USA: The Housing Mess

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Contents

DESPITE RECENT CNBC and MSNBC media hosts suggesting we may be at the 'bottom' of the housing market crisis, and Market Watch June 3rd commentary headlines like "Housing market may turn more quickly than you expect," statistics continue to say otherwise, in sobering fashion.

The first quarter of 2008 revealed another round of record drops in housing prices, and foreclosures seem unstoppable. The Fed has tried to alleviate the crisis by lowering rates, while battling oil and food price inflation and a weak dollar, and buying $30 billion of risky subprime assets from the now-defunct, but once top-of-the-subprime-game investment bank, Bear Stearns. That will only serve to prolong the problem under the guise of its solution.

As we march toward the post-primary presidential election, campaign rhetoric will settle on how to "fix the economy" — without analyzing the cause of the housing credit crunch that weakened it. The one, albeit dim, light at the end of the tunnel, is that Congress is attempting to send some life-boat legislation to sinking homeowners and borrowers, despite a veto promise by President Bush who feels that helping homeowners is a bad use of taxpayer money, as compared to say, helping banks.

But, the legislative 'why' of our housing fiasco remains largely uninspected. As politically advantageous as it might be to project otherwise, nothing happens by sheer chance when Washington legislation and banking deregulation collide. No matter how much blame is placed on abstractions like: "the economy" or "falling house prices" the roots of this crisis can be traced to Congressional decisions made and erased over the past four decades.

Sex, Drugs, and Truth in Lending

The year 1968 will forever hold a mystique of pronounced public intensity laced with despair and hope. It was the year of the Civil Rights Act, the Beatles' Grammy, title-topic of Tom Brokaw's recent bestseller and highlighted on the History Channel's epic, "One Year Changed the World Forever." The number of soldiers on the ground in Vietnam peaked, as did antiwar protests. Bobby Kennedy and Martin Luther King were shot.

What stability existed came from an economic place. Companies enjoying a period of expansion bestowed benefits on their staff, unemployment was at a 15-year low of 3.3%, wages were increasing, and fluctuations in interest rates resembled a coma patient's heart-monitor.

In that spirit of public advocacy, Senator Paul Douglas passed the 1968 Truth in Lending Act (TILA), requiring creditors to accurately and uniformly disclose terms to borrowers, protecting consumers from dishonest or abusive lending practices.

This harmonious time changed rapidly as interest rates nearly tripled between the late 1970s and early 1980s. Bank prime loan rates leapt from 8% in January 1978 to a high of 21.5% in December 1980 and stayed there through 1981. Commercial banks got nervous. Their funding costs were rising well above what they could charge borrowers for their capital; something had to be done.

Sighs of relief proliferated in the industry when the 1978 Supreme Court Marquette decision (Marquette National Bank vs. First of Omaha Corp.) released national banks from state-imposed usury rate restrictions, meaning they could re-locate lending operations to states where the interest rate sky was the limit. Citibank, among others, high-tailed operations to South Dakota. Other states, like Delaware and Utah, also deregulated rates to garner banks' business with limited consumer protections.

Transition to Free-Market 1980s

But federal focus was elsewhere: in fire-fighting, not long term planning mode. In 1979, the Carter administration was issuing gasoline price controls to thwart a second wave of spiking gas prices. The nation was careening towards a broader credit crunch. Congress had to react. The solution? Give the Fed more power, and take down some more banking system barriers.

So Congress passed the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA.) It eliminated usury caps for first mortgage loans and put state chartered banks and federal savings associations (S&L's) on the same footing as national banks, unleashing a race to the lending bottom.

Meanwhile the banking industry was fending off various litigation proceedings for violations of the Truth in Lending Act that transpired as rates were rising. They lobbied and got a "simplification" of that act which had the effect of making murky loans appear more legally compliant, and opened doors for further violations.

