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How Will Current Financial Instability Affect Housing and Community Development in NYC?

The Citizens Housing and Planning Council recently brought together a wide range of practicioners from the housing industry to discuss investor concern over subprime mortgages and global illiquidity, and the current turmoil that it has caused in financial markets. The discussion was led by Dan Levitan, a founding partner of the Home Mortgage Acceptance Corp. (HMAC), one of New York City's premiere brokerage firms. HMAC was acquired by Countrywide Financial Corp. in December 2006. Mr. Levitan currently works at The Manhattan Mortgage Company .

Dan Levitan

"This has the potential to be the worst financial crisis in 55 years."

During the month of August, financial markets around the world were battered by the onslaught of a deepening crisis in the U.S. secondary mortgage market. The troubles at Countrywide Financial Corporation, the largest mortgage lender in the country, intensified concerns over the health of the larger U.S. economy. It is not yet clear whether the current troubles will lead to a serious financial crisis or if they are simply the first manifestations of an expected market correction. In either scenario, however, there are potentially adverse consequences for New York City and its communities that the housing industry must address.

Our communities now face three distinct yet very connected challenges that can be imagined as a series of concentric circles. First, the number of mortgage defaults is increasing rapidly, threatening individuals and families, as well as the housing stock they occupy. Second, the largest increases in foreclosures are occurring in neighborhoods that have seen substantial public investment over the last two decades where the effects will be particularly damaging. And finally, the constriction of credit jeopardizes new investment into communities where acute housing and community development needs continue to exist.

The current mortgage market crisis and the attendent liquidity crisis may also seriously undermine the City's fiscal health. Wall Street accounts for a significant portion of the City's economic activity and even regular ebbs and flows in the economic cycle cause significant fluctuations in tax revenues. In FY 2006, when markets were strong, business income tax revenues from the financial sector were nearly double what they had been only three years earlier during weak market conditions.[1] Last year Wall Street firms paid out $38 billion in bonuses. A market correction which cuts that number in half would significantly affect personal income and sales tax revenues, and thus the ability of the City to continue funding vitally important infrastructure needs and basic services alike.

Is Countrywide Too Big to Fail?

The shaky position of any company that can legitimately inspire such a question should be of great concern to both consumers and investors alike. The current troubles at Countrywide began in the third week of August when it and several major lenders were unable to find buyers for their products on the secondary mortgage market. The securities being sold were primarily made up of investment grade AAA loans but, as with most mortgage paper securities, they also contained a smaller portion of Alt-A and subprime loans.

Because Countrywide underwrites over $40 billion in loans each month, the inability to raise new funds caused immediate concern over the company's financial health. Its stock price dropped 23 percent between August 14th and 16th and it was forced to exhaust an $11.5 billion emergency line of credit. On August 17th, the Federal Reserve cut the primary discount-window rate by 50 basis points in order to add liquidity to the market. Then on August 22nd, Bank of America Corporation invested $2 billion of cash equity into Countrywide, reassuring financial markets that an imminent collapse was unlikely. More recently the company announced plans to lay off up to 20,000 employees, or twenty percent of its workforce.

There were three factors that contributed to the collapse of the secondary mortgage market and led to the present liquidity crisis. First, a proliferation of exotic mortgage products began to appear on the market in 2001. Second, a dramatic run up in home prices came to an end with some markets even experiencing declining property values. Both factors contributed to the third problem: a rising number of delinquencies and defaults.

The most notable exotic mortgage product to be introduced was the Option Adjustable Rate Mortgage (ARM) that gave consumers a choice of paying interest only, interest plus a portion of the principle, or the fully amortized amount each month. While such ARMs were highly profitable

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Founded in 1937, CHPC is a non-profit policy research organization dedicated to improving housing and neighborhood conditions through cooperative efforts of the public and private sectors.

Other effects that were noted in the conversation:

•It can be expected that some condo projects currently under construction will be restructured as rental projects.

•The New York City housing market, with less speculative purchasing of condos and small homes, will probably suffer less than the rest of the country.

•It is still unclear how bad the effects will be, but there will be an increasing number of defaulted properties over the next two years.

•It does not seem realistic to think that there will be an opportunity to restructure problem loans on a large scale given the dispersed ownership of those loans.

•"Thrift" mortgage lenders who lend and hold mortgages in their own portfolios have been quickly oversubscribed and to a large extent have suspended the issuance of new loans.

•As increasing jumbo and adjustable mortgage rates bring banks back into the market it is likely that they will be forced to cut back in other areas. This will likely make commercial real estate financing and construction loans more expensive.

