GlobalResearch
Center for Research on Globalization

Inside Wall Street: Government Bets on Positive Spin to Save Failing Banks

By Shah Gilani
Global Research, July 10, 2009
Money Morning 10 July 2009

Region: USA
Theme: Global Economy

Just when you thought the U.S. banking system had regained its footing, the reality is that a carefully woven federal-government PR campaign may actually be masking the next phase of the worst financial crisis since the Great Depression.

Indeed, it's what's just out of sight that has some analysts and economists scared to death.

To rebuild public confidence in America's ailing banks the government has greased the system's liquidity wheels, directly injected capital, backstopped and guaranteed loan facilities, lowered banks' cost of funds, changed accounting rules to make balance sheets look better, bestowed passing grades on high profile stress tests and then allowed the propped-up (but still not healthy) banks to pay back government loans.

Analysts and economists question whether this race to instill confidence will outpace rising unemployment and lagging economic data, or will trigger the next phase of the global financial crisis if shaky banks end up snapping borrower lifelines.

The big confidence game began with a single "relief" program. Now, many of the titanic banking system's torpedoed institutions are remaining afloat only because of some rescue programs developed by the U.S. Federal Reserve and U.S. Treasury Department. Deemed absolutely necessary to prevent total financial collapse at the time of their hasty implementation, the legacy of these programs will be their indiscriminate reinforcement of weak links in the banking system and the acceptance of moral hazard. The Trouble With TARP

The granddaddy of all these rescue plans – the Troubled Asset Relief Program, or TARP – is a $700 billion program that was originally designed on fewer than four pages, and that was sold to Congress as a plan to buy toxic assets from sick banks.

That never happened.

Once passed, TARP immediately morphed into a direct-capital-infusion system for banks, allowing them to meet regulatory capital requirements and stay afloat. A wide variety of other relief programs followed. There were programs to backstop the commercial paper market, money market mutual funds, and issuers and purchasers of various asset-backed securities. There was a mortgage-relief initiative. And now there is even a re-constituted public-private partnership plan – worth between $1 trillion and $2 trillion – that is supposed to buy toxic assets from the same banks that still hold them.

With all the government backstopping going on directly and indirectly behind the scenes, what remains to be seen is whether the banks can succeed without the federal government cheerleading the public into believing that these institutions are actually standing on their own feet – when, in reality, many are still on their knees.

Without these plans, many banks would certainly be on their last legs.

Underlying all the relief programs, the U.S. Federal Reserve has done everything in its power to keep interest rates low – especially the benchmark Federal Funds Rate, the rate at which banks borrow from each other on an overnight basis.

One of the positive signs being pointed to lately by government public relations spinners is the positive net interest income being earned by banks. What they don't point out is that it's only as positive as it is because the government is artificially keeping banks' "cost of funds" low through a 0.00% Fed Funds Rate policy, and by continuing to grease every lever of liquidity to keep funding cheap. What's eventually likely to be overwhelming will be the impact on net interest income when artificially cheap funding dries up, interest rates rise and commercial-paper and money-market spigots are not gushing funds like they did before the global financial crisis took hold.

The combination of capital injections, relief programs and low interest rates was designed to work together to facilitate liquidity in the vast interwoven system of institutions and markets that makes business and finance possible. Banks are the singular linch-pin in the system, without whose proper functioning the entire system would seize up.

And yet, in spite of all that was being done to keep the banking system afloat, it was still sinking. Rock-Paper-Scissors

Not unlike the children's game rock-paper-scissors, the Fed's scissors that were used to cut out impediments to liquidity were smashed by the falling Rock of Gibraltar – namely the continuing erosion of trust in crumbling banks, to the point that only by papering over losses at banks could the game be won.

With a strong push from lobbyists, legislators threatened to make legal changes to accepted accounting standards. With a nod of approval from the highest government powers attempting to triage ailing banks, legal changes weren't necessary. Instead, two amendments to U.S. Generally Accepted Accounting Principles (GAAP) were hastily approved by the Financial Accounting Standards Board (FASB):

* The first of the two amendments gave guidance to assist preparers on how to determine whether a market is not active and a transaction is not distressed, which provides allowances for sidestepping mark-to-market rules and essentially allows internal modeling of asset values. * The second amendment provides a neat trick that facilitates changes in the recognition and presentation of other-than-temporary impairments on debt instruments. In short, if you don't want to declare losses in full view of the public, stick them in a walled-off section of your financials where you can pretend that they are going to be held to maturity and paid back in full. Scissors beats paper in the children's game, and in the case of banks the scissors of any sharp accountant will eventually shred the paper façade that's masking huge losses.

Not content to try and get the public to merely notice things might be getting better, the federal government PR machine decided that bank stress tests would provide definitive proof that progress was being made. The result of the much-ballyhooed stress tests was, indeed, effective. The announcement – more like a pronouncement – proclaimed the system sound, saw a strengthening of institutions in general and only pointed to a few laggards.

