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The Subprime Mortgage Crisis and Local Government

Immediate and Future Challenges

The fallout from the ongoing crisis in the mortgage credit market, which has now spread to other markets for credit, poses significant challenges to local and state government officials. Some of these challenges are immediate and obvious: how to cope with a rapid increase in property foreclosures and a similarly rapid decrease in local property tax revenues. Other challenges are just emerging and were unanticipated—for example, the recent turmoil in the municipal bond market as a result of credit concerns among the companies insuring those bonds. And now, scholars and commentators are suggesting that the current crisis, combined with other trends, will likely pose daunting new challenges to local government.

How Did We Get Here?

The current financial crisis illustrates what can happen when Wall Street investment bankers seeking to maximize profits, and "Main Street" mortgage brokers seeking to increase their income, enter a market with lax government regulation.[1] Traditionally, most home mortgages had issued from banks or savings institutions that held and serviced those same mortgages. These thrift institutions based their lending on relatively strict standards that considered the borrower's income, credit rating, and amount of the down payment, because the institution remained at risk for the borrower's default for the life of the loan.

This traditional system began to change dramatically about a decade ago. In the late 90's, real estate was seen as undervalued in relation to other assets. At the same time, investment bankers and mortgage brokers were transforming the mortgage loan industry. An ever increasing number of mortgage loans was originated by mortgage brokers, rather than traditional lending institutions. Many of these mortgages were so-called subprime loans, often made with little or no regard to the suitability of the mortgage for the particular borrower, or the borrower's ability to repay. In too many instances, particularly in minority low-income neighborhoods, there was outright fraud by mortgage brokers and appraisers.[2]

This transition was fueled, in large part, by the introduction of securitization into the home mortgage market. Simply put, securitization is the creation and marketing of bonds based on pools of mortgages that are "sliced and diced" into pieces and then "bundled" into investments. These mortgage-backed securities proved to be extremely attractive to investors (many from outside the United States), largely because the securities offered high rates of return combined with claims that these instruments had been structured to shield purchasers from much of the risk of default.[3] As the demand for mortgage-backed securities increased, the mortgage industry scrambled to find ways of increasing the supply of new loans. It soon came up with ever more exotic forms of adjustable-rate mortgages (ARMs), dramatically increased the number of subprime loans (i.e., loans to borrowers with lower credit scores), and took numerous other steps to make mortgages available to borrowers who had previously been unable to obtain home mortgages. Borrowers could obtain a mortgage with little or no proof of income, and with little or no down payment. A prospective homeowner could also take out a second mortgage at the time of purchase, make interest-only payments for up to 15 years, skip payments by reducing equity or, in some cases, obtain a mortgage that exceeded the home's value.[4]

Several other factors fueled the process and planted the seeds for the current crisis. In the wake of the economic jolts caused by the "dot.com" bust in 2000 and the reaction to the 9/11 attack in 2001, the Federal Reserve, under Alan Greenspan, reduced interest rates to historic lows and kept them there for several years, making mortgage financing rates extremely attractive. As with any hot market, investors gave in to the temptation to speculate by leveraging their investments. Both institutional investors in the securitized mortgages, and real estate speculators purchasing homes, followed the same strategy. Buy the asset, whether a bond or a house, with a little bit of your own cash and lots of borrowed funds—e.g., a $5,000 down-payment on a $500,000 house—and then reap a windfall profit by selling the house six months later

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for $550,000, turning your $5,000 investment into $50,000. As long as the underlying assets increased in value, things were fine, but once values began to slip, speculators were liable to find that they owed more than the asset could yield after sale. When that happened to housing speculators, the home ended up in foreclosure; when it happened to a hedge fund that borrowed $99 million of the $100 million purchase price for mortgage-backed bonds that subsequently lost 35% of their value, the result was the collapse of the fund.

The positive side of these developments was a significant increase in the rate of home ownership, which increased from 64.2% in 1994 to 69.2% in 2004, the highest percentage of home ownership ever recorded by the U.S. Census Bureau.[5] As subsequent events have shown, however, many of these new homeowners were highly susceptible to changes in their economic position and in the housing market. So long as the housing market remained strong, with increasing prices and brisk sales, homeowners who faced a steep increase in their mortgage payments when their ARM's low "teaser-rate" expired could simply refinance, or even sell, to avoid becoming delinquent on their payments. But when the housing market began cooling off in 2006, accompanied by an increase in both short- and long-term interest rates, many homeowners were unable either to refinance or sell, and were left with no option but to default on their mortgages. By the end of last year, the Mortgage Bankers Association reported that home foreclosures were at their highest level since 1971, when the Association began reporting such data. Over 900,000 households, representing 2.04 % of all mortgages, were in the foreclosure process. And the future could be worse: 2.9 million households—6.3% of all mortgages—were behind on their mortgage payments at the end of last year.[6]

