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Restoring a Viable System of Bank Credit

Bernanke Rolls Snake-eyes

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Fed chief Ben Bernanke is in a bit of a bind. He's being asked to restore a system for credit expansion which collapsed more than two years ago and has shown no sign of life ever since. During the boom years, securitization accounted for more than 40 percent of the credit flowing into the economy. No more. When two Bear Stearns hedge funds defaulted in July 2007, the system crashed as investors of all stripes backed away from complex, illiquid assets. The Fed's TALF lending facility–which provides up to 94% government funding for investors who are willing to purchase bundled debt for credit cards, mortgages, auto loans and student loans–was intended to breathe new life into securitization, but has fallen woefully short of its original objectives. It pretty much fizzled on the launching pad. Even the shrewdest hedge fund sharpie couldn't figure out how to make money on (what amounts to) fetid assets.

Ironically, the Fed's original plan for the TALF would have involved a $20 billion loan from the Treasury levered 10 to 1 to provide up to $200 billion in funding support for applicants. In other words, the Fed was planning to borrow money, to lend to people (Investment banks and hedge funds) who were borrowing money to lend to people who were borrowing money. (consumer credit cards, mortgages, car loans etc) Read that sentence again to fully appreciate how utterly fouled up the credit system really is. The Fed and Treasury are like private equity hucksters overseeing an inherently corrupt and immoral system. Michael Moore is right.

Fortunately, Bernanke's plan to rebuild securitization has no chance of succeeding. The system can't be restored because it required conditions which no longer exist; a strong currency, mega-surplus capital, and credulous investors who were unaware of the implicit risks of illiquid assets. Today, the dollar is wobbly, money is tight, and the pool of dupes ready to be fleeced has been greatly reduced. The notion that Wall Street can better perform the tasks traditionally left to highly-regulated banks, has also been called into question….and rightly so. Unfortunately, the largest banks in the country–which have transformed themselves into investment casinos–don't have the ability to return to the more conservative model of long-term lending to qualified applicants. They are stuck in a post-Glass Steagall mold, incapable of turning a profit on conventional loans to consumers and businesses. There's a glaring need for some opportunistic entrepreneur (Warren Buffet?) to step into the breach and create a bank where depositors feel comfortable leaving their life savings knowing their bank is at least a notch-or-two above a Monte Carlo roulette table.

Bernanke will not give up the hope of resuscitating securitization because the financial mandarins who employ the Fed chief see it as an exportable model which will give them greater control over the global financial system. This is not taken lightly by the powers behind the curtain. The beauty of securitization is its utter simplicity; it simply transfers the authority to generate credit (money) from highly-regulated banks to rogue players in the shadow banking system. By borrowing short to invest in dodgy long-term assets, fund managers and PE smarties are able to expand credit to unimaginable levels, skimming off fat bonuses and salaries for themselves while the monster bubble limps slowly towards earth.

This is the system that Bernanke is trying to electroshock back into consciousness, albeit with negligible results. The Fed is essentially pumping blood into a corpse hoping for some fleeting sign of life. But dead is dead. Capitalism requires capital. This is the disturbing truth behind securitization–which was not developed to allocate resources to productive activity more efficiently–but to allow credit expansion on smaller and smaller chunks of capital, further enriching a handful of well-connected speculators. This is the sole function of off-balance sheets operations and unregulated derivatives–to conceal the abysmal lack of capital that supports the debt. When trillions of dollars in complex debt-instruments, derivatives contracts, and loans to unqualified applicants are stacked atop a tiny scrap of capital, disaster is inevitable.

Bernanke is now busy sifting through the rubble trying to reassemble Wall Street's Golden Goose for one-last wild credit fling, but with no luck. So far, he's come up snake-eyes, which is probably best for everyone.

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