An issue of housing market collapse of 2008

Economics

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Financial Crisis and Housing Market Collapse of 2008

Arguably one of the defining events of this generation in America can be viewed as the complete collapse of the housing market in 2008 and the ensuing financial crisis that followed. The effects of which can still be felt in global markets today. This paper will examine some of the causes of the housing market collapse and the effects felt by it.

Some saw early signs that there was a storm coming that would wipe out the housing market as early as 2006. Robert Hardaway says at this time the rising prices of homes across America began to level off and in some places even start to decline. With this slight decline, speculators in the housing market who flipped houses for profit started to panic and subsequently get out of the housing market. This panic then caused the so-called housing market bubble to collapse, and on August 6, 2007 American Home Mortgage filed for bankruptcy. This was the start of a domino effect that would be the collapse of many large mortgage and lending companies internationally. At first, the United States government responded to this collapse by printing trillions worth in new currency in an attempt to help the housing market regain its liquidity. This only contributed to the losses that would accumulate to over $4. 7 trillion in losses to the world gross national product (Hardaway). Banks at the time of the housing market collapse had to greatly alter their lending practices in order to stay afloat because of the lack of affordable housing.

The widespread economic collapse beginning in 2008 prompted the government to step in and take over certain companies such as Fannie Mae,

Freddie Mac, and AIG. During this time the amount of money it would cost for corporate or bank borrowing rose drastically, and the volatility of the financial market skyrocketed. Bank lending fell significantly in the fourth financial quarter of 2008 to 47% than what it was the third quarter. Since the credit boom of 2007 lending dropped 79%. The loans decreasing were not just housing loans, but they were across all types of loans from the corporate sector to the private sector. In almost all cases during the crisis data shows that financial firms had to drawdown on their existing credit lines to corporations. These credit lines were commitments to banks to lend to corporations at certain times and up to certain limits. From what was shown on news outlets at the time, firms drew back on $26. 8 billion in credit lines. Companies did this in order to ensure liquidity in the times of economic uncertainty (Ivashina). Companies trying to ensure liquidity would in turn have negative effects on banks at the time.

The push for liquidity by many companies produced what experts call a “ run” on banks that would actually end up draining the banking sector of its liquidity. Short-term creditors, counterparties, and borrowers all attributed to the “ run”, and repo lenders and trading counterparties that needed more collateral to fund their loans and trades. All of these entities combined along with borrowers drawing on their credit lines nearly completely drained the banking sector of its liquidity. The banks that were getting more deposits by their customers cut their lending by less than banks with less deposits did. Also, even if banks had co-syndicated credit lines with a larger firm such as Lehman Brothers then the banks would not experience significantly less lending due to the failure of Lehman Brothers. Instead it would be credit line

drawdowns or the threat of credit line drawdowns that would cause a bank to reduce lending. Another reason why lending declined in the time of the economic crisis may be because of the decrease in demand for credit. This also sheds light on why more vulnerable banks cut lending the most. The more vulnerable banks, such as investment banks, tended to do more lending for stock acquisitions that are not funded by deposits. If the demand for acquisition lending fell, then subsequently the lending of those investment banks would have fallen as well. At the height of the credit boom of 2007 there were $700 billion worth of loans issued in the United States. A year later in the third quarter of 2008 that number had staggeringly decreased to only around $150 billion worth of loans being issued. In the credit boom of 2007 firms were more likely to refinance their loans because interest rates were significantly lower than before. This means that there would be a decrease in new loans in the following quarter because the old loans would have already been financed (Ivashina). Through this data and information it can be seen that the housing market collapse and the following economic crisis had a profound affect on the lending practices of banks during and after the economic crisis.

One type of lending that can be attributed to helping cause the housing market collapse is known as close junior lien lending or “ piggyback” lending. These are loans that are taken out simultaneously with the first mortgage on the home in order to finance the initial purchase of the home. These loans took place in about 22% of the owner occupied home purchases in 2006 alone, and these types of loans are very popular with high cost housing areas such as New York. For instance more than 30% of home purchasing

borrowers took out a piggyback loan in 2006. These types of loans may also have a correlation with the rise in foreclosure rates because arguably piggyback loans allow homeowners to take on a lot of debt in a short period of time. Piggyback loans also further complicate the loan modification process because the first mortgage and the piggyback loan that goes along with it are sold to different entities. One example of piggyback loans leading to foreclosure being that from 2006 to 2008 80% of California homes facing foreclosure had at least one outstanding piggyback loan. Data taken from the Journal of Housing Economics suggests that states and Zip codes with a higher percentage of piggyback loans were more likely to have more mortgage defaults (LaCour-Little).

