Drive mounts for US government bailout of banks

Barry Grey
7 March 2008

Amid signs that the US housing and credit crises are deepening, threatening the solvency of some of the biggest Wall Street banks, Federal Reserve Board Chairman Ben Bernanke has called for more drastic measures to stanch the spread of mortgage defaults and home foreclosures, and suggested he might support Democratic plans to use federal funds to at least partially bail out struggling banks.

On Tuesday, addressing a meeting of the Independent Community Bankers of America in Orlando, Florida, Bernanke called on lenders to aid distressed homeowners by reducing the principal on their mortgage loans. Bernanke also endorsed a bigger role for the federal government in backing home loans that otherwise are likely to default.

Bernanke's statements went well beyond the policies advanced thus far by the Bush administration to address the worsening housing crisis and its destabilizing impact on financial institutions as well as the broader economy. Treasury Secretary Henry Paulson has limited the federal government's direct role to coordinating voluntary actions by leading banks and mortgage companies to reduce interest payments on a relatively small fraction of the millions of outstanding subprime loans.

Last week, Paulson opposed proposals by congressional Democrats, backed by major US banks, to use federal funds to purchase non-performing mortgage loans from lenders and have the Federal Housing Administration (FHA) or some other government agency refinance the mortgages so as to avoid foreclosure. Somewhat straining public credulity, the former CEO of Goldman Sachs denounced such plans as a US-taxpayer bailout of Wall Street speculators.

However, economic reports continue to show plummeting home sales and prices as well as soaring loan defaults and foreclosures, all of which further undermine the stability of banks that have already written off tens of billions of dollars in subprime-linked investments. The banking crisis has led to a virtual collapse of confidence in the financial system, restricting credit and driving up its cost. This, in turn, is feeding recessionary tendencies, which further depress housing prices as well as the value of commercial real estate—further deflating the value of speculative investments and undermining the credit position of major banks.

On top of this, inflationary pressures are growing, with oil, gold and basic commodities hitting new record highs on nearly a daily basis, and the US dollar recording new lows against the euro, the yen and other major currencies.

In his speech on Tuesday, Bernanke emphasized the dangers arising from the growing number of homeowners with negative equity—that is, borrowers with mortgages higher than the value of their home. "The current housing difficulties differ from those in the past," he said, "largely because of negative equity positions."

He continued, "In this environment, principal reductions that restore some equity for the homeowner may be a relatively more effective means of avoiding delinquency and foreclosure than reducing the interest rate."

The Fed chairman went on to say that a "potentially important step" to encourage banks and lenders to reduce the principal on shaky mortgages would be to expand the authority of the FHA to guarantee bigger mortgages as well as mortgages that are heading for default. This would, in essence, put the federal government in the position of guaranteeing many

© World Socialist Web Site

mortgages held by banks and mortgage lenders.

At the end of 2006, 7 percent of mortgage borrowers had negative equity, according to First American CoreLogic, a research firm. A report issued by Goldman Sachs and Morgan Stanley estimates that the proportion of borrowers with negative equity will rise to 21 percent, or 10.5 million households, if home prices fall 15 percent, as expected. They conclude that some $2.6 trillion of mortgage debt will be "under water."

The implications of these figures are dire for the stability of the US and global financial system. Already reports are showing that a growing number of distressed homeowners are simply walking away from their homes because they would end up owing money if they tried to sell and pay off their outstanding loan. As long as the bottom keeps falling out of the housing market, mortgage-linked investments and other asset-backed securities and bonds will continue to deteriorate, leaving banks, mortgage firms, insurance companies, hedge funds, private equity firms and other financial institutions facing ever greater losses.

This is what both Bernanke and congressional Democrats are seeking to avoid by means of a more extensive federal government intervention. House Financial Services Committee Chairman Barney Frank (Democrat of Massachusetts) hailed Bernanke's speech and called it an endorsement of his own proposal for a partial government bailout of the banks. This somewhat misrepresents what Bernanke said, but the Fed chairman's remarks clearly pointed in the direction of Frank's proposal.

Frank said of his plan, which would allocate $20 billion in government money to the FHA, "It begins with [lenders] recognizing they've lost money. Once they've done that, we think the FHA should facilitate the refinancing."

The amount being proposed by Frank is a pittance compared to the massive scale of the foreclosure crisis. Last year 1.5 million homes were foreclosed and it is expected another 2 million will be foreclosed in 2008. His plan is narrowly crafted to expend the least amount of money needed to shore up the banks, rather than save millions of homeowners from either foreclosure or crushing debt resulting from predatory lending policies.

The context of Bernanke's speech was a raft of negative economic data, including a 2.5 percent decline in factory orders, a 5 percent fall in durable goods orders, an 18 percent increase in personal bankruptcies in February, the Federal Reserve Board "beige book" report showing a further slowdown in economic growth since the beginning of the year combined with weak retail sales and intensified inflation, and a slowdown in manufacturing and construction.

On the financial front, recent days have seen a number of hedge funds unloading bonds in order to meet margin calls, and on Thursday a publicly traded investment fund of the Carlyle Group private equity firm went into default.

Most ominous is the position of Citigroup, the world's largest bank based on assets. This week, Sameer Al Ansari, chief executive of Dubai International Capital, told a private equity conference that "it would take a lot more money to rescue Citigroup."

This is despite last month's $14.5 billion bailout of the bank by investors, including the Abu Dhabi Investment Authority and the Kuwait Investment Authority. In 2007, Citigroup suffered over $18 billion in write-downs and reported a $9.83 billion loss in the fourth quarter.

A Merrill Lynch analyst told investors Tuesday that, because of the continuing deterioration in the residential and commercial real estate markets, Citigroup would write down another $18 billion and report a loss of $1.66 a share for the first quarter of 2008. The company's stock has already lost more than half of its value over the past year.

Analysts are expecting the Wall Street bank to announce shortly a cut of 25,000 jobs from its 370,000-strong workforce.

Growing fears of a major banking collapse induced Donald Kohn, the vice chairman of the Federal Reserve Board, to reassure investors by telling a Senate committee Tuesday that the chances of a big bank going under "remained low."

To contact the WSWS and the Socialist Equality Party visit:

wsws.org/contact

© World Socialist Web Site