HOUSING AND THE FINANCIAL CRISIS:

WHAT HAPPENED AND WHAT TO DO ABOUT IT

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Introduction

Sub-prime lending is but the last act in a housing finance house of cards built over decades. Not only was the collapse of this house predictable; it was predicted 30 years ago, when the house had far fewer cards:

> *Meanwhile the inability of working-class families to keep up existing mortgage payments has increased mortgage defaults and foreclosures on both owner-occupied housing and apartment buildings.... Unable to deal with the causes of mortgage defaults and foreclosure, which lie within the institutions of capitalism, the options available will only compound the problem in the long run. The proposals all basically involve reductions in current housing costs by increasing debt.... Adding more claims to future income in these ways only adds to the increasing vulnerability of the entire financial system as well as the mortgage system in particular.... (Stone, 1975).*

Since then, I have chronicled the growing instability of the house of cards (Stone, 1978; 1980a; 1980b; 1983, 1986; 1993; 2006), albeit with no influence on the course of events. The recent events emerge from the deep structure of the housing and financial systems. Resolving the problems, and preventing similar occurrences in the future, will require fundamental changes to those systems. This paper examines each of the pieces in a schematic way. (For greater detail on the construction of the house of cards see Stone, 1993, Part II, and Stone, 2006a; and for more detail on the types of structural changes needed, see Stone, 1993, Part III).

House of Cards

There are 4 suits in a deck of playing cards (clubs, spades, hearts and diamonds), and there are four suits from which the housing finance house of cards is built:

1. Wide and widening income inequality (Tilly, 2006)
2. Treating housing as a speculative commodity at all levels
3. Over-dependence on debt and the private capital markets to finance housing
4. Public policies that exacerbate instability in the other three suits.

Wide and widening income inequality: consequences for housing

The first consequence of widening income inequality is reduced affordability and rising house prices (linked to the next suit of cards, the speculative housing market). On the one hand, inequality and low incomes makes it more difficult for most people to afford housing. On the other hand, those with more and more income at the top have driven up home prices, through gentrification, Mcmansions, tear downs, and so on. The rich also have lots more money put out in search of profit, including investments in apartment buildings and condos, adding to price increases in multi-family buildings.

The second consequence is decreasing ability for most households to save (linked to the third suit of cards, the debt system). As a result, most households have reduced capacity to make substantial down payments when buying, and hence the push for lower down payments, i.e, higher loan-to-value ratios in the mortgage market, with associated increases in risk. Furthermore, because middle-income households have not had money to put into savings (thrift) institutions, which traditionally were the self-sustaining source of most residential lending, housing finance became more dependent on the broader capital markets.

The third consequence is that people with hugely increased incomes at the top have sought high profits in the capital markets (also linked to the third suit of cards, the debt system), which fueled the bubble of mortgage-backed securities.

2. The speculative housing market

Everyone believes they are entitled to make a killing in residential real estate, not just distant investors, intermediate mortgage packagers, and nearby speculators and mortgage brokers, but also many homebuyers and homeowners. This attitude has been coupled with the idealization and over-promotion of speculative home ownership, based on the following myths (for critical examination of these myths, see, e.g.: Kemeny, 1981; Heskin, 1983; Edel, Sclar and Luria, 1984; and Stone, 1993, pp. 18-22):

i. you are always better off economically as a homeowner than a renter because you no longer have a landlord who can raise the rent;
ii. home-ownership is a sound and effective way to build assets/accumulate wealth;
iii. property values always go up, at least as long as undesirable activities and undesirable people can be kept out of your neighborhood;
iv. homeowners are full citizens ("real Americans"), but renters are not.

The mythology of home ownership has, in turn, been facilitated and lubricated by a dangerous and addictive hallucinogenic drug: the illusion of ownership through the reality of debt.

3. Over dependence on debt and the private capital markets to finance housing

Because housing is costly to produce, and most house producers are relatively small businesses, housing development is very dependent on borrowed money. More significantly, because housing is both a commodity and long-lasting, the transfer of houses is financed almost entirely by borrowed money, with the property as collateral. Furthermore, because housing is a speculative commodity, it is the prime source of collateral for borrowing even without transfer, i.e., refinancing and home equity borrowing.

