‘What Banking Crisis?’

Congress Is Faking Help to Homeowners

by Richard Freeman and Paul Gallagher

With state leaders demanding serious action against an out-of-control wave of home foreclosures and the threat of local bank failures, Congress in early October went into a flurry of “help for homeowners” activity—all based on *denial* that the economy faces a financial-collapse threat, and all doomed to fail.

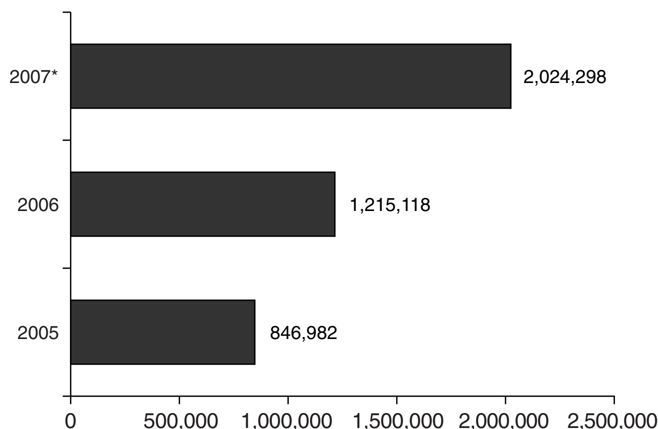
Suddenly giving a very high profile to the rising foreclosure “tsunami,” including a press conference of the full Democratic Congressional leadership on Oct. 3 and competing legislative initiatives, Congressional leaders still claimed that they could make small changes to “fix” the mortgage problem, while insisting that nothing else in the financial and banking system was broken. Most dangerously, they all ignored the gathering plunge in U.S. home values which is still at an early point, but already has started to pull down a roughly $20 trillion mortgage bubble, mortgage-backed securities, and banks and hedge funds worldwide which were speculating in that bubble.

On Oct. 5, Lyndon LaRouche issued a strongly worded warning to Senators Richard Durbin (D-Ill.) and Arlen Specter (R-Pa.), not to introduce legislation that would allow for case-by-case home mortgage “work-outs” under revised bankruptcy protection laws. LaRouche’s warnings were focussed on the fact that the crisis is not merely one of subprime mortgage foreclosures, but a general breakdown crisis of the banking system and the global dollar-based world monetary architecture.

“Don’t commit to pricing on mortgages,” LaRouche warned. “The whole banking system is undergoing a collapse, and a new system is going to have to be established. To tie mortgage values to the old, bankrupt system, would be a grave mistake.” LaRouche added, “What is wrong with just implementing a blanket freeze on mortgage foreclosures, until the whole mess is sorted out? Just set some appropriate interim payments so that there is some flow of funds into the banking system, as homeowners remain in their homes, paying, in effect, rental payments. But don’t attempt at this moment to deal with the issues of appropriate property valuations, mortgage rates, etc. It would only make matters worse.”

The Specter and Durbin proposals—also introduced in the House on Oct. 2—involve changing U.S. bankruptcy law so that homeowners facing foreclosure could declare Chapter 13 bankruptcy and have judges renegotiate their mortgages. The previous bills passed in the House and introduced in the Senate would merely temporarily increase the capitalization of the government-sponsored mortgage enterprises Fannie Mae and Freddie Mac, and the Federal Housing Administration, to allow them to fund or insure more renegotiated subprime, adjustable rate mortgages (ARM), and “exotic” mortgages. The bankruptcy reform was supposed to help up to 600,000 households stay in their homes—as bankrupts—as opposed to fewer than 100,000 who could be affected by the government agency changes; but the estimates of household facing foreclosure by the beginning of 2009 range from 2.5 million to 5 million!

FIGURE 1
U.S. Home Foreclosure Filings Explode
(Number of Filings)



* Projected based on first eight months of 2007.

Sources: RealtyTrac; *EIR*.

A study by Moody’s, widely reported Sept. 30, showed that the much-invoked “refinancing” is just not working for 99% of delinquent households. Reflecting the reality, a worried FDIC chairman Sheila Baer on Oct. 5 called on Congress to simply freeze all ARM interest rates.

