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Housing and the Financial Crisis: Causes, Consequences, Cures

↳ By Michael E. Stone[1]

Introduction

Sub-prime lending was but the last card in the house of cards that is the U.S. housing system and its senior partner – the global financial system. To those who say that no one could have predicted its collapse, I say "NONSENSE!" Not only was its collapse predictable; it was predicted. In 1975 – 34 years ago – I wrote the following:

Meanwhile the inability of working-class families to keep up existing mortgage payments has increased mortgage defaults and foreclosures on both owner-occupied housing and apartment buildings…. Unable to deal with the causes of mortgage defaults and foreclosure, which lie within the institutions of capitalism, the options available will only compound the problem in the long run. The proposals all basically involve … increasing debt…. Adding more claims to future income in these ways only adds to the increasing vulnerability of the entire financial system as well as the mortgage system in particular….

Since that time, I have chronicled the growth and instability of this house of cards (Stone, 1978; 1980a; 1980b; 1983, 1986; 1993; 2006b). Obviously, little heed was paid to my jeremiads.

This article sketches how the house of cards was constructed and collapsed, and will identify a few of the elements for building a different and solid house.

The house of cards

Just as there are four suits in a deck of playing cards, so there are four suits of cards out of which the housing house of cards has been built:

1. Wide and widening income inequality;
2. Persistent and pervasive racism in housing provision;
3. Treating housing increasingly as a speculative commodity at all levels; and
4. Over dependence on debt and the private capital markets to finance housing.

This deck of cards also includes wild cards and jokers in the form of public policies that exacerbated the growth and instability of the house.

Note that, with the exception of racism, which has a particular character and dynamic in the U.S. and connection to the crisis, all the other suits of cards are in no way unique to the U.S. and have highly relevant global linkages.

1. Wide and widening inequality: consequences for housing

For a generation after World War II in most of the developed capitalist world, there was modest reduction in inequality. However, during the 1960s the fabric began to unravel; the 70s were a transition time and by the 80s neo-liberal ideology and practice were well entrenched, leading to the drastic increase in inequality since then (Stone, 1993, pp. 103-140; Tilly, 2006).

The first consequence for housing, at least in the wealthier parts of the world, has been reduced affordability and rising house prices. On the one hand, since the mid-1970s most households in the U.S. have experienced little if any increase in their real incomes (Tilly, 2006, pp. 25-26). On the other hand, those at the top with more and more income have been driving up home prices, in both the owner-occupied and rental sectors, in existing housing and new (Stone, 2006a).

The second consequence has been decreased ability for most households to save. This, in turn, has had two major results: (a) Most households have had reduced capacity to make substantial down payment to buy, and hence there has been a push for lower down payments, i.e, higher loan-to-value ratios in the mortgage market, with associated increases in risk; (b) Furthermore, because middle-income households have not had money to put into savings (thrift) institutions, which traditionally were the self-sustaining source of most residential lending, housing finance has had to become more dependent on the capital markets.

The third major consequence for housing of widening inequality is that those at the top of the distribution have directly and indirectly also pursued high profits in the capital markets, contributing to the bubble of mortgage-backed securities.

2. Racism in all aspects of the provision of housing

There is a rather widespread view is that housing discrimination in the U.S. has largely ended, that segregation is an historical artifact that is gradually dissipating and that, to the extent it remains, reflects free choice in the market place. None of this is true.

Segregation has at best only modestly declined, and discrimination persists in the rental, sale, financing and insuring of housing. The burdens are greatest for Black households in most parts of the country, but there is evidence that the situation is worsening for Latinos and Asians (Denton, 2006).

The relevance of this to the current crisis is that the convergence of demography and geography – i.e., structural racism – created a largely untapped market, vulnerable to predatory practices in the sale, financing and refinancing of housing, as people of colour were swept into the grand illusions of mortgaged homeownership (Squires and Kubrin, 2006; Stone, 2006b, pp. 94-96).

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3. The speculative housing market

While treating housing as an object of speculation has a long and dishonourable history, it has become particularly pernicious in recent decades. Everyone came to believe that they are entitled to make a killing in residential real estate, up and down the food chain – not just distant investors, intermediate mortgage packagers, and nearby speculators and mortgage brokers – but including far too many homebuyers and homeowners.