Taking these 3 elements together, no sector of the economy has been as dependent on debt as housing. Since World War II, housing related debt has been the fastest growing component of the entire financial system; it has grown much faster than the overall economy and hence faster than the ability to repay (Stone, 1993, Table 5.1, p. 128).

Combined with ever-widening income inequality, and the more active and aggressive promotion of mortgage homeownership since the 1990s, this dependency has been turned into addiction, creating debt junkies at all levels of the system, with pushers emerging at all levels, because of enormous and growing opportunities for profit:

i. ever-higher incomes at the top led to the creation and expansion of hedge funds, structured investment vehicles, etc., inside and outside banks and brokerages, to attract and soak up this money;
ii. to maximize profits on these pools of funds, Wall Street decided to expand the volume of mortgage-backed securities (MBSs) and create multiple layers of derivatives of these;
iii. in order to expand the volume of MBSs, in turn, it was necessary to promote vast increases in mortgage lending; since homeownership rates were declining overall and were especially low for households of color, there was both motive and opportunity for a whole new wave of over-promotion of homeownership to underrepresented populations, along with rising refinancing, home equity borrowing, homeowners buying 2nd and 3rd homes and investment properties, etc.;
iv. this process created almost limitless profit opportunities, but also piled risks ever higher, as each level -- not just homebuyers and homebuyers

-- became leveraged to the hilt, borrowing far beyond any realistic potential of repayment – a classic pyramid scheme (discussed more fully later).

4. Public Policies

Instability in these first three suits of cards was in turn stimulated and exacerbated by four categories of public policies:

i. Monetary policy: loose money/low interest rates on the part of Greenspan's Federal Reserve Bank encouraged borrowing and speculation, and leveraging of little capital with lots of debt to invest in high risk/high return real estate and capital market vehicles.

ii. Tax policy: the flattening of the progressive income tax, and tax cuts, since 1986 contributed to widened income inequality, and provided more money at the top of the income distribution for speculation in housing and financial markets. Just as significant, regressive homeowner deductions for mortgage interest and property taxes, along with the elimination of taxes on capital gains from the sale of owner-occupied housing, created perverse incentives to borrow and speculate in housing. These tax benefits are available only to homeowners, and those homeowners who benefit from itemizing on their tax returns, ie., itemized deductions exceed standard deductions. Tax benefits rise with income tax bracket, house value, mortgage amount and interest rate. Over half the benefits flow to the top 10% of the income distribution. Even conservative economists recognize that this distorts the housing market (Glaeser and Shapiro, 2003; Carasso, Steuerle, and Bell, 2005).

iii. Privatization of the public institutions of housing finance (cf. Stone, 1993, Part II, and Stone, 2006a); the 1960s saw the end of the post-war prosperity, increased competition for credit, rising interest rates, and disintermediation from savings institutions. The late 1960s into the 1970s witnessed expansion and privatization of secondary markets. In 1968 Fannie Mae privatization began and Ginnie Mae was created; in 1970 Freddie Mac was created. Fannie and Freddie are (were) quasi-public government sponsored enterprises (GSEs), with implicit government guarantees of their paper, but also profit-motivated institutions with private shareholders. Ginnie Mae, by contrast, is a government agency, that issues MBS, with explicit government backing, against FHA/VA mortgages. GSEs package mortgages into pools; they issue securities sold into capital markets backed by pools; initially these were plain vanilla pass-through securities, bought mostly by institutional investors, like pension funds, insurance companies and commercial banks.

iv. Deregulation and lax regulation of private financial institutions activities (cf. Stone, 2006a): in the late 70s into the 80s, there was extensive deregulation of the financial system, with another wave since the 1990s. Over the past decade there has also been lax enforcement of the remaining regulations.

