Fed's approach to regulation left banks exposed to crisis

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Monday, December 21, 2009; A01

Foreclosures already pocked Chicago's poorer neighborhoods but the downtown still was booming as the Federal Reserve Bank of Chicago convened its annual conference in May 2007.

The keynote speaker, Federal Reserve Chairman Ben S. Bernanke, assured the bankers and businessmen gathered at the Westin Hotel on Michigan Avenue that their prosperity was not threatened by the plight of borrowers struggling to repay high-cost subprime loans.

Bernanke, who was in charge of regulating the nation's largest banks, told the audience that these firms were not at risk. He said most were not even involved in subprime lending. And the broader economy, he concluded, would be fine.

"Importantly, we see no serious broad spillover to banks or thrift institutions from the problems in the subprime market," Bernanke said. "The troubled lenders, for the most part, have not been institutions with federally insured deposits."

He was wrong. Five of the 10 largest subprime lenders during the previous year were banks regulated by the Fed. Even as Bernanke spoke, the spillover from subprime lending was driving the banking industry into a historic crisis that some firms would not survive. And the upheaval would shove the economy into recession.

Just as the Fed had failed to protect borrowers from the consequences of subprime lending, so too had it failed to protect banks.

The central bank's performance has sparked a great debate about its future as a regulator, pitting those who want to expand its role against those who want to strip its powers. It also has come under pressure from politicians seeking greater oversight of its primary job, adjusting interest rates to moderate economic growth. The battles have complicated Bernanke's bid for a second term as chairman. The Senate Banking Committee voted to approve Bernanke 16 to 7 on Thursday, setting the stage for a January battle on the Senate floor.

The Fed's failure to foresee the crisis or to require adequate safeguards happened in part because it did not understand the risks that banks were taking, according to documents and interviews with more than three dozen current and former government officials, bank executives and regulatory experts.

Regulatory agencies exist to lean against the wind. But rather than looking for warning signs, the Fed had joined -- and at times defined -- the mainstream consensus among policymakers that financial innovations had made banking safer. Bernanke said the economy had entered an era of smaller and less frequent downturns, which he and others called "the great moderation."

The consequences of this miscalculation can be seen in the stories of three large banks the government ultimately rescued from collapse.

The Fed let Citigroup make vast investments without setting aside enough money to cover its eventual losses. The company would need more than $45 billion in federal aid.

The Fed watched as National City made billions of dollars in subprime loans that were never repaid. Regulators would arrange its sale to a rival, PNC.

And the Fed approved Wachovia's purchase of a California mortgage lender shortly before California mortgage lenders led the nation into recession. Wachovia, on the verge of collapse, was bought by

Wells Fargo with government help.

"I don't think any regulatory agency can deny that it didn't have adequately targeted supervision in place," said Fed governor Daniel Tarullo, appointed by President Obama to overhaul the Fed's approach to regulation. "Worldwide, there wasn't enough done on capital, liquidity and risk-management requirements. . . . There wasn't a structure in the supervisory process in which to ask the questions that needed to be asked about emerging risks throughout the financial system."

Sen. Christopher J. Dodd (D-Conn.), who has called the Fed's performance an "abysmal failure," wants to give its job to a new agency. Tarullo said the appropriate response is to improve the Fed, not to replace it.

"Supervision of the largest institutions is something that's going to be very hard to do and to do well," Tarullo said, "and the Fed is the one part of government that has the resources and the capacity and the expertise to fill this role."

Citigroup's bad bets

Citigroup grew fat during the great moderation, thanks to rules crafted by the Fed that allowed banks to gamble beyond their means. For a time, the nation's largest bank profited massively. But as the crisis rolled in, Citigroup quickly ran low on money to cover its losing bets.

The crux of the problem was capital, the reserve that banks are required to hold against unexpected losses. While bank regulation is divided among four federal agencies, the Fed has long played the leading role in dictating how much capital banks should hold. By the late 1990s, those rules were outdated.

Rather than wait for borrowers to repay loans, banks were adopting a technique called securitization. The banks created pools of loans and sold investors the right to collect portions of the inflowing payments. The bank got its money upfront. Equally important, under accounting rules it was allowed to report that the loans had been sold, and therefore it did not need to hold any additional capital. But in many cases, the bank still pledged to cover losses if borrowers defaulted.

"It was like selling your car but agreeing to keep paying for any maintenance, repairs, oil changes," said Joseph Mason, a finance professor at Louisiana State University. "You've sold the benefit of the automobile, but you haven't sold the risk."

