

BEYOND THE MORTGAGE MELTDOWN:

ADDRESSING THE
CURRENT CRISIS,
AVOIDING A FUTURE
CATASTROPHE



ABOUT DĚMOS

Dēmos is a non-partisan public policy research and advocacy organization. Headquartered in New York City, Dēmos works with advocates and policymakers around the country in pursuit of four overarching goals: a more equitable economy; a vibrant and inclusive democracy; an empowered public sector that works for the common good; and responsible U.S. engagement in an interdependent world.

The Economic Opportunity Program addresses the economic insecurity and inequality that characterize American society today. The program offers fresh analysis and bold policy ideas to provide new opportunities for low-income individuals, young adults and financially-strapped families to achieve economic security.

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SUMMARY

One year into the story of the subprime mortgage meltdown, Washington stands almost ready to act. Congressional leaders have come to general agreement on a rescue plan championed by Christopher Dodd in the Senate and Barney Frank in the House. For months, the idea had seemed to be going nowhere. Now it appears to command broad bipartisan support. Its backers even include some legislators who, until mid-May, sounded like irreconcilable opponents of what was termed an unconscionable public bailout of lenders and speculators.

The breakthrough came when Dodd and two key members of the Senate Banking, Housing, and Urban Affairs Committee, which he chairs, worked out a funding arrangement that made it possible to claim that no tax dollars would be used. (The trick was to dip into a new affordable housing trust fund derived from the anticipated profits of the government-sponsored mortgage financing entities Fannie Mae and Freddie Mac.¹) On a deeper level, though, this may have been a case of reality overtaking ideology. As the magnitude of the subprime mortgage disaster sank in, the opposing camps came together in shared alarm, and then in shared determination. That convergence of opinion raises hopes for additional measures that may seem as unlikely today as the Dodd/Frank plan recently did.

Additional measures will surely be needed. The current legislation could allow upwards of half a million families to keep their homes. But it may not work (or work quickly enough) for many who need and deserve help. Some cases may call for a simpler approach, such as the loan pay-down plan proposed by Sheila Bair, chairman of the Federal Deposit Insurance Corporation.

And foreclosure prevention is only one part of what should be a concerted national response to the housing market crisis. The mortgage industry cries out for new rules, both to protect homeowners and honest lenders in the here and now, and to guard against the next wave of predatory lending. As soon as possible, Washington needs to become an unstinting partner in the effort of beleaguered state and local governments, working with community-based nonprofits, to contain the damage of a terrible human and economic tragedy.

An Epidemic of Foreclosures

The damage has been as bad as anyone imagined so far. Hundreds of thousands of families have already lost their homes because of loans that were often not fully explained or understood. Hundreds of thousands more face the same prospect. Foreclosures, after roughly doubling in the past year, are running at a rate of close to 25,000 a week.² That's an alarming figure in itself, and it points toward the loss of more than 2 million homes in 2008 and 2009—a number very close to estimates made by consumer groups (and widely dismissed by lenders) in early 2007.³

The surrender of so many homes—and the movement of so much housing into absentee ownership—will have ruinous consequences for cities, towns and neighborhoods, above and beyond the awful toll on those directly affected. Vacant houses attract looters and squatters and set off a contagion of vandalism and neglect. Homeowners with all kinds of mortgages (and no mortgages at all) suffer the spillover effects of neighborhood decay and falling home prices. Renters take their hits, too.

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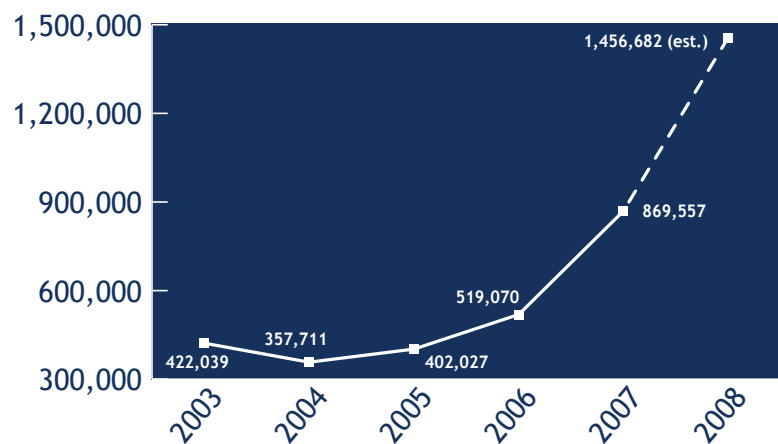
Many African-American and Latino households could lose “the little bit of wealth [they] have been able to accumulate through homeownership,” a Citigroup vice president says.

In many communities, the impact will be long-lasting. Banks and liquidators generally don't take very good care of their properties. That also tends to be true of the speculators and investors who predominate in the next wave of ownership once a neighborhood starts to lose its residential appeal. For local governments, foreclosures mean added expenses—costs which can add up to tens of thousands of dollars per property—and diminished tax revenues.⁴ “We are looking at hundreds of thousands of dollars being sucked out of a community that could desperately use that money to build wealth, to fix the roads, to send the kids

to better schools,” says Diane Thompson, a legal services lawyer in East St. Louis, Illinois, where a foreclosed property can be found on just about every corner.¹⁵

Minority communities received a disproportionate share of subprime mortgages. Now they are suffering a disproportionate share of the harm. Many African Americans and Latinos were steered away from safer, lower-interest loans by brokers and sales agents who, on top of their usual commissions, received bonuses for jacking up the interest rate.⁶ Home equity, at its current total value of \$20 trillion, represents the biggest source of wealth for most Americans; that is even more true, by and large, for African Americans and Latinos.⁷ As a result, says Citigroup vice president Eric Eve, many families stand to lose “the little bit of wealth [they] have been able to accumulate through homeownership.”⁸

Number of Foreclosures, 2003-2008



Sources: FDIC, Equifax and Moody's Economy.com

An Economic Catastrophe

Roughly 2.3 million homes (nearly 3 percent of the nation's total) are vacant and on the market—that's the highest proportion since the Census Bureau began keeping track in 1956.

A year ago, Federal Reserve Board Chairman Ben Bernanke spoke for much of the economic policy establishment when he predicted little damage to “the broader economy and financial markets.”⁹ Hardly anyone has expressed such an opinion lately—certainly not Bernanke, who has nearly exhausted the powers of his office trying to keep the capital markets flowing and avert an old-fashioned financial panic.

Despite the Fed's efforts, the fear and distrust that originated with booby-trapped mortgages have spread across the financial markets as a whole. Repayment anxiety has made credit more costly for college students, corporations and local governments. The mortgage lending industry itself is on life support; it would barely be functioning if not for a booster shot of capital from the government-sponsored entities Fannie Mae and Freddie Mac—and even *their* financial soundness is now doubted in some quarters.¹⁰

The real estate and construction industries—longtime heavyweight champs of the U.S. economy—have taken it on the chin. Home purchases are down by more than a third since 2005. Housing starts have fallen 60 percent, to their lowest level since 1991.¹¹

Foreclosures lead to an accumulation of so-called real-estate owned homes or REOs. At the end of March 2008, there were about half a million such properties on the market—more than twice the March 2007 figure.¹² Roughly 2.3 million homes (nearly 3 percent of the nation's total) are vacant and on the market—that's the highest proportion since the Census Bureau began keeping track in 1956.¹³

A glut of unsold properties is guaranteed to bring home prices down, and it has. Nationally, they have fallen by 15 percent from their peak in July 2006.¹⁴ As prices fall, household wealth erodes, consumers spend less, businesses cut back, jobs disappear, and still more people have trouble making mortgage payments. These are the pathways that led from last year's mortgage crisis to this year's looming recession. They could be carrying us toward something bigger than a recession: a mutually-reinforcing downward spiral in the housing market and the broader economy.

We've Been Here Before

The perils are large, interrelated, and worrisome. Nevertheless, the case for a housing rescue does not depend on apocalyptic assumptions about where the U.S. economy is headed. It is hard to predict the persistence or the scope of the harm in such a complicated economic scenario. But common sense suggests that a good deal of harm could still be avoided through decisive government action; and a serious housing rescue plan, compared to other ways of lifting the economy, seems likely to produce a large reward at a comparatively modest cost.

Most of today's endangered homeowners, it is generally agreed, would be all right if their tricky, high-priced loans became straightforward, reasonably-priced loans, with the principal written down to levels more in line with current market reality. That would be a good outcome for lenders and mortgage investors as well—compared to the alternative of foreclosure in a plunging market.

THE DODD/FRANK PLAN

While some details remain to be ironed out, the House and Senate bills are more alike than different. Both rely on a major expansion of the Federal Housing Administration's loan guarantee program.

Here's a hypothetical example of a family that could be saved from foreclosure:

The situation:

A home purchased for \$200,000, with no money down, in 2006—now worth \$150,000. A loan that has reset to a monthly payment that the homeowner cannot afford.

What the lender must do:

Agree to reduce the mortgage principal to 85 percent of the current appraised value, or \$127,500.

What the borrower must do:

Demonstrate the capacity to repay a new, 30-year fixed-rate mortgage equal to 90 percent of the home's market value, or \$135,000. Make the payments, plus an extra 1.5 percent for FHA risk insurance.

If the house is sold:

If that happens, and there's a profit, the government takes a share—at least 3 percent of the amount of the refinanced loan.

Source: *USA Today* and House Financial Services Committee

In theory, lenders and borrowers could arrive at this resolution without outside help. In practice, that has rarely happened despite a succession of industry summits and pledges, presided over by officials of the Treasury and Housing and Urban Development departments. Since late 2007, more than a million homeowners have received letters encouraging them to renegotiate loans through the Hope Now Alliance, a partnership of lenders, loan servicers, bondholders and credit counselors. As of February 2008, only a few thousand families had gained meaningful relief.¹⁵ Voluntary loan modification, we have learned, will not work. By contrast, there is good reason to believe that a government rescue operation could succeed.

