Government Says No to Helping States and Main Street, While Continuing to Throw Trillions at the Giant Banks

By Washington's Blog
Global Research, January 14, 2011
Washington's Blog 13 January 2010

Region: USA
Theme: Global Economy

The Wall Street Journal noted last week:

Federal Reserve Chairman Ben Bernanke on Friday ruled out a central bank bailout of state and local governments strapped with big municipal debt burdens, saying the Fed had limited legal authority to help and little will to use that authority.

"We have no expectation or intention to get involved in state and local finance," Mr. Bernanke said in testimony before the Senate Budget Committee. The states, he said later, "should not expect loans from the Fed."

Congress has also discontinued the Build American Bond program, which was significant in temporarily financing California and other states' budgets. See this,this, this and this.

That's unfortunate, given that many states and big cities are in a dire financial situation, and given that Keynesian economists say that aid to the states is one of the best forms of stimulus.

In any event, as Steve Keen points out, giving money to the debtors is much better for stimulating the economy than giving it to the lenders.

Unfortunately, as I will demonstrate below, virtually the entire government economic policy is to throw trillions of dollars at the biggest banks.

Because there are so many rivers and streams of bailout money going to the big banks, I will start with the specifics and end with broader monetary policies.

Tarp: a Preview of Things to Come

The $700 billion dollar TARP bailout was a massive bait-and-switch. The government said it was doing it to soak up toxic assets, and then switched to saying it was needed to free up lending. It didn't do that either. Indeed, the Fed doesn't want the banks to lend.

As I wrote in March 2009:

The bailout money is just going to line the pockets of the wealthy, instead of helping to stabilize the economy or even the companies receiving the bailouts:

Bailout money is being used to subsidize companies run by horrible business men, allowing the bankers to receive fat bonuses, toredecorate their offices, and to buy gold toilets and prostitutes

A lot of the bailout money is going to the failing companies'shareholders

Indeed, a leading progressive economist says that the true purpose of the bank rescue plans is "a massive redistribution of wealth to the bank shareholders and their top executives"

The Treasury Department encouraged banks to use the bailout money to buy their competitors, and pushed through an amendment to the tax laws which rewards mergers in the banking industry (this has caused a lot of companies to bite off more than they can chew, destabilizing the acquiring companies)

And as the New York Times notes, "Tens of billions of [bailout] dollars have merely passed through A.I.G. to its derivatives trading partners".

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In other words, through a little game-playing by the Fed, taxpayer money is going straight into the pockets of investors in AIG's credit default swaps and is not even really stabilizing AIG.

But the TARP bailout is peanuts compared to the numerous other bailouts the government has given to the giant banks.

And I'm not referring to the $23 trillion in bailouts, loans, guarantees and other publicy-disclosed programs that the special inspector general for the TARP program mentions. I'm talking about more covert types of bailouts.

Like what?

Mortgages and Housing

Most independent experts say that the government's housing programs have been a failure. That's too bad, given that the housing slump is now – according to Zillow's –worse than in the Great Depression.

Indeed, PhD economists John Hussman and Dean Baker, fund manager and financial writer Barry Ritholtz and New York Times' writer Gretchen Morgenson say that the only reason the government keeps giving billions to Fannie and Freddie is that it is really a huge, ongoing, back-door bailout of the big banks.

Many also accuse Obama's foreclosure relief programs as being backdoor bailouts for the banks. (See this, this, this and this).

Commercial Real Estate, Mortgage Backed Securities, Cars and Student Loans

Some pretty sharp writers allege that the government is also secretly bailing out the banks by supporting everything from commercial real estate, to mortgage-backed securities, car loans and student loans (and don't forget McDonald's and Harley).

Derivatives

The government's failure to rein in derivatives or break up the giant banks also constitute enormous subsidies, as it allows the giants to make huge sums by keeping the true price points of their derivatives secret. See this and this.

Foreign Bailouts

The big banks – such as JP Morgan – also benefit from foreign bailouts, such as the European bailout, as they are some of the largest creditors of the bailed out countries, and the bailouts allow them to get paid in full, instead of having to write down their foreign losses. So when the Fed bails out foreign banks, it is a bailout for American banks as well.

