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ASK YOURSELF WHY… THEY DIDN'T SEE THIS COMING

A REPORT FROM THE COMMON CAUSE EDUCATION FUND
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COMMON CAUSE

Executive Summary

This report, the latest in the *Ask Yourself Why* series, is about how the lending industry has prevented the government from doing more to prevent the current financial crisis or help families who have been hurt by it. It discusses the connection between the lobbying and campaign contributions of mortgage bankers and brokers and Congress' failure to stop or even respond forcefully to one of the biggest financial crisis in recent history.

Mortgage Bankers and Brokers Contributions and Lobbying: 2008 Election Cycle

Organization	Contributions	Dems	Repubs	Lobbying	Total
Fannie Mae	$916,250	62%	38%	$7,010,000	$7,926,250
Mortgage Bankers Assn	$622,175	53%	47%	$5,353,070	$5,975,245
Freddie Mac	$478,317	54%	46%	$12,970,000	$13,448,317
Countrywide Financial	$295,813	49%	51%	$2,029,000	$2,324,813
National Assn of Mortgage Brokers	$246,885	53%	47%	$1,705,017	$1,951,902
Total	$2,559,440	54%	46%	$29,067,087	$31,626,527

Source: Center for Responsive Politics

The top five spenders among mortgage bankers and brokers spent more than $31 million on lobbying and campaign contributions during the current election cycle alone. This industry, which stood to gain from the frenzy of barrowing and buying during the housing boom, successfully stopped the government from slowing the breathtaking growth of unsustainable lending that has caused the current financial crisis. After the crash, the industry was also successful in stopping Congress from taking more dramatic steps to help families keep their homes.

As the housing market took off, so did the more questionable lending practices of financial services companies. Many subprime loans to people with poor or no credit were designed to "reset" after an introductory period, sometimes doubling the borrower's monthly payments. This, combined with the decrease in value of the borrower's home, has driven many families into default and foreclosure. Although consumer groups have protested the sale and resale of these loans for years, the financial industry has used its political power, measured in the millions of dollars spent in campaign contributions and lobbying, to hold government regulators at bay.

One of the options considered by Congress to help homeowners now saddled with these unsustainable mortgages was to allow a bankruptcy judge to adjust the value of a loan to reflect the current value of the home. But the financial industry successfully opposed this policy as well, even though it was supported by an array of consumer groups and academics and would help an estimated 600,000 homeowners avoid foreclosure.

Ask Yourself Why… They Didn't See This Coming

Countrywide, Fannie Mae, Freddie Mac, IndyMac, Lehman Brothers, Merrill Lynch and the American International Group (AIG) have all basically collapsed under the weight of the housing crash. And it's not over yet.

About 100,000 homes went into foreclosure in August,[1] and analysts are still predicting another wave of foreclosures.[2] There are more than 2 million vacant homes on the market – the most ever recorded. Estimates of total foreclosures run as high as 3 million for 2007 and 2008[3].

These foreclosures were caused, in large part, by the popular subprime adjustable rate mortgages (ARM) – loans to people with bad credit or no credit – that gave everyone a piece of the American dream during the housing boom. Referred to as "exploding ARMs," many subprime loans "reset" after an introductory period, sometimes doubling the borrower's monthly payments. This, combined with the decrease in value of the borrower's home, drove many families into default and foreclosure. Although consumer groups protested the sale and resale of these loans for years, the financial industry used its political power, measured in the millions of dollars spent in campaign contributions and lobbying, to hold government regulators at bay.

Poor neighborhoods and often African-American and Latino neighborhoods have seen the highest incidence of subprime loans and housing foreclosures. According to an analysis of federal loan data, 71 percent of African-Americans in Michigan who bought or refinanced their home last year received a subprime loan.[4] Demos, a non-partisan public policy research and advocacy organization, recently reported: "African-American and Latino homeowners are twice as likely to suffer subprime-related home foreclosures … Estimates place the total loss of wealth among households of color at between $164 billion and $213 billion ... the greatest loss of wealth to people of color in modern American history."[5]

What is most troubling about this historic episode is that the problems were identified years ago. Yet, thanks in part to the political power of the financial institutions that stood to gain from the frenzy of borrowing and buying during the housing boom, the government refused to step in or even slow the breathtaking growth of unsustainable lending.

