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Lessons Offered But Not (Necessarily) Learned ...

... FROM THE COLLAPSE OF THE HOUSING MARKET AND NEAR IMPLOSION OF THE U.S. FINANCIAL SYSTEM

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Delivered at the John Marshall Law School, Chicago, Ill., Sept. 7, 2012

Good morning, I am honored to speak with you today regarding the continuing challenges faced by the U.S. housing market and, in particular, the disproportionate impacts of the foreclosure crisis on communities of color. My remarks this morning are based on an article with the same title I coauthored with George Mason University assistant professor Katrin B. Anacker. That more extensive paper will be published in the book being developed to accompany this conference titled From Foreclosure to Fair Lending edited by Gregory Squires and Chester Hartman.

Six years into the foreclosure crisis and nearly four years after the near collapse of the financial system and U.S. economy, America remains mired in a depressed housing market, struggling economy and uncertain economic future. Consider the evidence:

- According to the real estate data firm RealtyTrac, more than 11 million foreclosure notices have been filed since 2007, with more than one million issued during the first-half of this year;
- Fully 13 million workers remain unemployed with more than 40 percent out of those workers out of a job for more than six months; and
- The Federal Reserve estimates that the median American family has lost nearly 40 percent of its wealth since the start of the crisis. The Pew Research Center estimates that Latinos have lost an unbelievable two-thirds of their wealth and Asians and African Americans have experienced declines of more than half.

Yet, in spite of the lingering economic fallout and major challenges ahead, no major public policy interventions are being debated by Congress to jumpstart the economy and get the nation back to work. In fact, the opposite is happening; Congress is locked in a political stalemate with the Federal budget heading for a fiscal cliff— i.e., the potential for $600 billion of automatic budget reductions that could catapult the U.S. economy back into recession if a workable compromise deficit reduction plan is not reached by year-end. More disturbing is the fact that the American public is not demanding action.

To the extent citizens are demanding change, many are being influenced by well-funded and sophisticated political messaging that encourages them to demand policy interventions that actually work counter to their own best interests. The media have been inundated with messaging directly intended to deflect attention from the real causes of the crisis in order to avoid holding institutions and individuals accountable. Additionally, these messages are designed to avoid the imposition of appropriate regulatory oversight as well as payment of compensation to the millions of exploited victims.

This combination of lack of action by national policy makers and largely disengaged or counter-productive action by the American public toward the critical challenges facing the nation are leading America down a dangerous path. I will review briefly five lessons I think should have been clear as a result of the recent near total collapse of the housing and financial markets, but have not yet (necessarily) been learned:

1. Markets are not self-regulating.
2. Financial exploitation was fundamentally at the core of the foreclosure crisis.
3. Inequality has significantly worsened since the Great Recession and is driven as much by public policy as by market forces.
4. A robust housing market is essential to a strong and sustainable recovery.
5. The struggling U.S. economy will not self-correct.

1. Markets are not self-regulating

Perhaps the most powerful endorsement of the need for market regulation was the fact that in 2008, the Federal Reserve issued revised mortgage lending regulations that, in part, prohibited financial institutions from originating loans they know cannot be repaid. The need for and enactment of that single regulation should have demonstrated powerfully for anyone interested how far off track our financial system had veered and how inadequate our financial regulatory oversight had become. And, the fact that the regulation was needed should also have put to rest any idealistic and nonsensical notions about Adam Smith's invisible hand of free-market self-regulation. The recent financial crisis demonstrated that left unregulated, companies will often compete with one another to the point of self-destruction.

Leading up to the housing crisis, lenders had perfected a system of originating loans that were designed to trigger unaffordable loan payments after only a few years of the original loan's closing. The sole purpose of action was to force borrowers back to the table for a new loan and collection of additional abusive loan fees. Rising home prices helped this process by allowing lenders to tap the borrowers' accumulated home equity to pay the fees and in essence, create a perpetual refinancing scheme. Harvard University law professor and Massachusetts Senatorial candidate Elizabeth Warren dubbed these notorious loans "exploding mortgages."