Toxic Assets and Accounting Shenanigans

The PPIP program – which was supposed to reduce the toxic assets held by banks – actually increased them (at least in the short-run), and just let the banks make a quick buck.

In addition, the government suspended mark-to-market valuation of the toxic assets held by the giant banks, and is allowing the banks to value the assets at whatever price they desire. This constitutes a huge giveaway to the big banks.

As Forbes' Robert Lenzner wrote recently:

The giant US banks have been bailed out again from huge potential writeoffs by loosey-goosey accounting accepted by the accounting profession and the regulators.

They are allowed to accrue interest on non-performing mortgages " until the actual foreclosure takes place, which on average takes about 16 months.

All the phantom interest that is not actually collected is booked as income until the actual act of foreclosure. As a resullt, many bank financial statements actually look much better than they actually are. At foreclosure all the phantom income comes off the books of the banks.

This means that Bank of America, Citigroup, JP Morgan and Wells Fargo, among hundreds of other smaller institutions, can report interest due them, but not paid, on an estimated $1.4 trillion of face value mortgages on the 7 million homes that are in the process of being foreclosed.

Ultimately, these banks face a potential loss of $1 trillion on nonperforming loans, suggests Madeleine Schnapp, director of macro-economic research at Trim-Tabs, an economic consulting firm 24.5% owned by Goldman Sachs.

The potential writeoffs could be even larger should home prices continue to weaken…

And as one writer notes:

By allowing banks to legally disregard mark-to-market accounting rules, government allows banks to maintain investment grade ratings.

By maintaining investment grade ratings, banks attract institutional funds. That would be the insurance and pension funds money that is contributed by the citizen.

As institutional money pours in, the stock price is propped up ….

Fraud As a Business Model

If you stop and think for a moment, it is obvious that failing to prosecute fraud is a bailout.

Nobel prize-winning economist George Akerlof demonstrated that if big companies aren't held responsible for their actions, the government ends up bailing them out. So failure to prosecute directly leads to a bailout.

Moreover, as I noted last month:

Fraud benefits the wealthy more than the poor, because the big banks and big companies have the inside knowledge and the resources to leverage fraud into profits. Joseph Stiglitz noted in September that giants like Goldman are using their size to manipulate the market. The giants (especially Goldman Sachs) have also used high-frequency program trading (representing up to70% of all stock trades) and high proportions of other trades as well). This not only distorts the markets, but which also lets the program trading giants take a sneak peak at what the real traders are buying and selling, and then trade on the insider information. See this, this, this, this and this.

Similarly, JP Morgan Chase, Bank of America, Goldman Sachs, Citigroup, and Morgan Stanley together hold 80% of the country's derivatives risk, and 96%of the exposure to credit derivatives. They use their dominance tomanipulate the market.

Fraud disproportionally benefits the big players (and helps them to becomebig in the first place), increasing inequality and warping the market.

[And] Professor Black says that fraud is a large part of the mechanism through which bubbles are blown.

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Finally, failure to prosecute mortgage fraud is arguably worsening the housing crisis. See this and this.

The government has not only turned the other cheek, but aided and abetted the fraud. In the words of financial crime expert William K. Black, the government "created an intensely criminogenic environment".

And this environment is ongoing today. See this, for example.

Settling Prosecutions For Pennies on the Dollar

Even when the government has prosecuted financial crime (because public outrage became too big to ignore), the government has settled for pennies on the dollar.

Nobel prize winning economist Joe Stiglitz says about the way that the government is currently prosecuting financial crime:

The system is designed to actually encourage that kind of thing, even with the fines [referring to former Countrywide CEO Angelo Mozillo, who recently paid tens of millions of dollars in fines, a small fraction of what he actually earned, because he earned hundreds of millions.].

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So the system is set so that even if you're caught, the penalty is just a small number relative to what you walk home with.

The fine is just a cost of doing business. It's like a parking fine. Sometimes you make a decision to park knowing that you might get a fine because going around the corner to the parking lot takes you too much time.

Bloomberg noted on Monday:

The U.S. Securities and Exchange Commission's internal watchdog is reviewing an allegation that Robert Khuzami, the agency's top enforcement official, gave preferential treatment to Citigroup Inc. executives in the agency's $75 million settlement with the firm in July.

