Report from 'Ground Zero'

What Bankers Really Fear in Housing Crash

by L. Wolfe

After months of attempting to deny that there was any real problem in the U.S. housing market, the world's leading bankers and speculators are expressing alarm at the size of the bubble they have created—the largest in financial history. With huge numbers of unsold new homes colliding with an even larger number of existing homes that have been thrust onto the market in recent weeks by panicky homeowners, the concern in Wall Street, the City of London, and in other financial capitals is not with a crash in home equity values, which many so-called experts have now conceded is inevitable, but with the effect that this blowout will have on the financial system.

That system, as the world's leading economist, Lyndon LaRouche, has repeatedly warned, is hopelessly bankrupt; it has been kept on life support through the speculative flows, drained from the real, physical economy, into financial speculation, including on housing assets. The hyperinflated housing bubble was financed by huge flows of credit in mortgages, the which have penetrated every pore of the financial and banking system, and are on the books of those institutions. As these mortgages go up in smoke, and as the physical assets (homes, townhomes, condos, etc.) that ostensibly back them up are liquidated in foreclosure or other "fire-sales" for losses, those mortgages blow up the institutions that hold them, and the whole rickety financial system goes down the tubes.

It was this knowledge that made the U.S. housing bubble a major concern, especially in those away-from-the-public corridor discussions of the global stewards of the financial system at the recent International Monetary Fund meeting in Singapore. In the "Risks" section of the IMF *World Economic Outlook* report, released before the conference, the collasping U.S. housing bubble was discussed in the standard hushed tones of IMF-speak: "Growth in the United States is expected to slow from 3.4 percent in 2006 to 2.9 percent in 2007, amid a cooling housing market." At its Aug. 23 IMF Board meeting, the directors noted, "Risks to the [economic] outlook appear to be slanted to the downside, with a more abrupt cooling of the housing market being a particular concern."

While public statements on the matter were muted, the U.S. housing crash and related crises among the hedge funds reportedly cast a dark shadow over the meeting.

Where LaRouche's warnings on the bubble could be dismissed by foolish people in the past, the visible signs of the ongoing crash, including warnings by public figures from the housing and financial industry itself, have brought the problem front and center.

The Numbers Don't Lie—For a Change

In Loudoun County, Virginia, the hottest of the white-hot speculative housing "boom" markets, and the place which LaRouche identified as "ground zero" of the great housing bubble crash, there is a running joke that the county's official flower is the real estate "for sale" signs that dot almost every street and byway in this ex-burb of Washington, D.C. With more than 20,000 new homes coming on-line in the next several months, and with an existing housing stock that, at the current reduced rates of sales, could suffice for several years, Loudoun is now an example of national trends, *in extremis.* In the course of one year, the average length of time a property offered for sale stays on the market has risen from less than a month to more than three months. Realtors say that even that figure understates the problem since there have been many properties that could not be sold at any price, and have been withdrawn from the market.

The Loudoun market had been driven in large part by speculators who bought homes with the expectation that they

EIRNS/Stuart Lewis

The end of the real estate bubble at "Ground Zero," Virginia's Loudoun County.

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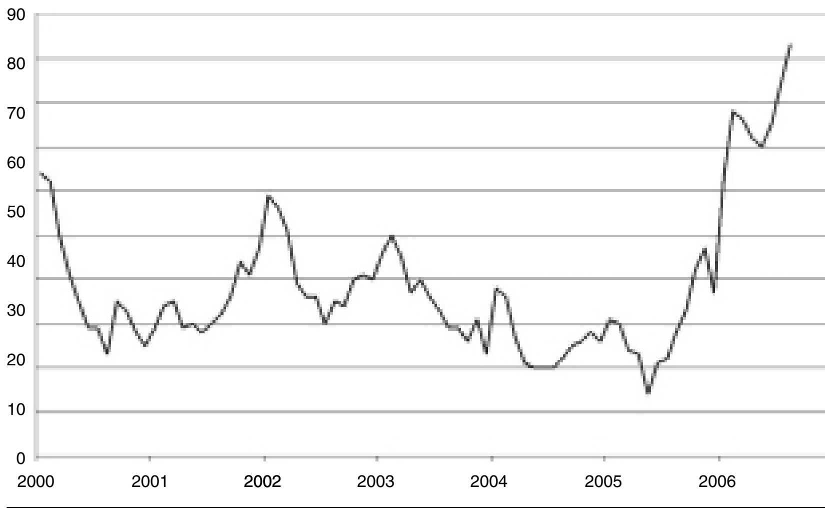
Loudoun County, Virginia Average Days Houses Stay on the Market

