Bailing out the Fraudsters instead of Saving America's Economic Base

Is the Economy as Broke as Lehman Was? The Angelides Committee Sidesteps the Mortgage Fraud Issue

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What is the difference between today's economy and Lehman Brothers just before it collapsed in September 2008? Should Lehman, the economy, Wall Street – or none of the above – be bailed out of bad mortgage debt? How did the Fed and Treasury decide which Wall Street firms to save – and how do they decide whether or not to save U.S. companies, personal mortgage debtors, states and cities from bankruptcy and insolvency today? Why did it start by saving the richest financial institutions, leaving the "real" economy locked in debt deflation?

Stated another way, why was Lehman the only Wall Street firm permitted to go under? How does the logic that Washington used in its case compare to how it is treating the economy at large? Why bail out Wall Street – whose managers are rich enough not to need to spend their gains – and not the quarter of U.S. homeowners unfortunate enough also to suffer "negative equity" but not qualify for the help that the officials they elect gave to Wall Street's winners by enabling Bear Stearns, A.I.G., Countrywide Financial and other gamblers to pay their bad debts?

There was disagreement last Wednesday at the Financial Crisis Inquiry Commission hearings now plodding along through its post mortem on the causes of Wall Street's autumn 2008 collapse and ensuing bailout. Federal Reserve economists argue that the economy – and Wall Street firms apart from Lehman – merely had a liquidity problem, a temporary failure to find buyers for its junk mortgages. By contrast, Lehman had a more deep-seated "balance sheet" problem: negative equity. A taxpayer bailout would have been an utter waste, not recoverable.

Only a "liquidity problem," or a balance sheet problem of negative equity?

Lehman CEO Dick Fuld is bitter. He claims that Lehman was unfairly singled out. After all, the Fed lent $29 billion to help JPMorgan Chase buy out Bear Stearns the preceding spring. In the wake of Lehman's failure it seemed to gain the courage to say, "Never again," and avoided new collapses by bailing out A.I.G. – saving all its counterparties from having to take a loss.

Was this not a giveaway? Mr. Fuld implied. Why couldn't the Fed and Treasury do for Lehman what they did with other Wall Street investment firms and stock brokers: let it reclassify itself as a bank so it could pawn off its junk mortgages at the Fed's discount window for 100 cents on the dollar, sticking taxpayers with the loss? (And by the way, will these firms ever be asked to buy back these mortgages at the price they borrowed against from the government? Or will they be allowed to walk away from their debts in a Wall Street version of "jingle mail"?)

This is the soap opera that Americans should be watching, if only it weren't conducted in the foreign language of jargon and euphemism. At issue is whether Lehman's crisis was merely a temporary "liquidity problem," that time would have cleaned up much like BP's oil spill in the Gulf; or, did the firm suffer a more deep-seated "balance sheet problem" (negative equity), as Federal Reserve Chairman Ben Bernanke claims – a junk balance sheet, composed of assets that not only had no buyers at the time, but had no visible likelihood of recovering their market price even after the $13 trillion the Treasury and Federal Reserve have spent to bail out Wall Street.

Insisting that Lehman should have shared in Washington's $13 trillion giveaway, Mr. Fuld testified that his firm was just as savable as Countrywide or A.I.G. – or Fannie Mae for that matter. Lehman was perversely singled out, he claims. Was it not indeed as savable as the Fed and Treasury claim the U.S. real estate sector is? Like over-mortgaged homeowners, all it needed was enough time to finish selling off its portfolio, given enough loan support to tide it over.

The problem, of course, is that the securities that Lehman hoped to pawn off were fraudulent junk. American homeowners are victims, not crooks. Wall Street bailed out crooks at Countrywide and its cohorts. The credit-rating agency Fitch has found financial fraud in every mortgage package it has examined. And these are the packages that have made Wall Street rich and powerful enough to gain Washington bailouts to establish them as a new ruling class, bailouts to use for buying up Washington politicians and lawmakers, and for buying out the popular press to tell people how necessary Wall Street financial practice is to "support" the economy and "create wealth."