Inspector General H. David Kotz opened the probe after a request from U.S. Senator Charles Grassley, an Iowa Republican, who forwarded an unsigned letter making the allegation. Khuzami told his staff to soften claims against two executives after conferring with a lawyer representing the bank, according to the letter.…

According to the letter, the SEC's staff was prepared to file fraud claims against both individuals. Khuzami ordered his staff to drop the claims after holding a "secret conversation, without telling the staff, with a prominent defense lawyer who is a good friend" of his and "who was counsel for the company, not the individuals affected," according to a copy of the letter reviewed by Bloomberg News.

And Freddie and Fannie's recent settlement with Bank of America – a couple of billions – has been criticized by many as being a bailout.

In "BofA Freddie Mac Putbacks Resolved for 1¢ on $", Barry Ritholtz notes:

Bank of America settled numerous claims with Fannie Mae for an astonishingly cheap rate, according to a Bloomberg report.

A premium of $1.28 billion was paid to Freddie Mac to resolve $1 billion in claims currently outstanding. But the kicker is that the deal also covers potential future claims on $127 billion in loans sold by Countrywide through 2008. That amounts to 1 cent on the dollar to Freddie Mac.

In "Is Fannie bailing out the banks?", Forbes' Colin Barr writes:

Someone must be getting bailed out, right?

Why yes, say critics of the giant banks. They charge that Monday's rally-stoking mortgage-putback deal between Bank of America (BAC) and Fannie Mae and Freddie Mac is nothing more than a backdoor bailout of the nation's largest lender. It comes courtesy, they say, of an administration struggling to find a fix for the housing market while quaking at the prospect of another housing-fueled banking meltdown.

Monday's arrangement, according to this view, will keep the banks standing — but leave taxpayers on the hook for an even bigger tab should a weak economic recovery falter. Sound familiar?

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[Edward] Pinto says truly holding BofA responsible for all the mortgage mayhem tied to its 2008 purchase of subprime lender Countrywide would likely drive it into the arms of the Federal Deposit Insurance Corp., which has enough problems to deal with. Though BofA would surely dispute that analysis, it's easy enough to see where the feds don't want that outcome.

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But how sharp is Freddie if all it can do is squeeze a $1.28 billion payment out of a giant customer in exchange for relinquishing fraud claims on $117 billion worth of outstanding loans? The very best its million-dollar executives can do is claw back a penny on each bubbly subprime dollar?

That seems pretty weak even given that this is Congress' favorite subsidy dispenser we're talking about.

"How Freddie can justify this decision to settle 'all outstanding and potential' claims before any of the private-label putback lawsuits have been resolved is beyond comprehension," says Rebel Cole, a real estate and finance professor at DePaul University in Chicago. "This smells to high heaven and they should be called out."

In "Bank Of America Just Admitted That Its Fannie And Freddie Settlement Was A Bailout", Business Insider's Joe Weisenthal writes:

Bank of America has basically confirmed that the critics are correct: It was the beneficiary of a bailout.

According to Bloomberg, BofA's Jerry Dubrowski said: "Our agreements with Fannie Mae and Freddie Mac are a necessary step toward the ultimate recovery of the housing market."

Get it? This was not about settling mortgage putback exposure at the legal level. It was about helping the greater good. It's the same too-big-to-fail logic all over again: What's good for Bank of America is good for America.

As the Washington post notes:

"This is a gift" from the government to the bank, said Christopher Whalen of Institutional Risk Analytics. "We're all paying for this because it will show up in the losses from Fannie and Freddie," he said.

Congresswoman Waters said:

I'm concerned that the settlement between Fannie Mae, Freddie Mac and Bank of America over misrepresentations in the mortgages BofA originated may amount to a backdoor bailout that props up the bank at the expense of taxpayers. Given the strong repurchase rights built into Fannie Mae and Freddie Mac's contracts with banks, and the recent court setback for Bank of America in similar litigation with a private insurer, I'm fearful that this settlement may have been both premature and a giveaway. The fact that Bank of America's stock surged after this deal was announced only serves to fuel my suspicion that this settlement was merely a slap on the wrist that sets a bad example for other negotiations in the future.

And see this, this and this.