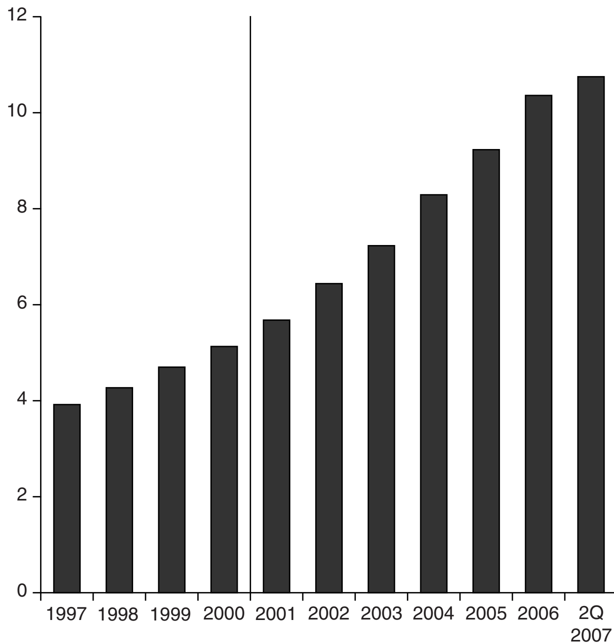
U.S. Housing Bubble: $20 Trillion

Figure 1 shows the growth in home mortgage foreclosure filings, 2005-07. A foreclosure filing is one of three steps in the foreclosure process: a default (which usually occurs when a household is 90 days past due on payment on a mortgage loan); a scheduled auction of a home; or a bank repossession of a home. Using the actual figures of the first eight months of 2007, it is projected that the number of households that will be plunged into some phase of the foreclosure process during 2007 will total 2.024 million, constituting a social-economic catastrophe continuing unabated into 2008. Of great importance is the increase in the speed of the foreclosure locomotive. Between 2005 and 2006, the level of foreclosure filings increased by 43%; between 2006 and 2007, it will have increased by at least 67%.

FIGURE 2

U.S. Home Mortgage Debt Outstanding

($ Trillions)

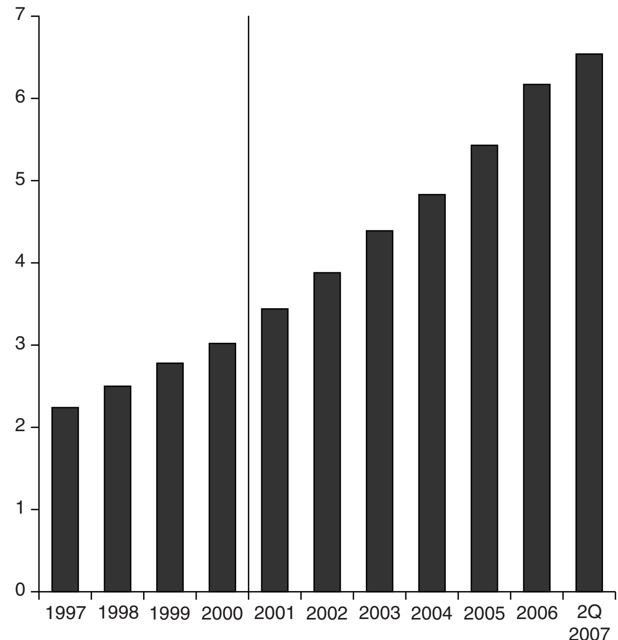


Sources: Federal Reserve Board of Governors; *EIR*.

FIGURE 3

Volume of U.S. Mortgage-Backed Securities Surges

($ Trillions)



Sources: Federal Reserve Board of Governors; *EIR*.

Foreclosure filings occur in specific regions, on county levels. The tsunami of foreclosures is the last phase in the housing bubble which Federal Reserve chairman Alan Greenspan intentionally created, beginning in 2001, which is now collapsing; this is seizing up credit markets around the world, several of which are far upfield from the housing market. But the housing market itself continues to generate plenty of incendiary sparks.

The mammoth scope of the housing bubble that Greenspan created, and its multiple connections into the world's collateralized debt obligations (CDO) and derivatives markets, is crucial to understanding why only LaRouche's Homeowners and Bank Protection Act would work to solve the housing, and broader credit market crises.

