

# THE CENTURY FOUNDATION

## Issue Brief

### A GUIDE TO THE HOUSING CRISIS: TEN QUESTIONS AND ANSWERS

BY BERNARD WASOW

#### 1. WHY DID HOUSING PRICES GET SO INFLATED?

An asset price bubble happens when buyers and sellers begin to believe that prices can only go up instead of asking what a reasonable price should be. A price bubble is enabled when easy credit makes it possible to speculate on the assumption that prices can only go up. That is what happened in the housing market beginning around the time that the dot.com stock bubble exploded.

#### 2. WHY DID LENDERS FINANCE THIS RUN-UP?

Four things resulted in bad loans being made.

- Many lenders, like borrowers, bought into the bubble psychology. Since they thought that the collateral behind mortgages (houses) could only become more valuable, they felt justified not paying attention to the creditworthiness of borrowers. Home buyers were just caretakers of appreciating assets.
- New markets enabled lenders to sell off, almost immediately, the mortgages they made. Therefore lenders were able quickly to pass on to someone else the risk that a borrower would default. The buyers of these new assets felt safe because many mortgages were bundled together into the mortgage packages that were sold off to investors, so they thought their risk was diversified.
- Employees of lending institutions were rewarded according to how much business they brought in, that is, by how many mortgages they arranged and the size of those mortgages. Brokers made money by arranging transactions; on the front line, lenders had little interest in the creditworthiness of borrowers.
- Lenders were confident that the government would step in if for some reason things got too bad, so their downside risk had a floor under it.

#### 3. HOW COME SO MANY DIFFERENT BANKS AND BROKERAGES ALL OVER THE WORLD ARE IN HOT WATER?

When new securities appeared, consisting of bundles of mortgages from all parts of the United States, money managers were pleased that they had a new kind of asset, with good returns and moderate risk. But this perceived low risk was based on the history of housing

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HEADQUARTERS: 41 EAST 70TH STREET – NEW YORK, NY 10021 – 212.535.4441 – 212.535.7534 (FAX) – INFO@TCF.ORG – WWW.TCF.ORG  
D.C. OFFICE: 1333 H STREET, NW – 10<sup>TH</sup> FLOOR – WASHINGTON, D.C. 20005 – 202.387.0400 – 202.483.9430 (FAX) – INFO@TCF.ORG – WWW.TCF.ORG

prices and mortgage default rates from another era, that is, from the time when bankers and brokers were careful in underwriting mortgages for fear they would be stuck with subsequent defaults. The housing boom that the market for mortgage backed securities helped fuel brought steadily rising prices that made these securities seem like safe bets. Everyone thought someone else was checking that the underlying mortgages were good loans. In fact, in many instances, nobody was undertaking due diligence before making the loans. Mortgages were even being issued with “teaser” interest rates that would expire after a few years, causing the borrower’s debt service costs to skyrocket.

Credit rating agencies, which are notorious for failing to anticipate spectacular financial market crashes, missed again in this case. Financial operators, on their side, packaged the worst mortgages together with other mortgages, and eventually even packaged bundles of mortgages together with bundles of other assets in new securities that consisted of bundles of bundles of securities (“collateralized debt obligations,” or CDOs). In 2006 alone, the CDO market issued more than \$600 billion of new securities, more than ten times the amount issued just a decade earlier.

This ratatouille of fresh and rotten obligations would have been extremely difficult for anyone to rate for risk, but the rating agencies—who are paid by those who issue securities—continued to add flavor to the pot by rating these new debt instruments highly. From Boston to Bahrain, asset managers with no direct understanding of the U.S. mortgage market snapped up these new assets to include in the portfolios of banks, insurance companies, pension funds, and foundations.

Market mechanisms were not sending up red flags, and government watchdogs, such as the Federal Reserve and the Securities and Exchange Commission, were staffed with people hostile to government regulation. As a result, even basic data on new securities markets were often hard to come by, to say nothing of transparent and honest appraisals leading to new standards and their enforcement.

