



HOUSE OF REPRESENTATIVES I Housing and Mortgage Crisis Update

By Andrew Chan

Introduction

The housing and mortgage crisis defined the United States' recession during 2008, and continues to be an unresolved problem. Recent statistics show that each month, more homeowners continue to default on their **mortgages**. Economists estimate that if the mortgage problem is left unresolved, up to one out of every 200 homes will face foreclosure in the United States. This means that every three months, some 250,000 additional families will enter into **foreclosure**.

Furthermore, the continuing crisis in the housing market has had tremendous effects on the rest of the economy, causing a financial meltdown on Wall Street, freezing loans for businesses, and leading to massive layoffs and bouts of unemployment all across the country. As Professor Martin Feldstein of Harvard University recently noted, the crisis in the housing and mortgage sector has created a recession which is likely to be the worst since the Great Depression of the 1930s. The eyes of the entire country are upon Washington to see what legislators will do to remedy this problem.

Summary of the Problem

The housing and mortgage problem began with the growth of the housing bubble during the mid-1990s through 2005, as housing prices soared at a rate above 6% a year, due to the growth of new home ownership. More families than ever before were eligible to purchase homes because of the low interest rates during the early 2000s, allowing families to borrow more money for their mortgages.

Wall Street firms soon sought to connect rich investors with the rapidly expanding housing market through the creation of **mortgage-backed securities**. The simple way to explain a mortgage backed security is to imagine that there are there homebuyers in a neighborhood who all receive loans from a local bank. The local bank then bundles these mortgages and sells the bundle to a big Wall Street firm. These bundles are offered to investors, and investors make money off of the interest payments from the original borrowers. In the rapidly expanding state of the housing market, granting loans always seemed to be a safe proposition, even if a buyer was unable to make a payment. This is because home prices were increasing so dramatically that usually buyers were able to make a hefty profit from selling their homes due to appreciation.

Mortgage—a loan for the purchase of real estate.

Foreclosure—legal proceeding in which a lender obtains a court-ordered termination of a mortgagor's right of redeeming a property's value due to missed payments.

Mortgage-backed securities—bond that is financed by home mortgage payments.

Some banks and institutions even began to lend money to homebuyers with poor credit and financial histories, which would have typically precluded them from qualifying for loans. These loans were called **subprime mortgages** because the loans included interest rates that were above the prime interest rates usually available to trustworthy borrowers. By 2006, nearly half of the loans in the housing industry were subprime mortgages.

What nobody expected was what CNN describes as “a perfect storm.” Simultaneously, people lost their jobs, the interest rate increased, and housing prices decreased. As all three of those things happened, consumers were soon foreclosing on their homes and unable to sell their property to pay off their debts. These defaulting loans affected entities all the way up to the rich investors who lost their money in mortgage backed-securities. Eventually, investors pulled out, and investment banks on Wall Street stopped loaning money, for fear that the funds would be used to purchase the now dangerous mortgage-backed securities. This is what caused the downturn in the stock markets and the massive level of unemployment which has been created in the United States over the past several months.

Recent Developments

More Bad News

Unfortunately, over the past several months, there has been more bad news than good in regards to the housing industry in the United States. Economic activity over the past few months has been characterized by government bail-outs and banks buying each other off and merging. In March 2008, the investment bank Bear Stearns was finally acquired by JP Morgan Chase for \$1.2 billion after the **Federal Reserve** promised to lend JP Morgan \$29 billion on a **nonrecourse basis**. In September 2008, Fannie Mae and Freddie Mac, the two government sponsored organizations for loaning funds to increase homeownership, were placed in **conservatorship**.

In September 2008, investment bank Merrill Lynch was also acquired by Bank of America, days after Lehman Brothers, another large investment bank, declared bankruptcy. In November 2008, the US government announced that it was purchasing \$27 billion in preferred stock in Citigroup. As investment banks have fallen into the red due to the sagging stock market and economy, the federal government has been forced to step in, providing emergency funds to countless banks in order to allow them to stay **solvent** through the 2008 and 2009 fiscal years.

Emergency Economic Stabilization Act of 2008

On September 19, 2008, the federal government announced a plan to purchase from financial institutions large amounts of mortgage

Subprime mortgages—lending at a higher rate than the prime rate to borrowers with worse credit histories

Federal Reserve—central bank of the United States charged with managing interest rates for borrowing.

Nonrecourse Basis—a secured loan that is secured by a pledge of collateral, typically real property, but for which the borrower is not per-

Conservatorship—legal concept in the US, whereby an entity is established via statutory or regulatory authority, that some property or entity be subject to the legal control of another person or entity, known as a conservator.

Solvent—the ability of a firm to meet its financial obligations and pay back owed debts.

backed securities, a plan which would cost at least \$700 billion. The plan also banned **short-selling** the stocks of financial firms, which is when investors borrow shares of stock of a particular company and hope that the stock will fall in order to make money. On September 29, 2008, the House of Representatives rejected an initial version of the plan, but on October 1, 2008, the Senate approved an amended version of the plan, which was eventually ratified by the House and signed into law by President Bush on October 3, 2008. Immediately after the law was passed, the US Treasury used the first \$350 billion of bailout funds to buy preferred stock in banks. The remainder of the bailout money has since been authorized to President Obama to use at his discretion.