Perhaps the best reason is that it has before—under far more daunting circumstances. In 1933, when Franklin Roosevelt entered the White House, this country faced the worst foreclosure crisis on record. Congress and the Roosevelt administration responded by establishing the Home Owners Loan Corporation (or HOLC). It was a temporary operation that, over the next three years, saved some 800,000 families from foreclosure and gradually brought stability back to the housing market.¹⁶

This bit of history has attracted a good deal of recent notice. Papers calling for a latter-day HOLC have been published by the Center for American Progress and the American Enterprise Institute. The idea has been championed by Robert Kuttner, co-founder of *The American Prospect* magazine, and by Alfred DelliBovi, president of the Federal Home Loan Bank of New York. Legislation has been introduced—in the House, by Mark Kirk, an Illinois Republican; and in the Senate, by Christopher Dodd, the Connecticut Democrat who chairs the Banking, Housing and Urban Development Committee.

Dodd's original proposal, like Kirk's, followed the 1930s model closely, calling for an independent agency with the authority to buy up troubled mortgages and issue new loans in its own name. But since Dodd first raised that idea in December, he has shifted his thinking toward a plan that relies on the loan-guaranteeing machinery of the Federal Housing Administration (FHA)—a tool that was not available in 1933. That is also the approach of the House-passed bill, which was put together in the Financial Services Committee under chairman Barney Frank.

In their intended effect, however, the Dodd and Frank plans resemble the Roosevelt administration's initiative of 75 years ago. The federal government buys up unmanageable loans at a discount, and engineers affordable, fixed-rate mortgages for qualifying homeowners. Uncle Sam's guarantee lends credibility to offers that lenders and bondholders would dismiss out of hand if the only signature on the dotted line was that of a financially shaky homeowner.

Boats and Bailouts

The case for a housing market rescue is a strong one. But it is a case that needs to be forthrightly made, because it goes against so much of what Americans have been hearing in recent decades. Free-market mythology tells us to regard every loan or financial transaction as an agreement between two willing parties. That mindset steels us against the use of public funds to—as critics would have it—save people from the consequences of their own irresponsibility. But that would be a highly inaccurate portrayal of the current legislation, even if Dodd and his allies had not gone to such extreme lengths to avoid a direct appropriation of tax dollars.

This was an industry that took off with lenders, not borrowers, in the drivers' seat. Ten years ago, the U.S. did not face an epidemic of foreclosures; today, we do. That fact is directly related to

the dramatic expansion of subprime mortgages—from virtually nil in the mid-1990s to more than \$1 trillion in loans (and about 13 percent of the nation's outstanding home mortgages) by the end of 2006.¹⁷ Human nature did not change over that span of time. What changed were the products and the marketing and financial practices of the mortgage lending industry.

Those changes occurred, moreover, with the tacit and, at times, active support of government. Again and again, the Federal Reserve Board, the Office of Comptroller of the Currency, and other regulatory bodies favored the short-term interests of bankers and lenders over the public interest. Washington did not simply fail to act against a wave of predatory lending. Two federally chartered institutions, Fannie Mae and Freddie Mac, poured hundreds of billions of dollars into the subprime market, even as they turned their backs on community-minded lenders offering more affordable (but less obviously profitable) mortgages.¹⁸ That will be a key point to remember when the “bailout” cry is heard again, as it will be.

Ever since the savings and loan crisis of the late '80s, bailout has been a potent political word in this country. It evokes a picture of unaccountable leaders pushing government beyond its proper bounds and “intervening” in the market. But this is a case where government was deeply involved all along. What some may call intervention might be more accurately understood as an effort to undo a small portion of the damage that government helped cause.

The bailout charge also conjures up the idea of a potentially vast outlay of money. That, too, is a misplaced fear in connection with the Dodd/Frank plan. To qualify, lenders and bondholders will have to “take a haircut,” as Dodd likes to say. No lender will receive more than 85 percent of a home's current market value. The legislation has been crafted with equal care on the borrower side, limiting eligibility to owner-occupied homes and to applicants demonstrating a high likelihood of repayment, which effectively excludes those who bought houses, or took out refinancing loans, well beyond their means. (The Home Owners Loan Corporation turned down about half of the applications it received.¹⁹) Those who get accepted will have to share the cost of special FHA risk insurance and give back a portion of any equity gains realized over the life of the new loan.²⁰

There are risks, to be sure, but none to compare with those of the savings and loan bailout, with its estimated \$150 billion price tag. Even if a substantial fraction of new mortgages end in foreclosure, the government can expect to recoup most of its investment as the market stabilizes and the other loans are repaid. HOLC's foreclosure rate was about 20 percent; nevertheless, the program eventually returned a small profit to the Treasury.²¹

What's at Stake

We've had a debate about whether government action is justified. The debate we need to have is over what kind of action is really called for. The Dodd/Frank proposal has its weaknesses, even if they are not the ones that have been cited by its critics. Most of the loans that need fixing have been pooled with other loans, converted into mortgage-backed bonds, and sold (and sometimes resold) to investors. The bondholders know they have big losses in store. But many may prefer to sit tight for now, hoping for an upturn in the market or just trying to postpone the unpleasant business of opening up their books, and problems, to outside scrutiny.

The bondholders are, in any case, hard to identify or locate. In practice, the decision to modify a mortgage rests with loan servicing companies, whose customary job is to collect payments

and take legal action in the event of default. Loan servicers may have reasons of their own (including financial incentives) to hang tough. Some situations involve a second as well as a first mortgage, and one lien-holder's interests may not be the same as another's.²² Even if a servicer is willing, the borrower's finances have to be taken into account. These and other complexities seem to dictate a case-by-case approach, and yet the situation is obviously one that cries out for speed. How can a rescue operation be careful and fast at the same time?

Neither the House bill nor the Senate proposal holds a clear answer to these questions. But they are questions that could be resolved with will and persistence. At a more basic level, the Dodd/Frank concept is sound. Unfortunately, what it seeks to accomplish falls well short of what Washington will have to do in order to mount a response equal to the scale of the problem.

A meaningful rescue effort must also deal with the vast number of properties that have already been foreclosed on, or that soon will be even in a best-case scenario for the Dodd/Frank proposal. In some cases, that will mean efforts to turn properties into affordable rental housing; in other cases, the goal could be to allow owners to remain in their homes as renters. Above all, this is a situation that calls for large-scale federal assistance to the emergency efforts of state and local governments in areas of the country that are taking the biggest brunt of damage.

Many elected leaders, and many of their constituents, remain stuck on questions of responsibility and irresponsibility, and who deserves help and who doesn't. Meanwhile, the consequences of this disaster continue to spread. Financially, the foreclosure crisis has been a double whammy for state and local governments, creating new needs and depleting resources at the same time. Largely as a result of the mortgage crisis, tax revenues are falling precipitously. Spending trends are destined to move in the same direction. In today's economy, state and local spending serves as an important cushion against economic adversity. Last year, state and local governments spent a total of roughly \$1.8 trillion—almost double the level of federal spending, even with the cost of the Iraq war included.²³

Over the course of the fiscal year that is about to begin, those expenditures are expected to decline by an estimated \$90 billion. In the worst-hit states, of course, the drop will be more drastic. The Florida legislature recently approved a budget calling for a \$5.5 billion decline. In California, the public schools alone face the loss of roughly \$4 billion in funding.²⁴ Under the circumstances, economists largely agree that federal aid to states and localities will be a far more effective form of economic stimulus than another round of tax rebates.

The case for a housing market rescue—the case, more generally, for a bold government response to the mortgage crisis—is compelling. On one level, it is about responding to a terrible human tragedy. On another level, it's about a vast amount of collateral damage to neighbors, communities, the economy, and the nation as a whole. In that sense, the issue also stands as a test of America's ability to break out of our cloisters of self-interest and group-interest and be a nation in the full and best sense. Nothing else that our government does, or fails to do, this year will be so important.

Never Again

Once the crisis has been addressed, it will be time—in fact, long past time—to develop a serious oversight system for the mortgage market. A big first step in that process should be the creation of a single watchdog agency—one unambiguously committed to the public interest.

The nation faces a foreclosure crisis today because of brokers and lenders who, with Wall Street's backing, sold inherently deceptive loans to the most vulnerable and financially unsophisticated borrowers. They got away with it because of regulations that failed to address a number of obviously abusive practices, and because key players were scarcely regulated at all.

But while the rules were weak, the enforcement was worse. At the national level, mortgage regulation is a responsibility divided among four major agencies (the Fed, the OCC, the Office of Thrift Supervision, and the National Credit Union Administration), and it's not the central concern of any of them. In practice, consumer protection tends to take a back seat to "safety and soundness" issues involving the financial system as a whole; and even in that sphere, regulators frequently hesitate to make decisions that could cause financial harm to lenders and bankers, or political harm to their superiors.

HOW DID THIS HAPPEN?