This attitude has been coupled with the idealisation and over-promotion of speculative homeownership, based on a series of myths (that Kemeny, the author and a number of others identified decades ago; for critical examination of these myths, see, e.g.: Dean, 1945; Stone, 1975; Kemeny, 1981; Heskin, 1983; Edel, Sclar and Luria, 1984; and Stone, 1993, pp. 18-22; for an Australian critical examination of homeownership, see Badcock and Beers, 2000):

I. that you are always better off economically as a homeowner than a renter because you no longer have a landlord who can raise the rent;

II. that homeownership assures you of free housing in your old age;

III. that homeownership is a sound and effective way to build assets/accumulate wealth;

IV. that property values always go up, at least as long as you can keep undesirable activities and undesirable people out of your neighbourhood;

V. that homeowners are full citizens, but renters are not;

VI. that the degree of societal development is correlated with the homeownership rate; and

VII. the illusion of ownership through the reality of DEBT….

4. Over dependence on debt and the private capital markets to finance housing

Because housing is costly to produce and most producers are relatively small businesses, housing development is very dependent on borrowed money. More significantly, though, because housing is both a commodity and long-lasting, the transfer of houses is financed almost entirely by borrowed money, with the property as collateral. Furthermore, because housing is a speculative commodity, it is the prime source of collateral for borrowing even without transfer, i.e., refinancing and home equity borrowing.

Taking these three elements together, no sector of the economy has been as dependent on debt as housing. Over the entire period since World War II, housing-related debt has been the fastest growing component of the entire financial system. Over the past three decades, housing finance became fully integrated into global capital markets, with the full fruition of mortgage-backed securities (MBSs) and their derivatives. A major consequence has been that housing related debt has grown faster than the overall economy and hence faster than the ability to repay it.

From the late 80s to early 90s, there was a deep recession in the U.S., declining house values, high foreclosures, slow recovery. From the mid-90s to the mid-00s, the U.S. experienced the longest period of growth in over a century, but it was built on increasing inequality and debt. Combined with ever widening income inequality, and the more active and aggressive promotion of mortgage homeownership since the 1990s, the dependency of housing on debt has been turned into addiction, creating debt junkies at all levels of the system and pushers emerging at all levels because of enormous and growing opportunities for profit (Stone, 2006b).

Public Policies

The instability in these suits of cards was in turn stimulated and exacerbated by an array of public policies:

a. Housing and related Taxation Policies: Since the 1930s, the primary focus of housing policy in most of the predominantly white, English-speaking countries has been the promotion of mortgaged homeownership. This has consisted of institutions to support lending, ideological promotion and marketing, and subsidies through the tax system.

   The flattening of the progressive income tax and tax cuts in the U.S. since 1986 has contributed to widened income inequality, and provided more money at the top of the income distribution for speculation in housing and financial markets.

   With regard to tax benefits for homeownership, they are particularly regressive in the U.S., but by no means unique. The benefits rise with tax bracket, house value, mortgage amount, interest rate. Over half the benefits flow to the top 10% of the income distribution. No wonder it has been labelled the "mansion subsidy." Indeed, recently even conservative economists have been recognising that they distort the housing market, create perverse incentives to borrow and speculate, as well as depriving the Treasury of revenue (Glaeser and Shapiro, 2003; Carasso, Steuerle, and Bell, 2005).

b. Privatisation of the public institutions of housing finance (see Stone, 1993, Part II, and Stone, 2006b): The end of the post-war prosperity in the 1960s led to increased competition for credit, rising interest rates, and disintermediation from savings institutions. One major response was the expansion and privatisation of secondary mortgage markets. In 1968 Fannie Mae (FNMA) privatisation began; in 1970 Freddie Mac (FHLMC) was created. Fannie and Freddie are (were) quasi-public government sponsored enterprises (GSEs), with implicit government guarantees of their paper, but profit-motivated institutions with private shareholders. GSEs package mortgages into pools; they issue securities sold into capital markets backed by pools of mortgages. Initially these were plain vanilla pass-through securities bought mostly by institutional investors like pension funds, insurance companies and commercial banks.

c. Deregulation and lax regulation of private financial institutions and activities has been another, more publicised, major facet. A big push in the 1970s culminated in extensive deregulation of the financial system in the 1980s, which in turn was a direct cause of the drastic decline of the traditional model of housing finance, leading to the late 1980s S&L crisis in the U.S. (Stone, 2006b). In the late 1990s there was a second wave, pushed by some of President Obama's top economic advisors (Helmore, 2008). Add to deregulation, lax enforcement of remaining regulations and failure to regulate new, high-risk products and institutions over the past decade.

d. Monetary policy: Loose money/low interest rates by Greenspan's Fed encouraged borrowing and speculation, and leveraging of little capital with lots of debt to invest in high risk/high return real estate and capital market vehicles (see, e.g., Morris, 2008, pp. 62-65).

