WebMemo
Published by The Heritage Foundation
No. 1881
April 3, 2008

Subprime Mortgage Problems: A Quick Tour Through the Rubble

Ronald D. Utt

The collapse of the subprime mortgage market in late 2006 set in motion a chain reaction of economic and financial adversity that has since spread to nearly all sectors of the economy, as well as to global financial markets, has created depression-like conditions in the housing market, and has led the American economy to the brink of recession. In response, many in Congress and the executive branch have proposed a number of new federal spending and credit programs that would greatly expand the role of government in the economy while doing little to alleviate the distress caused by the financial crisis.

How the Problem Started. These problems had their origin in the mid-1990s when mortgage lenders reduced the previously strict financial qualifications needed to acquire a mortgage to buy a house by offering credit-impaired households mortgage loans, albeit at higher interest rates to compensate for the greater risk. Despite the many different forms these mortgages would ultimately assume—no down payment, interest only, negative amortization, etc.—they were designated "subprime" because of the checkered credit histories of the households using them.[1] Despite the risk associated with these subprime mortgages, many mortgage lenders further relaxed their underwriting standards and in the process introduced even more risk into the system, some of it motivated by fraud and misrepresentation.

As a consequence, the availability of risky loans soared from the late 1990s through 2006. In 2001, newly originated subprime, Alt-A, and home equity lines (seconds) totaled $330 billion and amounted to 15 percent of all residential mortgages. Just three years later, in 2004, these mortgages accounted for almost $1.1 trillion in new loans, equal to 37 percent of the total. Their volume peaked in 2006 when they reached $1.4 trillion and 48 percent of the total.[2] Over a similar period, the volume of mortgage-backed securities (MBS) collateralized by subprime mortgages increased from $18.5 billion in 1995 to $507.9 billion in 2005.[3]

In turn, the looser lending standards allowed previously unqualified borrowers to become homeowners, and the homeownership rate soared from the 64 percent range of the 35 years prior to 1995 to an all time high of 69 percent in 2004. While most celebrated this accomplishment, the consequence of lending to riskier borrowers under diminished underwriting standards led to an escalation in the number of loan defaults beginning in 2006, followed by an escalation in the number of foreclosures. Because many of these loans had been repackaged into mortgage-backed securities, the growing default problem soon spread to investors in the national and international financial markets where these instruments were sold.

This paper, in its entirety, can be found at:
www.heritage.org/Research/Economy/wm1881.cfm

Produced by the Thomas A. Roe Institute
for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

The first to suffer was the housing market, where new construction and the sales of both new and existing homes plunged. This was soon followed by a decline in home values, which in turn worsened the financial problems in the mortgage market by reducing the value of the collateral securing these loans. As many subprime borrowers now found themselves owning a house worth less than the debt owed on it, the incentive to default increased, and by the end of 2007, more than 17 percent of subprime borrowers had fallen behind in their loan payments.

Implications for the Economy. After reaching the more than 1.7 million new units started in 2005, single-family housing starts in February 2008 fell to a seasonally adjusted annual rate of 707,000 units, less than half the level of production two years earlier. On a year-over-year basis, the decline in starts was 40.4 percent.[4] Sales of new homes fell precipitously over the same period. After reaching 1,283,000 units in 2005, they fell in February 2008 to a seasonally adjusted annual rate of 590,000, less than half the level of 2005 and down 29.8 percent from February 2007.[5] For existing homes, sales peaked in 2005 at 7,076,000 units, fell to 6.4 million in 2006, and by February 2008 had fallen to a seasonally adjusted annual rate of 5 million, nearly 30 percent below the peak levels of sales during 2005.[6]

After two years of declining activity in the housing market, many are hopeful that the bottom has been reached and that the market will soon revive, but this seems unlikely. The subprime default and foreclosure problems first emerged at a time when the economy was healthy, most borrowers were employed, and housing values were stable or rising. In 2008, home prices and sales are falling, some borrowers may soon confront unemployment, tightened credit standards will exclude many from homeownership, and the number of subprime mortgages resetting to higher payments will be greater than the number that reset in 2006 and 2007.

As a consequence, the homeownership rate is likely to fall from its record levels near 69 percent to something closer to the long-term historic norm of 64 percent. This trend in turn implies a greater number of lost homes coming onto the market at a time when sales are depressed. Under the circumstances, government policies should focus on cost-effective ways to facilitate the transition to a sustainable housing market of fewer homeowners and/or lower home prices, as opposed to a costly exercise to prop up the inflated an unsustainable market that characterized 2004 to 2006.

In response to the threat of a financial market panic that could contribute to a severe recession, as well as to the growing number of borrowers who might soon lose their homes, both Congress and the Administration began to take a number of steps to address the problems. Regrettably, they all involved expansion of existing federal programs and the creation of many new ones, often at very substantial cost to the taxpayer.

Notwithstanding the constituent and lobbyist pressure to do something costly and do it quickly, the history of government intervention in housing markets and the economy has not been one of notable success. Many of the proposals now on the table hold the promise of carrying on that tradition and doing so, as noted, at great cost to the taxpayer.

