Euphoria, *not* Mortgage Brokers, Caused Housing Crisis

By Charles M. Miller

The cover story in the November 2007 issue of CBA Report was titled "Predatory Lending: A New Order of Slavery." The strongly worded article concluded that a class of "economic slaves" is being created by the deflating housing bubble.

The alleged victims are the homeowners who have faced or will face foreclosure as housing prices decline. The villains, who were said to being castigating Ohioans to economic slavery, are the mortgage originators and lenders who funded the mortgages. This article responds to two concepts raised in the November article.

The idea that the American financial system is used to create a class of economic untouchables who will not be able to escape the bonds of poverty is not an accurate description of our financial system, which strives to provide credit access to all classes. Using the term "slaves" to describe individuals undergoing a home foreclosure demeans the experience of those who suffered physical enslavement in America's past and the modern-day victims of human trafficking. Similarly, the term also derogates the individuals facing foreclosure as belonging to a caste of the economically doomed.

Although mortgage brokers are a tempting target to be labeled as "probably the sole cause of" the mortgage crunch, the causes are many. Ironically, the root cause of the current housing crisis is the overwhelming desire in this country to maximize the number of people who live the American dream by owning their own homes. This strong desire led to lenient lending standards, which in turn led to speculation in the housing markets, which created the home price bubble that is now deflating.

As interest rates fell earlier this decade, more and more individuals were able to afford to own their own homes. The pool of individuals who were left out became increasingly riskier. To continue the politically popular expansion of homeownership, the lending rules were relaxed. For example, a twenty percent down payment was no longer required to purchase a house. Down payments decreased from 20 percent to 10, to 5, and finally to zero — meaning a person could buy a house without putting any money down. In addition, stated income loans — where the borrower does not document the level of income he claims — became more prevalent.

A low down-payment or no down-payment loan permits a person to purchase a house he or she could otherwise not afford. Those loans are particularly helpful to young first- time homebuyers and others without sufficient savings to afford a down payment even though the person has a sufficient income stream to afford the monthly payments.

These loans are riskier to the lender, however, because the home purchaser has little financial interest in the property and the lender has no cushion if the loan goes bad. Because of the heightened risk, these loans had correspondingly higher interest rates, mandatory mortgage insurance premiums and related fees. The availability of these loans is now being constricted, as it should be. However, these loans should not be completely eliminated as they are important tools for low-net-worth individuals to purchase a home in high-priced markets such as New York, Miami and southern California.

Expansion, Higher Prices

As the housing market continued to expand, and housing prices continued to climb, riskier and riskier loans were being made. Low down-payment loans began being combined with other high-risk features, such as interest-only payments, stated income qualification, negative amortization, and buy-down interest rates. The euphoria created by double-digit home value increases in some areas of the country fed the desire for these exotic loans. Borrowers were permitted to qualify for loans based upon the ability to make the initial monthly payments instead of the higher payments that would likely follow a few years later. Essentially, these loans were made based on forecasts that property values would continue to increase at a rate that would permit these loans to be profitable both for the lender and the home purchaser even if the purchaser later refinanced the loan or sold the house.

These loans were short-term means by which to finance long-term positions

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(houses). The wide availability of these loans contributed to the bubble. When housing prices stopped their rapid ascent and began to decline, the loans could not be refinanced and the houses could no longer sell for enough to cover the loans.

As the housing bubble deflates, it is not surprising that the loans that are the most likely to fail are the risky mortgages in which the borrower has little invested. Many of these risky loans were made to sub-prime borrowers. This does not mean that the sub-prime borrowers have been victimized or enslaved. Banks as far away as Germany are reeling from the losses they sustained through investing in collateralized debt obligations (CDOs) formed when the mortgages were pooled and sold.

The most prominent example of the expansive impact of the housing bubble is Citigroup. The world's largest bank recently sold 5 percent of itself to Abu Dhabi to cover a $6.8 billion writedown Citi has taken to cover its mortgage losses. Before the crisis ends, the total losses to lenders is expected to exceed $150 billion. The lenders face large losses.

The overall housing market has seen a 5 percent reduction in value. The capital markets are nearly frozen. Local governments will see tax bases dwindle. Some cities will battle increased blight. The economy as a whole has taken a major hit. Thus, while the borrowers who are forclosed upon certainly suffer, they are not alone.

We are in the middle of a housing downturn at the end of a housing boom. The pains associated with a downturn are being felt far and wide. The housing bubble was caused by a euphoric housing market spurred by the easy availability of short-term loans — not by mortgage brokers.

The November article also highlighted a CBA program called Credit Abuse Resistance Education (CARE). CARE is designed to teach financial responsibility to high school and college students just as they enter the consumer credit markets. This program educates these students in the responsible use of credit and warns them of the perils of poor financial decisions. I suggest all of you encourage local educators to contact the CBA to have the program taught at their school.

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