Implications for Households

Trends pointed to problems even before the sub-prime surge. First, there was a steady trend toward bigger, more costly houses. Second, in the U.S. homeownership peaked in 1980 and then declined until 1994. But in 1995 homeownership started to increase, with a focus on lower income households, especially households of colour. (This was the result of various factors, including the Community Reinvestment Act (CRA), easing of usury limits on interest rates resulting in more sub-prime lending, plus the Clinton administration's homeownership push; see Stone, 2006b; Immergluck, 2009.)

However, by the middle of the current decade, five vulnerabilities became apparent at the base:

I. the spread of high-risk non-traditional loans:

not just sub-primes, but a whole menagerie: alt-A, "ninja" (no interest, no job or assets), interest only, negative amortization, 100%+ loan-to-value, adjustable rate loans, option ARMs, etc.

II. rising housing occupancy costs: not only due to mortgage resets, but also increasing cashing out of equity, including refinancing of original primes into sub-primes; and debt costs, add rising property taxes, heating costs;

III. high leverage: meant lots of people with no equity cushion; so any decline in prices would mean negative equity in which default would be more likely;

IV. declining incomes: many people on the margin of being able to afford their housing (and other) debts, even with multiple jobs/incomes, facing risk of default if laid off, personal or family member illness, divorce, new child, etc.;

V. declining property values: fewer and fewer buyers able to sustain ever higher prices meant eventually and inevitably prices would turn down.

Implications and Consequences for the Financial System

Slicing and dicing of MBS into collateralised mortgage obligations (CMOs), originated by Freddie Mac in 1984, was so profitable for Freddie and Fannie, that in the 1990s Wall Street began private pooling and securitising of prime mortgages, outside of Fannie and Freddie, and then issued sliced and diced securities against these pools of plain vanilla MBS, derivatives of these securities, collateralised debt obligation (CDOs), etc. (Stone, 2006b; Immergluck, 2009).

But the mid-90s already gave hints of problems with securitisation and derivatives: computer models were inadequate because they did not account for the possibility of refinancing; thus, in the mid 90s there was an MBS crisis, with chaos in MBS markets (Stone, 2006b). Yet no constructive lessons were learned by the industry, regulators or policy-makers. Instead, new opportunities and new products were launched in the MBS markets.

In order to expand the volume of MBSs, it was necessary to promote vast increases in mortgage lending: on the one hand, since homeownership rates in the US were declining overall and were especially low for households of colour, there was both motive and opportunity for a whole new wave of over promotion of homeownership to underrepresented populations; on the other hand, among existing homeowners rising house prices created enormous increases in home equity, stimulating an orgy of refinancing, home equity loans, purchases of 2nd and 3rd homes and investment properties, etc.

Non-prime lending (sub-prime, Alt A, etc.) had long existed, but there had been no secondary market because such loans did not meet Fannie and Freddie standards. So, there were limited originations of such loans until the early 2000s, when Wall Street, looking for highly profitable outlets for vast pools of cash, started to buy and securitise non-prime mortgages. This led to a stampede into high-profit, non-prime MBSs and derivatives upon derivatives, with profits multiplied by fees and by high leveraging fostered by low interest, expansive monetary policies (Morris, 2008; Baker, 2009; Immergluck, 2009).

Instability in Fannie and Freddie was already apparent by early 2000s (Stone, 2006b). Nonetheless, with loss of market share to Wall Street, Fannie and Freddie lowered their standards to compete in non-prime secondary market and keep share prices up and stockholders happy, with heavy lobbying to prevent regulation.

This process generated almost limitless profit opportunities ostensibly for homebuyers, homeowners and speculators, but especially for the inventors and purveyors of exotic mortgage products.

Of course it also piled risks ever higher, as each and every level – not just homebuyers and homeowners – became leveraged to the hilt, borrowing far beyond any realistic potential of repayment – built on the myth that residential property values always and forever rise – a classic bubble.

Culmination and Collapse

Together these were a perfect storm that blew apart the house of cards. The vulnerabilities at the base resulted in surging defaults and foreclosures, and not just on sub-prime loans. While the foreclosure rate is of course much higher on sub-prime loans, most loans are not sub-prime and, indeed, about half of foreclosures have been on prime loans.

As all of the suits of cards had been built into an enormous yet precarious house, it was then inevitable that the collapse would spread up through the financial system to create the worst global economic crisis since the Great Depression, in which housing finance was also deeply implicated.

