Risk Professional: Fed's Bernanke favours corporates over consumers

Ben Bernanke, chairman of the US Federal Reserve Bank has made it clear where his loyalties lie: he will protect the financial sector at the expense of home-owners. And what happens to home owners today is likely to happen to businesses tomorrow.

On 5 May 2008, Bernanke - who is rapidly becoming our favourite for putting his foot in his mouth - spoke at the 32nd Annual Dinner of the Columbia Business School in New York. He was both guest of honour - and being given an award.

For a man whose days in post must be numbered, his acceptance speech was interesting: he started with the thanks: "I am very pleased to be here and especially honoured to receive the Columbia Business School's Distinguished Leadership in Government Award."

Then he lunged into his speech proper, if proper can be the word. His subject? "Mortgage Delinquencies and Foreclosures" - and yes, he really did use all those capitals.

There was a lot of political waffle - the important parts were close to the beginning before the words got in the way.

"As my listeners know, conditions in mortgage markets remain quite difficult, and mortgage delinquencies have climbed steeply. The sharpest increases have been among sub-prime mortgages, particularly those with adjustable interest rates: About one quarter of sub-prime adjustable-rate mortgages are currently 90 days or more delinquent or in foreclosure.1Delinquency rates also have increased in the prime and near-prime segments of the mortgage market, although not nearly so much as in the sub-prime sector.As a consequence of rising delinquencies, foreclosure proceedings were initiated on some 1.5 million U.S. homes during 2007, up 53 percent from 2006, and the rate of foreclosure starts looks likely to be yet higher in 2008. Not all foreclosure starts result in the borrower's loss of the home; sometimes the borrower is able to make up the missed payments or other arrangements are made with the lender. But, given the number of borrowers in distress and the weakness of the general housing market, the share of foreclosure initiations that ultimately result in the loss of the home seems likely to be higher in the current episode than customarily has been the case."

So far so good, if you pick your way through the verbiage that almost obscures the underlying truth: bad lending decisions by banks, bad borrowing decisions by borrowers and fraud by borrowers and agents have resulted in marginal lending falling prey to badly designed products which were either sold to those who hoped for an improvement in their income or allowed to be bought when prudence would have said the risks were poor.

So, both sides of the equation were at fault and both must suffer. Right?

Not in Bernanke's world. The money men must be protected, he announced.

Many foreclosures are not preventable. Investors, for example, are unlikely to want to hold onto a property whose value has depreciated significantly, and some borrowers--perhaps because they were put into an inappropriate loan or because personal circumstances have changed--cannot realistically sustain home ownership.

It begs the question whether those who borrowed money to buy a home realised that their future was not in the hands of the bank they dealt with but rather in the hands of someone who was trading their security as if it were one bean in a sack of coffee.

Bernanke did say "if a foreclosure is preventable, and the borrower wants to stay in the home, the economic case for trying to avoid foreclosure is strong. Because foreclosures impose high costs, including legal and administrative costs as well as the costs of leaving the property vacant for a possibly extended period, both the borrower and the lender often are better off avoiding foreclosure."

He then went on to discuss ways in which foreclosures may be preventable.

But the principle was already established: if "investors" consider that the security is worth less than their investment and if a loan is in default, then Bernanke does not expect them to take the long view, reschedule the debt, rearrange the interest rates to avoid shocks of rapidly changing rates and to wait for the market to come back.

In short, millions of US consumers who think they own their homes are finding out first that they

don't own them in any meaningful sense and the fund that is the effective owner and able to make all the decisions - and secondly that fund which has a duty to its subscribers to maximise revenue often within a fixed time frame has the full support of the Fed.

Bernanke did make an oblique plea to the money men: there is no point in cutting off your nose to spite your face, is the effective meaning. He said "foreclosures impose high costs, including legal and administrative costs as well as the costs of leaving the property vacant for a possibly extended period, both the borrower and the lender often are better off avoiding foreclosure. Moreover, it is important to recognize that the costs of foreclosure may extend well beyond those borne directly by the borrower and the lender. Clusters of foreclosures can destabilize communities, reduce the property values of nearby homes, and lower municipal tax revenues. At both the local and national levels, foreclosures add to the stock of homes for sale, increasing downward pressure on home prices in general. In the current environment, more-rapid declines in house prices may have an adverse impact on the broader economy and, through their effects on the valuation of mortgage-related assets, on the stability of the financial system."

If that's not pleading, then the following sentence makes it plain that the Fed has lost control and Bernanke needs help "Thus, finding ways to avoid preventable foreclosures is a legitimate and important concern of public policy."

Why is this issue relevant to The Risk Professional?

Simple: because other lending was also bundled into asset backed security - including commercial loans for property and equipment.

And that means one thing, and one thing only: the future of your business may well be in the hands of the same people that are currently acting to rapidly increase the number of home repossessions in the USA. If (when) your business suffers from the widespread economic downturn, you might find that the owner of your loan has one thing on his mind: if he's going to crystallise the floating charge on your plant and machinery he's going to want to sell it as quickly as possible before everyone else does the same and floods the market with used equipment.

That's what happened in the US in the post dot com bubble and savvy IT people picked up almost new equipment for perhaps 5% to 10% of its cost as supply far outstripped demand, and second hand furniture was almost valueless.

Already, the Fed reports that businesses in the US are making less and smaller loan applications. That suggests that businesses are not expecting to spend their way out of recession. It also reports that lenders are refusing more loans and making more stringent conditions, including higher interest rates, on those they do grant.

The risk to businesses of the fall out from the US banking crisis has, it seems, only just begun. And the shape of it is not a pretty sight.