The Fed embraced securitization nonetheless. Increased lending boosted the economy. The Fed also wanted banks to remain competitive with lenders including General Electric and GMAC that were not subject to capital requirements. Furthermore, the central bank trusted in the wisdom of financial markets, and investors were cheering companies that used securitization to boost profit.

In November 2001, the Fed and its fellow regulators ruled that securitization made banks safer. In general, banks must hold $10 in capital for every $100 in loans and other assets, but banks can hold less on safer assets such as U.S. government bonds. The safe list was now expanded. The Fed and its fellow federal regulators ruled that banks could hold as little as $5 on every $100 investment in loan pools.

The dangers of securitization were underscored the very next month by the collapse of energy giant Enron, which had abused the same accounting rules to conceal losses from investors. But in 2003, the board that writes accounting rules backed away from planned reforms after banks protested that Enron was an exception. The Fed sided with the industry, telling the board that securitization was safe and important to the economy, according to people familiar with the deliberations.

Citigroup took grand advantage. By the end of 2006, the company had created pools holding more than

$2 trillion in mortgage loans and other assets. The pools let Citigroup increase the assets it owned and controlled by 68 percent while increasing the size of its capital reserves by only 36 percent.

Citigroup kept creating loan pools for a year after the housing market started to sour. One of the last, launched July 27, 2007, was named Bonifacius, after a general immortalized by the historian Edward Gibbon as "the last of the Romans" because he died as the empire was collapsing. By the early fall the new Bonifacius, along with the rest of the mortgage industry, was collapsing, too.

Citigroup found itself unable to sell a huge supply of high-risk loans it had made and bought as stock for loan pools. It also held a vast portfolio of shares in loan pools. As borrowers defaulted, the value of these loans and investments plummeted.

By the fall of 2008, Citigroup's spiraling losses had pushed it to the brink of collapse. The company held enough capital to meet the Fed's requirements; it just didn't hold enough to survive.

The federal government raced to provide the company with a pair of taxpayer bailouts, effectively increasing its capital by $65 billion -- or 48 percent more than it held at the end of 2007.

'No substantial issues'

In fall 2006, the Fed conducted a broad review of the nation's largest banks. The result was a picture of an industry in good health.

The report, called "Large Financial Institutions' Perspectives on Risk," found "no substantial issues of supervisory concern for these large financial institutions" and that "asset quality . . . remains strong," according to a summary by the Government Accountability Office. The Fed declined to release the internal report.

One bank given a clean bill of health was National City, a Cleveland company that had slowly built a regional presence in the Midwest and then quickly expanded into one of the nation's largest subprime mortgage lenders. The Fed had another look in August 2007 when National City applied for permission to buy a small bank in Chicago. Fed regulators looked at National City's books and its management and again found nothing amiss.

In reality, the bank was ailing. Its subprime borrowers were starting to default on their loans. Less than two months after the Fed approved the merger, National City reported a third-quarter net loss of $19 million. The company never returned to profitability.

The Fed's failure to see the rot inside National City resulted from the central bank's reliance on others to identify problems.

In part this was a matter of policy. The Fed regulated National City, but the company's major subsidiary, a bank also called National City, was regulated by another federal agency, the Office of the Comptroller of the Currency. In 1999, Congress passed a law instructing the Fed to rely on the OCC "to the fullest extent possible."

The law clearly authorized the Fed to conduct its own reviews where necessary, but the Fed lacked an effective system for determining when it should look more closely, said Orice Williams, director of financial markets and community investment at the GAO.

"If you aren't looking, how would you know there is a problem?" Williams said.

The hands-off approach also was a matter of philosophy. Rather than scrutinize banks directly, the Fed decided to push them to appoint internal risk managers who imposed their own checks and balances. Regulators focused on watching the watchmen. Bernanke's predecessor, Alan Greenspan, said that banking was becoming too complicated for regulators to keep up. As he put it bluntly in 1994, self-regulation was increasingly necessary "largely because government regulators cannot do that job."

Greenspan revisited the theme in a 2000 speech, saying, "The speed of transactions and the growing complexities of these instruments have required federal and state examiners to focus supervision more on risk-management procedures than on actual portfolios."

Some experts say the reliance on others clouded the central bank's ability to see the trouble brewing on the balance sheets of large banks. Others argue that the Fed had a clear view of the problems; it simply underestimated the risk. Either way, the approach had dire consequences.