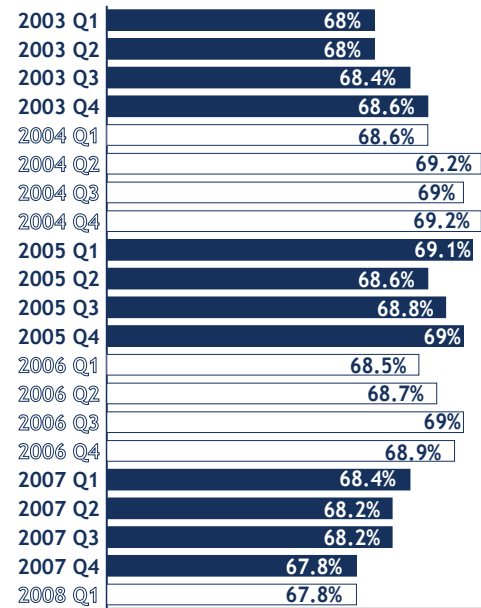
Most Americans do not live near one of the epicenters of this disaster. We may not be worried about foreclosure ourselves. We may not know anyone who is. The mortgage meltdown is still just a news story for many of us, in other words. And from a distance, it may look like a tale of financial irresponsibility—the sum of many reckless decisions made by people who craved bigger houses than they could afford or hoped to turn a quick profit in the housing market.

Up close, these comforting generalizations evaporate. Despite catchy stories about subprime mortgages taken out on investment properties or beachfront condos, the great majority of troublesome loans—and close to 90 percent of the threatened foreclosures—involve owner-occupied homes.²⁵ Most are ordinary homes rather than McMansions. In many cases, the owners have lived there for years; they're facing foreclosure because they were talked into trading affordable home-purchase loans for unaffordable refinancing loans.²⁶

Most mortgages are fairly straightforward. Subprime mortgages, by and large, were not straightforward. Borrowers often had to pay separately for services (credit checks, appraisals, escrow analysis, underwriting analysis, flood certification, property surveys, document preparation, notarization, pest inspection and so forth) traditionally considered part of the basic loan package. The extras could run into the thousands of dollars; nevertheless, they were spelled out, as a rule, in the fine print of documents that few borrowers read or were expected to read. Such charges were often added to the loan principal, triggering additional interest income for lenders.²⁷

Escalating-payment formulas were another standard feature of subprime mortgages. Borrowers signed up after being told about the affordable monthly payments they would be making at the outset—but without necessarily being told how high their payments would go later. About 80 percent of the subprime loans issued in the boom years of 2005 and 2006 were hybrid adjustable-rate mortgages. Many borrowers were confused by the adjustable-rate label. It referred to the fact that, after the first two or three years, the interest would go up or down with the prime rate or another banking-industry index of the cost of credit. It diverted attention from another important fact: the initial rate was a teaser rate, set so as to generally guarantee a sharp increase at the two- or three-year mark, regardless of whether interest rates in the broader economy rose or fell.²⁸

Home Ownership Rates, 2003-2008 Q1



Source: U.S. Census Bureau News, April 28, 2008.

Reeling Them In

The pioneers of the subprime mortgage industry were a group of lending companies that entered the field in the 1990s after the breakdown of the savings and loan industry. The nonbank lenders, as they were known, relied heavily on mortgage brokers and aggressive marketing. The bank loan officers of old sat at desks and waited for business to come to them. Subprime mortgage brokers went out looking for business. They telemarketed; they sent out mass-mailings; they knocked on doors. And the attitude of many, as summed up by Bloomberg reporters Seth Lubove and Daniel Taub, “was to reel in borrowers, period. Never mind whether customers needed loans or could manage payments.”²⁹

Normally the term *broker* suggests an intermediary with a sense of responsibility to those on both ends of a transaction. A real estate or securities broker is expected to look out for clients’ interests, proposing options suited to their particular needs. Mortgage brokers took advantage of that expectation, even as they resisted efforts to write it into law. “The mortgage broker does not represent the borrower,” the president of a Colorado brokers’ association declared after the legislature took up a bill intended to establish a fiduciary responsibility toward borrowers. “We sell access to money.”³⁰

The industry touted its brand of “risk-based lending” as a breakthrough for homeownership. In truth, the great majority of subprime mortgages were refinancing loans, and the costs often dwarfed the benefits. Many borrowers had experiences similar to that of Carol Mackey after she took out a refinancing loan on her condominium in Rochester Hills, Michigan. Her goal was to pay off a \$1,500 credit card bill and finance some renovation work. The loan produced \$18,645 in cash, while costing Mackey more than \$8,000 in fees. In the process, she traded a \$74,000 mortgage with a 7.5 percent annual interest rate for a \$100,750 mortgage with a 12.8 percent interest rate. Her monthly payments more than doubled from \$510 to \$1,103.³¹

And overall, African-American and Latino families were far more likely than white families to end up with a subprime loan. That was true even with income and credit history taken into account. Many borrowers were elderly homeowners who had given no thought to a refinancing loan until a broker proposed the idea. More than 60 percent of a sample of older borrowers surveyed by the AARP reported that a broker or lender had initiated the contact. These loans were “sold, not sought,” the AARP concluded.³²

The attitude of many mortgage brokers “was to reel in borrowers, period. Never mind whether customers needed loans or could manage payments.”

As far back as 2000, there were warning signs—and actual warnings. Edward M. Gramlich, a member of the Federal Reserve Board at the time, met with chairman Alan Greenspan to plead for a close examination of the subprime mortgage world. Lenders were directing “the most risky loan products” to “the least sophisticated borrowers,” Gramlich pointed out later, explaining one of the concerns he had at the time. He could see no good reason for that pattern; but he could see a bad reason: the expecta-

tion that such people would be unusually likely to agree to loans that were more expensive than they realized or could necessarily afford.³³

By the tail end of the subprime boom, more than half of all subprime loans (according to *The Wall Street Journal*) were going to people with credit scores that could have qualified them for traditional mortgages.³⁴ Ignorance was expensive. The typical \$150,000 subprime mortgage cost an extra \$4,500 or so up front, plus another \$8,000 over seven years.³⁵ In many cases, there was nothing accidental about the practice of steering customers into unnecessarily expensive loans. Subprime brokers routinely received a form of legal kickback known as a “yield spread premium,” which was a reward for doing exactly that. One big subprime lender, NovaStar, gave brokers a flier explaining how they could lawfully make loans “without disclosing YSP!” What the company was saying, in effect, was: Get your customers to pay extra, and we’ll pay you extra—and you won’t have to tell.³⁶

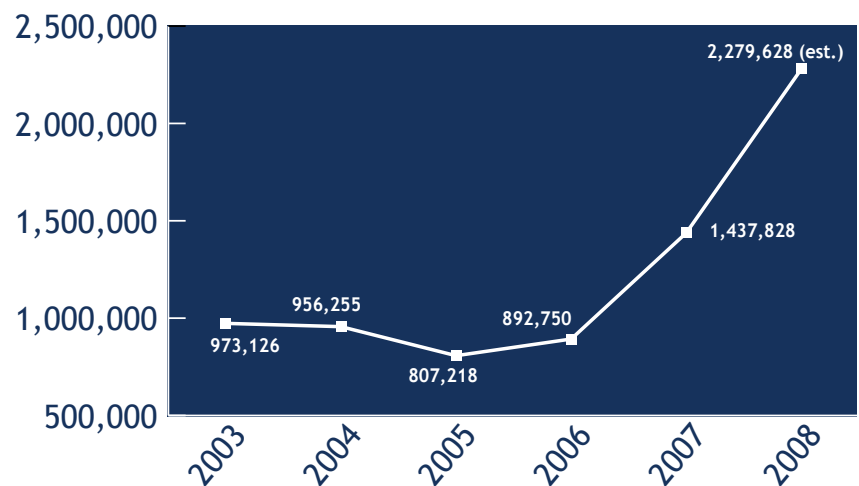
Friends in High Places

With their broker networks, the nonbank lenders were able to operate on a national scale. With Wall Street’s help, they put together a funding and lending machine to rival that of the banks and savings and loans they sought to displace. And yet, because they were not depository institutions, they did not have to answer to federal bank examiners; and for the most part they set up shop in states where a single licensed mortgage broker could supervise an officeload of unlicensed colleagues.³⁷

It was these unregulated entities that shaped the subprime mortgage business and issued the most dangerous loans. But as time passed and the financial world saw how lucrative the new market was, banks and other regulated institutions plunged in—either directly or as partners, securitizers and investors. HSBC, for example, became a subprime lender with the purchase of Household Finance, a company that had paid \$484 million to settle a predatory-lending lawsuit brought by all 50 state attorneys general.³⁸ Citigroup established its own subprime subsidiary, Citifinancial, which was soon issuing subprime loans to people who could have qualified for prime loans issued by other units of the same parent company.³⁹

Eventually the lines became thoroughly blurred, with banks and nonbanks alike underwriting loans on the basis of teaser rates, and making little or no effort to evaluate borrowers’ ability to bear the long-term costs. In the Home Ownership and Equity Protection Act of 1994, Congress called on the Federal Reserve Board to act against predatory mortgage lenders.⁴⁰ Issuing loans, as many lenders clearly did, based on the value of the property rather than the financial posi-

Number of First Mortgage Loan Defaults, 2003-2008



Sources: FDIC, Equifax and Moody’s Economy.com

tion of the property owner, is what predatory mortgage lending is all about; and yet beyond a few vaguely worded guidance documents, the Fed took no public action to restrain the practice.⁴¹

Subprime loans accounted for about 2 percent of the mortgage business in 1998. By the middle of 2007, the figure was nearly 14 percent.⁴² As the infection spread across the banking system, industry leaders claimed that the risks had been carefully calibrated and fully taken into account.⁴³ It was a widely accepted claim, partly because it carried what sounded like an official endorsement from Fed chairman Alan Greenspan. In a 2004 speech, Greenspan saluted the lending industry for its remarkable new ability to “quite efficiently judge the risk posed by individual applicants and to price that risk appropriately.”⁴⁴

