Barofsky and Bair on Banks and Bailouts*

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As the United States continues to pull itself out of the credit crisis, these two books shed light on the Washington infighting behind the government’s response to the crisis and, more broadly, the shape of financial regulatory reform. Both authors were actors in that drama clearly dissatisfied with the way it played out. Both are adept at using their books and the press to get their views across. While their accounts are from differing viewpoints within the government, each arrives at the conclusion that the motivation for the bail out was to protect big banks and financial firms, not ordinary people facing foreclosure or other

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adverse consequences of the government's failure to supervise these behemoths. For both, the personification of this allegedly wrongly directed focus is Treasury Secretary Timothy Geithner. Both share an immense dislike of Secretary Geithner for what they see as his singular interest in saving large banks. Now that Geithner has stepped down from his role as Treasury Secretary it will be interesting to see whether he too will recount to readers his views of the players in the bail out, including these two authors.

The less interesting of the two books is the one by Neil Barofsky. His book continually reminds the reader that he was a tough criminal prosecutor and a democrat. The reminders, though at times involving interesting war stories of bringing drug cartels to justice, are superfluous. It is clear that to Barofsky the big banks were no better — in fact, more dangerous — to the American people than the drug czars he had helped bring to justice. Sheila Bair, by contrast, spends little time establishing the credentials that gave her a seat at the bail out table. Barofsky was named by the Bush Administration as Special Inspector General (SIG) for the government’s bail out fund, the Troubled Assets Relief Program (TARP). An Inspector General (IG) is a form of internal auditor of a federal government agency. Congress felt that TARP required a special IG, referred to as SIGTARP, because of the large amount of funds involved that in and of themselves presented an invitation for potential fraud and waste. Barofsky's book makes the point that no one at Treasury or the Federal Reserve Board seemed to share that concern. One could argue that Congress may have shared that concern, and for that reason required SIGTARP to begin with. Treasury and the Federal Reserve Board did, after all, have their hands full trying to bring the US economy back from the brink of depression. Barofsky, however, sees both as having the singular focus of protecting the interests of Wall Street. That seems too myopic a view. It was Secretary Geithner, after all, who crafted the Obama Administration's proposal that ultimately became the Dodd-Frank Wall Street Reform and Consumer Protection Act — the most significant overhaul of the US financial system and the authority of the financial regulators to supervise its sustained financial stability in nearly a century.

Understandably, Barofsky brought to his SIGTARP position the viewpoint of a prosecutor. As a member of the mortgage fraud SWAT team formed by the New York US Attorneys' Office in June 2008, Barofsky had come to the conclusion that the housing bubble and mortgage fraud shared a common cause — greedy and unfettered Wall Street financial institutions. The lenders were complicit in — and in fact led — the increasingly 'immoral' behaviour, from offering unwitting borrowers liar's loans to enticing brokers with bonuses and fees to bring forward still more unsuspecting borrowers. Despite the author's first-hand view, he fails to provide details of the harm that befell specific individuals, or groups of individuals, leaving the reader to wonder just how 'obsessed' he was in protecting homeowners.
From his vantage point as SIGTARP, Barofsky uses his prosecutorial zeal to paint the picture of a Treasury Department wholly aligned with the interests of Wall Street. They did not just drink the Wall Street Kool Aid, he says; they mixed it up themselves, offering $700 billion in taxpayer funding without requiring the banks to be held accountable for how they spent the money. This is the book’s central point, and Barofsky’s main objection to how Secretary Geithner and the Treasury Department handled the bail out. The banks were saved, but left unaccountable. This left them to hinder the government’s effort to assist homeowners defaulting on their mortgages from losing their homes and to continue perpetrating a fraud on the American people. Barofsky portrays SIGTARP as the lone defender of the rights of homeowners facing foreclosure against the continuing unfettered abuses and fraud perpetrated by mortgage servicers aided and abetted by big banks. While the book does offer examples of SIGTARP crackdowns on abusive behaviour, the reader is left wondering just how many borrowers were wrongly harmed and why there has not been a more public outcry in their defence. One cannot help but wonder how many of the foreclosed homes were owner-occupied and of those, how many were not intentionally abandoned by underwater borrowers.

The biggest shortcoming of Barofsky’s book is that he fails to present the case for the reforms that he continues to believe are necessary. The book appears to serve only as a plaintiff’s brief seeking to convince the reader as judge to convict Geithner, the Treasury Department, and the financial regulators for their complicity in Wall Street’s bad behaviour. The reader by the end may tire of the continued and singular focus on a conspiracy theory. This reader, at least, would have been interested in some thoughts on housing finance reform that would protect homeowners from future undeserved foreclosure or other abuses. While Barofsky would undoubtedly question his motives, Tim Geithner did after all manage to present a proposal for housing finance reform prior to leaving office.