HOW TO BUILD A SOLID HOUSE

While it is apparent that a comprehensive program of reform is needed, my primary focus here will be on pieces of the ownership and financing agenda.

Ownership:

How can we address two major sources of both housing affordability and broader economic instability, viz, treating housing as a speculative commodity, and the over-dependence on debt to finance housing? We should greatly increase the amount of debt-free, non-speculative housing, which includes public housing, non-profit rental housing, and, my particular focus, an adaptation of the mutual housing alternative to mortgaged homeownership (Neighborhood Reinvestment Corporation, 1985; Stone, 1993, chapter 7; Stone, 2006c).

A mutual housing association (MHA) is a non-profit cooperative corporation, made up of residents, prospective residents and other community members. An MHA finances housing to the greatest extent possible through capital grants rather than mortgage debt. Residents make a modest "down payment," which is returned with interest upon moving out. In the conventional MHA model, capital grant financing is used to reduce residents' costs. In the modified MHA proposed here, residents would have monthly charges in lieu of mortgage payments, with the amount based on some affordability standard. This money, which would have gone for mortgage payments in conventional housing, would instead, like individual development accounts (IDAs), be put into safe investments such as term deposits at banks, money market accounts or similar vehicles; these investment funds could and should be managed by competent, respected, non-profit intermediaries, such TIAA-CREF.[2] Since wealth accumulation is separated from homeownership, residents may not sell their homes for a profit, thereby maintaining affordability for future generations.

What does the model offers residents?

- control over their homes comparable to conventional homeownership;
- greater security of tenure because there's no risk of mortgage foreclosure;
- asset development comparable in magnitude, on average, to conventional homeownership;
- but superior in terms of security (vulnerability), stability (volatility) and liquidity.

While especially beneficial for low and moderate income households, there is no reason for it to be limited. It is not second-class homeownership. It is a smart alternative that should be made widely available as a choice.

[16] The TIAA-CREF is a nearly $400 billion full-service financial services group of companies that has dedicated itself to helping those in the academic, medical, cultural, and research fields for over 90 years. For more information, please see www.tiaa-cref.org.

Financing:

Debt-free non-speculative housing of all types should be financed by capital grants from Housing Trust Funds. In the US there are several hundred state and local HTFs, and in the summer of 2008 a National Housing Trust Fund (NHTF) was finally enacted, after a very long grassroots campaign.

I have proposed that the NHTF be capitalised through a tax of about a few tenths of a percent on all capital market financial transactions, including stocks, bonds, mortgage-backed securities, derivatives, etc. Even such a tiny tax could generate several hundred billion dollars per year (Stone, 1993, pp. 266-268;Baker, 2000; 2008).

Such a dedicated revenue source would be

- progressively redistributive;
- not subject to the whims of the annual appropriation process; and
- not add to government budget deficits.

It could provide financing for upwards of a million units a year of debt-free non-speculative housing, though:

- new construction;
- acquisition of some private housing, such as foreclosed homes; and
- preservation of at-risk subsidised housing.

Macro-economic benefits:

A tax on financial transactions would reduce speculation in the capital markets. Also, under the MHA model the money that would have gone for mortgage payments into unproductive, speculative housing wealth would under the MHA model be available for investment in productive activities for a sustainable future.

Housing Finance Reform

In addition to the specific ownership and financing approach just described, I also propose a series of structural reforms to the existing housing finance system:

- Prohibit high-risk loans and restore plain vanilla mortgage loans: fixed-rate, fully-amortised, level-payment loans requiring non-negligible down payments (along with mortgage insurance and default insurance);
- Restore and strengthen local, mutually-owned & public lenders: credit unions, mutual savings banks, depositor owned s&ls, community loan funds and public lenders (HFAs);
- Promote the Ginnie Mae model for mortgage securitisation: now that Freddie and Fannie are fully in the public domain, they should remain there (without shareholders, without highly paid executives, without high-priced lobbyists), issuing government-backed, plain vanilla pass-through mortgage-backed securities on the plain vanilla mortgages; such securities should be prohibited from being sliced and diced and pyramided with derivatives; this would provide liquidity and access to the capital markets for responsible lending without the greed, speculation and risk that brought the system down;
- Strongly regulate financial markets, with transparency and accountability, including prohibition on pyramiding of securities, and including explicit criminal as well as civil liability for violations.