In fairness to the Fed, other agencies were just as uncritical. The Office of Comptroller of the Currency (OCC) is theoretically responsible for supervising nearly 1,800 commercial banks across the country. Yet between 2004 and 2006, that agency took a grand total of three enforcement actions involving home mortgages.⁴⁵ Illinois officials thought the OCC might want to know about Dorothy Smith, who had taken out a \$36,000 refinancing loan from the OCC-regulated First Union National Bank (now part of Wachovia). Smith had retired a decade earlier from her job at a Chicago retirement community and, at 67, lived on \$540 a month in government benefits. Her loan, including more than \$3,300 in fees and closing costs, called for a \$31,000 balloon payment in 15 years, when Smith would be over 80. Nevertheless, the OCC dismissed her complaint as “a private party situation regarding the interpretation or enforcement of [a] contract,” adding that it could “provide no further assistance.”⁴⁶

Key Enablers

Washington did not simply fail to crack down; it actively impeded state and local crackdowns. North Carolina was one of a number of states that found itself battling against federal regulators when it tried to set limits on prepayment penalties.⁴⁷ Waking up to the devastation that subprime lenders were causing in Cleveland, Ohio, the city council passed an antipredatory lending measure in 2001. The state, “heavily lobbied by Ohio banks” according to *Newsweek*, “stepped in to void the law, saying authority lay with the governor and the legislature in Columbus.” Then the OCC issued a preemption order declaring that the states did not have any authority, either. At that point, says Cuyahoga County Treasurer Jim Rokakis, “it was clear that this was the Wild West, and there was no sheriff in town. If you’re a lender, there’s nobody who can stop you.”⁴⁸

But this was more than a story of regulatory neglect. Key agencies took steps that, beyond siding with lenders over homeowners, favored unscrupulous lenders over honest ones. Officials of the Housing and Urban Development Department encouraged two government-sponsored entities, Fannie Mae and Freddie Mac, to become active participants in the subprime market. Permitted to count dangerous mortgages toward their assigned quotas of loans to low-income homeowners, Fannie and Freddie purchased a combined \$434 billion in subprime-backed securities between 2004 and 2006. It was a “huge, huge mistake,” says Patricia McCoy, who teaches securities law at the University of Connecticut. “They just pumped more capital into a very unregulated market that turned out to be a disaster.”⁴⁹

In addition to becoming the biggest single source of capital for the subprime market, Fannie and Freddie conferred an aura of legitimacy on these loans. Their example played a part in inspiring pension funds, insurance companies, and municipal governments around the world to invest in securities they might otherwise have correctly perceived as inappropriate.⁵⁰

Through their headlong plunge into the subprime market, Fannie and Freddie scored political points with HUD and the White House, which was unabashedly touting home equity loans as a way to (in the words of President George W. Bush, speaking shortly before the meltdown) “put a little extra money in your pocket.”⁵¹

Between 2004 and 2006, Fannie and Freddie purchased more than \$434 billion in subprime mortgages.

Financial considerations were also involved. As Freddie Mac's chief financial officer recently explained to a Washington Post reporter, the company could have “run for the hills and said we're not going to do any of that.” But the market might have continued to grow, and if it had, “We would basically be just taking our whole future and giving it away.” In 2007, Freddie Mac lost \$3.1 billion, largely because of subprime holdings. The company's chairman and chief executive, Richard F. Syron, nevertheless received \$3.5 million in bonuses, \$8.3 million in stock awards, and \$771,585 in assorted other benefits on top of his \$1.2 million salary.⁵²

Ponzi, Inc.

Issuing unaffordable loans is, of course, not a long-term business strategy. In the subprime mortgage world, key players did not always worry about the long term because they got their compensation up front. Brokers, as Edward Gramlich noted, “would just place a mortgage, collect their fee, and move on.”⁵³ Lending companies, too, arranged things so that by the time a loan failed, the problem was no longer theirs.

Banks take in money in the form of deposits and give it out in the form of loans. The nonbanks had to develop another source of capital. They did so by hooking up with financial services giants like Bear Stearns, Lehman Brothers, Merrill Lynch, Wachovia and Morgan Stanley, which packaged their loans into bonds and sold them to eager investors around the world.⁵⁴ The securities packagers, too, got paid whether loans worked out or not.

The bailout complaint conjures up fears of bottomless expense. In addition, it suggests a shadowy effort to push government beyond its proper bounds. What the Roosevelt administration did was fairly drastic, by the standards of the time. Today, for all the talk of free markets and deregulation, the federal government plays an important role in the housing market. By doing something for endangered homeowners, Washington would be undoing a measure of the harm that Washington helped cause.⁵⁵

After the collapse of the 1990s stock bubble, the Federal Reserve Board took extreme steps to keep the economy from tumbling. Beginning in January 2001, the Fed lowered one key lending rate 13 times until, by July 2003, it stood at 1 percent.⁵⁶ The Fed had been criticized for letting the stock market bubble get out of hand. Chairman Greenspan nevertheless declared a housing bubble “most unlikely,” and seemed to stick with that view even when home prices began rising at annual rates of 25 percent or more across much of California and Nevada.⁵⁷

A 20 percent down payment used to be a standard requirement for anyone seeking a home purchase loan. Subprime lenders threw that practice out the window, offering “piggyback” loans to cover the difference. The FHA would not insure a mortgage unless the borrower put tax and insurance money in escrow, and had an income at least three times greater than the mortgage payment.⁵⁸ Yet the Fed and other watchdog agencies stood by as subprime lenders dropped one cautionary practice after another.⁵⁹

Basic underwriting principles call for evidence of income and ability to repay. Subprime lenders would gladly spare you the trouble of providing these and get you a “low doc” or “no doc” loan, which allowed them to charge even more—though they did not always mention that detail. “The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans,” one lending executive told the *The New York Times* after his company went bankrupt. “What would you do?”⁶⁰ These loans, also referred to as liars’ loans or NINJA loans (for No Income, Job or Assets), accounted for an astonishing 44 percent of all the subprime mortgages issued in 2006.⁶¹

This was an industry designed to generate upstream rewards for insiders, and downstream risks for others—borrowers obviously, but also investors, financial institutions, and, as we now plainly see, the society at large. By the end of the boom, subprime lenders had turned the housing market into a kind of Ponzi scheme, in which a pattern of spectacular short-term gains rests on an ever-increasing intake of investment. It is hard to predict exactly when these situations will end; the one thing you can say for sure is that when they do, a relatively small number of people will be richer, and a much larger number will be poorer.

“The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans,” one lending executive told *The New York Times*. “What would you do?”

A LESSON FROM THE 1930s

“The broad interests of the nation require that special safeguards should be thrown around homeownership as a guarantee of social and economic stability.”

—Franklin Roosevelt, 1933⁶²

The Great Depression conjures up many images: the stock market crash, exploding joblessness, breadlines, banks closing their doors as mobs of depositors came to demand their money. It was also the period of the greatest wave of foreclosures the United States has known. In early 1933, about half of all mortgage debt was in default. By the end of the year, roughly 1 percent of the country's housing units had been foreclosed on.⁶³

The economy was in shambles when Franklin Roosevelt entered the presidency that spring. Nevertheless, the new administration recognized that a collapsing housing market could become an economic threat in own right. At Roosevelt's urging, Congress established the Home Owners' Loan Corporation (HOLC) in June 1933. It was a federally chartered corporation with a mandate to buy delinquent loans from lenders and refinance them directly with homeowners.

By the summer of 1935, nearly 2 million applications had been submitted. HOLC turned down close to half, insisting on evidence that homeowners could meet their financial obligations. But successful applicants got individual attention, including debt counseling, family meetings, and budgeting help.

The new loans could not exceed 80 percent of a property's appraised value or \$14,000 (about \$225,000 in today's dollars), whichever was lower. Many homeowners owed more than that. In such cases, HOLC had to convince the existing lender to take a loss. Most agreed, because HOLC made them an offer they couldn't refuse: a government guarantee of 4 percent interest on the reduced amount.

The Home Owners Loan Corporation ultimately saved about 800,000 families—mostly lower middle-class families—from foreclosure, while restoring stability to the housing market. (Incidentally, the program laid the basis for the modern fixed-interest, fully amortizing mortgage, although HOLC loans generally ran for 15 years instead of the 30 that later became the norm.)

As a lender, HOLC lasted just three years. It stuck around to collect payments for another 15 years, before being liquidated in 1951 at a small profit to the Treasury.⁶⁴

THE DAMAGE & THE DANGER

In the past, a foreclosure was caused by a personal or economic calamity such as illness, divorce, death or job loss. The current epidemic of foreclosures is different: its roots go back to the products and packages of the mortgage industry itself. Up to now, most of the destruction has been associated with tricky subprime loans—above all, with “exploding ARMs,” which are adjustable-rate mortgages with initially low interest rates that “reset” after two or three years, causing sharp monthly payment increases.