Starting in January 2001, after the Information Technology bubble collapsed with the crash of the Nasdaq stock index in March 2000, Greenspan built up the housing bubble to replace it. Greenspan cut the Federal Funds rate (at which banks trade overnight money) 13 times by August 2003, to a 40-year historic low. This brought down mortgage rates.

From this perspective, Greenspan, in concert with Wall Street and City of London bankers, transmogrified the house from a normal family dwelling into "a prized financial asset," whose market price was repeatedly boosted upward. This served two functions. First, against a vastly overvalued property, bankers could attach enormous mortgages, for which they would charge large fees and suck in big interest-income streams. Second, through "cash-out refinancing" and related processes, homeowners extracted cash from their homes for consumer spending, at an annual rate that reached three-quarters of a trillion dollars by 2005.

By keeping interest rates low and priming the housing bubble, Greenspan set up banks and hedge funds to pump tremendous sums of *international* liquidity into U.S. housing. **Figure 2** shows that from 2000 to 2006, Greenspan and the Wall Street/City of London banks caused the volume of lending for U.S. mortgage loans to double, from $5.13 trillion to $10.36 trillion.

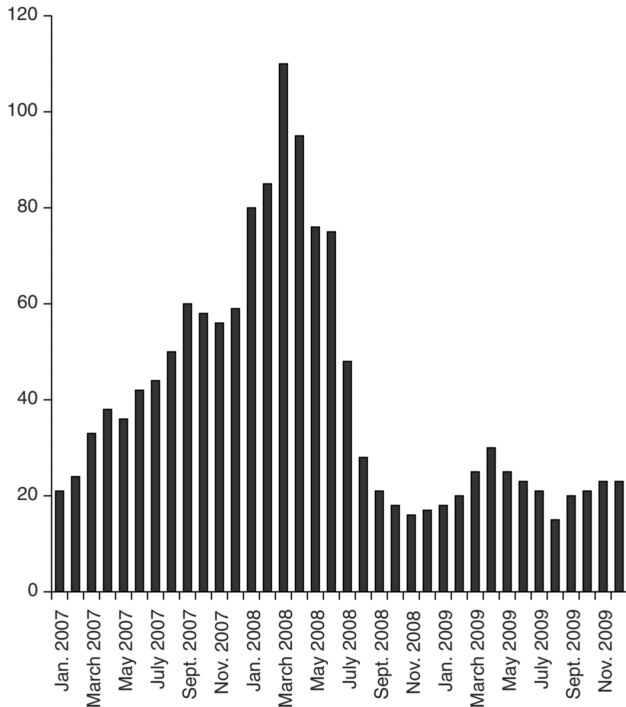
Within this special environment, all the exotic, dangerous types of mortgages were heavily advanced for purposes of securitization by Wall Street investment banks and hedge funds: subprime mortgages, interest-only mortgages, negative amortization mortgages, etc.

Critical to this process, was the vast expansion of the use of mortgage-backed securities (MBS). To create MBS, an institution, such as Lehman Brothers or Fannie Mae, will buy up a group of mortgages, say $100 million worth; bundle them into bond instruments; and then sell the MBS bonds to insurance companies, hedge funds, foreign central banks, and wealthy individuals. The interest and principal that is paid to the MBS bond-holders, is paid out of the cash flow from households making monthly payments on their mortgages. **Figure 3** shows, between 2000 and 2006, the doubling of MBS from

FIGURE 4

Volume of U.S. Adjustable Rate Mortgages (ARMs) That Will Reset, by Month

($ Billions)

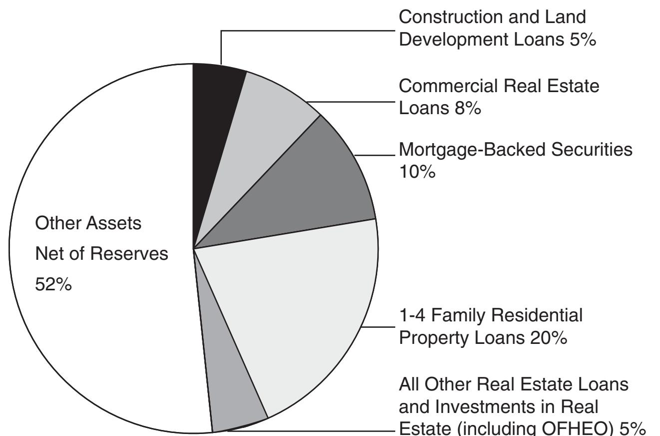


Sources: Center for Responsible Lending; *EIR*.