Of course, by 2008, the crisis was already well underway and those fraudulent exploding loans were no longer being offered -- because every major subprime lender had already failed or was in the process of closing its doors. Interestingly, while still in the depths of the financial crisis (in April 2009), Goldman Sachs chairman, Lloyd Blankfein, stated that "self-regulation has its limits. At the very least, fixing a system-wide problem, elevating standards or driving the industry to a collective response, requires effective central regulation and the convening power of regulators."

Mr. Blankfein was right.

Private firms, of course, must be allowed to take risks and compete. Risk-taking and competition are essential in a marketplace. And, some level of exploitation is also an inescapable fact of life in a free market system and to deny it is naive. The success of private firms rests, in large part, on their ability to exploit a range of opportunities. Firms exploit product and marketing weaknesses and management deficiencies of their competitors. They exploit regulatory weaknesses such as vagueness in rules and loopholes in regulatory regimes. And, they exploit the information and knowledge gaps and related vulnerabilities of consumers.

In fact, a central tenant of the theory of the efficiency of unfettered markets rests on the unrealistic concept of full and perfect information by all market actors, including consumers. Yet, consumers rarely, if ever, have the same information about a product or service as the company offering that product. Moreover, firms spend billions of dollars each year creating persuasive marketing campaigns around their products to make them attractive—even to consumers who have sufficient information that might otherwise lead them to reject that product or service.

Consider the successfulness of the soft drink industry, for example, that each year spends billions of dollars on marketing to convince consumers to drink beverages that contain high concentrations of sugar when hundreds of articles and websites point to the links between sugar, cancer, obesity, and diabetes which are now epidemic in this country.

When it comes to the health of the economy and our citizens, regulation is critical to ensuring that firms remain within acceptable and reasonable limits regarding how much they overstate the benefits or downplay the risks of their products and services. Regulation is also essential to help consumers better understand their legal obligations as well as rights when entering into contractual agreements with businesses.

And, finally, companies make mistakes. Commenting on their $5.8 billion trading loss in May and June of this year, JP Morgan Chase CEO Jamie Dimon stated the trading strategy responsible for the loss was "flawed, complex, poorly reviewed, poorly executed and poorly monitored." According to Dimon: "We were sloppy. We know we were stupid. We know there was bad judgment." I, personally, respect Mr. Dimon's candor. That kind of forthrightness by a corporate titan is rare. And condemnation for making mistakes—even big ones—in my view may be misplaced. Everyone makes mistakes. But the reality that mistakes can be made and often are, even by the most seasoned experts, is another powerful reason for strong regulation. Effective regulation helps to ensure those mistakes do not translate into massive problems for which the American taxpayer must ultimately pay.

2. Financial exploitation was at the core of the fore closure crisis

From the start, subprime mortgage lending was about financial exploitation and not sustainable homeownership. Although the predatory lending house of cards did not begin to topple until 2006-2007, high-cost lending, targeted principally to minority borrowers, was already so pervasive more than a decade ago that by 1999, the State of North Carolina had already enacted a statewide anti-predatory lending law.

The Center for Responsible Lending, which did seminal work on subprime lending, concluded that more than half of all subprime loans originated during the decade leading up to the crisis were for home refinancing and less than 10 percent for first-time homeownership. And lenders were not alone in the subprime market's financial exploitation. Almost every institutional actor in the home mortgage financing process played a role in the housing market's collapse:

- Brokers steered borrowers into risky high-cost loans regardless of their incomes or credit scores and they were allowed to collect what amounted to kickbacks in the form of "yield spread premiums" if they could mislead borrowers into accepting loans offered at higher–than-required interest rates;
- Appraisers inflated home valuations, driving prices to unsustainable record highs, credit rating agencies indiscriminately stamped "investment grade" on securities backed by subprime loans regardless of their actual risk profiles;
- Bond rating agencies stamped A credit ratings on securities backed by loans that were clearly headed straight to foreclosure; and

- Investment banks paid premium prices for those high-risk loans thereby encouraging lenders to originate them rather than affordable and sustainable fixed rate products. In the process, millions of good credit risk borrowers were transformed into high risk customers based solely on the basis of the deficient loans they received.

