Book Review: Bair during the crisis

Ex-FDIC chief's take on the Great Recession

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Bull By The Horns:
Fighting To Save Main Street From Wall Street And Wall Street From Itself. By Sheila Bair, former FDIC Chairman, Free Press. 388 pp.

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"They understood that I was doing my job--protecting the FDIC and the millions of depositors we insured. But Geithner just couldn't see things from my point of view. He never could."

"They" in this comment refers to Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke in an explosive comment found on page two of Sheila Bair's Bull By The Horns. Geithner, of course, is Timothy Geithner, the present Treasury

Secretary, and then head of the New York Federal Reserve Bank.

This remark refers specifically to one meeting held on Monday, Oct. 12, 2008, but the sentiment permeates the entire book--indeed, the entire tenure of Ms. Bair's career as FDIC Chairman. She and Geithner rarely agreed, it would seem.

Her obvious despondency at the time of that comment was for me, a former FDIC field examiner, particularly disturbing to read. I suppose it's in my professional DNA. On day one of my employment at FDIC in the New York Regional Office, our class was taught that our primary job function was to "protect the Deposit Insurance Fund." Every FDIC employee takes that as their mission.

The meeting, of course, was a historic gathering, portrayed in other publications and even a movie, called by Mr. Paulson when the heads of the largest financial institutions were summoned to Treasury headquarters and told that their banks would have to accept billions in government capital investments. There was $25 billion for Citigroup, Wells Fargo, and JPMorgan Chase; $15 billion for Bank of America; $10 billion for Merrill Lynch, Goldman Sachs, and Morgan Stanley; $3 billion for Bank of New York, and $2 billion for State Street.

Not only were capital injections on the table, but FDIC was also being asked to temporarily guarantee the large companies' debt to ensure continued funding. The Federal Reserve was offering trillions in special lending programs.

Our country was in crisis and the investment banks were in trouble. But Ms. Bair notes that there was a general lack of detailed information on each institution leading her to wonder if they were indeed in danger of failing. Citi was the exception, and in desperate need of assistance. It would need not only the bailout discussed then but two more later on. It was also widely known that JPMorgan Chase did not need the funds, prompting speculation that the whole affair revolved around ailing Citi.

Working and living at financial ground zero

Bair, frequently at loggerheads with the industry as well as fellow regulators, nevertheless filled a critical job at a critical time in the history of the nation's financial sphere. She frequently was on the historic spot, and this nearly 400-page book recounts the financial crisis and its aftermath through her eyes as FDIC Chairman from June 2006 to July 2011. Her detail level is incredible.

Ms. Bair's background working as an aide to Senator Robert Dole, her stint as commissioner and acting chairman of the Commodity Futures Trading Commission (CFTC), and past position as head of government relations for the New York Stock Exchange are briefly discussed in the book.

Her experience and education obviously qualified her for the pivotal FDIC job but what appears to be her greatest influence and attribute as FDIC Chairman was her Midwestern upbringing in rural Kansas, "Main Street" as she calls it, and the values that instilled in her.

As Bair portrays her time at FDIC, her fellow players in this financial crisis will ask her to use her agency's resources and authority over and over again to protect the interests of the "behemoths," as she calls them in the book, while putting DIF at even more risk than the crisis already posed. The book discusses in detail the reasons for the financial crisis, and there are several, but she explains them in a way that a lay person can understand. Several key topics emerge in the reading.

Toxic mortgage loans

Nontraditional mortgage guidance was already proposed when Bair took office, but this guidance covered only those loans that featured negative amortization. That excluded the subprime mortgage market, where the main attraction was loans known as "hybrid ARMs." These were mainly marketed in low-income communities.

These loans started out with higher than normal rates and then reset even higher with an interest rate jump of 4 to 6 percentage points after a few years. After the resets, borrowers could no longer afford the payments. Then these borrowers would refinance, incurring more fees, and even prepayment penalties. Payments frequently exceeded 50% of a borrower's gross income--if income was even documented. The public belief was that these loans were primarily made to investors in residential income property, but Bair states that more than 90% of subprime loans were originated to individuals or families occupying their homes.

By the end of 2006, subprime loan delinquencies were over 13%. Bair tried to persuade the Fed and OCC to include subprime mortgages in the NTM guidance but they refused until June 2007.

By that time it was too late. By the second quarter of 2007, subprime loans outstanding totaled $1.3 trillion and economic conditions had already worsened. (Please note all numbers in this review come from the book and are current to the book's publication.)