Could any other daytime telecast have a more typecast villain than Mr. Fuld? A novelist would be hard-put to better personify greed, arrogantly playing bridge with his boss while Lehman burned. Yet his testimony has a certain logic. If the negative equity suffered by a quarter of U.S. homeowners can be saved, as the Fed claims it can, where should the line be drawn?

Or to put this question the other way around, why are ten million American homeowners being treated like Lehman, if the Fed believes that they are as savable as Countrywide and A.I.G.?

Huge sums are at stake, because the bailout has left little for Social Security, and nothing to bail out the insolvent states and cities, or for more stimuli to pull the national economy out of depression.

Most relevant in Mr. Fuld's self-pitying defense before the Angelides Committee is not what he said about his own firm, but his accusation that the Fed and Treasury rescued the rest of Wall Street. Weren't other firms just as bad? Why was Lehman singled out?

The Fed's witnesses gave a devastating reply. They drew a clear distinction between a temporary "liquidity problem" and outright negative net worth – the "balance-sheet problem" of insufficient assets to cover one's debts. Lehman was so badly managed, the Fed claimed – so reckless and arrogant in its belief that it could cheat its customers by selling junk at a huge markup – that it could not have been rescued except by an outright taxpayer giveaway. As the Fed's Chief Counsel, Scott Alvarez, put matters: "I think that if the Federal Reserve had lent to Lehman … in the way that some people think without adequate collateral … this hearing and all other hearings would have only been about how we had wasted the taxpayers' money – and I don't expect we would have been repaid." Like downtown Los Angeles, there was no "there" there.

Included in the hearings' evidence is an exasperated e-mail sent by Treasury Secretary Hank Paulson's chief of staff, Jim Wilkinson, on Sept. 9, 2008: "I just can't stomach us bailing out lehman. Will be horrible in the press." Five days later, on Sept. 14, he added that unless a private buyer could be found (e.g., as JPMorgan Chase stepped forward to buy Bear Stearns), "No way govt money is coming in … also just did a call with the WH [White House] and usg [U.S. Government] is united behind no money … I think we are headed for winddown."[1]

Lehman's problem was not just temporary illiquidity. It had a fatal balance-sheet problem: Its assets were not worth anywhere near what it owed. So with poetic justice, it was in the same position as the subprime borrowers whose junk mortgages it had underwritten and sold to investors gullible enough to believe Moody's and Standard and Poor's AAA ratings. This fraudulent junk was supposed to be as safe as a U.S. Treasury bond. But it turned out to be only as safe as Social Security and state pension promises are in today's "Big fish eat little fish" world.

Yet Mr. Fuld is correct in pointing out that not only Bear Stearns and A.I.G., but also Morgan Stanley and Goldman Sachs would have failed without state support. So the question remains: Why bail out these firms (and their counterparties!) but not Lehman?

This is too narrow a scope to pose the proper question. What needs to be discussed is the result of Washington arranging for Wall Street to repay its TARP, A.I.G. and other bailout money – including that of Fannie Mae and Freddie Mac – by "earning its way out of debt" at the "real" economy's expense. Why has Washington refused to write down the bad debts of homeowners, states and cities, and companies facing bankruptcy unless they annul their pension promises to their employees? Why is Washington is treating the American economy like it treated Lehman and telling it to "Drop dead"?

The explanation is that a double standard exists. The wealthy get bailed out – the creditors, not the debtors. And even the fraudsters, not their victims.

Sidestepping the Fraud Issue: Bailing out fraudsters instead of saving America's economic base

Recent federal bankruptcy proceedings have exposed Lehman's deceptive off-balance-sheet accounting gimmicks such as Repo 105 to conceal its true position. No fraud charges have yet been levied, but this is the invisible elephant in the Washington committee rooms. "Everyone was doing it," so that makes it legal – or what is the same thing these days, non-prosecutable in practice. To prosecute would be to disrupt the financial system – and it is Fed doctrine that the economy cannot survive without a financial system enabled to "earn its way out of debt" by raking off the needed wealth from the rest of the economy?

So the Fed, the Treasury and the Justice Department have merely taken the timid baby step of pointing out that Lehman suffered from such bad management that no firm was willing to buy it out. Barclay's was interested, but Mr. Fuld was so greedy that he found its offer not rich enough for his taste. So he ended up with nothing. It is a classic morality tale. But evidently not fraud.

