edward j dodson's cooperative individualist view

As an L&L reader you will have formed your own opinions on how the current financial crisis could have been avoided. Based on my own thirty-plus years working in the US financial services industry, I offer these insights.

What we know is that credit acts as an accelerant poured on speculation-driven fires. Investors seeking high returns move from one speculative market to another—shares of stock, precious metals, property, raw land, currencies, mortgage-backed securities, and so on. Far better to use leverage and risk someone else's assets in speculation than one's own.

The use of credit by investors in the property markets is normal. What was not normal in this cycle was the aggregation of externalities, most importantly the bypassing in the US of Fannie Mae, Freddie Mac and the FHA as the gatekeepers of the quality of collateral going into mortgage-backed securities. Wall Street firms packaged approved loans without verification of income, employment or even creditworthiness—often with fraudulent property appraisals, or none required. Many of these loans originated under predatory terms if not outright fraud.

Whenever the pool of potential borrowers or homebuyers expands, market forces capitalise the change in equilibrium into higher land (and total property) prices. Fannie Mae and Freddie Mac responded by raising loan limits, reducing down-payment requirements, extending mortgage terms, creating interest-only mortgages, permitting negative amortisation and offering adjustable rates that enabled people to qualify for larger loans. And, these measures were adopted by the 'conventional' (ie. ostensibly conservative) market players.

Those of us in the industry who saw all this developing and feared the worst observed that on a growing number of property appraisals the land-to-total value ratio was skyrocketing. By the early 2000s, loans we were purchasing or securitising involved financing for more and more land and less and less housing. In New York City or San Francisco the land might comprise eighty or eighty-five percent of total value.

What economists ought immediately to understand is that at some point the financial stress on businesses and residential property owners brings on a collapse in property markets (with bank failures as collateral damage). Business profit margins are reduced by rising land acquisition costs. When relocations begin and vacancy rates increase, this is a clear indication of a property market crash on the horizon. In the residential property markets, the end comes when property (ie. land) prices become too high for first-time buyers—even with the exotic offerings from lenders. By 2004-5, the capacity of many US households to carry their debt had reached its limit. Household incomes were stagnant or declining, savings gone, and interest rates were as low as could go.

It is now too late to prevent the coming collapse: at best we can mitigate the depth and duration of the depression. The land market cycle will begin again when businesses see the opportunity to borrow and invest in new capital goods creation and once again generate profitable sales.

Among the numerous reforms we need is regulation that prohibits credit on land. This will require investors and homeowners to come up with cash down-payments from savings or other sources that do not put the financial system at risk. Removing credit as the accelerant for land speculation will not solve the problem, but it is an important first step.