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The Mortgage Mess and the Economic Meltdown: What McCain (and the rest of us) Should Learn from the Keating Scandal

The nation's escalating economic troubles -- triggered by the growing wave of home foreclosures, declining housing prices,and bank failures -- was entirely preventable. It will take years and trillions of dollars to dig ourselves out of this hole, as the ripple effects of the mortgage meltdown reverberate throughout the economy: millions of families losing their homes. a housing industry in disarray, skyrocketing consumer debt, tight credit, massive lay-offs, neighborhoods in decline, and serious fiscal woes for states and cities.

The issue should be at the forefront of this presidential campaign. John McCain is conspicuously silent, even as George Bush proposes to bail-out Wall Street, which played a major role in getting us into the mess. Barack Obama and Hillary Clinton have offered reasonable ideas for coping with the symptoms (especially homeowners facing foreclosure), but neither has proposed the sweeping reforms needed to address the root causes -- five pillars of which are outlined below.

The problem began in the 1980s, when -- under political pressure from the banking industry -- the Reagan administration and Congress stopped regulating the nation's financial institutions. Commercial banks and savings-and-loans used their political clout -- especially campaign contributions -- to get Congress to loosen restrictions on the kinds of loans they could make.

One of government's important roles is to establish ground-rules, and to regulate companies and industries, to save them from their own short-sighted greed. Government is necessary to make business act responsibly. Without it, capitalism becomes anarchy.

Washington now needs to put a short-term tourniquet on the banking industry to stem the damage, and to get back into the business of protecting consumers, employees, and investors from corporate greed. But in its last year in office, the Bush administration is repeating the same mistakes. It is about to invest huge sums of taxpayer dollars to bail out Wall Street -- including the investment bank Bear Stearns -- without insisting on any quid-pro-quo. And if there's anyone who should be screaming "stop!" before the Bushies gift-wrap the bail-out package, it should be John McCain, a politician who claimed that he'd learned his lesson after getting caught being a sock puppet for a sleazy banker. But so far his silence is deafening.

We're in the current mess because the financial industry has too much influence in Washington. This culture of corruption was epitomized by the Keating Five scandal. Five Senators -- including John McCain and four Democrats (none of them still in Congress) -- tried to intimidate federal bank regulators on behalf of Charles Keating, an Arizona real estate developer and owner of Lincoln Savings who had raised $1.3 million for the politicians. McCain, who received $112,000 from Keating and flew to the banker's home in the Bahamas on company planes, attended several meetings in 1987 with federal bank regulators who were investigating Keating for swindling investors.

McCain says he learned a valuable lesson from that experience about conflicts-of-interest, even though he later repeated the behavior in other instances, including intervening with the Federal Communications Commission on behalf of Paxson Communications, which was seeking to buy a television station license in Pennsylvania and which had donated more than $20,000 to McCain and lent him the company's jet for campaign travel.

But if McCain were alone in participating in this culture of corruption, we wouldn't be in the economic mess we're now in. Unfortunately, McCain's behavior was typical. Congress let the financial industry get away with giant rip-offs. While federal regulators looked the other way, banks engaged in an orgy of risky loans and speculative investments. Every aspect of the financial industry was so short-sighted and greedy that they didn't see the train wreck coming around the corner.

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 (FDIC), the Federal Home Loan Bank System, Home Owners Loan Corporation (HOLC), Fannie Mae, and the Federal Housing Administration (FHA), to protect consumers and expand homeownership. After World War II, until the late 1970s, the system worked. 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 subprime lending more feasible for lenders. The S&L industry, like Keating's Lincoln Savings, 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 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, about a thousand 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 looted to the tune of about $125 billion.

The icing on the cake was the Gramm-Leach-Bliley Act of 1999, enacted during the Clinton years by the Republican-controlled Congress, which tore down the remaining legal barriers to combining commercial banking, investment banking, and insurance under one corporate roof.

As a result of industry consolidation, between 1984 and 2004, the number of FDIC-regulated banks declined from 14,392 to 7,511. In 1960, the 10-largest banks held 21 percent of the industry's assets; by 2005, the 10 largest banks controlled 60 percent of the assets. Meanwhile, a netherworld of non-bank institutions that lend and invest money emerged, offering complex and risky loan products and investment vehicles that defy common understanding and resist government regulation.

The stable neighborhood S&L soon became a thing of the past. Banks, insurance companies, credit-card firms, and other money-lenders became part of a giant financial-services industry, while Washington walked away from its responsibility to protect consumers with rules, regulations, and enforcement.

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 subprime market.

