

A Brief History of the Mortgage Crisis

In recent history less people owned property (and less people took out mortgages) than is the norm today. Most of the laws and business practices which govern real estate transactions were products of this smaller, less active market environment. Over time home ownership in the U.S. increased. This is a good thing because home ownership provides substantial financial benefits, and the equity in one's home represents the most significant and stable investment that most Americans hold...however, an over-active housing market is largely to blame for the looming financial crisis which threatens America's economy.

In the 1990s Congress passed a series of laws which relaxed restrictions on consumer lending and the relationships between large financial institutions. Banks were able to offer more diverse lending products and outsource certain parts of the lending process such as loan marketing and credit applications. This made it easier and cheaper for people to obtain approval for a mortgage, thus increasing the number of homes purchased and loans given. Investment firms also took advantage of this deregulation to create new investment products which capitalized on the growth of the mortgage lending industry. This deregulation of the banking sector helped set the stage for the unprecedented growth which the real estate market would experience between 2002 and 2005.

The final ingredient of the housing bubble appeared shortly after the turn of the century. The terrorist attacks of September 11th, 2001 threatened to destabilize the global economy, and the Federal Reserve mitigated this damage by drastically lowering interest rates. This injected money into the economy by making credit--including credit cards and mortgages--more attractive to consumers. The resulting housing boom created new jobs in many sectors of the economy (particularly construction and banking). This infusion of cash (or, more often, credit) into the housing market also helped prop up the retail economy.

As the demand for property increased the value of property rose rapidly. More and more people refinanced their mortgages to take advantage of low interest rates and high property values. Those who couldn't previously afford a second home were able to purchase one because of greater access to credit, and a number of people purchased multiple investment properties to capitalize on soaring property values. Large brokerage firms-who had been shaken by the "dot com" bubble of the late 90s and stunned by the sharp decline of the stock market following the September 11th attacks-invested more and more capital in mortgage-backed funds.

In economics a bubble is broadly defined as a phenomenon in which people vigorously trade investments at prices which exceed the actual or sustainable value of those investments. The real estate market in the United States between 2002 and 2005 certainly

fit that description. The demand for home ownership was fueled by relaxed lending standards which made mortgages available to those who were previously unable to obtain them. This demand was increased by the sudden, deep cuts in interest rates which followed 9/11. The increased demand for real property created an unusual inflation in property values which was inconsistent with traditional real estate investment models and the actual cost of living. Increased borrowing activity created a larger market for those who invested in mortgage- and debt-backed securities. This market growth encouraged lenders at the "street level" to lend more and more money to consumers.

The housing market had overextended itself. Mortgage brokers who were paid on commission had an incentive to help traditionally under-qualified borrowers obtain home loans, often providing risky mortgage products (such as adjustable-rate and interest-only mortgages) to those who weren't financially equipped to handle them. Property values declined over time as the demand for real estate dwindled, leaving some investors and developers holding properties which were less and less marketable, especially in light of the loans which they took out to acquire those properties. Homeowners, many of whom carried substantial personal debt, were left with negative equity in their homes because they had refinanced near the peak of the property's value. Mortgage payments increased for those with adjustable-rate or interest-only loans. Consequently, more and more borrowers defaulted on their mortgages, which has created a steady increase in the rate of foreclosures and bankruptcy filings.

Large sectors of the economy were buoyed by the housing bubble and are now imperiled because that bubble is bursting. Numerous mortgage lenders have gone out of business or been absorbed by larger financial institutions who weren't so heavily dependent on the housing market. The "credit crunch," rising fuel prices (which affect prices for many goods in the consumer sector), sustained personal debt, and stagnant wages have all contributed to a decrease in consumer confidence. This, along with the declining value of mortgage-backed investments and the devaluation of U.S. currency, has contributed to a decline in the stock market. The U.S. economy is very likely experiencing the first stages of a recession.

The likelihood of recession has created popular and political responses to the conditions and institutions involved in the housing bubble. The Federal Reserve lent \$30 billion to JP Morgan for the acquisition of Bear Stearns, a firm whose future was uncertain in light of their heavy investments in mortgage-backed securities. Economists and politicians are reviewing and debating a number of possible remedies for the current market contraction, but there is no definitive cure available.

Mortgage lenders are responding to rising foreclosure rates in an effort to protect themselves and their borrowers. Borrowers who don't make their mortgage payments or who file bankruptcy represent a significant expense to these lenders, who lose income

and incur additional expenses at every stage of the foreclosure process. This has motivated lenders to work more closely with borrowers and help them stay out of default. In order to survive these lenders will continue to expand these efforts and find new ways to keep borrowers out of foreclosure. It's also likely that government intervention at the State and Federal levels will also occur in response to the unique threat which increasing foreclosure rates represent to the economy.

Throughout the housing bubble the foreclosure statutes of most states, which were written at a time when foreclosure was a relatively rare event, haven't changed. This has presented serious challenges to lenders and borrowers, as well as the attorneys in this practice area. Local governments have experienced difficulties in the administration and maintenance of property records related to the increase in market activity; Bankruptcy Courts have experienced similar growing pains.

Law firms have grown in response to the demand for attorneys who specialize in foreclosure and bankruptcy practices. Attorneys have been called upon by lenders to assist with more aggressive "loss mitigation" activity (which refers to the efforts made to work out an agreement which keeps borrowers out of foreclosure). New businesses have been created by outsourcers and software engineers to help lenders and attorneys manage this rapid increase in demand. The possibility of legislative reactions to the collapse of the housing market will create even greater demand for innovation and leadership in this practice area. As the housing market continues to correct itself and the economy slides into recession, law firms in this practice area will play an increasingly important role in protecting the rights of lenders and helping borrowers stay in their homes.

— W. Eric Graham, May 4th 2008