The American Nightmare: Reflections on this mess we’re in

Decades of promoting homeownership have taken their toll. For the first time in history, it seemed that everyone could buy a house – mortgages were abound and unbound. Subprime loans included households formally excluded from homeownership, but many of these loans were also granted with the idea to take title to the property as soon as possible and many more sub-prime loans were granted to households with prime credit. Classical economic theory cannot explain why people made choices that seem to go against their interest. We therefore need an institutional analysis to examine the roots of the current mortgage crisis, and by extension, the credit crunch. Such an analysis shows how all kinds of actors involved, from government to mortgage brokers and from major banks to "housing academics" have made mistakes. Housing advocates have often been blamed as they fought to expand homeownership and credit opportunities to disadvantaged groups, but a closer looks shows us that this charge is heavily overplayed if not downright absurd: the current mortgage mess is in the first place the product of the mortgage industry in cooperation with various government and government-associated institutions.
Introduction
The current financial crises is presented as one in which homeowners took out risky loans that were pushed by greedy loan brokers and lenders who didn’t care about the riskiness of these loans as they would be packaged and sold off as residential mortgage-backed securities (RMBS) anyway. It continues to present a network of agents that have not paid enough attention to risk: not only borrowers and lenders, but also the state, regulators, investors and rating agencies. Three roots to the financial crisis are often discussed: greed, the bursting of a real estate bubble and the fact that “everyone made mistakes”. This image of the roots of the financial crisis is not wrong, but it is limited in explaining what went wrong. Greed is nothing new, real estate bubbles need to develop before they can burst and we need to understand in which context actors made mistakes. In this paper I will discuss the roots of the financial crisis within the mortgage market.

Securitization and Deregulation
The current financial crisis originates in the housing and mortgage markets, but it affects financial markets around the world. A few decades ago most mortgage lenders were local or regional institutions. Today, most mortgage lenders are national lenders who tap into the global credit market. This is not so much the case because lenders are global financial institutions – most lenders are national in scope – but because they compete for the same credit in a global market. Before the financial crisis of the late 1980s, savings and loans institutions (S&L’s) granted loans based on the savings that got into the bank. Generally speaking, the savings and loans were made in the same geographical market. The fact that the S&L’s only worked in local markets was seen as a problem: what if the savings are available in one area, but loans are needed in another?; and what if a local housing market would bust? The ‘solution’ was to connect local markets and to spread risk. The idea was that interest rates on loans would fall because there was now a more efficient market for the demand and supply of money and credit. Moreover, national lenders could more easily take the burdens of a local housing market bust because risk would be spread.

The trend from local to national mortgage lenders was one thing, but, it was argued, mortgage markets could be even more efficient if they were connected to other financial markets and not just to savings. In the wider credit market it would be easy for mortgage lenders to get money as mortgages were considered low-risk. Mortgages would be an ideal investment for low-risk investors and cheaper credit, in return, would lower interest rates on mortgage loans. Securitization was already introduced in the 1960s by Fannie Mae and Freddie Mac, two government sponsored enterprises that were meant to spur homeownership rates for low and middle income households. Securitization enables mortgage lenders to sell their mortgage portfolio on the secondary mortgage markets to investors. Following the S&L crisis, deregulation favoured securitization, not only through Fannie Mae and Freddie Mac, but also through so-called “private labels”. Gotham (2006) has studied the deregulation of the mortgage market and demonstrates how the federal government, step-by-step, has enabled securitization, e.g. by the Financial Institutions Reform, Recovery and Enforcement Act (1989) that pushed portfolio lenders to securitize their loans and shift to off-balance lending. In other words, the state was at the origins of the current crisis.