From his book, it is not clear that Barofsky had a solid view of the basis of the crisis or that he acquired one in his role at Treasury. He, like many others, is content to lay most, if not all, of the blame on large commercial banks. While that makes for good sound bites, it seems too simplistic a view for someone so closely involved in the crisis or at least in stemming its fallout. A more realistic way to look at the roots of the crisis may be that ‘it took a village’—commercial banks, mortgage brokers, investment banks, Federal Reserve interest-rate policy, Congressmen, Fannie and Freddie, house flippers, liar’s loans, 3/27 and 4/26 “teaser” bank loans, etc. A bubble, after all, is a bubble because so many get wound up in it. Barofsky begins all of his arguments with the premise that the bail outs were a costly mistake. He cites AIG to support this, yet one cannot help but note that AIG did not turn out to be a costly error for the U.S. government. One may also ask, why is bailing out large banks who repaid their obligations bad and bailing out auto manufacturers good? Is it because of the number of jobs the latter
industry supports? How many jobs in the United States were saved by bailing out banks?

The banking aspect of the crisis in the United States can be viewed as two crises with much grey in between. Smaller banks faced a credit loss crisis. A large number of these banks failed. It can be argued that those banks had neither adequate geographic nor adequate product diversification. On the other hand, larger banks faced a mark-to-market crisis. That is, many of their 'toxic' assets were creditworthy. Because there was a very limited market for those assets, assets in banks' trading portfolios or their available-for-sale portfolios were marked to market and written down. TARP was designed to rebuild bank capital as a result of these write-downs. Because assets in banks' investment portfolios were not marked down, market observers remained concerned with banks' solvency notwithstanding the TARP injections. That concern may have prolonged the resurgence of a liquidity and breadth in the markets for financial securities and derivatives. Banks, however, did not sell those 'toxic' assets. They held on to them and are continuing to mark them up on their books.

Did the government abandon Main Street in rescuing Wall Street? The issue may be viewed as one of priorities, which Barofsky sees as misplaced in saving Wall Street. More realistically, the two were likely not viewed in Treasury as diametrically opposed. Faced with the failure of the US banking system, the decision was made to use available funds to recapitalize the system as a way of restoring stability to Wall Street and Main Street. The bail out may not have come with the provisos Barofsky thought were necessary. It did, however, come with the Treasury Department's proviso that the largest banking organizations receiving the funds undergo and pass stress tests of highly adverse scenarios – much worse than those experienced in the 2008 financial crisis. If the banking system had failed in 2008, Main Street would surely have followed. That would seem to make Barofsky's constant reporting of his battles with various Administration officials, though perhaps interesting gossip, nothing more than a distraction.

In her book, Sheila Bair takes a more substantive look at what she sees as the causes of the crisis and the government's serious missteps in addressing its resolution. One cannot doubt from reading her book or studying the work she did while at the helm of the Federal Deposit Insurance Corporation (FDIC) that Bair was a strong leader who effectively guided her team through the monumental task of dealing with the aftermath of bank failures. While she viewed the crisis from an entirely different vantage point than Barofsky, she shares his concern for the protection of homeowner rights, and regards Secretary Geithner's influence over the bail out as equally culpable in the drama as Wall Street banks.

As the chair of the FDIC, Bair had a seat at the table. From this vantage point, she attributed the bail out to a singular focus on saving Wall Street – perhaps one
large banking organization in particular – with little regard for the effect that it would have on Main Street and what it would cost taxpayers, or for the pain and suffering that the failure to reign in Wall Street had already caused Main Street. Bair is defensive of what she sees as efforts to marginalize her in the bail out process. She notes in this regard that Geithner and Treasury rebuffed her requests to be involved in the choice of which banking organizations would receive bail out funds and pushed her to agree to have the FDIC collect only nominal fees for guaranteeing their debt. Bair repeatedly describes being the victim of unfair treatment, but ultimately paints too monolithic a picture of Geithner and Treasury to be wholly convincing.

The book does better when it fleshes out the shortcomings of Treasury’s approach to the bail out and financial reform, rather than resorting to name-calling merely to conjure up unflattering images, such as her references to Geithner as the ‘bailout in chief’. By contrast, the reader is much more engaged and can appreciate Bair’s frustration at being ignored when she makes the case for the reforms she attempted to have considered. For instance, Bair is adept at presenting the explanation of why in her view Treasury’s version of the Volcker Rule did not go far enough, or the arguments in favour of the need for increasing bank regulatory capital requirements beyond the increases proposed by Treasury. This sort of analysis is more interesting to readers at this point than another rehash of the egos in view on either side of the conference table over which the TARP bail out was agreed.