(By Month, January 2000 through August 2006)



Source: Dulles Area Association of Realtors

could flip them in a few months for great profits. Those speculators have now basically left the market, having dumped their properties, in many cases for losses. Many homeowners themselves got caught up in this speculative frenzy, buying homes, not so much to live in, but to flip in a year or so: Those homeowners now find themselves stuck in expensive houses that they can't afford and never thought that they would have to pay for. According to local realtors, it is this segment of the market that is breeding a panic, as they dump homes, and when the homes don't sell, owners lower their prices.

As one local realtor reported, the panic is beginning to spread to other homeowners, who now fear that they will be caught in an equity collapse. "When you see one, two, then three and four of your neighbors putting their homes up for sale, you begin to think that you had better get out as well," said the realtor, who also commented that, although he might normally welcome such business, too many buyers "means that everyone will lose money."

The "official" line, backed up by statistics provided by realtors, is that housing prices, as measured by the median price, have *not yet* started to decline, absolutely in Loudoun; that prices have only dropped against expectations and are still rising, albeit more modestly than at the height of the bubble. But as anyone familiar with the market realizes, in a bubble economy, such expectations are what drives—and either pumps up the bubble—or causes it to go bust.

"I don't care any more what the numbers say," said the realtor. "The life's gone out of this bubble, period. We're headed down."

This sentiment is also being driven nationally by a spate of new figures that show the broad deline of the market. For example, the index of builder confidence, as reported by the National Association of Home Builders/Wells Fargo Bank, dropped from 33 to 30, from August to September. According to this widely watched index, any reading under 50 means that builders view conditions as "poor." An economist at Countrywide Financial Corp. in California warns that the decline is "very precipitous. . . . Residential construction is becoming a headwind for the economy instead of a tailwind."

Nationally, the growth in home prices, once soaring by double digits, slowed to a mere 1.7% in the second quarter, while the national inventory of unsold homes soared to a record of more than 4.4 million. Meanwhile, Lombard Street Research economist Gabriel Stein expects the median U.S. home price to fall next year for the first time since the Great Depression.

The ARM Time Bomb

In Northern Virginia, well more than half of all mortgages, including refinancings, are of the risky "zero interest" adjustable-rate types and similar non-traditional mortgages, reflecting a dangerous national trend. These mortgage instruments were designed to fuel the speculative frenzy, and gave buyers short-term low payments, with a time bomb fused over the longer term, when the interest rates and payments jump. As long as there was a rapid turnover, and as long as the housing-price growth covered the borrowing, the buyers and the lenders, which included every stripe of financial institution, appeared to be all right.

Now, with the market in a tailspin, the homeowners find themselves trapped in their homes, when the time-bomb increase in financing costs explodes. This is pushing many homeowners over the edge, into default, and precipitating a sharp rise nationally in home foreclosures.

Not surprisingly, this increase in foreclosures, the worst since the Great Depression, has hit the so-called auto-wreck states of the Midwest the hardest. Foreclosures in the Metro Detroit area jumped a whopping 137%—more than double—in the first eight months of 2006, compared to last year. A mass foreclosed-home auction in the state will take place in late September, with more than 250 bank-owned single-family homes, condos, and duplexes on the auction block. The majority of the properties, about 150 in all, lie within 60 miles of Detroit.

Nationwide, 115,292 properties entered some stage of foreclosure in August, RealtyTrac reported, up 24% from July, and 53% higher than a year ago.

The ARM time bomb and related spurious methods that have financed the bubble have drawn the finger-pointing scru-

tiny of both Congress and the so-called financial industry. While many Senators and regulators have expressed alarm at the extent of the problem and the lax regulation of these loans, these gentlemen either knew of this before and did not speak up, or should have known, and looked the other way. No matter. Such protestations and proposals are now, in effect, well after all the horses are out of the barn, and the barn has burned to the ground!

