Systemic Mortgage Threat Dawning on Congressmen?

by Paul Gallagher

A few members of Congress had begun to take the U.S. mortgage meltdown seriously—as a financial markets crisis in the making—as of mid-April. But they were still avoiding the central issue of the spreading mortgage crisis: the bankrupt practices, and asset-books, of the Wall Street banks which created the mountain of collapsing debt. The moves toward a direct Federal role in halting the runaway mortgage crisis meet a basic requirement; but they still ignore the primary necessity to reorganize the U.S. banking system as FDR did in March of 1933.

Half the assets in the entire U.S. banking system—$5.9 trillion of $11.9 trillion, or 49%—are based on commercial or residential mortgages. A simple attempt to bail out those vastly overwatered bank assets with Federal credit and money, while motivated by pressure to help millions of households avoid foreclosure, would be a disaster. The calls for expanding and using the FDR-created Federal Housing Administration (FHA) go in the right direction (See "Lessons From FDR's Handling of Housing Crisis," *EIR,* April 6). But the recently exposed cases of JP Morgan Chase mortgage lending in central Ohio, and Beazer Homes Mortgage Division lending in North Carolina, Maryland, and elsehwere, show banks and financial companies effectively using FHA guarantees to aid in committing mortgage loan fraud *en masse.* Beazer is under criminal investigation and on the skids; Morgan should be. Many banks' operations have been indistinguishable from those of out-and-out mortgage fraudsters, in driving up home prices in a household debt bubble, now exploding.

The dawning seriousness of the systemic collapse threat showed in the April 13 comments of Democratic chairman of the House Financial Services Committee, Barney Frank. Frank told the *Financial Times* that Congress had to "stop the market from collapsing," by new regulations making banks and mortgage security companies liable, in what has been, since 2001, their devil-may-care reselling (as securities) of more and more *unpayable,* high-interest mortgage debt. The *Wall Street Journal* and the Securities Industry Association worried that this would cut down the volume of the banks' "securitization" of mortgage debt, and thus on financial flows into the housing bubble. But Frank said, with an FDR echo, "It is not part of my concern whether investment banks make money. The purpose of housing finance is to get people in housing, not to finance the U.S. financial markets."

Sudden Drop in Demand for Mortgage Securities

In fact, the stage of deflation of mortgage securitization is already underway, as the financial disintegration stemming from the mortgage crisis spreads. As the IMF report on world financial stability was forced to warn on April 10, the so-called "U.S. sub-prime mortgage crisis" has definitely now spread beyond sub-primes into "Alt-A" mortgages and jumbo loans, and more importantly, into the mortgage-backed securities (MBS) markets. These markets sold off $2.4 trillion in mortgage-backed bonds in 2006, making large profits for hedge funds and banks.

Focussing on the illustrative case of American Home Mortgage Investment Corp., numerous wire reports on April 11 described how mortgage lenders outside the "sub-prime concentration" are slowly but steadily losing access to liquidity in the MBS market; i.e., banks and funds are not buying these lenders' securities. The volume of so-called "Alt-A" mortgages has been even greater than subprimes; these "self-stating" mortgages (or "liar loans") in which the borrower, typically a self-employed person, simply states his or her income rather than showing it, have been usually quite large, for expensive homes, and are often of the potentially deadly adjustable-rate (ARM) type. As a result, the foreclosure rate for homes *priced above $800,000* is now over 2.5%, higher than the national average for foreclosures. But delinquency and foreclosure rates on "Alt-A" loans are nowhere near those of subprime mortgages. Rather, the mortgage meltdown has spread to this sector, above all, because mortgage-backed securities based on Alt-A mortgages are becoming radioactive like those based on subprimes.

Alt-A lenders which have "taken hits" include American Home Mortgage, whose stock and credit ratings have rapidly been downgraded since April 9; First Horizon National Corp. of Memphis, which is sliding towards a sell-off to another bank; and M&T Bank Corp., which suffered a sudden $1 billion loss in its capital value due to its inability to sell MBS. Other big lenders and securitizers in the "heavily Alt-A" line of fire, include Countrywide (the nation's biggest), ResCap (part of GMAC), EMC Mortgage (part of Bear Stearns), and Washington Mutual, Inc. of Seattle.

Mortgage Bankers Association spokesman Doug Duncan, while downplaying the problems as best he could, acknowledged that mortgage originations (total lending) in 2007 was likely to fall to near $2 trillion, no more than half of the 2003 level. "The fact remains that for some of the riskier [and higher-interest] products they originate, there's a lack of demand for them."

One top hedge fund manager warned the subprime and spreading mortgage meltdown will cause "a massive default cycle" in the market for collateralized debt obligations, a type of derivatives contract sold in the trillions of dollars, and 40% based on mortgage-backed securities. Francois Barthelemy, a senior fund manager with F&C Partners, the fund-of-funds operations within F&C Asset Management, told Reuters, "I do think a massive default cycle is about to start in the CDO market. . . . The event that will destroy the CDO market has already happened."

