The Conservative Origins of the Sub-Prime Mortgage Crisis

JOHN ATLAS DECEMBER 17, 2007

Everything you ever wanted to know about the mortgage meltdown but were afraid to ask.

foreclosures, an economic tsunami that is causing chaos in the housing and stock markets, the banking industry, and the global money markets, not to mention upending families and neighborhoods. Business leaders, activist groups, and Democratic presidential candidates are calling for our government to do something before the situation declines even further. The problem is worsening in every part of the country, but two early primary states -- Florida and Nevada -- are among the hardest hit.

The crescendo of criticism recently pushed President George W. Bush to announce a plan to freeze interest rates for up to five years for some homeowners who purchased homes with high-risk adjustable rate mortgages (ARMs) that are scheduled to be "reset" at higher rates, in many cases, by hundreds of dollars a month.

The Republican candidates for president generally supported the Bush plan but were reluctant to call for further regulations to protect borrowers. Some pundits, including former Texas Rep. Dick Armey, a right-wing Republican who now runs a conservative think tank, FreedomWorks, suggested that the Bush plan violated the president's oft-spoken zeal for allowing the "free market" to work. The media fell for Bush's media spin, describing it as a interest rate "freeze" and an "agreement" hammered out with lenders and investors. But in fact the Bush plan involves no mandates or legislation, just a voluntary agreement by lenders that lacks the force of law. There's absolutely no requirement that would force banks or investors to share the pain or be part of the solution. It isn't even clear if investors in mortgage-backed securities will allow the lenders to reset the rates. They may even file suit to halt the freeze.

Consumer activists, and the Democratic candidates, pointed out that the plan excludes most sub-prime borrowers, including those who are in the deepest trouble and are delinquent on their mortgage payments and facing foreclosure. Of the perhaps 2 million adjustable-rate mortgages that are expected to reset through the end of 2009, only 240,000 of them -- 12 percent -- would be covered by Bush's proposal, according to Barclays Capital, as reported in The New York Times. The Center for Responsible Lending, a nonprofit group, estimates that only 145,000 households will qualify for the rate freeze. Most borrowers will be on their own to negotiate with their lenders on a case-by-case basis. Many families who persuade banks to temporarily freeze their rates still won't be able to afford to make the payments, and will face foreclosure.

"It's very disappointing," said Michael Shea, executive director of ACORN Housing, a national group that provides homeownership counseling for low-income consumers. "Wall Street has made billions and now they're hardly paying anything at all" for their role in the sub-prime crisis.

Make no mistake -- it is a crisis. Since 1998, more than 7 million borrowers bought homes with sub-prime loans. One million of those homeowners have already defaulted on their loans The crisis is likely to get worse. Financial analysts predict that at least a quarter of these people -- over 2 million families -- will default and face the financial pain and psychological grief of losing their homes over the next few years.

Bush, who once touted his administration's goal as creating an "ownership society," may now go down in history as the president on whose watch ownership *declined*. The nation's homeownership rate has fallen during the last two years and will plummet further next year. Moreover, Bush's unwillingness to take bold steps to regulate lenders, brokers, and investors will guarantee that the next president will inherit a much bigger mortgage mess.

To many Americans, the crisis seems too complex to comprehend. To understand it, we need to know: What is the problem? Who benefited? Who got hurt? Who is to blame? Who should we help? What should be done? Although the immediate cause is the widespread use of sub-prime mortgages, the root cause is a decades old failure of government to adequately regulate the banking industry.

What Is Sub-Prime Lending?

Sub-prime lending is a fancy financial term for high-interest loans to people who would otherwise be considered too risky for a conventional loan. These include middle-class families who have accumulated too much debt and low-income working families who want to buy a home in the inflated housing market. To cover their risk, lenders charge such borrowers higher-than-conventional interest rates. Or they make "adjustable rate" loans, which offer low initial interest rates that jump sharply after a few years. Only a decade ago, sub-prime loans were rare. But starting in the mid-1990s, sub-prime lending began surging; these loans comprised 8.6 percent of all mortgages in 2001, soaring to 20.1 percent by 2006. Since 2004, more than 90 percent of the sub-prime mortgages came with exploding adjustable rates.

