Soaring prices, risky mortgages

Is the US housing boom turning toward bust?

César Uco
6 August 2005

Recently released economic data suggest that the five-year-old housing boom may be coming to an end. With the US economy increasingly dependent on the real estate sector, some experts are expressing concern that the end of the housing boom carries with it the danger of throwing the country into the greatest economic crisis since the Great Depression of the 1930s.

At the center of the danger that the real estate "boom" will turn into "bust" are the new, unconventional risky mortgage products used by lenders to sell houses to families of moderate-to-low incomes, who otherwise would find it difficult to qualify for more secure 30-year, fixed-rate amortizing mortgages, traditionally used by working families to buy homes since the 1930s.

As the *Wall Street Journal Online* explains, the housing boom has been sustained by the "onslaught of creative mortgage products—from interest-only loans to adjustable-rate mortgages carrying starter rates as low as 1 percent-that have allowed buyers to keep initial payments down even as home prices have soared."

After these low interest rate mortgages had kept monthly payments low over the last three years, a first sign of a slowdown appeared when the average monthly payment for jumbo mortgages (loans above $360,000) climbed to $2,338 in the first quarter of this year, from $2,060 in the fourth quarter of 2004, according to a Bear Stearns analysis.

This whopping 13 percent jump in monthly payments in the short space of three months is just one more indication of an increasing crisis in the housing market, with home prices getting out of reach for average working families.

"In 41 out of 325 metro areas nationwide, home prices were so high during the first quarter that someone earning the median income couldn't afford a median-priced home based on traditional lending standards.... Home-price appreciation outpaced income growth in 38 of the 50 states and the District of Columbia in the 12 months through March.... Nationwide, home prices rose 6.7 percentage points faster than incomes during this period, according to the Federal Deposit Insurance Corp," writes the *Wall Street Journal.*

However, in spite of signs of trouble, home sales continue to rise nationwide. Recently, the National Association of Realtors (NAR) changed "its forecast of existing-home sales to show a rise of 2.8 percent to 6.97 million this year, setting another record."

Surprisingly, the greatest growth is taking place in more affordable areas instead of the more wealthy communities, as one would expect.

In California, for example, with price growth leveling up in the more ritzy areas of Orange County and San Diego, less expensive areas are experiencing price increases above 20 percent. Consequently, to maintain the housing market expanding in a state where "just 16 percent of households are able to afford the median-priced home," according to the California Association of Realtors, lenders are relying increasingly on risky forms of financing.

These new product are designed to reduce initial monthly mortgage payments, thus luring buyers into buying new homes. Among these new loans are interest-rate only (IO) mortgages and a new variation of the Adjustable Rate Mortgage (ARM).

IOs are loans that permit the borrower to pay only the interest on the mortgage for a specified period of time—usually five or 10 years. During this period, the monthly payment contains no principal.

How do these loans really work? Consider as an example a 30-year loan at a fixed rate of 6 percent on $200,000.

In a regular full amortizing (FA) loan, the homebuyer will make monthly payments of $1,199. In an IO mortgage with a five-year IO period, the homebuyer will pay instead $1,000 for the first five years, that is, 17 percent less than the FA loan. In exchange for initial lower monthly payments, however, the holder of an IO mortgage will see his or her monthly payments jump once the five-year IO period ends—in our example it would rise to $1,288, an increase of 29 percent over the initial payments and of 7.4 percent over the traditional FA loan.

Adding an IO period to Adjustable Rate Mortgages (ARMs) can reduce initial payment even further. The added risk on this loan is that following the IO period the loan holder will bear the risk of any interest rate rise. In our example, if interest rates climbed to 8 percent in five years and remained stationary for the rest of the mortgage's life, our home buyer would have to make average monthly payments of $1,543 (a 54.3 percent increase) and if interest rates go up to 10 percent, he or she would have to pay $1,817 (an 81.2 percent increase).

Because IOs and IO/ARMs carry more risk, lenders should require higher standards for borrowers than the traditional FA mortgages. But this prudent rule is rarely followed. Always seeking to maximize profits, lenders have focused on homebuyers' capacity to make payments today—and worry about higher future payments—and possible foreclosures—tomorrow.

Consequently, the growth of these high-risk financing products has been spectacular. According to a recent *Fortune* magazine report, in 2001 IO mortgages made up 1.6 percent of residential mortgages. That figure ballooned to 31 percent of residential mortgages in 2004.