But in a recent Bloomberg Markets article entitled, “Stress Management,” Janet Tavakoli, president of Structured Finance Inc., told writer Yalman Onaran that “the Federal Reserve, which designed the stress tests, used a 21% to 28% loss rate for subprime mortgages as a worst-case assumption. Already, almost 40% of such loans are 30 days or more overdue.”

Tavakoli predicts defaults actually might reach 55%. Positive Earnings or Positive Spin?

The release of the stress-test results coincided with some strong first quarter financials from banks. The markets rallied amid fertilized talk of “green shoots” and the actual arrival of spring. Now that’s really good PR. Too bad, like a lot of PR, it was managed to look that way.

Using the accountant’s scissors embedded in Onaran’s Bloomberg Markets article, Citigroup Inc. (NYSE: C) picked up 25% of its 2009 first quarter net income from a debt securities accounting rule change. It subsequently increased its loan-loss provisions more slowly – even as more loans were souring. Without the accounting changes Citi, would probably have posted a net loss of $2.5 billion for the quarter, concluded Martin Weiss, founder of the Jupiter, Fla.-based Weiss Research. Inc.

Weiss also found that “the new standards let Wells Fargo (NYSE: WFC) boost its capital $2.8 billion by reassessing the value of some $40 billion of bonds, and augmented net income by $334 million because of the effect of the rule on the value of debts held to maturity.”

In June, in a McKinsey Quarterly piece, writersLowell Bryan and Toos Daruvala are even more outspoken about the problems that accounting rules are masking, stating, “It might seem odd that accounting methodologies can make such a big difference. At the end of the day, what counts is the net present value of the cash flow from each asset, but those are unknowable until after a debt is repaid. Fair-value accounting, based on mark-to-market principles, immediately discounts assets when the expectation of a default arises and ability to trade the asset declines. Fair value therefore makes the holder of the asset look worse, sooner. Hold-to-maturity accounting works in reverse and makes the holder look better for a long time.” Looking Good is All That Matters

Why would 10 banks on the edge of the financial abyss only a few months ago want to pay back $68 billion in government bailout money when they have:

* No idea what the future holds for them? * Or if they’ll need to make a return visit to the taxpayer-filled rescue trough?

And why would the government, after all its bluster, let them pay the money back, especially in the face of a firestorm about extraordinarily excessive executive compensation at those same institutions?

Because it’s all about looking good.

It’s part of the PR spin to make banks look healthier than they are. And it just might spin out of control.

You can put lipstick on a pig, but you can’t make a silk purse out of a sow’s ear. Instead of admitting the depth of systemic risk we're facing from teetering banks and making the hard decision to shut some of them down or break them up once and for all, the federal government would rather pretty up the picture to try and convince us to open our purses again and more-quickly recharge our consumer-driven economy.

The danger in this government PR campaign to make banks look healthy is that if another meaningful economic bump rattles consumer confidence in a banking system the government says is safe, the resulting fear of a separate reality might engender a run on banks that would make the Great Depression look like a walk in the park.

News and Related Story Links:

* Money Morning Special Investment Report: Money Morning's Bank Stress Test Says These Three Banks Are the Strongest.
http://www.moneymorning.com/2009/04/30/bank-stress-tests-2

* About.com: Confidence Game.
http://www.answers.com/topic/confidence-trick

* About.com: Moral Hazard.
http://www.answers.com/topic/moral-hazard

* Wikipedia: Troubled Assets Relief Program.
http://en.wikipedia.org/wiki/Troubled_Asset_Relief_Program

* Money Morning News Analysis: Motivations Abound for Federal Reserve's Delayed Release of Bank Stress Test Results.
http://www.moneymorning.com/2009/05/04/bank-stress-test-results-2/

* Wikipedia: Toxic Assets.
http://en.wikipedia.org/wiki/Toxic_assets

* U.S. Federal Reserve: Federal Funds Rate.
http://www.federalreserve.gov/fomc/fundsrate.htm

* WiseGeek.com: Cost of Funds.
http://www.wisegeek.com/what-is-the-cost-of-funds.htm

* Wikipedia: Generally Accepted Accounting Principles.
http://en.wikipedia.org/wiki/Generally_Accepted_Accounting_Principles

* Wikipedia: Financial Accounting Standards Board.
http://en.wikipedia.org/wiki/FASB

* Financial Accounting Standards Board: Determining Fair Value of a Distressed Security.
http://www.fasb.org/project/fas157_active_inactive_distressed.shtml

* Financial Accounting Standards Board: Other-Than-Temporary Financial Impairments.
http://www.fasb.org/project/other-than-temporary_impairments.shtml

* Money Morning News Analysis: By Relaxing “Mark-to-Market” Rules, Has the U.S. Switched Off its Financial Crisis Early Warning System? http://www.moneymorning.com/2008/10/08/fair-value-accounting/