With interest rates low, housing prices on a steady rise, and practically no government regulation, mortgage finance companies devised high-interest, high-fee schemes to entice families to take out loans that traditional savings banks would not make. Many of the lenders were legitimate operations providing a market for credit-risky people. But there also were huge corporations, such as Household Finance, that sought extraordinary profits through unsavory means, called predatory loans. Not subject to government regulation, they bent the rules, lowering normal banking standards.

Mortgage brokers, the street hustlers of the lending world, often used mail solicitations and ads that shouted, "Bad Credit? No Problem!" "Zero Percent Down Payment!" to find people who were closed out of homeownership, or homeowners who could be talked into refinancing. They seduced millions of people into signing on the dotted line. Although sub-prime lending has been concentrated in minority and low-income urban areas, it has spread to the middle-class suburbs.

The sub-prime lenders didn't hold on to these loans. Instead, they sold them -- and the risk -- to investment banks and investors who considered these high interest rate, sub-prime loans a goldmine. By 2007, the sub-prime business had become a $1.5 trillion global market for investors seeking high returns.

The whole scheme worked as long as borrowers made their monthly mortgage payments. When borrowers couldn't or wouldn't keep up the payments on these high-interest loans, what looked like a bonanza for everyone turned into a national foreclosure crisis and an international credit crisis. For millions of families, the American Dream of homeownership has become a nightmare.

The mortgage meltdown has serious ripple effects. Foreclosed houses become vacant, deteriorate into eyesores, and detract from the neatness and feeling of well-being in neighborhoods. Vacant houses also attract crime and make it more difficult for neighbors to purchase homeowners' insurance.

In neighborhoods with several foreclosed homes, property values, and thus local property-tax revenues, plummet, making it harder for cities to provide good schools, police protection, and other services. According to a new report by the U.S. Conference of Mayors, the weak housing market and the large inventory of unsold homes will likely reduce home values by $1.2 trillion next year. About half of that amount is due to the sharp increase in foreclosures.

Who Benefited and Who Got Hurt?

Mortgage brokers, who occupy an unregulated niche of the lending world, made a commission for every borrower they handed over to a mortgage lender. These brokers are like the drug dealers on the street corner. They are the smallest link in a lending chain that includes some of the largest and most respectable Wall Street firms.

Large mortgage finance companies and banks made big bucks on sub-prime loans. Last year, 10 lenders -- Countywide, New Century, Option One, Fremont, Washington Mutual, First Franklin, RFC, Lehman Brothers, WMC Mortgage, and Ameriquest -- accounted for 59 percent of all sub-prime loans, totaling $284 billion.

Wall Street investment firms set up special investment units, bought the sub-prime mortgages from the lenders, bundled them into "mortgage-backed securities," and for a fat fee sold them to wealthy investors around the world. According to *The New York Times*, China's second-largest bank, Bank of China Ltd, held almost $9.7 billion of securities backed by U.S. sub-prime loans. These investors, who bought the collateralized securities, were happy as long as they got paid their higher interest on the bonds or other investments.

With the bottom falling out of the sub-prime market, more than 80 mortgage companies went under in the past six months. Major Wall Street firms took billion-dollar losses as the crisis ripped into foreign money markets, from London to Shanghai. Lehman Brothers underwrote $51.8 billion in securities backed by sub-prime loans in 2006 alone; as of September, 20 percent of those loans were in default, the Times reported. Similarly, about one-fifth of the sub-prime loans packaged by Morgan Stanley, Barclays, Merrill Lynch, Bear Stearns, Goldman Sachs, Deutsche Bank, Credit Suisse, RBS, Countrywide, JP Morgan, and Citigroup are 60 or more days delinquent, in foreclosure, or involve homes that have already been repossessed.

