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Like S&L's? Paying the Tab for a Cleanup

Get ready, American taxpayer -- you may be called on to solve the credit crisis.

So far in this debacle, now more than a year old, the government response has been mainly designed to keep the markets and economy running, with the Federal Reserve slashing interest rates and pumping cash into the financial system. The fiscal response, similarly, has kept consumers spending with tax rebates.

The next stage of the crisis won't be solved by easy money. It involves not liquidity but the capital base of financial institutions that have warehouses full of mortgage debt, leveraged loans and other toxic assets fouling up their balance sheets.

One approach for regulators could be to force these firms to either raise new capital or get out of the game by liquidating their assets.

"Our regulators have been lax in their enforcement of existing capital rules," says Daniel Alpert, managing director at Westwood Capital. "When you have top institutions, such as Merrill Lynch,scrounging around for the family silver to sell each quarter, clearly our financial institutions are not adequately capitalized for long-term viability."

At some point banks may run out of funding sources or willing buyers for their misfit loans. A three-letter solution is already on the lips of many investors: RTC.

Resolution Trust Corp. was established during the savings-and-loan crisis of the late 1980s and early 1990s. The clearinghouse sold off some $394 billion in assets of 747 failed S&Ls, costing the taxpayer about $76 billion, according to the Federal Deposit Insurance Corp.

Potential losses in this crisis are far larger, with estimates of $1 trillion or more being bandied about. Taxpayers won't be on the hook for anything close to that. But their bill could make the $124 billion they paid, in total, for the S&L crisis seem a bargain.

The alternative might be worse. If regulators wait too long to clean up the mess, the U.S. starts to resemble Japan in the 1990s, allowing "zombie" banks to shuffle along, unable to raise capital or lend while the economy lingers in purgatory.

In a speech earlier this month, Treasury Secretary Henry Paulson hinted at this when he proposed a "resolution process," a morgue of sorts where big banks can go to die without infecting the rest of the system. That's where the RTC idea comes in.

"Everybody's waiting for another Resolution Trust solution," says James McGlynn, managing director of equities at Summit Investment Partners. "The perfect part of that is the 'resolution' -- we want a resolution to the financial abyss we're in right now."

The RTC wasn't established at the start of the S&L crisis, but when the government's morgue was overwhelmed with dying banks. Election-year politics could delay the cleanup this time; candidates likely don't want to discuss the costs ahead.

Any taxpayer solution will only worsen already troubling fiscal problems. But that's the price for a system that -- as New York University economist Nouriel Roubini and others put it -- privatizes profits and socializes losses.