---

1. Edward Vincent Murphy, "Subprime Mortgages: Primer on Current Lending and Foreclosure Practices," Congressional Research Service *Report for Congress*, March 19, 2007, pp. 2 and 3.
2. All data from *Inside Mortgage Finance*, a proprietary information service at *www.imfpubs.com.*
3. Darryl E. Getter, Mark Jickling, Marc Labonte, and Edward Vincent Murphy, "Financial Crisis? The Liquidity Crunch of August 2007," Congressional Research Service *Report for Congress*, September 21, 2007, p. 4.
4. "New Residential Construction in February 2007," *U.S. Census Bureau News*, U.S. Department of Commerce, March 18, 2008, Table 3.
5. "New Residential Sales in February 2008," *U.S. Census Bureau News*, U.S. Department of Commerce, March 26, 2008, Table 1.
6. National Association of Realtors, "Existing Home Sales," at *www.realtor.org/Research.nsf/files/EHSreport.pdf/$FILE/EHSreport.pdf.*

More Regulation. Many in Congress and the Administration are calling for more regulation, yet a much more intensive system of federal regulations of the industry in the past contributed to the catastrophic collapse of the savings and loan industry in the late 1980s and early 1990s. Thanks to a burdensome system of intense federal regulations, the S&L industry—then the most important source of mortgage credit—was technically insolvent because the market value of its mortgage loan portfolio was less than the value of the deposits financing it. Although Congress belatedly responded by reducing the regulatory burden it had earlier imposed on the industry, that effort was too late, and by the end of the 1980s, the S&L industry was teetering on the brink of collapse.

And collapse it did. In the late 1980s, more than 1,000 S&Ls became insolvent and filed for bankruptcy. By 1995, there were only 1,645 S&Ls in operation compared to 3,234 in 1986, and the industry's share of the mortgage market fell from 44 percent in 1970 to 21 percent by 1990. Because the value of the insolvent S&Ls' assets was less than that of their deposits, the Federal Savings and Loan Insurance Corporation (FSLIC) had to cover the loss between what the assets were worth and what was owed to the federally insured depositors. The losses quickly exceeded the reserves of the FSLIC (which was subsequently merged into the Federal Deposit Insurance Corporation), and the final cost of the debacle to the taxpayers totaled approximately $130 billion.

A Bigger Fannie Mae. Another response to the current problem has been to expand the powers (and market share and profits) of the two major government-sponsored enterprises (GSEs): Fannie Mae and Freddie Mac. Until recently, the Bush Administration and some in Congress were working to diminish their role as a consequence of mismanagement, the concentration of risk, and misbehavior over the past decade or more. Despite the presumed intense federal oversight of these two GSEs, both of them found themselves mired in allegations of massive accounting fraud in the early part of this decade.[7] More recently, and again despite federal oversight, both have suffered major losses—almost $9 billion in the second half of 2007—from bad mortgage investments in their most recent fiscal year.[8]

Others see a bigger role for the Federal Housing Administration (FHA), but FHA loans experienced a higher default rate than subprime loans from 2003 through 2006, and more than 14 percent of FHA borrowers are now behind in their payments.[9]

As recent history reveals, there is little reason to have much confidence in a relief effort that relies upon a suspect process implemented by suspect institutions. While only a few of these proposals have been acted on, the threat of a worsening economy and the prospect of an upcoming presidential and congressional election may encourage many members of both parties to succumb to the temptation of a massive bailout. As noted, the history of such government intervention in housing markets has not been one of notable success. Many of the proposals now on the table would simply carry on that tradition.

Will History Repeat Itself? Among the many risks now confronting the nation is that substantial expansion of the federal government's scope will be both ineffective and permanent. While many know that the advent of the New Deal during the Great Depression of the 1930s led to a substantial and permanent increase in the scope of the federal government, few know that the process of federal expansion was well underway before Franklin Roosevelt took office in 1932.

Following the stock market collapse in October 1929, the Republican Administration of President Herbert Hoover attempted to spend its way out of the depression, increasing federal spending by 47 percent

7. Ronald D. Utt, "Time to Reform Fannie Mae and Freddie Mac," Heritage Foundation *Backgrounder* No. 1861, June 20, 2005, at *www.heritage.org/Research/GovernmentReform/bg1861.cfm.*

8. James R. Hagerty, "Fannie, Freddie Shares Suffer Hit As Mortgage-Default Fears Mount," *The Wall Street Journal,* March 11, 2008, p. A3.

9. *National Delinquency Survey, from the Mortgage Bankers Association*, Q407, Data as of December 31, 2007, Mortgage Bankers Association, March 2008.

between 1929 and 1932, Hoover's last year in office. As a result, the federal share of GDP increased from 3.4 percent in 1930 to 6.9 percent in 1932. By 1940, spending had increased to 9.8 percent of GDP while the level of government spending doubled. Indeed, many of the federal programs now being considered for expanded action—Fannie Mae, a resurrected Home Owners Loan Corporation, FHA, Federal Home Loan Bank Board—were created during the Great Depression for much the same purpose.

While this point of nostalgia has excited many of the current advocates of federal expansion, ordinary citizens and taxpayers should take note that, despite all this spending and government bureaucracy-building, the number of Americans with jobs in 1940 was less than the number with jobs in 1929. And despite the New Deal's focus on the problems of the housing market, the homeownership rate in 1940 was the lowest since that data series had been created—and even below that of 1890 (47.6 percent vs. 43.6 percent).

—Ronald D. Utt, Ph.D., is Herbert and Joyce Morgan Senior Research Fellow in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.