The executives and officers of some mortgage finance companies cashed out before the market crashed. The poster boy is Angelo Mozilo, the CEO of Countrywide Financial, the largest sub-prime lender. He made more than $270 million in profits selling stocks and options from 2004 to the beginning of 2007. And the three founders of New Century Financial, the second largest sub-prime lender, together realized $40 million in stock-sale profits between 2004 and 2006. Paul Krugman reported in *The New York Times* that last year the chief executives of Merrill-Lynch and Citigroup were paid $48 million and $25.6 million, respectively.

The hardest hit are the innocent borrowers of sub-prime loans. Many of them are working- and middle-class families who fell victim to the country's economic squeeze, a hardship not of their own doing but a symptom of the Bush years. They faced layoffs, stagnant wages, and rising costs of home heating, gasoline, utilities, food, and child care. For those without health insurance, one serious medical problem wiped out their savings. At a time when soaring housing prices were out of whack with the rest of the economy, sub-prime loans were the only way they could purchase a home. But when they could no longer keep up their mortgage payments, they had no safety net. They began skipping their monthly mortgage payments, especially after the adjustable-rate mortgages kicked in with higher interest rates, as high as a 30 percent spike for some borrowers.

Lenders sent letters threatening to take their homes in foreclosure if they didn't pay up. But for millions of families, the harsh warnings didn't matter. They couldn't refinance out of high-interest adjustable-rate mortgages because the value of their home had dropped below the outstanding mortgage or because they just didn't have the money. And they couldn't tap into a government aid program for at-risk homeowners facing foreclosure because none existed.

Those who deserve our greatest sympathy are the victims of predatory lending, a segment of the sub-prime market that involves deceptive practices by lenders, as well as unconscionable high fees and interest rates, sometimes running well over 22 percent. Predatory lenders range from sleazy operators in the financial netherworld to mainstream financial institutions like Household Finance. These lenders typically have salespeople who hound vulnerable families for months, soliciting and encouraging them to take out a loan to buy a house or refinance. Borrowers are charged hidden high fees, labeled with confusing terms like "discount points," suggesting that the fees will lower the interest rates, which they don't.

Predatory loans sometimes involve a conspiracy between loan agents and unscrupulous home-improvement contractors, as well as appraisers who inflate the value of a house so that families will borrow more than the houses are really worth. Predatory mortgages often include last-minute, hidden second mortgages. Using bait-and-switch tactics, predatory lenders tout low interest rates in ads targeting the elderly and residents of low-income, working-class, and minority neighborhoods, without explaining the actual interest rates or that adjustable-rate mortgages mean that the rates will increase.

Borrowers are enticed with deals that require them to pay little or nothing down. The unscrupulous lenders approve borrowers for loans even if they've recently been bankrupt or don't have sufficient income to keep up the payments. These lenders don't document an applicant's ability to pay back a loan. They often just accept the borrower's word about his income and expenses. "You could be dead and get a loan," a mortgage broker told Holden Lewis of Bankrate.com, a leading Web source for financial rate information.

Predatory lenders turn lending logic on its head. Instead of cautiously making loans to people who can repay them, they get their money by lending to people who are unable to repay. The loans are structured to guarantee failure. Predatory lenders get borrowers to agree to an adjustable-rate mortgage without explaining how it works, including the big bump in rates with a few years after taking out the loan. Borrowers suckered by predatory lenders often wind up having a monthly mortgage payment that is more than half their income. A predatory loan is often for more than the value of the house. The victims of predatory loans frequently don't realize they've been snookered until they're about to lose their homes.

Not all sub-prime borrowers are innocent victims. Some were speculators themselves, seeking to profit from the real estate housing bubble, and had their eyes wide open. They expected to rent their houses or quickly "flip" them to another buyer in a rising housing market. Others were simply living dangerously above their means, taking on too much debt and occupying houses that, by any reasonable standard, they couldn't really afford. These borrowers should live with the consequences of their behavior, not be rewarded with any help.

Where Do We Go from Here?

