Detroit: Government Chooses Big Banks Over the American People Once Again

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Government Sides with the Big Banks Every Time

Ellen Brown noted recently that Detroit is yet another example of the government choosing big banks over the American people:

> The argument for the super-priority of derivative claims [background] is that nonpayment on these bets represents a "systemic risk" to the financial scheme. Derivative bets are cross-collateralized and are so inextricably entwined in a $600-plus trillion house of cards that the whole financial scheme could go down if the betting scheme were to collapse. Instead of banning or regulating this very risky casino, Congress has been persuaded by the masterminds of Wall Street that it needs to be preserved at all costs.
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> The same tortured logic has been used to justify the fact that the federal government deigned to bail out Wall Street but not Detroit. Supposedly, the mega-banks pose a systemic risk and Detroit doesn't. On July 29th, former Obama administration economist Jared Bernstein pursued this line of reasoning on his blog, writing:
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>> [T]he correct motivation for federal bailouts — meaning some combination of managing a bankruptcy, paying off creditors (though often with a haircut), or providing liquidity in cases where that's the issue as opposed to insolvency – is systemic risk. The failure of large, major banks, two out of the big three auto companies, the secondary market for housing – all of these pose unacceptably large risks to global financial markets, and thus the global economy, to a major industry, including its upstream and downstream suppliers, and to the national housing sector.
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>> Because a) there's not much of a case that Detroit is systemically connected in those ways, and b) Chapter 9 of the bankruptcy code appears to provide an adequate way for it to deal with its insolvency, I don't think anything like a large scale bailout is forthcoming.

The New York Times Editorial Board writes:

> What we do have a problem with is shared sacrifice that does not seem to apply to the big banks that abetted Detroit's descent into bankruptcy.

Last month, just days before its bankruptcy filing, Detroit reached its first settlement with creditors. The settlement was with UBS and Bank of America, and though the precise terms will not be nailed down until the bankruptcy judge weighs in, Detroit is set to pay an estimated $250 million to terminate a soured derivatives transaction from 2005.

The derivatives, known as interest-rate swaps, were supposed to protect Detroit from rising interest payments on a chunk of its variable rate debt. The banks would pay Detroit if interest rates rose, and Detroit would pay the banks if rates fell. By 2009, both interest rates and the city's credit rating were falling, forcing Detroit to pay the banks some $50 million a year and to pledge roughly $11 million a month in casino-tax revenue as additional collateral. [Background on how the big banks suckered Detroit]

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But the haircut doesn't mean that the banks will suffer. They have already made money on the swaps; the true extent of any discount will not be known until the deal is finalized.

This much is clear:

■ The banks' 25 percent hit is nothing compared with the city's suggested 90 percent cut to the pensions' unfunded liability — which will result in benefit cuts that would be disastrous in both human and political terms and that the State of Michigan must prevent from happening.

■ Municipal officials are prey for Wall Street. The Dodd-Frank financial reform law called on regulators to establish "enhanced protection" for municipalities and other clients in their dealings with Wall Street, but the Securities and Exchange Commission has not yet completed rules, while the Commodity Futures Trading Commission's rules are so weak as to virtually invite the banks to exploit municipalities.

■ The special treatment banks receive when debtors are in or near bankruptcy is unfair and economically destabilizing. Detroit's agreement with the two banks requires court approval, but, in general, swap deals by banks are not subject to the constraints that normally apply in bankruptcy cases; in effect, the banks are paid first, even before other secured creditors and certainly before pensioners. That privilege, dating to the heyday of derivatives deregulation in the 1990s and 2000s, is destabilizing because the assurance of repayment fosters recklessness.