In the end, the entire subprime lending system had converted into a massive house of cards -- rooted in a foundation of unsustainable home price increases -- that imploded almost immediately as home prices began to soften in 2006.

Statements that the housing crisis was a result of government actions to promote homeownership among lower-income and minority households through the Government Sponsored Enterprises (GSEs) have absolutely no basis in fact. As the housing balloon was inflating, the GSE share of the market was deflating; from 52 percent to 44 percent between 2002 and 2006. It is inconceivable that the GSEs could be inflating the housing bubble as their market share was deflating precipitously during that period. In fact, according to George Washington University professors Jason Thomas and Robert Van Order, private label residential securitizations grew from $572 billion in 2000 to more than $2.6 trillion by the end of 2006. And a study by the Center for American Progress estimated that Wall Street's securitized mortgages defaulted at a rate of more than six times greater than those securitized by Fannie Mae and Freddie Mac.

As Nobel Prize winning economist and Columbia University professor Joseph Stiglitz put it: "Financial firms discovered there was money at the bottom of the [wealth] pyramid and did everything they could to make sure it did not remain there." In short, subprime lending was not about expanding an ownership society, building assets or promoting economic mobility and empowerment—it was financial exploitation at its worst.

3, Wealth and income inequality in America has worsened since the Great Recession, driven as much by public policy as by global market trends

As Stiglitz also has observed, "American inequality didn't just happen. It was created. Market forces played a role, but it was not market forces alone." And, from the start of the recent crisis, the focus of Federal policy has been on major corporations and by extension, their shareholders and executives.

Many may have forgotten that the Toxic Assets Relief Program (TARP) was initially conceived as an initiative to purchase troubled mortgage loans that could be modified to make them affordable. But immediately upon its enactment, TARP was used largely to provide liquidity to the banks. Separately, the Federal Reserve launched its own programs to aid the banks including offering zero percent loans and more than $2 trillion of asset purchases. And even today, while Congress refuses to enact any new stimulus spending to help working families get back on track, the Federal Reserve has already responded to the slowing economic growth this summer with the announcement in June of an extension of Operation Twist which translates into an additional $267 billion of stimulus activities.

In theory, the Fed's economic stimulus actions pass through the largest financial institutions and result in more loans at lower cost for individuals and businesses, and more jobs for the unemployed. But to date, that has not happened. As a result, neither the extension of Operation Twist nor another round of Quantitative Easing will create jobs or improve financial conditions for working families. The reason is that the problems impeding US economic growth are complex and structural and do not lend themselves to being resolved by a simple further lowering interest rates.

In fact, as in the case of tax cuts for the wealthy, the trickle down from the multiple bank bailouts has not occurred. And this skewed distribution of Federal economic support in favor of the wealthy is further fueling inequality between the rich and the rest while failing to address the structural challenges undermining the U.S. economy. Consider that even before the crisis, the top 1 percent of wealthy households controlled more assets than the bottom 90 [99?] percent. It will take years for the typical family to recover the loss of two decades of wealth resulting from the recent economic downturn. But the wealthy have already recovered their losses and are now padding their gains.

According to University of California-Berkeley economist Emmanuel Saez, the top 1 percent of wealthy households captured 93 percent of the income gains in 2010, the first year of the recovery. Impressive returns for the rich are the result of a strong recovery of the stock market, dividend payouts and corporate profits, all directly supported by the TARP bank bailouts and the Fed's ongoing stimulus actions. In fact, some Fed policies that help major corporations directly harm the middle class, such as zero percent loans for the big banks that translate into near zero percent returns on bank savings accounts.

