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Congress's Investigation into the Subprime Mortgage Meltdown: The So-Called Search for the Truth

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Although the subprime mortgage meltdown threatens to shatter the U.S. economy, Congress has thus far failed to conduct an honest bipartisan investigation into fundamental forces at the core of this crisis. Indeed, rather than focusing on the root causes that Congress is best positioned to investigate and understand—i.e., the effects of Congress's own policies and legislation—a majority of those in Congress apparently are far more intent in engaging in a hunt for "villains" they can castigate and pillory for public effect.

The November elections have cast a considerable shadow over congressional investigations into the subprime meltdown, and many legislators seem to be holding hearings in order to shift blame away from the Hill and onto mortgage lenders and Wall Street. By creating a narrative in which the alleged criminal behavior of "greedy Wall Street executives"—rather misguided federal legislation—caused the current financial crisis, Congress can not only obscure its own primary role in creating the subprime meltdown, but also position itself as the American people's last best hope in avoiding further financial catastrophe. Unfortunately, Congress's insistence on uncovering "villains" behind the subprime disaster all but ensures future economic crises.

Need for Introspection. Given that the subprime market would never have existed but for certain congressional actions, Congress's reluctance to consider its own critical role in the current meltdown is inexcusable. For instance, the enactment of the Community Reinvestment Act (CRA), Congress's targets for home "ownership" (which proved to be short-lived) by low-income households that it imposed on the Department of Housing and Urban Development (HUD), and Congress's mandate on Freddie Mac and Fannie Mae to, in effect, insure low-income mortgages laid the foundation for the current subprime crisis.

To be sure, Congress was by no means the only branch of the federal government that pursued and fostered similar failed policies. The Treasury Department made a major contribution to the groundwork of the subprime meltdown by issuing tough regulations almost two decades after the CRA was first enacted. The net effect of Treasury's harsh regulations was to pressure lenders who wanted to grow—and how many could afford not to grow?—to grant effective control to housing activists over billions of dollars worth of housing loans to direct in a manner that fit their social and political agendas.

Yet despite the House of Representatives' being engaged in a round of hearings ostensibly to find the causes of the meltdown, so far not a single witness has been called who can and will testify regarding

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Congress's own primary role in the crisis. Many experts who have written on the topic would presumably be happy to explain to Congress the destructive effects of its own policies and legislation. But Congress has instead focused its attention and wrath on a cadre of financial experts at the helm of government agencies and private financial institutions. Human nature being what it is—and self-interest being no less pervasive and destructive among those who pursue political power than among those who pursue wealth—Congress's unwillingness to engage in self-scrutiny is not surprising, especially in an election year.

Congress Must Help Americans Understand the Meltdown's Root Causes. But for the CRA—and the Treasury Department regulations that gave it teeth almost two decades after its initial enactment—the subprime mortgage market would not have existed. Lenders would almost certainly have continued their centuries-old practice of lending only to those persons who were highly likely to repay their mortgages. There still might have been a significant run-up and then downturn in housing prices. But the run-up would not have been fueled by the enormous increase in demand for housing caused by Congress's creation of the subprime market. Similarly, the dive in housing prices would not have been as steep if it had not been for the astronomically high delinquency and foreclosure rates for subprime mortgages.

The subprime mortgage market essentially did not exist before Congress first enacted the CRA in 1977. In 1994, one year before Treasury issued its tough CRA regulations, the subprime market constituted less than 5 percent of the American mortgage market.[1] By early 2007, however, subprime mortgages had surged to 13.7 percent of all U.S. mortgage loans.[2]

In the seven years from 2000 to 2006, before the meltdown began in earnest, the nationwide delinquency rate for mortgages in the prime market continued to hover right around 2.5 percent.[3] By contrast, the delinquency rate in the subprime market during the same seven years rocketed back and forth between about 10 and 15 percent.[4] In other words, the subprime delinquency rate was 400 to 600 percent higher than the delinquency rate in the prime market. Less than 60 days before Lehman Brothers and AIG crashed, the delinquency rate in the subprime market was over 70 percent.[5]

This is not to say that Congress's central role in creating and developing the market for subprime mortgages is the whole story of the meltdown. It seems apparent now that rating agencies gave ratings that were far too favorable to too many poorly understood securities and derivatives based on subprime mortgages. Interest rates were, many now think, abnormally low for far too long. These low interest rates combined with an abundance of foreign capital to create an unprecedented worldwide demand for—and unprecedented worldwide dependence on—U.S. mortgage-based securities and derivatives.[6]

