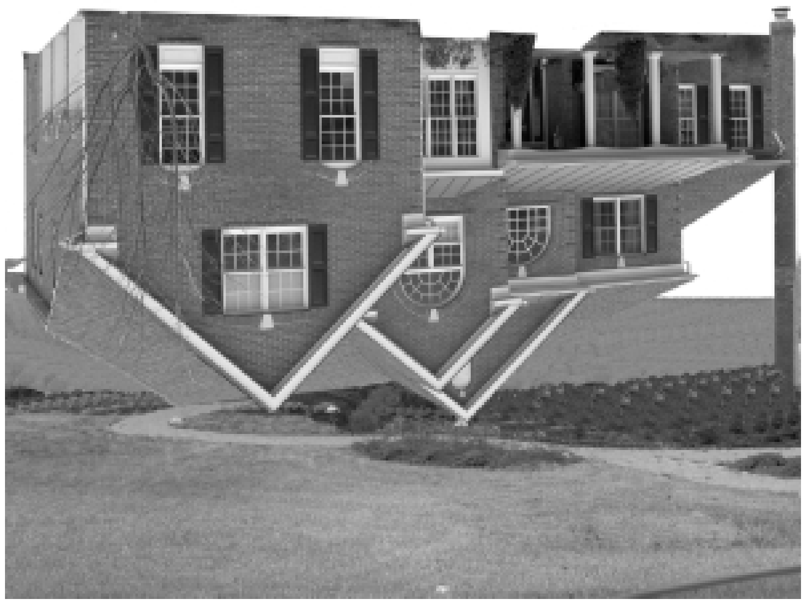
EIR Economics

'Upside-Down Loans' Show End Of Greenspan's Housing Bubble

by Richard Freeman



In the topsy-turvy U.S. housing market, many mortgages now exceed the market value of the home—a situation known as "negative equity." This is due both to collapsing markets in certain regions of the country, and to "exotic" interest-only and other loans that have kept the housing bubble aloft.

In its last two issues, *EIR* has reported the characteristics of the U.S. housing/real estate bubble's collapse in two economically very different areas: the industrial layoff-ridden upper Midwest states; and the so-called "golden housing market" of the Washington, D.C. suburbs' star performer, Loudoun County, Virginia. The series will explore the method by which Greenspan enlarged the housing bubble, through the use of mortgage-backed securities. Here we turn to the "red die marker" of the fact that a national collapse is under way, the epidemic negative-equity situation known colloquially as "upside-down mortgage loans."

Upon becoming Federal Reserve Board chairman in 1987, Alan Greenspan used mortgage-backed securities churned out by Fannie Mae and Freddie Mac, to monetize paper held by the commercial banks. He blew the real-estate bubble ever bigger, to pump out mortgage-backed securities, pump up M3 money supply, and pour money into the banks. The banks, in turn, took the cash through cycles of investment, through intervening layers of bubbles, including the notorious "Y2K" bubble of information technology and dot-com stocks—and ultimately into the primary commodities markets, igniting a hyperinflation.

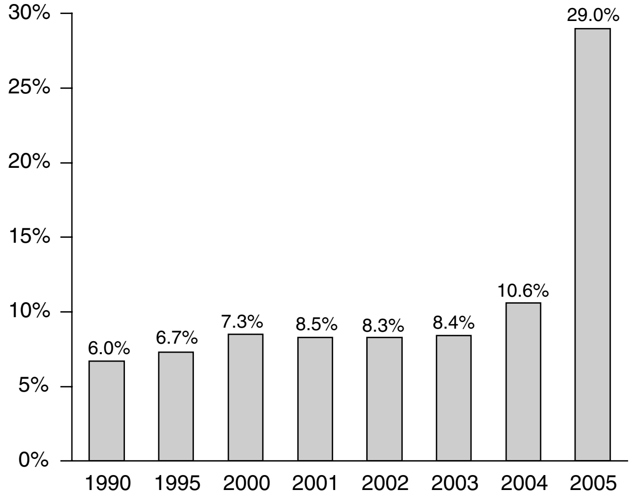
The ongoing crash of the U.S. housing bubble, will bring down not only an unprecedented $15 trillion in U.S. housing-related financial assets, but the commodities bubble, and the world financial system.