FIGURE 5

Real Estate Assets as a Percent of U.S. Banks' and Savings & Loans' Total Assets

(Total Assets=$12.26 Trillion, June 30, 2007)



Source: U.S. Federal Deposit Insurance Corp.; *EIR*.

$3.02 trillion to $6.17 trillion. Although MBS are based on underlying mortgages, they are totally separate instruments, with their own rate of interest, their own risk assessment.

But the process went a step further. MBS, which paid a higher yield than Treasury securities of comparable maturity, were sliced into tranches (some of which paid very high interest rates), and became the underlying stratum against which to issue another layer of speculative instruments: collateralized debt obligations; asset-backed commercial paper; and a variant of credit derivatives. This Ponzi scheme was pushed outward, and became embedded in the world financial system.

We are far from the end of the giant foreclosure wave in the United States, with similar phenonena now appearing in other countries. **Figure 4** shows the ARM reset schedule, by month, and by dollar amount. The ARMs reset, typically, after two years, from a lower interest rate of 2-4.5%, to a higher rate of anywhere from 5-8%. Households see their monthly mortgage payments increase by $300, $600, $1,000, or $2,000 per month. Unable to pay, they are thrust into foreclosure. The heaviest wave of resets is scheduled from January through July 2008.

Bank Losses

The trigger for an even larger foreclosure explosion, and a banking crash, is the price devaluation now taking hold. Homes will lose their built-up artificial value. The Schiller-Case index of real estate values for 20 major U.S. cities shows that prices have already fallen by 3.4% from their highs. The plunge will be much deeper. A March 2007 study by First American Core Logic indicates that, were home prices to fall by 10%, then 25% of the mortgages that originated in 2005, and 39% of those originated in 2006, would flip "upside-down"; that is, the households would owe more on the mortgages than the homes are worth. This often prompts foreclosure.

Remember that *mortgage-based debt is half the assets of the entire U.S. banking system* (including commercial banks and savings and loans association—**Figure 5**).

The fall from this process will be immense. As of the end of the second quarter of 2007, the volume of (1-4 family dwelling) mortgage debt is $10.75 trillion; the volume of MBS is $6.54 trillion, a total of $17.25 trillion. When one counts the non-MBS-related debt and derivatives that Fannie Mae and Freddie Mac have, the total reaches about $20 trillion. The failure of a mere one-twentieth of that total, through an increase in defaults and foreclosures, will be sufficient, with the chain-reaction derivatives losses it would set off, to bring down the U.S. banking system.

Moreover, the failure of the MBS-backed variety of Asset-Backed Commercial Paper, has frozen entire chunks of the $1.9 trillion commercial paper market. The failure of MBS-associated credit derivatives, could topple the $34 trillion credit derivatives market. That in turn, would puncture the $750 trillion-plus world derivatives market. Vaporization of the world financial system would follow.

Already, the mortgage- and MBS-crisis has served as the

TABLE 1

Sales of U.S. Existing Homes, Inventory

Year	U.S. Existing Homes Sales	U.S. Existing Homes Supply Inventory	Months of Unsold Homes Inventory
2004	6,778,800	2,244,000	4.3
2005	7,076,000	2,846,000	4.5
2006	6,478,000	3,450,000	6.5
Seasonally Adjusted Annual Rate			
2007 January	6,440,000	3,539,000	6.6
February	6,680,000	3,805,000	6.8
March	6,150,000	3,806,000	7.4
April	6,010,000	4,220,000	8.4
May	5,980,000	4,378,000	8.8
June	5,760,000	4,368,000	9.1
July	5,750,000	4,561,000	9.5
August	5,500,000	4,581,000	10.0

Source: National Association of Realtors.

trigger for failures in parts of the *already bankrupt* world financial system, which are far upstream from, or have nothing to do with mortgages.

