The social toll of the US home mortgage crisis

Part 1

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The following is the first in a two-part series.

Home foreclosures in the US have reached near-epidemic scope and scale. In Detroit, there was one foreclosure filing for every 97 households in July alone, according to RealtyTrac.com, the largest database of foreclosed properties. Michigan, Georgia and California each saw about one foreclosure action per 300 households in only the last month, while Nevada continued to hold the top statewide foreclosure rate of one per 200 households during the same period.

If trends seen during the first six months of 2007 continue, cities like Detroit, Las Vegas and Riverside/San Bernardino, Stockton and Sacramento in California will see one foreclosure action per 15 households this year. Nationwide in 2006 there were 1.26 million foreclosure filings—including default notices, auction sale notices and bank repossessions—and RealtyTrac expects over 2 million in 2007.

The rapid rise in foreclosures was triggered by a slowdown in the growth of housing prices—deflation of the bubble that had been growing for 12 years and ballooned from 2001 through 2005. Although fluctuations in the housing market are difficult to track, a recent Standard & Poor's/Case-Shiller survey of 20 cities found that single-family home prices fell by 2.8 percent from May 2006 through May 2007.

According to the index, May marked the fifth consecutive month of falling prices following 13 months of slowing price growth. "At a national level, declines in home price returns are showing no signs of a slowdown or turnaround," Robert Shiller, an economist connected with the survey, told the Associated Press. The same is true of foreclosure rates, which increased by 9 percent from June to July and by 93 percent over the same period, according to figures from RealtyTrac.com.

The recent bout of foreclosures precipitated a credit crisis throughout the US and international economy as investors dumped securities possibly exposed to bad mortgage debt in mid-August. In an effort to prevent a panic, the Federal Reserve moved to provide cheap credit to banks against a broad range of collateral. However, the longer-term financial impact of the housing crisis, not to mention the recessionary implications of a systemic downturn in the housing market, remains to be seen.

A foreclosure occurs when a borrower is consistently delinquent in paying his or her mortgage. A default notice is sent out, and, if the borrower is unable to sell the property, refinance his loan, or resume regular payments within an allotted timeframe, the lender repossesses the property, along with any equity the borrower may have in it.

In theory, foreclosure should be an absolute last resort, because the borrower loses his or her entire stake in the property, not to mention the disastrous effects on the borrower's credit ratings. In a period of rising home prices it is both possible and desirable to avoid foreclosure by selling or refinancing. When home prices fall, however, it is more difficult to avoid foreclosure. If a house decreases in value by more than the value of the homeowner's equity, the borrower will be left to pay the difference if he or she wishes to sell or refinance. In such a case, foreclosure may be the only way out for a borrower who cannot afford the monthly payments and does not have sufficient savings to cover the cost of refinancing.

One would expect a decrease in home prices, as seen this year, to bring with it some rise in foreclosures. The current foreclosure rate, however, is unexpectedly large, given the relatively small decline in prices. Furthermore, foreclosure rates increased sharply in 2005, correlating roughly with the beginning of the home price growth downturn, not with the actual downturn of prices, which started around of the beginning of 2007.

The high foreclosure rate must be understood in terms of both short-term and long-term trends. In the first place, the stage of the housing boom lasting from 2001 to 2005, which saw a 20-30 percent increase in real housing prices, also saw a massive increase in speculation, predatory lending and outright fraud, which led to large numbers of people taking out unaffordable mortgages.

Speculation and fraud

From 2001 to 2005, lenders loosened their standards and gave every incentive for mortgage brokers to prioritize the quantity of money loaned out over borrowers' ability to pay it back. This not only gave an impetus to the growth of the sub-prime mortgage sector, but also led to the proliferation of "exotic" (i.e., speculative) loans to people who would otherwise qualify for standard debt instruments if the size of their mortgage were smaller.

Foremost among the "exotic" retail debt instruments popularized during the recent housing bubble is the adjustable rate mortgage or ARM, in which the borrower pays a relatively low interest rate for several years (typically three to five years), after which the rate bounces back. Adjustable-rate mortgages reached a record-high 37 percent of the mortgage market in 2005.

Another risky mortgage instrument that has grown popular in recent years is the interest-only loan. Such mortgages accounted for less than 5 percent of the jumbo loans—those totaling over $417,000—taken out in 2004. By the second quarter of 2005, this figure had grown to 25 percent. A borrower who takes out an interest-only loan delays paying off any of the principal for a period of several years, after which

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monthly payments increase and the normal amortization process begins. The borrower then owns no more or less equity than was owned at the beginning of the loan.

By contrast, negative-amortization loans, in which a borrower pays less than the accruing interest, have also grown increasingly prevalent. Borrowers who take out such loans collect negative equity; that is, they owe more money after several years of mortgage payments than when they first took out their mortgages. As an "alternative" to interest-only and negative-amortization loans, California lenders began marketing 50-year mortgages for the first time in 2006.