In looking for the signs of that crash, sifting through reams of data is useless; rather, seek out those key parameters, which show a unique directional change:

- When homeowners realize that the housing bubble has crested, and that either the prices of homes have or soon will have peaked, and are headed down, they rush to put their homes on the market to sell them for as much as they can get, hoping the home is still salable. On April 25, the Mortgage Bankers Association reported that the nationwide inventory of unsold houses jumped to 3.194 million in March 2006, from 2.297 million in March 2005, an increase of nearly 900,000 or 39%. The inventory of unsold homes is growing by 50,000 to 100,000 per month, as "buyers" fail to purchase them at current prices.

- On April 24, RealtyTrac, a foreclosure monitoring service, released its "2006 First-Quarter U.S. Foreclosure Market Report." It found that in the first quarter of 2006, nationwide, 323,102 housing properties entered some state of foreclosure, a 72% increase over the first quarter of 2005. This is usually one step before the homeowner loses the home.
- But one of the most decisive parameters, which has reached epidemic proportions, and whose spread indicates the *curvature* of the housing bubble's collapse, is one of the least reported on. It is called negative equity, or frequently, "upside-down mortgages." It means, simply stated, that the homeowner owes, on mortgages on a home, more than the home and property is worth, or could be sold for on the market. The homeowner is in a completely no-win situation. The homeowner "can't pay, can't sell, can't refinance." The more that home prices fall, the more that homeowner sinks into his prison. Like the character in Edgar Allan Poe's story, "The Cask of Amontillado," he is walled in, with foreclosure looming large.

FIGURE 1
U.S. Home Mortgages That Have Negative Equity
(By Year That the Mortgage Originated)



Source: First American Real Estate Solutions, Christopher Cagan, "Mortgage Payment Reset."

Growth of Negative Equity

As an aid, consider how equity is defined with regard to homes: Equity is the value a homeowner has in a home that is free and and clear above debt. If a home has a market value of $500,000, and by borrowing against the home and to buy it in the first place, the homeowner has a mortgage of $400,000, then his home equity is $100,000. If, with that same $500,000 home, the homeowner has $550,000 in mortgage debts, then he has negative home equity of $50,000. In the first case, the homeowner is said to have a 20% positive equity ($100,000 divided by $500,000); in the second case, he is said to have a 10% negative equity.

On Feb. 8, First American Real Estate Solutions released a report entitled, "Mortgage Payment Reset: The Rumor and the Reality," that shone a spotlight on negative equity. It studied American homeowners' first mortgages only. The stunning result of the study was that, as of the third quarter of 2005, 9.4%—nearly one in ten—of such homeowners have negative equity.

But even more alarming for American households—and the housing bubble—is the dramatic rate of change in this measure during the past two years, a trend that appears to continue in 2006. **Figure 1** shows specific results for years in which mortgage loans were taken out, or "originated." For mortgage loans originated in 1985, 6.0% today have negative equity. For mortgage loans originated in 2003, 8.3% today have negative equity. Thus, for the period 1985-2003, there was a narrow, well-defined band of negative equity. But the shift started in 2004, and for loans originated in 2005, the percentage that have negative equity jumped to 29%, far beyond anything that had happened before.

Several million households took out mortgage loans in 2005; nearly one-third of them owe, on a mortgage, an amount greater than the value of the house it is attached to.

Christopher Cagan, author of the First American Real Estate Solutions report, told *EIR* on April 27, how this situation came about. "People who have read the report have said to me, that the 29% rate is just too big—how can that be?" Cagan said. "But I have done an accurate study with a large number of homes. There are several ways that negative equity is brought about. One way is that the price of the homes actually fall—as they are in Detroit, where they are falling 10% or more." As the market value of the home falls, the mortgage amount due remains the same, increasing the negative equity.

Cagan also focused on exotic loans—interest-only and negative-amortization mortgages—that lenders have used to keep the housing boom alive. "Another way is the [role] of negative-amortization loans." In this kind of mortgage, which has become widely used, usually for a period of the first 1-3 years of the mortgage, the mortgage borrower does not pay any principal, and, moreover, pays only a part of the interest due. "In this case, the borrower defers part of the interest payment, and the deferred interest is added on to the balance of the loan, so the balance grows." The mortgage debt swells above the home's value and causes a negative-equity predicament.

But there are many questionable practices that real estate agents and lenders are using to get people to buy homes. Said Cagan, "Let me tell you how the real estate market works in parts of California. You sell your house by adding $50,000 to what your neighbor's house sold for, and then adding 10% to the asking price. So let's say your house is worth $700,000. You ask for $800,000. Then a realtor tells the person who is thinking of buying the house, 'Offer $900,000, otherwise someone else is going to get the house.' The house sells for $900,000." He continued, "Then the lender is told, 'Do what you have to do to make [the sale] happen.' This is done because it is figured that the rising market will forgive you. The loan is made for $900,000, but even as the loan is made, the house is really worth only $750,000. That loan is underwater from the get-go."