Ascribing the current financial crisis to alleged criminal activity, Congress can appear to be acting in the role of federal law enforcement, swooping in to investigate and punish dastardly Wall Street criminals who (allegedly) caused the whole mess. Therefore, if members of Congress can convince enough Americans they should be mad as hell at mortgage lenders and Wall Street—while paying no attention to those men and women behind the walls and columns of the U.S. Capitol—then Con-

1. Tony Favro, "U.S. subprime mortgage crisis hurts individuals and whole communities," *City Mayors*, April 14, 2007, at *http://www.citymayors.com/finance/us-subprime.html* (October 26, 2008).
2. Tim Dunne and Brent Meyer, "Economic Trends: Subprime Statistics," Federal Reserve Bank of Cleveland, April 5, 2007, at *http://www.clevelandfed.org/research/trends/2007/0407/07ecoact_040307.cfm* (October 27, 2008).
3. *Ibid.*
4. *Ibid.*
5. *Ibid.*
6. What is also probably underestimated is that state-government officials generally turned a blind eye to shoddy lending practices and possible wrongdoing in the exploding subprime mortgage market and failed to implement and enforce many well-crafted state laws and regulations that could have significantly reduced the number of mortgage delinquencies and foreclosures.

gress has secured for itself a twofold victory. Not only will Congress seem to be absolved of its own role in the current crisis, but it can take credit for doing something to avenge the large number of angry Americans.[7]

Congress's Hunt for Villains. As in past economic crises, some criminal conduct associated with the subprime market has already been unearthed. More is likely to surface as investigations proceed. But to date there is precious little evidence that criminal conduct actually *caused* the meltdown. As in previous market-wide crises, including the savings-and-loan crisis of the 1980s and 1990s, even the preliminary conclusions suggest that any criminal activity was incidental to, rather than the cause of, the crisis.

This of course has not kept Congress from claiming that the problem was caused by criminal conduct. In the past few weeks, for example, members of Congress from both sides of the aisle have leveled the following charges:

- "Literally thousands and thousands of people ended up with mortgages vastly more expensive than ones they qualified for. That is criminal in my view," said Senator Chris Dodd (D–CT).[8]
- "Are the people that have caused this, is somebody going to go to jail?" said Representative Bill Sali (R–ID).[9]
- "We have got to set an example by bringing the full might of federal law enforcement against the people who illegally profited or destroyed companies at the expense of our country." This came from a joint statement issued by Representatives Mark Kirk (R–IL) and Chris Carney (D–PA).[10]

Perhaps the most revealing comment of all came from Representative John Mica (R–FL) who—*before the hearings were even completed*—informed Lehman Brothers CEO Richard Fuld that "if you haven't discovered your role, you're the villain."[11] Mica's comments, in addition to the other above-cited quotations, reveal that, for the most part, legislators are not conducting these hearings in order to uncover facts. Instead, Congress is more concerned about convincing the public these CEOs are Gordon Gecko–style villains, while simultaneously shifting blame away from the Hill.[12]

Congress Is Reverting to Type. Congress's immediate impulse to blame policy failures on private sector criminal behavior is hardly novel. Consider the following scenario: Lawmakers blame the failure of financial institutions on an "epidemic of fraud" and an "orgy of fraud and lawbreaking." One demands that federal law enforcement "throw the book at those who stole from taxpayers by making risky and sometimes fraudulent investments with the backing of federally insured deposits." The Department of Justice initiates numerous criminal investigations into the failed financial institutions, and Congress assures the public that the leaders of these institutions will not profit from their wrongdoing.

Sound familiar? It should, but these particular quotes and facts are drawn not from the subprime mortgage meltdown, but from the savings and loan crisis of the 1980s and 1990s. Then, as now, Mem-