What should government do to address this crisis? Public officials need to distinguish legitimate sub-prime lenders from the scam artists who engage in predatory lending. Likewise, the people facing foreclosure need to be treated differently depending on whether they failed to exercise personal responsibility or were victims of predatory practices. Banks and other lenders and investors who speculated in mortgage-backed debt must shoulder some of the blame for this debacle.

Government needs to help the victims of predatory lenders who are at risk of losing their homes, but it must also adopt preventative measures to stop the crisis from getting worse and prevent it from happening again. Congress should enact legislation to protect victims of predatory loans from foreclosure. The victims should have a right to a nonprofit loan counselor or lawyer who can help them renegotiate the loan or sue banks, including big Wall Street firms, for violations of state and federal consumer protection laws. Indeed, Congress should require lenders to restructure predatory loans and provide more funding to nonprofit groups that help homeowners renegotiate loans.

One of these groups, ACORN, a national network of community organizations, has been pressuring Citigroup to restructure loans rather than foreclose on low-income consumers. ACORN wants lenders to agree to 30-year, fixed-rate, affordable modifications to existing loans so borrowers can avoid interest rate increases that come with adjustable-rate mortgages. ACORN has also urged lenders to impose a moratorium on foreclosures, which some Democratic candidates have supported.

Another group, the National Community Reinvestment Coalition, has a foreclosure prevention program that has saved thousands of homeowners from losing their homes by pressuring lenders to change adjustable-rate mortgages into fixed-rate loans. "This is not a homeowner bailout," said John Taylor, group's president. "This is a bailout for failed regulatory oversight. Infectious greed and malfeasance by lending institutions is the overwhelming culprit, not consumer misbehavior."

And UNITE HERE, the garment and hotel workers' union, has launched a campaign against Countrywide Financial, the nation's largest sub-prime lender, calling on consumers to boycott the bank until it guarantees it won't foreclose on borrowers who have fallen behind on adjustable-rate loans.

These activist groups have made some headway, but without a federal mandate they have to rely on protest and other threats to get banks to cooperate. They support a bill sponsored by Rep. Brad Miller, a North Carolina Democrat, and Rep. Loretta Sanchez, a California Democrat, that would allow bankruptcy judges to amend the terms of home mortgages. Under current law, the terms of a mortgage on a yacht or a vacation home can be adjusted during bankruptcy, but not primary residences. "This makes no sense," said Eric Stein of the Center for Responsible Lending, testifying before the House Judiciary Subcommittee on Commercial and Administrative Law. Advocates say that the Miller-Sanchez bill could help as many as 600,000 homeowners avoid foreclosure, but the Mortgage Bankers Association is fighting the legislation.

Looking forward, we need the federal government to be a lending-industry watchdog, not a lapdog. Step one is to stop predatory lending. The Mortgage Reform and Anti-Predatory Lending Act of 2007, passed by the U.S. House of Representatives in November, contains some useful provisions. It requires lenders to verify all applicants' income and document that borrowers have a reasonable ability to pay -- not just at the initial interest rate, but any future hike in the rate. It puts private mortgage companies and mortgage brokers under the umbrella of federal lending regulations, requiring them to be registered and licensed, just like stockbrokers and insurance brokers. It would also allow a borrower to modify an illegal loan, before being forced into foreclosure. And it allows states to pursue cases against fraud, misrepresentation, false advertising, and civil-rights abuses. Under the bill, wronged borrowers could seek some redress from the original lender, even if they're not in danger of losing their homes.

But, under pressure from the banking lobby, Congress gutted some of the better parts of the bill. The Mortgage Bankers Association and the American Banking Association lobbyists persuaded the House to allow lenders to continue the insidious practice of paying an increased fee to brokers for steering borrowers into higher cost sub-prime mortgages. It also bars borrowers whose predatory loans have been sold on Wall Street from suing investors for relief until the homeowners are facing foreclosure. In effect, it forces borrowers into foreclosure as a condition for asserting their rights.

Under the bill, in other words, victims of predatory loans have almost no ability to pursue claims against investment banks and other investors. Wall Street and the big players in the mortgage market won't be held accountable for buying abusive loans. Borrowers who were ripped off should be encouraged, not discouraged to sue Wall Street firms in state court for relief from mortgages that they never had a realistic chance of repaying.