Deregulation also removed the walls between the different rooms of finance, thereby enabling existing financial firms to become active in more types of financial markets and providing opportunities for new mortgage lenders. Securitization meant that mortgage lenders could work according to a new business model whereby mortgages are taken off-balance. This frees up more equity for more loans and enabled non-banks to enter the mortgage market. Many of these new “non-bank
lenders” had different regulators than traditional lenders and were also held by other, i.e. weaker, regulatory frameworks. In addition, it is not always clear which regulator watches what, but even if this is clear, this is no guarantee that regulators actually execute their regulatory powers, sometimes due to a lack of interest and sometimes due to a lack of manpower. Mortgage portfolios could now be sold to investors anywhere in the world and because these investors thought mortgages portfolios were low-risk and there was a lot of money waiting to be invested, especially after the dot-com bubble crash (2000-2002), there was a great appetite for RMBS. In other words, the S&L crisis, the following bank merger wave (Dymski 1999), securitization, the entry of non-bank lenders and the demand for low-risk investments together shaped the globalization and financialization of mortgage markets (Aalbers, 2008).

Lenders, rating agencies and investors not only underestimated the risks of RMBS but also overestimated the returns. Even though housing prices on average fell by 20% between summer 2006 and summer 2008, the impact on the RMBS market was much bigger. This is not just a result of inflationary prices, but also of leveraging. Major players in the RMBS market like investment banks basically invested with borrowed money (ratio’s of 1:20 were not uncommon, 1:14 being the average) and because of this leveraging both profits and losses would be disproportionally big. For example, if an investment bank is able to borrow money for 6% and expects a return of 8% on low-risk, prime RMBS and 16% on high-risk sub-prime, it effectively makes, respectively, 2% and 10%. However, when returns are lower than the interest rate for which they have borrowed money, for example, respectively, 4% and 2%, the investment banks not only miss 4% or 14% calculated profit, they also have to take their losses on their equity, for instance: 14 (the average leverage factor) times, respectively, 2% (6%-4%) and 4% (6%-2%) equals equity losses of, respectively, 28% and 56%. Since the leverage factors in many cases were even much higher than 14, some financial institutions and investors that were heavily involved in RMBS, and especially sub-prime RMBS, effectively went bankrupt.

Subprime and predatory lending
Subprime lending is often defined as lending to a borrower with poor credit, but this would be a misrepresentation of the essence of subprime lending, which is lending at higher fees and interest rates whether or not the borrower actually has bad credit. Some estimates suggest that more than half of the subprime loans went to prime borrowers (Brooks and Simon 2007). Subprime mortgage lending has been growing fast, from about $35 billion (5% of total mortgage originations) in 1994 to $600 billion (20%) in 2006 (Avery et al. 2006), 75% of which is securitized. In some states like Nevada subprime loans accounted for more than 30% of the loans originated in 2006.

Both professionals and academic economists do not pass an opportunity to point out that many borrowers took out loans they could not afford. This is correct, but in most cases this was not because borrowers were eager to get a big loan even though they had bad credit. A majority of the sub-prime loans goes to borrowers with prime credit (Brooks and Simon, 2007; Dymski, 2007). In other words, sub-prime lending should not be defined as lending to borrowers with poor credit, but as lending at higher fees and interest rates whether or not borrowers actually have bad credit. In 2006, 13% of outstanding loans were subprime, but 60% of the loans in foreclosure were subprime, up from 30% in 2003 (Nassar, 2007). Selling sub-prime loans to prime borrowers was good business for both mortgage lenders and brokers. Lenders could charge higher interest rates on sub-prime loans and thus make more money. For this reason lenders gave brokers bigger sales fees for selling sub-prime loans. Brokers did not have negative results as a result of defaulting borrowers, as
they only get paid for what they sell. And defaulting borrowers actually created a bigger market for refinancing, which implied that brokers could make more money on clients by selling them another loan.

