US government brokers scheme to bail out Wall Street banks

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The three biggest US banks on October 15 announced a plan, brokered by Treasury Secretary Henry Paulson, to amass $80 billion to $100 billion in capital to prevent the collapse of highly speculative investment funds, which could in turn trigger a meltdown on financial and stock markets and cripple major Wall Street banks.

The announcement by Citigroup, the world's largest bank by market value, Bank of America and JP Morgan Chase made clear that the global financial crisis which erupted over the summer was not resolved by the US Federal Reserve Board's half-point cut last month in short-term interest rates, and is far deeper than previously acknowledged by US government and banking officials.

The New York Stock Exchange was rattled by the announcement. Investors sold off shares, resulting in a 108 point loss for the Dow Jones Industrial Average, with financial stocks among the biggest losers. The atmosphere of fear was heightened by Citigroup's report on its third quarter performance, which showed a profit decline of 57 percent over year-earlier levels.

Citigroup, of major Wall Street banks the most heavily invested in high-risk securities tied to shaky home mortgages, also said it wrote off $3.55 billion from falling securities prices, leveraged loans and bad trading bets, a figure far higher than it had forecast only two weeks previously. It said it had set aside an additional $2.24 billion to cover future losses from failing mortgages and consumer loans. Shares of Citigroup have declined by some 17 percent this year.

Citigroup joined Merrill Lynch, Bear Stearns and other Wall Street fixtures which have in recent weeks announced major losses resulting from the collapse in the US housing and mortgage markets and the drying up of the market for so-called collateralized debt obligations, or CDOs, disaggregated and resold bank loans that were used to finance the boom, now ended, in leveraged buyouts.

The stock market was further shaken by a speech given by Federal Reserve Board Chairman Ben Bernanke on Monday to the New York Economic Club. Bernanke acknowledged that the housing market had continued to weaken, and said "the further contraction in housing is likely to be a significant drag on growth in the current quarter and through early next year." He also admitted that credit markets had not recovered from the credit crunch that erupted in July and August and would continue to be "tight."

The bailout plan announced by the three biggest US banks is designed to prevent a fire sale of securities based on subprime mortgages and other high-risk investments by multi-billion-dollar investment funds known as structured investment vehicles, or SIVs. These funds, pioneered by Citigroup in the 1980s, are off-balance-sheet companies set up and controlled by banks, but nominally independent, much like the off-the-books entities established by Enron to conceal its riskiest financial gambles.

The SIVs until recently made huge profits by issuing short-term debt known as commercial paper and using the cash to invest in high-risk and therefore high-yield, longer-term securities such as those based on subprime mortgages and other forms of debt. They made money from the difference, or spread, between the relatively low interest they paid on their commercial paper—rated a safe investment by credit agencies—and the interest they earned on their speculative securities.

Since they are not subject to the same regulations that apply to their parent banks, the SIVs are not required to maintain the same level of capital reserves. They often issue commercial paper for 90 percent or more of the value of their assets. Their profits depend on their ability to continually issue new commercial paper to mutual fund money markets and other big investors to cover their past debts, while they benefit from entirely speculative financial manipulations.

The parent banks of SIVs generate huge profits by charging fees to their "independent" offspring,

The collapse of the housing and mortgage markets, and resulting contraction in credit markets, has made it impossible for the SIVs to sell their commercial paper to increasingly skeptical investors, while the underlying value of their assets has been thrown into question.

Large sums of SIV debt come due in November, and Wall Street has grown increasingly fearful that the SIVs will be forced to sell off their assets at vastly reduced prices, driving down the value of securities held by the banks and major financial institutions in the US and around the world. This is a scenario for a potential panic that could disable credit markets, precipitate a massive sell-off on global stock markets and result in huge losses for major banks.

There are some 30 SIVs around the world, with an estimated $400 billion in assets. Citigroup alone has seven affiliated SIVs, with $80 billion in assets. In recent weeks, Citigroup-linked SIVs have sold off $20 billion in assets.

The largest US bank is by far the most exposed of the Wall Street banks to the SIV crisis. Should its SIV assets takes a major

hit, Citigroup would suffer a further blow by being obliged to include these depreciated securities on its own ledgers.