A sweeping bill introduced last week by Sen. Chris Dodd, chairman of the Senate Banking Committee, closes many of the loopholes in the House bill by adding more consumer protections and industry penalties. The Homeownership Preservation and Protection Act of 2007 makes Wall Street and other investors liable for illegal practices of mortgage brokers and lenders. Unlike current law, which puts the burden on the borrower to identify the broker or lender who made the original deal, Dodd's bill allows the borrower to sue the current mortgage holder. The Dodd bill would prohibit lenders from steering borrowers towards more expensive loans than they would otherwise qualify for, and from influencing an appraisal's value of a house. It requires that lenders confirm that a borrower can afford to pay an adjustable rate mortgage after the rate jumps, and that loans provide a "net tangible benefit" to the borrower. It also prohibits prepayment penalties on sub-prime loans.

But to prevent the current crisis from getting worse -- and to avoid future crises -- Congress needs to take much bolder action to rein in abusive mortgage lending. Congress should simply outlaw adjustable-rate mortgages, which basically ask borrowers to treat their home mortgages like stocks, just like Bush wants to turn Social Security into individual accounts that people can invest, and risk losing their retirement savings.

Congress should also ban private lenders and brokers from issuing sub-prime loans of any kind. Instead, the focus should be on strengthening nonprofit lending institutions to serve the credit needs of high-risk borrowers. Like the old savings-and-loan (S&L) companies, these nonprofit lenders are highly regulated and devoted entirely to helping people purchase homes with transparent, stable loans.

Nonprofit lenders actually do better than their for-profit counterparts. One such lender, Neighborhood Housing Services of America (NHS), a federally charted nonprofit group with chapters in every American urban area, makes 90 percent of its loans to low and moderate income home buyers -- the so-called "risky borrowers" who only qualify for sub-prime loans in the private market. About 54 percent of NHS' borrowers are minority households. As of June 30, 2007, it has made some 3,000 loans totaling $205 million to these borrowers who otherwise would have been forced into the private sub-prime market. These NHS borrowers don't have the same mortgage problems as sub-prime borrowers in private sector. In fact, NHS' delinquency rate is only 3.34 percent -- well below the national rate of 14.5 percent for sub-prime loans in the private sector. The same is true for foreclosures. Only one half of one percent of NHS loans went into foreclosure during the second quarter of 2007, one fifth the foreclosure rate (2.45 percent) among private lenders.

NHS succeeds for two reasons. It has an effective mortgage education program carried out by its own loan counselors. It requires every borrower to participate in its counseling program before and after a loan is made. Moreover, and importantly, NHS makes no adjustable interest rates loans.

And It All Started with Deregulation

There was a time, not too long ago, when Washington did regulate banks. The Depression triggered the creation of government bank regulations and agencies, such as the Federal Deposit Insurance Corporation, the Federal Home Loan Bank System, Homeowners Loan Corporation, Fannie Mae, and the Federal Housing Administration, to protect consumers and expand homeownership. After World War II, until the late 1970s, the system work. The savings-and-loan industry was highly regulated by the federal government, with a mission to take people's deposits and then provide loans for the sole purpose of helping people buy homes to live in. Washington insured those loans through the FDIC, provided mortgage discounts through FHA and the Veterans Administration, created a secondary mortgage market to guarantee a steady flow of capital, and required S&Ls to make predictable 30-year fixed loans. The result was a steady increase in homeownership and few foreclosures.

In the 1970s, when community groups discovered that lenders and the FHA were engaged in systematic racial discrimination against minority consumers and neighborhoods -- a practice called "redlining" -- they mobilized and got Congress, led by Wisconsin Senator William Proxmire, to adopt the Community Reinvestment Act and the Home Mortgage Disclosure Act, which together have significantly reduced racial disparities in lending.