In addition, it is often argued that sub-prime lending enabled many people that were formerly excluded from homeownership, i.e., low-income and ethnic minority groups, to buy a house and enjoy the benefits of homeownership. This is questionable for at least two reasons. Firstly, many of these borrowers had bought properties at the low-end of the market that needed improvement work and because of the high interest rates their monthly expenses often went out of scale with their income. Homeownership for many sub-prime homebuyers became a burden rather than a joy. Secondly, most sub-prime loans were not enabling homeownership as more than half of them were refinance loans and second mortgages – in other words, loans for people who already owned a mortgaged property. Most of the refinance loans were designed in such a way that they looked cheaper than the original loan, but would, in fact, turn out more expensive for the borrowers and more profitable for the mortgage broker and the lender. Adjustable Rate Mortgages (ARMs) are a good example: an ARM may start with a low interest rate, but after 2 or 3 years the interest rate resets to a much higher rate. Borrowers are shown the initial, low interest rate while the higher interest rate is hidden in the small print of unreadable mortgage contract. Predatory loans were sold mostly in neighborhoods with ethnic minority populations. Almost half of the loans in minority areas were predatory compared to 22% in white areas (Avery et al., 2007). African-Americans receive more than twice as many high-priced loans as Whites, even after controlling for the risk level of the borrower (Schloemer et al., 2006). It then comes as no surprise that foreclosures are concentrated in certain parts of the city. These problems are not new: for at least ten years researchers have pointed out how sub-prime and predatory lending result in rising default and foreclosure rates (e.g. Pennington-Cross, 2002; Squires, 2004; Wyly et al., 2006). Yet, this was not considered a major problem until house prices declined and the value of RMBS fell.

Bubbles and wrong incentives
The root of the mortgage crisis, according to some observers, is in the housing market: the rapid increase of house prices forced people to take out bigger loans (Shiller, 2008). The housing bubble, like all bubbles, depended on a constant inflow of liquidity to sustain the rising market as well as the illusion that all participants in the market are winners (Lordon, 2007). Once the housing bubble burst, homeowners got in trouble, not just because their homes were worth less, but also because so many of them had taken out big loans with small down-payments and high interest rates. Negative equity, default and foreclosure were some of the negative results. Indeed, there was a strong housing bubble, but this did not so much fuel the mortgage market – the mortgage market, in the first place, fuelled the housing bubble. House prices increased far and foremost because mortgages allowed borrowers to buy more expensive homes, but since almost everyone could now afford a mortgage loan – and generally speaking a much bigger loan than a decade ago – the expansion of the mortgage market resulted in higher house prices forcing people to take out ever bigger loans. In that sense, the mortgage market created it own expansion. Thus, mortgage and housing markets fuelled one another, but it is crucial to understand that the driving force here is the mortgage market. As argued in the previous sections, this was enabled through deregulation and re-regulation.

Old and new lenders alike had an interest in making loans that could be sold off and in loans that generated higher yields. This resulted in riskier loans with higher interest rates (sub-prime lending). Mortgage brokers were rewarded with higher fees if they would sell loans with higher interest rates (i.e., riskier loans); many of these were not loans to buy a home, but refinanced loans and second mortgages, or, in
other words, loans that did not contribute to the spread of homeownership. The higher risk of default on these loans was taken for granted, not just because they would be sold off, but also because default presented a risk to the borrower who would lose her/his home; the lender could repossess the home and sell it quite easily as house prices continued to rise.

There were enough investors who had an appetite for RMBS, first in so-called confirming loans because of their low-risk that was comparable to state obligations. But a few years later they also showed an interest in sub-prime loans issued as RMBS: in an evermore competitive search for yield “each stage of market development replayed a dynamic of over-speculation based on competitive pressures to adopt riskier borrowers and loan products” (Ashton, 2008). Investors, in return, “had concentrated risks by leveraging their holdings of mortgages in securitized assets, so [when the bubble burst] their losses were multiplied” (Mizen, 2008: 532). Sub-prime loans were considered riskier, but this was compensated by higher returns and since the rating agencies still supplied high ratings, such RMBS were seen as low-risk, high-return. Rating agencies saw the increased likeliness of default on such loans, but like the lenders they didn’t see this as a major problem, more as an inconvenience. In addition, rating agencies get paid by the firms whose securities they have to rate. It is too easy to argue that this made the rating agencies less critical of RMBS. After all, they were also dependent on rating other financial products and if they would give high ratings to all of them, they would soon not be taken seriously anymore. So what did cause rating agencies to be so late in realizing the risk of these securities? First, as I suggested above, they simply did not realize the risk as they believed in rising house prices, just like homeowners, lenders, and the media – like everyone essentially. Second, because the rating agencies had become so heavily involved with securities that their own growth now depended on rating more and more of them. Third, throughout the years the most basic RMBS were complemented by ever more complicated products that few had an understanding of, not even the rating agencies on which investors trusted. It is sometimes argued that the rating agencies cannot be blamed for this as others in the mortgage network also didn’t understand the complexity and riskiness of these products, but since it is their job to understand and then rate financial products, it could be argued (in an almost tautologically fashion) that the rating agencies are responsible for rating high-risk products as low-risk.

