Bailout Bedlam: Robbing the Taxpayers to Save the Banks

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"Doesn't this seem like lunacy to you? The consequences of it are unbelievably bad in terms of public intrusion into the private sector. Is anybody thinking there? It's too late, it's not going to make any difference, and it's aggravating as hell when there's a better idea and you can't even get it in play." Former Treasury Secretary John O'Neill in an October 1 interview with Bloomberg on the bank bailout plan

The bank bailout bill that just passed the Senate and is being deliberated in the House would turn the banks' worst assets into good U.S. dollars. How many dollars? The figure was $700 billion a few days ago and has already climbed to $800 billion after the pork was added in. That's nearly the cost of two Iraq wars, but it still won't be enough, because the covered instruments eligible for conversion include the black hole of derivatives. Derivatives held by U.S. banks are now estimated at *$180 trillion*. How will the Treasury acquire the dollars to buy all these disastrously bad bank assets? The taxpayers are all taxed up and don't have $800 billion to spare. The money will no doubt come from an issue of U.S. securities, or debt; but who will lend to a nation that already has the highest federal debt in the world, one that is growing exponentially? The likely answer is the Federal Reserve, the bankers' bank that acts as "lender of last resort" when there are no other takers. The Federal Reserve is a private banking corporation owned by its member banks. The Fed returns the interest on the bonds it "monetizes" to the government, but only after deducting its operating costs and a 6% guaranteed return for each of its many bank shareholders.[1] The upshot is that we the people will be paying interest to the banks to bail out the banks from their own follies!

Why the Rush?

There must be a better way to unfreeze the credit system; but as former Treasury Secretary O'Neill observes, no other alternatives are on the table. Treasury Secretary Hank Paulson's plan has been rushed through in a matter of days. Why the rush to push through a plan that could bankrupt the nation, without formal deliberations on the alternatives? Treasury Secretary Hank Paulson wanted a deal by last weekend. It didn't happen, but the pressure has been on ever since.

Evidently the date the banks were trying to beat was Tuesday, September 30, the reporting day when they were required to reveal their "Tier 1" capital adequacy. To be adequately capitalized under federal bank regulations, a bank must have Tier 1 capital equal to at least 4% of its "risk-weighted assets." "Assets" are things that produce cash flow, including loans and derivatives that actually represent liabilities of the bank – money the bank would have to come up with if the borrower did not pay, or the derivative bet were lost, or the other party to the derivative bet did not pay. Capital requirements vary depending on the "risk" of these assets. Tier 1 or "core" capital consists of shareholders' equity (the amount originally paid to purchase the bank's stock), plus retained profits, less accumulated losses. Since losses to the banks of late have been substantial, many banks could have trouble meeting the Tier 1 capital adequacy requirement. That means they would not be able to make new loans, which explains all the talk of a "credit freeze." Indeed, on September 30, available credit was reduced to a trickle, with the London Interbank Offered Rate or LIBOR (the interest rate banks charge to lend to each other) rising sharply.

The collapse of the financial system has been blamed on the subprime crisis, but mortgage defaults are just the domino that triggered the fall. The real problem is the "d" word – something you don't hear much mention of in the major media, the derivative Ponzi scheme. Derivatives got a bad name with the Long Term Capital Management fiasco. Derivatives are basically just bets, which vacuum up value without producing anything. The imploding derivatives bubble is a giant black hole that could suck all the productive assets of the nation into banking coffers.

Borrowing from the Banks to Bail Out the Banks?

Paulson's solution is to fill the derivative black hole with federal money; but as just noted, the funds aren't likely to come from taxes or from loans from foreign central banks. The likely source is the Federal Reserve; and normally, the Fed gets its money just by printing it (or by creating it with accounting entries). In this case, however, something else may be in the works. The Fed's new "Term Securities Lending Facility" (TSLF) does not involve the usual "open market operations", in which the Fed prints green pieces of paper called Federal Reserve notes and swaps them for pink pieces of paper called bonds (government I.O.U.s). Rather, the TSLF works like this: the Treasury prints bonds and delivers them to the Federal Reserve, which then trades them with distressed banks for their unmarketable derivative paper. According to Wikipedia, which translates Fedspeak into somewhat clearer terms than the Fed's own website:

"The Term Securities Lending Facility is a 28-day facility that will offer Treasury general collateral to the Federal Reserve Bank of New York's primary dealers in exchange for other program-eligible collateral. It is intended to promote liquidity in the financing markets for Treasury and other collateral and thus to foster the functioning of financial markets more generally. . . . *The resource allows dealers to switch debt that is less liquid for U.S. government securities that are easily tradable*."

