Debt Relief and Regulation

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"We've explained the difference between a recession and a depression before. But we'll do it again. A recession is a pause in an otherwise healthy, growing economy. A depression is when the economy drops dead." Bill Bonner, The Daily Reckoning

There's good news and bad news. The good news is that Obama's economics team understands the fundamental problem with the banks and knows what needs to be done to fix it. The bad news is that Bernanke, Summers and Geithner all have close ties to the big banks and refuse to do what's necessary. Instead, they keep propping up failing institutions with capital injections while concocting elaborate strategies for purchasing the banks bad assets through backdoor transactions. It's all very opaque, despite the cheery public relations monikers they slap on their various "rescue" plans. This charade has gone on for more than a month while unemployment has continued to soar, the stock market has continued to plunge, and the country has slipped deeper into economic quicksand.

Paul Krugman summed up the administration's response in Friday's column, "The Biig Dither":

"There's a growing sense of frustration, even panic, over Mr. Obama's failure to match his words with deeds. The reality is that when it comes to dealing with the banks, the Obama administration is dithering. Policy is stuck in a holding pattern….

Why do officials keep offering plans that nobody else finds credible? Because somehow, top officials in the Obama administration and at the Federal Reserve have convinced themselves that troubled assets … are really worth much more than anyone is actually willing to pay for them — and that if these assets were properly priced, all our troubles would go away. …

What's more, officials seem to believe that getting toxic waste properly priced would cure the ills of all our major financial institutions.(Paul Krugman, The Big Dither, New York Times)

Krugman is right about the "dithering" but wrong about the toxic waste. Geithner and Bernanke know exactly what these assets are worth— just pennies on the dollar. That's why Geithner has avoided taking $5 or $10 billion of these mortgage-backed securities (MBS) and putting them up for public auction. That would be the reasonable thing to do and it would remove any doubt about their true value. But the Treasury Secretary won't do that because it would just draw attention to the fact that the banking system is insolvent; the vaults are full of nothing but garbage loans that are defaulting at a record pace. Instead, Geithner has cooked up a plan for a "public-private partnership" which will provide up to $1 trillion in funding for private equity and hedge funds to purchase toxic assets from the banks. The Treasury will offer low interest "non recourse" loans (with explicit government guarantees against any potential loss) to qualified investors. If the hedge funds or private equity firms don't turn a profit in three years, they simply return the assets to the Treasury and get their money back. In essence, Geithner's plan provides a lavish subsidy to private industry on an totally risk free investment. It's a sweetheart deal.

At the same time, the plan achieves Geithner's two main objectives; it gives the banks the chance to scrub their balance sheets of junk mortgages and it also allows them to keep the present management-structure in place. The $1 trillion taxpayer giveaway to the hedge funds is just another juicy bone tossed to Geithner's real constituents– Wall Street speculators.

Unfortunately, markets don't like uncertainty, which is why Geithner's circuitous plan has put traders in a frenzy. Wall Street has gone from scratching its head in bewilderment, to a stampede for the exits. In the last month alone, the stock market has plummeted a whopping 18 percent, indicating ebbing confidence in the political leadership. Geithner is now seen as another glorified bank lobbyist like his predecessor, Paulson, who is in way over his head. His lack of clarity has only added to the widespread sense of malaise. Markets require transparency and details, not obfuscation, gibberish and Fed-speak. This is how Baseline Scenario blogger Simon Johnson summed it up:

"Confusion helps the powerful… When there are complicated government bailout schemes, multiple exchange rates, or high inflation, it is very hard to keep track of market prices and to protect the value of firms. The result, if taken to an extreme, is looting: the collapse of banks, industrial firms, and other entities because the insiders take the money (or other valuables) and run.

This is the prospect now faced by the United States.

Treasury has made it clear that they will proceed with a "mix-and-match" strategy, as advertised….The course of policy is set. For at least the next 18 months, we know what to expect on the banking front. Now Treasury is committed, the leadership in this area will not deviate from a pro-insider policy for large banks; they are not interested in alternative approaches (I've asked). The result will be further destruction of the private credit system and more recourse to relatively nontransparent actions by the Federal Reserve, with all the risks that entails.

