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>
> *—Securities and Exchange Commission Chairman Christopher Cox (October 2008)*

I. Regulators' Failure to Heed Warnings Allowed Subprime Mortgage Lending to Spin Out of Control

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Most observers agree that reckless mortgage lending was an essential link in the chain of events that caused the housing bubble and subsequent financial crisis of 2008. In just one example, Securities and Exchange Commission Chairman Christopher Cox said in House testimony: "If honest lending practices had been followed, much of this crisis, quite simply, would not have occurred."[2]

If one accepts this view, the logical conclusion is that lax oversight of mortgage lending was significantly to blame for the crisis.

Those who reject this thesis often blame the 1977 Community Reinvestment Act, or CRA, which requires banks to lend to low-income borrowers. But abundant evidence contradicts this theory, especially the simple fact that the CRA did not cover the majority of risky loans made during the housing bubble.

This chapter describes three key ways in which regulation of the mortgage market was loosened over the past three decades: new federal laws gave lenders more freedom to customize the terms of their loans; federal regulatory agencies handed down a series of rulings that prevented states from imposing more stringent standards; and, most significantly, the leaders of federal regulatory agencies consciously—and, at times, brazenly—adopted a lax approach to enforcing the laws that remained on the books. These factors combined to allow reckless lending to flourish.

The Federal Government Loosened Lending Laws and Restricted States' Ability to Impose Higher Standards

In 1980, Congress passed the Depository Institutions Deregulation and Monetary Control Act, or DIDMCA, which prohibited states from capping interest rates for most residential mortgage loans.[3] The 1982 Alternative Mortgage Transaction Parity Act, or AMTPA, blocked states from requiring the use of conventional, fixed-rate mortgages for home loans.[4]

Eventually, DIDMCA and AMPTA permitted the exotic adjustable-rate, balloon-payment, option-ARM, and interest-only mortgages that fueled the subprime lending frenzy of the first decade of the 21st century.[5]

In a move that ostensibly would have reduced unsafe lending, Congress in 1994 passed the Home Ownership and Equity Protection Act, or HOEPA. The law was intended to police unfair and deceptive lending, particularly the "reverse redlining" practice of marketing deceptive loans to low-income borrowers.[6]

But Congress crafted this measure too narrowly. HOEPA's protections, such as its prohibitions on prepayment penalties and negative amortization loans, applied only to loans carrying interest rates 10 percentage points higher than Treasury securities.[7] The interest rate threshold was so high that the law ended up covering only a small percentage of mortgages.[8]

HOEPA gave the Federal Reserve permission to issue additional guidelines to prevent unfair and deceptive practices. But the Fed would not act on this authority for 14 years.[9]

The effects of laws that relaxed rules on mortgage lending were compounded by a series of rulings by federal regulatory agencies that stripped states of the authority to impose tougher standards on federally chartered lending institutions.

> "As a result of unfair and deceptive practices, and other federal law violations by certain lenders, vulnerable borrowers—including the elderly—are facing the possibility of paying significant and unnecessary fees and, in some cases, losing their homes."
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> *—Jodie Bernstein, director of the Federal Trade Commission's Bureau of Consumer Protection, Senate Testimony (1998)*

In 1996, the Office of Thrift Supervision, or OTS—which regulated federally chartered savings and loan associations—declared that it occupied "the entire field of lending regulation for federal savings associations" and that its rules preempted the states "regarding licensing, credit terms, loan fees, disclosure requirements, origination, and interest rate ceilings."[10] The OTS issued letters preempting predatory lending laws in Georgia, New Jersey, New Mexico and New York.[11]

The New Mexico letter, for example, invalidated the state's prohibitions against "balloon payments, negative amortization, prepayment penalties, loan flipping, and lending without regard to the borrower's ability to repay."[12]

In 2001, the Office of the Comptroller of the Currency, or OCC—which was in charge of supervising federally chartered banks—shielded state-chartered subsidiaries of national banks from state regulation. Four states challenged this decision. The Supreme Court ruled in favor of the OCC in 2007.[13]

In January 2004, the OCC declared that states did not have "visitation rights" to examine the affairs of federally chartered banks operating within their boundaries.[14] Three major banks soon converted from state to federal charters, resulting in $1 trillion of banking assets being transferred to the OCC's jurisdiction.[15]

Warning Signs Arose Long Before the Housing Bubble

Though far less publicized than in the ensuing decade, the 1990s saw significant increases in the risky lending and securitization practices that eventually wrecked the economy.

