

Is the U.S. housing mess headed our way?

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FROM SATURDAY'S GLOBE AND MAIL
JANUARY 19, 2008 AT 12:00 AM EST

CLEVELAND, Ohio — When Sam Robertson took out a second mortgage on his home in suburban Cleveland three years ago, he couldn't believe how easy it was. The interest rate seemed low, the approval process was quick and soon he had a \$61,000 (U.S.) loan, backed by a house worth about \$100,000.

Then Mr. Robertson, 55, lost his job at a plastic-bag company. He found temporary work, but he got behind on payments just as the interest on his loan automatically reset at a higher rate. This week, a letter came. The house his family has lived in for 27 years is in foreclosure.

"It's very embarrassing and very demeaning to me. I was going for the quick fix . . . I wish that I had never fallen for that."

Versions of Mr. Robertson's plight are being played out across Cleveland, which has become the epicentre for the problems plaguing the U.S. housing sector. For months, many economists hoped that the troubles would be contained to that market, but it is now clear that the pain is spreading throughout the U.S. economy . . . and across the border.

"We will feel the sting in Canada," says Michael Gregory, a senior economist at the Bank of Montreal's BMO Capital Markets.

Foreclosures in Cleveland have soared from less than 200 in 2003 to 7,583 in 2007, one of the highest rates in the United States. On average, 20 Cleveland homeowners faced foreclosure every day last year.

The defaults have depressed property values, cut local tax revenue and left many streets lined with vacant buildings. Most have been stripped of windows, doors, siding and even copper wiring and pipes. Some vacant homes carry signs saying, "No Copper. All PVC Piping," in an attempt to stave off looters.

"I don't think you can go down a street in the city of Cleveland without seeing at least one vacant house," says Mark Seifert, who runs a non-profit group called East Side Organizing Project (ESOP). Across the country, an estimated two million homes went into foreclosure last year, about double the 2006 level.

Over the next two years, 1.8 million more subprime mortgages, those aimed at riskier borrowers, are expected to reset at higher interest rates, prompting many experts to say the worst is yet to come. It is expected that as many 1.2 million of the loans will go into foreclosure and even those who don't default will barely get by after making their payments.

"It's like you are on a train heading for a bridge, but the bridge is out and you have no way of stopping the train," says Colin Kilgour, of Conner Clark & Lunn, a Toronto-based investment firm. "You can see it coming."

Mortgage woes and falling house prices have prompted consumers to cut their spending to a five-year low. Banks and other financial institutions, which pumped out more than \$2.5-trillion worth of subprime loans between 2000 and 2007, have taken massive losses. This week, two of the biggest, Merrill Lynch and Citigroup, reported a combined \$20-billion loss for the fourth quarter. In total, banks in the U.S. and Canada have piled up more than \$100-billion in housing-market losses.

Throw in high energy costs, weak employment and lower stock prices and it's no wonder that many economists have said the U.S. could fall into recession this year. And that means a slowdown for Canada as well.

Mr. Gregory of BMO points out that consumer spending accounts for 70 per cent of economic activity in the U.S., the main market for Canadian exports. When homeowners are paying off high debts, they have little left over. "No matter how you slice this, there is not a lot of confidence in spending."

So how did it get this bad? How could a bunch of loans in a place like Cleveland end up slowing down the entire North American economy?

Subprime loans don't exist in Canada, but they have been around in the U.S. for decades. They were initially intended to help wealthy people buy second properties, but as the housing market soared, they morphed into a vehicle for riskier borrowers to obtain a mortgage.

Typically, such loans carry a higher interest rate. But to entice borrowers, lenders usually start with a lower "teaser" rate that rises sharply after two years. Many subprime loans in Cleveland started out at 8 per cent and increased to 11 per cent. Borrowers were often told not to worry because they could always refinance later. After all, they were told, their house would be worth more by then.

To fund borrowers, mortgage companies sold their subprime loans to big banks. The banks then packaged them up as securities and sold them to investors on stock markets around the world. Investors snapped them up, convinced that the securities were backed by the booming U.S. housing market. As money poured in, banks bought more loans. From 2000 to 2006, the number of new subprime loans jumped from 911,369 to 3.2 million, according to a study by the Center for Responsible Lending.

To feed bank demand, mortgage companies offered higher commissions to brokers who steered clients into subprime loans, which prompted some to make loans with few if any background checks. Some loans required borrowers to show little more than "pride of ownership."

Mortgage brokers and lenders became aggressive salesmen, even going door to door in some neighbourhoods. In Cleveland, brokers would show up at houses with lists of purported building-code violations and coax the owners into taking out loans to fix the problems. One woman in a poor Cleveland neighbourhood ended up with a \$70,000 loan after being convinced that her garage needed repair. Some brokers worked with corrupt building inspectors . . . when the inspector told a homeowner to fix a structural problem, the broker would follow, offering a loan. Later, the two would split the fee.

Countrywide Financial Corp. talked Sheila Massey and her husband into a subprime loan to buy their suburban dream house, even though their credit was good enough to qualify for a regular loan. Their debts became so onerous that they fell behind on payments and the house was put into foreclosure last week. Their credit rating has been cut in half.

"It all just fell on top of us," says Ms. Massey, 39, who runs an in-home daycare while her husband works at a country club. They have two children and look after three relatives. "If we can keep the home, we would love to, but we just want to get out of the hole."

Seemingly high-risk borrowers could even buy more than one home. At one point, Rashaunda Smith, 38, had four homes around Cleveland. She rented out three. Things got tricky last year when she was laid off and couldn't afford the upkeep on one house.

"When one goes down, it becomes harder to maintain the others," she says. Soon, all four were in foreclosure.

