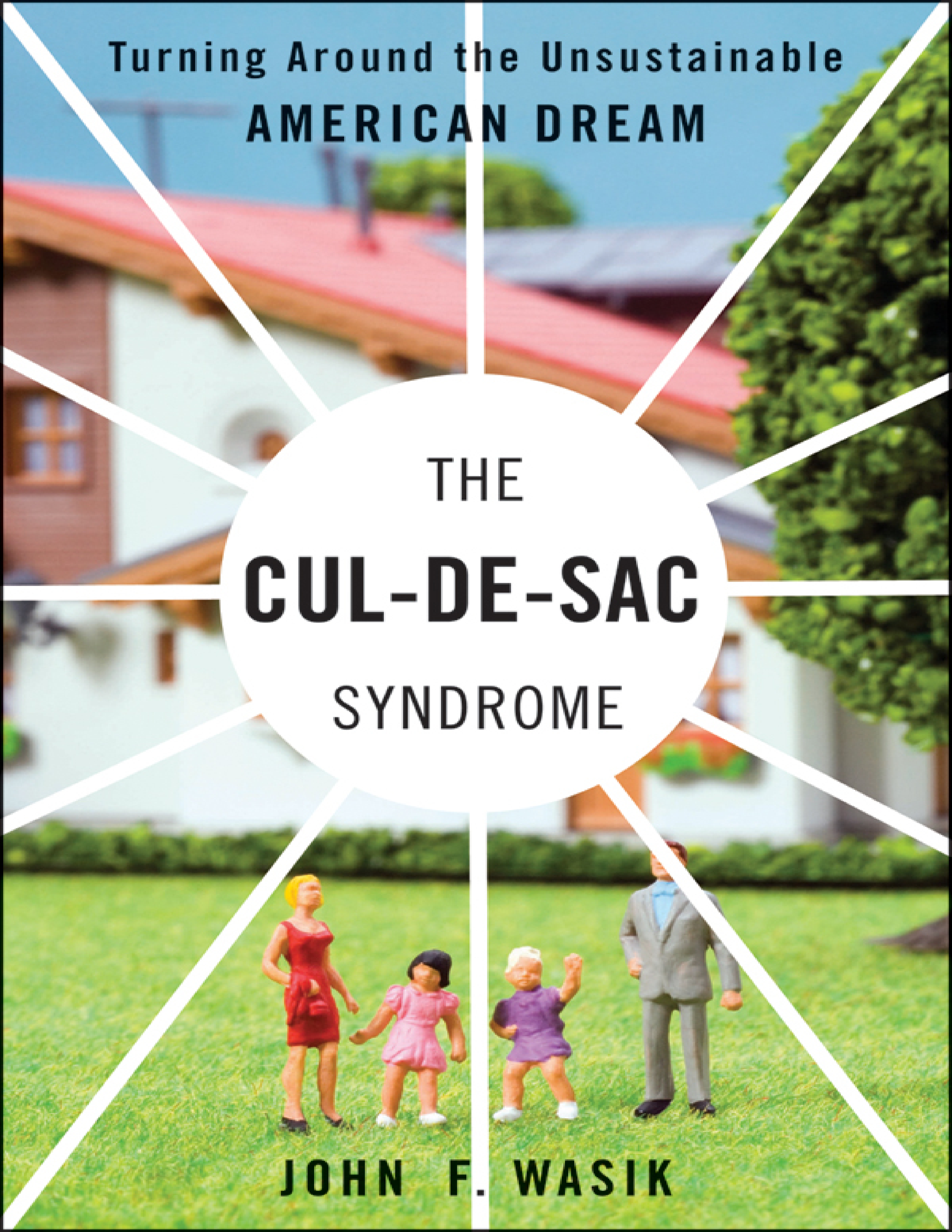
Turning Around the Unsustainable
AMERICAN DREAM

THE CUL-DE-SAC SYNDROME



JOHN F. WASIK

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Praise for The Cul-de-Sac Syndrome

Turning Around the Unsustainable American Dream

by John F. Wasik

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The CUL-DE-SAC Syndrome

Turning Around the Unsustainable American Dream

JOHN F. WASIK

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To my father, Arthur Stanley Wasik

Preface

One of the worst housing busts in history began in 2007 and was still ravaging the U.S. home market and several European countries by early 2011. Except for a few areas, foreclosures continued and home sales (through 2010) were the slowest since the Kennedy administration. Not even an $8,000 first-time homebuyer's credit in early 2010 was enough to revive the market. Many of the worst-hit areas (see Chapter 11) were still hobbled by foreclosures and huge inventories of bank-owned homes while others in Texas, the Northwest and Northeast were hobbling along.

