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Fed Shrugged as Subprime Crisis Spread

By EDMUND L. ANDREWS

WASHINGTON — Until the boom in subprime mortgages turned into a national nightmare this summer, the few people who tried to warn federal banking officials might as well have been talking to themselves.

Edward M. Gramlich, a Federal Reserve governor who died in September, warned nearly seven years ago that a fast-growing new breed of lenders was luring many people into risky mortgages they could not afford.

But when Mr. Gramlich privately urged Fed examiners to investigate mortgage lenders affiliated with national banks, he was rebuffed by Alan Greenspan, the Fed chairman.

In 2001, a senior Treasury official, Sheila C. Bair, tried to persuade subprime lenders to adopt a code of "best practices" and to let outside monitors verify their compliance. None of the lenders would agree to the monitors, and many rejected the code itself. Even those who did adopt those practices, Ms. Bair recalled recently, soon let them slip.

And leaders of a housing advocacy group in California, meeting with Mr. Greenspan in 2004, warned that deception was increasing and unscrupulous practices were spreading.

John C. Gamboa and Robert L. Gnaizda of the Greenlining Institute implored Mr. Greenspan to use his bully pulpit and press for a voluntary code of conduct.

"He never gave us a good reason, but he didn't want to do it," Mr. Gnaizda said last week. "He just wasn't interested."

Today, as the mortgage crisis of 2007 worsens and threatens to tip the economy into a recession, many are asking: where was Washington?

An examination of regulatory decisions shows that the Federal Reserve and other agencies waited until it was too late before trying to tame the industry's excesses. Both the Fed and the Bush administration placed a higher priority on promoting "financial innovation" and what President Bush has called the "ownership society."

On top of that, many Fed officials counted on the housing boom to prop up the economy after the stock market collapsed in 2000.

Mr. Greenspan, in an interview, vigorously defended his actions, saying the Fed was poorly equipped to investigate deceptive lending and that it was not to blame for the housing bubble and bust.

On Tuesday, under a new chairman, the Federal Reserve will try to make up for lost ground by proposing new restrictions on subprime mortgages, invoking its authority under the 13-year-old Home Ownership Equity and Protection Act. Fed officials are expected to demand that lenders document a person’s income and ability to repay the loan, and they may well restrict practices that make it hard for borrowers to see hidden fees or refinance with cheaper mortgages.

It is an action that people like Mr. Gramlich and Ms. Bair advocated for years with little success. But it will have little impact on many existing subprime lenders, because most have either gone out of business or stopped making subprime loans months ago.

Before this year, officials here enthusiastically praised subprime lenders for helping millions of families buy homes for the first time. “I was aware that the loosening of mortgage credit terms for subprime borrowers increased financial risk,” Mr. Greenspan wrote in his recent memoir, “The Age of Turbulence: Adventures in a New World.” “But I believed then, as now, that the benefits of broadened home ownership are worth the risk.”

As housing prices soared in what became a speculative bubble, Fed officials took comfort that foreclosure rates on subprime mortgages remained relatively low. But neither the Fed nor any other regulatory agency in Washington examined what might happen if housing prices flattened out or declined.

Had officials bothered to look, frightening clues of the coming crisis were available. The Center for Responsible Lending, a nonprofit group based in North Carolina, analyzed records from across the country and found that default rates on subprime loans soared to 20 percent in cities where home prices stopped rising or started to fall.

“The Federal Reserve could have stopped this problem dead in its tracks,” said Martin Eakes, chief executive of the center. “If the Fed had done its job, we would not have had the abusive lending and we would not have a foreclosure crisis in virtually every community across America.”

Mr. Greenspan, hailed as perhaps the best central banker in history when he left the Fed in early 2006, is now feeling defensive. In an extensive interview last week, he adamantly disputed the assertion that he could have prevented the mortgage bust.

The housing bubble, he said, had far less to do with the Fed's policy on interest rates than on a global surplus in savings that drove down interest rates and pushed up housing prices in countries around the world.

