Congress 'Surprised' by Crash Or Cowed by Hedge-Fund Money?

by Paul Gallagher

On the 110th Congress's Sept. 5 return from a month's recess, it was starkly confronted by the reality of a banking and credit crisis, and a collapsing real economy and employment, which knocked into a cocked hat the Democrats' planned Sept. 5-6 committee hearings on tax policy, and other tertiary matters. While they were debating how much to tax private equity and hedge funds, a global seize-up in lending among banks was threatening a bank collapse within "days or weeks," as one top European banker warned. And the Bureau of Labor Statistics on Sept. 7 delivered the shocking report of a net loss of employment in the American economy in August, with 70,000 manufacturing and construction jobs, and 30,000 real-estate/financial jobs disappearing in a month. The biggest mortgage lender, Countrywide, added 10,000 more layoffs on the day of the report. The nationwide wave of home foreclosures continued to rise toward 1.5 million a year, while home sales plunged.

On Sept. 5, just as the first "economic" Congressional hearings began, the condition of the world credit markets was described to the *Financial Times* as "a heart attack" by Jörg Rudloff, chairman of Barclays Capital and of the International Capital Markets Association, who added, "If we stay stuck, the patient [the banking system] is going to die." And the same day, the chairman of Deutsche Bank, Josef Ackermann, said that the governments and banks had only "the next few days or weeks" to try to restore confidence, and head off collapse. On Sept. 6, the Fed, Bank of England, and European Central Bank pumped nearly $100 billion in liquidity into their banking systems, resuming a month-long attempt to revive bank lending and credit assets by such measures, which were clearly not working. Interbank lending interest rates kept rising, as banks, fearing their own growing losses, hoarded the cash instead of lending it; trade associations and financial commentators screamed in pain for an emergency cut of a half-percent, or even one full percent, in the Federal Reserve funds rate—also sure to be unsuccessful.

Citibank, the world's biggest, on Sept. 7, cut off all lending to mortgage companies.

Leading Congressmen in both parties immediately used Rep. Barney Frank's (D-Mass.) Financial Services Committee hearing on Sept. 5, to proclaim that they were "completely surprised" that the so-called subprime mortgage collapse had spread throughout the markets to become a general financial crisis. Frank himself opened the hearing, saying, "I think the far greater surprise was the extent to which the residential mortgage crisis had a negative impact on the market in general. I don't know anyone who was predicting that a problem in subprime was going to lead to a failure in selling commercial paper. Now, clearly, there has been a broader degree of impact from this crisis, and it does not seem to me that any of us, charged with responsibility for knowing what was going on, anticipated this. . . . I was not pleased, that so many of us were surprised at the impact that the subprime crisis had on the entire financial system. . . . It may be that there is a systemic problem here."

All of Frank's witnesses—top officials from the Treasury, FDIC, Securities and Exchange Commission, and Office of the Comptroller of the Currency—echoed him with their expressions of surprise at the spreading bank/credit panic. Congressmen from both parties chimed in with their own pleas of innocent astonishment, until finally Democratic Rep. Gary Ackerman, with typical New York irony, remarked at how surprised he was, that all his colleagues

were so surprised: "Anyone with an eye open could see there was trouble ahead."

While Frank urged expanding the big government mortgage enterprises, known as Fannie Mae and Freddie Mac, to buy up and refinance troubled mortgages, others, like Rep. Paul Kanjorski (D-Pa.), pointed to the seriousness of the crisis: "I hear people talking about ... Freddie Mac and Fannie Mae. People are suggesting we get these folks involved and have them empowered to buy some of this bad paper, or bad mortgages, or do the work-out process. I have great fear in doing that, because ... we could do that, put them at risk, certainly strain their positions—and then have the real estate market really go awry and have us go into a recession, and then hell's going to break loose and we're going to have a multi-trillion-dollar disaster or perhaps systemic failure on our hands."

What They Really Knew, or Should Have Known

The cries of alarm from the chairmen of Barclays and Deutsche Bank characterized the bank crisis as just as extreme, and just as short-term, as had Lyndon LaRouche in a Sept. 1 speech: The U.S. Congress, in particular, has until the beginning of October, and no longer, to take emergency action to halt the foreclosure "tsunami" and bring the bank crisis under control. Otherwise, "the patient will die," and social and financial chaos will ensue, with mass evictions of households and widespread failure of banks over coming months, which could have been prevented.