> The risks posed by subprime lending could cause "astronomical default rates…That would spill over into other sectors of the economy, both in deflating the real estate market, as well as impact the safety and soundness of the banking system."
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> *—Rep. Ken Bentsen (D-Texas) (1999)*

Several institutions specializing in subprime lending and securitization of subprime loans flourished, then crashed in the 1990s.[16] Subprime loans are usually given to borrowers with lower credit scores and carry higher interest rates than prime loans. Securitization refers to the practice of bundling multiple loans into bonds, which are sold to investors.

The value of subprime mortgages soared from $20 billion to $160 billion from 1993 to 1999.[17] Issuance of securities backed by subprime mortgages jumped from $11 billion to $83 billion from 1994 to 1998.[18]

Many public officials recognized the danger of the increasing use of subprime loans. "Due to sharp growth in the subprime mortgage industry, it appears that the abuses by subprime lenders are on the rise," Jodie Bernstein, director of the Federal Trade Commission's Bureau of Consumer Protection, testified before a Senate committee in 1998.[19]

"As a result of unfair and deceptive practices, and other federal law violations by certain lenders, vulnerable borrowers—including the elderly—are facing the possibility of paying significant and unnecessary fees and, in some cases, losing their homes," Bernstein said.[20]

In a House banking committee hearing in 2000, Representative Ken Bentsen (D-Texas) warned that increased subprime lending coupled with securitization of subprime loans presaged "astronomical default rates…That would spill over into other sectors of the economy, both in deflating the real estate market, as well as impact the safety and soundness of the banking system."[21]

Several bills were proposed in the late 1990s and early 2000s to crack down on subprime lending abuses. Senator Richard Durbin (D-Ill.) in 1998 introduced an amendment to a consumer bankruptcy bill that would have restricted the ability of lenders who violated HOEPA from collecting on mortgage loans. The amendment was removed by the conference committee charged with reconciling the Senate and House versions of the bill.[22]

A bill introduced by Representative John LaFalce (D-N.Y.) in 2000 would have prevented lenders from issuing loans without "regard for the borrower's ability to repay the debt."[23] The legislation did not pass.

A task force formed in 2000 by the Department of Housing and Urban Development and the Department of the Treasury held hearings on subprime lending in several major cities. The task force found "patterns of abusive practices," including "substantial evidence of too-frequent abuses in the subprime lending market." These abuses included loan flipping, prepayment penalties that resulted in borrowers' losing the equity in their homes, and outright fraud.[24]

Subprime loans were disproportionately being given to African Americans regardless of income, the task force found. African-American borrowers in upper-income neighborhoods were more than twice as likely (39 percent) to receive subprime loans than white borrowers in low-income neighborhoods (18 percent).[25]

A potentially helpful regulatory response to subprime lending abuses, at least by non-federally chartered institutions (which remained subject to state laws), was quickly nullified by a concerted industry lobbying effort. The 2002 Georgia Fair Lending Act imposed liability on institutions that securitized predatory loans made to borrowers in Georgia.[26] The law, Gretchen Morgenson and Joshua Rosner posited in *Reckless Endangerment* (2011), might have short-circuited the subprime lending boom by holding those involved in securitizing mortgages accountable.[27]

"If you eliminated the 'plausible deniability' that securitization provided for participants in the loan pooling process, you would force players at each stop on the assembly line to increase their scrutiny of lending practices," Morgenson and Rosner wrote. The existence of liability for participants in the subprime lending industry could have begun "to slow down the securitization machinery that allowed fraudulent loans to wreak such havoc among poor and minority borrowers."[28]

A campaign to overturn the Georgia law was spearheaded by Wright Andrews, a lobbyist who headed several industry-funded front groups with consumer-friendly names, such as the Coalition for Fair and Affordable Lending.[29] Andrews' wife, Lisa, was a lobbyist for Ameriquest, one of the nation's leading subprime lenders.[30]

"Loans made in Georgia are looked upon with suspicion and a number of large secondary market investors are no longer interested in doing business in our state," Andrews wrote in an analysis of the Georgia law. "The time for the General Assembly to act is now to minimize the negative impact of the Act on Georgia borrowers, traditional lenders and the economy."[31]