About 3.6 million subprime mortgages were outstanding at the end of 2007; more than one in five of the borrowers were at least three months behind on their payments.⁶⁵ These loans will continue to be a source of trouble through 2009. Although recent interest-rate cuts have blunted the impact of some payment resets, the absolute number of resets has yet to reach its peak; in the third quarter of 2008, payments will shoot up on an anticipated 350,000 loans, compared with 270,000 in the first quarter.⁶⁶

The most dangerous subprime loans were those issued in 2005 and 2006. Although they made up only about 14 percent of all the mortgages outstanding in the first quarter of 2008, this set of loans accounted for more than half of the foreclosure proceedings underway, according to an April 2008 study commissioned by the Pew Charitable Trusts. The Pew study sees approximately 2.2 million foreclosures—involving one in 33 American homeowners—ultimately resulting from subprime loans originated in 2005 and 2006.⁶⁷ (Foreclosure, it should be said, is an area where precise numbers can be elusive. Most of the readily available data involves the initiation of foreclosure proceedings, without regard for whether a property is ultimately surrendered. The Pew projections, however, deal with *completed* foreclosures—currently believed to be occurring at an annual rate of about 1.3 million. That is several times greater than the average of the pre-subprime era.⁶⁸)

Predicting foreclosures is getting more difficult because the universe of endangered homeowners may be expanding. In recent months, there have been more defaults and foreclosures involving interest-only or “option payment” loans in the “Alt-A market”—a middle ground between prime, the loans deemed safest, and subprime, those deemed riskiest. Here, too, hundreds of thousands of borrowers will soon see their payments increase. Many have not paid back a penny of principal. Some have not even paid all the interest and may be hit with hikes of 100 percent or more once they are asked to make amortizing payments of principal and interest combined.⁶⁹ There have been tremors in other corners of the mortgage market, too—for example, among holders of so-called “jumbo ARMs,” which are adjustable-rate mortgages of \$475,000 or more.⁷⁰

The Threat to Neighborhoods and Communities

Since the summer of 2007, big red refuse bins have become a common front-lawn sight in a Detroit neighborhood where Aretha Franklin, Marvin Gaye and Motown Records founder Berry Gordy used to live. The bins were placed there by banks, eager to empty out the contents of foreclosed homes in an effort to make them more sellable. It hasn't been easy. “Nobody's going to want to buy into a neighborhood with 20 percent foreclosures,” says one local realtor.⁷¹

In Cleveland, the number of foreclosures already rivals the displacement caused by Hurricane Katrina three years ago.⁷² Cuyahoga County, which includes Cleveland and 58 suburbs, has

Proportion of Home Loans that were Subprime, 2006

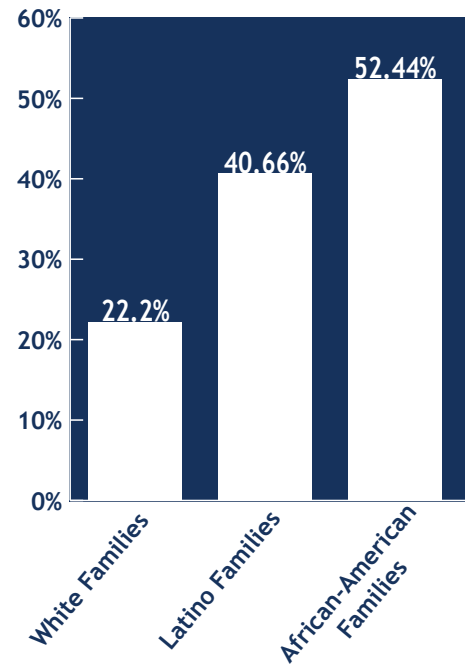
about 395,000 homes; roughly five percent of them—22,000—have already been foreclosed on.⁷³ Hundreds of homes have been through foreclosure in the Euclid Avenue area; many belonged to elderly people who, after refinancing with two-year teaser rates, got hit with payment increases of 50 percent or more.⁷⁴ Across town, the Slavic Village neighborhood was recently described by a British newspaper as a “vandalized ghost-town.” To keep up appearances, local officials have been pasting decals with curtains, flowers, and smiley faces over boarded-up windows and doors; more than 100 homes have received this treatment so far.⁷⁵

The foreclosure epidemic started in the industrial Midwest, spurred by a regional economic downturn. But some of the highest foreclosure rates can now be found in Florida, California, Arizona, where the story involves overdevelopment and home prices that, after rising to crazed heights, are falling precipitously. Those four states alone account for about 400,000 of the 1 million homes currently in some stage of the foreclosure process nationwide.⁷⁶ In Nevada, subprime loans accounted for nearly a third of the mortgages originated in 2006. In parts of that state, over half of all mortgage-holders are currently “underwater”—that is, they owe more than their homes are worth.⁷⁷ In Las Vegas, one out of every 20 homes is in foreclosure. In Washoe County, which includes Reno, the housing crisis has led to proposals for \$20 million in local budget cuts.⁷⁸ One in 11 Nevada homes could end up being foreclosed on, according to the Pew study referenced earlier.⁷⁹

Some California communities are experiencing more foreclosures than home purchases. Across the state as a whole, the inventory of lender-owned properties has gone up tenfold since the beginning of 2007.⁸⁰ Home sales in the Bay Area and Southern California have fallen by 41 percent in the last year alone; Southern California home values have dropped 24 percent—the biggest decline registered since 1988.⁸¹

The Impact on African Americans and Latinos

Households of color were more than three times as likely as white households to end up with exploding ARMs and other tricky subprime loans. Factors that should have worked against this result—a good credit record, for example—often made no difference.⁸² Even many upper-income African Americans and Latinos were steered into subprime mortgages. (It happened to



Source: Center for Responsible Lending analysis of the 2006 Home Mortgage Disclosure Act (HMDA) data reported by the Federal Financial Institutions Examination Council, at <http://www.ffiec.gov/hmda/default.htm>.

In the Slavic Village section of Cleveland, local officials have been pasting decals with curtains, flowers, and smiley faces over boarded-up windows and doors; more than 100 homes have received this treatment so far.

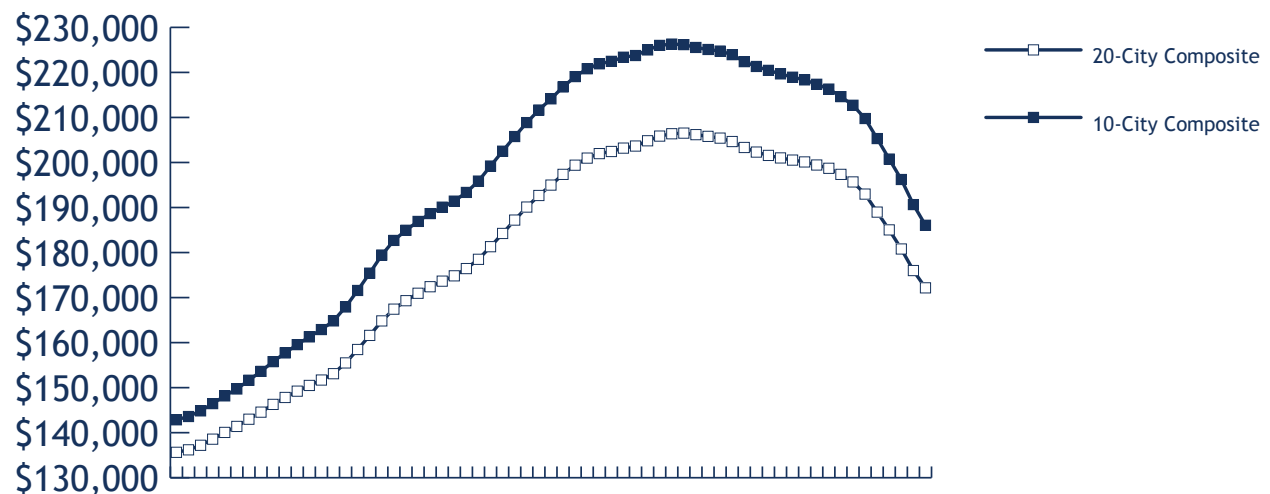
African Americans, having lived through the era of red-lining, were often pleasantly surprised to learn that they could get credit at all. Many never suspected that they might be eligible for lower-cost loans than the ones they were offered.

upper-income whites as well, but less than half as often.⁸³ One explanation for this emerged in a 2007 report issued by a team of Harvard University housing-market researchers. African Americans, having lived through the era of red-lining, were often pleasantly surprised to learn that they could get credit at all. Many never suspected that they might be eligible for lower-cost loans than the ones they were offered.⁸⁴ Some people assumed that the terms of a loan were dictated by a rigorous process in which brokers or loan officers sat down and reviewed an applicant's finances based on a standard formula.⁸⁵

As a result, African-American and Latino homeowners are twice as likely to suffer subprime-related home foreclosures as white homeowners. Foreclosures are projected to affect 8 percent of recent Latino borrowers and 10 percent of African-American borrowers. In contrast, only about 4 percent of white mortgage holders will be affected.⁸⁶ African Americans and Latinos are not only more likely to have been caught in the subprime loan trap, they are also far more dependent, as a rule, on their home as a financial resource. Although property values are typically lower in nonwhite neighborhoods, home equity constitutes the majority of wealth for nonwhite homeowners. Housing equity accounts for an estimated two-thirds of the wealth of African-American homeowners, while representing only about one-third of white homeowner wealth.

Estimates place the total loss of wealth among households of color at between \$164 billion and \$213 billion for subprime loans taken during the past eight years.⁸⁷ That would be the greatest loss of wealth to people of color in modern American history.

Average Home Prices, January 2003-March 2008



Source: Standard & Poor's/Case-Shiller Home Price Indices, March 2008.