Detroit's problems are a reminder of broader challenges, identified but still unmet: protecting pensions; protecting municipalities from Wall Street; and, at long last, revoking the obscene privileges of banks that allow them to prosper on the failings of others

Reuters adds some details:

The city is paying its swap counterparties a fixed interest rate of approximately 6 percent and receiving payments back of approximately 0.57 percent (current three month Libor ~0.27 percent + 0.30 percent = 0.57 percent for the floating rate). The city's swap counterparties cannot take haircuts if bankruptcy is filed, according to a creditor attorney that I spoke to. In fact, they move to the head of the creditor line. The same part of the bankruptcy code that was used in the Lehman bankruptcy (Chapter 11) applies to Detroit (Chapter 9). Swaps are settled (netted and paid) when the entity enters the bankruptcy process. From the Stanford Law Review:

> Under the Bankruptcy Code, creditors of a failed entity are stayed or prohibited from seizing that entity's assets. Since 1978, however, Congress has exempted derivatives counterparties from the automatic stay and permitted the termination of the derivatives contracts.

> Clearly Detroit's derivative counterparties will siphon precious cash away from the insolvent city if it were to enter bankruptcy. This cash payment to swap counterparties could likely be in the $400 million range.

The bigger pictures is that the government always chooses the big banks over the little guy:

> All of the top independent economists and financial experts (and many bankers) say that we've got to break up the big banks to save the economy.
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> Instead, the government has thrown trillions at the big banks to artificially make them appear profitable.
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> The bailouts are continuing non-stop … to this very day (and see this).
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> Indeed, the government chose the big banks over Main Street, the average American … or the economy as a whole. And see this and this.
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> As such, the government has sucked trillions out of the real economy by pushing policies which destroy jobs (sorry … Obama doesn't care), redistributed wealth upwards from the broad economy to a handful of the very richest (which trashes the economy .. and Obama is even worse than Bush), and destroyed savers and Main Street.
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> In other words, we have thrown many trillions of dollars at the banks, and then sucked trillions more out of the real economy.
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> As we noted recently:
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>> The central banks' central bank – the Bank for International Settlements- warned in 2008 that bailouts of the big banks would create sovereign debt crises … which could bankrupt nations.
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>> That is exactly what has happened.
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>> The big banks went bust, and so did the debtors. But the government chose to save the big banks instead of the little guy, thus allowing the banks to continue to try to wring every penny of debt out of debtors.
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>> Treasury Secretary Paulson shoved bailouts down Congress' throat by threatening martial law if the bailouts weren't passed. And the bailouts are now perpetual.
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>> Moreover:
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>>> 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, to redecorate 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.

Moreover, a large percentage of the bailouts went to foreign banks (and see this). And so did a huge portion of the money from quantitative easing. Indeed, the Fed bailed out Gaddafi's Bank of Libya, hedge fund billionaires, and big companies, but turned its back on the little guy.

A study of 124 banking crises by the International Monetary Fund found that propping up banks which are only pretending to be solvent often leads to austerity:

> 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.
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> 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.
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> All too often, central banks privilege stability over cost in the heat of the containment phase: if so, they may too liberally extend loans to an illiquid bank which is almost certain to prove insolvent anyway. Also, closure of a nonviable bank is often delayed for too long, even when there are clear signs of insolvency (Lindgren, 2003). Since bank closures face many obstacles, there is a tendency to rely instead on blanket government guarantees which, if the government's fiscal and political position makes them credible, can work albeit at the cost of placing the burden on the budget, typically squeezing future provision of needed public services.

In other words, the "stimulus" to the banks blows up the budget, "squeezing" public services through austerity.

Numerous top economists say that the bank bailouts are the largest robbery and redistribution of wealth in history.

Why was this illegal? Well, the top white collar fraud expert in the country says that the Bush and Obama administrations broke the law by failing to break up insolvent banks … instead of propping them up by bailing them out.

And the Special Inspector General of the Tarp bailout program said that the Treasury Secretary lied to Congress regarding some fundamental aspects of Tarp – like pretending that the banks were healthy, when they were totally insolvent. The Secretary also falsely told Congress that the bailouts would be used to dispose of toxic assets … but then used the money for something else entirely. Making false statements to a federal official is illegal, pursuant to 18 United States Code Section 1001.

Given the above – and the fact that we no longer prosecute the big white collar criminals – we no longer have a free market economy … we have fascism, kleptocracy, oligarchy or banana republic style corruption. As such, the machinery of capitalism – which could generate enough prosperity to dig us out of this budget deficit – has been broken.

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