Thus, due to this action, the mortgage exceeds even the real estate market value of the home from day one: Its equity is negative.

Cagan is very concerned that in many of these loans, the household took out an adjustable rate mortgage (ARM) at "teaser rates of 1%," and then, after the pre-arranged period of time, the ARM resets to a higher interest rate. That could increase the interest amount due monthly by such a great amount, that the borrower can't pay the mortgage.

The homeowner with negative equity—and there are millions of them—has exhausted his options. He can't *pay* the mortgage, because the mortgage has become too onerous. He can't *sell* the home, because if the homeowner could even sell the home at the market price, he would still owe a part of the original mortgage attached to the house. He can't *refinance* the house, because the bank would see that the home has a market value less than the existing mortgage; under those conditions, the bank would not refinance, that is, lend new money. The homeowner is trapped in this neighborhood, even as market conditions turn more and more against him.

Falling Home Prices

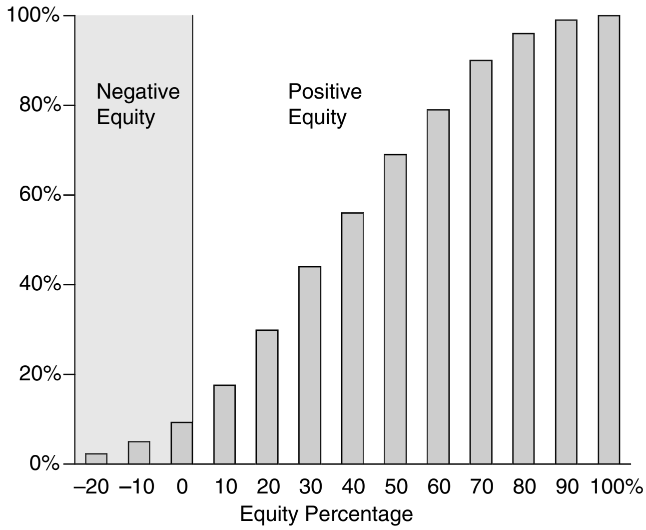
In his report, Cagan raises the real question: what would happen to the number of people with negative equity were home prices to fall not just in Detroit and the Midwest, but across the United States, by, say, 10-30%. **Figure 2** is the model he uses to examine the consequences. This figure depicts the prevailing situation, in which *cumulatively* 9.4% of all homeowners with mortgages have zero or negative equity. That is designated by the vertical line; everything to the left of the line, in the zone which is shaded in the figure, represents those households with zero or negative equity. However, if home prices fall, that line will move to the right, encompassing more households.

For example, the graph shows the percentage of households that possess 10% equity or less (including those with negative equity). This represents 17.7% of all households. However, were home prices to fall 10%, then those who previously had 10% equity, would now have no equity. The line would shift to the right, and now 17.7% of all households would have zero or negative equity. Were home prices to fall 30%, the line would shift further to the right. Those households which previously had 30% positive equity, would have no equity. With that 30% fall in home prices, 44.4%, or nearly half, of all households in the nation would have zero or no equity.

FIGURE 2

Cumulative Distribution of U.S. Homeowner Equity Percentage, Third Quarter 2005

(Percentage of Homeowners)



Source: First American Real Estate Solutions, Christopher Cagan, "Mortgage Payment Reset."

Cagan stresses that those households that have adjustable rate mortgages, especially those who signed on for initial interest rates of 4% or less, are vulnerable, because those rates are rising, and will increase monthly payments by hundreds of dollars.

He determined that within the next few years, $297 billion of vulnerable mortgage loans, many with negative equity, will default.

Cagan argues that this level of defaults will have a small impact on the banks, or the much larger world of mortgages. However, he overlooks that this is a dynamic process. Mortgage defaults of $297 billion would register for all to see the dire nature of the bubble; it would drive home prices down another notch, pushing more and more homeonwers into negative equity. The world of mortgage-backed securities would be rocked, putting pressure on Fannie Mae and Freddie Mac to churn out money to hold it up. This would puncture the multi-layered $15 trillion in housing-related paper, and that, in turn, would bring the commodities bubble to the point of explosion.