But that wasn't enough deregulation; lenders wanted to create less traditional mortgages, to be competitive, flexible, and profitable. In 1982, Senator Fernand St. Germaine (D-RI) obliged, passing the Alternative Mortgage Transaction Parity Act (AMPTA). The act allowed lenders to construct complicated products, not just on first mortgages, but any mortgage. This immediately introduced another risk element to the market. When lenders were limited on rates and terms, so was their profit so they had to ensure borrowers could pay back their loans. Without limits, lender and borrower risk grew.

With fewer constraints on their lending activity, commercial banks began consuming traditional Savings and Loan (S&L) territory, especially mortgages. S&L's resorted to shady practices to stay in the game, but high rates, stripped-away business, and fraud pushed the industry to crisis in the late 1980s. The government stepped in to bail out the institutions that were left, but the damage was done, and the fractious, deregulated nature of lending grew.

Newt, Clinton and the Roaring '90s

In the early 1990s wake of the S&L crisis, lower interest rates spurred a new class of finance companies who based their lending on refinancing and home improvement loans (a larger repeat of which occurred at the start of the new millennium). They set about enticing borrowers into multiple refinancing and home equity loans, which appeared on their books like newly originated mortgages, increasing their market share, and targeting the elderly, low-income families and minorities, with egregious abusive loan terms.

Increasing public unrest about this matter forced the House Committee on Financial Services to pass The Home Ownership and Equity Protection Act of 1994 (HOEPA) to cap the most outrageous loans. It was not perfect, but was still the last piece of legislation in the 1990s (or since) to regulate appalling lending practice. But, there was an unintended consequence. Lenders didn't want to be subject to HOEPA loan restrictions, so they began making loans just below HOEPA triggers.

This shift from very high-interest to subprime loans (just below the triggers), marked the start of subprime lending. Concurrently in 1994, securitization of subprime loans began its dramatic ascent, with a volume of $11 billion in 1994, ultimately skyrocketing to $508 billion in 2005.

In retaliation to HOEPA, the banking industry successfully lobbied for less restrictive acts including, in 1996, more Truth in Lending Act Amendments shepherded by Wall Street and Real Estate industry favorites, Senator Connie Mack (R-FL) and representative Bill McCollum (R-FL).

No one in Congress paid attention to the possible ramifications of less accountable lenders. During the late 1990s and into the new millennium, dot com fever raged, the federal budget stood at a surplus, and the stock market raged. Merger mania engulfed Wall Street, ignited by the 1999 repeal of the 1933 Glass Steagal Act that had once kept commercial and investment banks from merging. Those newly larger supermarket banks, like Citigroup, had to find ways to stay at the top of their league tables (the Billboard charts for finance) in terms of originating deals, so they started merging corporations in record volumes, piling them on with cheap debt to finance these marriages. At first, this had the effect of making the new companies stock prices soar, and citizen market investments, on paper, created enticing illusions of wealth, which did not go unnoticed by the same lenders and banks. Home prices escalated.

Home equity and second mortgage loans flourishing as homeowners were encouraged to tap into the equity of their rising home values to fund other aspects of their lives. At the same time, investment banks were securitizing, repacking and reselling loans, without caring about the standards of any one loan. They bought and sold in bulk.

Nor were the investment banks legally responsible for whether any borrower at the bottom of their food chain couldn't afford mortgage payments, or lost their home. Unregulated mortgage brokers took advantage of the deregulated environment to offer esoteric products, and banks were happy to keep collecting and trading the loans for profit.

The Inevitable Subprime Crisis

The end of Clinton's last term was rife with failed attempts at regulation and deregulation intensified into Bush "ownership society" years. But it was initially camouflaged by the dramatic interest rate cuts of Alan Greenspan's Fed.

Between January 2001 and July 2003, the Fed cut rates 13 times, bringing them to their lowest levels since1958, and making cheap debt even easier for banks to extend.* And as debt-laden corporations started going bankrupt (a.k.a. Enron), banks turned from corporate to home-based lending with that cheap money, trading the securities collateralized by these home related loans, with no regulations on that trading.