The fraud issue lies as far outside the scope of the financial committee meetings as does the question of how the economy should cope with its unpayably high mortgage, state and local debts in the face of its inadequately funded pension obligations. Fed Chairman Bernanke testified on Thursday, Sept. 2, that "the market" itself breeds what most people would call fraud. Widening the market for home ownership necessarily involves lowering loan standards, he explained. But as the Lehman failure illustrates, where should we draw the line between "illiquidity" and insolvency on the one hand, and higher risk and outright fraud?

The Fed argues that the economy cannot recover without a solvent financial system. But what about that large part of the financial system based on fraud? Would the economy fall apart without it – without mortgage fraud, without deceptive packaging of junk mortgages, and for that matter without computerized gambling on derivatives? What of the credit-ratings agencies whose AAA writings were as much up for sale as the conscience and honesty of politicians on the Senate and House Banking Committees? Do we really need them?

And does the economy need more credit (that is, debt)? Or does it need jobs? Does it need to un-tax the banks and give tax-favoritism to Wall Street ("capital gains" tax rates) to enable it to earn its way out of debt at the expense of the production-and-consumption economy?

The question that Washington financial committees should be asking (and economics textbooks should be posing) is whether wider home ownership is really dependent on easier and looser lending standards. After all, the effect of easy credit is to enable borrowers to bid up housing prices. Is this really how to make the U.S. economy more competitive – given the fact that industrial labor now typically pays 40% of its wage income for housing?

Or, does the Fed's easy-money policy deregulation of oversight open the way for asset-price inflation that puts home ownership even further out of reach – except at the price of running up a lifetime of debt to the banks that write the loans on their keyboard at steep markups over their cost of funding from the compliant Fed?

Qui bono? Who is to benefit from the Fed's easy money policy – consumers and homeowners, or Wall Street? This is the broad issue that should be discussed. What would have happened without the bailout? (Remember, Republican Congressmen opposed it – before that fatal Friday when Maverick John McCain rushed back to Washington and said he would not debate Mr. Obama that evening unless Congress approved the bailout of is Wall Street backers.) What if debtors had been bailed out by a write-down of bad debts, instead of the lenders who had made bad loans and the large institutions that bought them?

The bailout has saddled taxpayers not only with $13 trillion that now must be sacrificed by the economy at large (but not by Wall Street), but with the cost of a decade-long depression resulting from keeping the bad debt on the books. This is what rightly should be deemed criminal.

Defenders of Wall Street insist that there was no alternative. And the committee hearings are carefully only listening to such people, because these are very respectable hearings. They are writing mythology, almost as if they are crafting a new religion. In this new ethic, Wall Street financial institutions – "credit creators," that is, debt creators – are supposed to fund industry, not strip assets or make bad loans. Without rich people, who would "create jobs"? Such is the self-serving logic of Wall Street. For them, Wall Street is the economy. The wealth of a nation is worth whatever banks will lend, by collateralizing the economic surplus for debt service.

What the Angelides Commission really should focus on is whether this is true or false. That would make it a soap opera worth watching. The Fed so far has stonewalled attempts to discover just who was bailed out in autumn 2008? But most important of all is, what dynamic was bailed out? What class of people?

The answer would seem to be, financial firms employing and serving the nation's wealthiest 1%? Any and all fraudsters among their ranks? (There has not been a single prosecution, as Bill Black reminds us.) Or the remaining 99% of the population – their bank deposits and indeed, their jobs themselves?

Academic textbooks pretend that the economy is all about production and consumption – factories producing the things their workers buy. The distribution of wealth does not appear, nor is it regularly tracked in statistics. But in Washington and at the hearings, the economy seems to be all about lending and debt, all about balance sheets.

I believe that the beneficiaries were fraudsters, and that the system cannot be saved. Trying to save it by keeping the debts in place – and letting Wall Street banks "work their way out of debt" at the U.S. economy's expense – threatens to lock the economy in a chronic debt deflation and depression.