This report, the latest in the *Ask Yourself Why* series, looks at the government's response to the housing crisis and its effects on homeowners. It discusses the connection between the lobbying and campaign contributions of the financial services industry and Congress' unwillingness to prevent or respond forcefully to one of the biggest financial crisis in recent history. For many years, especially during the housing boom, the financial services industry successfully steered government policy away from more hands-on regulation of the lending market. And in the end, the biggest losers in this story are not the thousands of now-unemployed Wall Street brokers, but the low income and minority neighborhoods that have been the focal point of the bad lending itself.

The Build-up

As the housing market took off, so did the more questionable lending practices of financial services companies. The total value of subprime loans went from $97 billion in 1996 to $640 billion in 2006, increasing from 12 percent to 21 percent of the total market.[6] These risky mortgages took off because each player in the process believed they could collect while passing the risk of default onto the next guy. Mortgage brokers were not lending their own money, so they pushed risks onto the lenders. Lenders sold the mortgages to investment banks, which packaged them into securities and then sold pieces of them to investors all over the world.[7] The inherent problem of this system must have been visible to members of Congress and the Bush administration a long time ago, but they chose not to act.

In 2000, the National Consumer Law Center and Consumer Federation of America submitted comments to the Office of Thrift Supervision warning of the growth in the market for subprime loans:

> The inflation in real estate values in the 1980s … continues to make aging homeowners a prime target of predatory lenders... The appreciated value of the property led to "asset-based lending" … [which] is a legitimate-sounding justification to ignore sound underwriting principles, and make unaffordable loans... The 1990s saw the phenomenal growth in the use of asset-based securities to fund an ever-increasing supply of mortgage credit... "Subprime" homeowners are the hot new market of the 1990s... The securitization of home equity loans is a driving force behind the subprime market popularity.[8]

In early 2005, during debate on the landmark bankruptcy legislation, which made it more difficult for individuals to declare bankruptcy, Senator Dick Durbin (D-IL) offered an amendment to discourage predatory lending practices. The amendment prohibited mortgage lenders from collecting on claims in bankruptcy court if the lenders illegally extended credit to borrowers. Upon introducing the amendment, Senator Durbin made the following remarks on the Senate floor:

> As predatory mortgage lending increases, it continues to target lower income women, minorities, and older Americans. **In 1998**, Senator Grassley of Iowa, my friend and colleague and the author of the bankruptcy bill, held a hearing in the Senate Special Committee on Aging looking into predatory lending. At the hearing, this is what a former career employee of that industry had to say… My perfect customer would be an uneducated woman who is living on a fixed income, hopefully from her deceased husband's pension and Social Security, who has her house paid off, is living off credit cards but having a difficult time keeping up her payments, and who must make a car payment in addition to her credit card payments… Mr. President, 1 in 100 conventional loans ends in foreclosure, but 1 in 12 subprime predatory loans ends in foreclosure… the magnitude of the differences tells us that there is more at stake here than just the creditworthiness of the borrower. (emphasis added)[9]

The amendment was defeated in the Senate by a vote of 40 to 58.