Foreseeing the coming calamity that this new demand for loans could spur more abusive loans, including what became the subprime catastrophe, Senator Paul Sarbanes (D-MD) and Rep. LaFalce (D-NY) tried to push several versions of the Predatory Lending Consumer Protection Act through, including stronger HOEPA legislation. Each attempt died in committee.

Sarbanes' legislation would have brought HOEPA triggers down so they would cover more loans, and cut the origination fees that lenders could charge. That way profit would have had to come from payments instead of points and fees and oddities. But neither political party wanted to constrain the free markets. Nor did the finance community and their media mouthpieces.

After that, the sector really took off; particularly the subprime affiliates of banks operating under the umbrella of a bank holding company. Consumers had the impression they were regulated like a bank since they shared the bank's name. They considered their lenders to be requisitely safe.

Unabated by regulation and feeding Wall Street appetite du jour, subprime loan volumes tripled from $500 billion 2001 to $1.5 billion in 2006, or from 5% of the overall mortgage market to 15%. Home equity loans ballooned simultaneously.

By the spring of 2005, interest rates were rising and borrowers were nearing the end of their home equity faucets as equity was tapped out, home values starting leveling off, and the first wave of adjusting upward in mortgage loans was coming through But those adjustable rates ultimately kicked in.
Borrowers payments suddenly increased by 25% to 30% just as housing values were faltering.

If that weren't bad enough, on that brink of crisis, commercial banks and credit card companies were lobbying hard to make it more difficult for consumers to declare bankruptcy (unlike corporations who often benefit from the process.) In a major coup to the industry, Senator Charles Grassley's (R-IA) passed the Bankruptcy Abuse and Consumer Protection Act of 2005.

Prior to that act, if a borrower's asset was valued at less than the amount owed on it, a borrower would only have to pay the current market value on that asset. That caveat for primary homes had been the only way to force all interested parties — borrowers, lenders and secondary securitization and trading institutions — to the table to negotiate reasonable solutions and terms for ailing borrowers before bankruptcy.

Where Do We Go Now?

Three years later, on April 11, 2008 Senator Durbin tried to pass an amendment to reinstate this consumer protection on one's home. It failed on the floor. A month later, the House Relief Bill of Barney Frank (D-MA) passed, which would provide $300 billion in additional funding (or half an Iraq war) to struggling homeowners for new Federal Housing Administration loans. Separately, it would ask lenders to accept certain losses on original mortgage loans, enabling homeowners to refinance into an affordable mortgage to avoid foreclosure.

Senate Banking Chairman Chris Dodd's proposed fix was similar, where lenders could chose to take part in a voluntary program in which they would receive 85% of the current assessed value of the house, while the borrower would receive a refinanced loan equal to 90% of that new assessed value. The plan would be financed with a fee imposed on Fannie Mae and Freddie Mac portfolios.

Neither bill was perfect, though both attempted to help struggling borrowers. They didn't eradicate the source of the subprime problem: the lack of enforceable regulation to deter lenders from extending non-transparent loans to those least able to afford their hidden time bombs. That would entail strengthening a very weakened Truth in Lending Act. They didn't install legislation to ensure every Wall Street speculator along the subprime chain has legal accountability for their role in perpetuating the creation and trading of these loans. And, they both faced a presidential veto.

The uphill battle to fix the housing crisis should minimally understand its legislative roots, and that serious regulation is needed. Yes, it's imperative to help those in immediate foreclosure danger, to force (not ask nicely for volunteers) lenders to negotiate loan terms before foreclosure, to assign full responsibility for loan integrity and suitability to every single actor in the loan creation and trading chain. It is a must to tighten capital requirements, suitability and transparency standards through real enforcement, not merely oversight power. These remedies would help solve a problem that has festered for three decades, and ensure that reincarnations don't keep occurring.

P.S.

* Against the Current, July/August 2008, No. 135.