Andrews' cause was aided in early 2003, when the credit rating agencies announced harsh responses to the Georgia law. Standard & Poor's, for instance, said it would not rate mortgage securities that included loans originated in Georgia because of potential complications the law could pose for investors in those loans. The other credit agencies quickly followed suit.[32]

In March 2003, legislation gutting the law was signed by Governor Sonny Perdue (R).[33] Morgenson and Rosner argue that the Georgia law could have served as a template for legislation around the country. Instead, "the lending binge that would drive the economy into the ditch five years later was back on track."[34]

Federal Agencies Abdicated Their Enforcement Duties

The absence of legislative redress and the preemption of states' authority heightened reliance on agencies in charge of enforcing existing laws. But leaders of three key federal agencies—the Federal Reserve, the Office of the Comptroller of the Currency and the Office of Thrift Supervision—did not exercise their authority assertively.

> "I stood up at a Fed meeting in 2005 and said, 'How many anecdotes makes it real? How many tens or thousands of anecdotes will it take to convince you that this is a trend?'"
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> *—Margot Saunders, attorney,*
> *National Consumer Law Center (2009)*

In 1998, the Fed decided not to conduct compliance examinations of mortgage lenders that were subsidiaries of banks but not legally classified as banks.[35] The next year, the General Accounting Office (now the Government Accountability Office) recommended that the Federal Reserve reconsider its decision, but the Fed rejected the GAO's advice.[36]

After the crisis, former Federal Reserve Chairman Alan Greenspan told the congressionally appointed Financial Crisis Inquiry Commission, or FCIC, that his organization lacked the resources to examine non-bank subsidiaries. But the Fed never asked for an increase in funding for enforcement, the FCIC reported.[37]

In 2000, the Federal Reserve held hearings on HOEPA's effectiveness at achieving its objectives of protecting borrowers. For high-interest loans, the Fed's staff recommended requiring lenders to verify borrowers' income and debt.[38]

The Federal Reserve board rejected the recommendation. Instead, the Fed slightly lowered the threshold for a loan to be covered under HOEPA's predatory lending provision.[39] The new rule ended up covering only 1 percent of subprime loans.[40]

Greenspan later said that his strategy had been to enforce the laws on the books rather than issue new rules. "If there is egregious fraud, if there is egregious practice, one doesn't need supervision and regulation, what one needs is law enforcement," he said.[41]

But the Federal Reserve did not meaningfully enforce the law during Greenspan's tenure. From 2000 until the end of Greenspan's term in 2006, the Fed referred to the Justice Department only three institutions for alleged fair lending violations related to mortgages.[42]

"Our goal is to allow thrifts to operate with a wide breadth of freedom from regulatory intrusion."
—*Office of Thrift Supervision Director James Gilleran (2004)*

Consumer advocates said it was almost impossible to convince the Fed that problems warranted action. "I stood up at a Fed meeting in 2005 and said, How many anecdotes makes it real? How many tens or thousands of anecdotes will it take to convince you that this is a trend?" Margot Saunders, a former managing attorney of the National Consumer Law Center, recalled.[43]

Lax regulation was, in fact, the Fed's policy, as Fed General Counsel Scott Alvarez acknowledged to the FCIC. "The mind-set was that there should be no regulation; the market should take care of policing, unless there already is an identified problem," he said.[44]

The Office of Thrift Supervision Celebrated Deregulation as Reckless Lending Proliferated

The Office of Thrift Supervision, or OTS, may have been the worst offender of facilitating subprime lending abuses. (In 2010, the Dodd–Frank Wall Street Reform and Consumer Protection Act terminated the OTS and delegated its authority to the Office of the Comptroller of the Currency, which already regulated federally chartered banks.)

