<u>How our financial system is stabilized</u>

What happens when things go south in a big way, as they do sometimes? Most of us remember the bank panic in “It’s a Wonderful Life”. All a “panic” is, is a collective realization that the bank has already spent your money. Most all of us have grown up in a world far distant from such a thing. The FDIC, we are taught from an early age, is the solution to bank panics. You don’t have to take your money out, since it is insured. This is sort of true, and sort of a lie.

The truth is that the Federal Deposit Insurance Corporation charges fees for the insurance it provides. Who do you think pays this? We do. When the world seemed like it was collapsing in 2008, the deposit amount the FDIC insured was raised from $100,000 to $250,000. Who do you think paid for that rate increase? We did. Do not most of you remember receiving halfway decent interest on savings accounts, say 4-5%? Now it is close to zero. The banks pay the insurance, and then have less left to pay us for the use of our money. We are loaning it to them, by and large, for nothing right now. Most of us simply don’t understand this. We pay for our own insurance. This is vastly more beneficial to large depositors--who gain much more from such insurance--making FDIC insurance effectively a regressive tax we pay to protect our money from a fundamentally unstable system.

Further, and more importantly, the FDIC only keeps on hand some 1-2% of the deposits it supposedly insures. Were an actual, widespread panic to hit for any reason, they would be wiped out almost instantly. The Federal Reserve or Federal government would have to provide the difference. The FDIC works as long as people believe it works, which has been close enough to prevent any panics in a long, long time.

Practically, there are three classes of bank failures: small, medium, and large. In general , small banks are allowed to fail. They are simply liquidated. Their assets are seized and sold, and their depositors are paid out of FDIC funds and the proceeds of the asset sales. Since the amount of money in play is not large, this works reasonably well.

Medium banks are normally purchased by larger banks, at steep discounts. Remember the problem is typically cash flow, such that with money injected and new management, they can keep going. Thus when they get into financial trouble, buying them up makes sense for the banks with the money to do so. This outcome is common. The money to keep them going normally just comes from other banks, possibly with some pot-sweetening guarantees or cash from some branch or other of the Federal or State government. They fail, come into FDIC control—nothing changes outwardly, as the bank continues in operation as before--and are then in effect flipped to the buyer that makes the best offer.

Finally, there is the supposed “Too Big To Fail”. You have heard this argument: If the “X” Bank is allowed to fail, there will be a ripple effect, that could bring our economy down. Think about that for a moment: if such a failure can bring our economy down, then our economy is not built properly.

For now, let's see what happens.

Large banks can still file bankruptcy, in which case the assets are sold, and depositors paid. This is what happened with Lehman Brothers, whose various businesses were sold to a variety of interests around the world.

If the bank appears viable, money can be voted by Congress, or issued by the Federal Reserve, to provide cash. This is a bit like the Discount Window/Federal Funds transaction we looked at earlier, but with *much* more money involved, and with a much longer time horizon. Moreover, it's understood to be a loan, but with the important distinction that it is unknown if the money will be repaid.

As an example, in 2008, a $700 billion fund (called TARP, for Troubled Assets Relief Program) was created by Congress so that the Treasury Department could inject money into different troubled companies, like AIG and GM. This is what has normally been called "the bailouts". The intent was to put cash into the system, so that financial companies would keep making loans, and in the case of GM so they wouldn't be forced into liquidating their company, and firing all their employees.

The basic premise of the Too Big to Fail is that all companies exist in an economic web. AIG employs X number of people. All their jobs disappear if they close their doors. Those people then lose their houses and stop going out to eat, devastating small banks and the restaurant industry. Those industries then lay people off, because they aren't making any money. This process continues until we are in a full blown Depression. Further, AIG owed a lot of people a lot of money, and if they didn't pay it, all those loans would go south, such that many other banks would get into the position of the bank we looked at in the previous section that had their mortgage loan go into default. One bankruptcy would lead to a cascade of bankruptcies, which would sooner or later require a bailout anyway, or lead to a complete loss of liquidity/cash in the system, and another Depression.

This logic is not entirely wrong, given the nature of our financial system. That is a big caveat, though: with a sound system, all these bailouts would be unnecessary. That will be a topic I take up later.

Practically, though, this money was used by most recipients—especially the financial concerns--as money that just landed in their laps, and which they intended to use to further increase their market positions.

As one bank president put it: "With that capital in hand, not only do we feel comfortable that we can ride out the recession, but we also feel that we'll be in a position to take advantage of opportunities that present themselves once this recession is sorted out."[1]

Effectively free money is, of course, a good thing for banks, as it would be for any of us. If $1 million landed in your lap, do you think you could find a way to turn it into $2 million? This is how the rich get richer.