But by the early 1980s, the lending industry used its political clout to push back against government regulation. In 1980, Congress adopted the Depository Institutions Deregulatory and Monetary Control Act, which eliminated interest-rate caps and made sub-prime lending more feasible for lenders. The S&Ls balked at constraints on their ability to compete with conventional banks engaged in commercial lending. They got Congress -- Democrats and Republicans alike -- to change the rules, allowing S&Ls to begin a decade-long orgy of real estate speculation, mismanagement, and fraud. The poster child for this era was Charles Keating, who used his political connections and donations to turn a small Arizona S&L into a major real estate speculator, snaring five Senators (the so-called "Keating Five," including John McCain) into his web of corruption.

The deregulation of banking led to merger mania, with banks and S&Ls gobbling each other up and making loans to finance shopping malls, golf courses, office buildings, and condo projects that had no financial logic other than a quick-buck profit. When the dust settled in the late 1980s, hundreds of S&Ls and banks had gone under, billions of dollars of commercial loans were useless, and the federal government was left to bail out the depositors whose money the speculators had put at risk.

The stable neighborhood S&L soon became a thing of the past. Banks, insurance companies, credit card firms and other money-lenders were now part of a giant "financial services" industry, while Washington walked away from its responsibility to protect consumers with rules, regulations, and enforcement. Meanwhile, starting with Reagan, the federal government slashed funding for low-income housing, and allowed the FHA, once a key player helping working-class families purchase a home, to drift into irrelevancy.

Into this vacuum stepped banks, mortgage lenders, and scam artists, looking for ways to make big profits from consumers desperate for the American Dream of homeownership. They invented new "loan products" that put borrowers at risk. Thus was born the sub-prime market.

At the heart of the crisis are the conservative free market ideologists whose views increasingly influenced American politics since the 1980s, and who still dominate the Bush administration. They believe that government is always the problem, never the solution, and that regulation of private business is always bad. Lenders and brokers who fell outside of federal regulations made most of the sub-prime and predatory loans.

In 2000, Edward M. Gramlich, a Federal Reserve Board member, repeatedly warned about sub-prime mortgages and predatory lending, which he said "jeopardize the twin American dreams of owning a home and building wealth." He tried to get chairman Alan Greenspan to crack down on irrational sub-prime lending by increasing oversight, but his warnings fell on deaf ears, including those in Congress.

As Rep. Barney Frank wrote recently in *The Boston Globe*, the surge of sub-prime lending was a sort of "natural experiment" testing the theories of those who favor radical deregulation of financial markets. And the lessons, Frank said, are clear: "To the extent that the system did work, it is because of prudential regulation and oversight. Where it was absent, the result was tragedy."

Some political observers believe that the American mood is shifting, finally recognizing that the frenzy of deregulation that began in the 1980s has triggered economic chaos and declining living standards. If they needed proof, the foreclosure crisis is exhibit number one.

Those who profited handsomely from the sub-prime market and predatory lending, the mortgage bankers and brokers, are working overtime to protect their profits by lobbying in state capitals and in Washington, DC to keep government off their backs. The banking industry, of course, has repeatedly warned that any restrictions on their behavior will close needy people out of the home-buying market. Its lobbyists insisted that the Bush plan be completely voluntary.

This isn't surprising, considering who was at the negotiating table when the Bush administration, led by Treasury Secretary Henry Paulson, forged the plan. The key players were the mortgage service companies (who collect the homeowner's monthly payments, or foreclose when they fall behind) and groups representing investors holding the mortgages, dominated by Wall Street banks. The Bush plan reflected both groups' calculation that -- for some loans -- they would do better temporarily freezing interest rates than foreclosing. Groups who represent consumers -- ACORN, the National Community Reinvestment Coalition, the Greenlining Institute, Neighborhood Housing Services, and the Center for Responsible Lending -- were not invited to the negotiation.

The best hope for real reform rests with a Democratic Party victory in November. And after an electoral win, it will require that Democrats make sure that these consumer groups are key participants in shaping legislation..

And wouldn't it be nice to hear the next president tell the American people that, "the era of unregulated so-called free-market banking greed and sleaze is over"?

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