The foreclosure crisis and accompanying collapse of the housing market have had unanticipated repercussions throughout the economy. Access to credit tightened dramatically last summer as a result of the growing uncertainty about the true value of the various financial instruments created to further the securitization of mortgage debts. Not long after, we learned that major bond insurers were on the verge of default, further tightening access to credit. As this article is being written, Bear Stearns is being rescued by the extraordinary actions of the Federal Reserve, and there are rumors that Lehmann Brothers and other Wall Street firms are in perilous financial condition.[7]

Short-Term Effects for Local Governments

Revenue Shortfalls. The most obvious repercussion from the foreclosure crisis for local governments is its effect on municipal revenues. Homeowners who are in default on their mortgage or in foreclosure proceedings are often also defaulting on their property taxes or are in tax forfeiture proceedings, so real property tax proceeds are depressed. Further, tax proceeds from properties whose owners are current on their mortgage will also be negatively affected because the decline in property values will lead the owners to seek a reduction in property tax assessments; the same thing occurs when someone buys a home for less than its current valuation for tax purposes. The steep drop in housing sales also means that proceeds from real estate transfer taxes are significantly reduced.

The foreclosure crisis also reduces sales and income tax revenues. Homeowners with mortgage problems will normally cut back on other spending in an effort to avoid default, and may choose to accumulate some savings, rather than spend, if default cannot be avoided. Even homeowners with no mortgage problems are likely to reduce spending. First, the reduction in a home's value—generally the most valuable asset for most families—makes the homeowner feel less wealthy and reduces the ability to tap into the home's equity; both of these factors lead households to cut back on expenditures. Even households that have significant assets in addition to their home have likely seen their investments decline significantly over the past year, which also tends to reduce spending. Second, many households will react to more difficult economic times by targeting any "surplus" dollars to debt reduction rather than spending. All of the above results in a reduction in general sales tax revenues, while cities that rely heavily on "targeted" sales tax proceeds from largely discretionary purchases—such as tobacco, alcohol, entertainment, hotels and restaurants—suffer even larger reductions. Finally, the foreclosure crisis, housing price deflation, and credit crunch—along with soaring energy prices—have now led to a serious economic downturn, so municipal income tax revenues are also in steep decline.

Increasing Costs. The foreclosure crisis is also increasing costs for cities at the same time it has reduced revenues. Many cities, especially those in low or no-growth areas, rightly believe that it is in their long-term interest to spend money to try to prevent foreclosures and property abandonment, and to monitor vacant properties (or even provide minimal exterior maintenance, like grass-cutting services) in an effort to maintain neighborhood stability and prevent even further reductions in property values. That belief is validated by research demonstrating that the value of surrounding properties declines by 0.9%, on average, for each foreclosed house in the vicinity; further, the decline is significantly greater for a low-income neighborhood, at 1.44%.[8] Based on that research, the Center for Responsible Lending has estimated that homeowners living near foreclosed properties will see their property value decrease, on average, about $5,000. The Center's most recent forecast, in January 2008, projects that nationally, foreclosures on subprime home loans originated in 2005 and 2006 will lead to a loss of value for 40.6 million neighboring homes, with the resulting decline in house values and the tax base from nearby foreclosures totaling $202 billion.[9]

Abandoned and vacant properties also impose higher police, fire, and sanitary costs on cities, particularly municipalities with older housing stocks and weak housing demand. Such properties, if not appropriately secured, can quickly become targets for vandals or havens for squatters or criminals, further accelerating the decline of the neighborhood. Abandoned properties are fire hazards and can also become public safety hazards requiring demolition, at a significant cost to the municipality. When a house burns or is demolished, the resulting vacant lot can easily become a free dumping ground for trash and debris. To help avoid these costs, cities must devote significant resources to an "early warning" system that will identify vacant and abandoned properties in a timely manner, and allow the cities to respond appropriately. It's clearly the better approach, but still results in increased costs at a time when revenue is decreasing.