At issue is the concept of capital. Does money that is made by short-term, computer-driven financial trades qualify as "capital formation" and hence deserving of tax breaks? Are the billions of dollars of "earnings" reported by Wall Street speculators to be taxed at the low 15% "capital gains" rate? That is only a fraction of the income-tax rate that most workers pay – on top of which is piled the 11% FICA wage withholding for Social Security and Medicare that all workers have to pay on their salaries up to the cut-off point of about $102,000. (This cut-off frees from this tax the tens of millions of dollars that hedge fund traders pay themselves.) Or should these trading gains – a zero-sum activity where one party's gain is, by definition, another's loss (usually one's customers) – be taxed more highly than poverty-level income of workers?

A short while ago the Blackstone hedge fund's co-founder, Stephen Schwarzman, characterized the attempt to tax short-term arbitrage trading gains at the same rate that wage-earners pay as analogous to Adolph Hitler's invasion of Poland in 1939. It is a class war against fraudsters and criminals – an unfair war as serious as World War II. In Mr. Schwarzman's inspired vision the Democrats are re-enacting the role of Adolph Hitler by mounting a fiscal blitzkrieg to force billionaires to pay as high a tax rate as workers. Are not Wall Street firms doing "God's work," after all, as Goldman Sachs chairman Lloyd Blankfein, put it last fall? And if they are, then are not those who would tax or criticize Wall Street "God-killers"?

If religion can be turned on its head like this – where the Invisible Hand of Wall Street (invisible to the Justice Department, at least) is elevated to a faux-Deist moral philosophy –

is it any surprise that economic orthodoxy and formerly progressive tax policy is succumbing? The rentiers are fighting back – against the Enlightenment, against Progressive Era tax policy, and against hopes for U.S. economic recovery. Given today's florid emotionalism when it comes to discussing Wall Street finances, it hardly is surprising that the Angelides hearings do not dare venture into such territory as to ask whether the bottom 90% of the U.S. economy might need to be bailed out with debt relief just as Wall Street's elites were.

On September 2, Fed Chairman Bernanke tried to put the financial flow of funds that led up to the crisis in perspective. In his testimony before the Financial Crisis Inquiry Commission he described a self-feeding process that actually started with the U.S. balance-of-payments deficit that made foreigners so flush with dollars. They understandably wanted yields higher than the Treasury was paying, as the Fed was flooding the economy with credit to keep asset prices afloat to save the banks from having to take loan write-downs and admit that debt creation was not really the same thing as Alan Greenspan euphemized in calling it "wealth creation." So foreign financial institutions became a large but overly trusting market for packaged junk mortgages.

"The market made us do it."

' When asked just who was pushing the great explosion of mortgage lending, Mr. Bernanke pointed to the mortgage packagers – Wall Street profiting from the commissions and rake-offs it was making by pretending that the loans were not bad. However, he reminded his audience, there also had to be popular demand for housing. People were panicked. They worried that if they did not buy a home back in 2005, they could not afford to buy in the future. And they were cajoled with financial televangelists assuring them that they would always enjoy the option of selling at a profit. But Mr. Bernanke said nothing about fraud in all this. To widen the market for home ownership, banks had to write more mortgages, and this required lowering their standards.

So they did it all for us, for "the people" – and the backers of Fannie Mae and Freddy Mac who egged them on.

Where does "lowering loan standards" turn into outright fraud? Has that simply become part of "the market"? This is what the commission seems to fear to address. But it is getting late – already we are in September, and the report is scheduled for December. So is this really going to be "it"? This would be like a soap opera ending in the middle of the desert, with the main protagonists stranded. This seems to be where the Commission is leaving the U.S. economy as it waits for the recommendations of the Joint Commission to Roll Back Social Security, or whatever the name of Mr. Obama's Republicanized Democratic commission is more formally called. The result is more like the cliffhanger of a serial, leaving the viewer to try and imagine how the protagonist – in this case, the economy – will ever manage to be saved.

Note

[1] Tom Braithwaite, "Fuld criticises Fed for letting Lehman fail," Financial Times, September 2, 2010, and John D. McKinnon and Victoria McGrane, "Clashing Testimony Over Lehman Bankruptcy," Wall Street Journal, Sept. 2, 2010.

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