Q&A: How could things go so bad and so quickly?

by Dean Calbreath

Just three years ago, the housing boom seemed like such a good thing. Property values were skyrocketing. Home equity loans were helping homeowners live in luxury. Mortgage rates were low enough to attract low-income buyers who never thought they'd be able to afford a home.

REAL ESTATE WOES - A sign at this San Diego home last September told prospective buyers it was a foreclosure. CNS Photo by James Baird. The market was so hot that crowds of speculators found they could make good money by buying property, holding it a month or two, and then reselling it at a much higher price.

And then it all came crashing down.

By late 2005, the housing market stalled, and over the past two years, it has been on a downhill slide, dragging the economy to the verge of recession - if it isn't already in one.

How did things get this bad?

Here are answers to some common questions.

- How did the housing bubble happen?

First came the easy-money policies of the Federal Reserve. To stimulate the economy after the recession of

2001, the Fed slashed interest rates to their lowest point in 40 years and injected billions of dollars into the economy. That made it easier for lenders to dole out mortgages. Wall Street investment firms, burned by falling stock prices, invested heavily in the mortgage industry, pushing lenders to offer more loans. The resulting flood of new home buyers and speculators drove housing prices to stratospheric heights.

- What made the loans risky?

Lenders were competing intensely to get borrowers so they could meet the demand of their investors. To attract borrowers, they abandoned traditional lending standards and floated an exotic array of loans, including adjustable-rate mortgages with no down-payment, no equity and no proof that the buyer had enough income to pay off the loan. Loans with no down payment or equity are risky for lenders because borrowers have little incentive to stay in a house. Adjustable rates are risky for borrowers because the rates might rise to unaffordable heights.

- Why would anybody take those risks?

With low mortgage rates and skyrocketing home prices, both lenders and borrowers felt that if there were problems paying off loans, the borrowers could either refinance or sell the house at a profit. Also, many borrowers did not realize their loans were so risky. They had no idea how much their loans could adjust upward.

- What went wrong?

Home prices got so high they no longer attracted buyers. As prices stalled and then declined, many borrowers were stuck with houses that were worth less than their mortgages. In the meantime, the adjustable rates began moving upward, putting a squeeze on homeowners who were already struggling to make ends meet. An adjustment of a single percentage point could tack hundreds of dollars onto a monthly mortgage payment. Making matters worse, some homeowners had added to their debt by taking out home equity loans to buy flat-screen TVs, cars and other luxury items. The payments on those items increased the debt burden from their homes.

- So some people can't pay their mortgages. How did that push the economy to the brink of recession?

The crashing property prices hurt the economy in several ways. Less demand for houses meant less employment for construction workers, real estate agents and mortgage brokers, pushing the jobless rate higher. Fewer home equity loans meant lower retail sales, a key measure of economic growth.

But most important, the rising number of defaults on loans meant problems for the entire financial system. Many mortgage brokers have gone out of business since the crisis began. The Wall Street firms that supported them have reported multibillion-dollar losses. Most financial firms, which have also been losing money badly, have tightened their lending standards to stanch the bleeding. Tighter credit standards make it tougher for anybody to borrow, including businesses that drive the economy. Student loans, auto loans, commercial loans and credit cards are all getting more restrictive.

- Why can't the lenders just renegotiate the loans?

Unlike in times past, when mortgage originators often had direct control over the loans, in recent years those loans have been divvied up among hundreds of investors, many of whom are overseas. Even if a lender wanted to renegotiate a loan, it would still have to pay off its overseas investors, which makes renegotiation harder.

- How bad is this going to get?

Nobody knows for sure. One problem is that mortgages were packaged into securities when being sold to investors. These securities included portions of many mortgages of many varying qualities. Loans to wealthy borrowers with sterling credit ratings were mixed with loans to low-income first-timers with no credit history. The fact that these loans were all mixed together means that financial firms with these securities in their portfolios have little way of determining their possible losses in the mortgage meltdown. Distrust in financial firms has led to a worldwide downturn in stock markets.

Joseph Quinlan, chief market strategist for Bank of America, says that since November, stock markets have lost $7.7 trillion in value, largely due to the mortgage crisis.

- What is the government doing?

So far, the main initiative from the Bush administration has been to encourage lenders to voluntarily renegotiate loans and temporarily freeze adjustable-mortgage rates. For qualified home buyers, the administration has also encouraged six of the nation's largest lenders to put a 30-day freeze on foreclosure proceedings. Congress recently changed lending standards for so-called jumbo loans to allow more borrowers to qualify for lower interest rates. And some lawmakers are working to revive a Depression-era agency to help borrowers buy their homes out of foreclosure. Economists agree that while each of those measures will help some borrowers, none will completely fix the problem.

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