Edward Dodson

THE 2008 CRISIS & TAKING THE LONG VIEW

Studying the works of Henry George was of tremendous help to me during most of my professional life in the financial sector. George provided me with a broader understanding of the relationship between household income, household savings, mortgage interest rates and what owners of land could charge for land they offered for sale. I came to understand that any measures taken to increase the demand side of the market would be capitalized into higher land prices, that our systems of law and taxation strongly favored rentier interests.

Early on in my career I was trained to analyze the creditworthiness of potential borrowers. Statistics gathered over many decades told us that the potential risk of default increased whenever the borrower had to spend more than 25-28 percent of gross monthly income toward what we called "PITI" (principal, interest and an escrow for property taxes and homeowners insurance). During the early 1970s we would not even include a female spouse's income in this calculation, unless her profession was in teaching or medicine. One benefit of such conservative underwriting was that if the primary borrower lost employment and income, the possibility existed for a spouse's income to help keep the family current on its loan repayment. In the late 1970s I was hired by a commercial bank to manage its mortgage servicing department.

A few years later I was promoted to manage both mortgage originations and servicing. At that time, the bank still required a minimum cash down payment of 20 percent of the purchase price of the subject property (although exceptions were made for borrowers who had more extensive relations with the bank). Throughout the 1950s and well into 1960s, the property purchaser was essentially paying cash for the land parcel and financing the purchase of the home itself. However, as land prices began to climb faster than household income and savings, banks and other mortgage loan investors had to accept greater risk in order to be competitive and maintain market share.

A segment of the U.S. homebuyers with lower savings and lower household income were already being served under a government mortgage guarantee program administered by the Federal Housing Association (FHA). FHA loan limits were significantly lower than "conventional" bank limits, and the borrowers paid a monthly mortgage insurance payment calculated based on the outstanding loan balance. This mortgage insurance payment continued for the life of the loan. As property costs increased, conventional lenders were forced to increase their maximum loan limits almost every year. Cash down payment requirements were reduced, to 10 percent, then to 5 percent. Insurers stepped forward to offer private mortgage insurance, paid for by the borrower, to protect the lender from a significant portion of any loss associated with a defaulted loan and sale of a property take by foreclosure and later resold. On average, even after payment of a claim by the private mortgage insurer, a lender would experience a loss unless the loan had amortized to an effective loan-to-value ratio of under 75 percent. By the mid-1980s the ongoing deregulation of the banks resulted in an almost endless process of bank consolidations.

The bank I worked for merged with a larger institution. Our mortgage lending program was absorbed into the senior bank, and I sought employment elsewhere, accepting a position to supervise a group of review credit underwriters with Fannie Mae, at one time a government agency that since 1968 had become shareholder owned but with a very limited charter to serve as a secondary market for residential mortgage loans. At the time, Fannie Mae's financial picture was bleak, indeed.

Fannie Mae purchased mortgage loans from mortgage bankers, savings banks and commercial banks, holding these loans until they were repaid. In an effort to tame inflation, the Federal Reserve had lifted all efforts to control interest rates, and the cost of funds for Fannie Mae (and its main competitor, Freddie Mac) climbed well above the interest income generated by loans held in portfolio.

Two strategies developed to offset these losses. One was to introduce mortgage loan product with rates that would rise or fall based on what happened to market interest rates. The second was to begin to pool the loans as collateral for new mortgage-backed securities. These initiatives would not have been sufficient to prevent insolvency and a government take-over. Fortunately, the Federal Reserve Board eventually declared victory over inflation and interest rates began to fall.

The nation's bankers had also gone through the same interest rate risk problem, although only a few were overly exposed to declines in the value of these fixed-rate assets. The larger banks capped their residential mortgage loan portfolios to around 10 percent of assets. Less fortunate were the nation's thousands of savings and loan associations and savings banks (the "thrifts"), subject to restrictions on what type of loans they could originate and the rate of interest they could charge. One after another they became insolvent and were forced to close their doors, waiting for regulatory changes that would allow them to compete for deposits with the fast-growing money market mutual funds.

By the early 1990s the banks and surviving thrifts were selling most of their residential loans to Fannie Mae or Freddie Mac, or they were working with Fannie and Freddie to package the loans and issue mortgage-backed securities, securities given a stamp of approval by Fannie or Freddie in exchange for payment of a guarantee fee. The banks could then hold the securities as a form of liquid asset or market the securities to investors through Wall Street. Regulators required the banks to hold much lower reserves against mortgage-backed securities than for whole loans because of the greater liquidity of the securities. The mortgage loan market was becoming increasingly complex. As interest rates continued to fall, millions of borrowers refinanced to lower monthly payments or to convert an adjustable rate structure into a fixed rate loan, locking in the rate of interest for the life of the loan. Transaction volume steadily increased, providing huge increases in fee income to all of the participants. And, as the demand side of the market rebounded, so did property (i.e., land) prices.