In 2006, the Center for Responsible Lending (CRL) issued the results of a nationwide review of millions of subprime mortgages that originated from 1998 through the third quarter of 2006. In the report, CRL projected that one out of five (19.4%) subprime loans issued during 2005-2006 would fail, costing American families as much as $164 billion due to foreclosures in the subprime mortgage market.[10] Speaking to the *Boston Globe* earlier that year, Thomas Callahan, executive director of the Massachusetts Affordable Housing Alliance said: "People have put problems off by multiple financings and increasing equity. I have a sense it could get ugly soon."[11]

In early 2007, Jim Rokakis, the County Treasurer for Cuyahoga County in Ohio, delivered the following testimony to the Subcommittee on Domestic Policy, Committee on Oversight and Government Reform in the U.S. House of Representatives:

> For at least the **past seven years** urban leaders in cities like Cleveland, Dayton, Toledo, Cincinnati, and other older, more mature cities throughout America have been decrying the explosion in foreclosure filings in their communities. They have complained of abandonment, of property flipping and of a lending industry that was behaving so irresponsibly that we were convinced that someday that a segment of that industry—the subprime sector—would implode. We complained of no document loans and of Adjustable Rate Mortgages that would reset at a rate that would be well beyond the means of the borrower. We complained of borrowers known as NINJA's-No Income-No Job-No Assets—who were buying properties, often multiple properties, often with no down payments. We complained of fraud on an unprecedented scale that involved buyers, sellers, brokers, bankers and appraisers. We pleaded for help at the State level Mr. Chairman but were no match for the lobbying team assembled by the mortgage brokers, the mortgage bankers and financial services industry … (emphasis added)[12]

In late 2007, AARP, AFL-CIO, the Center for Responsible Lending, the Consumer Federation of America and the National Fair Housing Alliance wrote an open letter to all members of the House of Representatives, which stated:

> …in recent years, subprime lending has been dominated by unaffordable, complex loan products that borrowers do not understand and lenders do not properly underwrite. Many subprime loans and exotic prime loans are underwritten – if at all – only to a low teaser rate, which typically lasts just two or three years, and sometimes far less. These loans also usually contain costly prepayment penalties that penalize and trap borrowers, preventing them from refinancing into a more affordable loan.[13]

All of this has been overshadowed by the historic bailout of the financial services industry as the Bush administration took control of Fannie Mae and Freddie Mac and assumed a majority stake in AIG, by committing $85 billion to keep that company afloat. Two other titans of Wall Street, Lehman Brothers and Merrill Lynch have disappeared.

The problems that led to the demise of these companies trace back to an overexposure to bad loans made during the housing boom. But because there was good money to be made in bad mortgages – and little or no federal regulation of predatory or unsustainable lending – the industry flooded the market with easy credit.

Government Response: Voluntary Programs Only

In July, the first substantial piece of legislation to address the mortgage crisis was passed by Congress and signed by the President. While this legislation included some new provisions to help homeowners avoid foreclosure, much of it was too little too late. The bill did include a grant of approximately $3.9 billion certain homeowners could access to refinance their mortgages, but only if their lenders voluntarily agreed to take substantial losses on the existing loans. While this option would be attractive to some lenders because it would likely lose money if the property went into foreclosure, it ultimately depends on voluntary action on the part of banks and lenders.

To date, this approach has had limited affect. The State Foreclosure Prevention Working Group recently reported that only 24 percent of seriously delinquent borrowers were working with professionals toward preventing foreclosure.[14] Foreclosures still outnumber loan modifications three-to-one, and the numbers of delinquencies and foreclosure starts will continue to rise through 2008 and 2009 as another round of subprime "resets" kicks in.[15] As a recent *New York Times* article reads: "The first wave of Americans to default on their home mortgages appears to be cresting, but a second, far larger one is quickly building."[16]

The shortcomings of this purely voluntary system are further heightened by the growth in mortgage-backed securities – meaning that many home loans are owned by investors all over the world, rather than just the bank down the street. In order for lenders to voluntarily modify the terms of a loan, all the parties who own a stake in that loan must agree to the new terms. Congress' reliance on voluntary loan modifications, as the financial companies prefer, disregards the prospect of investor lawsuits and "piggyback" loans (second liens) that make voluntary modifications difficult.[17] If any investor stands to lose more than another as a result of the modification, or could make more from moving to foreclosure (which is not uncommon), they can sink any new agreement and push the loan to foreclosure. As the Former Federal Reserve Board Vice Chairman Alan Blinder said, the emergence of securitized mortgages sold and resold to investors across the globe "bolsters the case for government intervention rather than undermining it. After all, how do you renegotiate terms of a mortgage when the borrower and the lender don't even know each other's names?"[18]