LaRouche and *EIR* representatives had told Congress as a whole, and briefed numerous offices in detail, *in March*, exactly what disaster was going to happen to the banking system and financial markets during the remainder of 2007, and what kind of actions they had to take to protect the underlying U.S. economy and population.

At that time, some Members of Congress, and experts on their staffs, flatly denied that the mortgage bubble meltdown would "become systemic." But they knew what the potential danger was, as Ackerman observed. And they understood the warnings from LaRouche and his colleagues. It was not that they didn't know what was occurring, but that they didn't *want* to know what their real responsibilities were: They were paralyzed by a combination of political cowardice, and an attachment to the hedge fund/private equity fund gang represented by "Democrat" Felix Rohatyn and "Republican" George Shultz.

In late February, a LaRouche memo for circulation and discussion with elected officials, "A Yen for Disaster," said: "The hedge funds' derivatives markets are moving toward an historic blowout—the banks are reporting this warning to each other; and financial writers are pointing to the mortgage-based credit derivatives market, which has suddenly soared to as much as $27 trillion, from nothing in 2002. Economic reports on the U.S. economy in January showed that the underlying U.S. mortgage-bubble meltdown accelerated through the 'floor' the pundits were proclaiming; and industrial production fell, led by a drastic plunge in the auto sector." LaRouche stressed the British/Bank of England role in "steering" this crisis, and that of the hedge funds in stoking the coming explosion of debt and derivatives. Pointing to the yen carry trade and the U. S. mortgage bubble as the "bookends" of the crisis, LaRouche identified the hedge funds as the key problem. They had taken over many functions of the banks, were completely unregulated, and their "mathematics/computer trading strategies" had come to dominate the trading in *all* markets, from mortgage-backed securities (MBS), to commercial loan paper, to currency and commodity speculation, etc.—guaranteeing that they would spread a blow-up in one market, into all the rest.

Tax them; control them; ban them, LaRouche urged.

On March 9, California-based New Century Financial Corp, the second-largest lender of subprime mortgages and one of the U.S. biggest mortgage firms overall, started to collapse with $40-70 billion in subprime mortgages, and the huge HSBC bank reported big losses in MBS. *EIR* published and circulated a warning and explanation from LaRouche, that a "financial disintegration" was under way, which could not be timed precisely, but could collapse the financial system before the end of 2007. "The whole subprime mortgage-backed securities market is turning illiquid," *EIR* reported, "even Fannie Mae, Freddie Mac, and the biggest bank purchasers of these mortgages are becoming unable to re-issue them as securities.... By March 7, the contagion of rapidly rising 'risk premiums' on debt [was] spreading into other debt markets.... This contagion is the 'disintegration' of the financial system that LaRouche points to, as increasing categories of unpayable debt can't be rolled over into new debt securities—and it is not stoppable except by a thoroughgoing bankruptcy reorganization, carried out by leading governments."

Then on March 23, *EIR* published a 10-page cover feature entitled, "How U.S. Mortgage Crisis Can Trigger Global Crash." This detailed analysis showed that the $18-19 trillion U.S. mortgage and MBS bubble, piling on top of previous bubbles blown up by Alan Greenspan's Federal Reserve, had come to account for 49% of all assets in the U.S. banking system. The rate at which that bubble was now collapsing, *EIR* showed, essentially guaranteed a banking system disintegration in the year to come—though not precisely predictable as to the moment of the event—and an explosion of home foreclosures across the country.

Which Side Is Your Congressman On?

This grave situation—and LaRouche's proposed actions to protect the economy, reorganize chartered banks, and create new productive credit for infrastructure to re-

place the collapsing bank credit—were debated in detail in offices throughout the Congress in March and April, by *EIR* correspondents, LaRouche PAC organizers, and LaRouche Youth Movement leaders. Members of Congress knew then, in fact—others should have known—what was coming this Fall.

"The entire financial system is coming down. What no one can determine," LaRouche was quoted in that March 23 feature, "is the rate at which this will happen. But this much is undeniable: It can not be stopped from collapsing under present policies. I could bring this collapse under control. . . . I would act to change the financial system; the existing, collapsing banking system must be put into bankruptcy reorganization, and a new financial system built on initiative from the United States. But so far, I'm not getting the support urgently needed from Congress, including the 2008 candidates for President. If that continues, the entire system is coming down."

