The Fleecing of the American Taxpayers

Six months ago, we prognosticated the crisis facing the United States' banking system. In September, the world was shocked by the apparently sudden demise of Lehman Brothers, several regional financial institutions, and AIG. The current generation of Americans has yet to see the U.S. banking system in such dark times. Never before have Americans had to worry if their money was safe in the bank. Generations that did not experience the Great Depression became complacent that their savings would be safe in their bank, a belief supported by the FDIC that insures up to $100,000 in savings per individual. But over the summer, a number of factors working in concert drove the financial system to the brink. This phenomenon was boiling and festering for the better part of a year and only now has erupted and sent a systemic shock throughout the economy and, indeed, the world. Combine this with an impotent Federal Reserve, a self-serving Treasury Secretary, greedy and opportunistic banks, a panicked Congress, and a weary public, and we are faced with what many believe is the most significant financial crisis since the Great Depression.

The current crisis facing the financial system stems from the deflating of the bubble in real estate markets that has left banks holding billions (if not trillions) of dollars in non-performing mortgages. Not only are many of these mortgages non-performing but many of these same mortgages have outstanding balances that are now more than the current market values of the properties that secure the notes. The banks are like consumers who are "upside down" on the financing of their automobiles. This certainly is not a position in which the banks want to find themselves.

Technically, many of these banks are now insolvent. Bank assets are comprised of the loans that have been made. The funds on deposit by depositors are used to make these loans but are actually the liabilities of the bank; after all, the bank owes these funds to the depositors. Non-performing loans decrease the assets of the bank with no impact on liabilities but, rather, a corresponding reduction in equity. So, consider this simple example. Suppose the bank has $100 million in assets of which $75 million are loans (mortgages). On the liability side, the bank has $80 million in deposits and $20 million in capitalization (equity) or reserves. Further, suppose that the bank realizes that $25 million in the loan portfolio is non-

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performing. In essence, the bank now only has $75 million in market valued assets ($100 million less $25 million of non-performing loans=$75 million). However, the bank still has deposits of $80 million but the equity has been erased and is now -$5 million. The banks liabilities are more than its assets, thus the bank is technically insolvent.

This is, of course, the financial markets' worst fear. That fear has virtually come to pass in the last several weeks as several banks went under and others begged the Federal Reserve and the Treasury for help. This situation and the attending fear could have the capacity to prompt a traditional "run on the banks," a scenario that would likely spiral out of control. It would seem that the U.S. banking system has been hanging on the precipice of sparking a run on the banks, a situation that could prompt a complete financial system meltdown here in America and abroad. However, in light of rapidly deteriorating conditions in credit markets and the banking industry, the Treasury Secretary, Hank Paulson, stepped up to the plate with bold "bailout" initiatives aimed at stabilizing the financial markets and ensuring a properly functioning and liquid financial system.

The initiatives started with the bailouts of Fannie Mae and Freddie Mac. Despite President Bush's efforts to more strictly regulate these implicit government sponsored entities in 2001 (an initiative eclipsed by the terrorist attacks on America on September 11, 2001), Fannie and Freddie grew bloated during the real estate bubble, backing loans that would ultimately not be repaid by the borrowers. In the face of certain bankruptcy, the government took over both Fannie and Freddie, in the process taking a massive amount of equity in the companies in exchange for financial assistance.

Next, Lehman Brothers, one of the oldest investment banks in the world, collapsed under massive debts (in excess of $600 billion). The government ultimately turned down Lehman's pleas for help and the assets of the firm were absorbed by Barclays. That was a wise decision on the part of the Treasury, but given that Treasury Secretary Paulson was the former head of Goldman Sachs (a Lehman rival), it is not all that surprising. The failure of Lehman just means less competition for Secretary Paulson's buddies at Goldman.

Then came the near collapse of AIG, the insurance conglomerate that teetered on the verge of bankruptcy while management spent nearly $500,000 on a corporate retreat to reward executives and top

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performers at the company. That seems an awful lot like Nero playing the violin while Rome burned. But nonetheless, the Treasury came to the rescue with an $85 billion rescue “loan” to AIG in exchange for another massive equity position in the company. The plan, of course, contained some carrots to make the package appealing to the public—a favourable 11% interest rate and the possibility that the government could actually make money from selling the shares at a higher value in the future once the company had turned itself around and stabilized.

The Treasury justified this bailout as necessary to ensure properly functioning financial markets, given AIG’s ties to Wall Street, banks, insurance markets, and corporate America as well as overseas markets. The Feds claimed that everyday Americans would be negatively impacted by the collapse of AIG, but what no one asked was who really benefited from a bailout of the insurance giant? Who actually received the massive amount of fees paid to advisors on the transaction? Could it have been some of the Wall Street good old boys?

But what would have happened had the Treasury not bailed out AIG? In all likelihood, the assets of the insurer would have been repriced to the market value and acquired by other investors. Had AIG actually collapsed, there is no doubt that someone would have taken over the assets of the company—someone like Warren Buffet, for example, whose Berkshire Hathaway group could easily have absorbed AIG’s insurance operations. But no, it was much easier for the Treasury to provide a bailout in the form of a loan that we suspect will never be repaid. The taxpayers will just have to eat this one.

