

Rescue the Banks not the Bankers and Shareholders

Nationalization of the insolvent banks is the only solution to the financial crisis

The new plan to rescue the banks follows the same logic as the Bush-Paulson plan: throw taxpayer dollars at the problem to put off nationalizing financial institutions. Treasury Secretary Timothy Geithner's vague proposal relies on another huge infusion of federal equity into "healthy" banks and a massive government insurance program to underwrite a "private market" for financial institutions' toxic assets. This plan is the same "lemon socialism" – socialization of the mega-losses of private financial institutions – that the Bush Administration put in place.

Financial institutions such as Bank of America and Citigroup have already been *de facto* nationalized by the infusion of taxpayer equity whose value swamps that of these firms' market equity. So far, the Obama administration plans to continue the Bush administration's policy of receiving only bond-like "warrants" instead of voting stock that would provide majority control. These insolvent "zombie banks," as economist Paul Krugman calls them, are only "living" as private entities because of the endless infusion of government funds – funds that continue failing to offset the declining value of the banks' toxic assets.

The banks gladly take the government equity and use it to shore up their deteriorating balance sheets rather than to engage in renewed lending. Healthier banks reward their managers and their stockholders but refuse to lend because they fear a further deterioration of the toxic assets on their balance sheets. Despite prior massive federal aid to financial institutions failing to unlock the frozen credit markets, the Geithner plan proposes to waste \$1 trillion more in equity infusions and insurance guarantees to avoid *de jure* nationalization – and without getting much new lending!

They argue that the federal government can create a private market for the toxic assets where none exists now. Geithner's plan is so vague precisely because he knows what is to come: spending hundreds of billions of taxpayer dollars to subsidize private purchasers of the assets (as private offerings on their own will not meet banks' asking prices). Or the Federal Reserve and TARP will write "insurance" guaranteeing a high floor price to investors who buy the toxic assets. In other words, the federal government will create a "free market" by guaranteeing private investors against any sharp decline in the value of the toxic assets they purchase. And this is supposed to be the capitalism that rewards successful risk and penalizes failed risk?

But why are so many of our financial institutions *de facto* insolvent? Massive losses in the value of exotic financial instruments and other assets carried on balance

sheets have left banks and shadow financial institutions such as hedge funds and private mortgage lenders owing their depositors more than they are worth. These institutions relied on exotic economic models that assumed that housing prices were extremely unlikely to fall in value. They became overleveraged with "collateralized debt obligations" (the bundling of risky and less-risky mortgage-backed securities) that the burst housing bubble transformed into non-marketable, valueless assets. As the economy declined, fear of similar securitized debt instruments spread to other forms of credit, including auto loans and credit cards, exacerbating the banks' unwillingness to lend. Hence, Geithner also calls for an \$800 billion expansion of the Fed's Asset-Backed Securities Loan Facility in order to recreate a private market for such debt.

The only rational means to restore the value of these toxic assets is to provide immediate federal relief to homeowners facing foreclosure or struggling to pay mortgages for homes whose market value is now far less than the value of the mortgage. As in the Great Depression, relief will come to the housing market only if the federal government creates a Home Loan Corporation with the power to renegotiate the terms of distressed mortgages – by both lowering the value of the mortgage (with the federal authority splitting the loss in equity with the banks and mortgage companies) and refinancing the adjusted loan at an affordable market rate. The Obama plan devotes \$75 billion for incentives to mortgage-servicers to engage in a voluntary "mortgage readjustment" program. But the plan does not require servicers to renegotiate distressed loans, and many financial institutions will still prefer foreclosure over accepting lower mortgage payments.

Widespread foreclosures can only be avoided if Congress passes legislation giving bankruptcy courts the power to restructure "distressed mortgages." If judges reset the mortgage to the property's current value and reset the interest rate to the current rate, most homeowners would avoid foreclosure. Homeowners unable to pay a restructured mortgage should be allowed to rent (from the bank) for at least a 10-year period. Such measures will provide a floor under housing prices and keep families in their homes.