Mortgage brokers sought to convince borrowers—especially in states with ballooning housing markets—that real estate was a no-loss commodity; that borrowing money on unfavorable terms for properties they could not afford (i.e., highly leveraged speculation) in hopes that prices would continue to grow represented a sound "investment" strategy.

Various hucksters sprung up in seminars, infomercials and TV shows such as "Flip this House," encouraging people to "get rich on other people's money" by means of leveraged speculation in real estate. Some people succeeded in this enterprise until they were washed out by the market slowdown, which hit highly speculative markets, like Florida and California, faster than the rest of the country.

One Florida Keys real estate broker told the *Financial Times*, "People were buying places figuring they would put in a new kitchen and then flip them. It was greed. We were all in the same game." Dorothea Sandland, an agent for Remax, told the newspaper, "A lot of buyers took out second mortgages, risky loans or even special bonds because they thought they could get rid of the property very quickly." She continued, "I'm looking at condos coming to market that were bought for $259,000 when there are brand new ones next door selling for $180,000."

The great majority of people who were affected by the foreclosure crisis, however, were simply looking to buy homes under conditions where home prices had been continually increasing while their wages or salaries remained stagnant or decreased. Lenders turned a blind eye as brokers, rewarded by the size of the contracts, convinced borrowers to take out loans they could not possibly repay if housing prices stopped growing. In many cases, brokers reverted to outright fraud, lying about property values, hiding the real terms of the contracts they put forward, and charging exorbitant fees. A recent FBI report noted "a strong correlation between mortgage fraud and loans which result in default or foreclosure."

Carol Trowell, an Associate Broker at Century 21 DuPont Realtors in Detroit, blamed much of the problem on irresponsible brokers. She told the WSWS, "There was a lot of fraud, jacked up appraisals, people starting off at extremely high rates."

But brokers weren't the only ones defrauding homeowners. In one recent case, Charlotte, North Carolina homebuyers sued the construction company Beazer Homes, alleging that its lending arm misconstrued their financial information to qualify them for government-backed mortgages they could not afford. According to a local newspaper, some sections of the city with Beazer-built homes have foreclosure rates of over 20 percent, while the statewide rate is around 3 percent.

Even the lenders that did not engage in outright fraud sought to sign up as many buyers with bad credit and low incomes as possible, taking advantage of these borrowers' inability to get standard loans to charge extra fees and higher interest rates. In a period of housing price growth, this makes sense; if housing prices never fall, borrowers can sell or refinance instead of foreclosing. As far as lenders are concerned, the benefits of charging higher interest rates are not offset by increased risk in the short term.

However, this strategy falls apart as soon as the housing market cools down. As early as 2005, borrowers began defaulting in record numbers, and as home prices began tumbling, so did lenders specializing in sub-prime and "exotic" mortgages. One such lender, New Century Financial, filed for Chapter 11 bankruptcy in April of this year, and American Home Mortgage, the tenth largest retail mortgage lender in the US, folded in August.

Countrywide Financial, which had a 2005 net income five times greater than that of New Century, barely avoided collapse in mid-August when the Fed lowered its discount rate and a consortium of 40 banks offered the company an $11.5 billion emergency credit line. According to a recent survey by Fannie Mae, the average foreclosure costs the lender approximately $60,000, despite the fact that the borrower loses his or her entire stake in the property.

Lenders' difficulty with obtaining credit, fueled by concerns over the viability of mortgage-backed securities, seems to have precipitated a general reversal of previous lending policies. In a survey of large lending institutions conducted by the Federal Reserve, 67 percent of the lenders surveyed said they had raised their lending standards for sub-prime mortgages, and 47 percent said they had raised their minimum qualifications for adjustable rate mortgages. Higher qualification standards translate into greater difficulty refinancing, which in turn puts borrowers with adjustable rate mortgages in an even more precarious situation.

Under conditions of rising real estate prices and easy credit, borrowers retain the ability to sell or refinance if payments prove too high after the introductory period. But since banks are tightening their lending standards, it has become even more difficult for borrowers with sub-prime and exotic mortgages to refinance, even if their home prices have not decreased significantly.

Between falling home prices and difficulty refinancing, borrowers who were maneuvered into taking out risky mortgages find it ever more difficult to avoid foreclosure. Even up to a year ago, some nine out of ten borrowers who fell behind on their monthly payments succeeded in avoiding foreclosure by selling their houses or refinancing, according to property analysis firm DataQuick. By contrast, less than half do so now. "Refinancing is no longer easily or automatically available, even for those with good credit, and some of those who cannot refinance are losing their homes," noted Jim Saccacio, chairman and CEO of RealtyTrac.com.

Predatory lending practices, speculation and widespread fraud cannot, however, fully account for the scale of the foreclosure crisis. Rather, the ultimate causes lie in long-term trends; the stagnation of wages, the lack of affordable housing and the growing indebtedness of American households.

To be continued

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