It's Not the Homes, But the Bubble Loans That Won't Sell

by Richard Freeman

The era of "exotic" or "non-traditional" mortgage loans is coming to an end with a vengeance. On Sept. 26, the National Association of Realtors reported that in August, expressed on an annualized basis, total existing homes sales fell to 6.30 million units, compared to a 7.21-million rate in August 2005, a collapse of 12.1%. The median price of an existing home fell to $225,000 in August, a fall of 1.7% from the level of $229,000 in August of 2005; this is the first year-to-year price drop in eleven years. Punctuating the alarm is that the inventory of unsold homes rose to 3.9 million existing homes available in August, which would take 7.5 months to sell—the highest inventory level since 1993.

What is becoming unsaleable now is the mortgage speculation in the housing bubble, rather than the homes themselves, commented Lyndon LaRouche, the world's foremost economist, on Sept. 26. "It's not the houses that won't sell, it's the mortgages that won't sell," he observed. Over the last five years especially, in regions of the United States, bankers have proliferated exotic mortgages to pump up housing prices, and make it possible to sell homes at inflated prices to home purchasers, many of whom could not afford them. Through these exotic mortgages, the bankers, as well as speculators in these mortgages, sucked out enormous money flows, usually in the first months of the mortgage, from the home-buyers onto whom the mortgages were dumped. Now, without the ability to sell these homes at an even more inflated price, the home-owner, whose living standard has been collapsing, cannot meet the mortgage payment.

There's not a solitary national housing bubble, added LaRouche. There are specific regions where the risky mortgages and speculative practices dominated, where the housing bubble built. Now, these regions inundated with "non-traditional loans," are the ones whose housing markets are blowing apart.

U.S. homeowners owe $9.84 trillion in home mortgage debt, as of the end of the second quarter of 2006. But against that mortgage paper, the giant secondary housing market agencies, Fannie Mae and Freddie Mac, have pyramided an additional, *separate* $6 trillion in mortgage-backed securities, derivatives, and bonds. Accounting for additional housing-linked debt, U.S. housing-related paper is above $16 trillion. It penetrates every pore of the U.S. economy, as much of consumer spending comes from borrowing against the value of homes. The oncoming series of homeowner defaults and foreclosures will ignite a shock wave blowing out the leading banks, financial institutions, and foreign lenders who have invested more than $2 trillion in U.S. housing—and the $500 trillion derivatives market.

Dangerous Loans from A to Z

There is a veritable alphabet-soup of mortgages, which are mislabeled "non-traditional" or "exotic" mortgages. With such mild names they are often passed off as basically normal mortgages with a few added features. In reality, they have all the safety of permitting a six-month old infant to play with a hand grenade.

Two standard "non-traditional" mortgages are frequently used:

• *Interest-Only Mortgage* These are mortgages in which the home purchaser is permitted to take out the first few years of a long-term mortgage—a period of anywhere from two to five years—at a fixed, low, teaser rate of interest of 2-3%. During this initial period, the home buyer pays no principal, and interest at this lower rate only. After the initial period is over, the mortgage "resets," and the home-buyer must pay an adjustable rate of interest (called an Adjustable Rate Mortgage or ARM), currently above 6%, and which could go to double digit levels. Plus, the home-owner must start paying principal. This often leads to a shock, as the amount of monthly payment required can rise by 50%.

• *Minimal Payment Loan.* This is the most widely used of "option payment loans." This loan is even more radioactive than the interest-only loan, having the feature that during the mortgage loan's initial period of 2-5 years, the borrower not only, as under the interest-only loan, pays no principal; he also pays only part of the interest. Let us say a borrower takes out a "minimal payment" mortgage loan in which the interest is $2,000 per month, but the borrower pays only $1,200 and does not pay the remaining $800 in interest. After three years of this arrangement, the borrower owes the full original loan amount, plus $28,000 in back interest, which is rolled over into the total loan. Interest must be paid on the additional $28,800. This loan should be declared illegal.