Members of Congress are not fools and do know what is happening to homes, jobs, credit markets, and banking systems. What they now face, as LaRouche said on Sept. 7, "is the choice of whether to save the banks and housing, or to go with a grouping which would sacrifice both the banks and the housing, to the hedge funds," which have been liberally funding Presidential candidates and Congressional coffers alike. "So we have a fight: who's on one side, and who's on the other side."

Testimony to Congress

Monetary, Not Tax Reform Needed Now

This testimony of Executive Intelligence Review, *asserting that U.S. policy must "Start With Protecting Homeowners, Banks, and Economy From 'Foreclosure Tsunami,'" was presented on Sept. 6, 2007, to the U.S. House of Representatives Ways and Means Committee Hearing on Fair and Equitable Tax Policy.*

Proposals to require private-equity and hedge-fund managers to pay taxes at the fair rate of other corporate managers and employees, are needed and justified; but the super-profits they would tax, are disappearing in the ongoing credit crisis and "financial disintegration." By far the worst of this credit crisis, and of the mortgage bubble collapse which triggered it, is yet to come.

Thirty-five percent of zero, is no greater tax revenue than 15% of zero. The entire hedge fund sector, at best available estimate, has lost money for the past two months, and is rapidly approaching a losing position for the year to date.

Private-equity funds are a more important problem, having taken control of companies employing many millions of workers. While their profits have not yet disappeared—the Blackstone Group claims that its taxes would increase by $525 million under proposed Senate or House legislation—their leveraged debt financing has. In just one example: The inability of Cerberus Capital Management to finance its takeover of Chrysler, combined with its losses in other, previous auto-sector takeovers, threatens severe consequences for employment and business activity of the whole auto sector, in the midst of national auto contract negotiations.

The "off-shoring" strategies of these funds and other corporations have cost the OECD countries $1.7 trillion, and the United States over $100 billion in annual tax revenue, according to the Tax Justice Network.

The offshore centers have overwhelmingly been shielded by registration under United Kingdom sovereignty fostering unregulated "tax competition."

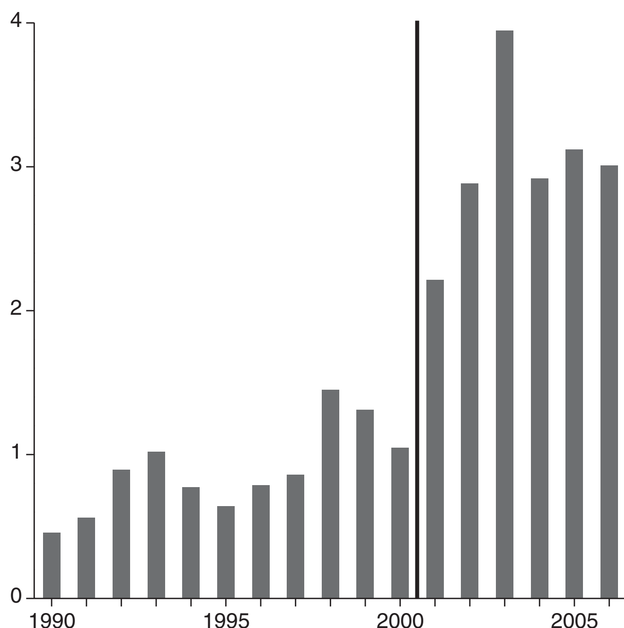
Thus the decision Aug. 30 of the Bankruptcy Court of the Southern District of New York, in the matter of the Bear Stearns hedge funds, is a very important one for Congress. Judge Burton Lifland's decision struck down the Cayman Island monetary authorities' claim of jurisdiction in the liquidation of the Bear Stearns funds, and ruled that the burden of proof is upon anyone claiming foreign registration for a corporation or partnership whose evidence of economic activity is in the United States. This juridical reaffirmation of United States sovereignty over firms and funds claiming offshore registration, is an important basis for Congressional action.