The road to economic hell is paved with good intentions and bad banks."(Simon Johnson Baseline Scenario)

This is unusually harsh criticism from a former head economist at the IMF, but Johnson's analysis is dead-on. Geithner is putting the interests of the banks before those of the country. The "public private partnership" is just a convoluted way of avoiding the heavy-lifting of rolling up the banks, wiping out shareholders, separating the bad assets, and replacing management. The same is true of Bernanke's Term Asset-Backed Securities Loan Facility (TALF) which is another futile attempt to restart Wall Street's failed credit-generating mechanism, securitization. It was securitization (which is the conversion of pools of mortgages into securities) which got us into this mess to begin with. It doesn't do any good to restore in inherently crisis-prone system that only works properly when the market is going up. There are more efficient ways to recapitalize the banks than the PPP, just as there are better ways to promote consumer spending than the TALF. Treasury should be looking into debt relief, jobs programs and higher wages, instead of barreling blindly down the same dead end. There are solutions that do not involve artificially low interest rates, government subsidies for toxic waste or lavish handouts to hedge funds. They simply require a commitment to rebuild the economy on sound principles of hard work, productivity and fair distribution of the the profits.

Even industry cheerleaders, like the Wall Street Journal, are skeptical of Bernanke's TALF and have denounced it as just another boondoggle.

Wall Street Journal: "If you missed the first hedge-fund boom, now may be the time to put up your shingle. Looking at the terms of the Federal Reserve's new Term Asset-Backed Securities Loan Facility, investors using it should be able to generate hefty returns with little risk. The TALF effectively turns the Fed into a generous prime brokerage."

Who needs a free market when Obama's Politburo is more than willing to prop up private industry with hundreds of billions of tax dollars?

There is another part of Geithner's plan that is even more troubling, that is, after the banks sell their dodgy assets to the hedge funds, what will they do with the money? Consumers are retrenching, so the pool of creditworthy customers will remain small. And businesses are trying to work off existing inventory, so they won't be borrowing to increase investment or retool anytime soon. If the opportunities for lending dry up, the banks will be forced to seek unconventional means for generating profits. My guess is the banks will put a large portion of their money into hedge funds for commodities speculation, which will push the price of oil, natural gas and other raw materials into the stratosphere just like they did last year when oil shot up to $147 bbl. The banks really have no choice; 65 percent of their business was securitized investments. That door has been slammed shut for good.

"TOO BIG TO FAIL"?

The Financial Times economics editor Martin Wolf warned in Friday's column of the dangers of our present course. He said:

"If large institutions are too big and interconnected to fail… then talk of maintaining them as "commercial" operations… is a sick joke. Such banks are not commercial operations; they are expensive wards of the state and must be treated as such.

The UK government has to make a decision. If it believes that costly bail-out must be piled upon ever more costly bail-out, then the banking system can never be treated as a commercial activity again: it is a regulated utility – end of story. If the government does want it to be a commercial activity, then defaults are necessary, as some now argue. Take your pick. But do not believe you can have both. (Martin Wolf, Big risks for the insurer of last resort, Financial Times)

Citigroup is now officially a "ward of the state" although CEO Pandit and his scurvy band of pirates are still allowed to collect their paychecks and hang out by the water cooler. Citi's survival depends on the reluctant generosity of the US taxpayer who is now its biggest shareholder. The mega-bank has slumped from $58 per share to $1 per share in less than 2 years. It's now more expensive to buy a grande latte at Starbucks than it is to buy three shares of Citi…and, at least with the Starbucks, the buyer gets a buzz on. There's no upside to the Citi deal. It's a dead-loss. The real question is, how long will Geithner let this joke continue before he does his job?

Wolf is correct to draw attention to the myth of "too big to fail". In fact, the Kansas Federal Reserve President, Thomas Hoenig made the same point in a PDF released this week:

"We have been slow to face up to the fundamental problems in our financial system and reluctant to take decisive action with respect to failing institutions. … We have been quick to provide liquidity and public capital, but we have not defined a consistent plan and not addressed the basic shortcomings and, in some cases, the insolvent position of these institutions.