The OTS presided over many of the most notorious banking collapses during the financial crisis, including those of Washington Mutual, IndyMac Bank and Countrywide. The OTS was even responsible for overseeing the overall affairs of American International Group, or AIG. The federal government ended up committing up to $182 billion in bailout funds to AIG to prevent the company from defaulting on its obligations.[45]

The OTS was led from 2001 to 2004 by James Gilleran, an unapologetic deregulator. He cut one-fourth of the agency's 1,200 employees during his tenure, even as the value of mortgages under the OTS's purview increased by 50 percent.[46]

Thrifts "have demonstrated that they have the know-how to manage [option-ARMs loans] through all kinds of economic cycles."
—*Office of Thrift Supervision Director John Reich (2005*)

To express his deregulatory zeal, Gilleran in 2003 posed for a photo with banking regulators and industry officials next to a large stack of paper wrapped in red tape, signifying government regulation. While some participants in the photo-op arrived with garden shears in hand, Gilleran brought a chainsaw.[47]

Gilleran marginalized the OTS's consumer protection function. Thrifts would be responsible for conducting "self-evaluations of their compliance with consumer laws," he said.[48]

"Our goal is to allow thrifts to operate with a wide breadth of freedom from regulatory intrusion," Gilleran said in 2004, just as subprime lending was about to soar to unprecedented levels.[49]

The OTS also reduced the amount of capital that thrifts were required to retain. By September 2006, thrifts' reserves fell to their lowest level since the mid-1980s, when a series of savings and loan failures precipitated a $125 billion federal bailout.[50]

The OTS's reluctance to regulate continued during the tenure of John Reich, who succeeded Gilleran in 2005. By then, other banking regulators were becoming concerned about a surge in option-adjustable rate mortgages, or option-ARMs, which gave borrowers leeway on how much to pay at first.[51]

In 2005, the Office of the Comptroller of the Currency pressed for a joint ruling by federal regulatory agencies mandating that lenders ensure that borrowers could afford their payments. "Too many consumers have been attracted to products by the seductive prospect of low minimum payments that delay the day of reckoning," Comptroller of the Currency John C. Dugan said.[52]

But Reich resisted signing on to this common sense measure because thrifts "have demonstrated that they have the know-how to manage these products through all kinds of economic cycles."[53] The OTS eventually agreed to the guidance in September 2006. But significant damage occurred during the delay. Leading subprime lender Countrywide Financial said it would have refused 83 percent of its loans in 2005 and 89 percent in 2006 under the guidance. Those loans added up to $138 billion.[54] Countrywide subsequently suffered enormous losses on its subprime portfolio and entered into an agreement to be acquired at a fire-sale price by Bank of America in January 2008.[55]

Washington Mutual, also under OTS supervision, became the largest thrift ever to fail when it was taken over by the FDIC in September 2008.[56] "OTS should have lowered WaMu's composite rating sooner and taken stronger enforcement action sooner to force WaMu's management to correct the problems identified by OTS," a Treasury Department inspector general's report said.[57]

FDIC Chairman Sheila Bair said that her examiners "were very concerned about the underwriting quality of WaMu's mortgage portfolio" but "were actively opposed by the OTS in terms of going in and letting [FDIC] examiners do loan-level analysis.[58]

The OTS also committed to regulate the overall affairs of insurance company AIG, the collapse of which threatened the entire financial system and prompted a huge federal bailout.[59]

The European Union required financial institutions doing business in its countries to have a regulator that oversaw all of their operations. The OTS said it would serve that role for AIG. "AIG and its subsidiaries are subject to consolidated supervision by OTS," the agency wrote in 2005. "OTS will conduct continuous on-site reviews of AIG and its subsidiaries."[60]

But the OTS did not fulfill its promise. Reich, director of the OTS when AIG collapsed, later told the FCIC that his agency's promise to provide overall supervision of AIG was "totally impractical and unrealistic."[61]

"I think we thought we could grow into that responsibility," Reich said. "But I think that was sort of pie in the sky dreaming." Reich acknowledged that he had "no clue—no idea" about the liabilities of AIG's Financial Products division as late as September 2008, when Financial Products' losses brought down AIG.[62]

"Nipping this in the bud in 2000 and 2001 with some strong consumer rules applying across the board…could have done a lot to stop this."

—FDIC Chairman Sheila Bair (2010)

Subprime and Exotic Loans Caused the Housing Bust

The types of lending practices that watchdogs had been warning about since the 1990s were by far the most likely to result in failures after the housing bubble burst.

