



Wrong assumptions in the financial crisis

Manuel B. Aalbers

*Amsterdam Institute for Metropolitan and International Development Studies,
University of Amsterdam, Amsterdam, The Netherlands*

Abstract

Purpose – The purpose of this paper is to show how some of the assumptions about the current financial crisis are wrong because they misunderstand what takes place in the mortgage market.

Design/methodology/approach – The paper discusses four wrong assumptions: one related to regulation, one to leveraging, one to subprime lending and one to predatory lending. It briefly discusses some policy implications.

Findings – The role of the state in the mortgage market is more complex than suggested by those who blame the state for not doing anything. The concept of leveraging can explain, at least in part, why the losses in financial markets are bigger than the losses in the housing market. Many subprime loans were sold to prime borrowers. Subprime lending was not designed to increase homeownership rates, but to fuel profits by exploiting vulnerable borrowers.

Practical implications – It is too easy to argue that everyone made mistakes; most borrowers cannot be blamed for being sold risky, overpriced loans. A rescue plan is needed for defaulting borrowers and those already in foreclosure.

Originality/value – The paper does not present new research, but brings together research that demonstrates that the roots of the crisis in the mortgage market are in many ways different from what is suggested by professionals and journalists alike.

Keywords Recession, Credit, Mortgage default, Loans, Regulation, United States of America

Paper type Viewpoint

The current financial crisis is presented as one in which homeowners took out risky loans that were pushed by greedy loan brokers and lenders who didn't care about the riskiness of these loans as they would be packaged and sold off as residential mortgage-backed securities (RMBS) anyway. It continues to present a network of agents that have not paid enough attention to risk: not only borrowers and lenders, but also the state, regulators, investors and rating agencies. This image of the roots of the financial crisis is not wrong, but it is limited in explaining what went wrong. In this short contribution I will discuss four wrong assumptions in discussions on the roots of the financial crisis in the mortgage market.

First, it is too easy to argue that the state and regulators were not acting. The state has enabled both securitization and subprime lending (Aalbers, 2008; Immergluck, 2009). Gotham (2006) has studied the deregulation of the mortgage market and demonstrates how the federal government, step-by-step, has enabled securitization, for example by the *Financial Institutions Reform, Recovery and Enforcement Act* (1989), which pushed portfolio lenders to securitize their loans and shift to off-balance lending. In other words, the state was at the origins of the current crisis. Many regulators have done too little, because they either were heavily understaffed or assumed financial markets could work most efficiently if they were self-regulated. More importantly, since the 1990s most mortgage lenders were non-banks that did not have to live up to



banking regulations and could operate within an almost non-existent framework. On the other hand, several American states such as North Carolina and West Virginia introduced additional state regulation. In 2003, four years before the crisis, New Mexico even introduced a *Home Loan Protection Act*. Yet, many state initiatives were blocked by the federal government and states were forced to withdraw certain acts and regulations. Something similar happened on a lower level. In Ohio, the City of Cleveland, which includes the zip code with the highest number of foreclosures in the country and had already had a foreclosure crisis since the beginning of this century, tried to introduce local regulation to make abusive lending practices more difficult, but got into trouble with Ohio State as the latter argued that it was not the City's responsibility to come up with financial regulation. In other words, we cannot say that the state did not do anything: while some state institutions enabled securitization and subprime lending by implementing "facilitating laws" and by ignoring their regulatory responsibilities, other state institutions tried, often unsuccessfully, to combat the negative aspects of the new financial regime.

Second, the idea that "everyone is guilty" does not really explain why losses in the financial markets run into hundreds of billions and perhaps even one to two trillion US dollars worldwide. How could a national house price decline of 20 per cent cause such big losses for investors involved in RMBS? The short answer is leveraging. Because many investors, such as investment banks, bought RMBS with borrowed money, both the profits and the losses would be disproportionately large. A leverage factor of 14 was average; factors of 20 or 30 were not uncommon. For example, if an investment bank is able to borrow money for 6 per cent and expects a return of 8 per cent on low-risk, prime RMBS and 16 per cent on high-risk subprime, it effectively makes, respectively, 2 per cent and 10 per cent. However, when returns are lower than the interest rate for which they have borrowed money, for example, respectively, 4 per cent and 2 per cent, the investment banks not only miss 4 per cent or 14 per cent calculated profit, they also have to take their losses on their equity. For example: 14 (the average leverage factor) times, respectively, 2 per cent (6 per cent minus 4 per cent) and 4 per cent (6 per cent minus 2 per cent) equals equity losses of, respectively, 28 per cent and 56 per cent. Since the leverage factors in many cases were even much higher than 14, some financial institutions and investors that were heavily involved in RMBS, and especially subprime RMBS, effectively went bankrupt.