Implications for Households

There were evident problems before the sub-prime surge. First, there was a steady trend toward bigger, more costly houses. Second, homeownership peaked in 1980, and then declined until 1994. In 1995 homeownership started to increase, with a focus on lower income households, especially households of color. This was the result of various factors, including the Community Reinvestment Act (CRA), easing of usury limits on interest rates resulting in more sub-prime lending, plus the Clinton administration's homeownership push. And rising household debt burdens and mortgage stress were already apparent by the early 2000s, prior to the new growth of homeownership (Stone, 2006a).

By the middle of the 2000s, five vulnerabilities became apparent at the base of the housing system.

i. The spread of high-risk non-traditional loans: not just sub-primes, but alt-A, "ninja" (no interest, no job or assets) loans, interest-only, negative amortization, 100%+ loan-to-value loans, adjustable rate loans, etc.

ii. Rising housing costs: not only due to mortgage resets, but also increasing cashing out of equity, including refinancing of original primes into sub-primes; and rising property taxes, heating costs, etc;

iii. Declining incomes: many people on the margin of being able to afford their housing (and other) debts, even with multiple jobs/incomes, faced the risk of default if laid off, or with personal or family member illness, divorce, new child, etc.

iv. Declining property values: fewer buyers able to sustain ever-higher prices meant, eventually and inevitably, housing prices would turn down;

v. High leverage meant lots of people with no equity cushion; so any decline in prices would mean negative equity in which default would be more likely.

Implications and Consequences for the Financial System

The late 1980s brought the Savings and Loan crisis. In the late 1980s to early 1990s, economic recession brought declining house values, high foreclosures, slow recovery. From the mid-90s to the mid-00s, there was the longest period of growth in over a century, but it was built on increasing inequality and debt. This period also saw the full fruition of mortgage-backed securities (MBSs). Housing finance became fully integrated into global capital markets. Slicing and dicing of MBS into CMOs/CDOs, originated by Freddie Mac in 1984, and proving profitable for Freddie and Fannie, became standard practice, as private pooling and securitizing by Wall Street, outside of Fannie and Freddie, issuing sliced securities against pools of plain vanilla MBS, derivatives of these securities etc. But the mid-90s already hinted at problems with securitization and derivatives: inadequate computer models did not account for refinancings; so in the mid 90s there was an MBS crisis, with chaos in the MBS markets (Stone, 2006a).

Non-prime lending (sub-prime, Alt A, etc.) had long existed, but there had been no secondary market, because such loans did not meet Fannie and Freddie standards. So, there were limited originations of such loans until the early 2000s, when Wall Street, looking for highly profitable outlets for pools of cash, started to buy and securitize non-prime mortgages. This led to a stampede into high-profit, non-prime MBSs and derivatives, with profits multiplied by fees and by high leveraging fostered by low interest, expansive monetary policies. They provided huge profits on the upside, huge risks on the down side.

Instabilities were apparent in Fannie and Freddie by the early 2000s (Stone, 2006a). Nevertheless, with loss of market share to Wall Street, Fannie and Freddie lowered their standards to compete in non-prime secondary markets and keep share prices up and stockholders happy, with heavy lobbying to prevent regulation.

Culmination in Collapse

Taken together these were the perfect storm that blew apart the house of cards. Vulnerabilities at the base resulted in surging defaults and foreclosures, and not just on sub-prime loans. While the foreclosure rate is of course much higher on sub-prime loans, most loans are not sub-prime and, indeed, about half the foreclosures have been on prime loans. As well documented in the media, and some deeper analyses (see, e.g., Morris, 2008), the collapse has spread through the financial system to create the worst financial crisis since the Great Depression, in which housing finance was also deeply implicated (see Stone, 1993, Part II).

How to Build a Solid House

The ideas presented here are adapted in part from the long-term program outlined in Stone 2003 (Part III), with some new elements. The focus is on dealing with the essential housing elements of the first three suits of cards -- income inequality, ownership, and financing – through fundamentally different kinds of government intervention and action.

1. Income Inequality

I propose the creation of a Refundable Housing Affordability Tax Credit (HATC). This would be a demand-side government program, patterned somewhat after EITC, administered through IRS, but unlike EITC the credit would not be lost if there were job loss. And it would reach higher up the income ladder. Such a program would be tenure-neutral, progressive, an entitlement with no waiting lists and no means testing.