Now, as millions of Americans lose their homes, Wall Street institutions face collapse, and the economy is in a deepening recession, all the players within the financial and housing industry are pointing fingers, and lawsuits, at each other. Here's what really happened:

At the bottom rung of the industry ladder are the private mortgage brokers and bank salespeople who solicited and hounded families, encouraging them to take out a loan to buy a house or to refinance their homes. These street hustlers earned fees for bringing borrowers to lenders--the larger the mortgage, the larger the fee. They were often in cahoots with real estate appraisers, who inflated the value of homes (on paper) to make the loans look reasonable. Brokers persuaded many borrowers who were eligible for conventional loans to take out risky subprime loans, including adjustable-rate mortgages start with low rates and jump sharply after a few years. Subprime loans typically have higher application, appraisal, and other fees, as well as higher mortgage insurance payments, principle and interest payments, late fees, and fines for delinquent payments. Many borrowers were snookered into taking loans whose terms they barely understood because the documents were confusing. And in many cases, lenders simply lied about the costs of the loans and whether borrowers could really afford them.

Some of these brokers and banks were engaged in predatory lending, an array of abusive practices that targeted those least likely to be able to repay. Predatory lenders charged unconscionably high fees and interest rates, sometimes running well over 22 percent. Borrowers face hidden fees masked by confusing terms such as "discount points," erroneously suggesting that the fees will lower the interest rates. Many of these loans had prepayment penalties that make it difficult or impossible for borrowers to refinance when interest rates decline. Many banks were so eager to profit on these loans failed to require the documentation needed to evaluate the risks.

Only a decade ago, subprime loans were rare. But, starting in the mid-1990s, subprime lending began surging. They comprised 8.6 percent of all mortgages in 2001, soaring to 20.1 percent by 2006. Since 2004, more than 90 percent of subprime mortgages came with exploding adjustable rates.

Big mortgage finance companies and banks cashed in on subprime loans. These include Household Finance, New Century, Countywide, CitiMortgage, WMC Mortgage, Fremont Investment, Ameriquest, Option One, Wells Fargo, and First Franklin. The executives and officers of some of these companies cashed out before the market crashed, most notably Angelo Mozilo, the CEO of Countrywide Financial, the largest subprime lender. Mozilo made more than $270 million in profits selling stocks and options from 2004 to the beginning of 2007.

At the other end of the financial services industry are the investors -- people and institutions that borrowers never see, but who made the explosion of subprime and predatory lending possible. Subprime lenders didn't hold onto these loans. Instead, they collecting fees for making the transactions and sold the loans -- and the risk-- to investment banks and investors who considered these high-interest-rate loans a goldmine. By 2007, the subprime business had become a $1.5 trillion global market for investors seeking high returns. Because lenders didn't have to keep the loans on their books, they didn't worry about the risk of losses.

Wall Street investment firms set up special investment units, bought the subprime mortgages from the lenders, bundled them into "mortgage-backed securities," and for a fat fee sold them to wealthy investors worldwide. (According to the New York Times, for example, some towns in Australia are suing Lehman Brothers, the Wall Street bank with the biggest mortgage business, for improperly selling them risky mortgage-linked investments).

When the bottom began falling out of the subprime market, many banks and mortgage companies went under, and major Wall

Street firms took huge loses. They include Lehman Brothers (which underwrote $51.8 billion in securities backed by subprime loans in 2006 alone), Morgan Stanley, Barclays, Merrill Lynch, Goldman Sachs, Deutsche Bank, Credit Suisse, RBS, Citigroup, JP Morgan and Bear Stearns. These investment banks are now accusing the lenders and mortgage brokers of shoddy business practices, but the Wall Street institutions obviously failed to do their own due diligence about the risky loans they were investing in.

Finally, the major credit agencies -- such as Moody's and Standard & Poor's -- raked in big bucks by giving these mortgage-backed securities triple-A ratings. They had their own conflicts of interest, because these ratings agencies get their revenue these Wall Street underwriters. No politician has yet called on Washington to hold these powerful credit agencies accountable.

So there you have it. The entire financial and housing food chain -- brokers, appraisers, mortgage companies, bankers, investors, and credit agencies -- participated in this greedy shell game. Some of what they did was illegal. But most of it was simply business as usual.

At the heart of the crisis are the conservative free-market ideologists, like former Fed Chair Alan Greenspan, whose views have shaped public policy 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 a misguided interference with the free market.

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

"The Federal Reserve could have stopped this problem dead in its tracks," Martin Eakes, chief executive of the Center for Responsive Lending, a nonprofit watchdog group, recently told The New York Times. "If the Fed had done its job, we would not have had the abusive lending and we would not have a foreclosure crisis in virtually every community across America."

As Rep. Barney Frank (D-Mass.), chair of the House Financial Services Committee, wrote recently in The Boston Globe, the surge of subprime lending was a sort of "natural experiment on the role of regulation." 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."

So, what to do now?

First, the federal government should help homeowners who have already lost their homes or are at risk of foreclosure. It should create an agency comparable to the Depression-era Home Owners Loan Corporation, buy the mortgages, and remake the loans at reasonable rates, backed by federal insurance. Created in 1933, HOLC helped distressed families avert foreclosures by replacing mortgages that were in or near default with new ones that homeowners could afford. It purchased mortgages from banks and issued new loans to homeowners. Within a few years, almost one-fifth of all mortgage were owned by the HOLC. A modern version of HOLC would focus on owner-occupied homes, not homes purchased by absentee speculators.

