The Regulator: Bailouts, bank failures and the burdens of history

Sen. Chris Dodd’s proposal to bail out troubled borrowers and lenders to assuage the ever-deepening foreclosure epidemic underscores the differences between today’s banking hardships and those of the savings and loan crisis that set the financial world reeling in the 1980s.

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The proposal from Senate Banking Committee Chairman Chris Dodd, D-Conn. to bail out troubled borrowers and assuage the ever-deepening foreclosure epidemic underscores the differences between today’s banking hardships and those of the savings and loan crisis that set the financial world reeling in the 1980s.

Although the decision to invoke the dreaded “b”-word is a nightmare for politicians attempting to enact responsible public policy, Congress would not have the luxury of considering a bailout if a large swath of major lending institutions had already collapsed, as was the case in the S&L debacle, when more than 1,000 thrifts went into receivership. The very fact that the bailout option is now firmly on the table serves as a testament to the effectiveness of regulatory reform enacted in the ’80s and early ’90s, according to former Federal Home Loan Bank Board member Lawrence J. White, who served on the FHLBB during some of the darkest days of the S&L crisis between 1986 and 1989.

“It cost us about $150 billion,” White told SNL, “But we got a new regulatory system, a much better regulatory system.”

Make no mistake, the government committed serious errors this time around. The S&L crisis should have taught regulators that the use of new and widespread financial products must be accompanied by intensified safety and soundness regulations, stricter capital requirements and more stringent examinations, according to White. When thrifts received regulatory approval to diversify their assets in the early ’80s, the new types of loans offered would have helped curb the risks inherent in providing only one type of financial product, in this case mortgage loans. But the government failed to provide adequate oversight for the diversified loan portfolios, with disastrous results.

“You needed to make sure these guys weren’t going to use the new opportunities in a fast and loose way,” White said.

In today’s crisis, it seems clear that both subprime loans themselves and their securitization are useful products, but it seems equally obvious that the massive increases in the volume of originations and packaging of the loans should have set off alarm bells at regulators years ago.

Nevertheless, for all the criticism heaped on Federal Reserve Chairman Ben Bernanke, Treasury Secretary Henry Paulson and President George W. Bush, the federal government is actually somewhat ahead of the curve on the current crisis when compared to prior debacles. Political leaders deserve to be held accountable for failing to adopt measures that could have avoided the problem, but debating a bailout is clearly preferable to simply paying off depositors burned by bank failure.

The FHLBB served as the primary regulator for the thrift industry during White’s tenure and the decades preceding his appointment. In 1989, the board was legislated out of existence and replaced by the OTS, the Federal Housing Finance Board and the unfairly maligned Resolution Trust Corp., which has been routinely bashed in the popular media over the past two decades as a “bailout” fund.

It is important to draw a distinction here between the current regulatory options and the solutions adopted after the S&L crisis: RTC never bailed anyone out, even in the face of an insolvency outbreak that ravaged U.S. thrifts, spurred by massive losses incurred as a result of the now-cliché problem policy of borrowing short and lending long. Far from paying off speculators and thrift investors, RTC paid depositors at defunct thrifts and cut taxpayer losses by liquidating the assets of the founding companies. The result was similar to an ordinary bankruptcy proceeding, with the exception that depositors got back 100% of what they initially turned over to the bank, while investors, in White’s words, “were washed away.”

“My view was, this is simply the government honoring its obligations as a deposit insurer, and then trying to deal with the stinky assets,” White told SNL. “The bad guys at minimum were getting washed away, sometimes were getting sued. A few of them went to jail.”

At the moment, the financial world is struggling with a subprime meltdown so severe that President Bush’s final annual budget proposal actually warns of massive bank failure. Such epic verbiage may help Bush push his spending priorities, but few people take seriously the notion of such an outcome reaching fruition.

“WaMu may be the only S&L that will suffer difficulties,” White said. “And WaMu, I don’t think is going to end up costing the government any money.”

As a result, Dodd is now in the unenviable position of having proposed the first true bailout of the U.S. financial system since the Great Depression.

Bailouts bring to mind the perverse specter of politicians paying off bad businessmen for making bad business decisions, of taxpayers funding moral hazard in industries that need free-market corrections to discourage future abuses.

“The press loves to use the word ‘bailout,’” White told SNL, and one need look no further than the headline of this column for the evidence. “My teeth would grind every time I would hear the word, ‘bailout,’” White said, referring to RTC.

Though Dodd’s proposal is as vague as it is radical, it reveals a deft political touch. Dodd rolled out the package at a time when most economic rejuvenation ideas in circulation were focused on tax cuts. By eschewing a specific, detailed program in favor of a broad outline, Dodd effectively forced a lengthy negotiation process, giving law-
makers no choice but to discuss mortgage reforms, which Dodd and many other Congressional Democrats prefer to a set of unfunded tax cuts. Although enactment of any bailout fund is a long way off, a delayed package would not be a complete failure by historical standards, though its usefulness would be seriously curbed. As Keefe Bruyette & Woods Inc. analyst Brian Gardner notes, the government’s reaction time to financial crisis is usually very long.

“A lot of the institutions were created after the fact. RTC was not in the middle of the S&L crisis, it was actually formed later on,” Gardner told SNL. “Same thing with the Federal Housing Administration and the different organizations that came out of the Roosevelt administration. It was several years after the Great Depression hit before these things came into being.”

Dodd has noted that his Home Ownership Preservation Corp. would purchase loans at a “discount,” limiting the moral hazard promoted among lenders, servicers and investors. Such a program would allow investors to sell off mortgage-backed securities without incurring further losses from foreclosures — the same rationale behind the Treasury Department’s “teaser-freezer” plan — but with taxpayer funding attached. Dodd claims the program would come “at little or no cost to taxpayers over the long run,” since the government would refinance the mortgages into loans borrowers could afford. Over the course of the mortgage, the government would get a substantial portion of its investment back, unlike the $150 billion spent to insure deposits in the S&L crisis.

Provided that bailout legislation is carefully constructed and limited in scope, Dodd may find more support down the line than he received at the Banking Committee meeting.

“I have no sympathy for the speculators. The liar loans I don’t have a lot of sympathy for,” White told SNL. “But the idea that we might spend a couple of billion dollars to help in this situation doesn’t bother me. And that’s the magnitude that I think ought to be spent, not tens of billions. We’re a rich country; we’ve got a federal budget that is going to be approaching $3 trillion. A couple of billion dollars to try to ease this situation doesn’t offend my sensibilities.”