Another option considered by Congress was to allow a bankruptcy judge to adjust the value of a loan to reflect the current value of the home. Current bankruptcy law exempts first mortgages from the jurisdiction of a bankruptcy court. In all other cases, such as a vacation or rental property, a bankruptcy judge could modify the terms of the loan between creditors and borrowers as part of a long-term solution. But the financial industry has successfully opposed this route as a response to the mortgage crisis because it could cost the companies big for making bad loans. Proponents of this measure argue that it is the cleanest, easiest way to strike at the heart of the problem many homeowners now face – a home that has lost value and is now worth less than their mortgage. More than one-third of families in this situation, known as being "underwater," have not benefited from voluntary modifications by their lender.[19]

Former Housing and Urban Development (HUD) director and U.S. Congressman Jack Kemp recently wrote in the *Los Angeles Times*: "When servicers are unwilling or unable to voluntarily modify exploding, unsustainable home mortgage loans, Congress has a duty to consider involuntary modification in bankruptcy court, where the same relief is granted on all other secured loans."[20]

The Democratic leadership originally introduced legislation that included a provision to temporarily give bankruptcy judges the authority to modify subprime and nontraditional mortgages. The measure was eventually stripped from the original package but reintroduced in HR 3609, the "Emergency Home Ownership and Mortgage Equity Protection Act," and S. 2136, "Helping Families Save Their Homes in Bankruptcy Act," by Representative Brad Miller (D-NC) and Sen. Durbin, respectively.

In a letter to Senate Majority Leader Harry Reid (D-NV) and Senate Minority Leader Mitch McConnell (R-KY) in February, a group known as the Bankruptcy Coalition wrote that allowing bankruptcy judges to modify the terms of mortgages, "would undermine the recovery of the housing market and the economy … This provision will have the exact opposite effect intended by increasing the cost of mortgages for all borrowers in the form of higher interest rates or down payments, or both."[21] Members of the Bankruptcy Coalition spent more than $65 million in lobbying and campaign contributions since the beginning of 2007.

Contributions and Lobbying: Members of Bankruptcy Coalition

Organization	Lobbying 2007	Lobbying 2008	Contributions 2007-2008	Total
American Bankers Association	$6,171,648	$4,479,157	$2,008,488	$12,659,293
American Financial Services Association	$200,000	$100,000	$118,500	$418,500
Bank of America	$3,220,000	$2,260,000	$1,677,742	$7,157,742
Citigroup	$8,480,000	$3,830,000	$593,501	$12,903,501
Consumer Bankers Association*	$2,494,000	$1,238,000	$23,975	$3,755,975
Countrywide Financial Corporation	$1,323,000	$706,000	$295,813	$2,324,813
Financial Services Roundtable	$6,380,000	$4,360,000	$256,829	$10,996,829
Huntington Bancshares	$100,214	$143,483	$112,800	$356,497
Ind. Community Bankers of America	$3,428,985	$2,060,000	$694,667	$6,183,652
Mortgage Bankers Association	$2,988,387	$2,364,683	$622,175	$5,975,245
Wachovia	$1,360,000	$925,000	$662,152	$2,947,152
Total	$36,146,234	$22,466,323	$7,066,642	$65,679,199

Source: Center for Responsive Politics

* includes only contributions from political action committee

The Mortgage Bankers Association (MBA) lobbied hard against the proposal. "Giving judges free rein to rewrite the terms of a mortgage would further destabilize the mortgage backed securities market and will exacerbate the serious credit crunch that is currently hindering the ability of thousands of Americans to get an affordable mortgage," said Kurt Pfotenhauer, Senior Vice President for Government Affairs and Public Policy for MBA.[22]