Third, both professionals and academic economists do not pass up an opportunity to point out that many borrowers took out loans they could not afford. This is correct, but in most cases this was not because borrowers were eager to get a big loan even though they had bad credit. A majority of the subprime loans went to borrowers with prime credit (Brooks and Simon, 2007; Dymski, 2007). In other words, subprime lending should not be defined as lending to borrowers with poor credit, but as lending at higher fees and interest rates whether or not borrowers actually have bad credit. In 2006, 13 per cent of outstanding loans were subprime, but 60 per cent of the loans in foreclosure were subprime, up from 30 per cent in 2003 (Nassar, 2007). Selling subprime loans to prime borrowers was good business for both mortgage lenders and brokers. Lenders could charge higher interest rates on subprime loans and thus make more money. For this reason lenders gave brokers bigger sales fees for selling subprime loans. Brokers did not have negative results as a consequence of defaulting borrowers, as they only get paid for what they sell. And defaulting borrowers actually

created a bigger market for refinancing, which implied that brokers could make more money on clients by selling them another loan.

Fourth, it is often argued that subprime lending enabled many people that were formerly excluded from homeownership, i.e. low-income and ethnic minority groups, to buy a house and enjoy the benefits of homeownership. This is questionable for at least two reasons. Firstly, many of these borrowers had bought properties at the lower end of the market that needed improvement work and because of the high interest rates their monthly expenses often went out of scale with their income.

Homeownership for many subprime homebuyers became a burden rather than a joy. Second, most subprime loans were not enabling home ownership as more than half of them were refinance loans and second mortgages – in other words, loans for people who already owned a mortgaged property. Most of the refinance loans were designed in such a way that they looked cheaper than the original loan, but would, in fact, turn out more expensive for the borrowers and more profitable for the mortgage broker and the lender. Adjustable rate mortgages (ARMs) are a good example: an ARM may start with a low interest rate, but after two or three years the interest rate resets to a much higher rate. Borrowers are shown the initial, low interest rate while the higher interest rate is hidden in the small print of an illegible mortgage contract. Predatory loans were sold mostly in neighbourhoods with ethnic minority populations. Almost half of the loans in minority areas were predatory, compared to 22 per cent in white areas (Avery *et al.*, 2007). African-Americans receive more than twice as many high-priced loans as Whites, even after controlling for the risk level of the borrower (Schloemer *et al.*, 2006). It then comes as no surprise that foreclosures are concentrated in certain parts of the city. These problems are not new: for at least ten years researchers have pointed out how subprime and predatory lending result in rising default and foreclosure rates (e.g. Pennington-Cross, 2002; Squires, 2004; Wyly *et al.*, 2006). Yet, this was not considered a major problem until house prices declined and the value of RMBS fell.

Rescuing Fannie Mae and Freddie Mac was needed to guarantee the continuation of mortgage lending in the USA. Fannie and Freddie are so crucial to the entire system that without them the current mortgage market would fall apart. They are responsible for guaranteeing loans, for issuing “confirming” RMBS (i.e. low-risk, standardized securities), and have also bought so-called “private label” RMBS (i.e. securities that are not issued by Fannie and Freddie and include many subprime RMBS). Giving up on Fannie and Freddie would have meant giving up on the American economy. But as we all know the intervention of the federal government goes much further than the bailout of Fannie and Freddie. The Paulson plan of \$700 billion is only part of a bigger effort to help the financial sector. Yet, very little of the money invested is designated to help defaulting homeowners from being foreclosed on. The *American Housing Rescue and Foreclosure Prevention Act* of 2008 will probably help up to 500,000 homeowners. The number of foreclosures for 2007-2009, however, will add up to seven to ten million. In other words, government is bailing out financial institutions that made major mistakes with billions of dollars, but does not even make enough funding available to stop the increase in the millions of homeowners that are being foreclosed on. The priority of the state is with *exploiting* financial institutions, not with *exploited* homeowners, even though a “foreclosure rescue plan” would have been much cheaper and could have guaranteed the flow of money from homeowners to RMBS investors, albeit at a lower rate of profit.

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About the author

Manuel B. Aalbers (PhD) is a researcher at the Amsterdam Institute for Metropolitan and International Development Studies (AMIDSt) at the University of Amsterdam, The Netherlands. He is the Associate Editor of the *Encyclopedia of Urban Studies* and Guest Editor of a Special Issue of the *International Journal of Urban and Regional Research* on mortgage markets. His main research interest is in the intersection of finance, the built environment and residents. He has published on redlining, social and financial exclusion, gentrification, the privatization of social housing, financialization, and the Anglo-American hegemony in academic research and writing. Manuel B. Aalbers can be contacted at: m.b.aalbers@gmail.com