A number of cities have taken aggressive action to address property abandonment. In Cleveland, which has a Housing Division as part of its Municipal Court, the presiding judge has used the court's exclusive jurisdiction to hear nuisance abatement cases brought pursuant to the state's receivership statute[10] to address property abandonment. The receivership statute authorizes a receiver to take control of a residential structure that has become a public nuisance and abate the nuisance, while recovering the costs through a superpriority lien.[11] An important feature of the statute is that the receiver need not be the plaintiff; a community nonprofit corporation, or any other qualified property manager, may be appointed as the receiver.[12]

Buffalo has addressed its abandoned property problem by suing 28 national mortgage lenders to force these companies to take responsibility for properties that were abandoned after the companies initiated foreclosure and forced the occupants to leave.[13] Several cities in South Florida are levying daily fines against mortgage banks if they fail to maintain properties on which they've foreclosed.[14] In Southern California, some cities have adopted legislation that requires owners, banks, and other lenders to register vacant and abandoned homes in foreclosure with the city, and imposes an obligation to secure and maintain the homes.[15] Failure to register or a violation of the ordinance subjects the lender to fines of up to $2,500.[16]

Acess to Credit. One of the more surprising effects of the economic crisis has been the constriction of credit for local and state governments as a result of the unprecedented lowering of credit ratings for the companies that insure municipal bonds.[17] Municipal bond insurers, who entered the market in the early 1970's, have become an increasingly common feature of municipal bond finance. In 1980, only 3% of municipal bond issues were insured; by 2007, 60% of all issues were insured. The enormous growth in the use of bond insurers stems from the fact that the credit rating for an insured municipal bond is based on the credit of the insurer, rather than the underlying credit of the issuing municipality. Since bond insurers traditionally enjoyed the highest credit ratings, issuing insured bonds was attractive for any governmental issuer with a lower credit rating because they would not have to pay a higher interest rate as a risk premium.

BANK
OWNED
OPEN HOUSE

As more local and state governments issued insured bonds, competition among insurers for the growing business increased and profit margins declined. In search of increased profits, municipal bond insurers entered new markets, including the novel mortgage-backed securities being created on Wall Street. We now know that neither the insurers nor the credit rating agencies really understood the risks posed by these novel, and increasingly complex, security instruments. When the real estate market nosedived, leading to soaring default and foreclosures rates, these securities proved to be far riskier than anyone had believed, and the bond insurers suddenly faced huge unanticipated liabilities. As losses mounted among bond insurers, the credit rating agencies lowered the insurers' ratings, which, in turn, lowered the ratings —and raised the interest rate—on the municipal bonds they insured.

Many cities, thus, face a nasty confluence of decreasing revenues and increasing costs of borrowing. Some local governments, including Chicago and Miami-Dade County, have already chosen to forego planned bond issues rather than face the prospect of having to pay higher interest rates.[18] In addition, as cities forego borrowing for capital projects, they exacerbate their declining revenue situation because they are also foregoing the increased income and sales taxes that their capital spending would have provided.

Longer Term Effects

Predicting the future, at least without a reliable crystal ball, is a perilous endeavor. It seems fairly clear, however, that cities like Cleveland and Detroit that were already suffering from weak employment and housing markets before the current crisis, will have more serious and prolonged effects than cities like Las Vegas and Phoenix, which had a strong economy before the current crisis.

Cities that enjoyed relatively good job and housing markets before the crisis will suffer the short-term effects, discussed above, and a depressed housing market for some time as excess inventory is slowly absorbed. In short, once these cities begin to produce new jobs again, they will attract new residents and their housing markets will rebound.

The outlook for cities whose economies were weak before the crisis is far less bright. In these "weak market" cities,[19] the "current" crisis actually began much earlier. Cleveland, Ohio, for example, was one of the first cities

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to face a serious problem in its housing market, where a combination of a weak housing market, job losses, and abusive "predatory lending" led to a significant spike in foreclosures—and sharp increases in the number of abandoned properties—beginning in 2003. As early as 2000, however, community groups were seeing their neighborhood revitalization efforts undermined by unscrupulous mortgage brokers who flooded vulnerable, and largely minority, neighborhoods with high-risk loans, many of which were predatory and fraudulent. The problem was further exacerbated by an epidemic of property "flipping" by speculators.

Cities like Cleveland face only difficult choices. Cleveland itself has 10,000 abandoned homes and there were more than 27,000 foreclosures in surrounding Cuyahoga County over the last two years.[20] Both the City and the County have been losing population for decades: between 2000 and 2007, Cuyahoga County lost more people—both in numbers and as a percentage of its population—than any of America's 100 largest counties.[21] There is little expectation that these trends will slow, let alone reverse.

Cities that face similar demographic trends have little choice but to adopt a strategic planning and investment approach. It will simply be impossible to "save" all the neighborhoods that have been devastated by property abandonment. Limited resources should be deployed strategically, paying close attention to which neighborhoods have the existing housing stock and community amenities to compete for a pool of purchasers that had been shrinking even before credit standards tightened. Inevitably, this strategy will leave significant areas where parcels are abandoned, unmarketable, or vacant.

