Obama administration plan for "toxic assets": A windfall for Wall Street

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Global Research, March 23, 2009
World Socialist Web Site 23 March 2009

Region: USA
Theme: Global Economy

The Obama administration is expected to provide more details today of its plan to enable Wall Street banks to offload up to $1 trillion of their bad mortgage loans and other "toxic" assets at public expense.

Over the weekend, the administration leaked to the press key features of the scheme, to be announced by Treasury Secretary Timothy Geithner. The press reports make clear that the plan is designed to provide a windfall for the very banks and investment firms which precipitated the deepest economic crisis since the 1930s by speculating on high-risk investments that generated extraordinary returns—until the housing and debt bubbles burst—and sustained the multi-million-dollar pay packages of Wall Street CEOs.

According to the reports, the plan will have three major components, all of which involve the use of taxpayer money to guarantee large profits for hedge funds, private equity firms and insurance companies who agree to use low-cost government loans to purchase virtually worthless mortgage loans and securities that are weighing down the balance sheets of the banks.

The government will put up as much as 97 percent of the cash to carry out the purchases and agree to absorb 75 percent or more of any losses that might result from the deals. At the same time, the government will expand a Federal Reserve program launched last week to revive the dormant market in asset-backed securities, otherwise known as the "shadow banking system," to enable the Wall Street billionaires who participate in the scheme to eventually repackage and resell the assets they take off of the hands of the banks at a substantial profit.

As for the banks, the plan will enable them to not only offload their failed investments at public expense, but profit handsomely from a resulting rise in the price of their stock.

Geithner is expected to announce the creation of a new government entity, called the Public Investment Corporation, which will oversee the bailout. This agency will be backed by $100 billion not yet allocated from the $700 billion Troubled Asset Relief Program (TARP) that was proposed by the Bush administration and authorized by the Democratic-controlled Congress last October.

Geithner is not expected to directly request any additional bailout funding from Congress, in part because of the eruption of public anger over $165 million in bonuses handed out by the insurance giant American International Group (AIG), which is now 80 percent owned by the government after the injection of over $170 billion in bailout funds. However, the Obama administration allocated an additional $750 billion in bank bailout funds as a "place holder" in the budget it submitted last month.

The first prong of the three-part plan involves the Federal Deposit Insurance Corporation (FDIC), the agency created in the 1930s to insure the savings of ordinary bank depositors. The FDIC will establish partnerships with hedge funds and other private investment firms to buy whole home loans—as distinct from loans packaged into mortgage-backed securities—from banks that agree to sell them. (In this, as in the other parts of the plan, the participation of banks and investment firms is entirely voluntary).

According to a report in Saturday's New York Times, the FDIC will provide non-recourse loans—that is, loans secured only by the value of the home loans bought—to participating firms worth up to 85 percent of the value of a portfolio of "troubled" bank assets. Of the remaining 15 percent of the cost, the Treasury will use public funds to cover up to 80 percent, leaving the investment firms to contribute as little as 3 percent of the total cost. The government will, moreover, set the interest rate it collects on loans to the firms well below current market rates.

In its report on Sunday, the Washington Post indicated that the government will guarantee 75 percent of any possible losses. The private investors, not the government, will manage the loan portfolios.

This means that the function of the FDIC will be largely transformed from guaranteeing the bank deposits of small savers into guaranteeing the investments of billionaire investment fund managers.

As for the cost to the public, it is doubtful that Geithner will mention that on March 5 Christopher Dodd, the Democratic chairman of the Senate Banking Committee, submitted a bill at the behest of the Obama administration to authorize the FDIC to increase the limit on funds it can borrow from the Treasury from $30 billion to $500 billion. This fiscal sleight of hand will allow the administration to claim that it is allocating "only" $100 billion in taxpayer money for its new bailout scheme.

The other two prongs of the administration plan are directed at the banks' money-losing securities backed by mortgages and other forms of consumer and commercial debt. One will expand a Federal Reserve program, the Term Asset-Backed Securities Loan Facility (TALF), which was launched last week to extend low-cost loans and guarantees against losses to hedge funds and private equity firms that purchase new securities backed by auto loans, credit card debt, commercial mortgages and small business loans.