At a Sept. 20 Senate Banking Committee hearing, there was a push to put tighter restrictions on "non-traditional mortgage lending." Such mortgages put both borrowers and lenders at increased financial risk. "It seems to me there's been a race to the bottom," noted Sen. Jim Bunning (R-Ky.), referring to lending standards. He said that if real estate values continue to fall, the market pullback could become a prelude to a crash. Whereas the risky mortgages were originally designed for those with very strong financial records, according to the GAO, 75% of those with such mortgages packaged into securities in the first half of 2005 were not required to fully document their income.

Even more worrisome is that the Federally created mortgage re-lender, Fannie Mae, which former Federal Reserve chairman Alan Greenspan turned into a cash cow to finance his housing bubble, is ready to blow up from the glut of worthless mortgages it holds. Fannie Mae could lose more than half its capital on sub-prime mortgage blowouts, warns Gilchrist Berg, founder of the $2 billion hedge-fund firm Water Street Capital. Berg said that Fannie could lose $22 billion to $29 billion of its $46 billion capital, if, as he expects, the housing bubble bursts and foreclosures increase. "We are not sure the folks running the show fully embrace the risk of declining house prices," Berg wrote in a letter to investors. Berg also said most that analysts and investors are underestimating the impact of the end of the "historic housing and mortgage bubble."

Fannie is involved in financing one-fifth of U.S. mortgages through bundling into mortage-backed securities (MBS), and it has increased its exposure to sub-prime mortgages in recent years. In 2004, it bought 44% of all sub-prime MBSs; in 2005 it bought 35%, and in the first half of 2006, it bought 25%. Berg says that sub-primes could be 15% of Fannie's portfolio.

Saving Themselves

The financial fools who created the bubble that is now collapsing are desperately trying to manage the coming financial shipwreck. No longer able to keep the collapse of the bubble "secret," they are attempting to give it an air of "inevitability," while trying to limit the panic within the general population. That is what is behind the explosion of press reportage, which attempts to tell people, that while they will lose money, and most certainly the function of their home as a cash-producing ATM machine, the worst effects can be contained.

Meanwhile, several banking sources have reported that Treasury Secretary Henry Paulsen, the former head of Goldman Sachs, may be cooking up a scheme to try to save the banks and their financial books. According to these sources, Treasury, along with the Fed, is trying to come up with a Federally funded mechanism that would take the explosive short-term and ARM debt off the books of lenders, and reissue it at longer-term debt—a scheme that sounds strikingly similar to Felix Rohatyn's Big MAC debt recycling operation that "handled" the New York City debt crisis three decades ago. (Fannie Mae might have been a possibility for this role— but, Fannie Mae is itself hopelessly bankrupt and may have to be bailed out.)

As LaRouche has warned, such taxpapyer-financed bailouts cannot save the housing market or the bankrupt financial system. The only solution to the housing crisis is the global solution proposed by LaRouche—the one that makes the speculators and financiers pay for their incompetence, taking away their power to control financial policy. And, nothing can save the hyperinflated equity values of residential real estate.

Documentation

Senate Hearings on Home Mortgage Bubble

During September, two hearings were held in the United States Senate on the U.S. home mortgage bubble by the Committee on Banking, Housing and Urban Affairs. "The Housing Bubble and Its Implications for the Economy," was the topic on Sept. 13; and on Sept. 20, "Calculated Risk: Assessing Non-Traditional Mortgage Products." Whatever partisan or policy differences prevail in Washington, D.C., there was no disputing the facts presented at the hearing on the dangerous features of today's U.S. speculative home mortgage crisis.

We here provide excerpts from the Sept. 20 session, which was a joint hearing of the Subcommittee on Housing and Transportation, and the Subcommittee on Economic Policy, chaired by Sen. Jim Bunning (R-Ky.). Along with statements by 18 Senators, there were ten witnesses, ranging from the Government Accountability Office and Office of the Comptroller of the Currency, to the Federal Reserve Bank, various mortgage brokers associations, and consumer advocates.

Defaults Rising on 'Non-Traditional' Mortgages

Sen. Jack Reed (D-R.I.) *provided a summary of the situation:*

Two of the most commonly utilized non-traditional mort-

gage products are interest-only and payment-option loans [where not only no principal, but only partial payment on interest is paid, thus creating more debt]. According to the First American Real Estate Solution, I.O. [interest only] and payment option loans comprised only 1.9% of the mortgage market in 2000 but represented 36.6% of the market by 2005.

These loans pose significant dangers to the sustainability of home ownership for many American households. A recent *Business Week* article reported that 80% of the borrowers are making the minimum payment on their payment option loans, eroding their home equity with every payment.