Guaranteeing a Fat Spread on Interest Rates

Bloomberg notes:

"The trading profits of the Street is just another way of measuring the subsidy the Fed is giving to the banks," said Christopher Whalen, managing director of Torrance, California-based Institutional Risk Analytics. "It's a transfer from savers to banks."

The trading results, which helped the banks report higher quarterly profit than analysts estimated even as unemployment stagnated at a 27-year high, came with a big assist from the Federal Reserve. The U.S. central bank helped lenders by holding short-term borrowing costs near zero, giving them a chance to profit by carrying even 10-year government notes that yielded an average of 3.70 percent last quarter.

The gap between short-term interest rates, such as what banks may pay to borrow in interbank markets or on savings accounts, and longer-term rates, known as the yield curve, has been at record levels. The difference between yields on 2- and 10-year Treasuries yesterday touched 2.71 percentage points, near the all-time high of 2.94 percentage points set Feb. 18.

Harry Blodget explains:

The latest quarterly reports from the big Wall Street banks revealed a startling fact: None of the big four banks had a single day in the quarter in which they lost money trading.

For the 63 straight trading days in Q1, in other words, Goldman Sachs (GS), JP Morgan (JPM), Bank of America (BAC), and Citigroup (C) made money trading for their own accounts.

Trading, of course, is supposed to be a risky business: You win some, you lose some. That's how traders justify their gargantuan bonuses–their jobs are so risky that they deserve to be paid millions for protecting their firms' precious capital. (Of course, the only thing that happens if traders fail to protect that capital is that taxpayers bail out the bank and the traders are paid huge "retention" bonuses to prevent them from leaving to trade somewhere else, but that's a different story).

But these days, trading isn't risky at all. In fact, it's safer than walking down the street.

Why?

Because the US government is lending money to the big banks at near-zero interest rates. And the banks are then turning around and lending that money back to the US government at 3%-4% interest rates, making 3%+ on the spread. What's more, the banks are leveraging this trade, borrowing at least $10 for every $1 of equity capital they have, to increase the size of their bets. Which means the banks can turn relatively small amounts of equity into huge profits–by borrowing from the taxpayer and then lending back to the taxpayer.

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The government's zero-interest-rate policy, in other words, is the biggest Wall Street subsidy yet. So far, it has done little to increase the supply of credit in the real economy. But it has hosed responsible people who lived within their means and are now earning next-to-nothing on their savings. It has also allowed the big Wall Street banks to print money to offset all the dumb bets that brought the financial system to the brink of collapse two years ago. And it has fattened Wall Street bonus pools to record levels again.

Paul Abrams chimes in:

To get a clear picture of what is going on here, ignore the intermediate steps (borrowing money from the fed, investing in Treasuries), as they are riskless, and it immediately becomes clear that this is merely a direct payment from the Fed to the banking executives…for nothing. No nifty new tech product has been created. No illness has been treated. No teacher has figured out how to get a third-grader to understand fractions. No singer's voice has entertained a packed stadium. No batter has hit a walk-off double. No "risk"has even been "managed", the current mantra for what big banks do that is so goddamned important that it is doing "god's work".

Nor has any credit been extended to allow the real value-producers to meet payroll, to reserve a stadium, to purchase capital equipment, to hire employees. Nothing.

Congress should put an immediate halt to this practice. Banks should have to show that the money they are borrowing from the Fed is to provide credit to businesses, or consumers, or homeowners. Not a penny should be allowed to be used to purchase Treasuries. Otherwise, the Fed window should be slammed shut on their manicured fingers.

And, stiff criminal penalties should be enacted for those banks that mislead the Fed about the destination of the money they are borrowing. Bernie Madoff needs company.

Interest Paid on Excess Reserves

The Fed has been paying the big banks interest on the "excess reserves" which those banks deposit at the Fed.

Specifically, the Fed is intentionally paying the banks a higher interest rate to park their money at the Fed than they would make if they loaned it out to Main Street. This is money going to the big banks.

(Moreover, top Fed officials have publicly stated that this policy of paying interest on excess reserves deposited at the Fed is intentionally aimed at reducing loans to Main Street, as a way to fight inflation.)

See documentation here and here.

Quantitative Easing

As I noted last August:

[The] Treasury Department encouraged banks to use the bailout money to buy their competitors, and pushed through an amendment to the tax laws which rewards mergers in the banking industry.