To "switch debt that is less liquid for U.S. government securities that are easily tradable" means that the government gets the banks' toxic derivative debt, and the banks get the government's triple-A securities. This improves the banks' capital position because U.S. securities are considered "risk-free" for purposes of calculating the banks' "risk-weighted assets." Risk-laden derivatives are traded for risk-free U.S. securities, reducing the capital the banks must have in reserve in order to make new loans.[2]

The beauty of this scheme is that no lender has to be found to underwrite the newly-issued

U.S. securities. Federal I.O.U.s are just issued by the Treasury and traded with the banks for their unmarketable derivative debt. The "lenders" holding the government's I.O.U.s are the distressed banks themselves! But the taxpayers have to pay interest on these securities. *The taxpayers are in the anomalous position of paying interest to the banks for the privilege of providing the funds to bail out the banks*.

Here are some more references throwing light on what is going on. On September 18, the Associated Press reported:

"The Treasury Department, *for the first time in its history*, said it would begin selling bonds for the Federal Reserve in an effort to help the central bank deal with its unprecedented borrowing needs. Treasury officials said the action did not mean that the Fed was running short of cash, but simply was a way for the government to better manage its financing needs."3

For the first time in history, instead of the government borrowing from the Fed, the Fed is borrowing from the government! Yahoo Finance reported on September 17:

"The Treasury is setting up a temporary financing program at the Fed's request. The program will auction Treasury bills to raise cash for the Fed's use. The initiative aims to help the Fed manage its balance sheet following its efforts to enhance its liquidity facilities over the previous few quarters."

Treasury bills are the I.O.U.s of the federal government, and they obviously add to the federal debt. The federal debt hasn't been paid off since the days of Andrew Jackson, but the interest is always paid; and today the interest comes to nearly half a trillion dollars annually. The taxpayers are now on the hook for the Fed's "enhanced liquidity facilities" as well, meaning the billions in loans that the Fed has been and will be making to an unprecedented range of financial institutions, exercising obscure provisions in the Federal Reserve Act. We the taxpayers are paying interest to the Fed so that the Fed can use taxpayer money to bail out its banking cronies from their gambling ventures. At the very least, doesn't it seem that the Fed and the banks should be paying interest to *us* for the privilege of drawing on the national credit card?

A Better Way

Not only does Paulson's bailout plan reward the guilty at the expense of the taxpayers, but it is not an efficient way to recapitalize the banking system. As William Engdahl observes in a September 30 article, citing economist Nouriel Roubini for authority:

"[I]n almost every case of recent banking crises in which emergency action was needed to save the financial system, the most economical (to taxpayers) method was to have the Government, as in Sweden or Finland in the early 1990's, nationalize the troubled banks, take over their management and assets, and inject public capital to recapitalize the banks to allow them to continue doing business, lending to normal clients. In the Swedish case, the Government held the assets, mostly real estate, for several years until the economy again improved at which point they could sell them onto the market and the banks could gradually buy the state ownership shares back into private hands. In the Swedish case the end cost to taxpayers was estimated to have been almost nil. The state never did as Paulson proposed, to buy the toxic waste of the banks, leaving them to get off free from their follies of securitization and speculation abuses."

To "inject public capital" means to issue the currency and credit of the nation itself. A sovereign government does not need to borrow from private banks that create the money as it is lent (the "fractional reserve" lending scheme prevalent today). Bankrupt banks can and should be left to those same free market forces they have been so eager to defend until now. Let them go bankrupt, impose a receiver and nationalize them. If a series of banks was to be nationalized, these truly "national" banks could issue the "full faith and credit of the United States" directly, without having to borrow the money first. That idea is not new. It was the solution extolled by Benjamin Franklin, advocated by Thomas Jefferson, and implemented by Abraham Lincoln. Jefferson wrote in an 1802 letter:

"If the American people ever allow private banks to control the issue of their currency, first by inflation, then by deflation, the banks and corporations that will grow up around them will deprive the people of all property until their children wake up homeless on the continent their fathers conquered. *The issuing power should be taken from the banks and restored to the people, to whom it properly belongs*."

Ellen Brown, J.D., developed her research skills as an attorney practicing civil litigation in Los Angeles. In *Web of Debt*, her latest book, she turns those skills to an analysis of the Federal Reserve and "the money trust." She shows how this private cartel has usurped the power to create money from the people themselves, and how we the people can get it back. Her eleven books include the bestselling *Nature's Pharmacy*, co-authored with Dr. Lynne Walker, and *Forbidden Medicine*. Her websites are www.webofdebt.com and www.ellenbrown.com.

NOTES

1 "Frequently Asked Questions: Federal Reserve System," FederalReserve.gov.

2 William Hummel, "Bank Capital Requirements," http://wfhummel.cnchost.com/capitalrequirements.html (December 11, 2002).

3 Ellen Simon, "Fed, Central Banks Move to Boost Global Confidence," Associated Press (September 18, 2008).