Dangerous Waves

If tricky loans were the only source of concern, we could expect the foreclosure rate to come down in 2009, as the payment-reset problem subsides. Unfortunately, the complicating factors of rising unemployment and falling home values have entered the equation. Because of higher unemployment, more people are finding it hard to pay their mortgage bills; because of lower home values, many people may wonder if the mortgage bill is still worth paying. What started out as a subprime mortgage crisis, in other words, could turn into a generalized mortgage crisis.⁸⁸

Home prices have fallen by an estimated 15 percent since their peak in 2005.⁸⁹ In the first quarter of 2008, single family home prices were down 7.6 percent from the first quarter 2007 level—that's the biggest one-year drop since the National Association of Realtors began keeping track in 1982.⁹⁰ With half a million new homes and nearly 4 million existing homes currently on the market, there's no reason to expect a reversal of the trend anytime soon.⁹¹

Housing prices fell by about 30 percent during the Great Depression. Robert Shiller, an economist known for his accurate assessment of the 1990s stock market bubble, believes that prices could eventually decline by that much or more this time around; others think a 20 or 25 percent fall is more likely.⁹² But price declines have already left nearly 9 million homeowners—10 percent of the nation's total—underwater.⁹³ Roughly 30 percent of those who bought homes in 2005 and 2006 are now in that unenviable condition.⁹⁴ The number of underwater homeowners has tripled since 2005, and seems destined to increase further as home values continue to fall. Some authorities expect that figure to exceed 12 million—nearly one-fifth of all mortgage-holders—by the end of 2009.⁹⁵

Already, lenders have noticed rising default rates and foreclosures involving conventional fixed-rate loans, as well as a surprising number of cases in which people who can seemingly afford to pay their mortgage bills choose not to. In California, a company called You Walk Away helps homeowners abandon their homes and mortgage debts. For a fee, according to *US News & World Report*, the company will “hold cash-strapped borrowers' hands as they lose their most valuable asset, tarnish their credit, and erode their self-worth.”⁹⁶

HOPE NOT YET

Since the fall of 2007, more than a million endangered homeowners have received letters encouraging them to renegotiate their loans with the help of the Hope Now Alliance, a partnership of lenders, loan servicers, bondholders and credit counselors. As of February 2008, only about 21 percent of the recipients had responded; of that group, a similarly small proportion had gained meaningful relief.⁹⁷

The Hope Now Alliance, which operates under the umbrella of the Financial Services Roundtable—the lobbying arm of the banking industry—says it has a staff of counselors standing ready to provide assistance. But only about 4 percent of callers (ac-

ording to the Alliance's own data) have met with a counselor face to face, and some have had trouble getting through by phone.

New York Times reporter Lynnley Browning called the 800-number herself as a test. She spent 50 minutes on hold, listening to periodic recorded messages urging her to “start an online counseling session” at hopenow.com.

In April 2008, a group of state prosecutors and regulators found that “the collective efforts of servicers and government officials to date have not translated into meaningful improvement in foreclosure prevention outcomes.”⁹⁸

Besides encouraging more foreclosures and forced sales, falling home prices reduce household wealth and depress consumer spending, which together account for about 70 percent of all economic activity. Net household wealth declined by \$900 billion in the last quarter of 2007, according to Federal Reserve data.⁹⁹ If home values eventually fall 25 percent from their 2005 peak, that would mean a \$5 trillion total loss of wealth.¹⁰⁰ Since home equity represents the principal form of savings for the middle class and working poor, this would be a terrible blow to the modest wealth held by ordinary Americans. It would also represent a serious drag on purchasing power and the potential for economic recovery.

When Americans spend less, businesses retrench, and people lose their jobs. The official unemployment rate stood at 5.1 percent in April 2008—up from 4.5 percent a year earlier, when the mortgage crisis was just beginning to unfold.¹⁰¹ The meltdown has contributed to the unemployment spike in two ways: first, through plunging home equity and consumer spending; second, through heavy job losses in fields related to housing and lending. The number of Americans employed in construction, for example, has declined by 457,000 since its peak in September 2006, according to Bureau of Labor Statistics figures. Cutbacks in construction have had a heavy influence on Latino unemployment, which has increased from 5.5 percent in April 2007 to 6.9 percent in April 2008.¹⁰²

The financial markets also feed the economic downturn by making debt more expensive. Investors and regulators interpreted the subprime mortgage meltdown as a wakeup call about a whole array of complex financial securities. Since early 2007, the troubles have spread, according to *Washington Post* columnist David Ignatius, “from bundles of subprime residential mortgages to bundles of other kinds of debt—from student loans to retailers’ receivables to municipal bonds.” Bankers and investors, Ignatius says, are “going on strike, if you will—to escape the unraveling daisy chain of securitized assets and promissory notes that binds the global financial system. As each financier tries to protect against the next one’s mistakes, the whole system begins to sag.”¹⁰³

Although some aspects of the situation evoke the early 1930s, few economists think today’s economy is vulnerable to another Great Depression. A more plausible analogy, some suggest, would be the prolonged stagnation that took hold of Japan after its housing bubble burst in the 1990s. But even if that comparison, too, turns out to be overstated, the wider economic implications are clear. A year after the collapse of the subprime mortgage industry, the housing market remains a zone of short- and long-term economic peril, with the potential to cause troubles far worse than the serious ones already in view.

ADDRESSING THE EMERGENCY

In October 2007, the Treasury and Housing and Urban Developments departments announced a voluntary effort by lenders, bankers, investors and loan counselors to “reach out and help homeowners who may not be able to pay their mortgages.”¹⁰⁴ Consumer groups were skeptical: What kind of help could homeowners expect, one advocate wondered, from a program dominated by “the very industry that created the crisis?”¹⁰⁵

Not too much, to judge by the results. The Hope Now Alliance—including Countrywide Financial, Citigroup and Wells Fargo & Co., among other names associated with the subprime mort-

gage boom—claims to have provided assistance in more than a million cases.¹⁰⁶ But critics say the assistance has rarely amounted to more than giving delinquent borrowers time to catch up on their payments. Neither the Alliance nor its high-level Washington sponsors dispute that point (see “Hope Not Yet,” p. 17).¹⁰⁷

What Won't Work

Lenders should be offering more serious concessions. A payment of 70 cents on the dollar would be a better result than many are likely to get through foreclosure.¹⁰⁸ So why are homeowners and mortgage counselors getting such a poor reaction to their appeals? The problem is partly the same one that led to massive foreclosures in the early 1930s. A lender who is already worried about repayment may not see the point of trying to strike a new deal with someone who hasn't delivered on the old deal. The difficulty has been greatly compounded, though, by the process known as “securitization.”

Mortgage lending used to be a simpler business. Until recent decades, the company that issued a loan (most likely a bank or savings and loan) would normally finance and collect that loan as well. Today these are seen as separate functions, and often handled by separate entities. By the time a typical loan goes bad, it has been pooled with thousands of other loans, transformed into a mortgage-backed bond, and then subdivided into shares which may now be held by multiple, far-flung investors.

Loan modification could benefit bondholders as well as borrowers. But that's not an easy result to bring about when, as former Federal Reserve Board Vice Chairman Alan Blinder has noted, the two parties “don't even know each other's names.”¹⁰⁹ Bondholders are often unreachable; and many would not want to be reached, since no particular bondholder's fortunes will be greatly affected by the fate of any particular mortgage. Since the original lender is now out of the picture, financially speaking, that leaves only a third party, known as a loan servicer, to consider a loan modification request—and there, too, the idea may not be warmly received.

The loan servicer's customary role is to receive mortgage payments and, after taking a cut, to send the rest on to the bondholders. In a default situation, the servicer becomes a collection agent, charged with getting as much money as possible out of the homeowner. Legally, servicers have the right to renegotiate loans in order to avoid the expense of foreclosure. But mercy may not come naturally to them. For one thing, they tend to worry about being sued by bondholders if they seem to yield too much. In addition, many loan servicers get to keep late fees and other charges that come into play in a default situation; so their own financial interests may lean against compromise. And even if a loan servicer stands ready to make a deal, it won't happen unless the homeowner asks. Some homeowners may be too overwhelmed by their debts to take action on any particular front. Others may be frightened of exposing their financial weaknesses to a creditor. Whatever the reason, in about half of all foreclosures the lender or loan servicer hears nothing from the borrower until it is too late.

What Could Work

The foreclosure crisis of the early 1930s was the result of a wider economic calamity—the Great Depression. Seventy-five years later, bad loans and Byzantine financing arrangements have brought us to a similar pass. Once again, an alarming number of Americans face the loss of their homes even though most could afford a fair mortgage based on a realistic valuation.

Once again, what's needed is an outside force to unravel a disaster that has the private sector stymied. Once again, the only plausible candidate is the federal government.

In 1933, the rescue operation was carried out by a new federal agency created for that purpose. In their current plan Dodd and Frank assign the job to the Federal Housing Administration (FHA), and a supporting role to private lenders, who issue new loans backed by FHA insurance. But the net effect is the same. The FHA, like the Home Owners Loan Corporation, reaches out to lenders and loan servicers, offering guaranteed repayment of a reduced loan balance. Under the terms of the House bill, the FHA is authorized to insure up to \$300 billion in refinanced mortgages. Its guarantee-issuing power, like the original HOLC's lending power, is temporary—running for two years, with potential six-month extensions for up to an additional two years.

Eligibility is limited in a number of ways—to owner-occupied homes, to families owning only one residence, and to cases in which current mortgage payments exceed 35 percent of household income. The existing lender (or loan servicer) must agree to write the loan down to no more than 85 percent of a property's current market value, and the FHA has to validate the homeowner's ability to repay a 30-year fixed-rate mortgage at that level. Homeowners are required to bear a portion of the cost of special FHA risk insurance, and to return a share of any equity gains realized during the first five years of their new loans.¹¹⁰

Political considerations clearly influenced the decision to build on an existing federal program instead of proposing a new one. In their choice of the FHA in particular, Frank and Dodd were seeking common ground with the Bush administration, which, since the summer of 2007, has been nudging the FHA slowly into the mission of preventing foreclosures.¹¹¹ In the same spirit, the House and Senate proposals incorporate administration-backed measures to expand the FHA and establish a new oversight agency to watch over the financial practices of the government-sponsored enterprises Fannie Mae and Freddie Mac.¹¹²

But there is nothing inherently unworkable about an FHA-based approach and proponents plausibly argue that a rescue mission of this fashion could take less time to launch. The main obstacle will be the same one that would face a 21st-century HOLC. The question is how to get recalcitrant bondholders and loan servicers to acknowledge their losses and bargain seriously—or, more precisely, how to get a great many of them to do so in time to avert a great many economically devastating foreclosures.