However, Adam J. Levitin, Associate Professor of Law at Georgetown University Law Center evaluated MBA's claim based on housing market research. "There is no empirical evidence that supports a conclusion that permitting either strip-down or other forms of modification of principal home mortgage loans in bankruptcy would have more than a minor impact on mortgage interest rates or on home ownership rates… MBA's claim of an effective 150-200 basis point increase from allowing strip-down is groundless."[23]

Other academics also weighed in on the proposal by comparing it to the financial crisis in the farming industry almost thirty years ago. During the 1980s, many family-owned farms in the Midwest faced a financial crisis that also forced families to seek bankruptcy protections. As part of the response to that crisis, Congress passed the Family Farmer Bankruptcy Act of 1986, which created a new Chapter 12 bankruptcy to amend the Bankruptcy Code. According to Professor Susan A. Schneider at University of Arkansas School of Law, an expert in agricultural law and farm finance and bankruptcy: "[T]he concerns raised in opposition to Chapter 12 did not materialize in any respect. The availability of credit to the agricultural sector has increased over time, not decreased. Interest rates did not increase because of the availability of Chapter 12. Instead, like other loans they have consistently reflected over-all market conditions."[24]

Senator Durbin attempted to attach the bankruptcy bill to the larger Senate housing package as an amendment. It was voted down by a vote of 58 – 36. Some members who cosponsored the original housing legislation, such as Sen. Joseph Lieberman (I-CT), later voted against the bankruptcy provision in the stand-alone bill. Many of the financial services corporations are based in Connecticut – two of the top five contributors to Sen. Lieberman since 2003 are Lehman Brothers ($154,650) and the now-defunct Bear Stearns ($103,260). The House version was never even considered on the floor.

Even with passage of the recent housing bill, Congress has not passed any legislation in response to the mortgage meltdown and housing crisis that the lending industry has opposed. After all that has come to light about the abusive lending practices of the financial industry to vulnerable American families, Congress still seems afraid to move aggressively. The housing package President Bush just signed into law does not include any changes to Bankruptcy

Code, sticking instead to a system of voluntary modifications by the lending industry, albeit with tax dollars to help pay for some of the losses.

Fannie and Freddie

The Federal National Mortgage Association, nicknamed Fannie Mae, and the Federal Home Mortgage Corporation, nicknamed Freddie Mac, invested more than any other company in risky subprime loans that were being securitized and sold on the secondary market,[25] despite the warnings of groups like National Consumer Law Center and Consumer Federation of America. This had the effect of bestowing subprime-backed securities with more legitimacy while also shrinking the market for more sound investments.

Until their collapse and government takeover, both companies had managed to avoid government intrusion even though they have been at the center of controversy before. Both have had multibillion-dollar accounting scandals. In 2003, Freddie Mac understated billions in profits to smooth earnings reports. In 2004, the Securities and Exchange Commission ruled that Fannie Mae had overstated profits by an estimated $9 billion. The housing bill also leaves management of Fannie and Freddie untouched and imposes no penalties on their shareholders.

In 2004, the chief risk officer at Freddie Mac reportedly told the CEO at the time, Richard F. Syron, that the company was exposing itself to the possibility of significant losses by purchasing too many risky loans thanks to a loosening of underwriting standards. Mr. Syron increased subprime mortgage purchases against the recommendations of his staff. Mr. Syron, who left the job in 2005, received $38 million in total compensation since 2003, even as Freddie Mac lost $80 billion in shareholder value – largely as a result of investments made during Mr. Syron's tenure.[26]

Former member of the House Financial Services Committee Jim Leach (R-IA) has long advocated reining in the two companies, describing Fannie and Freddie in October 1991 as "an arrogant, two-headed monopoly, controlling 90 percent of the market."[27] In a recent statement titled, "Fixing Fannie and Freddie," Leach writes:

