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The "Mortgage Pickle"

By Chuck Bates

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Unless you have been living under a rock you are no doubt aware of the financial meltdown taking place in the home mortgage and real estate markets. Frankly, the U.S. and international economics have been to the edge of the abyss and back in the last couple of months. If most knew just how close the U.S. has come recently to the real possibility of a depression, the markets likely would have unraveled completely.

I am not one to make rash or fear-inciting statements; but the last several years have been a credit orgy, with "free" money going out left and right and the personal debt level of the average American going through the roof.

Now, before my real estate and banking friends burst a spleen from what we are about to discuss, let's be honest, shall we? Let's agree that mal-investment must always be liquidated – and mal-investment is exactly what we are talking about in regard to the most recent economic crisis. The term sub-prime has been thrown around a lot recently. That term pertains to borrowers with "less-than-wonderful" credit – or more frankly, *bad credit*. The expansion of credit over the last decade from banks and other lenders, via monetary policy of the Federal Reserve, has been incredible – and at the same time, incredibly stupid. Of course we have an economical system that is driven by consumption; and if folks are not borrowing and spending, then the economy seizes up. But lending to those who really don't qualify for such credit and loans is faulty business, and the chickens are now coming home to roost.

There was a time in the not-too-distant past when lenders expected a borrower to be a partner in a loan transaction. When an individual decided he wanted to purchase a home, he visited his local banker, where his creditworthiness was discussed, using the four C's of credit: *Character* – Were you a person on integrity with whom the lender would want to do business? *Capacity* – How much could you afford? *Collateral* – What you were willing to put up to secure the loan and protect the lender? And *Credit History* – How well had you done keeping up your end of the deal in previous agreements?

Typically, if you were looking to purchase a home you came to the table with an average down payment of 20-30 percent of the value of the home you were hoping to purchase. Over the last ten to fifteen years these common sense rules have largely been tossed aside, and the latest economic crisis is the result.

Today we hear advertisements for everything from cars to homes shouting, "Poor credit, bad credit, bankruptcy – no problem!" But there is a problem when the mal-investment has to be liquidated and it affects the rest of us. A good friend of mine, who happens to be a banker, used to tell me how appalled he was when he saw zero percent financing ads – or worse yet, 125 percent home mortgages. Now it wasn't because he, as a banker, wanted to make sure he squeezed every last cent out of a customer; rather, he knew that there is a cost to borrowing money and the lenders must exercise prudence with the depositors' money. Otherwise, the bank regulators would "have you for lunch" because of your poor business practices.

"Creative financing," as I have come to call it, is bad business for the lenders, the customer, and the economy at large. It is an unnecessary risk for the lender; and more often than not, it results in devastation to the finances of the borrower. Think with me for a moment: why on earth would I want to loan someone 125 percent of the value of something? That defies logic. Why would someone want an interest-only loan, under which he pays nothing toward accumulating equity in the home? He might as well rent. Why would a person risk the volatility of interest rates with an "adjustable rate mortgage" instead of a fixed rate? The answer is, the lenders wanted the quick business and the borrowers wanted immediate gratification – and neither gave any real consideration to the consequences.

Over the next 30 days, another $50 billion in adjustable rate mortgages will escalate from their low rates of two or three years ago to the current rates. Most of the adjustable rate mortgage borrowers only qualified for a loan at the lower rate; and normally, they would not even have qualified for a loan. On average, their financial status has not appreciably changed; so how will they make the higher mortgage payments now? Sadly, a great number of them will not be able to make those higher payments. Neither the borrower – in his desire for the "American dream" of home ownership, nor the lender – eager to do business on the edge, was dealing with reality. Nearly 85 percent of "sub-prime" loans are ARM's, and this is just a tidal wave of foreclosures waiting to happen.

Not surprisingly, there is the push for a government bailout, with Congressman Barney Frank (D-MA) and Sen. Christopher Dodd (D-CT) pressing for legislation, along with various left-wing groups pushing for the same. This approach completely ignores the individual's responsibility and simply blames the problem on the banks and mortgage lenders. Now, it is indeed true that lenders have found creative ways to get folks into houses. Ultimately, however, the buyers signed on the dotted line; and there is legislation already in effect that dictates that full details of any home loan be in writing and presented to the borrower at the time the loan contract is signed. So, if you don't read the contract, should the taxpayers of the United States bail you out? The answer is a responding NO! Caveat Emptor, meaning, "buyer beware," is an old saying, but it applies today just as it did when it was the language of the day.

Even on the state level we have seen some in government calling for the taxpayers to bail out those who made bad choices in their home purchases. The somewhat irrational fear is that of these folks lose their homes then it will be an additional burden on society to feed and care for masses of newly homeless. Let's face facts: Everyone has to live somewhere, and if an individual cannot purchase a home he still has the option to rent a house or an apartment. A prudent individual has the option to save until he has the financial cushion that will enable him to get a real loan, not one of these recently contrived, "creative financing" deals. Government is NOT responsible for you. YOU are responsible for you. Government bailouts are not only patently unconstitutional, but economically indefensible as well. They set a terrible precedent: *that if an industry, or a group of individuals, uses poor judgment and unstable business practices that result in an economic disaster, they can expect the taxpayers to bail them out.*

There is also the reality that a bailout in this case will not allow the real estate market to "normalize" (as it ultimately must) to a more realistic, sustainable level. A useful corollary here is the game of musical chairs. At some point in the game, the music will always stop and there will be a mad scramble for seats. The "music" in an unstable segment of the mortgage business has stopped now, and lots of folks are losing their "seats." It was bound to happen, given loose lending practices and the euphoric – and totally unrealistic – expectation that the music would never stop.

We would advise prospective sellers to be prepared for a wait, particularly if that home is valued in excess of $417,000, which is the maximum allowable jumbo loan the quasi-governmental lending agencies will buy from your mortgage lender. You can use the higher priced real estate in an area as the "canary in the mine" early warning system, because high-end real estate values typically take a hit first. Even if you are not holding property in the higher ranges, real estate will, by-and-large, remain a buyer's market at least until the middle of 2008. If you are looking to buy, you may want to wait a bit longer. You are almost assured of some bargains, as a glut of homes seems to be inevitable trend for the near term.