The Fed fumbles

by the St. Louis Post-Dispatch

With Congress up in arms and the housing market collapsing around its ears, the Federal Reserve last week finally proposed some restrictions on the subprime mortgage industry. It was like buying a fire extinguisher after the house burned down.

Had the Fed acted three or four years ago, when consumer advocates were screaming for regulation, we might have avoided part of the current foreclosure crisis. As it is, the Fed's new rules probably will make very little difference. The subprime mortgage business is in ashes, and few such loans are being made.

The most amazing thing about the new rules is that they are so wimpy. For instance, the Fed simply could have banned prepayment penalties, which trap homeowners in high-cost loans for years when they could qualify for cheaper ones. Instead, the Fed put a five-year limit on such penalties. On adjustable rate mortgages, the penalties must expire before interest rates reset.

The Fed could have banned the sleazy practice of paying mortgage brokers a bonus when they talk borrowers into higher-rate loans, even when the borrowers qualify for lower ones. Instead, the Fed simply required that brokers reveal how they are paid.

On the positive side, the Fed now requires lenders to verify the borrowers' income. Unbelievably, that was optional until now, and lots of borrowers and brokers lied.

The new rules forbid lenders from engaging in a "pattern or practice" of making loans that borrowers can't afford to repay. That language will help state attorneys general go after shady operators, but it will do little for an individual homeowner suckered into a high-priced loan he can't possibly repay. How is an individual homeowner supposed to prove a "pattern and practice" involving hundreds of other borrowers?

That brings up another galling fact about the subprime mortgage business: Making bad loans can be a good business, so long as the loan is sold before the borrower falls behind. Most mortgages these days, in fact, are packaged into securities and sold to investors.

The new rules drew boos from liberals in Congress. "We now have confirmation of two facts we have known for some time: One, the Federal Reserve System is not a strong advocate for consumers, and two, there is no Santa Claus. People who are surprised by the one are presumably surprised by the other," said Rep. Barney Frank, the Massachusetts Democrat who chairs the House Financial Services Committee.

In fact, even though the Fed for years has had the power to regulate mortgages, it had to be dragged into actually doing it.

As early as 2000, the late Fed Governor Ed Gramlich began urging the agency to look closely at subprime lending. He wasn't the only one. Consumer groups were complaining loudly that unwary borrowers were being lured into expensive loans they couldn't afford. Newspaper editorial pages, including this one, joined in the cry for a crackdown on abusive lending.

Former Fed Chairman Alan Greenspan turned a deaf ear.

Greenspan, a self-described "libertarian Republican," has an aversion to regulation, believing that free markets work best when the government's hand is light.

That failure was one of two great gaffes in Greenspan's otherwise masterful 18-year tenure at the Fed. The other was his 2001 endorsement of the Bush tax cuts, which plunged the federal budget back into deficit.

No one really saw the subprime crisis coming. That's because the Fed and the Bush Treasury Department weren't paying attention to ample evidence that the housing boom was fed partly by monumental debt loaded onto people with bad credit and dubious ability to repay.

Not only were the Fed and the Treasury Department surprised by the collapse of the subprime contraption, but so were the chief executive officers of Merrill Lynch, Citibank and other pinnacles of finance. They invested heavily in subprime securities and now those firms are losing their well-tailored shirts. Such men get multimillion-dollar paychecks because they are supposed to be too smart to be suckered. As Fortune magazine asked on its cover recently, "What were they smoking?"

Whatever it was, they can afford it. Merrill Lynch CEO Stanley O'Neal was let go after leading his company to a $8.4 billion loss on subprime securities; he walked away with $161 million in compensation. That's on top of the $48 million he received last year while digging his company into its hole. He and other fallen princes of finance should be the poster boys for a shareholder uprising against kingly executive pay.

The Fed, meanwhile, has had an important reminder that financial markets sometimes go mad. At such times, it takes a deft touch of regulation to restore sanity.

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