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Don't Let Industry Win With Disaster Bailouts

By Steven Pearlstein
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Hold on to your wallets, Mr. and Mrs. America. Congress is in session, Katrina relief is on the agenda and special interests are drumming up schemes to help themselves under the guise of helping others.

Let's start with an ingenious proposal to extend, retroactively, federal flood insurance to all those owners of damaged homes along the Gulf Coast who didn't have it.

At first blush, it sounds reasonable. After all, if we want people who have lost everything to return home and rebuild, they'll need a little capital to get started.

But the hidden winner in this arrangement would be the mortgage industry, which otherwise would have to write off billions of dollars in loans when owners stop making monthly payments for homes that are beyond repair. That explains why the idea is being championed by the Consumer Mortgage Coalition, representing large companies that originate, service and guarantee home mortgages.

That is the same Consumer Mortgage Coalition that for years has been trying to shut down Fannie Mae and Freddie Mac. Its complaint has been that the government's implied guarantee to bail out Fannie and Freddie if something goes really wrong encourages them to boost profit by taking on too much financial risk -- an example of what economists call "moral hazard."

But you'd be hard-pressed to name a clearer example of moral hazard than allowing people to purchase flood insurance after the flood. It's bad enough that premiums are so low that the federal flood insurance program will have to borrow about $15 billion to cover payments to those unlucky homeowners who had the foresight to buy insurance. But if you were to set the precedent of providing retroactive insurance, you would guarantee that in the future, only fools would ever buy insurance in advance, thereby destroying the market completely.

Nor is there any rationale in using taxpayer funds to bail out a mortgage industry that is coming off five years of spectacular growth in sales and profit. Sophisticated companies like Wells Fargo and Citigroup should have known the risks of loans to homeowners in flood-prone areas. All they had to do was read about it in the New Orleans Times-Picayune.

If the government wants to help out, better that a new, federally chartered Gulf Coast Reconstruction Authority buy foreclosed properties at auction -- presumably at a steep discount -- and give the land back to the original homeowners, with new low-interest mortgage loans to rebuild. And this time, let's not forget the mandatory flood insurance.

Also worried about getting repaid are the holders of bonds issued by municipalities in the disaster zone. With residents displaced and unemployed, businesses closed, and property values plummeting, the flow of tax revenue used to service their debt has slowed to a trickle. The prospect of default hangs in the air.

But have no fear. Not 10 days after Katrina hit, the National Association of Bond Lawyers had forwarded to the Treasury an 18-page legislative proposal for a gold-plated federal bailout. As you'd expect, the cover letter drips with empathy for the people in the Gulf Coast while holding out the prospect that taxpayers across America would be forced to pay more for municipal borrowings if even one hurricane-ravaged parish defaults on its bonds. Avoiding default, they argued, would also guarantee that these cash-strapped municipalities would be able to float new bonds to repair infrastructure -- bonds that, by the way, would generate a new round of fees for underwriters and lawyers.

The first part of the bond attorneys' plan would allow municipalities to borrow money from the Treasury to keep up on their payments to bondholders if no other source of funds is available. In theory, there is nothing wrong with this. But as a condition for such assistance, shouldn't bondholders be forced to accept a 12-month delay in getting their money, as a price for their miscalculation in making these loans?

After all, the underwriters for these bonds were sophisticated financiers who knew or should have known of the flood risks and built them in to their pricing structure. More to the point, what sort of precedent would it set if the federal government rescued bond issuers and holders who failed to buy default insurance? It's that moral hazard thing again.

Even worse is a second proposal to allow states and municipalities to finance reconstruction with $40 billion to $80 billion in new tax-exempt bonds that carry a federal guarantee -- and then exempt interest on these bonds from the federal alternative minimum tax. These bells and whistles would lower the cost of borrowing for these cash-strapped communities -- but also raise the cost of borrowing for every other government bond issuer while adding further complexity and unfairness to the tax code.

Don't get me wrong: There is good reason for the federal government to step in as a subsidized lender of last resort for individuals, businesses and local governments walloped by natural disaster. But none of that money should cover the losses of sophisticated lenders who took their chances, placed their bets and made tons of money before the dice finally came up snake eyes.

Steven Pearlstein will host a Web discussion at 11 a.m. today onhttp://washingtonpost.com. He can be reached atpearlsteins@washpost.com.