Importantly, the Federal Reserve does not have direct authority over spending and taxes that would enable it to pursue more targeted policies to help working families. As a result, the middle class is at the mercy of a unproductive political process where extreme political partisanship precludes any rational discussions on ways to invest in the future of America.

The lopsided support for the financial system will not lead to a robust economic recovery—rather, it may only ensure we remain on the fringes of recovery. Drilling down into some recent positive economic data points clarifies this point:

In May, the FDIC reported that U.S. banks experienced their highest quarterly profits since mid-2007. But those earnings were not the result of loans used to start or expand businesses, rebuild the nation's infrastructure or help families buy homes—loan balances actually fell during the first quarter of 2012;

In spite of stellar bank earnings, the bond rating firm Moody's downgraded 15 big banks including the five largest in the U.S. one day after the Fed's decision to extend its stimulus efforts. Lowered ratings reflect the fact that not even exceptional Federal support can insulate the banks from the reality that their institutional and individual customers at home and abroad are drowning in an ocean of debt and mired in economies that are barely afloat; and

While many politicians argue that corporations need additional tax breaks to raise the capital they need to invest, the largest nonfinancial corporations in American are already sitting on more than $2 trillion of cash and other liquid assets. They're not waiting for another tax break in order to invest, they're waiting for the signs that the fundamentals undermining the U.S. economy are being addressed.

2. A healthy and robust housing market is essential to a strong U.S. economy

Normally, housing leads an economic recovery. This time, it's neither leading nor following. It's a drag on recovery in spite of the recent positive housing market news that the housing market has stabilized. It has found its footing far from a healthy market. On the positive side, home prices appear to have stabilized -- and in many markets -- prices have actually shown some important gains. Yet, home prices remain more than 30 percent below their highs. That translates into more than $7 trillion of lost wealth in the form of home equity. At the same time, nearly one quarter of all mortgage borrowers are upside down with their loans—meaning the amount due on their home loan exceeds the value of their properties. And that reality translates into more than $700 billion of mortgage debt upside down nationally.

Ironically, one of the key reasons for some of the improvement in prices is a result of a falloff in foreclosures that began last year and continued into early 2012. Foreclosures fell significantly last year, down nearly 35 percent between 2010 and 2011. But the reason for the fall in foreclosures was not due to improved economic circumstances of borrowers or more effective loan modifications. Rather, mortgage servicers were constrained in their ability to process foreclosures due to a variety of legal challenges.

Most of those legal barriers have now been removed and servicers are free to more aggressively clear out their foreclosure pipelines. And that pipeline is significant—Morgan Stanley estimates there are more than 7 million homes in the foreclosure pipeline. If there is no dramatic downturn in foreclosure within the next few months, we will likely end the year 2012 with over 2 million total foreclosure filings.

Organizations such as the National Association of Realtors, Mortgage Bankers Association and National Association of Homebuilders are flush with data and information on the value of home construction and home purchases to the U.S. economy. But the value of a healthy homeownership market extends far beyond bricks and mortar and mortgage financing. Owner-occupied housing is the most important asset of the typical American family. Fallen home prices are therefore damaging because they reduce the real wealth of owner-occupied households and limit their ability to leverage the equity in their homes for expenditures such as small business investments, children's educations, home repairs, vacations and other large expenditures. Also, as the typical family's largest source of savings, lowered home prices also depress consumer confidence. With consumer spending making up roughly 70 percent of the economy, it's not surprising that the economy remains in the doldrums. Proposals to revamp the mortgage finance system threaten to further damage the opportunities for homeownership which will harm current, as well as future potential homeowners. And they would make it particularly difficult for people of color to access mortgage credit. This does not bode well for the future of the homeownership market or the competitiveness of America in the global arena. Within 35 years, people of color will become the majority population in America.