Other data presented that examines each of the fifty states and Washington D. C. show that the states with the higher percentage of piggyback loans have a significantly higher rate of foreclosures. From 2001 to 2005 foreclosures due to piggyback loans declined in all the states examined, however the rate of foreclosure started to increase in 2006 the early onset of the financial crisis. Early in the housing market collapse states with a higher percentage of piggyback loans had a lower rate of foreclosure, but as housing prices fell these states felt a much sharper increase in foreclosure rates than those states with a lower percentage of piggyback loans. A few other things that can attribute to a higher foreclosure rate in a state can be higher unemployment, more subprime mortgages, and price depreciation in houses over the year. As for different types of piggyback loans, first-lien prime and second lien prime loans are more likely to result in foreclosure only if that property is an investment property and not one that the owner

occupy. However, first-lien prime and second-lien subprime are associated with the highest percent increase in foreclosure rates, due to the fact that these types of piggyback loans are more common with investment properties and therefore have a higher risk of mortgage default. No matter what type of piggyback loan, they are all very highly associated with foreclosure rates (LaCour-Little). The practice of piggyback loans most certainly was a factor in bringing down the housing market, and if these loans were not given then maybe people would not have incurred more debt than they could have handled.

Aside from the piggyback loans, one of the main causes of the collapse of the housing market bubble was the sale of subprime mortgages. These subprime mortgages were very attractive to low income homebuyers or homebuyers with bad credit. In the year of 2005 the profits made from subprime mortgages was up to $625 billion. The largest buyers of these subprime mortgages were large investment banks like Bear Sterns and Lehman Brothers who bought tens of billions of dollars in subprime mortgages annually. As the subprime mortgage market was on the rise in the late 1990s, the Clinton administration pressured Fannie Mae to relax their credit requirements for loans that the company would buy from lenders. This was done in an effort to make loans more available to low income and minority homebuyers. This made Fannie Mae and Freddie Mac buy more subprime mortgages, and many other companies followed suit such as Citigroup and Merrill Lynch. After these subprime mortgages had been bought up by firms, the firms then bundled the loans together, categorized them by level of risk, and sold the rights to the loan profits. These loans

being sold became known as mortgage-backed securities. These mortgage-backed securities would often be structured to have corporate, consumer, and government all together to form a collateralized debt obligation. When subprime mortgage holders started to default on their loans in 2006, the buyers of these collateralized debt obligations and mortgage-backed securities went broke (Comisky). The process of bundling and selling off mortgage-backed securities and collateralized debt obligations would prove to have negative effects to the economy and towards the investors who bought them.

Most of the people who owned the mortgage-backed securities were institutional investors who had a lot of money to invest from America, Europe, or Asia. Investors were attracted to these mortgage-backed securities because at the time it seemed like they could have been lucrative investment opportunities. Shortly before the housing market collapse people generally believed that the price of housing would only rise. Another reason that investors were attracted to mortgage-backed securities was that the Wall Street agencies such as Standard and Poor’s or Moody’s rated them as a safe investment. Wall Street agencies thought they were safe because of the diverse instruments, the agencies did not fully understand complex collateralized debt obligations, the rating agencies were paid by the companies that sold mortgage-backed securities, and most people assumed that housing prices would never fall (Comisky). The assumption that housing prices would never fall would certainly prove to be a foolish assumption by many investors.

The reason why the belief that housing prices would always rise mattered was because in a normal situation where a person defaulted on their mortgage they would be able to sell their home at a higher price than they paid for it and use the money they gained to pay off their mortgage. When the price of housing fell however, homeowners who had defaulted on their mortgage no longer had this option. The entity that gave that homeowner the mortgage would then have to repossess the house and sell it for significantly less than they issued the mortgage for the home. In 2006 the people who held mortgage-based securities started to realize that they would see little to no income from the mortgage-based securities they had bought. Housing prices fell because of the overproduction of homes by contractors and because the Federal Reserve raised interest rates from 2004 to 2006 in an attempt to stave off inflation. The rising interest rates then made payments on adjustable rate mortgages rise, and many people who had taken out subprime mortgages on their homes could now not afford to make their mortgage payments. This in turn forced more people to default on their loans, producing more foreclosures, and increased amount of houses on the market making the market droop even lower (Comisky). Along with bad lending practices, governmental policies may also have something to do with the fall of the housing market.

