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# **New Gimmicks To Salvage A Sinking Economy**

By Joel Skousen

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President Bush continues to pander to sinking mortgage payers while the Fed keeps devising new ways to bail out the debt markets. There are numerous hidden consequences of the government attempt to bail out various parties to the subprime mortgage crisis, including the borrowers themselves. First, and foremost it is an assault on the sanctity of contracts. It matters not that Treasury Secretary Paulson supposedly backed away from a government mandate to freeze mortgage rates and instead switched to a "voluntary" program of re-writing mortgage contracts. The threat of force was enough to get the victims to agree to "voluntary" rewrites. Legal issues still loom large because not all parties to the "agreement" are willing to forego their rights. Then there is the issue of fairness to those who faithfully sacrifice each month to make their mortgage payments. They'd like a lower interest too--but by being honest and faithful to their contracts, they are disqualified from the program.

All of this sends a chilling message to bond markets: As Bloomberg News wrote, "President George W. Bush's plan to freeze interest rates on some subprime mortgages may prove to be a cure that breeds another disease. Milton Ezrati, senior

economist at Lord Abbett & Co. says, 'When the government comes in and says you have contracted to have this arrangement and you can no longer have it, I think it opens the door for lawsuits.'

"The plan may force investors in the \$6.3 trillion market for home-loan bonds, created by pooling loans and funneling interest payments to bondholders, to revalue their holdings. 'It could end up there's less confidence in the viability in the bond markets and the mortgage markets going forward and it could lead to higher interest rates and higher mortgage rates for everybody,' said Kenneth Hackel, managing director of fixed-income strategy at RBS Greenwich Capital Markets." And, that is why the government is shoveling ever more liquidity out the door, and why the dollar keeps falling. Oil prices rose \$5 a barrel solely based on the anticipation of a weaker dollar value.

Sean Olender addresses the lawsuit threat: "The ticking time bomb in the U.S. banking system is not resetting subprime mortgage rates. The real problem is the contractual ability of investors in mortgage bonds to require banks to buy back the loans at face value if there was fraud in the origination process.

"The 'freeze,' [is] the brainchild of Treasury Secretary Henry Paulson. It sounds good: For five years, mortgage lenders will freeze interest rates on a limited number of 'teaser' subprime loans. Other homeowners facing foreclosure will be offered assistance from the Federal Housing Administration. But unfortunately, the 'freeze' is just another fraud - and like the other bailout proposals, it has nothing to do with U.S. house prices, with 'working families,' keeping people in their homes or any of that nonsense.

"The sole goal of the freeze is to prevent owners of mortgage-backed securities, many of them foreigners, from suing U.S. banks and forcing them to buy back worthless mortgage securities at face value - right now almost 10 times their market worth."

## THE MORTGAGE MELTDOWN ISN'T OVER, BUT THEY HAVE ANOTHER FIX

In the wake of Morgan Stanley's full recession alert for the US economy, the Federal Reserve announced that, "The Bank of Canada, the Bank of England, the European Central Bank, the Federal Reserve, and the Swiss National Bank are

announcing measures designed to address elevated pressures in short-term funding markets. Actions taken by the Federal Reserve include the establishment of a temporary Term Auction Facility and the establishment of foreign exchange swap lines with the European Central Bank and the Swiss National Bank. Under the Term Auction Facility (TAF) program, the Federal Reserve will auction term funds to depository institutions against the wide variety of collateral [subprime debt, anyone?] that can be used to secure loans at the discount window. All depository institutions that are judged to be in generally sound financial condition by their local Reserve Bank and that are eligible to borrow under the primary credit discount window program will be eligible to participate in TAF auctions. All advances must be fully collateralized."

What this really means is that the fed will begin to accept packages of subprime mortgages as collateral that otherwise have no value on the open market. This move will allow devalued debt to act as security for new loans that do have value, based upon the overall reputation of the borrowing bank. In short, the Fed has joined forces with other central banks to LAUNDER the subprime mortgage debt packages into other forms of debt. It also pumps billions of liquidity into bank coffers so they don't have to liquidate these bad debts to cover investor withdrawal or legal demands to make good on the original value of these subprime package deals. Slick.

All of this points to the fact that the US and world debt structure is in much worse shape than is admitted by governments. Bloomberg reports that "Citigroup Inc [with new cash from it's Arab investors] will take over seven troubled investment funds and assume \$58 billion of debt to avoid forced asset sales that would further erode confidence in capital markets. Moody's Investors Service lowered the bank's credit ratings." Last week I mentioned Florida's troubled state investment pool. This week Bloomberg reported that "Florida's state investment pool will keep November's interest income instead of paying it to counties and schools, using the \$95 million to shore up a troubled portion of the fund." That's a stop gap measure aimed at forestalling default.

Stock markets aren't fooled either. This week, for the first time, based upon the supposed "good news" of a rate cut, the Dow Jones average plunged nearly 300 points. It is supposed to go the other way. But investors felt the 1/4 point drop wasn't enough.

Sean Olender wrote in the SF Chronicle the definitive piece on the legal

implications of the mortgage meltdown. He says that bankers are paying lip service to family finances while "scurrying to avert law suits, and prison." Is it that bad? Yes, and without a whole new set of intervention, the banks were in real trouble.

"New proposals to ease our great mortgage meltdown keep rolling in. First the Treasury Department urged the creation of a new fund that would buy risky mortgage bonds as a tactic to hide what those bonds were really worth. (Not much.) Then the idea was to use Fannie Mae and Freddie Mac to buy the risky loans, even if it was clear that U.S. taxpayers would eventually be stuck with the bill. But that plan went south after Fannie suffered a new accounting scandal, and Freddie's existing loan losses shot up more than expected.

"And, to be sure, fraud is everywhere. It's in the loan application documents, and it's in the appraisals. There are e-mails and memos floating around showing that many people in banks, investment banks and appraisal companies - all the way up to senior management - knew about it. I can hear the hum of shredders working overtime, and maybe that is the new 'hot' industry to invest in."The catastrophic consequences of bond investors forcing originators to buy back loans at face value are beyond the current media discussion. The loans at issue dwarf the capital available at the largest U.S. banks combined, and investor lawsuits would raise stunning liability sufficient to cause even the largest U.S. banks to fail, resulting in massive taxpayer-funded bailouts of Fannie and Freddie, and even FDIC."The problem isn't just subprime loans. It is the entire mortgage market. As home prices fall, defaults will rise sharply - period. And so will the patience of mortgage bondholders. Different classes of mortgage bonds from various risk pools are owned by different central banks, funds, pensions and investors all over the world. Even your pension or 401(k) might have some of these bonds in it.

"Perhaps some U.S. government department can make veiled threats to foreign countries to suggest they will suffer unpleasant consequences if their largest holders (central banks and investment funds) don't go along with the plan, but how could it be possible to strong-arm everyone?" They have their ways.

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