For millions of Americans who overbought homes and were unprepared for the consequences of the bust, it represented a great reckoning. For others who prudently lived within their means and paid their mortgages, it represented an unfair loss in equity. Their stake in the American Dream, a stable middle class lifestyle and upward mobility was diminishing.

How did the United States succumb to one of the most devastating housing recessions since the 1930s? Weren't homes supposed to be the safest investments on the planet? Ultimately, the housing bust may turn out to be one of the biggest financial blowups in history, rivaling the Great Depression with more than $4 trillion in wealth evaporating. Millions entered a financial dead end during this period of irrational exuberance. It may take years for them to escape from it.

What drove this flood of exuberant optimism? Did everyone from mortgage brokers to Wall Street simply get greedy? Or do the true causes lie much deeper, in the American dream itself and in the goal that eventually became an obsession with ever-bigger homes? A bubble in which demand exceeded realistic economic fundamentals was triggered by a number of uniquely American cultural values, desires, and economic shortcomings. These underlying reasons for the debacle have been ingrained in Western culture for almost half a millennium. They're myths that have flourished precisely at a time when Americans' view of themselves, their post-9/11 security, and their shaky financial future were being tested as never before.

The stereotypical villains in the subprime story have been Wall Street bankers, the government, and greedy participants, from speculating "flippers" to the Federal Reserve. There's plenty of blame to spread around when it comes to who was motivated by pure avarice or criminal exploitation, and much of that picture has been illuminated. Those who thought they would profit handsomely have already been exposed, have taken their losses, and are known to anyone following this calamity. It's far too easy, though, to point fingers at the purveyors of human excesses. That's only part of the story.

The American dream—and what it has cost us—is what underlies the crisis and what this book explores. How did we come to believe that a home should be an investment worth enough to propel millions to leverage beyond their ability to pay? In an age of burgeoning info-technology, why are we still building homes with the latest *nineteenth-century* techniques? What was the market behavior that drove homeowners into subprime loans and moving ever farther away from jobs and cities? How did we come up with the idea that we should buy as much house as we can afford, with no regard for the cost of heating and cooling it and the time and expense of getting to it?

We've gotten stuck in a vicious cycle, a cul-de-sac of unsustainable costs and serious long-term consequences for our health and our environment. After following the bubble and its aftermath since 2001 as a personal finance columnist for Bloomberg News, I've gained some insights into urban planning, resource depletion, and homebuilding techniques and economics that cast a critical—and disturbing—light on the American dream of homeownership. That dream led to the creation of what I call "spurbs," the car-dependent sprawling urban areas, unconnected to core cities by public transportation and beset by unsustainable costs for infrastructure, services, and resources. As highly leveraged locations ravaged by foreclosures and falling property values, these enclaves will hurt the most in coming years.

We've suffered from a cul-de-sac syndrome on not only how to finance the American dream, but how to build it in the future so that it's economically and ecologically sustainable. How do we cure this malady, one that's responsible for global financial calamity? Even if the home market fully recovers with higher prices, home starts, and sales, the deep-seated problems this shortsighted cultural mythology brought about will haunt future generations if we don't correct them.

I've traveled from coast to coast several times to highlight the myriad stories of innovators, dreamers, activists, and visionaries who are still creatively searching for a way to make the American dream attainable and affordable. I've consulted with the leading minds in architecture, economics, engineering, homebuilding, and urban planning to uncover insights on the past, present, and future of the home market.

Readdressing, reimagining, and redesigning the foundation of the American dream has no downside because we will be creating and preserving jobs and wealth and even addressing global warming. In the words of John Ruskin, "That country is the richest which nourishes the greatest number of noble and happy human beings; that man is richest, who, having perfected the functions of his own life to the utmost, has also the widest helpful influence, both personal, and by means of his possessions, over the lives of others.” It all starts in our homes and communities—my home, your home.

Introduction

The Foundation Cracks

The last Spanish sultan, Boabdil, sobbed as he left the Alhambra. His heart was broken as he looked back upon the heavenly complex of crenulated arches, fountains, and pools within the splendid palaces of the Moorish rulers of Granada in southern Spain, on his way to exile in Africa in 1492. He was not only mourning the loss of his bastion to the Catholic monarchs Ferdinand and Isabella but also grieving for what might have been—a culturally vivacious state where no group had to supplant the other due to lack of land or resources. Although there was certainly barbarism during and after the Alhambra’s golden age, the combined will of the houses of Castile and Aragon set in motion a land lust that would ravage two continents.