Foreclosure Driver Keeps Building Speed

The seemingly unstoppable U.S. national "foreclosure tsunami" is making the same banks now losing capital because the MBS market is contracting, swallow assets which are rapidly losing their value. The lenders' attempts to auction off the wave of foreclosed homes as quickly as possible, to liquidate their falling mortgage assets, is pushing down home prices. Some 5,316 homes were sold at foreclosure auctions in March in California, representing a whopping 264%-increase during the past six months, according to figures compiled by Foreclosure Radar—and constituting 15% of all homes for sale in the state. Of the $2 billion worth of properties which foreclosing banks tried to sell statewide in March, the overwhelming majority (4,796) went back to the lender after receiving no bids. The story of foreclosed homes now selling "for the price of a car" in Michigan and Indiana, is well known.

One foreclosure tracking company on April 13 released a figure of 158,000 foreclosures nationally in March. This was another large jump, after January and February had each had just over 130,000, for the first time since these data have been tracked. The first quarter, then, saw about 425,000 homes go into foreclosure (32% more than first-quarter 2006 and 220% more than first-quarter 2005)—an annual rate of one home in every 50, but a rate clearly accelerating.

The most rapid growth in foreclosures is occurring in Florida, California, and Massachusetts, each of whose rate jumped by 33% from February to March. Florida in March had 27,000 foreclosures, one for every 270 homes—if continued throughout the year, that would see one home in every 25 go into foreclosure. California in March had one foreclosure for every 370-380 homes, one home in every 30 as an annual rate. Michigan and Ohio are still higher, with annual rates of one foreclosure, roughly, per 20 homes. And Colorado and Georgia are much higher still.

The combustible fuel of unpayable household debts to drive this foreclosure wave still higher, is already aflame. Because of the strong promotion by Alan Greenspan's Federal Reserve, of ARMs and subprime mortgages from Spring 2004 on, millions of one- and two-year ARMs are "resetting" all during 2007-08, to much higher interest rates based on short-term Fed rates, and much higher payments. One million of these ARMs will reset during 2007 alone.

Studies, Congressional hearings, and investigations are showing that Wall Street banks and firms deliberately spread the foreclosure fuel now burning, particularly in the so-called "starter home" subdivisions and town districts where those foreclosure rates are now extremely high. Beazer Homes' mortgage division is the biggest, and the clearest example of what "Wall Street-designed financial products" were doing in the 2001-06 housing bubble boom. In starter-home subdivisions all over North Carolina—and in other states—Beazer Mortgage loaned new homeowners not only their interest-only mortgages, but their downpayments, their closing costs and fees, and gave them back their $500 "earnest money" payments as a rebate after closing—all but $1! Massive foreclosure rates of 20% blossomed everywhere in Beazer starter-home subdivisions in the South in 2005-06; some reached 30-35%. And the *Charlotte Observer* showed that the FHA was also being looted. The paper profiled Southern Chase, a Beazer-built and -financed subdivision of 406 homes in Cabarrus County, North Carolina. Of a total of 75 homes in foreclosure in February, 45 were insured by the FHA, which had paid $5 million to cover foreclosures in that subdivision, and was similarly hooked through Beazer's dominions.

A Service Employees' International Union study has just showed that JP Morgan Chase banking practices are proliferating foreclosures in central Ohio in exactly the same manner—and also substantially knocking down the home values of neighbors who do not default. This is essentially mortgage fraud by the banks on a large scale, piling up assets which are really unpayable debts, but selling them as securities "bundles" of debt before that became evident. This is what is now propelling the financial disintegration of the mortgage meltdown, into the securities markets.

Even the National Association of Realtors got a bit more real about the crisis in their new 2007 forecast, released April 11. It foresees—through glasses still very rose-colored—a drop in existing home sales by 2.2%; a fall of new home sales by 14.2%; and a drop in the median home price nationally by 0.7%. Hardly credible—but the "just hit bottom and rising again" talk has disappeared.

A Congressional "summit" was being convened by Sen. Cristopher Dodd (D) of Connecticut on April 20, to decide what Federal measures to take to slow down the waves of foreclosures across the country. But this cannot be done without making the banks and other financial mortgage lenders and securitizers, write down their mortgage-based assets, which were entirely connected to a financial bubble now collapsing. Forget trying to collect securities and derivatives bets on high-interest, effectively short-term monstrosities of unpayable debt like ARMs, subprimes, "exotics," and so forth. This write-down could lead to the issuance of new, fully amortized and fixed-rate long-term mortgages with aid of the FHA, Fannie Mae, and other agencies.