Already, I could see signs of trouble ahead. In many regions of the country appraisal reports were showing a steady increase in land prices. Median land-to-total value ratios in higher priced markets such as New York City, Boston, Washington, DC and San Francisco rose to 40 percent, higher in some neighborhoods. Ratios for existing ocean-front properties or in resort areas were as high as 80 percent, meaning that the depreciated value of the property improvement comprised only 20 percent of total value. We were throwing more and more financial fuel into speculation-driven markets. And, everyone around the globe wanted in on the game. Huge amounts of financial reserves came pouring into the U.S. residential and commercial real estate markets. Investors then began to look at other countries when the U.S. demand for additional funding sources was fully satisfied.

The fundamental reasons for the eventual global crash in land markets is one most readers of this publication fully grasp. Everyone who owns land or bids for the purchase of land expects the value to continually increase. Only a small number of investors recognize the signs that a crash is coming and cash out at or near the peak to capture their gains. On the other hand, individuals and entities that have owned the land they hold for years or decades and are carrying little or no mortgage debt know that even in the event of a steep decline in a few years land prices will climb back and are likely to surpass the previous high. As economists sometimes say, "land prices are sticky downward." For land prices to fall and remain at a low level for years and years an entire area must experience a significant economic downturn and the loss of business activity.

What occurred in the financial sector to deepen and lengthen the crash of 2008 was the culmination of a long period of deregulation, ineffective internal controls and many decisions made to secure and protect market share and transaction volume. Although Fannie and Freddie did not participate in any direct way to the growth of the sub-prime mortgage market, their decisions almost every year to increase maximum loan limits had devastating longer-run consequences. As these loan limits were increased, the banks began to lose market share in what had been the "jumbo" market. Loans that a few years earlier would have been made by the banks at a rate of interest similar to that charged to commercial borrowers were going into the conventional market. Bank profits were suffering. With restrictions on business activities lifted, many banks had acquired finance companies and second mortgage lending companies, channeling billions of new dollars into those markets. Within the financial sector, these were the companies that too often victimized borrowers with high cost loans, teaser initial interest rates and other predatory terms. Early in the 2000s they entered the first mortgage loan market with the so-called "sub-prime" mortgages.

Most of my colleagues and I knew this business would have serious fraud and default problems. The problem would have been much less if the banks had actually performed rigorous quality control reviews on the loans to ensure borrowers could handle the debt and confirm the property values were supported by accurate appraisals. Instead, the new securities were submitted to the bond rating companies who did almost no loan level quality control analysis.

From what I have read, the few people who tried to sound an alarm came under heavy criticism by more senior executives whose compensation was depending on a continuous flow of this very business channel.

Near-depression level unemployment and literally millions of foreclosures have ruined the lives of a lot of people, some of whom were victims, many others were willing participants in the property market casino. The major banks have all been bailed out with infusions of near-zero cost funds by the Federal Reserve. Historic low rates of interest on mortgage loans allowed millions of property owners to refinance out of high cost sub-prime mortgage loans. Millions of other properties turned over to new owners, a high percentage of whom were and are investors speculating that demand would recover and asset (meaning "land") values would renew their upward climb. In many markets this has occurred. Land prices are back to and even above levels reached prior to the 2008 crash.

What should have been done to stabilize the property markets was not even considered. To protect the bankers from themselves and taxpayers from the bankers, new regulations should have been passed to prohibit any financial institution that accepts government insured deposits or other government loan guarantees from extending credit for the purchase of land or acceptance of land value as collateral for borrowing. After 2008, Fannie Mae and Freddie Mac (now managed directly by the Federal government) were the only investors purchasing mortgage loans, so this restriction would have had little immediate effect on the banks.

Exceptions would be necessary to make it feasible for victims of predatory lending to refinance out of high cost mortgage terms, but this would be a one-time opportunity. Those purchasing a property would have to make a cash down payment equal to the land cost component of the property value, or seek a second mortgage loan from an investor operating outside the protection of depository insurance. With these regulations in place, the level of speculation in the property markets would be far lower. Property prices would remain affordable for more households, provided they accumulated sufficient savings and could meet high standards of creditworthiness.

A side benefit of removing some of the speculation from the nation's land markets would be the construction of a higher percentage of housing units affordable to individuals and households with lower incomes.

Sadly, none of the most important lessons to be learned by the study of the build-up to 2008 have been studied by any level of government or resulted in meaningful changes in public policy. By the infusion of cash into the banking system, the banks are able to meet the more stringent "stress tests" developed by the Federal Reserve. However, if the banks are not watched carefully, they will gradually return to practices that bring in the high fees and high nominal yields but also expose them (or their institutional and individual investors) to the huge losses that come with imprudent lending practices.

When the next downturn occurs we will have moved into uncharted territory. The United States government will by then have accumulated a public debt in excess of $30 trillion. Just servicing this debt may require curtailment of spending on many existing programs.