During the 1990s, these exotic loans were rare. In 2000, they constituted only 15% of all mortgages. But in 2005, non-traditional mortgages constituted 37% of all new home mortgage loans originated, with a value of $420.6 billion. *EIR* projects that non-traditional mortgage loans outstanding total $2-2.5 trillion, with somewhere between $400 billion and $1.2 trillion "resetting" during the next 15 months. The resetting process is already underway: Realtytrac, a foreclosure tracking service, reported that in August, nationwide home foreclosures rose 24% from the level in July, and 53% from August of 2005.

Exotic Loans

If you buy a home today, more than half the time, you will be offered completely free, either: swimming pools, fireplaces, marbled table tops, hardwood floors, garages, or landscaping, or a combination of several of these.

Gopal Ahluwalia, director of research for the National Association of Home Builders, reported that 55% of homebuilders are offering "free upgrades" to get a customer to buy their home, up from 37% in 2005. Four percent of homebuilders are offering free cars, and four percent are handing out free vacations. These figures are for new homes, but increasingly the broad trend applies to existing homes, as well.

Lawfully, the housing market has become like the desperate auto market, where bountiful incentives are ladled out to move the product. This was a reckless last gasp to buy a few more months' time for the housing market. But cold reality is intervening; the "free goodies" are not working.

Rupturing Regional Bubbles

It is precisely in those regions in America where bankers forced excessive and speculative non-traditional mortgage loans onto home-buyers, to create artificial "red-hot" housing markets, that the bubbles are blowing apart; this is striking confirmation of LaRouche's assessment. Many home-buyers were witting participants in this process: they thought they could buy homes, even under onerous mortgage terms, reckoning that they could hold the home properties for less than a year, and then sell them at a higher price for a profit. They reckoned wrong.

California: California's home sales plunged 30.1% in August, compared to sales in August 2005, the California Association of Realtors reported Sept. 26. *This is the steepest year-to-year home sales decline since August 1982;* during that time 24 years ago, Federal Reserve Board chairman Paul Volcker's "controlled disintegration" policy—with prime interest rates above 15%—was in effect.

California is America's largest housing market, accounting for one-eighth of all U.S. home sales. The California home market is important in itself, but also as a harbinger for what will occur in the rest of America. In areas such as the San Francisco Bay region, 80% of all new mortgages written this year were risky "non-traditional" mortgages. In several other parts of the state, 40% or more of all new mortgages written were non-traditional loans; but they were used to keep the median home price in California at $576,360. Leslie Appelton-Young, the chief economist of the California Association of Realtors, reported Sept. 25, "The share of [California] homes on the market for 90 days or longer has nearly quadrupled from 6% in August 2004 to 22% last month." Most revealing, more than 43,000 California homes are in one stage or another of foreclosure. Even in this state, Alexis McGree, President of Foreclosures.com warns that the worst is yet to come. She stated Sept. 25, "You could say that this . . . is the calm before the storm."

Massachusetts is a haven of exotic mortgages. ForeclosuresMass reported Sept. 25 that foreclosures in the state are escalating at rates that it hasn't seen "since the housing crash of the early 1990s." Massachusetts foreclosures for the year ending Aug 31, 2006, compared to the same period a year earlier, leapt by 72%. In August, home prices fell by 6% statewide compared to July, to $352,000; at the same time, sales declined for the fifth straight month.

Florida: Foreclosures.com reported that "It looks to us like they have been selling [homes] to each other in Florida, rather than to end users. Now, the party is over." Every irresponsible mortgage financing gimmick was used to sell homes in Florida. For 2006, through Sept. 11, almost 23,000 people's homes in the state were in a stage of foreclosure, more than 33% more than last year.

Driven by foreclosure, as millions of households are unable to pay mortgages that are inherently unpayable, the whole rotten structure of exotic mortgages is poised to fall.