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Feinberg: EU Crisis: Searching for the Bernanke Put

By Robert Feinberg – October 8th 2012

In preparation for a conference on the EU crisis to be held at the CATO Institute in Washington, D.C., Wednesday, I searched for information on the operation of the so-called Term Asset Lending Facility (TALF), one of the array of programs put in place by the Federal Reserve and the Treasury to support the financial markets.

On March 23, 2009, Joe Weisenthal wrote for the Business Insider that under the program, "The banks get to dump 'toxic' assets, the hedge funds set a price and taxpayers get their money back if anyone makes a profit,"

Tyler Durden posted on Zero Hedge a primer on how the program worked and how this program could be exploited if a hedge fund bought assets with a face value of $100 for $80 by putting up $2.40, with the Fed putting up the rest. A day later, the fund would discover that the asset was only worth $20, which was the market price, so the fund would lose $2.40, and the taxpayer $77.60. Supposedly the bank would then buy the asset for $20 and pay the fund a $5 million fee for the privilege.

This scenario is similar to what the original Troubled Asset Relief Program (TARP) was supposed to do until Congress started asking questions about why the government should overpay for toxic assets. So, the Treasury, then headed by Hank Paulson, changed its plan and decided just to give the banks the money, to be repaid out of money the banks would receive through the other programs and transactions that support the teetering banking industry.

At a CATO event in June, Efraim Benmelech, a Harvard economics professor, presented data showing that a surprising share of TALF funding went to foreign banks, predominantly in the European Union. Even as he presented these data, though, Benmelech mused that he had no theory to explain them. At a congressional hearing where the subject was raised, a mid-level Treasury official said the purpose of supporting EU financial institutions, in this case through currency swaps, was to support dollar lending by banks that have had difficulty obtaining dollars. The ultimate purpose was stated as supporting exports by U.S. firms to the European Union.

Now, as the European Union struggles to put its own programs in place while handicapped by the lack of the mechanisms to administer common fiscal and monetary policies, questions arise as to how much support is expected to be provided by U.S. authorities. In his own congressional testimony, Treasury Secretary Tim Geithner referred to this as a European problem that the Europeans would have to resolve, with the United States providing some help as a reflection of its own interest in supporting international trade on which the export sector relies.

It is important to keep an eye on the extent of the exposure of U.S. banks to the EU crisis. Both Geither and Fed Chairman Ben Bernanke have minimized what they call the "direct" exposure, but there is indirect exposure to the stakes EU banks have in the debt of peripheral countries. In addition, money market mutual funds invested in highly rated EU sovereign debt in an effort to boost yields brought to the vanishing point by the Fed's zero-rate/quantitative easing policy. Do the Europeans believe there is a Bernanke put for the toxic assets their governments don't want?

Robert Feinberg served on the staff of the House Banking Committee for 10 years that encompassed the savings-and-loan debacle and the beginning of its migration to the banking sector. Subsequently, he has consulted on issues related to the crisis for law firms, accounting firms, securities firms, and trade associations.

Feinberg holds a BS.E. from the Wharton School and a J.D. from the Law School of the University of Pennsylvania. He has drafted dissenting views on landmark banking legislation, contributed to a financial blog, and written hundreds of reports for clients to document the course of the financial crisis as it has unfolded over the past three decades.