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The Banking System Is Still Broken

Borrow from the Federal Reserve at zero and lend to Treasury for a profit. That's some racket.

By ANN LEE

Treasury Secretary Tim Geithner and Federal Reserve Chairman Ben Bernanke have announced that the recession is over. Now that the Dow Jones Industrial Average has broken the 10,000 mark, we'll surely be hearing assurances that economic growth is here to stay. But the credit markets are in much worse shape than some indicators suggest.

First of all, not all U.S. banks are created equal. A few multinational banks such as Citigroup are officially too big to fail. Credit spreads in the markets reflect the relatively risk-free nature of these large companies, which now have implicit government guarantees.

But this protection doesn't apply to smaller banks, some of which are being shut down by the FDIC without much media attention. These smaller banks have done most of the lending to the many small and medium-sized enterprises that do the bulk of the hiring in our economy. They've now had to cut off the flow of credit to their clients.

According to Automatic Data Processing Inc.'s August employment report, large businesses shed 60,000 jobs, and employment at medium-sized and small businesses declined by 116,000 and 122,000, respectively, in August alone. Small businesses, defined as employing anywhere from one to 49 people, account for 48 million jobs in the U.S., and medium-sized businesses, between 50 and 499 employees, account for 42 million jobs. Large businesses account for just 17 million. Without access to capital, these small and medium-sized businesses will continue to lay off their employees, creating a vicious cycle of shrinking consumer credit and demand.

The volume of overall bank lending has not returned to pre-crisis levels. While credit spreads have contracted, not much debt has been underwritten. In fact, banks that received government bailout money reduced their average loan balance by $54 billion in July, compared to the previous month, according to the Treasury's Capital Purchase Program Monthly Lending report.

The first reason for this slowdown in lending is that underwriting standards have risen across the board, making it much more difficult for businesses to obtain loans. Institutional investors no longer tolerate the easy loans so characteristic of this latest credit bubble. Banks are now also being asked to retain a portion of any loans they underwrite in order to align their interests with their investors. As a result, credit has scaled back dramatically. According to reports issued by the major rating agencies, in 2007 $700 billion of asset-backed securities were underwritten. Only $10 billion has been issued in 2009. This has a significant knock-on effect across every sector of the economy.

The banks have no incentive to lend. Most of them still have a significant amount of bad loans sitting on their books that they don't want to recognize as nonperforming. If the banks recognize these bad loans, all the write-offs may force them into bankruptcy. Instead, they hope that over time renegotiated loan terms will eventually allow the borrowers to make their payments. This ordeal could last at least a decade if this cycle is similar to other crises, like Japan's lost decade of the 1990s. As the fed funds rate goes to zero and existing loans in technical default continue to sit in bank portfolios, why should banks make new loans when they can make money for free with the government? There is no longer a stigma associated with borrowing from the Fed, so banks can earn a huge spread by borrowing virtually unlimited amounts for nothing and lending that same money back to the Treasury.

Wall Street will most definitely get richer again. But a return to easy credit for the average consumer and business is not likely in the near future. The only reason that credit spreads have tightened is because of the extraordinary interventions by the Fed and the Treasury.

Such unprecedented actions by the government have led to speculation over when inflation might get out of control. But why not question whether our current banking system actually makes any sense? Rather than giving capital to businesses with real products and services, Wall Street plays a government-backed shell game, enriching bankers' pockets at everyone else's expense.

If banks are being supported by taxpayer dollars as a public good, wouldn't it be logical to make Citigroup and Goldman part of the government so that they can serve the public like the Department of Motor Vehicles? The powerful banking lobby will likely prevent the nationalization of the entire banking system. But expect new challenges to our assumptions about the status quo if this recovery and the proposed regulatory reforms fail.

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