These RMBS were now traded on global markets that are localized in places like New York and London (Pryke and Lee 1995; Sassen 2001). While in the past a mortgage bubble or a housing bubble would affect the economy through homeowners, the current bursting of these bubbles affects the economy not just through homeowners, but also through financial markets. Because lenders are now national and international in scope this does no longer affects only some housing markets, but all housing markets throughout the US. Housing markets may still be local or regional, mortgage markets are not. Since primary mortgage markets are national, the bubble in the national mortgage market affects all local and regional housing markets, although it clearly affects housing markets with a greater bubble more than those with a smaller bubble. In addition, secondary mortgage markets are global markets, which means that a crisis of mortgage securitization implies that investors around the globe, and therefore economies around the globe, are affected. The mortgage market crisis affects the US economy on both sides of the mortgage lending chain – through homeowners and through financial markets – while it affects other economies in the world mostly through financial markets, not just because investors around the globe have invested in RMBS, but also because the mortgage market has triggered a whole chain of events that have decreased liquidity and this affects even agents in financial markets that have never been involved in RMBS.
Conclusions
Greed, the bursting of real estate bubbles and the credo that "everyone made mistakes" cannot explain the current financial crisis. The roots of the crisis are in the structural developments of the mortgage market. Deregulation supported both securitization and subprime lending. While the primary mortgage market after the S&L crisis of the late 1980s developed into a national market, the secondary mortgage market (i.e., the market for RMBS) developed into a global market in which mortgage funding is increasingly tied to other credit markets. It is this combination of deregulation, securitization and financialization that is at the root of the current crisis. This not only resulted in more connected mortgage markets, but also in vastly expanding mortgage markets. This fuelled housing prices, but also extended mortgage funding beyond what was deemed good business in the past (and beyond what is deemed good business today). Homeowners were lured into overpriced loans, often through expensive refinancing. The subprime and predatory boom were not meant to increase homeownership, as is often argued – instead, they were designed to maximize profits for lenders, mortgage brokers, investment banks, rating agencies and investors in RMBS, not borrowers.

Rescuing Fannie Mae and Freddie Mac was needed to guarantee the continuation of mortgage lending in the US. Fannie and Freddie are so crucial to the entire system that without them the current mortgage market would fall apart. They are responsible for guaranteeing loans, for issuing “confirming” RMBS (i.e., low-risk, standardized securities), and have also bought so-called “private label” RMBS (i.e., securities that are not issued by Fannie and Freddie and include many sub-prime RMBS). Giving up on Fannie and Freddie would have meant giving up on the American economy. But as we all know the intervention of the federal government goes much further than the bailout of Fannie and Freddie; the Paulson plan of $700 billion is only part of a bigger effort to help the financial sector. Yet, very little of the money invested is designated to help defaulting homeowners from being foreclosed on. The American Housing Rescue and Foreclosure Prevention Act of 2008 will probably help up to 500,000 homeowners. The number of foreclosures for 2007-2009, however, will add up to 7 to 10 million. In other words, government is bailing out financial institutions that made major mistakes with billions of dollars, but does not even make enough funding available to stop the increase in the millions of homeowners that are being foreclosed on. The priority of the state is with exploiting financial institutions, not with exploited homeowners, even though a “foreclosure rescue plan” would have been much cheaper and could have guaranteed the flow of money from homeowners to RMBS investors, albeit at a lower rate of profit.
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