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[1] http://www.nytimes.com/2009/01/18/business/18bank.html?_r=1

With respect to the Federal Reserve, it's worth looking in a bit more detail into one of the more sordid aspects of that whole mess of 2008, the saga of Bear Stearns. I will paint with a broad brush, which is accurate in general terms, but may be a bit off in some specific details, such as the exact money flow through Bear Stearns, which had many subsidiaries who did many different things.

Bear Stearns got into trouble, mainly by overinvesting in risky mortgages, which paid high rates of interest, but which also defaulted at high rates. People would buy homes on easy credit terms, at high rates of interest, and simply find themselves unable to make the payments, sometimes from Day One. As mentioned previously, strict underwriting standards (which is to say, the care taken in assessing someone's likelihood of being prompt and regular with their payments) are a critical feature of sound banking. Bear Stearns did not practice these principles. To be clear, they did not originate the mortgages, but entities under their control did. What they did is package the loans as securities and sell them.

Their troubles came when it became obvious that the value of those securities was indeterminable, since good loans were piled in with bad ones. This meant that piles of stocks were sitting somewhere, and nobody was buying them. They had paid for the mortgages—the money went out—but with nobody taking them off their hands, no money was coming in.

As a result, they got into a "liquidity crisis". In plain terms, they did not have enough money in the proverbial vault to pay out their creditors and their depositors. We saw two ways that can happen in the previous piece. In their case, the problem was an old fashioned "run on the bank", by institutional investors. Banks like Bear Stearns don't take John Q. Public's deposits. They take money from professional investors, who put up the money to buy stocks and other investment products that Bear Stearns and their ilk produce. These investors got antsy, realizing that the vaults were virtually empty. Bear Stearns had "X" in the bank, and institutional depositors asking for "5X" or whatever in cash. Bankruptcy was imminent.

Here is where it gets interesting: the Federal Reserve Bank of New York decided to loan $30 Billion to JP Morgan Chase, a competitor, so that JP Morgan could buy Bear Stearns. That money was collateralized by Bear Stearns assets, not JP Morgan's assets. What this meant is that if the loan went into default, the Fed could seize Bear Stearns assets but not JP Morgan Chases's, even though JP Morgan Chase is who actually got the loan and assets, and who actually stood to profit most by gaining the business of a competitor.

This "loan", of course, was an Open Market Operation, in which money was created from nothing. The Fed can do that. Who did they have to consult to decide to do this? Nobody. Congress did not need to be consulted. The President did not need to be consulted. They didn't even really need to consult Bear Stearns, except to the extent that they needed their approval to finalize the deal. Who did they certainly consult? JP Morgan Chase. The deal was initially going to be done at $2/share (Bear Stearns being a publicly traded company), but howling from investors—who do have pull on Wall Street, if they have enough money—caused it to be raised to $10.

JP Morgan Chase got Bear Stearns. This reduced their competition, and gave them access to all the profitable business Bear Stearns had. Importantly, too: the deal was structured such that if they defaulted on the loan completely, nothing bad happened.

Several points need to be highlighted here. First, J.P. Morgan himself—one of a handful of de facto billionaires at the beginning of the 20th Century—was an ardent supporter of the Federal Reserve. One of his right hand men was there at the private meeting that developed the plan for the Fed. Do you see why? Is not money for nothing a beautiful thing?

Secondly, the executives at JP Morgan Chase—and every other large bank on Wall Street, including Bear Stearns—are buddies with the Federal Reserve. They *are* the Federal Reserve. The decision to loan the money to JP Morgan Chase was made by the Board of Directors of the Federal Reserve of New York, presumably in conference with the Federal Open Market Committee in Washington, which had to actually commit the money. This Board is elected by member banks, whose names are not a matter of public record; that is proprietary information that the Federal Reserve protects, even though they are supposedly operating on behalf of the public.

Interestingly, their CEO, Jamie Dimon, now sits on that Board, *as a representative of the interests of bankers.*[2] His term apparently started in 2009, not long after they got the money. He will be overseeing the use to which that money is put when he puts on his Federal Reserve hat, and using that money to make more money when he puts on his CEO hat. This would be blatant conflict of interest, if the Fed were overseen by anyone except the Old Boy's Club that runs it. As it is, no one can say anything. Indeed, most of what they do happens in complete darkness. Their meetings are secret—no reporters, no Congressman--and they are directly accountable to no elected or appointed member of our government.

They claim this is to protect them from being unduly influenced by "politics", but one doesn't need much imagination to see much more obvious motivations.

The bottom line here is that our system is oriented around taking care of the needs of large banks who come out smelling like roses no matter what they do, and not in the least bit around "we the people", except to the extent that we are needed as consumers of credit.

Discussion Questions

1. Would you consider the FDIC to be an actual insurance program? Why or why not?
2. Does our financial system appear safe and solid? Why or why not?
3. Who do you think this system most benefits?

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[2] http://www.newyorkfed.org/aboutthefed/org_nydirectors.html