And in the "hottest" real estate markets (particularly on the east and west coasts) it has been reported that 70 percent of new loans are interest-only.

At the beginning of 2005, ARMs accounted for 30 percent of all mortgages, according to the Federal Housing Finance Board (FHFB). That is an increase of 50 percent over the previous year. Forecasts put the figure at 37 percent for 2005 overall.

Such spectacular growth has raised deep concerns about the future of the housing industry. Consumer advocates, for example, are warning of a lack of clarity on the part of mortgage lenders in disclosing the risks to middle class and working class families.

A new set of gimmicks, these advocates claim, is based on misinformation.

First, IOs carry a higher interest rate than the standard FA mortgage.

© World Socialist Web Site

This is needed by the lender to cover the added risk of default on the loan inherent in these products.

Second, because of higher interest rates, IO mortgages will amortize less rapidly. This means that a borrower will end up paying more in interest with an IO mortgage than with a traditional FA mortgage.

Third, if the interest paid over the IO period is very low (as low as 1 percent), it only means that the borrower is adding debt to the original loan. In other words, the bank keeps lending more money to the borrower during the IO period, a practice known as negative amortization. In order to pay back a loan bigger than the initial one, the monthly payments following the IO period will increase significantly.

Finally, consumer advocates claim that many homebuyers believe the initial rate in an IO/ARM lasts for the entire IO period. In reality, most ARMs reset the rate after one year, usually higher (in some cases up to 2 percent per year), according to a formula and/or the prevailing interest rate.

These advocates point out that loan officers don't really misinform, but they don't bother to correct the homebuyers' misconceptions.

For half a century, owning a home has been a cornerstone of the "American Dream" for millions of middle class and working class families.

The exploitation of this dream is at the heart of mortgage lenders' marketing schemes. "Skip that starter house. Get the home you've dreamed of. You deserve it," says one add.

Another come-on used is: refinance to an IO mortgage; by lowering monthly payments, you will free money to spend in other things you like or need.

For homeowners who have accumulated equity from the rise of home prices, lenders push for them to take a second mortgage. The argument employed by lenders is that these homeowners are "sitting on untapped gold mines in the property they own."

Lenders are also taking advantage of the trend to sell or refinance in five to 10 years. The problem here is that IOs don't accumulate equity and if the property has not appreciated, a homeowner will end up selling at a loss after covering closing costs.

Remorse is not a quality of mortgage lenders. Always hungry for an extra buck, they are using IOs and IO/ARMs to lure families with lower incomes or who are already in financial distress to enter the housing market.

An investigative report recently published by the *Washington Post* unmasked a series of "predatory lending" schemes and "foreclosure rings" to defraud homebuyers. It cites a recent FBI Financial Crimes Report stating that reported mortgage finance violations jumped from 4,225 in 2001 to 17,127 last year, with the amount of money lost in such fraudulent operations having doubled in the past year alone.

Though the *Post* article deals with criminal activity in the real estate industry, the line separating this activity from the methods employed widely in the industry is fine indeed.

The article points out that the real estate fraud is "fueled by loose credit and lending standards," which also facilitate the growth of IO mortgage products.

And the article indicates that these "disreputable mortgage companies target the elderly because they have built up so much home equity. They target immigrants and renters because they often understand little about buying homes." Lenders of IO mortgages also target the weakest sectors of society.

In the end, IO and IO/ARM mortgages are big bets on interest rates and higher home prices. If rates remain the same or decrease, and if income levels improve steadily, the risk of default remains low.

But if interest rates rise (which, in addition, will have a negative effect on home prices) and/or family incomes diminish for whatever reason—wage cuts, higher unemployment or inflation—there is a real danger of an avalanche of foreclosures and a severe crisis in the real estate market.

For many, the writing is on the wall. "We postponed the inevitable with these interest-onlies and negative-amortization" loans, David Lereah, chief economist of the National Association of Realtors, told the *Wall Street Journal*. "But you can't sustain double-digit price appreciation and keep homes affordable."

There are mounting indications that not all is well in the housing market, particularly for the American working class. As Michael Powell of the *Washington Post* notes in a recent article, the housing boom has "a dark side—a sharp rise in foreclosures that is destroying the single greatest generator of personal wealth for most Americans. Foreclosure rates rose in 47 states in March, according to Foreclosure.com, an online foreclosure listing service. The rates in Florida, Texas and Colorado are more than twice the national average. Even in New York City and Boston, where real estate markets are white-hot, foreclosures are rising in working-class neighborhoods.

