Many factors fed housing breakdown

By Deborah Donovan | Daily Herald Staff
Published: 11/25/2007 12:14 AM

Daily Herald

While some put the blame on borrowers and lenders for being greedy or outright fraudulent, the reasons why so many American homeowners are facing foreclosure these days are more complicated than that, experts say.

The worst places are being found in areas of the country where there was an enormous rise in home prices and the housing market overheated, says Daren Blomquist, spokesman for RealtyTrac, a foreclosure information services provider in Irvine, Calif.

"People couldn't afford the prices of homes any more and stretched financially to get into homes," he said.

In the early part of this decade, money flowed into real estate at least partially because of players on the stock market.

Investors were looking for higher yields, which led them to riskier borrowers and which helped lead to the relaxation of lending standards, said Pat Callan, president-elect of the Illinois Association of Realtors.

On the other side, homeownership has long been considered a stepping stone to personal financial success and neighborhood stability. The Federal Reserve wanted homeownership numbers increased, especially among minorities who have lower rates of ownership, said Bill McNamee, president of the Illinois Association of Mortgage Professionals.

Lenders stepped up with subprime mortgages, or loans for those with credit histories considered risky, to help accomplish this, he said.

Subprime mortgages carry higher costs than regular loans. The interest rates also usually adjust upward after a period of time.

"It was always assumed the subprime borrower would clean up their credit and refinance," McNamee said. "These were designed to help them get into homeownership; they were never intended to be the long-term solution."

However, refinancing to a better loan requires both good credit and equity in a home, often achieved with rising home values.

Overbuilding and investor speculation led to a glut of houses on the market and were reasons for price stagnation, said McNamee, president of Pinnacle Home Mortgage in Lombard.

Also not everyone with a subprime mortgage was able to improve their credit ratings enough to make refinancing possible, he said. Of course, others ran into problems with health or job loss that made refinancing impossible.

Brenda Procter, an instructor in personal financial planning at Missouri University Extension in Columbia, estimates half of these borrowers could have qualified for a less-risky prime loan. Procter said these loans would generally be less expensive for the borrower and might not have had the pitfalls of steeply rising payments that could lead to foreclosure.

Subprime loans can sometimes have very low original, or teaser, interest rates, but eventually the rate resets at a higher level and monthly payments can double, she said.

In such a scenario, the starting interest rate can be as low as 1 percent or 2 percent, but the real cost of borrowing money is more like 5 percent or 6 percent. The difference is added to the loan, and sooner or later a market-rate interest is charged to the borrower.

The borrower also at some point will be charged the difference between the low starting interest rate and whatever the market rate was when the artificially low rates were in effect.

These loans were based on the assumption that home prices would continue to appreciate in a strong housing market, so the home buyer could sell or refinance and have enough equity to cover costs, said Jack Guttentag, finance professor emeritus at the Wharton School of the University of Pennsylvania.

Another factor that has led to loan defaults, experts say, is some mortgages offered did not require borrowers to prove their income. These were designed for borrowers such as the self-employed whose tax returns might not reflect their cash flow. Both borrowers and lenders have been accused of fraud in taking advantage of these loans and lying about income.

And it's not just home buyers in trouble.

Many homeowners looking for more spending money refinanced using the equity in their house. That could place them in a precarious position if they lost their jobs or had medical emergencies.

In some cases home appraisals were higher than they should have been. The Appraisal Institute, an industry organization, is supporting legislation to fight pressure on appraisers to put higher values on property.

Home prices in the Chicago metropolitan area increased about 8 percent to 10 percent a year between 2001 and 2005, according to figures from the Illinois Association of Realtors. This compares to some areas like Florida, Arizona and California, where prices increased as much as 30 percent to 50 percent in a year, said Callan, an owner of Realty Executives Premiere in Wheaton.

Today, prices in the Chicago area generally are considered stagnant, Callan said. In some places they may have dropped. This makes it difficult for homeowners to sell or refinance their homes if they are unable to pay their mortgages. It is especially a problem for people who purchased homes without down payments and financed 100 percent of the price.

McNamee said it was unrealistic to expect record increases in home ownership without record defaults unless there was a plan to make this work.

"The good news that nobody seems to be focusing on is that the overwhelming majority of people with easier qualifying mortgages from the past few years still own their homes today, are making their payments on time and are not in trouble," McNamee said.