The fact that so many institutions that have nothing directly to do with mortgage lending, but which own mortgage-backed securities, are in trouble is at the heart of this crisis. The danger of widespread collapse of institutions that depend on credit (all businesses!) has made a housing crisis into a crisis of the entire international economy. This crisis is getting so much attention not because some banks and brokerages are threatened with bankruptcy, but because if the financial system seizes up, production and jobs will bleed in every corner of the world economy.

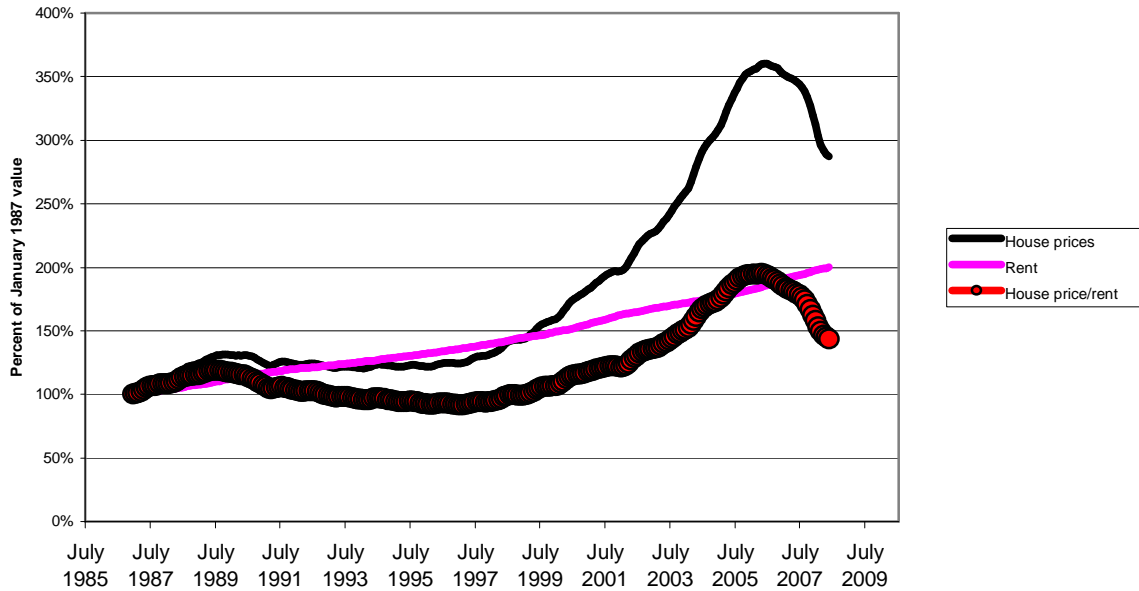
#### **4. WHAT ARE THE ASSETS REALLY WORTH THAT THE TREASURY PROPOSED TO BUY FOR \$700 BILLION?**

Nobody knows. We know that about \$6.5 trillion in mortgages got packaged into securities and sold. Nobody knows what proportion of these loans were rushed through without scrutiny of the borrowers’ creditworthiness. “Sub-prime” mortgages, which include “ninja” mortgages (no income, no job, no assets) may well be only the tip of an iceberg.

We do know that housing prices got way out of line with people's incomes and rents and that household indebtedness got way out of line with families' ability to service debt. As housing prices fall, more and more homeowners do better defaulting on their mortgages than repaying them. As the government brings in relief programs for distressed home buyers, more owners will declare distress.

One measure of the price of houses departing from the fundamental value of housing is the ratio of house price to rent. This is like a price/earnings ratio for housing. Below is a graph that illustrates how rent, house prices, and their ratio have behaved since 1987. Rent has increased steadily, along with inflation. Housing prices stagnated between a run-up in the late 1980s and the price surge that began in the late 1990s. The ratio of home prices to housing rent also surged from the late 1990s through mid-2006. Between January 1997 and July 2006, rent rose by 37 percent, the price of houses rose by 190 percent, and the ratio of house prices to rent more than doubled.

**Price of Houses, Rent, and Their Ratio, January 1987 to June 2008**



Source: Rent from the Bureau of Labor Statistics Consumer Price Index; house prices from Case-Shiller composite-10 (house price series), available [online](#).