By 2006, National City had become primarily a subprime mortgage lender, federal data show. Even as the Fed continued to regard National City as healthy, the company's executives were increasingly divided, with some warning that National City needed to pull back. The following year, the bank sold its subprime lending operation to Merrill Lynch, but by then it was too late to get rid of the loans. As defaults rose, so did losses, and the bank could no longer persuade investors to lend it the money it needed to survive.

In fall 2008, regulators arranged for the company to be sold for a pittance to its Pittsburgh rival PNC.

A warning ignored

In January 2005, National City's chief economist had delivered a prescient warning to the Fed's board of governors: An increasingly overvalued housing market posed a threat to the broader economy, not to mention his own bank and others deeply involved in writing mortgages.

The message wasn't well received. One board member expressed particular skepticism -- Ben Bernanke.

"Where do you think it will be the worst?" Bernanke asked, according to people who attended the meeting, one in a series of sessions the Fed holds with economists.

"I would have to say California," said the economist, Richard Dekaser.

"They have been saying that about California since I bought my first house in 1979," Bernanke replied.

This time the warnings were correct, and the collapse of the California real estate market would bring down the nation's fourth-largest bank, the largest casualty of the financial crisis.

Dekaser and Bernanke declined to comment on the exchange.

The Obama administration wants the Fed to police financial risks to the broader economy, a job that entails sorting real threats from the constant false alarms. But in the dying days of the great moderation, the Fed repeatedly failed to discern which warnings were worth heeding.

In May 2006, the nation's fourth-largest bank, Wachovia, signed a deal to buy Golden West, one of the largest mortgage lenders in California. The Fed again was bombarded with warnings about California's housing bubble. A few even warned that the deal could endanger Wachovia.

"Should Wachovia's acquisition be approved, no commercial bank in the country will be in a more potentially unsafe financial position," Robert Gnaizda, policy director for the Greenlining Institute, a fair lending group in California, wrote in an August 2006 letter to the Fed.

The next month the board unanimously approved the deal. The Fed wrote in its approval that it had "carefully considered" the warnings about Golden West and concluded that Wachovia had sufficient capital to absorb losses and effective systems for assessing and managing risks.

The Fed's power to reject the merger application was a potentially important check on the wave of mergers that created banks so large that their distress would threaten the economy. But from 1999 through last month, the Fed approved 5,670 applications to create or buy a bank and in that time denied only one. Fed officials note that 549 banks withdrew applications, in some cases under pressure from regulators.

The Fed's confidence in Wachovia was misplaced. The company's executives would later concede basic errors in risk management. Wachovia concentrated lending in California's inland counties, where housing prices would fall more sharply than along the coast. The bank also continued to offer Golden West's signature product, a mortgage built like a credit card that allowed borrowers to pay less than they owed each month for the first several years of the loan. When the time came to start making full payments, many borrowers lacked the money. Consumer advocates described the loans as "time bombs."

By fall 2008, the bombs were exploding and Wachovia's losses were rising rapidly. Two years after Wachovia closed its deal for Golden West, regulators told the company it could no longer survive on its own. A hasty sale to Wells Fargo was arranged with the help of billions of dollars in federal tax breaks.

Trusting the banks

Even on the verge of the financial crisis, the Fed continued to push for new international rules that would let many large banks hold less capital.

Under the proposed rules, called Basel II after the Swiss city where they were drafted, regulators further increased their reliance on banks' risk assessments, which now for the first time would form the basis for determining how much capital they should hold.

Not surprisingly, a test run conducted as part of the negotiations in 2005 found that the new rules would allow the 26 largest American banks to reduce their capital reserves by an average of 15 percent. A key reason: The rules let banks hold much less capital on mortgage loans, still regarded as safe by regulators blind to the impending crisis.

The Fed presided over the international negotiations, but the skepticism of other U.S. regulators delayed the process and forced the Fed to limit how much capital banks could shed. As late as summer 2007, Sheila C. Bair, chairman of the Federal Deposit Insurance Corp., warned that the new rules "come uncomfortably close to letting banks set their own capital requirements." Others warned that banks had no proven track record of measuring their own risks.

Finally, in December 2007, after almost a decade of work, the Fed persuaded the other agencies to approve the rules, although implementation was again delayed by several years.

One month later, Citigroup announced that it had lost $18 billion on mortgage-related investments. The former chief executive, Charles Prince, later told Congress that the company's internal systems for measuring risk "were wrong." The company immediately raised $12.5 billion in new capital from private investors.

It would eventually need much more.

This is the second in an occasional series of articles about the record of the Federal Reserve.