The biggest lenders were nonbanks and savings institutions, regulated by the OTS (Office of Thrift Supervision). The most expensive bank failure was IndyMac, a West coast mortgage lender supervised by OTS, which loaded up on these toxic loans and ultimately failed in July 2008, costing DIF more than $7 billion. For me, the most surprising and discouraging points Bair made on this failure was the reluctance at OTS to even downgrade this institution to "troubled" status until the second quarter of 2008. Some see this as a prime example of an institution and its regulator being too close.

There are more examples and very interesting recounts of the demise of other institutions such as WaMu and Wachovia.

Securitization's dark side

Describing this book would be incomplete without a discussion on securitizations. This process, in its earliest form, is the basis of the huge secondary mortgage market. The securitization process involves an issuer, usually a major financial institution, which accumulates a large volume of residential mortgages and "pools" them into a security while working with a Wall Street investment bank. The security has several "tranches," each of which has different priorities for cash payments received. The top tranche receives payments first, followed by the second or "mezzanine," and finally the bottom, or "equity"' tranche. The investors in the mezzanine and equity tranches pay less as there is added risk. The securities are sold to investors such as pension, mutual, and hedge funds, and insurance companies, as well as Fannie Mae and Freddie Mac.

During the crisis, the top tranches typically received a triple-A rating even though the advent of huge numbers of subprime mortgages filled some securities with toxic contents.

To complicate matters further, the bottom or "equity" tranches were frequently packaged together into collateralized debt obligations (CDOs) and also received a triple-A rating, as Bair sketches out. Once again, the underlying assets were very toxic mortgages with a high rate of default.

Investors were also able to purchase credit default swaps, which is essentially a form of protection against the risk of default on the security they own. Wall Street firms also created "synthetic" CDOs which allowed large institutions to make speculative bets on how certain CDOs would perform without owning them.

Because of securitizations, mortgage brokers all over the country, particularly in hot housing areas such as Florida, Nevada, and California, churned out mortgage loans, often using predatory practices, funded by the immediate sale. There was generally little perceived risk because of the immediate transfer. However, once loans defaulted there was some obligation to buy them back. So far major banks have bought back billions of securitized loans with another estimated $472 billion to come.

The trials of Fannie and Freddie

Bair discusses the Fannie Mae and Freddie Mac debacle in detail as well. Essentially these government-sponsored enterprises (GSEs) were created by Congress to support housing finance. However, executives started issuing bonds at low interest rates because investors assumed they were implicitly backed by the government and used the money to invest in subprime mortgage securities. As Bair portrays the result, this turned the GSEs into giant hedge funds. Executives paid themselves lavish bonuses and their shareholders huge dividends. Eventually the securitizations defaulted generating huge losses, and forcing the GSEs into conservatorship.

They remain there today. Taxpayers have already funneled more than $180 billion into them with more to come, Bair notes. She makes a case for abolishing the GSEs, while offering alternative solutions.

Housing market impact

More than six million people have already lost their homes in the resulting crisis. The spillover went into the prime market and also resulted in a slowdown of credit that ended up costing more than eight million people their jobs.

One wonders how much better the country would have been if more people been given the opportunity to remain in their homes. Bair advocated efforts to make this possible for greater numbers of borrowers, but received much pushback from other players.

As Bair discusses at length, there was tremendous economic incentives to hold the securities rather than the actual mortgages, including accounting and regulatory advantages. As a result, the ultimate owners of the mortgages were different from those who would be responsible for restructuring them. The resulting structure and relationships favored investor self-interest for the foreclosure process when borrowers encountered financial difficulties, rather than a mortgage modification.

A serious read for bankers

Everyone in finance ought to read this eye-opening book. There is much to learn both about finance and how things really work in Washington. For me there were many places in the book where it was astonishing to believe what was going on.

One of the most notable was about midway through, where Bair discusses the fact that Citi's primary regulator hadn't even downgraded the bank's CAMELS rating to a 4--even after it had been already bailed out twice. It's astounding to see in black and white how different treatment can be for banks of different sizes.

Bair is often accused of not being a team player or at odds with the industry in the media. To that I disagree and agree.

In the book, you will find an abundance of evidence to support the conclusion that she was a team player.

I agree that she was at odds with the industry in many instances. To me, she was doing her job, a case bolstered by this book. As an FDIC regulator she was charged with the responsibility of protecting DIF, among other responsibilities and that she did very well. It becomes clear in this book that some other players had no concerns about the fund--they had other agendas.

In the end, Sheila Bair was a tough woman in a tough place for an extended period. I, for one, am happy there was a woman playing in the man's sandbox during this crisis.

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