As for his role as a regulator, Mr. Greenspan argued that the Fed was ill-suited to investigate deceptive lending practices.

"I got the impression that there were a lot of very questionable practices going on," he said. "The problem has always been, what basically does the law mean when it says deceptive and unfair practices? Deceptive and unfair practices may seem straightforward, except when you try to determine by what standard."

Mr. Greenspan also contended that the Federal Reserve's accountants and bank examiners were ill-suited to the job of investigating fraud.

"It becomes essentially an enforcement action, and the question is, who are the best enforcers?" he said. "A large enough share of these cases are fraud, and those are areas that I don't think accountants are best able to handle."

Others are more critical.

"Hindsight is always 20-20, but it's clear the Fed should have acted earlier," said Ms. Bair, who became chairman of the Federal Deposit Insurance Corporation in 2006. "Financial innovation is great, but you have to have some basic rules. One of the most basic rules is that a borrower should have the ability to repay."

A Booming Industry

Mr. Greenspan and other Fed officials repeatedly dismissed warnings about a speculative bubble in housing prices. In December 2004, the New York Fed issued a report bluntly declaring that "no bubble exists." Mr. Greenspan predicted several times — incorrectly, it turned out — that housing declines would be local but almost certainly not nationwide.

The Fed was hardly alone in not pressing to clean up the mortgage industry. When states like Georgia and North Carolina started to pass tougher laws against abusive lending practices, the Office of the Comptroller of the Currency successfully prohibited them from investigating local subsidiaries of nationally chartered banks.

Virtually every federal bank regulator was loathe to impose speed limits on a booming industry. But the regulators were also fragmented among an alphabet soup of agencies with splintered and confusing jurisdictions. Perhaps the biggest complication was that many mortgage lenders did not fall under any agency's authority at all.

Subprime loans carry high interest rates, sometimes as high as 12 percent, and were designed for people with weak credit records. Unlike traditional banks and thrifts, which traditionally financed their loans with deposits, most subprime lenders are financed by investors on Wall Street who buy packages of loans called mortgage-backed securities.

Starting from a virtual standstill 10 years ago, subprime lenders became by far the fastest-growing segment of mortgage lending before they collapsed. They made $540 billion in mortgages by 2004 and $625 billion at their peak in 2006 — about one-quarter of all new mortgages.

Mr. Gramlich, a Democratic appointee to the Federal Reserve who had spent much of his career studying problems of poverty, saw both great benefits and great perils in the new industry.

As head of the Fed's Committee on Consumer and Community Affairs from 1997 to 2005, he agreed that subprime lending had opened new doors to people with low incomes or poor credit histories. Home ownership, which had hovered around 64 percent for years, climbed to almost 70 percent by 2005. The biggest gains were among blacks and Hispanics, groups that had suffered discrimination for decades.

What alarmed Mr. Gramlich was that many subprime loans were extremely complicated and loaded with hidden risks.

Borrowers were being qualified for loans based on low initial teaser rates, rather than the much higher rates they would have to pay after a year or two. Many of the loans came with big fees that were hidden in the overall interest rate. And many had prepayment penalties that effectively blocked people from getting cheaper loans for two years or longer.

"Why are the most risky loan products sold to the least sophisticated borrowers?" Mr. Gramlich asked in a speech he prepared last August for the Fed's symposium in Jackson Hole, Wyo. "The question answers itself — the least sophisticated borrowers are probably duped into taking these products."

Turning Away a Bigger Role

In 2000, Mr. Gramlich privately urged the Fed chairman to send examiners into the mortgage-lending affiliates of nationally chartered banks. Many of them, like Bank of America's affiliate, had already come under fire from state regulators and consumer groups. Fed examiners, Mr. Gramlich argued, could clean up those practices from the inside.

Mr. Greenspan was against the idea. In an interview last week, he said he feared that Fed examiners would fail to spot deceptive practices and inadvertently give dubious lenders what amounted to a government seal of approval.