The Lending Industry Responds

Along with government action to help reduce the number of foreclosures in the United States, lenders have offered troubled borrowers more favorable mortgage terms like **refinancing**, **loan modification**, or **loss mitigation** in order to allow for borrowers to once again afford the monthly payments on their loans. On October 5, 2008, Bank of America announced a more aggressive and systematic program intended to help an estimated 400,000 borrowers keep their homes, limiting payment as a fraction of household income, and reducing mortgage balances. In November 2008, Fannie Mae, Freddie Mac, and a number of other mortgage service providers announced a streamlined loan modification program and foreclosures suspension, designed to help keep borrowers in their homes.

Focus of the Debate

Conservative View

Though both conservatives and liberals agree that the housing industry faces serious problems, the two sides of the political spectrum disagree on possible solutions. Rather than bail out or provide funds to homeowners who are at risk of defaulting on their loans, Republicans in both the House and Senate have pushed for the US government to financially insure 4% fixed rate mortgages for the entire country, which would encourage homeowners back into the market because of the lower fixed rate mortgages that do not change over time. Rather than helping each family that is in trouble, Republicans are more in favor of plans which are meant to prevent systematic risk that would threaten the security of the entire financial system. It is for this reason that Republicans were in support of the \$50 billion bailout of the investment bank, Bear Stearns.

Unlike their stances from several months ago, none of the Republicans are now in favor of plans which do nothing and allow for the business cycles of the United States economy to correct the problems in

Short-selling— *practice of selling a financial instrument that the seller does not own at the time of the sale.*

Refinancing— *replacement of an existing debt obligation with a debt obligation bearing different terms.*

Loan modification— *process whereby a homeowner's mortgage is modified and both lender and homeowner are bound by the new terms.*

Loss mitigation— *describes a third party helping a homeowner, or a firm that handles the process of negotiation between a homeowner and the homeowner's lender.*

the housing industry. Most Republicans are in favor of at least some change or provisions to help solve the problem, but usually in the form of tax cuts.

Liberal View

Most Democrats are in favor of one or both of two major proposals: (1) providing more money to groups that help homeowners renegotiate their loans, and (2) temporarily allowing Fannie Mae and Freddie Mac, the huge government-sponsored mortgage financiers, to hold more mortgages in their own investment **portfolios**. This would effectively give mortgage lenders more money to work with to prevent them from filing for **bankruptcy**. Several senior Democrats have even considered giving bankruptcy judges the authority to change the terms of a mortgage for borrowers and lenders, such as creating new traditional 30-year fixed interest mortgages that will be affordable for both borrowers and lenders in the long run. Supporters of the measure argue that bankruptcy judges are the only people in a position to modify mortgages that have been bundled into complex securities and may be owned by investors anywhere in the world.

Still, other Democrats are in favor of using tax dollars to give homeowners immediate relief in the face of foreclosures. During her campaign for the presidency, Senator Hillary Clinton (R-NY) proposed the creation of a \$30 billion Emergency Housing Fund for states and communities struggling with mounting foreclosures. The Emergency Fund would give governors, mayors, and community organizations the resources they would theoretically need to stem the downward economic spiral that accompanies concentrated foreclosures. Specifically, they would give funds to local and state governments to rehabilitate and put foreclosed properties back into constructive use, expand foreclosure prevention and counseling programs, and support community-level efforts to combat poverty.

Presidential View

President Barack Obama's plan for the housing crisis would allow for all homeowners, even those with bad credit, to refinance their loans and create new 30-year fixed mortgages as long as they are able to prove that they have the ability to make new payments. As Obama has noted: "We can extend a hand to people who have been struggling on Main Street." He has also called for a \$10 billion fund for increased counseling for at-risk homeowners as well as for change in bankruptcy laws so that homeowners can also renegotiate their mortgages with lenders. Although economists and experts believe that this plan is useful in the short term, they argue that it does not create a long-term solution that would prevent the housing crisis from occurring again in the future.

Portfolios—*of or collection of investments held by an institution or a private individual.*

Bankruptcy—*legally declared inability of an individual or organization to pay their creditors.*

Questions for Policymakers

How should the United States government deal with the millions of homeowners who have already lost their homes? How about the investment banks and investors who put their money into mortgage-backed securities that have **defaulted**? What can be done to prevent current homeowners from defaulting on their loans in the struggling state of the economy? What should be done to prevent future disasters like this from happening?

Defaulted—*Failure to perform a task or fulfill an obligation, especially failure to meet a financial obligation.*

Conclusion

The United States economy has been dramatically and drastically affected by the financial crisis that foreclosures and the failure of the mortgage industry have created, and Congress has the difficult, yet immensely important, task of determining how to best assist homeowners, lenders, and banks. Now that Congress has finally recognized the severity of the situation, the time has come to act. Some members of Congress believe that the job of the government is to leave the situation alone and let the economy prevail on its own, whereas others argue that the US government must intervene in the crisis and help middle-class Americans. Still others believe that long-term solutions are necessary to ensure that another crisis like this one will never occur again.

Bibliography

Coy, Peter. "Analyzing the Housing Crisis." *Businessweek*. 31 January 2008 <http://www.businessweek.com/magazine/content/08_06/b4070040767516.htm>

Markels, Alex. "Comparing Today's Housing Crisis with the 1930s." *US News & World Report*. 28 February 2008 <<http://www.usnews.com/articles/business/real-estate/2008/02/28/comparing-todays-housingcrisis-with-the-1930s.html>>

Taneeru, Manav. "How the 'Perfect Storm' Led to the Economic Crisis." *CNN*. 29 January 2009 <<http://www.cnn.com/2009/US/01/29/economic.crisis.explainer/>>