Preventing the Next Financial Crisis

Edward J. Dodson

[December 2011]

Many economists in the United States are presenting a cautiously optimistic picture of the future of our economy, conditioned in part on a gradual recovery of "housing" prices as a significant driver of economic activity. Remarkably, despite the decline in nominal household net worth attributable to declining property values, household spending increased over the summer. The number of people who feel financially secure and/or optimistic about their employment situation has infused the United States economy with a raised baseline of spending.

An important question left unanswered is how much of this spending has occurred out of household savings versus the use of relatively high-cost consumer credit. Although government reports over the last few years indicate a decline in consumer debt, some of this is the result of individual bankruptcies and more stringent credit standards re-established by the banking sector. BEA reports an annual savings rate of 3.5 percent in November; however, what is far more important is the distribution of household savings across the population. And, here, the picture is grim. As Daniel Gros (Director of the Center for European Policy Studies) wrote earlier this year:

"... in the U.S., the increase in the average savings rate is obscured by an income distribution which is so skewed toward the top that a large fraction at the bottom of the distribution barely gets by and is even less able to save today than before the crisis brought about high unemployment."

And, with continued high unemployment comes worsening chronic poverty and increasing demands on government social welfare programs. More and more households and individuals survive only because of the government safety net and the efforts of charitable organizations. Corporate leaders in the United States seem slow to realize that household poverty is a growing threat not only to the future of our economy but to the stability of our society.

When Kate O'Sullivan reported in this month's CFO Magazine that "GDP in the third quarter grew by 2.5% roughly in line with economists' expectations" she repeated by her absence of analysis that this increase in GDP is not indicative of the real economy experiencing growth. It is the result of government borrowing and spending. Too few economists and other analysts are raising the crucial question of where, absent fundamental tax reform, the revenue will come from to continue to pay for public goods and services. At some point in the near future public revenue will be insufficient even to service the skyrocketing federal debt. Cities look to the states for revenue, and the states look to the federal government for revenue. At the moment, the federal government looks to the Federal Reserve to create purchasing power out of thin air. This is a very dangerous game that becomes ever more dangerous with each passing day.

Readers of this commentary have certainly formed their own opinions on how the current financial crisis could have been avoided. Based on my own 30 plus years working in the U.S. financial services industry*, I offer these insights about the boom-to-bust nature of our economic system and what might be done to mitigate the problems as the next cycle begins. What I learned financing real estate development and affordable housing is that credit-fueled property markets are inherently unstable and are prone to collapsing every 18-20 years.

What we know is that credit acts as an accelerant, poured onto speculation-driven fires endemic to our property markets. Investors seeking high returns move financial assets from one speculative market to another: into shares of stock, into precious metals, into property, into raw land, into currencies, into mortgage-backed securities, and so on. And, of course, from the investor's point of view, it is far better to use leverage and risk someone else's assets in speculation than one's own.

The use of credit by investors in the property markets is normal. What was not normal in this cycle was the aggregation of externalities -- most importantly the bypassing in the United States of Fannie Mae, Freddie Mac and the FHA as the gatekeepers over the quality of collateral going into mortgage-backed securities. No objective analyst would suggest that the GSEs are blameless. However, Wall Street firms with support from the bond rating agencies approved and packaged mortgage loans originated without verification of income or employment or even creditworthiness -- often with fraudulent property appraisals or no appraisal required. A high percentage of these loans was originated under predatory terms and outright fraud. The high nominal yields attracted all manner of investors in an environment absent of meaningful regulatory oversight.

What happens whenever the pool of potential borrowers or homebuyers expands as occurred in response to the explosion in the "sub-prime" business is that market forces capitalize the change in equilibrium into higher land (and total property) prices. Property prices were already increasing at dangerously high annual rates. The sub-prime market accelerated the cycle but with the added component of a greater level of criminal activity than previously experienced. As property prices climbed, Fannie Mae and Freddie Mac responded by raising maximum loan limits, reducing down payment requirements, extending mortgage terms, creating interest only mortgages, permitting negative amortization and offering adjustable rates that enabled people to qualify for larger loans. All of these steps involved elaborate risk assessment and concurrence by the private mortgage insurance providers. In the short run, these measures protected the GSEs from erosion of market share and kept stock analysts reasonably confident in profit projections.