"I remember telling him, 'be careful,' " Mr. Greenspan said. If the Fed gave the appearance that it was overseeing thousands of local institutions, which he said it did not have the resources to do, "we're going to end up with a situation that very well could be worse rather than better."

To be sure, some of the speculative excesses of the housing bubble and the subsequent bust were driven by broader forces.

The Fed helped stoke the housing market by slashing short-term interest rates from 2000 to 2004. The rate cuts drastically reduced the effective cost of buying a house, which added more fuel to what was already a powerful housing boom.

In addition, foreign investors were pouring trillions of dollars into American securities. Much of that money, often described as the "global savings glut," flowed directly into mortgage-backed securities that were used to finance subprime mortgages.

But by 2005, federal banking regulators were beginning to worry that mortgage lenders were running amok with exotic and often inscrutable new products.

The agencies, however, were like a Rube Goldberg machine with parts moving in different directions. The Office of the Comptroller of the Currency was in charge of nationally chartered banks and their subsidiaries. The Federal Reserve covered affiliates of nationally chartered banks. The Office of Thrift Supervision oversaw savings institutions. The Federal Deposit Insurance Corporation insured deposits of both state-chartered and nationally chartered banks.

Because each agency receives its funding from fees paid by the banks or thrifts they regulate, critics have long argued that they often treat the institutions they regulate as constituents to be protected. All of them are wary about stifling new financial services.

Ms. Bair was an exception, especially for the deregulation-minded Bush administration. As a former assistant secretary of the Treasury in 2001 and 2002, she had worked with Mr.

Gramlich to raise concerns about abusive lending practices. Indeed, she tried to hammer out an agreement with mortgage lenders and consumer groups over a tough set of “best practices” that would have covered subprime mortgages.

But that effort largely stalled because of disagreement. Though some big lenders did endorse a broad code of conduct, she recalled, they soon began loosening standards as competition intensified.

The drop in lending standards became unmistakable in 2004, as lenders approved a flood of shaky new products: “stated-income” loans, which do not require borrowers to document their incomes; “piggyback” loans, which allow people to buy a home without making a down payment; and “option ARMs,” which allowed people to make less than the minimum payment but added the unpaid amount to their total mortgage.

Fed officials noticed the drop in standards as well. The Fed’s survey of bank lenders showed a steep plunge in standards that began in 2004 and continued until the housing boom fizzled in 2006.

But the regulators found themselves hopelessly behind the fast-changing practices of lenders. In a bid to set new standards for exotic mortgages, the agencies waited until December 2005 to propose a “guidance” to banks and thrifts. They did not agree on the final standard until September 2006.

Standards for Lenders

But the real shock to consumer groups — and even to some of the regulators — was that the new underwriting standards did not apply to subprime loans. Instead, they applied to only a fairly narrow array of exotic mortgages like “option ARMs.”

“The gaping hole was that it would only apply to nontraditional mortgages,” Ms. Bair said. But the exotic mortgages were already fading from the market, in part because of bad publicity. Subprime lending, by contrast, was still booming and represented a much bigger business.

“We hadn’t really focused on that,” said John C. Dugan, Comptroller of the Currency, who had pushed hard for the new guidance. “From our own perspective of national banks, it was really a smaller part of our universe.”

It was not until March 2007 that the group of regulators proposed yet another “guidance,” this one to address standards for subprime lending. But those standards were not finished until June 29. By that time, more than 30 subprime lenders had gone out of business and many more were headed that way.

Several people familiar with the regulatory deliberations said the delays stemmed in part from intense resistance among some policy makers to challenging subprime lenders.

“I had concerns, I really had concerns,” acknowledged Mr. Dugan, adding that he became convinced after listening to enough public comment on the issue.

In the end, any concerns for the industry quickly became moot. Less than two months after the new standards were issued, the subprime industry was essentially dead.

Ben S. Bernanke, who succeeded Mr. Greenspan as Fed chairman, is now scrambling to head off a recession. Last week, the Fed lowered its benchmark interest rate for the third time since August, and officials now worry that the subprime crisis has inflicted deep damage on credit markets that could in turn derail the entire economy.

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