Yesterday, former Secretary of Labor Robert Reich pointed out that quantitative easing won't help the economy, but will simply fuel a new round of mergers and acquisitions:

A debate is being played out in the Fed about whether it should return to so-called "quantitative easing" — buying more mortgage-backed securities, Treasury bills, and other bonds — in order to lower the cost of capital still further.

The sad reality is that cheaper money won't work. Individuals aren't borrowing because they're still under a huge debt load. And as their homes drop in value and their jobs and wages continue to disappear, they're not in a position to borrow. Small businesses aren't borrowing because they have no reason to expand. Retail business is down, construction is down, even manufacturing suppliers are losing ground.

That leaves large corporations. They'll be happy to borrow more at even lower rates than now — even though they're already sitting on mountains of money.

But this big-business borrowing won't create new jobs. To the contrary, large corporations have been investing their cash to pare back their payrolls. They've been buying new factories and facilities abroad (China, Brazil, India), and new labor-replacing software at home.

If Bernanke and company make it even cheaper to borrow, they'll be unleashing a third corporate strategy for creating more profits but fewer jobs — mergers and acquisitions.

Similarly, Yves Smith reports that quantitative easing didn't really help the Japanese economy, only big Japanese companies:

A few days ago, we noted:

When an economy is very slack, cheaper money is not going to induce much in the way of real economy activity.

Unless you are a financial firm, the level of interest rates is a secondary or tertiary consideration in your decision to borrow. You will be interested in borrowing only if you first, perceive a business need (usually an opportunity). The next question is whether it can be addressed profitably, and the cost of funds is almost always not a significant % of total project costs (although availability of funding can be a big constraint)…..

So cheaper money will operate primarily via their impact on asset values. That of course helps financial firms, and perhaps the Fed hopes the wealth effect will induce more spending. But that's been the movie of the last 20+ years, and Japan pre its crisis, of having the officialdom rely on asset price inflation to induce more consumer spending, and we know how both ended.

Tyler Cowen points to a Bank of Japan paper by Hiroshi Ugai, which looks at Japan's experience with quantitative easing from 2001 to 2006. Key findings:

….these macroeconomic analyses verify that because of the QEP, the premiums on market funds raised by financial institutions carrying substantial non-performing loans (NPLs) shrank to the extent that they no longer reflected credit rating differentials. This observation implies that the QEP was effective in maintaining financial system stability and an accommodative monetary environment by removing financial institutions' funding uncertainties, and by averting further deterioration of economic and price developments resulting from corporations' uncertainty about future funding.

Granted the positive above effects of preventing further deterioration of the economy reviewed above, many of the macroeconomic analyses conclude that the QEP's effects in raising aggregate demand and prices were limited. In particular, when verified empirically taking into account the fact that the monetary policy regime changed under the zero bound constraint of interest rates, the effects from increasing the monetary base were not detected or smaller, if anything, than during periods when there was no zero bound constraint.

Yves here, This is an important conclusion, and is consistent with thewarnings the Japanese gave to the US during the financial crisis, which were uncharacteristically blunt. Conventional wisdom here is that Japan's fiscal and monetary stimulus during the bust was too slow in coming and not sufficiently large. The Japanese instead believe, strongly, that their policy mistake was not cleaning up the banks. As we've noted, that's also consistent with an IMF study of 124 banking crises:

Existing empirical research has shown that **providing assistance to banks and their borrowers can be counterproductive, resulting in increased losses to banks, which often abuse forbearance to take unproductive risks at government expense.** The typical result of forbearance is a deeper hole in the net worth of banks, crippling tax burdens to finance bank bailouts, and even more severe credit supply contraction and economic decline than would have occurred in the absence of forbearance.

Cross-country analysis to date also shows that accommodative policy measures (such as substantial liquidity support, explicit government guarantee on financial institutions' liabilities and forbearance from prudential regulations) tend to be fiscally costly and that these particular policies do not necessarily accelerate the speed of economic recovery. Of course, the caveat to these findings is that a counterfactual to the crisis resolution cannot be observed and therefore it is difficult to speculate how a crisis would unfold in absence of such policies. Better institutions are, however, uniformly positively associated with faster recovery.