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This is the first in a series of CHPC briefings examining current issues of importaance to the NYC housing and community development industries.

for lenders, they were often marketed to consumers with little understanding of their terms. Generally, they offered a very low initial interest rate which would reset after a period of two years. Mortgage brokers often received higher commissions for the inclusion of prepayment penalty terms. In return, consumers were given more favorable rates upon expiry of the first term of their loans.

With strong federal policies encouraging homeownership and easy access to credit, housing prices rose dramatically over the past six years and equity gains made it possible for buyers to refinance many of these loans after their initial terms. Loans made in 2005 and 2006, however, are just now coming to the end of their first two-year "teaser" terms. With housing prices remaining flat or in some cases beginning to decline, any expectation consumers had about refinancing such loans to a lower monthly payment are quickly evaporating. Plus many of the financing products that once readily supplied easy credit are no longer available.

This combination has led to a sharply increasing number of foreclosures nationwide. The subprime delinquency rates for the quarter ending in June stood at 14.82 percent, just below the cyclical highs of 14.96 percent in 2002 [see Figure 1]. Yet because the subprime market has grown so much in the previous five years, the current delinquency rate is equivalent to a 78 percent rate in 2002[2]. And though the effects have been somewhat late coming in New York where Wall Street money and foreign buyers have kept prices strong, investors in the secondary market products are not able to discriminate as to geographic location or housing market. Also, it is generally not possible to restructure the terms of bad loans as investors are spread out around the world.

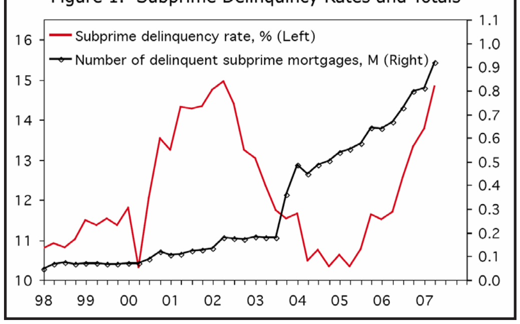
What Can Be Done?

A significant portion of mortgage defaults, even in New York, are occurring on one- and two-family homes. For policy makers, dealing with single family homes is often more challenging than assisting larger multifamily buildings. Policy prescriptions can take two forms: those that seek to assist owners before they are forced to vacate their homes and those that target buildings and maintenance in selected neighborhoods. The line between those consumers that were unwittingly taken advantage of and those that simply over leveraged themselves is a fine one. It remains an open question about whether or not public policy should seek to assist consumers that simply made irresponsible financial decisions.

One of the biggest fears when the number of foreclosures in a given neighborhood begins to increase is that properties will not be maintained and that a critical mass of such properties will depress values throughout a given area. One way to prevent this would be for the City to intervene prior to the foreclosure auction. In effect this would create a new version of *in rem*. It is not clear, however, whether the City could effectively deal with a large stock of properties in a down or declining market.

One way to keep owners in place as tenants until they are able to repurchase their properties would be to construct a leaseback program whereby the City or a non-profit organization functions as interim owner. The City would need a large pool of funds for property acquisition if it were to adopt such a policy. In the United Kingdom, shared ownership is a common option for lower income households. In the current scenario, a foreclosed home could be purchased jointly by a non-profit and the existing owner. Such an option, however, would still require large amounts of capital.

Figure 1. Subprime Delinquency Rates and Totals



Both the State of New York and the federal government have indicated a willingness to assist some homeowners. On September 4th, the State of New York Mortgage Agency introduced the Keep the Dream Mortgage Refinance Program. $100 million will be available to prevent distressed homeowners with interest-only and non-conventional loans from defaulting. President Bush recently announced FHASecure, a federal program that will assist about 80,000 borrowers nationwide to refinance delinquent loans with FHA insurance premiums. Such programs, when well targeted, can be helpful but will only be able to assist a narrow segment of the population.

Notes:

1. NYC Department of Finance, NYC Business Income Tax Collection Update, FY 2006 2nd Quarter.
2. High Frequency Economics, Daily Notes on the United States. September 7, 2007. Also see Figure 1, data from Mortgage Bankers Association.

(This brief has been written by Jeffrey Otto, adapted from a discussion held at CHPC on August 27, 2007. The following persons were in attendance: Sandra Acosta, John Daviglio, Tanya Dempsey, Henry Lanier, Dan Levitan, Marvin Markus, Lucille McEwan, Jeffrey Otto, Jerilyn Perine, Vincent Rizo, Richard Roberts, Brian Siegel, Gordon Shanks, Harold Shultz, Phil Tugendrach, John Warren, and Marian Zucker.)