7. See Generally, Rachel Brand, "Making It a Federal Case: An Inside View of the Pressures to Federalize Crime," Heritage Foundation *Legal Memorandum* No. 30, August 29, 2008, at *http://www.heritage.org/Research/Legalissues/lm30.cfm*.
8. Tom Walker "Senate Dems Argue Over Financial Crisis," WTHR, *http://www.wthr.com/Global/story.asp?S=9191889&nav=menu188_2* (October 26, 2008).
9. "Greenspan Admits 'Flaw' to Congress, Predicts More Economic Problems," PBS Newshour transcript, October 23, 2008 at *http://www.pbs.org/newshour/bb/business/july-dec08/crisishearing_10-23.html* (October 26, 2008).
10. Press release, "Kirk and Carney: Triple FBI's Financial Crime Investigations," October 10, 2008, at *http://www.house.gov/apps/list/press/il10_kirk/Kirk_Carney_FBI.html* (October 26, 2008).
11. Helen Kennedy, "You're the Villain, Pols Tell Former CEO of Lehman Brothers," *New York Daily News*, October 7, 2008, at *http://www.nydailynews.com/money/2008/10/06/2008-10-06_youre_the_villain_pols_tell_former_ceo_o.html* (October 27, 2008).
12. See also Justine Rood and Tom Shine, "Lawmakers Blame Execs for Meltdown," ABC News, October 22, 2008, at *http://abcnews.go.com/Blotter/story?id=6079598&page=1* (October 26, 2008); Mike Buttrey, chief of staff for Senator Chuck Hagel (R–NE), Freddie Mac Lobbied Against Regulation Bill," Associated Press, October 19, 2008, at *http://www.msnbc.msn.com/id/27266607* (October 26, 2008); Evan Perez, "FBI Investigates Four Firms at Heart of the Mess," *The Wall Street Journal*, September 24, 2008, at *http://online.wsj.com/article/SB122221103979869021.html* (October 26, 2008).

bers of Congress blamed the widespread failure of savings and loan institutions on financial executives while downplaying Congress's own failures.

So if recent attempts to attribute the current financial crisis to criminal behavior on Wall Street trigger a sense of déjà vu, that is to be expected. After all, our nation has been down this path before. As Pulitzer Prize–winner and Presidential Medal of Freedom recipient Robert L. Bartley noted just a few years ago, Congress obscured its role in the savings and loan crisis of the late 1980s and converted the truth into a morality tale centering around one particular "robber baron" and ancillary corporate crooks.

> Various politicians caused a savings-and-loan crisis and the 1990 recession by inflating deposit insurance and leaning on regulators not to clean up thrift balance sheets. Their fall guy was Michael Milken and his supposedly malign junk bonds, which in fact had almost nothing to do with the S&L problem and have since been universally recognized as a legitimate financing tool.… Prosecutors and politicians want scapegoats, and often have the collaboration of businessmen.[13]

And as another white-collar expert recently noted, the eight members of the bipartisan National Commission on Financial Institution Reform, Recovery and Enforcement concluded in their final report that "fraud was not the cause of the S&L debacle."[14] Indeed, after the S&L crisis cooled down, economic and legal experts who had no political capital or reputations at stake in the S&L crisis took a cooler, more reflective look to see whether it was caused by criminal conduct. The main factors they found were economic: abnormal interest rates, inflation, and precipitous declines in the real estate market. They also emphasized the role of government regulatory failures, including regulations that hamstrung financial institutions from using market forces to protect themselves and their customers.

Despite the overwhelming evidence that criminal behavior was not the driving force behind the S&L crisis, history nevertheless repeats itself. The Justice Department recently reported that it alone has at least 26 companies under investigation, including inquiries into failed behemoths American Insurance Group, Lehman Brothers, and those creatures of Congress themselves, Freddie Mac and Fannie Mae. Criminal charges are possible in each case and could perhaps be warranted.

Yes, some criminal activity was uncovered by the S&L investigations. But most of it consisted of highly technical "books and records" violations, bank insiders exploiting market problems to derive personal profit, or desperate and misdirected efforts to forestall institutions from failing. There was little or no good evidence that criminal conduct had anything to do with *causing* the S&L crisis. At most, it was a symptom of the market's distress.

And there's no hard evidence this time around—not yet, anyway—that corporate criminal misconduct (as opposed to mismanagement) had much to do with the mortgage meltdown and current financial crisis. But that has not stopped the calls from Congress to get tough and punish the criminals who caused this crisis.

Toward a Solution. Congress is uniquely positioned to investigate and help Americans understand the root causes of the current economic crisis. Influential members of Congress thus must immediately exercise the courage to put the American taxpayer first and conduct an honest investigation. Such an investigation must include discussion of the congressional policies and legislation that created the subprime market. The goal of these investigatory hearings thus must be not only resolving the current crisis, but preventing future meltdowns. An honest bipartisan discussion devoid of scapegoating is the only way to realize this goal.

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13. Robert L. Bartley, "Businessmen in the Dock: How to tell if we're in a recession," *The Wall Street Journal*, May 6, 2002, at *http://www.opinionjournal.com/columnists/rbartley/?id=110001668* (October 24, 2008).
14. Abbe D. Lowell, "Don't Overstate Crimes," *The National Law Journal*, October 27, 2008, at *http://www.law.com/jsp/nlj/PubArticleNLJ.jsp?id=1202425504001* (October 27, 2008).

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