In describing the events that led up to that meeting, Bair cannot help but point out the in-fighting and lack of trust among the banking regulators. She does nonetheless do a good job of describing how the creation of securitizations, such as collateralized debt obligations and credit default swaps, allowed for the proliferation of subprime mortgage financing and ultimately the financial crisis. She makes clear that under her direction the FDIC paid close attention to the interplay between the securitization and residential mortgage markets and the effect that the former was having on the latter. One question that readers will have is why then did Bair not have the FDIC take action before the collapse of Lehman Brothers? Here Bair seems content to be deferential to the other financial regulators, regarding them as primarily responsible for oversight of bank participation in the mortgage markets, not the FDIC. One must also ask, is there sufficient capital in the banking system to support the housing market without securitization? Securitization is not a necessary evil. It is and will be a necessary tool. One wonders whether the changing standards for qualified mortgages that will go into securitizations without the securitizer having to put skin in the game will result in a larger number of lower income individuals being denied mortgage credit.

The book is least compelling when belittling Wall Street. While Bair does seem to admire at least a couple of the executives who were leading several of the
financial institutions that received bail out funds, she is harshly critical of several others and finds at least one to be wholly incompetent. She chastises the institutions receiving bail outs for allowing their employees to be paid year-end bonuses with taxpayer funds, and the Treasury Department for not forbidding it. She points to this as an example of Wall Street’s unchecked greed and the government’s inability to impose any restrictions on Wall Street’s actions. What she does not do is look at what might have been the consequences of the large financial institutions losing talent as they struggled to remain sources of funding for US businesses and individuals.

An interesting aspect of her book is that bank supervisory information is treated by the federal supervisors as confidential. This information is not disclosed to the public; it is exempt from disclosure under the Freedom of Information Act. However, some of the information set out in Bair’s book seems to be of that nature. In addition, the author lays bare discussions with senior officials of other agencies, both agreements and disagreements. Bair uses the instances of agreement over policy with these officials to validate her own positions.

Bair, though, does not simply recount the missteps and highlight the misfocus of the bail out. Her book lays out the compelling arguments for a number of reforms to the supervision of large banking organizations. From a review of these, it becomes clear that any disagreement one might have with Bair’s policy positions and recommendations are for the most part related to timing. The author would have favoured a ‘take the bull by the horns’ approach to financial reform, especially with respect to imposed limitations on large banking organizations. Many of the reforms she professes as necessary to financial stability are, in fact, being taken up. Considerable actions have been taken by the Basel Committee on Banking Supervision globally and the federal bank supervisors in the United States under their Dodd-Frank Act mandate that address many of the areas of reform suggested by Bair. The difference is that they are being implemented with due regard to the fact that the United States and European nations are still slowly working their way back to normal growth. In hindsight, at least, it would seem unwise to have sought to impose more stringent requirements on banking organizations during the worst of the crisis and before clarity on their ability to continue operations had been established. Bair’s finding the bail out to be one of the most unpleasant acts of her career is understandable. That does not seem to have made it any less necessary.

Bair’s recounting of the bail out is interesting in that it sheds some light on the view of the Administration and the bank regulators on how vulnerable the financial system was. Even today, these concerns exist in at least parts of the global banking sector. The Basel Committee and national supervisors continue to delay implementation of all or portions of the risk-based capital reforms known as Basel III and are loosening some of the enhanced requirements originally proposed.

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Bair may be reassured that one interesting and unspoken lesson of the crisis is the change with respect to the identification and handling of a future systemic situation. Prior to the crisis, the responsibility for addressing a systemic situation rested solely on the government. Banks were to prepare as best they could, but the underlying implication was that the government would save the day. In today's post-financial reform environment, that burden has shifted to the larger banking organizations. They are being expected to have sufficient equity and debt to continue functioning as financial intermediaries without government assistance, and, if they do not, to face orderly liquidation by the financial regulators. They are subject to rigorous stress testing and regulator-imposed limits on permissible activities, including decisions that used to belong to the banks' board of directors, such as whether or not dividends may be paid or shares repurchased. The goal of this 'enhanced' supervision seems designed to allow banking organizations to continue extending credit and providing services in the worst crises imaginable – just as public utilities are expected to do. Banks are expected to maintain back-up capital sufficient to allow them to keep on lending through the next crisis. That may work to eliminate the moral hazard that some – such as the authors of these two books – argue required the government to provide bail out funding. But it does not address the effect on the US economy and its residents of banks that, as a result of being required to meet 'enhanced' capital and other requirements, have a lending appetite limited to only plain-vanilla fully secured loans to prime quality borrowers. One can imagine a thriving shadow banking sector taking up the slack. And one can not help but wonder if US taxpayers, the group that both authors are concerned with protecting, will be any better off – especially those with less than stellar credit seeking a loan to start a new business or a 30-year mortgage.

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