At a time where prices are leveling or even declining in many parts of the country, many borrowers with option adjustable-rate mortgages, ARMs, may, in fact, soon be left with few options.

Borrowers with other non-traditional products also may soon be facing significantly higher payments in the near future, leading Goldman Sachs to estimate that non-traditional mortgage products are at a, "very high risk of default."

In fact, foreclosure rates are escalating. Indeed, non-traditional mortgages default at a higher rate than fixed-rate mortgages. In Rhode Island, for example, defaults on prime ARMs are 21% higher than prime fixed-rate loans.

Sub-prime ARMs have almost a 40% higher default rate than fixed-rate loans. As a result, according to Fitch Ratings' 2006 finance outlook, mortgage delinquencies, which have increased by 53% over the last year, are expected to rise by an additional 10% to 15% in 2006.

Sub-Prime Loans and Payment Shock

Michael Calhoun, *president, Center for Responsible Lending, testified that though home ownership has been the "traditional ladder to the middle class for Americans," their involvement now in "many of these non-traditional mortgages has created a trap door to financial ruin for these families":*

Much of the discussion about non-traditional mortgages is focussed on the prime market. However, today in the sub-prime market, which is nearly one-fourth of the overall mortgage market, the dominant product in that market is a non-traditional product. And it will inflict, in our view, far more harm than the other types of non-traditional mortgages that you've heard about today.

These so-called sub-prime hybrid ARMs, with low teaser rates, are the leading product in the sub-prime market, and that is where I'll direct my testimony today.

I'm going to first describe the nature of this product. . . . A sub-prime hybrid ARM has an initial short fixed-rate period—the typical one is two years—and then for the remaining [of the 30] years of the mortgage it's an adjustable rate, so they're often called 2/28 mortgages.

The key factor is that the initial payment is set far below the fully indexed payment. To give you an example of what typical rates would be in the market today, the initial payment would be based on an interest rate of maybe 7.5% or 8%.

However, after the end of that initial two-year fixed-rate period, the fully adjusted rate would be in the range of 11.5% to 12%, even with interest remaining the same, the market rates remain the same. This produces a payment shock typically of 40% to 50% for the borrower.

And perhaps, it's most dramatic that even if you take a very favorable scenario, if interest rates are reduced, market rates, by 200 basis points, these borrowers still would typically face a 20% to 25% payment shock.

And that, I would think—the testimony today is [that] one of the common themes of the risks of the non-traditional mortgages has been payment shock and how most families are very ill-equipped to handle that.

In the sub-prime market, this payment shock is exacerbated by several factors. First of all, the underwriting on these loans is done at a very high debt ratio, up to 50% to 55%, which means that that mortgage payment can be 50% to 55% the total debt of the borrower, 50% to 55% of the borrower's gross income, before-tax income.

Second, the standard underwriting practice in the sub-prime market is to underwrite only the initial payment, so they allow the initial payment to be 50% or 55% of the borrower's income. When you add a payment shock of 20% or 40%, you end up with loans where the mortgage burden is more than the borrower's take-home pay.

Third, in the sub-prime market, the practice is in the majority of loans not to escrow for insurance and taxes, and the reason for that is, it's a way to artificially depress that monthly payment, make it look lower, but you leave another financial shock out there for these borrowers.

The impact of this is that many borrowers are threatened with losing their homes. And this impact is especially felt in minority communities. Recent HMDA [Home Mortgage Disclosure Act] showed that the majority of African-Americans have high-interest sub-prime loans. More than one-third of Hispanic borrowers have high-interest sub-prime loans. . . .

Millons at Risk From 'Lending Boom'

Allen Fishbein, *director of Housing and Credit Policy, Consumer Federal of America, described the impact on families swept up into the home mortgage "lending boom." The "resets" of adjustable rate mortgages to higher monthly payments "are likely to mean that more than one in eight or more of these loans will end up in default:*

A recent study by First American Real Estate Solutions has reported that $368 billion in adjustable-rate mortgages originated in '04 and '05 are sensitive to interest rate adjustments that would lead to default, and $110 billion of these are expected to go into foreclosure.

Now, this translates into numbers of 1.8 million families that are at risk as a result of the possibility of default and another 500,000 that are likely to go into foreclosure. So the numbers are quite large.