Comprehensive Program

These are a few of the building materials needed to construct a strong house on a solid foundation. For other elements of a comprehensive program to address not only the manifestations but underlying causes of the housing crisis, see the Appendix.

Conclusion

At this monumental moment, we have the opportunity to begin constructing a New Social Democracy for the 21st Century. I am not naively optimistic about the prospects politically, but am nonetheless certain that it is a goal worth pursuing.

We housing researchers have a particular responsibility in this effort - as intellectuals, as practitioners and as activists. Housing, as all of us surely know, lies at the core of the dilemmas and challenges facing our families, our communities, our nations and our planet. The resolution of these dilemmas is to be found not through the celebration of selfish individualism, but rather through the rediscovery of social responsibility and the transformation of our economic institutions. Let us join in this grand endeavour.

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Appendix

A COMPREHENSIVE PROGRAM TO SOLVE THE HOUSING, HOMELESSNESS AND INCOME CRISIS IN THE UNITED STATES

Expand social, non-profit, and non-speculative ownership and production of housing, to ensure long-term affordability, community viability, and responsible use of public resources. Social, non-profit and non-speculative housing can be expanded through:

- new housing production;
- preservation of subsidised rental housing (public and privately-owned) as permanently affordable to low-income households, with increasing resident and community control and ownership;
- financial assistance to low and moderate-income homeowners who are shelter poor or facing foreclosure, in return for their agreement to transfer to social ownership;
- buyout of absentee-owned, unsubsidised private rental housing through negotiated sale or eminent domain.

Finance the production and acquisition of social housing through direct public capital grants rather than debt, to reduce both the affordability burden of mortgage payments and the instability of the financial system.

Reform the financial system, in order to deflate the credit bubble, reduce speculative uses of credit and assure an adequate supply of credit -- to complement capital grants -- for productive investment in housing, as well as infrastructure and job-producing industry. All private capital market participants should be required to make below-market set-asides to finance non-speculative housing and community development. Credit allocation authority and incentives should be used to steer private savings to community loan funds, state housing finance agencies and mutually-owned thrift institutions.

Increase the capacity and scale of housing development by socially-oriented developers, and increase public and community control over land and housing production. Public and social resources for housing development should be directed increasingly to community development corporations, mutual housing developers, regional non-profit housing organisations, labour unions, and local housing authorities. Public financing of responsible private development for non-speculative ownership should not be precluded, particularly if under community control or in joint ventures with social developers.

Reform landlord-tenant law to facilitate tenant unionisation and institutionalise collective bargaining rights, just cause for eviction, habitability standards and enforcement, dispute resolution, and resources for technical and organising assistance.

Establish employer accountability and financial responsibility for contributing to meeting the housing needs of their workers and communities. Unions should negotiate for housing trust funds as part of their members' benefits. Private commercial and luxury developers should make linkage payments or meet inclusionary housing requirements. Other employers should establish voluntary housing programs or make payroll tax payments into housing trust funds.

[16] The TIAA-CREF is a nearly $400 billion full-service financial services group of companies that has dedicated itself to helping those in the academic, medical, cultural, and research fields for over 90 years. For more information, please see www.tiaa-cref.org.

Recognise in housing and income policies the disproportionate growth of affordability problems among larger households, and among households headed by women (both non-elderly single parents and older women without spouses). Since the housing crisis is one of the causes and manifestations of the crisis of U.S. families (with "family" broadly understood to include both non-traditional and traditional living arrangements), resources and support should be provided for appropriate and innovative housing schemes and designs, and supportive social and community services, as well as economic assistance.

Enforce anti-discrimination laws fully and aggressively, along with affirmative programs within communities of colour and the larger society to expand housing as well income opportunities for those who have always been disproportionately shelter poor because of racism.

Support community control and resident empowerment in the production and operation of housing, in balance with principles of social responsibility, non-discrimination, and inclusionary planning and development.

Assure adequate and secure incomes to all households. This should be through gainful employment at decent wages for all those able to participate in the paid labour force and through appropriate income supports for those who cannot obtain adequate incomes through employment. Income supports should consist of direct affordability assistance for those unable to afford social-sector housing costs, plus supplemental aid to the very lowest income households who would be unable to meet their non-shelter needs at a minimum level even with full housing assistance.

Provide adequate public resources and allocate them equitably for social housing, community development, services, and income supports. Resources should be generated through balanced economic growth, redirection of federal budget priorities away from the military, plus creation of a truly progressive income tax (including strong disincentives for speculation in housing, land and other assets, and phasing out of the increasingly regressive deductions for mortgage interest and property taxes).