Christopher Columbus had met with Queen Isabella in the newly conquered Alhambra, and he had his marching orders. Gold and land were the primary objectives of the Spanish crown. They had coffers to fill, armadas to build, and conquistadors to finance. Keeping everything in check was their form of the Gestapo—the Inquisition. Jews or Moors who would not convert to Christianity were tortured or killed. Even if they were baptized, they were subject to abuse and discrimination. Jews, who had contributed immeasurably during the halcyon days of the Alhambra, were eventually exiled.

As strangers in a strange land, the Moors were the most successful diplomats on the Iberian peninsula, building their dominion over a seven-hundred-year period. During their tenure, they practiced tolerance, translated the great works of antiquity from Greek into Arabic and Latin, and then entreated Europe to feast on the knowledge and imagination of the classical authors. Pythagoras, Ptolemy, Aristotle, and the great theoreticians of ethics, physics, and philosophy were reborn in the learning enclaves of Toledo and Córdoba. Andalusia became the Harvard, Princeton, and Yale of Western civilization from the eighth century through the fifteenth. Establishing a multicultural ministate on a peninsula that had been invaded by Celts, Romans, Franks, and Visigoths, the Moors had few peers in the realm of cultural sustainability in their heyday.

A Housing Crisis and a Fractured Dream

Ever since anyone can remember, most Americans, including millions who arrived on these shores as strangers, have wanted their own Alhambras in shining cities on a hill. "A man's home is his castle," the old expression goes, dating back to the height of the Spanish empire. Yet at the time I was exploring the Spanish palace complex, millions of Americans were about to lose their citadels. A period in which nearly 70 percent of Americans were able to own homes was about to end as dramatically as the sultan's life in his palace. A new era of recrimination and economic loss on a scale that had not been seen since the Great Depression was beginning.

By the time the housing bust sucked the air out of the stock market in 2008, the *New York Times* had trumpeted a front-page headline that read "Housing Woes in U.S. Spread Around the Globe." The U.S. home market was in a vicious recession and the general economy was on the brink, too. In the most expensive areas for homeownership—far-away places where Americans moved so that they could afford their Alhambras—the economic strain was like a dam that had been breached. A half a trillion dollars in adjustable mortgages would be resetting through 2009; that is, their monthly payments would likely rise to unaffordable levels. Those unable to refinance would be forced into foreclosure. Some 60 percent of those loan holders were in California, where purchasing the basic American home was the costliest proposition in the United States. Other places—Chicago, Cleveland, Detroit, Miami—were feeling acute pain, too.

How did the American dream turn into such a crushing, unsustainable debt burden? Populists blame Wall Street. Conservatives blame greedy, underfinanced homeowners. Liberals cite the lack of regulation in lending and securities markets. As I followed this developing crisis—indeed, I warned about it in my Bloomberg News column as early as 2002—only one thing is certain: The debacle had been brewing for *centuries* and has intimate ties to a cultural obsession. The great bubble in home prices was not only economically unsustainable, it revealed some deep-seated ecological, social, and public health woes. To understand how this downturn unfolded, we need to examine what I call the "cul-de-sac syndrome," a combination of some of the more glaring financial and cultural ailments that have led us to a dead end in private American housing.

Devaluing Castles: Inside a $10 Trillion Debacle

Spain is five thousand miles and eight months away as I glance at the latest headlines on my Bloomberg terminal, my ever-vigilant connection to the colossus of global finance. Forecasts on how much the housing market will decline in the long run range from 30 percent to 50 percent. Places like Boston, Chicago, New York, and Seattle were relatively unscathed but still are glutted with unsold homes, apartments, and condos. About 80 percent of the nation's houses declined in value in 2008 in the top one hundred largest markets. This was the steepest decline in residential property prices in a generation. When the housing market peaked in late 2006, few could envision its global devastation from Shanghai to Frankfurt. The resulting credit crunch strangled bond and stock markets and triggered a massive recession that began in 2007. Unemployment soared from Wall Street to Main Street. The idea that a home was a solid investment for eternity has become a cruel footnote to early twenty-first-century history.

The housing cataclysm will rival the Great Depression in terms of its economic damage and will redefine the journey known as the American dream. Imagine the largest, most valuable ship in the world carrying the equivalent of most of U.S. home equity, stock values, and mortgage securities hitting a reef and spewing its cargo into the sea; some $10 trillion may be lost. Banks that had invested in this ship wrote down about $1 trillion in losses. The government flotilla that mounted the rescue and recovery pledged $8.5 trillion (and counting) to fix the disaster. That's more than the gross domestic products of China, India, and Canada (as of 2008).