Backup Measures

In an ideal world, bondholders and servicers would face some measure of legal liability for their part in creating this tragedy. Securitization is generally explained—and defended—as a way to draw capital into the mortgage market. But it also has a more insidious effect, enabling bondholders and securities packagers to profit from loans without assuming full responsibility for them. The worst of these mortgages were issued in 2005 and 2006, the last two years before the meltdown. By that time, lenders were running on auto-pilot, issuing loans as fast as they could in order to satisfy the rapacious appetite of investors. As Alan Greenspan (among others) has noted, the “big demand was not so much on the part of the borrowers as it was on the part of the suppliers who were giving loans which really most people couldn't afford.” If it had not been for securitization, Greenspan added, “the subprime loan market would have been very significantly less than it is in size.”¹¹³

Many of today's troubled loans should never have been permitted; many could have been stopped through proper enforcement of predatory lending laws, mortgage underwriting standards, and capital reserve rules. And yet, as things stand, homeowners have little or no practical recourse against any of the parties that have placed them in jeopardy. One way to correct this situation—maybe the best available option—would be liberalizing bankruptcy rules in order to allow court-supervised negotiations over home mortgages. Under existing law, a debtor can make a deal to keep a yacht or a vacation property, but not to hold onto a primary residence. Eliminating that legal barrier would put legal force behind the principle of a “cramdown”—a reduction of loan principal to current market value.¹¹⁴

The bankruptcy idea would be especially helpful in dealing with the complexities of piggyback loans—a factor in half or more of the subprime mortgages issued in some parts of the country.¹¹⁵ Bills to accomplish this have been introduced in the Senate, by Illinois Democrat Richard Durbin, and in the House, by North Carolina Democrat Brad Miller and Ohio Republican Steve Chabot, among others. Under their proposals, bankruptcy courts would be allowed to modify the terms of subprime and nontraditional mortgages that seem likely to end in foreclosure.¹¹⁶ Perhaps only a small proportion of homeowners would actually resort to bankruptcy; but the possibility could be a powerful motivator for lenders and bondholders, just the same.¹¹⁷

The House and Senate bills do include what amounts to a grant of legal immunity for loan servicers who make reasonable concessions without bondholder approval; that could turn out to be a useful provision. Unfortunately, in the face of intense resistance from the banking industry, House and Senate leaders have backed away from the bankruptcy idea. With that bipartisan failure of nerve, they have settled for a plan that is, in the end, still voluntary; the fate of every homeowner depends on the cooperation of a lender or loan servicer.

The “big demand was not so much on the part of the borrowers as it was on the part of the suppliers who were giving loans which really most people couldn’t afford.”

-Alan Greenspan

There are other questions that could be raised about this compromise. Many families facing foreclosure have second as well as first mortgages to contend with. Unraveling these situations could be difficult. It might be easier with a program like the one proposed by FDIC chairman Sheila Bair. Her plan calls for direct government loans to allow homeowners to pay off 20 percent of the first mortgage in a lump sum, thereby reducing their interest payments. Homeowners would have to pay the government back before any sale or refinancing of the property.¹¹⁸

The Dodd/Frank plan places a heavy burden on the Federal Housing Administration, a relatively small agency that has had its share of difficulties, including \$4.6 billion in recently revealed losses on some loans.¹¹⁹ By dropping the bankruptcy provision, Dodd and Frank have settled for a plan that is pretty much all carrot and no stick, but the carrot—a buyout at 85 percent of current market value—will probably be attractive to many lenders and servicers. The Congressional Budget Office foresees an eventual half a million loan modifications—that would be a large accomplishment in itself.¹²⁰

As successes begin to be recorded, moreover, failures will become conspicuous. Many loan servicing companies are subsidiaries of name-brand banks. Working through executives of the parent firms, advocates and public officials may be in a position to bring pressure on servicers to break the logjam and get a rescue mission going in earnest. By setting the process in motion, even a flawed plan could turn out to have more potential for good than we can see through the lens of conventional policy analysis.

Help for Hard-Hit Communities

In 1933, about half of all the country's mortgage debt was in default. The average homeowner who succeeded in getting a HOLC refinancing loan was two years delinquent on mortgage payments and about three years behind on property taxes.¹²¹ By most of the obvious measures, the foreclosure crisis of that era was much worse than today's. In one respect, though, the current situation can be seen as worse. That is in the concentrated effects on particular cities, neighborhoods, and demographic groups.

The uneven impact and the intense local effects mean that a federal effort, while essential, cannot be sufficient. The Dodd/Frank formula may turn out to be best-suited to parts of the country, like California or Florida, where huge run-ups in home prices have been followed by equally dramatic declines, giving lenders an obvious motivation to come down on the principal. But in Rust Belt states like Ohio and Michigan, lenders might be less willing to yield on principal; by the same token, interest-rate concessions might be enough to make the difference for many homeowners.

Any serious rescue plan must give states and localities the latitude to find their own answers, not only when it comes to preventing foreclosures, but also to the work of reclaiming vacant properties and stabilizing neighborhoods. Because financial resources are weakest where the need is greatest, the federal government should be shouldering a large share of this burden. The House, on the same day it approved its rescue plan—formally known as the FHA Housing Stabilization and Homeownership Retention Act—passed a bill, sponsored by California Rep. Maxine Waters, to provide \$15 billion in grants and loans for state and local initiatives.¹²² That plan seems to have been sacrificed, for now, in the bipartisan determination to avoid any direct appropriation of funds. But the need is great and, if supporters fight on, such a measure could still be enacted—as it should be—in the current Congress.

Help for Renters

Renters are affected by this crisis, too. If you live in a building that gets foreclosed on, you can be evicted even if you have never missed a month's rent. Banks and property managers often play hardball in such situations. Tenants get threatened with lawsuits or damaged credit reports if they don't move out expeditiously. Some tenants are convinced to leave by "cash for keys" offers that don't begin to cover the cost of moving in somewhere else.¹²³

Current estimates project that about 100,000 renters with incomes under \$20,000 could soon lose their homes due to foreclosure.¹²⁴ The federal government should support efforts to help renters reclaim security deposits, resist unnecessary evictions, and pay relocation expenses. A relatively small level of funding—enough to provide, say, \$3,000 for each affected low-income family—could make a huge difference in terms of preventing homelessness. Congress can also support local efforts to turn vacant or foreclosed properties into rental units. The mortgage crisis should be seen as a chance to broaden affordable housing options for nurses, police officers, firefighters, maintenance personnel and others who, in the current market, are far too often priced out of communities that depend on their labor.¹²⁵

NEW RULES FOR HOME LOANS

The subprime mortgage boom and bust was a case study in the perils of deregulation. The mortgage industry promised to work wonders if government would get out of the way. Give us the freedom to tailor our products to different levels of risk, lenders said, and we will deliver a great democratization of credit, bringing loans and homeownership to the excluded and the disadvantaged.¹²⁶

The results fell badly short. What the industry liked to call risk-based lending turned out to be a euphemism, in too many cases, for predatory lending. It became a raid on the assets of middle- and low-income families—African-American and Latino families in particular. The cause of homeownership was not served. Of the subprime loans originated between 1998 and 2006, fewer than 10 percent went to first-time homebuyers. That works out to about 1.4 million families—a figure far exceeded by the number of foreclosures during that period.¹²⁷ The homeownership rate, which peaked at 69.2 percent in 2004, has dropped back to 67.5 percent—roughly where it was when George Bush entered the White House.¹²⁸ And it seems destined to continue falling: While subprime mortgages aren't producing more homeowners, they will be generating foreclosures for years to come.

Deregulation Theory and Practice

Deregulation was supposed to bring more choice to the mortgage market. Instead, the worst of the subprime lenders dragged others down to their level. Traditional lenders could have responded by offering better and safer loans to the same customer base; but most banks opted for imitation rather than competition. Regulated institutions pushed their own lending practices to the legal limit. Many banks, while hesitant to engage in the most extreme practices themselves, found indirect ways of profiting from those practices—by investing in subprime lenders or packaging and selling their loans.

Since the spring of 2007, federal agencies have proposed or implemented a variety of new rules for the mortgage market. Many have been directed at the specific abuses and excesses of subprime lenders. Some practices clearly do need to be outlawed and the subprime mortgage scandal has called a number of glaring examples to light. It is time to ban the broker kickbacks that have led borrowers to pay extra-high interest. Just as surely, it is time to end the ratings-for-hire deals that have elevated some bait-and-switch mortgages to the same triple-A plane as treasury bonds.¹²⁹

But the mortgage market cries out for broad, tough, common-sense rules, not just for a crackdown on the abuses of the moment. This disaster has been, among other things, a lesson in the limits of highly prescriptive rulemaking. Thou-shalt-nots have a place in an effective body of regulation. But the greater need is for broad and essentially positive rules that promote straightforward and responsible business practices, not a nitpicking effort to stay on the right side of the law.

In that spirit, we propose six bedrock principles of a new era in home equity loans:

1. Easy Exit

High-cost loans, economically vulnerable borrowers, and heavy prepayment penalties have proved to be a toxic combination. Many of today's endangered homeowners accepted worrisome loans after brokers assured them that they could always refinance a year or two down the road. That was true, as

long as prices kept going up. Yet most subprime loans included heavy prepayment penalties, whether borrowers realized it or not. About 80 percent of the subprime mortgages issues in 2005 contained such penalties; only about 2 percent of that year's prime mortgages did.¹³⁰

Prepayment penalties became a major profit source, generating \$268 million in 2006 revenues for Countrywide, the biggest of the subprime lenders. A homeowner prepaying a typical \$200,000 first-lien subprime loan would have to pony up \$6,000.¹³¹ The effect was to leave borrowers in a no-win situation when the market went sour. They could continue making payments on overpriced loans, with a high risk of ending up in foreclosure; or they could pay the penalty, and lose precious equity.