Many believe that the liberal policies trying to broaden home ownership might hold some of the blame. These policies would have a negative affect on the housing market because it would give people with lower income the opportunity to buy houses that they may not be able to afford without taking out multiple mortgages. Then these homeowners may have to default on

their mortgages down the road. The risks taken by the financial institutions that created and sold mortgage-based securities also share some of the blame. These institutions took these risks because of the thoughtless belief that the price of housing would not fall. The institutions also did too much with funds that were only borrowed and not actually theirs. Because of this if their mortgage-based securities decreased only a little in value they would incur massive debt. One major government policy that people such as Conservatives blame as creating the slippery slope that would eventually be the housing market collapse is the Community Reinvestment Act of 1977. This act was passed to make it easier for low income, often minority homebuyers with bad credit to be able to get a loan. On the other hand, Comisky puts more of the blame on the Bush administration and the growing demand during it for mortgage based securities. Conservatives also state that the government interfered with the housing market too much by putting too much funds into the government run mortgage companies Fannie Mae and Freddie Mac. With all this money that the government pumped into Fannie Mae and Freddie Mac the companies then bought up billions in subprime mortgages, making inflation much more rampant (Comisky).

Another entity that can be noticed as having some blame is the Federal Reserve. The Federal Reserve took almost no measure to curtail predatory lending in the subprime market. The chairman of the Federal Reserve, Alan Greenspan, is recorded as believing that there were so many subprime lenders that they could not all be audited, and that taking disciplinary action against them would stop subprime lending that he saw as desirable. Comisky states that the Federal Reserve probably should have taken some of the

most abusive lenders and made an example of them by publicly punishing them. However these actions were not taken because of the high opportunity for profits in subprime lending. The biggest criticism of Greenspan however is how up until 2004 interest rates were incredibly low, and after that point he began to raise interest rates highly and rapidly. When Greenspan raised the interest rates in 2004 and again in 2006 they might not have been as high rate hikes as others in history, but due to the fact that American mortgage holders were so overdrawn it had a profoundly greater effect (Comisky). The Federal Reserve and the actions of Chairman Alan Greenspan had repercussions that helped shape the eventual collapse of the housing market and the ensuing economic crisis.

The collapse of the housing market was felt throughout all the sectors of the housing industry from concrete contractors to people who made home furnishings. One of the industries associated with the housing market that was hit hard in particularly was the forest products industry in the Western United States. From the years 2003 to 2005 the United States Forestry Department recorded a record high in lumber consumption. However in 2008 lumber consumption plummeted to a 50 year low. In some states the lumber industry accounts for 11% to 23% of manufacturing employment. When something like the housing market collapse happens and grinds lumber manufacturing to a halt it can negatively affect both local and state economies. Areas that were hit hardest were most likely small communities or counties that were almost completely reliant on the lumber industry for their source of trade and income. The surplus of foreclosed homes along with

a collapse in the housing investment market saw caused the worst wood products market from 2009 to 2011 since the Great Depression (Keegan).

There are two different sectors of the timber industry known as the primary and secondary. The primary sector deals with the harvesting and processing of timber while the secondary sector deals with things such as window and door manufacturing, cabinetry, and truss manufacturing. In 2006 the value of the primary industry dropped from $49 billion to $34 billion in 2009, and employment dropped 29% from 2005 to 2009. The value of outputs in the five Pacific states from the forestry industry also fell from $40 billion in 2005 to $28 billion in 2009. Over the same period the Western timber producing states sales fell from $10. 5 billion to $6. 6 billion. Along with a loss in sales the industry experienced also witnessed a decrease in employment. From 2005 to 2009 on the Pacific Coast employment from roughly 185, 000 jobs to 134, 000 jobs, and the wood products sector experienced the harshest economic times after the housing market collapse because of the lessened need for materials to build houses. The Western timber industry was hit especially hard because the West is where the housing market was at its worst. Places like Las Vegas, Los Angeles, Phoenix, and San Diego all experienced some of the worst housing markets and because of that the timber industries that supplied local contractors suffered greatly. For instance in 2010 and 2011 the amount building permits issued were only 14% of the number of building permits issued in 2004 and 2004 in Las Vegas and Phoenix. When the timber market was at its strongest in recent history in 2004 and 2005 there were over 1, 100 timber mills in the West producing all types of wood products. However by 2010 that number of active mills had

dropped to only 800. Due to the market collapse and lack of demand both price and production lowered significantly in the West. Lumber produced in the West lost value by as much as 60% from $8 billion in 2005 to $6 billion in 2010 (Keegan). The timber manufacturing industry has suffered greatly from the housing market collapse, and this industry serves as an example for how far reaching the effects of the housing market collapse actually was.

The housing market collapse of 2008 and the economic crisis that came afterward was one of the greatest setbacks our generation has ever experienced. People who were not able to pay their mortgages defaulted on them as the price of houses went down. The banks that then repossessed the foreclosed houses could not sell the houses for a profit so many financial institutions had to close their doors for good. Due to bad lending practices, the deterioration of the subprime mortgage market, mortgage-backed securities, piggyback loans, and the actions of the Federal Reserve, the housing market collapsed in

2008 causing a global economic crisis the likes of which have not been seen since the Great Depression.