the limited sense of reducing tax rates to increase GDP) will be replaced with a Keynsian approach. In the past, the Keynesian approach has has led to 1) even greater increases in the money supply, in an attempt to stimulate economic activity; 2) increased cost-push inflation (higher inflation caused by higher wages (wage-push inflation, including higher minimum wages) or other higher costs of production (typically higher prices of raw materials, such as oil)); 3) leading to demand-pull inflation (more dollars chasing a limited supply of goods which are thought to maintain their value; 4) higher taxes, which leads to 5) decreased investment (immediate consumption being favored over savings), which leads to 6) decreasing productivity, which leads to 7) declining real wages, coupled with increasing nominal wages and increasing unemployment, which equals . . . stagflation once again.

If we are lucky, we are headed for an economic replay of the 1970s; if we are unlucky, we are headed for a replay of the 1930s.

I also think that we are headed for a replay of the 1970s and 1930s geopolitically, but that is another essay.