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ARMed and Dangerous

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Following the savings and loan crisis of 1987, Secretary of the Treasury Nicholas announced that the federal government's response had been guided by two watchwords: "Never again." As he signed the Financial Institutions Reform, Recovery and Enforcement Act, President George H. W. Bush promised that the legislation would "safeguard and stabilize America's financial system and put in place permanent reforms so these problems will never happen again."

Less than two decades later, the housing bubble burst and financial institutions collapsed again, this time igniting a global economic meltdown. In Other People's Houses, Jennifer Taub, a professor at Vermont Law School and the former associate general counsel at Fidelity Investments, provides a concise, clear, and compelling account of the rise and fall of subprime loans, ARMs (adjustable rate mortgages), securitization, and credit default swaps. As in the S&L crisis, she argues, the culprits were predatory lenders, gullible and greedy investors, and politicians and government bureaucrats who believed that self-regulation and self-interest would insure market stability. Executives at investment and lending institutions (like Washington Mutual), she argues, were leaders and followers, who were able to implement predatory practices because the federal government "took down the guard rails" put in place during the New Deal in the 1930s.
Although her prose is at times a bit clumsy, Taub demolishes the claims, still circulating in some quarters, that the Great Recession of 2008 was brought on by too much government regulation and pressure by the Clinton administration to get banks to make loans to people with low incomes. In fact, she demonstrates, court decisions, acts of Congress, and lax agency supervision removed "traffic lights, stop signs, and speed limits" that had prevented financial crises for 50 years. And they "kept in place and even expanded those pieces of the regime that provided private banks with a safety net backed by the federal government."

In November 2001, to cite one of many examples in this book, the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Depositors Insurance Corporation reduced the amount of capital required for banks and thrifts holding mortgage-backed securities. The new policy permitted them to borrow $9.84 billion to purchase $10 billion in private-label MBSs, if they had triple A or double A ratings -- and, alas, ratings agencies proved all too eager to comply. This "leverage" led to riskier and riskier practices and, when the bubble burst, the "too big to fail" institutions were bailed out by the $700 billion Troubled Asset Relief Program (TARP).

Individual homeowners, however, were not nearly so fortunate. In Nobelman v. American Savings Bank (1993), a unanimous Supreme Court declared that bankruptcy courts could not allow them to pay back only the current market value of properties instead of the entire remaining principal. In 2009, the U.S. Senate failed to adopt a measure that would have permitted this practice if the homeowner agreed to share gains with the lender in a subsequent sale. Most telling, perhaps, is the fact that the $50 billion in TARP which was promised to help homeowners was "barely used" -- and that the Treasury Department put banks in charge of the Home Affordable Modification Program (HAMP). Little wonder, then, that only $3 billion of the $50 billion authorized by HAMP was used.

Taub is concerned that another meltdown may well occur in the not too distant future. Although the Dodd-Frank Act of 2010 contains some "strong tools," she notes that lobbyists from the financial services sector are still working to subvert it. Congress has underfunded implementation and blocked appointments made by President Obama. About half of its rules have yet to be issued and more than a hundred deadlines have been missed, including implementation of "the Volcker Rule," a provision banning banking entities from buying and selling securities for profit.

Nor is Taub at all convinced that Dodd-Frank has ended "too big to fail." The biggest banks are bigger than ever. They still borrow trillions of dollars in short term markets, "leaving them vulnerable to runs." And they are still permitted a leverage ratio of 3 percent (equity to total assets). The FDIC has the power to dismantle financial institutions but when a failing firm is taken over, taxpayers will supply the money the FDIC needs, with the hope that they will get it back from the proceeds of the liquidation. Critics question, Taub writes, "whether regulators will have the courage to pull the plug" and whether cross-border insolvencies are feasible.

These days, a contrite Jamie Dimon, the CEO of JP Morgan Chase, can call for "Old Testament" justice, in which failed banks are dismantled, their names "buried in disgrace." But you have to wonder if he -- or any of the powers that be -- will sing that song on Judgment Day.
More:

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