But this action cannot be expected to provide significant new tax revenues in a financial collapse crisis. Congress has to take the kind of action Franklin Roosevelt's Administration took in the worsening banking collapse in 1933: protecting the economy, homeowners, and chartered banks themselves with a "firewall," from the the storm of collapsing mortgage securities; and issuing Federal credit to generate real new economic activity and public works—not to attempt to bail out the mortgage bubble.

Despite many earlier official claims of "containment," the U.S. mortgage bubble meltdown—soon followed by those in the United Kingdom, Spain, Scandinavia, and elsewhere—is a financial disintegration spreading and taking down the entire financial system. Denials cannot change the fact that 49% of the assets of the U.S. banking system are mortgage-based, more than 30% of them based on the collapsing residential

Annual U.S. Single-Family Home New Mortgage Loan Originations

($ Trillions)



Sources: Office of Federal Housing Enterprise Oversight (Ofheo); *EIR*.

mortgage bubble, according to Federal Reserve data; and the entire banking system is threatened. The timing of this collapse cannot be precisely predicted, but its impact on the real, underlying economy is global, and cannot be stopped without urgent steps to reorganize and protect the banking system, and reform the monetary system.

These should begin immediately with Congressional action to protect millions of American homeowners from the mass foreclosure wave under way, and to protect Federal and state-chartered banks from failure as a result. The principles of a "Homeowners and Bank Protection Act of 2007" are below.

This Committee and Congress face the tax-revenue consequences which will now follow: from the wipeout of value of "structured" debt instruments, which have become the basis of most activity of the financial services sector; from the continued decline in home values and assessments which are the basis of county and local taxes; from the losses of firms throughout the consumer industries; from the sharp drop which began in July in flows in foreign net investment into the United States, and so on. Shortfalls are already appearing in the Fiscal 2008 budgets and Fiscal 2009 plans of states around the country.

The Congress's planning for increased tax revenue from increased real economic activity, must turn to Federally issued credit to expand that activity in new infrastructure and industry, to raise productivity, and to replace with real economic value, large volumes of financial "value" which are disappearing in the collapse of mortgage and related bubbles.

A 'Firewall' for the Economy Against Mortgage Bubble Collapse

Three million or more American households are being foreclosed or are threatened with foreclosure in the near future, due to highly inflated home prices, unsustainable and unamortized mortgages, and escalating real estate taxes during the speculative mortgage bubble of recent years. Over 800,000 homes are likely to be lost to foreclosure in 2007, after 625,000 were lost in 2006. There are 9-10 million subprime/ARM mortgages outstanding; even before this spreading credit crisis hit, 20% of subprime/ARM mortgages were winding up in final foreclosure within four years. Now, there are nearly 3 million ARM mortgages due to "reset" to higher rates and higher payments between September 2007 and March 2009, the bulk of them by May 2008. There are already an estimated 4 million residential properties whose owners owe more debt on their mortgages, than they have equity at the property's current market value; and average home prices are falling. State mortgage "refinancing"/bailout plans such as that of Ohio, have admittedly failed to work; the falling market, with growing margins of negative equity, have made these plans fail. These facts make a wave of millions more homes lost to foreclosure a certainty, unless Congress acts to stop it.

The General Welfare of the United States and its citizens requires that the nation's households be protected from this growing wave of foreclosures, which must be stopped by securing them in new mortgage titles at fixed and lower interest, and at uninflated, sound home values. Mortgage borrowers paying equivalent rent can be a transitional situation, while these new mortgages are being worked out. This requires a Federal agency capitalized by long-term bonds to insure and, where necessary, to extend these mortgages. (See Appendix A.)

The speculative securities and loans derived from these overinflated mortgages have flooded the bank asset books of the world, making these banks unsound in the rapid deflation and collapse of this mortgage bubble, and threatening the international financial system with collapse.

The General Welfare and economic recovery also require the sound operation of local and regional banks all over the country, including operations dedicated to origination of sound, fully amortized home mortgages. Congressional intervention to halt the mass foreclosures should also protect Federal and state-chartered banks from liquidation as a result of the collapse in value of inflated mortgage instruments. Con-

gress should prevent a repeat of the widespread liquidation and wholesale disappearance of Savings and Loan banks by Federal intervention in the credit crisis of the 1987-89 period. (See Appendix B.)