Normally, the negative balance sheets of major financial institutions would lead the Federal Deposit Insurance Company to take them over in order to "unwind" their bal-

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ance sheets of the valueless assets (whose deteriorating value precludes lending, as the banks do not have enough assets to securely meet their obligations to their depositors). Thus, as with the Savings and Loan crisis of the early 1980s (when toxic commercial mortgages choked off the home mortgage market), the FDIC should take over the insolvent banks and other financial institutions, seize their presently valueless assets, and place them into a Resolution Trust Company (RTC), leading to restructured banks with asset sheets that would support more lending.

Once the sickly financial firm had regained its health, the FDIC could either re-sell it to private investors or the government itself could choose to run the bank. (There is no reason to believe that publicly-hired managers could make any worse decisions than did our vaunted private financial wizards!) When and if the housing market recovered, so would the value of the toxic assets. Then the RTC could sell the toxic assets to private investors without the expensive guarantees, with the proceeds repaying a portion of the banks' bailout cost.

As the Swedish experience of the early 1990s (and the disastrous Japanese delay in eventually nationalizing much of their insolvent financial sector in the late 1990s) proves, the only way to work a financial system out of a calamitous period of speculative hyper-leveraging is to rework the banks' balance sheets by a careful public process of "unwinding." That is, rather than continually paying inflated prices for "toxic assets" that cannot be sold on a truly private market, the government should simply take those assets off the books of distressed financial institutions so that their balance sheets can be restored to health.

Rather than re-selling all the restructured nationalized banks to private investors, the government should maintain full ownership of at least one major bank. Such a bank could provide benchmarks, setting standards for investment in community housing, alternative energy development, and infrastructure that private banks would have to match.

The crisis brought on by unrestrained financial deregulation demonstrates that absent public regulatory restraint, finance capital will engage in irresponsible acts of speculation during financial booms and resort to excessively conservative lending practices during financial busts. Bank deregulation has been a 30-year joint project of Republican monetarists and Democratic neoliberals. It started with the Carter administration's deregulation of the Savings and Loans; accelerated under Reagan's gutting of the entire government regulatory apparatus; and culminated in the Clinton administration's abolition of the Glass-Steagall Act's separation of commercial banks from investment firms (so the very banks that invest in risky financial instruments marketed these instruments to clients!). It was

Lawrence Summers who convinced President Clinton not to allow the Commodity Futures Trading Corporation to create and regulate an open, transparent market for credit-default swaps (insurance against defaults). The unraveling of this unregulated, non-transparent \$60 trillion market still might bring the global financial system to total collapse.

Thus, if the federal government is to restore a sane credit system – a must for any productive economy – it should not only engage in the fiscally prudent step of nationalizing and restructuring insolvent financial institutions (the least costly path for the public treasury); the Obama administration must also recreate a vibrant and effective regulatory system for domestic financial institutions and cooperate with other states, in both the advanced industrial and developing worlds, to build a global financial regulatory system that prioritizes investment in productive enterprise over speculative efforts to make money on money.

The race to the bottom of global neoliberal capitalism is the other half of the story behind this economic crisis. Productive workers across the globe are no longer paid wages sufficient to purchase the aggregate goods and services they produce. The result: the Western working class went heavily into debt, particularly by borrowing massively against inflated home equity values, temporarily forestalling this impending global crisis of overproduction and under-consumption. And the exploited working classes of China and Southeast Asia subsidized Western living standards, while their governments "managed" the market so as to run massive trade surpluses and invested them not in domestic needs but in Treasury bonds and private equity.

Restoration of a stable global economic system will require raising the floor on global living standards and working conditions and creating global regulatory institutions that insure that investment and trade benefit the working people of the world. The era of deregulatory free-market mania is crashing down upon us. Only by reviving the capacity of democratic governments to regulate the economy so that it serves people's needs rather than the speculative desires of corporate elites will we ever recover from the current global economic nightmare.

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