During the past two weeks, the roll call of the world's major financial institutions releasing third quarter earnings reports, has a stunningly recurring theme of write-downs and/or losses, from subprime mortgages, mortgage-backed securities, leveraged loans for leveraged buy-outs that did not materialize, etc. On Oct. 2, Citigroup, America's largest bank, announced $5.9 billion in write-downs; on Oct. 2, UBS, continental Europe's biggest bank, $3.4 billion in write-downs; on Oct. 5, Merrill Lynch, $5.5 billion in write-downs, and so forth.

At the same time, at the Federal Reserve's insistent direction, a group of 40 primarily commercial banks have extended $23.5 billion in emergency bail-out loans to Countrywide, America's largest mortgage lender until recently, and now a basket-case. None of these 40 banks would lend a cent to Countrywide, unless they were told that the fate of the world financial system depends upon making such a loan. The same applies to the Bank of England's $20 billion hyperinflationary loan to Northern Rock, once Britain's largest mortgage lender.

All of this happens within a context, in which the Federal Reserve, the Bank of England, and the European Central Bank have, since mid-Summer, cranked up the printing presses and officially pumped an extraordinary three-quarters of a trillion dollars to save the world's failing financial system. This bail-out will create Weimar-style hyperinflation.

States Getting Hit Hard

On Oct. 3, Florida became the latest state to have to call special legislative sessions to cope with the budget impact of disappearing real estate values and foreclosures. Others include Connecticut, Michigan, Maryland, and Ohio. Most real estate taxes are paid to cities and counties—putting them also in trouble—but states collect recordation or transfer fees on all home sales, business taxes from construction companies, real estate companies, etc. They also depend on personal income tax from construction, real estate, and mortgage industry employees who are now losing their jobs in large numbers, so the state budget failures will get worse. Florida is facing a shortfall of over $1 billion—nearly 2% of its two-year budget—due to the collapse of the mortgage bubble.

Michigan, already slammed for years by the vanishing of the auto industry, and having already made large cuts to schools, hospitals, and other vital services, was driven into special session by a new, huge deficit of $1.75 billion. This was the session at which 21 legislators signed the call on Congress for the Homeowners and Bank Protection Act; it was also a session compelled to raise both the state income tax and sales tax, and to legislate $440 million in annual budget cuts, including funds for public universities and community colleges.

In Pennsylvania, while more than 40 legislators at a Sept. 19 special session signed Rep. Harold James' resolution for the Homeowners and Bank Protection Act, they discussed a mortgage shock in Lancaster County, in the eastern part of the state. Pennsylvania has a 5.8% statewide mortgage delinquency rate, and suffered 3-4,000 foreclosures a month in June, July, and August; but Lancaster County had only about 500 properties in foreclosure as of August. But in September, the bankruptcy of one mortgage broker's companies suddenly exposed 800 county households to monthly mortgage payment increases averaging $500, threatening some with foreclosure. The mortgage broker, Personal Financial Management (OPFM), and a number of affiliates, had conducted a years-long speculation scheme involving "wrap-around mortgages." The broker gave apparently legal mortgage loans to 800 families for over 1,000 properties, at low valuations and low interest rates; but used their deeds—and artificial appraisals—to secure progressively much bigger mortgage loans on the same properties from banks and mortgage companies, pocketing and investing the difference, which ran to at least $50 million. By grabbing that "rising equity," the broker made payments on the larger mortgages—until it went bankrupt, and 800 households found they owed much larger monthly payments, for longer terms, to banks and other lenders.

OPFM had the gains of a Ponzi scheme for years; the big banks and lenders got the unregulated broker to do for them what they could not have done themselves, inflating the mortgage value of these properties; and the families got large and unexpected debts. A microcosm of how the mortgage bubble exploded, and is now imploding. A class-action lawsuit by homeowners, names, as defendants, no fewer than 21 big banks and lenders, from ABN Amro, Citimortgage, Wachovia, and JP Morgan Chase to Countrywide Home Loans and SunTrust Mortgage.