MORTGAGE MELTDOWN and the EUROPEAN ECONOMIC CRISIS: KINDA' SIMILAR …… RIGHT? (Do I hear phones hanging up?)

Stephen L. Bakke – December 10, 2011

Way Back When, Each Mortgage Transaction Stood on Its Own

First we had individual home mortgages. The bank or other lender would evaluate the collateral value and the borrower's ability to pay, and decide on whether to make the loan. Then the original lender would often retain that mortgage, with all its credit risks, and collect the payments. Alternatively, in some cases the lender would sell the loan and its credit risk to another lender or mortgage servicer for collection of payments. In any case, the mortgage documents were unique to that transaction, the flow of funds was clearly identifiable with that transaction, and the ultimate success or failure of that mortgage transaction remained uniquely identifiable.

So Too With the European Economy

First we had individual countries in Europe, each with unique laws, cultures, languages, priorities, forms of government, economies, economic policies, currencies – and bad habits. That is not to say they were not interdependent, if for no other reason than geographic proximity and cross-border mobility. But they were not "joined at the hip." Each country's fate certainly had implications on their geographical partners, but for the most part the individual economies' success remained identifiable with the appropriate country.

And Someone Proclaimed, "Let There Be Home Ownership for All"
– Whence Cometh Fannie, Freddie and Mortgage Backed Securities

Using someone's infinite wisdom it was determined to do a wonderful thing and "grease the skids" for creating "home ownership for all." If only we had the right institutions, laws and policies in place! And just think what a great thing it would be if there was more liquidity in the mortgage market (read "more dollars chasing the same mortgage transactions"). We legislatively created the Community Reinvestment Act, and Fannie and Freddie stepped in to facilitate the process. After all, what could be handier? F&F aren't regulated, and if they could buy up more and more mortgages from the lenders, that could free up more lender dollars to make more loans. And the process was accelerated by permitting "low doc" loans (read "throw away underwriting standards – after all, F&F will take them off our hands anyway").

And the concept of "securitization" came into prominence. This means that many loans, of varying risk levels, are bundled into a huge "pool" which are then "sliced and diced" into small pieces called mortgage backed securities. After all of this, and after some sales and re-sales of the securities, there is no unique identity for the original transaction! The failure of any one original loan transaction now has negative implications for the entire securitized pool. And if a "whole bunch" of individual loans fail, well …… the pool "crashes." (OK, I've oversimplified - so what!)

And Someone Else Proclaimed, "Let There Be One Powerful European Economy"
– Whence Cometh the European Union and the Euro

Then, over a number of years, and after many "fits and starts," the European Union (EU) was formed by 27 countries. And, almost all of those began using a common currency, the euro. (Please once again forgive the huge oversimplification here, but a study of the EU or euro is not the purpose here – look it up if you wish.) The obvious goal was to combine into one powerful marketplace with uniform laws and policies to "grease the skids" for European and international commerce.

The goals were understandable, perhaps even commendable. While the upside was substantial, the downside was very real. We had a situation in which the failure of any one country now would have a magnified affect for the entire "pool" of countries. And if enough countries have trouble or fail economically, well …… the EU and euro "crash."

The Pieces are in Place for a Mortgage Meltdown

We had a perfect storm forming:

- Incentive to be careless – F&F will buy anything.
- Congress "looking the other way" in spite of warnings from powerless regulators.
- Overheated market caused by too many unqualified homebuyers chasing houses.
- Too much available capital fueling the fire – securitization invites uninformed investing.
- No real "culprit" to go after if things go bad – all transactions have lost their identity.

Under-secured and inadequately underwritten loans proliferated and eventually unqualified buyers did default on their loans. Because the "perfect storm" exacerbated the situation, it was inevitable for the meltdown to occur.

There are lots of things that could have mitigated this crisis, but if individual transactions had continued to have an identity and if pooling (securitization) of loans hadn't taken place, and if F&F hadn't been there to buy anything and everything, the worst of this would't have occurred. Really, this is all about creating and retaining documentation and insisting on continued accountability.

The Pieces are in Place for a EU and Euro Meltdown

We had a perfect storm forming. Unfortunately, at least for achieving their goal of uniformity and joint success, the real differences from country to country remained:

- Among the 27 EU countries, there still exists different priorities for life and government.
- There is no uniformity of financial strength among the EU countries.
- There are different types of governments and disagreement about the role of government.
- Differences in culture, lifestyle, and spending habits are enough to make a real difference.
- There is not a uniform level of sincerity to make it all work.
- And there will always be traditional nationalism which certainly limits altruistic tendencies.

There are lots of things that could have mitigated this crisis, but realistically, if there never had been an effort to smooth over (read “ignore”) inherent European differences, this wouldn’t have happened. If individual countries had maintained their individual economic identity, this crisis would have been less alarming. The pooling of diverse fortunes by establishing the EU and euro, while well intended, made an eventual meltdown almost inevitable. Again, it’s all about accountability! That is lost when individual parts of a relationship or transaction lose their identity.

Bringing This Closer to Home

Assume you lived in a fairly homogenous neighborhood. Homogenous yes, yet: one is a plumber, another a CPA, a pastor, a lawyer, two school teachers, a banker, a bar owner, a renter, and so on. Each family has established different priorities which result in vastly different budgets for mortgages, food, alimony, automobiles, entertainment, jewelry, charity, and “toys.” I could go on, but you get the point.

Now, assume that a couple of families start a movement to have a neighborhood “purchasing unit” for acquiring household goods, food, electronics, small equipment and lawn maintenance. However, to do so they need to have a line of credit which must be secured by “guess what” …… your cash deposit or your home, and those of your neighbors. Except that one neighbor who will be using the service actually rents, so there is no collateral to “put up.”

Each household is free to use the service at their discretion, and of course, some go a little overboard (the renter maybe?). This causes a request for more collateral because of the high level of credit being used. You are then given the choice of offering some cash as additional collateral, or perhaps “upping” your mortgage obligation. Gosh! You agree to do it, but not everyone is able to, so you have to do “a little bit more.”

It happens again (perhaps this time it’s the renter **and** the pastor who had special “needs”) and most of your neighbors refuse to jump on the bandwagon again. The obligations can’t be met, the loan is foreclosed on, and the neighborhoods’ financial stability and viability comes down around your collective “ears.” I should mention that the renter moved out when it was obvious the neighborhood was going “downhill.”

You forever regret hooking your wagon to everyone else’s fate and circumstances!

Sovereignty is Important

It seems to me that, in spite of the fact that the jury is still out, and many Europeans (like the renters) swear that it will work in the long run, it just doesn’t make logical sense to me. And I think the recent Euro crisis (caused by Greece et. al. overspending etc.) bears out that opinion. Only time will tell, but the EU has only been around for 20 years and there’s a lot yet to learn.

I find sovereignty compellingly important! Any time you superimpose one government over other sovereign governments (European Union over most European countries), you are looking for eventual problems, maybe even a meltdown like we experienced in the U.S. Mortgage system.

Why forcibly attach the affairs of any person, family, or country to that of another. That may be consistent with Obama’s theory of “collective salvation” (refer to my earlier report on “Salvation is the Goal After All!”), but it can lead to a “domino effect” crisis collapse **which we must avoid!**