How to pay for it? By converting the current high-income housing subsidy program -- homeowner tax deductions (upwards of $120 billion a year) -- and the current low-income subsidy programs -- Section 8, etc. (about $30 billion a year) -- into a single program of about $150 billion a year. Not only would such a program be budget-neutral, costing no more than current housing subsidies cost the US Treasury, but it would be fundamentally redistributive, and eliminate one of the most perverse incentives to housing speculation.

2. Ownership

I propose that homeownership be transformed from a de facto junk bond back into a savings account. Instead of offering the promise of windfall profits, with the risk of losing everything, protection would be provided on the downside with modest return on the upside.

In the short term, this means dealing with foreclosures by offering at-risk homeowners the opportunity for low-cost refinancing, with resale restrictions for non-speculative ownership; this offers downside protections with upside limits on gain. For housing that has already gone into foreclosure, the opportunity should be provided for individual and collective purchase for non-speculative ownership (see Stone, 2006b, for explanation of various models of non-speculative ownership).

As a longer-term strategy, I offer a Mutual Housing Association alternative to home-ownership for secure tenure and wealth accumulation (NRC, 1985; Stone, 2006b, pp. 248-249): resident-savers in debt-free housing (Stone, 1993, pp. 193-198). In comparison with conventional and shared equity homeownership, this model offers:

i. Control of space and inheritability: comparable;
ii. Affordability and security of tenure (no mortgage payments; no foreclosure risk): superior;
iii. Wealth accumulation of comparable magnitude but superior re vulnerability, volatility and liquidity (opportunity cost of mortgage payments invested in money market or similar vehicle).

3. Financing

I propose, as part of reforming the financial system, that there be a tax on all capital market financial transactions, with a large share of the revenues put into the National Housing Trust Fund for capital grant financing (Stone, 1993, Chapter 8) of social housing (Stone, 2006b). Capital grants would greatly increase the amount of debt-free social housing, through new construction and acquisition. This would be a supply-side, government housing finance program to complement the demand-side Housing Affordability Tax Credit. This program would be capitalized through a wealth tax of about a tenth to a quarter of a percent on all capital market financial transactions, which would generate over $100 billon per year. Paid into the National Housing Trust Fund, this could finance about 1 million debt-free social housing units per year.

I proposed such a tax for a National Housing Trust Fund in the early 1990s (Stone, 1993, pp. 266-268). Dean Baker (2000, 2008) has proposed a similar speculation tax on financial transactions, which he estimates could have raised over $120 billion a year as of 2000. In his presidential election campaign Ralph Nader (2008) proposed a 0.1% tax on derivative transactions, the volume of which he estimated (without documentation) at $500 trillion in 2008, which would have meant revenues of $500 billion.

I also propose a series of structural reforms to the existing housing finance system:

i. prohibit high-risk loans and restore plain vanilla mortgage loans: fixed-rate, fully-amortized, level-payment, non-recourse loans requiring non-negligible down payments (along with mortgage insurance and default insurance);
ii. restore and strengthen local, mutually-owned & public lenders: credit unions, mutual savings banks, depositor owned S&Ls, community loan funds and public lenders (HFAs);
iii. promote the Ginnie Mae model for mortgage securitization: Freddie and Fannie should remain in the public domain (without shareholders, without highly paid executives, without high-priced lobbyists), and they should return to issuing, government backed, plain vanilla pass-through mortgage-backed securities on the plain vanilla mortgages described in b.; such securities would be prohibited from being sliced and diced and pyramided with derivatives; this would provide liquidity and access to the capital markets for responsible lending without the greed, speculation and risk that brought the system down;
iv. strongly regulate financial markets, with-

transparency and accountability, including prohibition on pyramiding of securities, and including explicit criminal as well as civil liability for violations.

Conclusion

The house of cards cannot be stuck together with bubble gum. It won't work: gum is not strong enough to keep it from collapsing again.

Instead, we must build a solid house with different architects, different building materials and different building contractors.

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