

# US Federal Reserve's subprime regulations shield Wall Street banks

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21 December 2007

The US Federal Reserve Board on Tuesday proposed new regulations on subprime home loans that would ban or limit some of the most egregious predatory lending practices, while leaving undisturbed many others. Most significantly, the proposals shield US banks from any liability for their role in profiting from the victimization of home buyers and creating the housing bubble that has now imploded.

Fed Chairman Ben Bernanke announced the proposals four months after the collapse of the US housing market and the upward spiral of home foreclosures sparked a crisis on Wall Street, which is massively invested in subprime mortgage-backed securities whose market value has plummeted. In the intervening period, major US and European banks have written off some \$90 billion in subprime-linked investments, some of the biggest US banks have reported huge losses, and global credit markets have all but frozen, raising the specter of a deep and protracted recession.

With home prices relentlessly falling and mortgage rates resetting sharply higher for borrowers who took out adjustable rate mortgages, hundreds of thousands of families are losing their homes and it is estimated that 2 million more will do so over the next 30 months. Subprime loans, taken out by borrowers with shaky credit, carry interest rates far higher than those for conventional, or prime, loans. Many have adjustable rates that reset after two or three years, in many cases raising monthly payments by 30 percent.

The measures proposed by the Fed will do nothing to help the victims of past predatory lending practices or those falling behind in their payments and facing foreclosure. They are tailored to shore up the banking system and preempt tougher measures against lenders, mortgage servicers and banks that have been introduced in Congress. These measures, introduced by Democrats, are themselves extremely limited and include no serious proposals to halt foreclosures or help working class families in distress.

The new rules would require mortgage companies to show that borrowers can realistically afford their mortgages. They would also require lenders to disclose the hidden sales fees often rolled into interest payments—while not banning such

fees—and bar certain types of advertising.

Borrowers would be allowed to sue their lenders if they violated the new rules, but they would be allowed to seek only a limited amount in compensation.

The rules would prohibit so-called “no document” mortgages, in which mortgage companies and brokers sell home loans without requiring any documentation of the income and assets of the borrower. This type of mortgage fraud, designed to lure low-income borrowers into mortgages with exorbitant interest rates, became a staple of the mortgage industry at the height of the housing boom.

Subprime lending was a critical component of the housing bubble that was engineered by Wall Street banks and their affiliated mortgage companies in the first half of the decade. It went from \$136 billion in 2000 to a peak of \$660 billion in 2005 and \$635 billion in 2006. In 2006, 25 percent of new home mortgages were subprime, and more than half of these—over \$50 billion worth—were “no document” loans.

Subprime loans became by far the fastest growing segment of mortgage lending before the subprime industry collapsed.

The Fed's rules, which are slated to take effect after a 90-day period for public comment, do not ban one of the most abusive lending practices: the imposition of costly penalties on subprime borrowers who make prepayments on their loans. These provisions are designed to prevent borrowers from extricating themselves from high-cost loans and moving into cheaper, conventional mortgages. The Fed proposed only that such penalties be dropped at least 60 days before the termination of initial “teaser” rates and the onset of upward-adjusted rates.

The new rules would cover all mortgage lenders, whether banks, thrift institutions or independent mortgage companies. They would apply to any mortgage with an interest rate three percentage points or more above Treasury rates. Fed officials said that would cover all subprime loans, as well as many so-called “Alt-A” loans made to people with relatively good credit scores.

Most significantly, the Fed's proposals would assign no liability to Wall Street firms for effectively underwriting

predatory subprime loans. The major banks were the biggest players in the subprime mortgage boom. They provided mortgage companies and brokers with the capital to extend high-interest loans by buying the loans and repackaging them into securities, which they then sold to other banks and investors. They were fully aware of the predatory practices that flourished in the subprime industry. Many banks, moreover, have their own mortgage subsidiaries and affiliates that were directly involved in making such loans.

The *Wall Street Journal* on December 3 published a front-page analysis of the over \$2.5 trillion in subprime loans made since 2000 showing that “as the number of subprime loans mushroomed, an increasing proportion of them went to people with credit scores high enough to often qualify for conventional loans with far better terms.”

The study said that 55 percent of all subprime loans in 2005, the peak year of the subprime boom, went to borrowers who met the qualifications for lower-interest conventional mortgages. The proportion rose even higher by the end of 2006, to 61 percent.

The basic reason is that the mortgage industry rewarded brokers for persuading borrowers to take a loan with an interest rate higher than that for which the borrower qualified. “On average,” the *Journal* reported, “US mortgage brokers collected 1.88 percent of the loan amount for originating a subprime loan, compared to 1.48 percent for conforming [conventional] loans, according to Wholesale Access, a mortgage research firm.”

The big banks reaped massive profits from the victimization of millions of low- and middle-income borrowers. Moreover, the explosive growth of the subprime sector was a critical element in the creation of a vast edifice of inflated values based on high-risk investments that reaped returns of 20 percent or more, far more than could be extracted from investment in the production of material goods and infrastructure.

Wall Street executives, hedge fund managers and big investors added tens of millions and even billions to their personal fortunes from this entirely parasitic and speculative process, one that by its very nature was rife with fraud and corruption. Meanwhile, the productive base of society continued to be starved of investment and the living standards of broad masses of people continued to stagnate or decline.

This is why, as long as the housing and banking boom continued, neither the Federal Reserve, nor other regulatory agencies, Congress or either of the two parties sought to rein in the vast fraud that was occurring. They were all, either directly or indirectly, partaking in the spoils and supporting the activities of the financial elite to which they are entirely beholden.

It is only now, when the inevitable bursting of the speculative bubble has occurred, threatening the entire financial system with disaster, that the most minimal measures are proposed to rein in the mortgage industry. As many have observed, the practices addressed by the Fed have virtually ceased on their own because the subprime industry has ground to a halt.

As has been pointed out by the *New York Times* and other newspapers, as early as 2000 a Federal Reserve Board governor and other regulators were urging the Fed to investigate fraudulent lending practices by mortgage companies affiliated to nationally chartered banks. Then-Federal Reserve Board Chairman Alan Greenspan rejected all such proposals. When states like Georgia and North Carolina started to pass tougher laws against abusive lending practices and sought to investigate local affiliates of national banks, the Office of the Comptroller of the Currency blocked them.

Neither the *Times* nor congressional Democrats who are now denouncing Greenspan for failing to act and criticizing Bernanke’s proposals for not going far enough offer any explanation for the complicity of all levels of government in the victimization of working class and middle class families. They cannot, because predatory lending was an essential component of the speculative boom, and the housing and credit bubble was, in turn, an expression of the parasitism and underlying crisis of American capitalism itself.



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