But (to put it charitably) the Fed sees the world through a bank-centric lens, so surely what is good for its charges must be good for the rest of us, right? So if the economy continues to weaken, the odds that the Fed will resort to it as a remedy will rise, despite the evidence that it at best treats symptoms rather than the underlying pathology.

Buying Bonds

So quantitative easing in general favors the big guys – by encouraging mergers and acquisitions, allowing them to take risky gambles and engage in other shenanigans – and doesn't help the economy as a whole.

But quantitative easing also provides a more direct bailout for the big banks.

Specifically, the current round of quantitative easing involves the Federal Reserve buying U.S. treasury bonds from the "primary dealers" – i.e. the biggest banks.

The Fed announces well in advance how much of what bonds it will be buying, and also buys the bonds in it's own name (not anonymously or through a proxy). That ensures that the banks can charge more for the bonds.

For example, as the New York Times notes:

“A buyer of $100 billion a month is always going to be paying top prices,” [Louis V. Crandall, the chief economist at the research firm Wrightson ICAP] said of the Fed. “You can’t be a known buyer of $100 billion a month and get a good price.”

In addition, people such as Jonathan Loman argue that the Fed is actually “gifting” the primary dealers with $5 billion dollars per month by intentionally overpayingfor the bonds.

Too Big As Subsidy

The fact that the giant banks are “too big to fail” encourages them to take huge, risky gambles that they would not otherwise take. If they win, they make big bucks. If they lose, they know the government will just bail them out. This is a gambling subsidy.

For example, as the Special Inspector General of the Troubled Asset Relief Programsaid today:

When the government assured the world in 2008 that it would not let Citigroup fail, it did more than reassure the troubled markets — it encouraged high-risk behavior by insulating risk-takers from the consequences of failure.

The very size of the too big to fails also decreases the ability of the smaller banks to compete. And – since the government itself helped make the giants even bigger – that is also a subsidy to the big boys (see this).

The monopoly power given to the big banks (technically an “oligopoly“) is a subsidy in other ways as well. For example, Nobel prize winning economist Joseph Stiglitzsaid in September that giants like Goldman are using their size to manipulate the market:

“The main problem that Goldman raises is a question of size: ‘too big to fail.’ In some markets, they have a significant fraction of trades. Why is that important? They trade both on their proprietary desk and on behalf of customers. When you do that and you have a significant fraction of all trades, you have a lot of information.”

Further, he says, “That raises the potential of conflicts of interest, problems of front-running, using that inside information for your proprietary desk. And that’s why the Volcker report came out and said that we need to restrict the kinds of activity that these large institutions have. If you’re going to trade on behalf of others, if you’re going to be a commercial bank, you can’t engage in certain kinds of risk-taking behavior.”

The giants (especially Goldman Sachs) have also used high-frequency program trading which not only distorted the markets – making up more than 70% of stock trades – but which also let the program trading giants take a sneak peak at what the real (aka “human”) traders are buying and selling, and then trade on the insider information. See this, this, this, this and this. (This is frontrunning, which is illegal; but it is a lot bigger than garden variety frontrunning, because the program traders are not only trading based on inside knowledge of what their own clients are doing, they are also trading based on knowledge of what all other traders are doing).

Goldman also admitted that its proprietary trading program can "manipulate the markets in unfair ways". The giant banks have also allegedly used their Counterparty Risk Management Policy Group (CRMPG) to exchange secret information and formulate coordinated mutually beneficial actions, all with the government's blessings.

In addition, the giants receive many billions in subsidies by receiving government guarantees that they are "too big to fail", ensuring that they have to pay lower interest rates to attract depositors.

These are just a few of the secret bailouts programs the government is giving to the giant banks. There are many other bailout programs as well. If these bailouts and subsidies are added up, they amount to many tens – or perhaps even hundreds – of trillions of dollars.

And then there is the cost of debasing the currency in order to print money to fund these bailouts. The cost to the American citizen in less valuable dollars could be truly staggering. From another perspective, running up our national debt to pay for the bailouts is costing us dearly by reducing our economy's growth (and seethis).

And it is the top executives who reap the benefit of the bailouts through huge bonuses. Since the big banks continue to engage in highly-leveraged, risky, speculative activities, the bailouts have not made them any more stable. See this, for example.

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