We understandably would prefer not to "nationalize" these businesses, but in reacting as we are, we nevertheless are drifting into a situation where institutions are being nationalized piecemeal with no resolution of the crisis." (Too Big has Failed, thanks to Calculated Risk)

Hoenig and Wolf are smart enough to know that the problem is not as simple as it sounds. They know that the largest financial institutions are lashed together in a net of complex counterparty contracts–mainly credit default swaps (CDS)–which run into tens of trillions of dollars, and, that if one player is allowed to default, it could pull all of the others down the elevator shaft along with it. The problem could be resolved with proper regulation which would force all CDS onto a regulated exchange so that government watchdogs could make sure that they are sufficiently capitalized to pay off whatever claims are levied against them. But, so far, no one in Congress has taken the initiative to propose the necessary regulation. Thus, the taxpayer continues to pay off hundreds of billions of dollars of insurance claims against AIG, which was so grossly under-capitalized, it couldn't meet its own obligations. The AIG fiasco provides a window into the real motivation behind financial engineering and the alphabet-soup of complex debt-instruments. (CDOs, MBSs, CDS) Wall Street knew that the fastest way to fatten the bottom line was to circumvent minimum capital requirements and expand leverage to unsustainable levels. In other words, a system of debt-fueled capitalism with only specks of capital. It worked beautifully, until it didn't.

Nobel prize-winning economist, Myron Scholes, who helped invent a model for pricing options, added his voice to the growing chorus of angry reformers who think the CDS market should be scrapped altogether. According to Bloomberg News: Scholes said "regulators need to 'blow up or burn' over-the-counter derivative trading markets to help solve the financial crisis. The markets have stopped functioning and are failing to provide pricing signals… The "solution is really to blow up or burn the OTC market, the CDSs and swaps and structured products, and let us start over." (Bloomberg)

Treasury and the Fed have taken the position that they will not fix the system until they are forced at gunpoint. This is a prescription for disaster, not just because of growing public frustration or the free-falling stock markets, but because the banks are just the tip of the iceberg. The other non bank financial institutions are brimming with mortgage-backed sludge that will require emergency treatment, too. MarketWatch gives us a glimpse of the magnitude of the problem in last week's article "Banks fall out of bed, Citi shares under a buck":

"Market strategist Ed Yardeni's latest research shows that…..80.6%, or $7.4 trillion, of the assets held by the S&P financials companies were Level 2," he said in a research report. Level 2 assets are so-called mark-to-model, which are carried at a value based on assumptions, not true market prices."

What does "Level 2 assets" mean? It means that the financial giants are short on liquid assets–like cash or US Treasurys–and loaded with sketchy mortgage-backed paper to which they have arbitrarily assigned a value that no one in their right mind would ever pay. The entire US financial system, including the pension funds and insurance companies, is one humongous debt-bloated time bomb that is set to blow at any minute.

Surprisingly, Bernanke thinks he can simply wave his wand restart the moribund credit markets. That's what the TALF is all about. The problem is that even if the Fed buys all of the AAA securities held by the respective financial institutions, (most of them are non banks) that's still only accounts for 20 percent of the bad paper on the books. Here's what Tyler Durden said on Zero Hedge web site:

"Unfortunately for Geithner, who apparently did not read too deeply into the data, the bulk of the $1 trillion decline in securitizations came from home equity lending and non agency RMBS (Residential Mortgage Backed Securities), which reflect the "non-conforming" mortgage market, i.e. the subprime, alt-A and jumbo origination, loans which are the cause for the credit crisis, and which are rated far below the relevant AAA level. The truly unmet market, which the Treasury is addressing is at best 20% of the revised total amount." (Tyler Durden, Could TALF be the biggest disappointment yet?, Zero Hedge)

That leaves Geithner and Bernanke with few good choices. Either they expand TALF to include crappy AA (and lower) graded securities–putting the taxpayer at even greater risk–or they devise some totally new lending facility that will bypass the financial institutions altogether and issue credit directly to consumers and small businesses. There is no third option.

The problem with the TALF is that it ignores the new economic reality, that consumer demand has collapsed from the massive losses in home equity and retirement accounts. When credit markets froze last year, housing values dropped sharply raising havoc with household balance sheets and forcing a radical change in spending habits. That cutback in spending created a negative feedback loop to the financial sector which made it impossible to re-inflate the credit bubble. The ultimate size of the financial system will be determined, to large extent, by the capacity of people to borrow again which depends on many factors including job security, savings, and optimism about the future. Needless to say, the growing worry over a 1930s-type Depression will not help to lift spirits or improve the chances for a speedy recovery. That said, there are positive steps the administration can take now to restore confidence in the markets and put the ship o' state on even keel. These measures fall under three main headings; debt reduction (forgiveness), regulation and accountability. Confidence is not built on inspiring oratory or personal charisma, but concrete actions to reestablish a rules-based system that penalizes crooks and fraudsters. Recovery isn't possible without a strong commitment to these basic changes.

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