Cities facing that inevitability are well advised to consider working with other local government officials to establish a multi-jurisdiction land re-utilization authority—a land bank—to assist in the recovery of such land.[22] The Genesee County Land Bank Authority in Flint, Michigan, has pioneered this approach. The critical features of the Genesee approach are a county-wide scope, financial self-sufficiency, efficient procedures for clearing titles, protection of owner-occupants in tax foreclosures, and land re-utilization based on benefit to the public.[23]

Conclusion

The current subprime mortgage crisis poses serious problems for local government. In the short run, cities will face diminished revenues, increased costs, and restrictions on access to credit. Moreover, these three factors are likely to exhibit a negative synergy, with each exacerbating the problems of the others. In the longer run, cities that have been faring well economically are likely to recover from the current difficulties relatively quickly once the growth-induced housing demand reduces the current over-supply. The picture is far less rosy for "weak market" cities that were already struggling with sluggish job and housing markets before the current crisis. These cities will face difficult choices about where to invest diminished resources, and will need to look at new approaches, such as land banking, to revitalize neighborhoods devastated by the fallout from the mortgage crisis.

Notes

[1] *See, e.g.*, David Leonhardt, *Can't Grasp Credit Crisis? Join the Club*, The New York Times, Mar. 19, 2008, at http://www.nytimes.com/2008/03/19/business/19leonhardt.html?hp.

[2] *See, generally*, Kathleen C. Engel and Patricia A. McCoy, *Turning A Blind Eye: Wall Street Financing of Predatory Lending*, 75 Fordham L. Rev. 2039 (2007).

[3] *Id.* at 2045-48.

[4] *See, e.g.*, "The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues and How We Got Here," Report and Recommendations by the Majority Staff of the Joint Economic Committee, U.S. Congress, October 2007, at http://jec.senate.gov/Documents/Reports/10.25.07OctoberSubprimeReport.pdf.

[5] U.S. Census Bureau, *Housing Vacancies and Homeownership* (CPS/HVS) (Fourth Quarter 2007) at http://www.census.gov/hhes/www/housing/hvs/qtr407/q407tab5.html.

[6] Alexander Coolidge, *Foreclosure Record Set*, The Cincinnati Enquirer, March 7, 2008, at http://news.cincinnati.com/apps/pbcs.dll/article?AID=2008803070360.

[7] *See, e.g.*, Edmund L. Andrews, *Fed Acts to Rescue Financial Markets*, The New York Times, Mar. 17, 2008, at http://www.nytimes.com/2008/03/17/business/17fed.html?hp.

[8] Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure:The Impact of Single-Family Mortgage Foreclosures on Property Values*, Housing Policy Debate (17:1) Fannie Mae Foundation (2006) at http://www.fanniemaefoundation.org/programs/hpd/pdf/hpd_1701_immergluck.pdf.

[9] Center for Responsible Lending, Issue Paper, *Subprime Spillover* (revised Jan. 18, 2008) at http://www.responsiblelending.org/pdfs/subprime-spillover.pdf.

[10] Ohio Rev. Code Ann. § 3767.41 (West 2008).

[11] *Id.* at § 3767.41(H)(2)(b).

[12] *Id.* at § 3767.41(B)(1)(a).

[13] Jonathan Epstein, *City Sues Lenders Over Forgotten Houses*, The Buffalo News, Mar. 01, 2008.

[14] Polyana da Costa and Terry Sheridan, *Municipalities Struggle to Clean Up Dilapidated Properties Abandoned After Foreclosure Actions*, Palm Beach Daily Business Review, Mar. 18, 2008.

[15] Karen Maeshiro, *Abandoned homes becoming scourge of neighborhoods*, Daily News (Los Angeles), Mar. 07, 2008.

[16] *Id.*

[17] *See, e.g.*, David Cho, *Municipal Bond Deals Squeezed by Credit Crisis*, Washington Post, Nov. 29, 2007, at http://www.washingtonpost.com/wp-dyn/content/article/2007/11/28/AR2007112802486.html.

[18] *Id.*

[19] The Brookings Institution has termed older cities with weak employment and housing markets "weak market" cities. *See, e.g.*, *Revitalizing Weak Market Cities in the U.S.*, Brookings Institution, May 8, 2006, at http://www.brookings.edu/speeches/2006/0508cities_katz.aspx.

[20] Jerry Zremski, *mortgage crisis guts Cleveland neighborhoods as it bypasses Buffalo*, The Buffalo News, Mar. 07, 2008.

[21] Robert L. Smith, *Cuyahoga County's population drain now extends to the region*, Cleveland Plain Dealer, Mar. 20, 2008, at http://blog.cleveland.com/metro/2008/03/cuyahoga_countys_population_dr.html.

[22] *See* Frank S. Alexander, *Land Bank Authorities: A Guide for the Creation and Operation of Local Land Banks*, published by Local Initiatives Support Coalition (2005), at http://www.lisc.org/content/publications/detail/793.

[23] The Land Bank Website is http://www.thelandbank.org/default.asp. **ML**