Congressional leaders, following the lead of lawmakers in 35 states—including Maryland, North Carolina, New Mexico and Iowa—have proposed measures prohibiting or sharply limiting prepayment penalties in high-cost loans.¹³² This is a crucial reform. Borrowers deserve some maneuvering room when they run into trouble. The more important objective, though, is to point lenders away from the temptation to sign people up for loans they are likely to regret. That becomes a far less attractive business model when borrowers are free to refinance without significant penalty.

2. One Set of Rules for All

Reasonable people may disagree about the level of protection that consumers should enjoy when they take out a loan. It is hard to make a case for one level of protection if the loan comes from a bank and another, lower level of protection if it comes from a nonbank lender or an "independent" mortgage broker. Yet that is the system we have.

Regulations, when they fall more heavily on one set of institutions than another, do not prevent undesirable activity; they simply cause it to migrate out of regulated areas into places where it becomes harder to see and control. Mortgage market reform can begin by taking some of the basic rules for banks—such as verification of ability to repay and the requirement that a loan provide a "net tangible benefit"—and applying them to all lenders and loan parties. Securities brokers and real estate brokers have to pass tests, abide by rules, and look out for clients' interests. Mortgage brokers should face the same requirements. Piggybacking on state systems where they exist, the federal government should create a national registry of brokers and loan officers, making it easy for borrowers to check out any broker's employment history and record of violations or complaints.

Securitizers and bondholders, like brokers and nonbank lenders, have operated largely outside of the regulatory system and they, too, have sought to turn that fact into a source of profit. Modern financial regulation grew out of the bank failures of the Great Depression. Because of that history, banks came to be heavily regulated. By contrast, investment banks and, more recently, hedge funds and private equity funds have been excused from regulation (including disclosure rules) on the assumption that their actions hold less relevance for ordinary citizens and the stability of the financial system.

That logic breaks down when investment banks and commercial banks operate under the same roof, financing and profiting from high-risk loans without being held accountable to the borrower. Hedge funds, too, become hard to ignore now that we have seen two of them collapse, bringing down a major investment bank and nearly causing a run on Wall Street, which was only averted by a \$29 billion loan commitment from the Fed. Many economists—indeed, many bankers—have called for measures to bring investment banks and hedge funds under greater control.¹³³ Congress needs to move quickly to begin that challenging but necessary process.

3. Skin in the Game

Lenders used to hold onto their own loans and take the hit when one went bad. Now, thanks to securitization, they make their money up front and keep it even if a borrower defaults. So do the brokers who sign people up for loans; and so, by and large, do the investment banks and other securities packagers.¹³⁴ This arrangement has served the short-term interests of insiders. It plainly has not served borrowers, the financial system, or the society at large. It has led to a system of institutionalized irresponsibility, in which everyone's fingers are dirty but everyone can point the finger at someone else.

The originator of any mortgage should have a stake in the result. Securitizers should also bear a reasonable share of the risk of default. Everyone who “touches a mortgage” should have capital at risk, says Richard K. Green, an economist who teaches at George Washington University.¹³⁵ Securitizers, in addition to facing civil liability for fraudulent loans, should be subject to the same capitalization requirements as banks. These steps might have the effect of barring some forms of securitization, or closing down some nonbank lenders. That will be a good thing if it clears the opportunism out of the market and bolsters banks and other institutions that have stood against the tide by offering offer honest and fair loans and working with borrowers to help ensure repayment.

4. Clear and Early Disclosure

As other forms of regulation have fallen away, disclosure has assumed more of the burden of protecting borrowers from abusive loans. Unfortunately, as disclosure has become more crucial, it has also become less meaningful.

The complexity of today's loans and legal requirements has turned the disclosure process into an information dump. The typical borrower receives a heap of documents at once. Somewhere in the pile—in there with the promissory note, the deed of trust, the HUD-1 settlement statement, and the power of attorney form (authorizing the lender or title company to correct any errors after the fact)—lies a contract setting forth the important facts, and the unimportant ones, in what Treasury Secretary Henry Paulson has aptly described as “unintelligible and mostly unread boilerplate.”¹³⁶ Small wonder that in a 2007 study by the Federal Trade Commission, a third of all borrowers could not identify their interest rate, while half could not state the loan amount and fully 90 percent had no idea what their total up-front charges were.¹³⁷

The key characteristics of a loan need to be laid out clearly and briefly. Alex Pollack, a fellow at the American Enterprise Institute (and a former president of the Federal Home Loan Bank of Chicago), has come up with an excellent model. His one-page form focuses on essential information and links it to the borrower's financial circumstances. It explains what you'll pay up front in “total ‘points’ plus estimated other costs and fees,” tells you what your monthly payment will be—now, later, and with taxes and insurance included; and lays out the expenses both in absolute dollars and as a fraction of income.¹³⁸

This is what disclosure should be like, and it should happen early—soon after a loan application has been submitted, and before any fees are charged.¹³⁹

5. A Safe and Simple Default Mortgage

Fewer rules mean more choice. More choice is good for consumers. That was the promise of deregulation. The mortgage market has revealed deep flaws in the argument.

In the era of regulated mortgages, you could size up a loan pretty accurately by looking at two factors—interest rate and closing costs. The Truth in Lending Act of 1980 established the annualized percentage rate, or APR, as the single most important loan variable, which had to be prominently displayed.¹⁴⁰ Subprime mortgage lenders (following in the footsteps of the credit card industry) responded with teaser rates, prepayment penalties, and a host of front-loaded, back-loaded and contingent fees. APR became just one cost factor among many. Some lenders incidentally managed to evade the intent of the Home Ownership and Equity Protection Act of 1994, which imposes extra requirements on “high-cost loans,” using the APR as its main measure of cost.

Lenders insisted that they were not trying to sow confusion. But on the other end of the transaction, confusion was a very clear result. “If consumers have trouble comparing the value of one hamburger patty and another,” says Ellen Seidman of the New America Foundation, “they can hardly be expected “to tell the difference between a 2/28 with a teaser and a regular old ARM [adjustable rate mortgage].”¹⁴¹

The mortgage market has become a case study in what the psychologist Barry Schwartz calls the “tyranny of choice.”¹⁴² The solution is a simple and safe standard-issue mortgage. Such a formula has been proposed by Michael Barr, Sendhil Mullainathan, and Eldar Shafir—a law professor, an economist, and a psychologist, respectively. They compare their approach to the way, in many of today’s workplaces, employees are enrolled in employer-sponsored retirement plans unless they opt out. Barr, Mullainathan, and Shafir call for a default model 30-year, fixed-rate mortgage, which borrowers would have to affirmatively choose to reject; if that happened, the lender would face additional disclosure requirements and penalties for inappropriate loans.¹⁴³

6. A Dependable Watchdog

Regulatory authority over mortgage lending is badly fragmented. At the federal level, oversight has been spread across a constellation of agencies with blurry lines of authority and, in some cases, an uncertain sense of duty. Regulators have pulled back from monitoring lenders and examining their financial instruments directly; instead, they have farmed out much of the job to the ratings companies (notably Moody’s, Standard & Poors, and Fitch), while letting them collect fees from lenders and securitizers—the higher the rating, the higher the fee.¹⁴⁴

It’s time to establish a single regulatory body for mortgage lending. Borrowers and lenders alike deserve a watchdog that can give full time and attention to the job. The new agency should have rule-making authority and be lodged within a unit of government (the Federal Trade Commission, for example) with a tradition of protecting consumers. Its rules and enforcement actions should apply to all mortgages and all participants in the mortgage market.

But while Washington’s oversight needs to be consolidated, the parallel authority of the states should be reaffirmed. Fourteen years have passed since the last major congressional federal legislation in this area; during that time, at least 30 states have taken action. As the subprime market swelled, North Carolina and New Mexico passed ambitious new predatory lending laws; partly as a result, both states were spared the worst.¹⁴⁵

Rules—Who Needs Them?

Lenders, bankers, and some public officials continue to argue for “market discipline” as a better way to keep abuses in check. But there’s not much repeat business in the mortgage field. When the lure of extra gain tempts lenders to engage in questionable conduct, concern about sully-ing their reputations may not hold them back. Borrowers also don’t get much chance to learn. Many people never take out more than one mortgage. One really bad one—like one defective airplane or medicine—can cause tremendous harm.

Consumers plainly need more protection than they’ve been getting in this field. The mortgage lending industry—with many good and responsible lenders—needs protection, too. The banking and lending world has a long history of bubbles and panics. The bank failures of the early 1930s, which cost Americans more than \$400 million in lost deposits, led to new forms of public support, including deposit insurance and access to discount window loans through the Federal Reserve. In exchange, banks were required to accept stricter limits on the ratio of loans to assets, bans on business activities that could create conflicts of interest, and “transparency rules” requiring them to open their books to regulators.¹⁴⁶

It was an imperfect system, sometimes inflexible and slow to change. Nevertheless, it served this country well, on the whole, for a period of decades. The rules that some bankers and lenders now regard with scorn created an aura of trust in American banking. The trust was global. It helped make financial services one of the few U.S. industries in recent decades with a net trade surplus. Regulation spurred growth and efficiency and entrepreneurship, even as it protected consumers.

The mortgage industry, with all its recent troubles, has placed two large projects on the public policy agenda. One is rescue and damage control. The other is the construction of new rules to prevent another such disaster. Mistakes will surely be made in both these enterprises, but history joins common sense in suggesting that the long-term results will be positive for lenders, borrowers and the nation as a whole.

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