But not to be one-upped by Treasury, the Federal Reserve had to get involved in the rescue with its own policy action in the form of a fifty basis point cut to 1½%, a move that makes real rates effective 0%. Let us not forget that the Fed’s actions—low rates for too long—are what started the mess by creating a moral hazard for banks to loan money whilst the money was cheap, with little regard for fundamental valuations for real estate. So much for the Federal Reserve oversight of banks over the last several years…

With the fifty basis point cut in the federal funds rate on October 8, 2008 to 1½%, the Fed has done nothing but attempt to bail out the equity markets with a protective “Bernanke put.” After all, the rate cuts now will not help those already in foreclosure or those

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who cannot afford their homes anymore—homes for which they overpaid and the values of which have dropped considerably—and that will ultimately go into foreclosure. Further, the rate cut has done little to help consumers or businesses obtain credit in the tight markets of late. Quite simply, banks have clamed up and are just not letting go of the purse strings. The rate cut was nothing more than a maneuver to restore confidence in the financial markets in hopes of preventing further falls in the major indices and preventing massive losses in retirement accounts of Americans invested in the stock market.

All of these events led up to the $700 billion bailout of the banks proposed by Treasury and the Federal Reserve. The plan involved the government purchasing toxic mortgages from banks to bolster the capital of the banks and in an effort to help homeowners in foreclosure or about to go into foreclosure. This proposal is a disgrace and a massive fleecing of the American taxpayers. Banks made the loans when times were good. They exhibited poor judgment in making many of these loans. Buyers of CDO (collateralized debt obligations) and CMO (collateralized mortgage obligations) assumed some of the risks when banks packaged and sold off parts of their loan portfolios that they could reasonable pawn off on others. This was like a vast Ponzi scheme where the investors and taxpayers left holding the bag are out billions.

There are those who would argue that the motivation behind this bailout was to prevent a run on the banks when a major financial institution collapses. The Federal Reserve is the lender of last resort and provides emergency liquidity to the banks in the financial system. If the banks were concerned about liquidity, they could simply have borrowed from the Fed's discount window at the overnight rate. This was designed to ensure adequate liquidity in the banking system, particularly in the event of a crisis or a perceived crisis. Whilst many banks have borrowed from the Fed, the bailout is a way to recapitalize without any interest costs or adverse financial consequences to the bank.

This is further evidence that the banks just wanted to pawn off their bad investment decision on others, namely the taxpayers via the U.S. Treasury, with little or no apparent consequences for the poor decision makers who created this mess. This is abjectly wrong and will only promote further moral hazard in the future. The homeowners who made bad investment decisions and the banks that enabled this should not be rewarded for poor investment decisions. Rather, the banks and the homeowners should work together to find a solution, other than foreclosure, to the problem. Irresponsible homebuyers and the banks are being bailed out at the expense of the taxpayers and the millions of Americans who diligently pay their mortgages. Further, this $700 billion bailout creates a moral hazard and sets the stage for banks to make irresponsible loans again. All the while, the bankers are still living the high life and laughing all the way to the bank.

The banks should have been forced to work the problem out on their own. Prior to the bailout, many banks had already started taking massive write-offs for bad mortgages. This, in itself, is financial hocus pocus—the writedowns damage profits now but some of the loans written off will still be collected. When they are collected in part or in full, the banks' profits will be higher than anticipated.

Rather than sell off their loans to the government, banks should have been forced to renegotiate the outstanding non-performing loans by increasing the amortization period, reducing interest rates, etc., so that the loans are once again performing. The money will ultimately be recovered when the homeowner sells the property. If the property is sold for less than the value of the mortgage because the property is appraised at less than the value of the mortgage, the bank should just have to eat this and write it off as a loss.

Rather than cutting the federal funds rate, the Fed should begin the process of raising the reserve requirements of banks. Had this policy tool been used in the past (the last time the Fed used this was to *cut* the reserve requirement), bank capital ratios would be higher now—negating the need to shore up balance sheets with additional capital from foreign investors such as the Saudis. Banks would also have been more judicious in their lending habits, particularly in a period of low rates, which may have prevented many of the toxic mortgages from ever having been offered.

In absence of this bailout, financial assets would have been repriced in the markets to a fair market value and would have been acquired by other investors or strategic buyers. The role of government and the Fed is not to attempt to artificially prop up asset prices, like the stock market. The cut in the federal funds rate in October, which was part of internationally coordinated

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monetary policy action, was further evidence of the Bernanke put, a notion that the Fed will prop up the market with protective interest rate cuts. The actions by Treasury and the Fed create a significant moral hazard that the government will bail out any big business that can reasonably make the argument that its failure will have a major impact on the economy. Will the taxpayers be on the hook for a bailout of General Motors or Ford? The bailout has been politically motivated and aimed at assuaging a nervous public whose pensions have deteriorated drastically as markets fell worldwide. The Congress, the Treasury, and the Fed rushed to judgment in hopes of winning votes for their parties in the upcoming general election at the expense of the taxpayers. At the end of the day, the most important factor from these events is the following: the bailout package is a financially irresponsible move that indebts future generations with significant financial burdens when there is no guarantee that the monies spent on the bailout will ever be repaid to the government. We the taxpayers have been fleeced.

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