Those of us in the industry who saw all this developing and feared the worst observed that on a growing number of property appraisals the land-to-total value ratios were dangerously high in many markets. Only a few decades ago, the purchase of a residential property required a 20 percent cash down payment. The logic of this requirement was understood. Mortgage financing was made available for the purchase of a home; cash was required for the purchase of the land parcel on which the house was constructed. As land prices escalated beginning in the 1960s, fewer and fewer households were able to meet the traditional down payment requirement. The industry responded by accepting a lower down payment and requiring the purchase of private mortgage insurance. Here, again, market forces capitalized the increased potential pool of property purchasers into higher and higher land prices.

By the early 2000s, the loans being purchased or securitized involved financing for more and more land and less and less housing. In New York City or San Francisco, for example, the land might comprise 80 or 85 percent of the total value in parts of these regions. These very high ratios were more common in transactions involving properties already improved and where existing homes were under-improvements in markets where new construction was almost universally priced beyond loan limits for the conventional market.

Development firms have long employed a number of strategies to overcome high land acquisition costs. Those with sufficient cash reserves acquire land at the margins of existing communities, holding the land until demand for new housing units materializes. Or, they will attempt to secure approval to increase densities or build upward. At the level of the individual firm these strategies make sense; however, a far more effective societal strategy would be to tame our land markets so that developers are not required to tie up financial assets in land-banking operations.

What is clear is that at some point escalating land prices impose unmanageable financial stress on businesses and residential property owners. At the peak of the land market cycle, the stress triggers a collapse in property markets (with bank failures, business failures and foreclosures as collateral damage).

As land prices increase business profit margins are reduced by rising land acquisition costs (pushed forward as increases in the cost of leasing space in office buildings, retail shopping centers, etc.). So, businesses look for ways to reduce costs of doing business. When business relocations begin and vacancy rates increase, this is a clear indication that a crash in the property market is on the horizon.

In the residential property markets, the end comes when property (i.e., land) prices become too high for first-time homebuyers to enter the market even with the exotic mortgage offerings provided by lenders. By 2004-2005, the capacity of millions of U.S. households to carry housing debt on top of other debt and expenses had reached its limit. Household incomes were stagnant or declining, household savings had disappeared for many, and interest rates were as low as they could go. To those dependent for their incomes on maintaining a high rate of property turnover, the temptation to engage in fraudulent practices was difficult to resist.

It is too late to prevent the collapse, of course. At best, actions by governments around the globe have served to create an illusion of stability by injecting huge amounts of new credit into the financial system. Serious cracks in the system have developed on the European continent, serving to divert attention from the skyrocketing debt taken on by the United States government.

The land market cycle will begin again when businesses see the opportunity to invest (to borrow and invest) in the expansion of their production facilities and begin to lease space in available buildings. As vacancy rates decline, the owners of quality buildings will quickly seek to convert rising demand into higher charges for space. Gradually, the asking price for land parcels will begin to climb and speculators will again be attracted to the land market in search of quick and above-market asset price gains. Even now, with land prices down in many markets, many investors (including foreign investors) with adequate cash reserves are acquiring land from financially distressed owners with no plans for development, waiting for land prices to recover to flip the property for what we allow to be treated as a "capital gain." One of the real problems with our system of taxation with respect to the impact of the real economy (i.e., the production of goods) is the treatment of gains on financial transactions as more beneficial than income earned by producing goods or providing useful services. Actual capital goods depreciate in value over time and rarely sell at a price above initial cost.

Among the numerous reforms we need is regulation that prohibits banks and any other financial institution that accepts government insured deposits or other guarantees from extending credit for the purchase and/or refinancing of land. This will require investors and homeowners to come up with cash down payments from savings or other sources that do not put the financial system at risk. Removing credit as the accelerant for land speculation will not solve the problem - this requires significant changes in how government raises its revenue -- but it is an important first step.

The long term solution is to remove from land markets the potential for profit from land hoarding and land speculation. The only effective way to achieve that objective is to impose an annual tax approaching 100 percent of the potential annual rental value of all types of land: land parcels in our cities and towns, natural resource-laden lands, the broadcast spectrum, rights of way granted to private entities, takeoff and landing slots at airports, and what economists describe as other forms of "natural monopolies."

In summary, the only effective solution to the boom-to-bust nature of our economy is to tame the nation's land

markets. And the only effective means of taming our land markets are the measures I describe above. The question is whether our civic, business, labor and government leaders can come together to embrace and work for the changes we really need.

---

* *I retired in 2005 from Fannie Mae, where I held positions as a manager of credit risk, and later as a market analyst and business manager in the Housing and Community Development group. Prior to joining Fannie Mae in 1984 I managed the residential mortgage loan program for a regional bank in Philadelphia. Today, I teach political economy to seniors at the Osher Lifelong Learning Institute at Temple University in Philadelphia.*