Government warned of mortgage meltdown

Regulators ignored warnings about risky mortgages, delayed regulations on the industry.
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WASHINGTON (AP) -- The Bush administration backed off proposed crackdowns on no-money-down, interest-only mortgages years before the economy collapsed, buckling to pressure from some of the same banks that have now failed. It ignored remarkably prescient warnings that foretold the financial meltdown, according to an Associated Press review of regulatory documents.

"Expect fallout, expect foreclosures, expect horror stories," California mortgage lender Paris Welch wrote to U.S. regulators in January 2006, about one year before the housing implosion cost her a job.
Bowing to aggressive lobbying -- along with assurances from banks that the troubled mortgages were OK -- regulators delayed action for nearly one year. By the time new rules were released late in 2006, the toughest of the proposed provisions were gone and the meltdown was under way.

"These mortgages have been considered more safe and sound for portfolio lenders than many fixed-rate mortgages," David Schneider, home loan president of Washington Mutual, told federal regulators in early 2006. Two years later, WaMu became the largest bank failure in U.S. history.

The administration's blind eye to the impending crisis is emblematic of its governing philosophy, which trusted market forces and discounted the value of government intervention in the economy. Its belief ironically has ushered in the most massive government intervention since the 1930s.

Many of the banks that fought to undermine the proposals by some regulators are now either out of business or accepting billions in federal aid to recover from a mortgage crisis they insisted would never come. Many executives remain in high-paying jobs, even after their assurances were proved false.

In 2005, faced with ominous signs the housing market was in jeopardy, bank regulators proposed new guidelines for banks writing risky loans. Today, in the midst of the worst housing recession in a generation, the proposal reads like a list of what-ifs:

--Regulators told bankers exotic mortgages were often inappropriate for buyers with bad credit.

--Banks would have been required to increase efforts to verify that buyers actually had jobs and could afford houses.

--Regulators proposed a cap on risky mortgages so a string of defaults wouldn't be crippling.

--Banks that bundled and sold mortgages were told to be sure investors knew exactly what they were buying.

--Regulators urged banks to help buyers make responsible decisions and clearly advise them that interest rates might skyrocket and huge payments might be due sooner than expected.

Those proposals all were stripped from the final rules. None required congressional approval or the president's signature.

"In hindsight, it was spot on," said Jeffrey Brown, a former top official at the Office of Comptroller of the Currency, one of the first agencies to raise concerns about risky lending.

Federal regulators were especially concerned about mortgages known as "option ARMs," which allow borrowers to make payments so low that mortgage debt actually increases every month. But banking executives accused the government of overreacting.

Bankers said such loans might be risky when approved with no money down or without ensuring buyers have jobs but such risk could be managed without government intervention.

"An open market will mean that different institutions will develop different methodologies for achieving this goal," Joseph Polizzotto, counsel to now-bankrupt Lehman Brothers, told U.S. regulators in a March 2006.

Countrywide Financial Corp., at the time the nation's largest mortgage lender, agreed. The proposal "appears excessive and will inhibit future innovation in the marketplace," said Mary Jane Seebach, managing director of public affairs.

One of the most contested rules said that before banks purchase mortgages from brokers, they should verify the process to ensure buyers could afford their homes. Some bankers now blame much of the housing crisis on brokers who wrote fraudulent, predatory loans. But in 2006, banks said they shouldn't have to double-check the brokers.

"It is not our role to be the regulator for the third-party lenders," wrote Ruthann Melbourne, chief risk officer of IndyMac Bank.

California-based IndyMac also criticized regulators for not recognizing the track record of interest-only loans and option ARMs, which accounted for 70% of IndyMac's 2005 mortgage portfolio. This summer, the government seized IndyMac and will pay an estimated $9 billion to ensure customers don't lose their deposits.

Last week, Downey Savings joined the growing list of failed banks. The problem: About 52% of its mortgage portfolio was tied up in risky option ARMs, which in 2006 Downey insisted were safe -- maybe even safer than traditional 30-year mortgages.

"To conclude that 'nontraditional' equates to higher risk does not appropriately balance risk and compensating factors of these products," said Lillian Gavin, the bank's chief credit officer.

At least some regulators didn't buy it. The comptroller of the currency, John C. Dugan, was among the first to sound the alarm in mid-2005. Speaking to a consumer advocacy group, Dugan painted a troublesome picture of option-ARM lending. Many buyers, particularly those with bad credit, would soon be unable to afford their payments, he said. And if housing prices declined, homeowners wouldn't even be able to sell their way out of the mess.

It sounded simple, but "people kind of looked at us regulators as old-fashioned," said Brown, the agency's former deputy comptroller.

Diane Casey-Landry, of the American Bankers Association, said the industry feared a two-tiered system in which banks had to follow rules that mortgage brokers did not. She said opposition was based on the banks' best information.

"You're looking at a decline in real estate values that was never contemplated," she said.

Some saw problems coming. Community groups and even some in the mortgage business, like Welch, warned regulators not to ease their rules.

"We expect to see a huge increase in defaults, delinquencies and foreclosures as a result of the over selling of these products," Kevin Stein, associate director of the California Reinvestment Coalition, wrote to regulators in 2006. The group advocates on housing and banking issues for low-income and minority residents.

The government's banking agencies spent nearly a year debating the rules, which required unanimous agreement among the OCC, Federal Deposit Insurance Corp., Federal Reserve, and the Office of Thrift Supervision -- agencies that sometimes don't agree.

The Fed, for instance, was reluctant under Alan Greenspan to heavily regulate lending. Similarly, the Office of Thrift Supervision, an arm of the Treasury Department that regulated many in the subprime mortgage market, worried that restricting certain mortgages would hurt banks and consumers.

Grovetta Gardineer, OTS managing director for corporate and international activities, said the 2005 proposal "attempted to send an alarm bell that these products are bad." After hearing from banks, she said, regulators were persuaded that the loans themselves were not problematic as long as banks managed the risk. She disputes the notion that the rules were weakened.

In the past year, with Congress scrambling to stanch the bleeding in the financial industry, regulators have tightened rules on risky mortgages.

Congress is considering further tightening, including some of the same proposals abandoned years ago.