The “Geithner Put”: It’s time to break up the big banks

dumping $1 trillion of toxic assets onto US taxpayers

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Global Research, February 25, 2009
25 February 2009

Region: USA
Theme: Global Economy

Timothy Geithner is putting the finishing touches on a plan that will dump $1 trillion of toxic assets onto the US taxpayer. The plan, which goes by the opaque moniker the “Public-Private Investment Fund” (PPIF), is designed to provide lavish incentives to hedge funds and private equity firms to purchase bad assets from failing banks. It is a sweetheart deal that provides government financing and guarantees for illiquid mortgage-backed junk for which there is no active market. As one might expect, the charismatic President Obama has been called in to generate public support for this latest addition to the TARP bailout. In this week’s address to Congress he said:

“This administration is moving swiftly and aggressively to restore confidence, and re-start lending.
We will do so in several ways. First, we are creating a new lending fund that represents the largest effort ever to help provide auto loans, college loans, and small business loans to the consumers and entrepreneurs who keep this economy running.”

The Obama administration is clearly afraid to use the unpopular Geithner to sell this boondoggle to the American people. Geithner’s last performance set off a political firestorm and put the equities markets into a swan-dive. No one wants to see that again.

Details of the plan remain sketchy, but the PPIF will work in concert with the Fed’s new lending facility, the Term Asset-Backed Securities Loan Facility, or TALF, which will start operating in March and will provide up to $1 trillion of financing for buyers of new securities backed by credit card, auto and small-business loans. Geithner’s financial rescue “partnership” will also focus on cleaning up banks balance sheets by purging mortgage-backed securities. (MBS)

In Monday’s New york Times, Paul Krugman summed up the Geithner plan like this:

“Now the administration is talking about a “public-private partnership” to buy troubled assets from the banks, with the government lending money to private investors for that purpose. This would offer investors a one-way bet: if the assets rise in price, investors win; if they fall substantially, investors walk away and leave the government holding the bag. Again, heads they win, tails we lose.
Why not just go ahead and nationalize?”

Why not, indeed, except for the fact that Geithner’s main objective is to “keep the banks in private hands" regardless of the cost to the taxpayer. The Treasury Secretary believes that if he presents his plan a "lending program" rather than another trillion dollar freebie from Uncle Sam, he'll have a better chance slipping it by Congress and thereby preserving the present management structure at the banks. Keeping the banking giants intact is "Job 1" at the Treasury.

The PPIF is a way of showering speculators with subsidies to purchase non-performing loans at bargain-basement prices. The Fed is using a similar strategy with the TALF which, according to the New York Times, could easily generate "annual returns of 20 percent or more" for those who borrow from the facility.

From the New York Times:

"Under the program, the Fed will lend to investors who acquire new securities backed by auto loans, credit card balances, student loans and small-business loans at rates ranging from roughly 1.5 percent to 3 percent.

Depending on the type of security they are borrowing against, investors will be able to borrow 84 percent to 95 percent of the face value of the bonds. Investors would not be liable for any losses beyond the 5 percent to 16 percent equity that they retain in the investment.

In the initial phase, the Treasury will provide $20 billion and the Fed will provide $180 billion. Treasury Secretary Timothy Geithner said last week that the Treasury could increase its commitment to $100 billion to allow the Fed to lend up to $1 trillion." (NY Times)

This is a blatant ripoff, which is why the plan is being concealed behind abstruse acronyms and complex explanations of how the transactions actually work. The only way investors can lose money is if they hold on to the securities after they fall below 16 percent of their original value which, of course, is unlikely, since the buyers can bail out at any time leaving the taxpayer holding the bag. Call it the "Geithner Put", another gift from Uncle Sugar to Wall Street land-sharks.

Geithner thinks that by obfuscating the details of his plan, he'll be able to carry it off with no one the wiser. But he's mistaken. His credibility has already been badly battered by his chronic evasiveness. Now the pundits are blaming him for falling consumer confidence and the plummeting stock market. Whatever plan Geithner proposes, will be put under a microscope and dissected word by word. He won't get a second chance to pull the wool over the public's eyes. If he botches the rescue operation, Obama will be forced to give him the sack. The political furor would be too much to bear.

It is no surprize that the Fed announced its expansion of the TALF on the same day that Geithner presented his outline for a "public-private partnership". The two plans represent the Obama Team's strategy for "squaring the circle", that is, for keeping the big banks in private hands while purging their balance sheets of worthless assets at the public's expense. Here's how it's presented on the Fed's website:

> "Under the TALF, the Federal Reserve Bank of New York will provide non-recourse funding to any eligible borrower owning eligible collateral… As the loan is non-recourse, if the borrower does not repay the loan, the New York Fed will enforce its rights in the collateral and sell the collateral to a special

> purpose vehicle (SPV) established specifically for the purpose of managing such assets… The TALF loan is non-recourse except for breaches of representations, warranties and covenants, as further specified in the MLSA"

Non-recourse funding? In other words, the loans will be like mortgages, where if the homeowner finds that he is underwater, he can just walk away and leave the bank to cover the losses? In this case, it is the taxpayer who will be left taking the loss.

The PPIF is basically the same deal, 90 percent government-funded "no risk" financing offered to the same speculators who just blew up the financial system. It's a complete scam. The process allows Geithner to avoid assigning a market value to these garbage assets that no one wants. That means that he's planning to pay inflated prices–up to $1 trillion– to keep the banks happy. Once their balance sheets are scrubbed clean, the banks can begin engineering their next swindle. Meanwhile, the hedge funds and private equity firms will demand refunds for the toxic waste they bought but cannot offload on skeptical investors. Once again, the government will pick up the tab. No problem.

Does Geithner really think he can sneak this by the American people?

The markets aren't going to like the idea of recapitalizing the banks through the backdoor. Wall Street will see right through the smoke n' mirrors and hit the "sell" button. If the banks need recapitalizing, they will have to do it the old fashion way. They'll have to restructure their capital, which means that shareholders get the ax, bond holders get a haircut, management gets the door, and the American people become majority shareholders. That's how it works in a free market. When businesses are insolvent; they file for bankruptcy and the debts are written down. Period. No exceptions. Geithner thinks he can just make up the rules as he goes along, but he's in for a big surprise. This plan is not going to fly. The banks are going to have to take their lumps and start over. Geithner could save us all a lot of trouble by just doing his job and nationalizing them now.

The Baseline Scenario's Simon Johnson put it perfectly when he said:

"Above all, we need to encourage or, most likely, force the large insolvent banks to break up. Their political power needs to be broken, and the only way to do that is to pull apart their economic empires. It doesn't have to be done immediately, but it needs to be a clearly stated goal and metric for the entire reprivatization process."