Principles of the Homeowners And Bank Protection Act of 2007

1. Congress must establish a Federal agency to place the Federal and state chartered banks under protection, freezing all existing home mortgages for a period of however many months or years are required to adjust the values to fair prices, restructure existing mortgages at appropriate interest rates, and write off all of the cancerous speculative debt obligations of mortgage-backed securities, derivatives, and other forms of Ponzi schemes that have brought the banking system to the point of bankruptcy.

2. During this transitional period, all foreclosures must be frozen, allowing American families to retain their homes. Monthly payments, the effective equivalent of rental payments, shall be made to designated banks, which can then use the funds as collateral for normal lending practices, thus recapitalizing the banking system. Ultimately, these affordable monthly payments will be factored into new mortgages, reflecting the deflation of the housing bubble, and the establishment of appropriate property valuations and reduced fixed mortgage interest rates.

It is to be expected that this process of shakeout of the housing market will take several years to achieve. In this interim period, no homeowner shall be evicted from his or her property, and the Federal- and state-chartered banks shall be protected, so that they can resume the traditional functions, serving local communities, and facilitating credit for investment in productive industries, agriculture, infrastructure, and so on.

3. State governors shall assume the administrative responsibilities for implementing the program, including the "rental" assessments to designated banks, with the Federal government providing the necessary credits and guarantees to assure the successful transition.

From September-October, unless this legislation is enacted as a first order of business of the 110th Congress in September, many millions more Americans will be evicted from their homes, setting off a process of social chaos that must be avoided. The freezing of foreclosures is the vital first step in a thorough reorganization.

Under this plan, the Federal Reserve System will itself be put through bankruptcy reorganization, and transformed into a Third National Bank of the United States. As developed in Lyndon LaRouche's just-released draft platform for the Democratic Party, these actions shall be complemented by the creation, by treaty agreement among leading nation-states, of a new Bretton Woods System, based on fixed exchange rates, and long-term treaty agreements for large-scale development projects on a global scale. (See Appendix C.)

Appendix A

Franklin D. Roosevelt

The President's Message to Congress on Small Home Mortgage Foreclosures, April 13, 1933:

To the Congress:

As a further and urgently necessary step in the program to promote economic recovery, I ask the Congress for legislation to protect small home owners from foreclosure and to relieve them of a portion of the burden of excessive interest and principal payments incurred during the period of higher values and higher earning power.

Implicit in the legislation which I am suggesting to you is a declaration of national policy. This policy is that the broad interests of the Nation require that special safeguards should be thrown around home ownership as a guarantee of social and economic stability, and that to protect home owners from inequitable enforced liquidation in a time of general distress is a proper concern of the Government.

The legislation I propose follows the general lines of the farm mortgage refinancing bill. The terms are such as to impose the least possible charge upon the National Treasury consistent with the objects sought. It provides machinery through which existing mortgage debts on small homes may be adjusted to a sound basis of values without injustice to investors, at substantially lower interest rates and with provision for postponing both interest and principal payments in cases of extreme need. The resources to be made available through a bond issue to be guaranteed as to interest only by the Treasury, will, it is thought, be sufficient to meet the needs of those to whom other methods of financing are not available. At the same time the plan of settlement will provide a standard which should put an end to present uncertain and chaotic conditions that create fear and despair among both home owners and investors.

Legislation of this character is a subject that demands our most earnest, thoughtful and prompt consideration.

Appendix B

Former Rep. James Wright

Former Speaker of the House "Jim Wright Was Right," wrote Harley Schlanger in EIR*, Sept. 7, 2007, referring to the protection of savings banks in the 1980s foreclosures crisis. Here are some of the main points:*

"Understanding and forbearance from regulators" on foreclo-

sures, and against shutting down local troubled banks, was House Majority Leader James Wright's approach to the 1986-89 foreclosures crisis triggered by the collapse of traditional Savings and Loan mortgage lending. Wright, a Texas Democrat, was hounded out of Congress in 1989 by scandals pushed by Rep. Newt Gingrich (R-Ga.), and charged with "cronyism and corruption" for defending Texas banks from seizure and shutdown.

