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Opinion

Meltdown should be investigated

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By Joseph R. Pitts, Guest Columnist

Congress has taken the unprecedented step of authorizing the Treasury secretary to spend $700 billion in taxpayer money in order to shore up troubled financial institutions.

Congress has acted. It is now up to the Treasury, the Federal Reserve, and other agencies to use the tools Congress has given them to stabilize markets and revive our economy. Congress must also fully investigate the causes of this crisis to ensure mistakes are not repeated and to make sure wrongdoers are held to account.

I agree with those who say greed on Wall Street is to blame. But government's own involvement in the market had a great deal to do with creating and encouraging the subprime market which has produced so much toxic debt, eroding the value of many banks.

In 1977, Congress passed, and President Carter signed, the Community Reinvestment Act (CRA). The CRA was intended to encourage banks to help meet the credit needs of communities in which they operate, including low- and moderate-income neighborhoods. Activist groups like ACORN began challenging banks in court, forcing them to reduce lending standards in order to remain compliant with the law.

During the '90s, President Clinton's Department of Housing and Urban Development (HUD) pressured Fannie Mae and Freddie Mac to expand these subprime mortgages until half of their portfolios were made up of the risky loans.

Fannie and Freddie were able to hold this much risky debt because investors understood that the institutions had the backing of the federal government. It was believed, and ultimately became true, that the federal government would not let Fannie and Freddie fail. No other private financial institution would have been able to access capital at the rates Fannie and Freddie did, and investors would never have been willing to accept the level of risk that Fannie and Freddie embraced without the implicit backing of the federal Treasury.

These expanding subprime mortgages were bundled with other, less risky mortgages and sold off to financial institutions around the world as "mortgage-backed securities." When the housing bubble burst, prices fell and foreclosures increased.

The fallout spread through the financial system, following the path the bundled mortgages had taken. Financial institutions found themselves holding billions of dollars in toxic debt.

There were political leaders along the way who saw the risks of this situation and called for reform. Unfortunately, they were thwarted in their attempts at reform, often by powerfully placed politicians who had received millions of dollars in campaign donations by Fannie and Freddie. That's right: quasi-government enterprises spent millions of dollars lobbying members of Congress to keep from being reformed so that they could continue to make risky investments with the implicit backing of the federal Treasury. During this time, the profits of Fannie and Freddie went to private stakeholders, even though the taxpayers are now on the hook for their losses.

Several high-profile congressmen have been among the largest recipients of campaign donations from Fannie and Freddie, as well as the greatest defenders of the subprime model that eventually led to the current credit crisis. In 2005, I voted on the House floor for an amendment that would have improved the regulatory structure of Fannie Mae and Freddie Mac, giving the regulator responsible additional authority to review and adjust Fannie and Freddie's portfolios in order to protect against systemic risk to our financial system. The amendment failed. In 2001, the president identified Fannie and Freddie as a "potential problem" and noted that any problem with them could "cause strong repercussions in the financial market."

At every turn, Fannie and Freddie's congressional apologists stepped in to assure the public that the financial institutions were financially sound and that there was nothing wrong with their financial model. They simply touted the benefits of increased homeownership and refused to use their oversight committees to carry out the necessary due diligence to prevent this disaster from getting so big and spreading so far.

There is no doubt financial institution executives should have been more vigilant in their buying and selling of mortgage-backed securities that contained risky subprime mortgages. The banks that offered the mortgages are culpable as well, in addition to the individuals who borrowed more than they could pay back. But it is important that we not lose sight of the political leaders who pushed Fannie and Freddie to expand the subprime market and then the leaders who stood in the way of reform once they became dangerously committed to the risky debt.

Government involvement in the market had more to do with creating this situation than government ignoring the market. If we fail to understand this, and hold accountable the political leaders that helped to create the situation, then we are doomed to repeat this disaster.

(U.S. Congressman Joseph R. Pitts of East Marlborough represents the 16th District.)

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