Last summer, she bought another house for \$180,000 with two subprime loans from Countrywide. The interest rate on both loans is scheduled to go up next month and Ms. Smith said she won't be able to afford the new \$1,600 monthly payment. She recently got a job driving a school bus, but she is single and has five children.

The subprime market peaked in 2006, but it was only last summer that the housing market began to crack. As prices sagged, investors and banks got worried about what was really behind those mortgage-backed securities. Soon, markets around the world went into a tailspin. Many investigations have followed. Several major mortgage lenders have gone out of business, leaving borrowers scrambling for answers. Banks, insurance firms and pension funds in the U.S. and Canada have taken massive write-offs on their loan portfolios.

ESOP's Mark Seifert saw all this coming years ago. He is a lawyer by training and he cut his teeth in community activism by working with homeless people and campaigning for safe streets.

In 1999, Mr. Seifert noticed that some of his key members had stopped showing up for ESOP meetings. When he went around to their houses, he found them boarded up.

He started looking into what had happened and discovered that most of them had fallen victim to subprime loans.

He started challenging lenders publicly, showing up at executives' homes with protesters carrying flyers decrying loansharking. They would dump bags of tiny plastic sharks at the door.

"For six years, nobody would listen to us," he says. "And then, all of a sudden, all hell broke loose. The reason that happened was because now white people were being impacted. It is a race issue, there's no question about it."

Like other activists, he alleged that predatory lenders targeted inner-city, African-American neighbourhoods, where they fudged property values and signed up thousands of borrowers without explaining the details of the loans. A study by the Housing Research & Advocacy Center, a non-profit group based in Cleveland, found that in 2005 nearly 60 per cent of all mortgages taken out by African Americans in the city were "high-cost loans" — compared with about 34 per cent of those taken out by whites.

"A lot of people of lower income are not financially literate," says James Jones, who runs seminars at ESOP for people facing foreclosure. "We have to spread the blame around. Some of the folks agree into a situation not really knowing what the result of that loan contract was going to be."

Since the foreclosure crisis hit the news last year, ESOP's staff has jumped from two to six full-time positions, thanks to a huge increase in government funding to tackle the issue. Last year, the group helped borrowers renegotiate 1,500 loans, three times more than in 2006. Demand for the seminars has been so strong, they have gone to four sessions a week from just one a year ago.

And yet those efforts are only scratching the surface. "We haven't even begun to see the end of this," Mr. Seifert says.

One of the worst-affected neighbourhoods is just a few blocks from the ESOP office. It's called Slavic Village, reflecting its heritage as a place where immigrants from Eastern Europe came in the 1800s to work in steel mills and manufacturing plants. It has always been a blue-collar area — not long ago, it was one of the few parts of Cleveland that was actually gaining population.

The neighbourhood's 30,000 residents always prided themselves on tidy lawns, American flags over the doorsteps and a low crime rate. But now vacant houses line many streets. Last fall, this zip code had the highest number of foreclosures in the U.S., according to data from RealtyTrac Inc. It remains in the top five.

On one street, eight out of 13 houses have been boarded up. On another, three houses stand crumbling side by side, the roof over one veranda has collapsed and nearly all of the doors and windows have been stripped off.

Some of the homes have been vacant for years. In one, garbage has been strewn ankle-deep. A calendar on the wall dates from 2003 and there are even a few cups in the kitchen cupboard. But all the piping, sinks and wiring have been removed and half of the aluminum siding has been stripped. Tires have been dumped in the backyard and the walls inside and out are full of holes.

"We are seeing two foreclosures a day in this area," says Anthony Brancatelli, the local city councillor.

"It's devastating," says Barbara Anderson, 60, who has lived in Slavic Village for 25 years and has watched as more than half of her neighbours have been forced out of their homes. When empty houses on her street became a haven for drug dealers, she pushed the city to erect a fence and install security cameras.

But the city cannot keep up with the foreclosures. Last year, Cleveland spent \$7-million demolishing abandoned homes, compared with about \$1-million a couple of years ago. By some estimates, the city would have to spend at least \$70-million to tear down all the vacant buildings.

Rising foreclosures and falling property values have cut into the city's finances as well. Less money is being raised

through property taxes and new developments in some areas are feasible only if the home buyers are promised tax holidays.

Last week, the city sued 21 financial institutions, including major banks in the U.S. and abroad, alleging that their actions cost Cleveland hundreds of millions of dollars. "The epidemic of foreclosures has devalued not only the homes directly affected but surrounding properties as well, deeply depleting Cleveland's tax base," alleged the lawsuit, which was filed under the city's "public nuisance" law.

For Tamarra Funches, the fight to keep her home in a Cleveland suburb is just beginning. The 36-year-old single mother recently received notice that the house is in foreclosure and she has come to ESOP for help. The house has been appraised at \$160,000 and she owes \$128,000 to Litton Loan Services. But the monthly payments keep rising because of higher interest costs and other fees.

"I could make it, but not when they keep adding on," says Ms. Funches, who earns \$10 an hour as a nursing assistant. An 18-year-old son, a baby grandson and a seven-year-old niece live with her.

Some of her friends are in the same position, but are too ashamed to speak out. "Frankly I'm beyond being embarrassed," she says sternly. "I've got to try to keep my house for my niece and my grandson."

Sitting next to her, Fannie Ford vows to fight foreclosure as well. She is a nurse with two sons who had to stop working last summer because of a foot injury. That put her behind on her mortgage payments, and with her interest rate set to rise soon, she is stuck. She acknowledged that she didn't consider the loan carefully when she bought her house a year ago.

"I was thinking, 'I'm doing the right thing. I'm getting a home.' That's what everybody wanted to do," she says. "I'm really trying my best to keep it. I'll go down fighting."

Paul Waldie is a reporter with The Globe and Mail's Report on Business.

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