In fact, a study recently released by the Brookings Institution finds that half of all new births are minorities.

What will replace homeownership as the main driver of wealth and asset accumulation? What does all this portend about the health of our economy if the fastest growing populations in the U.S. have no effective mechanism to build wealth and leverage that wealth to drive further consumer spending, launch businesses, pay for college tuition, and transfer wealth to future generations?

5. The struggling U.S. economy will not self-correct

One need only read the front page or front business page of any major newspaper in America to see stories about the Federal Reserve pondering whether to implement another round of economic stimulus or "QE3" to understand why the economy is not "self-correcting." Investors of all types follow the Federal Reserve's actions intensely because they know that Federal Reserve monetary policy plays a critical role in how the economy will perform. And make no mistake about it, the Fed's monetary policy tools are a form of subsidy to the firms that directly benefit from those actions. It's time to level the table on government support and intervention to promote economic opportunity.

A recent paper by the Center for American Progress points to a range of impediments to a robust and sustainable U.S. recovery and dramatically illustrates how the economy will not just work itself out. Those challenges include:

- An increase of more than two billion newly-employable (and mostly low-wage) workers largely from China, India and the former Soviet bloc states;
- Massive consumer and institutional debt in the U.S. and Europe; and
- A general global lack of consumer demand for products and services.

These challenges demand a comprehensive economic recovery program—including economic stimulus spending—to jump-start demand and get America back to work. President Barack Obama has asked Congress numerous times to join him in passing legislation that invests in America's infrastructure and green technologies and creates jobs for working Americans.

But all focus in Washington is on deficit reduction—as if it's possible to cut and slash our way to national prosperity. While deficit reduction is important, the deficit did not cause the crisis and cutting it will not rebuild the economy. In fact, attempting to achieve major deficit reduction without simultaneously enacting policies and programs to address the fundamental challenges will likely weaken further the nascent recovery.

Conclusion

At the beginning of the current foreclosure crisis, many economists argued the foreclosure crisis should be allowed to work itself out. In effect, that's what happened, given the many weaknesses and shortcomings of the various national foreclosure prevention interventions implemented over the past four years. And failing to deal more effectively with foreclosures has been a colossal mistake.

The widespread abuses within the mortgage market leading up to the recent crisis sufficiently demonstrates that markets are not, nor can they be self-regulating. Whether the recent financial meltdown was a result of intentional financial exploitation, sloppy execution and poor judgment, or just plain stupidity matters little—the public should be protected from the catastrophic costs that can arise when major financial firms find themselves on the verge of imploding. Likewise, waiting for the economy to recover without some form of stimulus is a mistake.

While the busting of the housing bubble was the trigger that initially toppled the economy, the foreclosure crisis also exposed weaknesses in the U.S. economy that had been growing for more than two decades. Rather than investing in programs to address structural challenges inhibiting greater economic output and a stronger jobs market for working families, however, public policies have further fueled the trend toward economic inequality.

And finally, homeownership is essential to protect and support. For more than half a century, it has been the largest source of wealth and pride for the typical American family and the cornerstone of the American Dream. Expanding that opportunity to communities of color is particularly important given the twin concerns of the enormous wealth loss as a result of the current crisis and the reality that Latinos, African Americans, Asians and Native Americans together will soon constitute the majority of the American population.

The economy depends on a solid homeownership market for ALL Americans. Communities thrive with homeownership, and families dream to attain it. Proposals to remake the mortgage market must recognize its multifaceted importance to our American way of life and the fact that homeownership is a key lens through which Americans evaluate their success at achieving the American Dream.

If we are to succeed at achieving a sustainable, robust and equitable economic recovery, we will need to act on the lessons offered from the recent crisis. But before we act on the lessons, there must be widespread recognition and acceptance by the public of the lessons that have been offered. ◆

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