The Bush Administration's Banking Rescue Plan

By Prof Rodrigue Tremblay

Global Research, September 23, 2008
23 September 2008

Region: USA
Theme: Global Economy

"Those who cannot remember the past are condemned to repeat it." George Santayana

"The bill gives [Sec.] *Paulson the ability to nationalize an unlimited amount of private debt and force you and your children to pay for it.... I predict that if this passes it will precipitate the mother and father of all financial panics."* Karl Denninger (Market Ticker)

"Decisions by the Secretary pursuant to the authority of this Act are non-reviewable and committed to agency discretion, and may not be reviewed by any court of law or any administrative agency." Section 8, Bush's administration proposed legislation to bailout U.S. banks [Legislative Proposal for Treasury Authority to Purchase Mortgage-Related Assets].

"The Fed is merely trying to inject money to keep prices not supported by fundamentals from falling. It is a prescription for hyperinflation. The only way to keep prices of worthless assets high is to lower the value of money. And that appears to be the Fed unspoken strategy." Henry Liu, economist

If I may simplify somewhat the situation, (but only slightly) we can say that over the last quarter of century, **Wall Street** firms bought out Congress and the White House (and paid at wholesale prices). Now, they want the **U.S. government** to buy them back (and they want to sell at retail prices).

Over the years, indeed, Wall Street firms have lavished hundreds of millions of dollars in lobbying Washington D.C. so that their more and more complicated financial businesses would be less and less regulated. During the 1980s, the **Savings & Loans industry** (S&Ls) was the recipient of Washington largesse. The epitome was the lobbying by five prominent U.S. senators, one of them **Sen. John McCain**, to deregulate the borrowing and lending practices of savings and loans banks. During the Reagan-Bush era of the 1980's, such deregulation encouraged unsound real estate lending by Savings & Loans financial institutions and this led to the 1986-1995 **Savings and Loans crisis**. Some 747 savings and loans banks failed and about $160 billion was lost, most of it through a $124.6 billion bailout by the U.S. Government.

During the Clinton and Bush-Cheney eras, large banks were allowed to buy relatively long term subprime home mortgages from regional banks and other mortgage lending firms and repackage them, **"securitize"** them and resell them as sliced **mortgage-backed securities.** The banks sold them as short term-like commercial paper, but without guaranteeing them. In 1999, for example, the banking industry spent more than $300 million in lobbying Congress and the White House to repeal the **1933 Glass-Steagall Act** that closely regulated banking activities. In November 1999, the Glass-Steagall Act was eviscerated after many years of lobbying efforts. It was replaced by the **Gramm-Leach-Bliley Act** which established the new market-driven unregulated system for many financial institutions, the largest ones being the New York-based **investment banks.**

With scant regulation, banks could engage in highly leveraged new banking practices, in violation of sound banking practices. For example, regulated commercial banks normally keep a 1:10 ratio between reserves and loans. But U.S. unregulated entities embarked upon highly leveraged finance, keeping a 1:30, 1:40 or even 1:50 ratio between reserves and risky loans. In so doing, the unregulated banks raked in huge fees at what (they thought) was very little risk for them, because they had hoped to transfer the inherent risk to the buyers of their repackaged securities.

However, when some of the original mortgages downstream became delinquent as the housing price bubble burst, in the spring of 2005, and home foreclosures began to rise, more than $1 trillion of the artificial mortgage-backed securities previously created thus became less secure and less liquid. As time went on, the market for such artificial securities *de facto* dried up. As a consequence, the issuing banks were left with a large inventory of now toxic securities that nobody wanted to buy. Huge permanent losses replaced huge but illusory short-term profits, although banking CEOs kept receiving large (some would say obscene) total **corporate compensations.**

The incestuous relationship between unregulated high finance and Washington politics is coming to a climax with the U.S. Treasury Secretary, a former Wall Street CEO of one of the Wall Street banks in relative distress, being declared by **legislation** a *de facto* **economic tsar** and a public Santa Claus. According to proposed legislation, indeed, Mr. Henry Paulson, the former Chairman and Chief Executive Officer (June 1998 – July 3, 2006) of **Goldman Sachs**, would be entrusted with the power to buy from troubled banks, at his discretion, the bad financial assets they now have on their books. To accomplish that task, as much as $700 billion would be placed in his hands. It is said that Congress, in this election period, does not have time to create an independently-run Bank Resolution Trust under the model of the 1989 **Resolution Trust Corp,** and all the power to intervene has to be concentrated in the person of the Treasury Secretary.

There you have it. —This is the overall feature of the Bush administration's plan to place hundreds of billion dollars of public money at risk to shore up the U.S. banking industry and prevent the unstable financial house of cards from collapsing.

At the bottom of the problem is the fact that American banks are presently very short of **capital,** to the point of being insolvent, because of overleveraged investments in the past and because of the huge losses they have suffered in illiquid mortgage-backed securities. The purchase by government of the most illiquid financial assets they have on their books could have the effect of providing some badly need capital to banks through some form of public subsidies, provided it is done in a not too transparent way.

Indeed, the government rescue of U.S. banks comes down to this: How many of the toxic financial assets is Sec. Henry Paulson willing to buy from banks and at what prices?

The "Paulson put"

Henry Paulson is being placed in the role of a government financial plumber who promises to unplug the pipes of finance and cleanse them of the mortgage-backed sludge. He is asking taxpayers' representatives for a blank check, to create a huge slush fund, $700 billion, that he would be free to use to buy toxic depreciated securities from troubled banks and relieve their balance sheets from this undesirable load.

If Sec. Paulson were to pay a high price for the most illiquid bank-owned mortgage-backed securities, this would amount to a **"Paulson put"** because it would have the effect of guaranteeing the profitability of many risky financial operations that otherwise would have failed. As a matter of fact, at what price would Sec. Paulson buy the illiquid bank toxic assets? At 70 percent of initial book value, or at a price closer to market value which may be 20 to 30 percent of face value. Who would know? When? Under what guidance?

Answers to these questions are crucial because they will help to calculate what could be the final cost to the public purse of the bank bailout. But there is a fundamental dilemma here for the government. If Sec. Paulson were to overpay for the banks' garbage securities, the bailout would amount to a **recapitalization** of the banks, with taxpayers' money. This would not be a popular move, considering how much money the banks' CEOs made in driving their institutions into the ground. On the other hand, if Sec. Paulson were to pay strictly fair market value for those bad debts, priced at a substantial discount to reflect their poor liquidity and marketability, then the troubled banks would have to write down their **losses** and would still remain weak and unstable.

There is something surreal and profoundly immoral that the individuals who were front and center in creating the **subprime financial meltdown** are also those who have been entrusted by the government to solve the mess they have created. Are there not independent economic and financial experts in the United States who could have been assigned this task?

Conclusion

Even though it is the primary responsibility of a government to make sure that financial markets and institutions function properly, the Bush administration's banking rescue plan leaves a lot to be desired before being called economically efficient, and socially and politically acceptable.

__Rodrigue Tremblay__ is professor emeritus of economics at the University of Montreal and can be reached at ***rodrigue.tremblay@ yahoo.com.***

*He is the author of the book **'The New American Empire'**.*

*Visit his blog site at **www.thenewamericanempire.com/blog.***

*Check Dr. Tremblay's coming book "The Code for Global Ethics" at: **www.TheCodeForGlobalEthics.com/***

Comment on Global Research Articles on our Facebook page

Become a Member of Global Research

Articles by: Prof Rodrigue Tremblay