Second, Washington should not bail out any investors or banks, including Bear Stearns and its suitor, JP Morgan, that does not agree to these new ground rules. The Fed brokered the deal between Bear Stearns and JP Morgan without any conditions for the consumers who were ripped off. There will be more Bear Stearns-like failures in the foreseeable future -- institutions that the Fed considers "too big to fail." But if the federal government is about to provide hundreds of billions from the Federal Reserve, as well as from Fannie Mae, Freddie Mac and the Federal Home Loan Banks, to prop up Wall Street institutions, it should require the industry to be held accountable for its greed and misdeeds.

Third, Washington should consolidate the crazy-quilt of federal agencies that oversee banks and financial institutions into one super agency. Federal oversight has not kept pace with the dramatic transformation of the financial services industry. Four federal agencies -- the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation -- have some jurisdiction over mortgage lending. States have jurisdiction over the growing number off nonbank mortgage lenders (which accounted for about 40 percent of new subprime loans) and have no agreed-upon standards for regulating them. States are responsible for regulating the insurance industry (including homeowner insurance), and do so with widely different levels of effectiveness. It is simply absurd to have so many competing and overlapping agencies involved in regulating these financial services institutions, often at cross purposes.

"We need to go in the direction of more regulatory consolidation," Sheila C. Bair, chairwoman of the FDIC, recently told the New York Times. "It would make more sense to have some type of umbrella agency, if for no other reason than facilitating information."

Fourth, the federal government should be a financial services industry watchdog, not a lapdog. Senator Chris Dodd (D-Conn.), chair of the Senate Banking Committee, and Rep. Frank have proposed decent legislation. Congress should require lenders to verify applicants' income and document that borrowers have a reasonable ability to pay. It should puts private mortgage companies and brokers under the umbrella of federal lending regulations, requiring them to be registered and licensed. Wall Street and other investors should liable for the illegal practices of mortgage brokers and lenders. Borrowers should be allowed to sue the current mortgage-holder, even if the original lender sold the loan. Lenders should be prohibited from steering borrowers toward more expensive loans and from influencing an appraiser's value of a house.

These proposals may seem like common sense solutions, but they are already under attack by financial services industry lobbyists. Indeed, under pressure from the lobby, the House already gutted some of the better parts of the Frank bill. For example, the Mortgage Bankers Association and the American Banking Association lobbyists persuaded legislators 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. Wall Street and the big players in the mortgage market won't be held accountable for buying abusive loans.

Fifth, and finally, we need real campaign finance reform, so that the banks, insurance companies, Wall Street firms, and other players in the financial services industry can't use their political influence to avoid adhering to responsible business practices. Washington is awash in Wall Street money. In 2000 George Bush collected nearly $4 million from the securities and investment industry, according to the Center for Responsive Politics. Al Gore received $1.4 million. Four years later, Bush received $8.8 million, double Sen. John Kerry's take. This year, so far, Hillary Clinton has collected at least $6.3 million from the industry, compared to $6 million for Obama and $2.6 million for McCain, who will no doubt start closing the gap. Wall Street has also spread its largesse to candidates for Congress from both parties.

We are now seeing the consequences of this system of legal bribery.

Under Bush, Treasury Secretary Henry Paulson, and Fed Chairman Ben Bernacke, the solutions have reflected the priorities of the financial services industry: bail-outs for Wall Street but resistance to strong regulations and help for troubled homeowners.

This isn't surprising, considering who was at the negotiating table when the administration forged its plans. 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. 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.

John McCain hasn't offered any ideas to seriously address these issues. This isn't surprising. McCain is a free market fundamentalist. And his major economic adviser is former Senator Phil Gramm of Texas, who, while in the Senate, was the key architect of the deregulation of the financial services industry and a fervent opponent of the Community Reinvestment Act. Gramm is now the vice chairman of UBS, the Swiss investment banking giant, and would be a leading candidate to be Treasury Secretary in a McCain administration.

In contrast, both Hillary Clinton and Barack Obama are cosponsors of Senator Dodd's bill and have offered proposals to protect homeowners facing foreclosure and add sensible regulation to the financial services industry. On Monday, in a speech in Philadelphia, Clinton added more details; she called for a $30 billion housing stimulus package to allow cities and states to purchase foreclosed properties and improve neighborhoods blighted by foreclosure. But she also proposed a new nonpartisan housing panel led by the likes of Robert Rubin (a close advisor who runs Citigroup, which is knee-deep in the subprime mess, and was her husand's Treasury Secretary) and Greenspan -- both of whom were part of the problem. So far, neither Democrat has proposed the kind of sweeping reforms needed to restore stability and accountability to the financial services industry and challenge their basic business practices.

Faced with a similar situation, President Franklin Roosevelt worked with Congress to give the federal government the tools it needed to make the banking industry act responsibly. At the time, some critics called him a socialist. But in retrospect, it is clear that what he did was to rescue capitalism. Once again, we have a financial services industry unable to police itself. The next president should tell the American people that "the era of unregulated so-called free-market banking greed and sleaze is over."