Starting in mid-September, while he was publicly downplaying the severity of the credit crisis, Paulson began meeting with major banks and other financial institutions to work out a scheme for heading off a fire-sale of SIV assets. A Citigroup research report, issued two days before the banks and Treasury Department officials met for the first time, noted, "SIVs now find themselves in the eye of the storm."

The plan announced last Monday was the fruit of these meetings.

Under the plan, Citigroup, Bank of America and JP Morgan Chase will head up a new capital fund, called Master-Liquidity Enhancement Conduit, or M-LEC, that will issue its own commercial paper in the hope of attracting a pool of $80 billion to $100 billion from major investors. The M-LEC will, for fees charged to the SIVs, buy some of their debt at current market prices. Bank of America and JP Morgan Chase, which do not have SIVs, have presumably agreed to participate because they fear the consequences of an SIV meltdown and stand to profit from their share in fees.

The idea is that the backing of the three biggest US banks will overcome investor resistance and succeed in marshalling sufficient capital to bail out the SIVs, and shield Citigroup from the consequences of its own policies. Paulson, himself a former Wall Street banker, having headed Goldman Sachs prior to becoming treasury secretary, hailed the plan at a speech Tuesday at Georgetown Law Center in Washington. However, he insisted that it was not a government bailout of the banks, since no public funds are involved.

This, however, is a bit of sophistry. The very public backing of the US government and the Federal Reserve Board for the scheme gives it an official imprimatur and is meant to assure investors that, if necessary, public funds will made available to rescue major Wall Street institutions.

As Floyd Norris, the chief financial reporter for the *New York Times*, put it on Tuesday, "In the meantime, it is hoped that what amount to bank guarantees of some debt—coupled with the fact that the Federal Reserve is the lender of last resort for banks—will persuade investors like money market funds to buy securities issued by the new conduit."

It is not clear, however, that the scheme will prove viable. According to Tuesday's *Wall Street Journal*: "So far, most major Wall Street firms are hanging back. Among those that haven't given a commitment are Goldman Sachs Group Inc., Morgan Stanley, UBS AG, DeutscheBank and Credit Suisse Group, according to people on Wall Street."

Even if it does materialize, the scheme will essentially compound the underlying crisis, since it will add more speculative debt to the huge mass of inflated values that are not based on any real productive investment. And it does nothing to address the growing social distress of tens of millions of Americans facing job losses and declining living standards, including millions of households finding it difficult or impossible to meet rising mortgage payments.

In his speech to the Georgetown Law Center, Paulson painted a gloomy picture of the prospects for the US economy. He noted that the housing "correction" was not ending as quickly as had been predicted, and said it would "continue to adversely impact our economy, our capital markets, and many homeowners for some time yet."

He said one quarter of mortgages were adjustable rate loans, "exposing mortgage holders to much greater risk than the traditional 30-year fixed rate mortgage..."

Sales of existing single-family homes are down by nearly 25 percent from the peak in 2005, he noted, and the inventory of unsold homes has increased "to levels last seen in the early 1990s."

Foreclosures increased 50 percent from 2005 to 2006, and foreclosures on subprime loans were up 200 percent in the same period. "Current trends," he said, "suggest there will be just over 1 million foreclosure starts this year—of which 620,000 are subprime."

"Yet, the problem today," he added, "is not limited to subprime mortgages as the number of homeowners having trouble making payments on prime mortgages is also increasing."

The government-backed bailout plan for Citigroup and Wall Street underscores the increasingly parasitic and socially destructive operations of American and world capitalism. The role of the SIVs exemplifies the degree to which immense wealth is generated for a layer of mutli-millionaires and billionaires on the basis of financial manipulations almost entirely divorced from the process of production and socially useful investment.

The industrial and productive base and social infrastructure of America continue to deteriorate, living standards for the broad mass of the people continue to decline, while both government and corporate policy are focused on the further enrichment of a small and fabulously wealthy financial elite. At the same time, deregulated markets intensify the inherent anarchy of the capitalist market, creating a situation in which the Wall Street bankers and corporate CEOs, economists and government policy makers have no real idea of the actual value of financial instruments, often highly complex and exotic, contrived to divert ever greater shares of the national wealth into the coffers of the super rich.

Bernanke, asked following his speech to the New York Economic Club, about the real value of CDOs, "asset-based securities" and other investment novelties, replied, "I'd like to know what those damn things are worth."