In technical terms, the mortgage surge was driven by non-prime loans, which consisted of subprime loans (usually for those with blemished credit records) and "Alt-A" loans (usually issued to borrowers providing little or no documentation of their income). Issuance of non-prime loans nearly tripled—from 12 to 34 percent of the market—between 2000 and 2006.[63]

The value of subprime mortgage originations grew from $100 billion in 2000 to $600 billion in 2006.[64] Adjustable rate mortgages, or ARMs, which offered a teaser rate that had the potential to rise suddenly, made up nearly 80 percent of all subprime originations in 2005.[65] Alt-A loans grew from $25 billion in 2000 to $400 billion in 2006.[66]

By mid-2007, the housing bubble burst amid rapidly rising mortgage defaults. Nearly 25 percent of subprime loans were delinquent or seriously delinquent by 2009.[67] Delinquency rates for payment-option loans, in which borrowers could choose how much to pay, rose to about 30 percent by 2009.[68]

In contrast, the delinquency rate for prime loans never rose above 5 percent, although the rate for adjustable rate prime loans neared 20 percent by 2009.[69]

The Community Reinvestment Act Was Not the Driver of the Increase in Subprime Lending

An alternative to the theory that lax regulation enabled the subprime-lending binge is the argument that the government caused the problem by forcing lenders to make loans to low-income buyers. Adherents to this claim point to the Community

Reinvestment Act, or CRA, a 1977 law intended to combat discrimination by providing incentives to banks and savings associations to make loans to buyers in low- and moderate-income areas.

But the data flatly contradict the claim that the CRA caused the surge in loans to low-income buyers. Most non-prime loans during the housing bubble were not issued to receive credit for fulfilling CRA objectives. Further, those loans that were used to obtain credit toward CRA goals faired far better than those that were not.

For instance, a study by two Federal Reserve economists found that only 6 percent of subprime loans issued in 2005 and 2006 were covered by the CRA. The other 94 percent of higher-cost loans either were made by institutions not covered by the CRA or ones that did not seek CRA credit for the loans.[70]

"The small share of subprime lending in 2005 and 2006 that can be linked to the CRA suggests it is very unlikely the CRA could have played a substantial role in the subprime crisis," the Federal Reserve economists concluded.

Other researchers also have concluded that the CRA was not to blame. For instance, Federal Reserve economists have found that lenders not covered by the CRA were disproportionately more likely to issue subprime loans than CRA-covered lenders.[71]

Recent Developments: The Law Now Forbids Lenders from Issuing Loans to Those Who Lack an Ability to Repay Them

The Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 established several standards aimed at preventing subprime lending abuses in the future. Fundamentally, the law prohibits mortgage originators from steering a consumer toward a mortgage that the consumer "lacks a reasonable ability to repay."[72]

The law also prohibits originators from steering eligible consumers away from traditional mortgages or engaging in "abusive or unfair lending practices that promote disparities among consumers of equal credit worthiness but of different race, ethnicity, gender, or age."[73]

> "All efforts should be made to strengthen our regulatory system to prevent a recurrence of the crisis."
> —*Federal Reserve Chairman Ben Bernanke (2010)*

More broadly, and perhaps most importantly, Dodd-Frank created the Consumer Financial Protection Bureau, or CFPB, to "protect consumers by carrying out federal consumer financial laws."[74] These are the laws that the agencies in charge of overseeing mortgage lending failed to enforce. The CFPB issued a rule implementing the new mortgage guidelines in January 2013.[75]

Stronger lending laws or more vigilant enforcement of existing statutes would have stopped the housing bubble before it caused so much agony. That view is shared by Sheila Bair, the former chairman of the Federal Deposit Insurance Corp.

"Nipping this in the bud in 2000 and 2001 with some strong consumer rules applying across the board that just simply said you've got to document a customer's income to make sure they can repay the loan, you've got to make sure the income is sufficient to pay the loans when the interest rate resets, just simple rules like that…could have done a lot to stop this," Bair told the FCIC.[76]

Federal Reserve Chairman Ben Bernanke offered similar sentiments and issued a call for stronger regulation in the future.

Efforts by the Federal Reserve and other agencies to address poor mortgage underwriting practices "came too late or were insufficient to stop the decline in underwriting standards and effectively constrain the housing bubble," Bernanke said in 2010. "We must be especially vigilant in ensuring that the recent experiences are not repeated. All efforts should be made to strengthen our regulatory system to prevent a recurrence of the crisis."[77]