The Congressional Budget Office has looked at the ratio of house prices to rent for a longer period and shows that there was essentially no trend to this ratio from 1975 through 1996. In other words, in the two decades before the housing bubble began in the late 1990s, house prices rose on average at the same rate as rents. To reestablish the relative price of houses and rent at the January 2000 level, housing prices would have to fall another 35 percent from the level of June 2008. Of course, nobody knows what ratio is sustainable, since no one knows what future demand for housing or construction and maintenance costs will be. What is more, the relative price will fall as long as rents continue to rise while housing prices

stagnate. Therefore the actual price people pay for houses may fall much less than 35 percent. But it is unlikely to rise soon.<sup>1</sup>

## **5. WHO WILL EVENTUALLY OWN THE REAL ESTATE PROPERTIES INVOLVED?**

This is one of the many things that is not yet clear. It is not even clear who owns the mortgage after it is included in a package of securitized mortgages. One academic study found that 40 percent of creditors who were in the process of foreclosing on mortgages that had been securitized could not show proof of ownership.<sup>2</sup>

Everyone would like to see the properties occupied and generating income. But we need to clarify ownership law. We also need to pursue policy that preserves incentives to be careful in granting mortgages and in borrowing. Both those who made bad loans and those who applied for them should bear costs. This is not easy to arrange, and it may eventually require mortgage-by-mortgage negotiation, a time-consuming and expensive prospect.

One of the big problems is that some people who have mortgage debt higher than the value of their property are continuing to pay off their mortgages while other people in this position are defaulting on their mortgages. A solution must simultaneously:

- a) treat families similarly if their incomes and mortgage debts are similar,;
- b) maintain an incentive to repay mortgages,
- c) retain a cost for bad borrowing decisions, and
- d) not destroy the wealth and the housing options of many families.

It is likely that mortgages will be renegotiated to reflect falling housing prices. This will avoid the costs of foreclosure and resale as well as protect families from homelessness.

## **6. WHAT WILL HAPPEN TO THE BANKERS AND BROKERS WHO OPERATED THE INSTITUTIONS THAT CREATED ALL THESE BAD LOANS?**

Just as we must be concerned that borrowers bear costs for bad decisions, the same should apply to lenders. Unfortunately, rewards in the banking and brokerage businesses are based primarily on very recent results. A person who originated one hundred bad mortgages a few years ago probably never will bear a cost because those mortgages are no longer associated with his or her work. At the top of the firms that did the bad lending, executives will receive smaller bonuses if their firms do poorly in 2008, but past income is theirs, regardless of how many mortgages we learn their firms originated or packaged without due diligence in 2005 and 2006. Many top executives have contracts that guarantee big severance packages.

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<sup>1</sup> Peter R. Orszag, Director, Congressional Budget Office, "The Current Economic Situation," Testimony before the Committee on the Budget U.S. House of Representatives, December 5, 2007, available online at <http://www.cbo.gov/ftpdocs/88xx/doc8876/12-5-Economic.htm>.

<sup>2</sup> Gretchen Morgenson, "Foreclosures Hit a Snag for Lenders," *New York Times*, November 15, 2007, available online at <http://www.nytimes.com/2007/11/15/business/15lend.html>.

An instructive example of the extent to which employees of the financial system escape accountability for their mistakes is found in the fall of the world's biggest insurer, AIG.<sup>3</sup> One small division of this 116,000 employee giant—a London branch with 377 employees—created a new insurance product, which covered default risk on financial derivatives such as mortgage backed securities. To avoid regulation, the product was sold as a bank product, not an insurance policy, and business boomed for many years. Between 2001 and 2007, the employees of this unit earned an average of more than \$1 million each per year. In 2008, the collapse of the housing bubble destroyed this division; it dragged the rest of AIG with it. The company has been effectively nationalized in order to prevent further damage to the financial system. What are the consequences for the 377 employees who made this nightmare come true? They still have the millions they made between 2001 and 2007, and many of them will have to find new jobs, if they still want to work. Their experience at the cutting edge of financial innovation should be an asset if they decide to continue working.