TALF will be enlarged to include the purchase of previously existing asset-backed securities, including those backed by residential mortgages. In addition, the Fed will be required to offer longer-term loans to private investors than under the original TALF plan, possibly as long as seven years. This is designed to provide sufficient time for markets to recover so that the investors can reap big profits before their loans come due.

Finally, the government will establish a so-called "public-private partnership," in which the Treasury Department hires a number of investment management firms to buy mortgage-backed and other securities from the banks. The Treasury will match, dollar-for-dollar, money from private investors who participate and will also loan funds to increase the investment funds' purchasing power.

In all, the plan amounts to a racket in which the federal treasury is placed at the disposal of Wall Street. One question that arises is why the Obama administration chooses not to directly purchase the bad assets from the banks? There are two basic reasons.

The first is bound up with immediate political considerations. Under conditions of mounting public opposition to the bailout of Wall Street, the administration does not want to be seen as setting absurdly high prices for the purchase of the banks' bad debts. By subsidizing private investors, who will bid against one another in auctions for home loans and securities offered for sale by the banks, the government can claim that the "market" is setting the price.

This is a fraud. By paying investors to buy the banks' junk assets and insuring them against losses, the government is creating conditions where the buyers will be willing to pay outlandishly high prices and the banks will receive multiples of the real market value of the assets they offload.

The New York Times columnist and economist Paul Krugman characterized the scheme aptly in a blog he published on Saturday:

"In effect, Treasury will be creating—deliberately!—the functional equivalent of Texas S&Ls in the 1980s: financial operations with very little capital but lots of government-guaranteed liabilities. For the private investors, this is an open invitation to play heads I win, tails the taxpayers lose. So sure, these investors will be ready to pay high prices for toxic waste. After all, the stuff might be worth something; and if it isn't, that's someone else's problem."

The second, and more basic, reason goes to the class character of the administration and the reality of class relations in the United States. Decades of financial parasitism, aided and abetted by successive administrations, Democratic as well as Republican, have transformed the ruling class into a financial aristocracy that exercises overwhelming and unchecked power over the state. Only a government that functions as the open instrument of this miniscule segment of society could present such a flagrant scheme to plunder the country's resources and utilize the crisis of the financial aristocracy's own making to further enrich it at the expense of the people.

When Geithner, formerly the president of the Federal Reserve Bank of New York and a key architect of the Bush administration bailout, announced the outlines of the new administration's bailout plan last month, he was pilloried by Wall Street—the Dow Jones Industrial Average plummeted 380 points—because he was deemed to have provided insufficient guarantees for the wealth and power of the banks and Wall Street firms. Obama, who was elevated to the presidency by the most powerful sections of finance capital to serve as their front-man, got the message. In the intervening period, his top economic advisers have undoubtedly been involved in talks with the masters of Wall Street to make sure that the new announcement will meet with their satisfaction.

As the Washington Post reported on Sunday, some of the richest and most powerful figures on Wall Street were the real authors of the administration's plan. The newspaper noted: "Last fall, billionaire investor Warren E. Buffett, Goldman Sachs chief executive Lloyd Blankfein and William H. Gross, the managing director of PIMCO, the largest bond fund in the world, approached Treasury officials about an idea to create investment funds, using public and private money, to buy toxic assets from banks, according to former senior Treasury officials."

The utter servility of the administration to Wall Street was on full display on the Sunday television talk shows. Administration spokesmen all but begged the banks and hedge funds not to allow their indignation over congressional moves to limit executive bonuses to dissuade them from participating in the government's new bailout scheme.

Christina Romer, chairwoman of the White House Council of Economic Advisors, appearing on the "Fox News Sunday" program, signaled that the administration did not support such moves and sought to reassure Wall Street that no firms which participated in the bailout plan would face limits on executive pay.

"What we're talking about now are private firms that are kind of doing us a favor," she said, "coming into this market to help us buy these toxic assets off banks' balance sheets. And I think they understand that the president realizes they're in a different category… They are firms that are being the good guys here."