"Should the nation's housing bubble deflate, as many economists and federal officials expect, the foreclosures could prefigure a national crisis," the *Post* writes. "Americans now shoulder record levels of housing debt—more than 8 percent of homeowners spend at least half of their income on their mortgage."

In contrast to lenders' enthusiasm to push riskier mortgage products, economists are warning against a potential disaster on the horizon.

Federal Reserve Chairman Alan Greenspan told a congressional committee last month: "The dramatic increase in the prevalence of interest-only loans" is a development "of particular concern."

These worries are well justified. As the *Wall Street Journal* article explains: "Interest-only mortgages were the standard mortgage in the 1920s, but they disappeared during the Great Depression, and for good reason ... the drop in real-estate values during the Depression pushed a large proportion of interest-only loans into foreclosure. Lenders switched entirely to fully amortizing loans, and that has been the standard mortgage loan since."

The difference between the 1930s and today, the *Journal* adds, is that "the new breed of IOs" is "more risky." Though the IO period is limited (in the 1920s it was not), attaching the IO to an ARM means mortgage owners are fully exposed to interest rate rises, thus taking on considerably more risk.

One would think that investors run the same risks as borrowers if interest rates go up. This is not quite true, however. Wall Street has developed "insurance programs"—known as Collateralized Mortgage Obligations (CMOs)—to attract investors to invest in the housing market. Through CMOs investors buy notes (the proceeds of which are used to finance the individual mortgages) that are secured by a collateral consisting of many individual mortgages.

Diversifying into a large number of IOs, which dilutes the impact of one mortgage defaulting, mitigates the additional default risk inherited in each individual IO mortgage. Further protection is derived from packaging baskets of IOs located in several geographic regions with different risk profiles. Also, investors have at their disposal derivative products to protect themselves against a drop in home prices caused by rising interest rates.

Individual homeowners have no such "insurance programs." To make matters worse, home mortgages usually give lenders recourse against the borrower's other assets, not just the house. This means that if the lender forecloses and the value of the property doesn't cover the loan balance, the lender can go after the borrower's car and bank accounts.

With more than 30 percent of the multimillion-dollar housing market being financed through IOs, a large portion of the middle class and working class is taking a huge bet on interest rates. The whole game is predicated on projections of rising home prices and continued low interest

© World Socialist Web Site

rates.

In investment banking terms, these people are holding a huge open, unhedged exposure to interest rates that no bank with a reasonable risk-management system in place would be willing—much less allowed—to take.

As a result, a significant rise in interest rates could bring about the collapse of the housing market. A wave of foreclosures would multiply the financial problems of masses of working people, already burdened by rising costs in health care and college education.

However, the impact of a housing market bust wouldn't be limited to homeowners losing their homes and possibly other assets. A housing market bust would have far-reaching consequences, affecting the whole of the economy.

For certain, it would have a huge negative effect on the job market. With 2.5 million manufacturing jobs having disappeared since 2000, the shrinking US domestic market has become increasingly dependent on the construction sector. According to economy.com, 43 percent of new jobs derive from the housing bubble, which has added 700,000 jobs nationwide over the last four years. In that period, the rest of the economy lost nearly 400,000 jobs.

A web site describing the history of the mortgage industry had this to say about the horrors of the 1930s—a useful reminder standing in sharp contrast to the pompous sales pitches of mortgage lenders:

"The economic disaster of that period pummeled the largely unregulated banking, real estate and mortgage lending industry to its knees. With little protection, many people lost their savings, jobs and homes. It was a period of vicious cycles.

"As deposit owners withdrew their funds from banks across the nation, banks and lenders were forced to curtail their lending. Homeowners could not refinance mortgages that were becoming due, while in other cases, banks were calling in loans before the end of their term.

"With no money to pay off the mortgage balance and no lender to refinance, thousands of homeowners lost their homes to foreclosure."

The growing instability related to the spectacular growth of IO mortgages at the expense of the traditional FA loan could trigger a comparable housing bust, plunging American capitalism into a profound social and political crisis with revolutionary implications.

To contact the WSWS and the Socialist Equality Party visit:

wsws.org/contact