From 1986-88, the foreclosures crisis in the Southwest, driven by Federal regulators taking over troubled Savings and Loans and pushing them to foreclosure on delinquent borrowers, was evicting 30-40,000 households a year in Texas alone. Deregulation of banking had damaged the S&L "thrifts." The S&Ls with their traditional 6% fixed-rate mortgages had been squeezed out, in the high-interest-rate 1980s, by money-market funds and other unregulated funds paying 6-7% to investors and selling the first ARM mortgages, that quickly reset to 8-9% or more.

Blackstone Group managing partner Lawrence Fink declared in 1987, "It would appear that the thrifts have outlived their usefulness." Major commercial banks and investment groups like Blackstone bought up S&Ls and local commercial banks to get their deposits, and direct those deposits into commercial real estate deals, foreign investments, corporate takeovers—anything but the steady local mortgage and business lending those banks had done since the New Deal. The Federal Home Loan Bank Board and FDIC seized 225 Texas S&Ls in less than a year, forcing mass foreclosures of their mortgage borrowers and causing the price of home real estate to plunge—and then losing 200% more money on those banks than the banks had been losing before the seizures.

Wright responded to constituents, and in January 1988, said, "It's a natural instinct to want to salvage something rather than see it torn down and destroyed, to protect citizens from unreasonable exercise of power by appointed agents of government." He warned, "I believe I can see a conscious government policy to concentrate wealth in fewer and fewer hands."

Speaking in Houston the following month, Wright said, "What we are seeking is some understanding and forbearance from regulators. Don't be so premeditated that you encourage lending institutions to adopt arbitrary policies that force homeowners to vacate their homes. "People who want to earn their own way should not be forced into bankruptcy."

And on May 5, 1989, Wright spoke about where credit needed to go: "We need to rebuild America and rehabilitate its basic public infrastructure. We need to invest in the modernization of American industry and the education of the skilled American workforce. We need to push forward and stay ahead of the curve in the application of new research and new technology to our nation's commercial advantage."

But during the 1990s, nearly all of the remaining S&Ls disappeared, absorbed into regional or money-center commercial banks, brokerages, and other financial institutions, or liquidated.

The United States thus lacking any class of *dedicated mortgage-lending banks,* mortgage lending in the 2000-2007 mortgage super-bubble (now collapsing), was carried out not by banks, but by largely unregulated "mortgage lenders" through completely unregulated mortgage brokers.

Appendix C

Lyndon H. LaRouche, Jr.

LaRouche replied on Aug. 27, to a question from Giorgio Vitangeli, director of Finanza Italiana *magazine in Rome:*

"The needed action of reform must begin immediately during the rapidly unfolding weeks of September and October. . . . We are already witnessing the rapidly rising storm presently hitting the mortgage-based securities system and the banking system, that with inevitable global, early, chain-reaction effects hitting all nations, world-wide. . . .

"As I indicated in my international LPAC webcast of July 25, 2007, where I announced the actual opening of the breakdown-phase of the worldwide monetary system, the new global crisis is already under way. That international crisis is a general breakdown-crisis of the present world monetary-financial system, but *not necessarily* an economic breakdown-crisis. The physical economy can be saved, if appropriate reforms are made in time; the planet's present, "floating exchange-rate" monetary-financial system can not be saved.

"The crisis will proceed in successive phases. We have entered the first phase, which is typified by the collapse of a global real-estate bubble on which the entire current monetary-financial system hangs today. The most immediate of these challenges, is being presented at this time.

"The U.S.A. and other governments must now react to the need for an immediate placing of home mortgages and chartered banks of the U.S. under bankruptcy protection by law. This measure is the indispensable lawful protection needed to prevent an uncontrollable, chain-reaction, hyper-inflationary collapse of the present world monetary-financial system as a whole. . . .

"This emergency reform is indispensable. Without it, other reforms needed could not be implemented successfully.

"We must return immediately, to a virtual reestablishment of a global, fixed-exchange-rate mode of the Bretton Woods system of international and national credit. . . .

"The general reform of the world's monetary-financial system must be premised on an underlying physical-economic commitment, expressed in chiefly long-term capital investments in capital-intensive modes, and in a global climate of a simple underlying interest-rate for long-term lending of 1-2%. At least half of the investment would be in long-term modern infrastructure, and the remainder in agriculture and industry. The combination of the elements of this program will represent an investment cycle of about fifty years maturity of new obligations generated."