How the Bailout Killed Local Lending

And How Some States Hope to Bring It Back

By Ellen Brown
Global Research, July 01, 2011
Web of Debt 1 July 2011

Region: USA
Theme: Global Economy

"Wall Street banks have cut back on small business lending... [by] more than double the cutback in overall lending.... [Small business] options just keep disappearing." –Elizabeth Warren, Chair of the TARP Congressional Oversight Panel

The Wall Street bailout of 2008 has radically altered the banking business. The bailout was supposed to keep credit flowing to Main Street, but it has wound up having the opposite effect. Small and medium-sized businesses have traditionally been the main engines for increasing employment, and they need bank credit for their working capital; but today credit to local businesses has collapsed nearly everywhere.

That's why so many states—the total is now fourteen—are considering turning to state-owned banks to get local credit flowing again.

The Bailout that Missed Main Street

The credit collapse of September 2008 was triggered by the speculative activities of giant Wall Street banks. These profligate banks, which would have gone bankrupt without federal support, have emerged from the crisis bigger and more powerful than before. The federal government has supported and subsidized bank consolidation, resulting in the elimination of more than a thousand community banks by takeover or failure.

The five largest banks now hold 40 percent of all deposits and 48 percent of all bank assets. These banks—Bank of America, Wells Fargo, JPMorgan Chase, Citigroup, and PNC—currently control more deposits than the next largest 45 banks combined.

They are big, they are powerful, and they have lost interest in local lending. In the past three years, the four largest banks have cut back on small business lending by a full *53 percent*. The two banks that were the largest recipients of TARP funds, Bank of America and Citigroup, have cut back on local lending by *94 percent and 64 percent*, respectively.

Why? In 2010, the six largest bank holding companies made a combined $75 billion; and of this, $56 billion was in trading revenues—income from speculating in derivatives, futures, commodities, and currencies. If the too-big-to-fail banks win on these bets, they win big and can pocket the proceeds. If they lose, the federal government can be relied on to bail them out. In those comfortable circumstances, why lend to risky local businesses that might go bankrupt, or to homeowners who might default?

Why Banks Aren't Lending Locally

Another perk of the bailout that has put a tourniquet on local lending involve interest rates. The Federal Reserve dropped the Fed funds rate (the rate at which banks lend to each other) to an extremely low 0 to 0.25 percent. It was a very good deal for the big banks—too good to be wasted on local lending. As Dirk van Dijk, writing for the investor website *Zacks.com,* explained in April 2010:

Keeping short-term rates low should be good for the stock market, and is particularly helpful to the big banks like Bank of America (BAC) and JPMorgan (JPM). Their raw material is short-term money, which is effectively free right now. They can borrow at 0.25% or less, and then turn around and invest those funds in, say, a 5-year T-note at 2.50%, locking in an almost risk-free profit of 2.25%.

On big enough sums of money, this can be very profitable, and will help to recapitalize the banking system (provided they don't drain capital by paying it out in dividends or frittering it away in outrageous bonuses to their top executives).

It can be very profitable indeed for the big Wall Street banks, but the purpose of the near-zero interest rates was supposed to be to get banks to lend again. Instead, they are, indeed, paying "outrageous bonuses to their top executives;" using the money to engage in the same sort of unregulated speculation that nearly brought down the economy in 2008; buying up smaller banks; or investing this virtually interest-free money in risk-free government bonds, on which taxpayers are paying 2.5 percent interest (more for longer-term securities).

Investing in Treasury bills is an attractive alternative for banks, not just because it provides 2.25% of risk-free profit but because it requires no capital investment. The amount of capital a bank must hold against its assets (mainly loans) depends on how risky the assets are. Treasuries are considered "risk-free," so there is NO capital requirement for holding them. Naturally, banks prefer investing in Treasuries under these circumstances over making risky loans, against which they must maintain capital reserves of 7%. The banks can borrow virtually for free and make a nice return at taxpayer expense without tying up their capital, which can be used instead to speculate in the market.

And speculation is particularly lucrative at these very low interest rates. As blogger Philip George explains:

The entities who really benefit from low interest rates are hedge funds and traders of financial instruments. Typically, they take advantage of mispricings of securities amounting to a few cents. And how do they parlay such tiny mispricings into incomes amounting to tens and hundreds of millions of dollars? By leveraging their equity ten, fifty, or a hundred times. And of course they can do that only if money is dirt-cheap.

Equally important, this hurts the producers of real goods and services who are looking for loans. At present the prime rate is around 3.25%. What self-respecting bank would lend at 5% or even 10% and wait a whole year when they can earn more in just a few weeks by trading in financial instruments?

Even when banks do deign to use their nearly-interest-free funds to support loans, they typically do not pass these very low rates on to borrowers. For example, the Fed funds rate was lowered by 5 percentage points between August 2007 and December 2008, but during the same period the **30 year fixed mortgage rate** dropped by less than 1 percent, from

6.75 percent to only about 6 percent; today it is still at 4.5 percent.

State-owned Banks to the Rescue?

With lending to Main Street still anemic, some states are taking matters into their own hands and considering legislation that would put local credit back into the local economy. Fourteen states have now initiated legislation for state-owned banks based on the model of the Bank of North Dakota (BND), which provides liquidity for local banks and credit lines for local government. North Dakota has not lost a single bank to insolvency over the last decade.

Other ways in which the BND supports local lending are detailed in a Demos report by Jason Judd and Heather McGhee titled "Banking on America: How Main Street Partnership Banks Can Improve Local Economies." They write:

Alone among states, North Dakota had the wherewithal to keep credit moving to small businesses when they needed it most. BND's business lending actually grew from 2007 to 2009 (the tightest months of the credit crisis) by 35 percent. BND accomplished this through participation loans, in which BND contributes to a community bank's loan, in order to free up the bank's capital for more lending. Other tools that boost bank lending power and lower interest rates include purchases of community bank stock and—together with the state's targeted economic development programs—interest rate buy-downs. As a result, loan amounts per capita for small banks in North Dakota are fully 175% higher than the U.S. average in the last five years, and its banks have stronger loan-to-asset ratios than comparable states like Wyoming, South Dakota and Montana.

While we wait for the Fed to reform its monetary policy and for Congress to break up the banking monoliths, we can follow the lead of North Dakota and set up our own local credit engines. State-owned banks can not only nurture and protect local lending but can provide cash-strapped states with new revenues—without raising taxes, slashing services, or selling off public assets.

First posted by Yes! Magazine.

Ellen Brown is an attorney, author, and president of the Public Banking Institute, *http://PublicBankingInstitute.org. In Web of Debt, her latest of eleven books, she shows how the power to create money has been usurped from the people, and how we can get it back. Her websites are http://webofdebt.com and http://ellenbrown.com. For information on specific state bank legislation, see here.*