

Taxpayers to Scoop up Toxic Assets, Will Force Banks to Recapitalize

By [Sujata Srinivasan](#) | 25 March 2009

Which is worse? (1) Letting toxic assets continue to erode banks' balance sheets, or (2) Repackaging those assets and transferring the risk to taxpayers?

The goal is to jumpstart the beleaguered economy by making loans available for credit-worthy businesses and individuals. But banks are not lending, and the government is going to make them, with your money, of course. How do you feel about that?

Well taxpayer, it really doesn't matter what you think because like it or not, the U.S. Treasury will purchase up to \$1 trillion in toxic assets (residential and commercial mortgages, and mortgage-backed securities) in partnership with private investors and guaranteed by the FDIC. Fund managers, approved by the government, will scoop up mortgage-backed securities and Uncle Sam will match their investments.



Good grief.

Why should taxpayers subsidize the risk of investors who wouldn't have come a thousand yards of those assets until the government stepped in to share a large portion of the risk?

The last time the government intervened, encouraging Fannie Mae and Freddie Mac to buy mortgages from banks, lending standards plunged across the board and the risk-reward process of the free market was distorted.

Yesterday, the [Financial Times](#) reported that the government's toxic assets plan would compel banks to significantly writedown their loans and record losses, requiring additional capital from taxpayers or investors.

That's right, more bailout money.

But why are banks refusing to lend? James Wood offers an interesting perspective in his Feb. 15, 2009 column in '[Seeking Alpha](#)', he wrote:

New conservative credit standards and the lack of new securitized funding are the real causes of the inability of the banks to lend, not the current bad assets. Every financial bubble is based on lots of low cost money. Securitization is what provided lots of low cost money. Like all bubbles, this one finally blew up starting in 2006 with the home mortgage market financing. As in every bubble, banks have learned again that easy, low cost financing is not a substitute for good credit. While banks lent 10 to 15 times their capital in the 1970's, banks were lending in 2007 30 to 100 times their capital when you take into account derivatives and off balance sheet financing such SIVs.

Every bank is now deleveraging to get its risk profile back in order. Even if they wanted to fund themselves through the traditional source of securitized transactions, banks are drying up with the new recognition of the danger they can be. Home equity issuance is off 98%. Securitized auto loans were down 40% in 2008. Student loan issues were down 43% in 2008. Credit card financings were down 21%. About the only one still provided this type of securitized financing is Ginnie Mae and Fannie Mae ([FNM](#)). Both have lost all their capital and are bombs which will explode (again) very shortly. In short, buying up all the bad debts of the banks will not jump start lending again, because the current bad assets are not the real cause of not lending more now.

Paul Krugman wrote on March 21, 2009 in his widely quoted blog in [The New York Times](#):

In effect, Treasury will be creating - deliberately! - the functional equivalent of Texas S&Ls in the 1980s: financial operations with very little capital but lots of government-guaranteed liabilities. For the private investors, this is an open invitation to play heads I win, tails the taxpayers lose. So sure, these investors will be ready to pay high prices for toxic waste. After all, the stuff might be worth something; and if it isn't, that's someone else's problem.

There's something morally wrong with this, isn't it?

One Response to "Taxpayers to Scoop up Toxic Assets, Will Force Banks to Recapitalize"

1. [J. Nick Puglia](#) Says:
[March 25th, 2009 at 1:45 pm](#)

Wrong but not surprising.