

Collapse of California's housing market reveals underlying social inequality

Rafael Azul**7 December 2007**

The collapse of the US housing market has had a particularly devastating effect in the state of California, where the housing price boom was particularly pronounced, and the subsequent decline has been particularly disastrous. Hundreds of thousands of working and middle class citizens are in danger of losing their homes.

Six of the nation's top ten metropolitan areas with the highest foreclosure rate are in California, according to RealtyTrac. The top three were all in California—Merced, Stockton, and Modesto. The state as a whole has the second highest foreclosure rate in the country, behind Nevada.

According to a Congressional Economic Committee report, in California, the number of homes in danger of foreclosure in October was 224,000—triple what it was in October 2006. As many as one in every 88 homes in the state—one in 43 in Southern California's San Bernardino and Riverside Counties—may face foreclosure in the near future. Lending institutions sent out nearly 80,000 notices of default in the third quarter of this year, 18 percent more than the previous record set in 1996.

California Assembly Speaker Fabian Nuñez recently reported that the cost of the crisis will add \$10 billion to the state's budget deficit next year. As the number of home foreclosure auctions hits a record, there is every indication that the present crisis is just the beginning of much larger implosion that threatens every aspect of the state's economy.

The immediate cause of this crisis is the collapse of the housing bubble and the inability of many homeowners to make their payments. The shifts in the housing market have exposed a system in which millions of Californians have financed their homes on the basis of ever larger levels of debt, even as wages have stagnated or declined.

Between May of 2002 and May of 2005, home prices increased in California by more than 40 percent. Disconnected from real fundamentals such as income or demographic changes, housing in California increasingly derived its value from speculative and unrealistic expectations of future appreciation and future rents. These

expectations were actively encouraged by a predatory and unscrupulous mortgage lending industry.

Prospective homeowners—whose incomes were not rising—were then seduced by thirty-year variable rate loans at low initial rates. Known as 2/28 and 3/27 adjustable rate mortgages, they featured little or no down payments and lower monthly payments for the first two or three years of the loan, followed by unspecified, but substantially higher monthly payments after that.

In some cases, the initial payments did not even cover the actual interest rate on the loan—a portion of the interest rate was added to the principal every month so that, following the initial two or three years of the loan, many homeowners owed more than the original price of the home. These loans—known as negative amortization mortgages—were designed to maintain the bubble by bridging California's disparity between workers' stagnating median incomes of less than \$17 an hour and accelerating median prices that reached over \$520,000 per home in mid-2005.

These negative amortization loans proved to be very profitable to the lenders and very risky for borrowers. In effect, in a period of rising prices, the lender was laying claim to some of the expected increase in equity (the difference between the original purchase price and the current market price) of the home. Under falling prices, homeowners, unable to get out of the loan have now become liable for a non-existing appreciation.

Sharing some of the home's anticipated appreciation might have seemed to be a small price to pay for homeowners with increasing equity. Such thinking was actively encouraged by big lending companies that aggressively pushed buyers into increasing debt by cultivating the myth of never-ending appreciation. In many cases, brokers encouraged owners to take on high-interest second and third mortgages on existing homes to buy another property, a desperate gamble disguised as a sure thing.

In that manner, the bubble was fed by buttressing demand with new debt instruments. An article published October 28,

2005 in *Realty Times*, a trade publication for realtors, observed that following a series of increases in home values, consumers continued to purchase homes thanks to innovative financing. “Zero-down loans, interest-only loans, choose-your-own-payment loans, piggy-back mortgages and other loans with the leverage necessary to get into a California home are *de rigueur*,” said the article.

Banks and mortgage brokers in many cases protected themselves by forcing borrowers to pay hefty pre-payment penalties to get out of loans—effectively barring them from refinancing the property.

The standard practice employed by lenders of spreading default risks by bundling and selling questionable loans to larger financial institutions, banks and hedge funds—the so-called ‘secondary market’—channeled large sums of cash into the California mortgage market throughout this period. Rather than reduce risk, these practices instead paved the way for a global crisis as soon as rosy calculations went sour.

For California homeowners, once prices began to stagnate in 2006, hundreds of thousands were placed in the position of having to pay a principal that is tens of thousands of dollars higher than the selling price of the house. Prices peaked and began to fall in September 2006. By that time an average Los Angeles home fetched 174 percent over its year 2000 price.

Even worse, in many cases buyers were encouraged by lenders to take on risky loans, even when they qualified for conventional fixed rate mortgages.

According to an article in the December 1 edition of the *Sacramento Bee* many subprime adjustable rate mortgages, with interest rates of 7 to 9 percent could jump to 12 percent next March. Already, in the Central Valley and in San Bernardino Counties for instance, many buyers in default have walked away from their properties. In the city of Stockton, south of Sacramento, approximately one third of the homes in default are now empty.

The resulting crisis in mortgages is already the worst that the housing market in California has experienced since the Great Depression of 1929-1939. Defaults and foreclosures are widely expected to continue through 2008 on loans made in 2005 and 2006.

Ironically, the less affordable it became to buy a house, the higher the demand rose as potential owners sought to buy before prices increased once more. In 2004, as California was surpassing Hawaii in median house values, a record 625,000 sales took place. Sales for the first three months of 2005, 141,000, were the highest of any three month period since 1988—three percent higher than the same period in 2004.

The inflation in house prices meant that to buy a house, the

working class and middle class devoted an increasing percentage of their pre-tax income to finance their home. Twenty percent of homeowners spend 50 percent or more of their income financing a home. Coupled with an increase in fuel prices, thousands of ‘house rich’ families now face the prospect of having to choose between feeding themselves and paying their utilities or paying their mortgage.

This week, the Bush administration announced a plan to freeze interest rates for a small percentage of homeowners facing foreclosure, which will do nothing to help the vast majority of those facing extreme economic difficulties.

The federal proposal is broadly similar to one being worked out by California Governor Arnold Schwarzenegger. The low interest period of the 2/28 and 3/27 mortgages would be extended to 5 or 7 years before the adjustment kicks in. Only owners that live in their homes, that are current in their payments and that can demonstrate that they would not be able to pay the higher interest rates, would qualify.

Assuming that it can actually be enforced, this is a half measure that only postpones the day of reckoning for homeowners. Those homeowners with negative amortization loans are courting much worse financial disaster 5 or 7 years from now if these measures were to include them, having to make payments on a ballooning principal, the result of seven years of partially postponed payments.

For the first time since the Great Depression thousands of California’s families—and many more throughout the United States—are losing their homes, left standing on the courthouse steps while the fruit of their hard work is auctioned off. What should be the democratic right of every family to decent shelter is sacrificed to the profit needs of banks and financial institutions.



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