> The legislated perks granted Fannie Mae and Freddie Mac are of a multi-billion dollar yearly magnitude and the regulatory advantages they enjoy magnify the capacity of each to grow. It is no accident that no commercial companies in the past generation have had as muscular a lobbying operation on Capitol Hill. When, for instance, I once introduced a battery of constraining amendments, including a doubling of capital requirements, to legislation favorable to Fannie and Freddie, it took each less than 48 hours to orchestrate both parties' leadership to weigh in against trimming their wings of privilege.[28]

To some extent, Fannie and Freddie were proxies for the entire financial services industry. They own or guarantee about half of the country's $12 trillion in mortgage debt and have the most extensive network of connections with lawmakers and government officials of perhaps any other companies. They invested more than $400 billion in dicey subprime-backed securities over the last several years; further inflating the mortgage bubble, and now the government has been forced to assume the losses.

Contributions and Lobbying: Freddie Mac

Cycle	Contributions	% to Democrats	% to Republicans	Lobbying	Total
2008	$483,667	55%	45%	$12,970,000	$13,453,667
2006	$648,802	46%	54%	$21,424,048	$22,072,850
2004	$211,988	60%	40%	$33,280,000	$33,491,988
2002	$4,176,674	43%	57%	$16,960,000	$21,136,674
2000	$2,466,539	43%	57%	$8,060,000	$10,526,539
Total	$7,987,670	49%	51%	$92,694,048	$100,681,718

Contributions and Lobbying: Fannie Mae

Cycle	Contributions	% to Democrats	% to Republicans	Lobbying	Total
2008	$916,250	62%	38%	$7,010,000	$7,926,250
2006	$955,250	53%	47%	$20,240,000	$21,195,250
2004	$794,024	62%	38%	$17,490,000	$18,284,024
2002	$2,394,750	51%	49%	$13,647,000	$16,041,750
2000	$1,591,757	54%	46%	$14,030,000	$15,621,757
Total	$6,652,031	56%	44%	$72,417,000	$79,069,031

Source: Center for Responsive Politics

In 2006, the Federal Elections Commission fined Freddie Mac $3.8 million for violations of the Federal Election Campaign Act (FECA) when it held 70 campaign fundraisers – raising about $1.7 million – mostly for members of the House Financial Services Committee.[29] Since the 2000 election cycle, the two companies spent roughly $180 million on lobbying and campaign contributions. In the first six months of 2008 alone, Fannie Mae and Freddie Mac spent a combined total of about $7.4 million on lobbying and hired more than 40 outside firms.[30]

Fannie and Freddie have been a forceful presence in Washington, advocating for the principles of light government regulation of the financial services and real estate industries even in the face of gathering threats. In February, then-CEO of Fannie Mae Daniel Mudd submitted testimony to the Senate Banking Committee imploring members to give the company flexibility during the housing crisis.[31] Like many of the companies in the financial services industry, Freddie and Fannie were "double-givers," donating large amounts to members of both parties, especially those who sit on the committees with jurisdiction over their industry – the House Financial Services Committee and the Senate Banking Committee. Since 1998, the two companies have donated $3.8 million to current members of Congress.[32]

The story of the housing bubble and meltdown that now threatens the homes and communities of literally millions of Americans is largely about political power. The financial services industry focuses its lobbying efforts around its immediate desires, and for more than the past decade, this focus has been on relaxing regulation of the mortgage lending and securitization market. The result has been the creation of a system that had encouraged lenders to extend loans to borrowers which may ultimately lead to an overextension of the homeowner's finances and foreclosure, but for which the neither the broker, lender nor securities purchase can be held liable for at that later time of distress.

While there may be other remedies to the housing crisis – indeed, more are needed – the inability of Congress to break through the wall of money built by the financial services industry to help struggling families is striking. In the end, the lending industry has carried the day, as it has before. In our political system, where the politicians are elected with private money, the merits of any policy position are largely measured by the ability of its proponents to back it up with millions of dollars in contributions and lobbying. This is why, with almost limitless resources to devote to lobbying and campaign contributions, the financial services industry will always win.

Endnotes

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