It is likely that the finance industry will contract, since we are now learning that many of its employees have added little if any value. This outcome depends on introduction of regulation that prevents recurrent bubbles and bailouts. If the industry contracts, there is little reason to believe that those who lose their jobs will be those who made bad decisions in the early 2000s.

## **7. WHICH PARTS OF GOVERNMENT FAILED TO PULL THE ALARM LEVER AND PERHAPS TO INTERVENE IN REAL ESTATE AND BOND MARKETS AS THIS CRISIS WAS BUILDING?**

Two quasi-governmental institutions—Fannie Mae and Freddie Mac—are at the center of the U.S. housing market. They were created to increase homeownership. While they have been under pressure to create more homeowners, they have used their huge cash flows to lobby in Washington for policies that would enable them to support more housing lending. Limits on the mortgages Fannie Mae and Freddie Mac could issue means that the worst mortgages—the sub-prime trash—were produced by other lenders. But the result of industry pressure, together with conservative resistance to regulation, has been lax oversight over mortgage lending throughout the industry.

Public policy, instead of leaning against the wind of over-lending, helped create that wind by applying pressure to increase homeownership. In the face of rapid institutional innovation, many parts of the financial system are not well regulated. Behind the lack of oversight of mortgage lending and securitization of mortgages lie the federal commitment to homeownership and the hostility to regulation of new products such as securitized mortgages.

In this context, we should remember that bundling and securitization of home mortgages was only one part of a huge explosion of financial innovation. Financial derivatives have been created out of almost every traditional product of the banking industry. It is possible to swap currencies, swap interest rates, break a loan into its interest and its principal portions and sell them separately, and generally to buy and sell pieces and bundles of products as

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<sup>3</sup> Gretchen Morgenson, "Behind Insurers Crisis, Blind Eye to a Web of Risk," *New York Times*, September 27, 2008, available online at <http://www.nytimes.com/2008/09/28/business/28melt.html>.

mundane as car loans and student loans, and as far from the typical family's experience as international sovereign debt commitments. Wherever possible, the finance industry has pushed government regulators to let them carry new products off their balance sheets, and to trade them with minimal regulation. The working assumption was that market transactions among consenting adults are self-regulating through price movements and reputation. Those chickens have come home to roost.

**8. WHAT IS THE “WORST CASE” OUTCOME OF THIS CRISIS THAT SEEMS MODERATELY LIKELY?**

In the worst case, trust and confidence will fail first for American credit institutions, then for similar institutions internationally, and perhaps for all dollar-denominated assets. As lending and borrowing remain constricted, and perhaps as long-term interest rates rise in anticipation of future inflation, the production of goods and services will be reduced. Declining credit, production, and incomes creates the vicious circle we call a depression. The shock of recognition will hit Main Street when a big company such as General Motors is forced into bankruptcy.

**9. WHAT IS THE “BEST CASE” OUTCOME OF THIS CRISIS THAT SEEMS MODERATELY LIKELY?**

At best, as the Treasury trades real money for “trash paper,” credit institutions worldwide will regain confidence in each other and in the ability of the U.S. government to contain the financial crisis. Credit markets will resume lending, businesses will not cut back much, and the economy will avoid a significant decline. With relatively quick recovery of the economy, the housing market, too, could stabilize, limiting the cost of the government bailout.

**10. WHAT SORT OF POLICY IN THE UNITED STATES WOULD INCREASE THE CHANCES OF THE GOOD OUTCOME?**

International wealth managers must be convinced that the United States government can and will solve the credit crisis that originated in housing. The following measures would help:

- 1) The triumph of rational discussion over electoral politics in the debate leading up to a bailout.
- 2) Injection of sufficient resources into credit institutions to ensure that they will be confident to resume lending and borrowing.
- 3) Checks and balances on those administering the bailout packages. While speed is important, accountability of those in charge of the rescue effort must be ensured.
- 4) Political commitment in the United States to:
  - a) Introduce financial regulation to avoid a repeat bubble.
  - b) Enough relief to homeowners and penalties to bank executives to satisfy Main Street.
  - c) Pursuit of fiscal policy consistent with major new expenditures; a plan to pay for the bailout. That is, at some point, higher taxes.