The ship started out charting a very different course: *Everyone* could make money owning, selling, or financing an American home. Anyone could be a real estate entrepreneur. The traditional rules of supply and demand, historical price increases, and creditworthiness were thrown out the window of high and low finance during this age of "froth," which is how Federal Reserve Chairman Alan Greenspan described the housing market at its height. This epic understatement ignored the fraudulent reality of the bubble when credit ratings agencies rated junk mortgage securities "AAA," real estate appraisers vastly overvalued properties, and mortgage sellers freely handed out money to anyone with a few blood cells. Stories like the one about the migrant strawberry picker with $14,000 of annual income getting a mortgage for a $720,000 home were common. If you could sign your name, you got credit, because the mantra of this bacchanal was “home prices only go up.”

Much of the catastrophe was blamed on greedy Wall Street bankers, mortgage brokers, compromised appraisers, mortgage fraud artists, and aggressive speculators, also known as “flippers.” What has received little attention is the culture that lit the fuse to this explosion: the hallowed good intentions of the American ideal, the sacred goal of homeownership, and the fallacy that house values never fall. Millions had bet wrongly on these misconceptions. The violent economic reality was that millions couldn’t afford this promise in the face of ever-lower after-inflation wages, reduced benefits, and devastated 401(k) balances in the aftermath of the 1990s dot-com meltdown. Homes were overpriced and beyond the financial reach of far too many Americans (and Europeans as well). No savings? No problem! Everyone qualified for a mortgage in the age of froth.

Did anyone see this coming? A few prophets spoke up, but the sternest warnings were ignored even as powerful money moguls like Ben Bernanke and Alan Greenspan at the Federal Reserve knew it was happening. When the bubbles were inflating, regulators and bond-rating agencies—like the bumbling cop Inspector Clouseau—looked the other way. More obvious scoundrels were the mortgage brokers, predatory loan sharks, bankers, and Wall Street financial engineering sharpies who took their fees as the riskiest junk mortgages were sold to the highest bidders.

Who enabled these financial purveyors? Just about anyone who wanted to buy, sell, finance, or build a house. An overriding cultural ethos promoted homeownership at any cost. Everyone from President George W. Bush to a massive combine of government and private interests had a stake in promoting home buying. After all, a key rite of ascension into the middle class was buying a home. Millions felt that they were entitled to the symbolic status of one's castle.

The Unattainable Home

Even before the home bubble burst, homes cost too much for more than four out of ten Americans. Only 56 percent of Americans could afford a modestly priced home in 2002, the first full year of the bubble. And as Americans went deeper into debt to finance their dream, they accumulated less and less of a tangible ownership stake. Home equity as a percentage of market value peaked in 1982—at 70 percent—after a brutal recession. More than half of American homeowners with a mortgage would *owe* more than they owned at the end of 2008. About 7.5 million were spending more than half of their income on housing costs.

The craving for upward mobility through home ownership escalated even as families on the edge of "making it" were falling behind economically. The think tank Demos said that 23 million families became "economically insecure" from 2000 to 2006, while 4 million experienced economic decline. This erosion in prosperity was triggered by a 22 percent decline in financial assets (following the dot-com bust), loss of health benefits, and an overall rise in the cost of homeownership (up 9 percent during that period). The reaction to this backsliding—buying a home as an investment—was the equivalent of a couple on the verge of divorce deciding to have a child in hopes that it would save their marriage. For more than 3 million in or facing foreclosure in 2009, this thinking proved financially catastrophic.

The housing bust represents a profound loss of wealth since few households had significant savings outside of their homes, as values dropped to a median $200,000 in early 2009 from $221,900 at the height of the bubble in 2006. In California, always on the fault line between profound innovation and multiple disasters, the boom and bust was a tragic manic-depressive episode. The median home price in Southern California alone slid to $285,000 by the end of 2008, 44 percent below the peak of $505,000 in 2007. Although the decline allowed more people to afford homes, even during the bust only one-fifth of Los Angeles residents could afford the median-priced home—up from 2 percent during the boom.

The Bust's Fallout

The housing bust created a firestorm of collateral damage.

- Lehman Brothers, one of the oldest and most venerable investment banks, was forced into bankruptcy and liquidation during a run on its assets in the late summer and fall of 2008. Its subprime mortgage and credit default swap holdings were essentially to blame, creating the largest business bankruptcy in U.S. history. Its demise released a tsunami of securities- and derivatives-related demons. Basically, when home prices collapsed, the value of the securities holding mortgages also went south. These “toxic assets” imperiled any institution that held them.
- When the run commenced on Lehman, it drove Merrill Lynch, the country's largest brokerage house, into the arms of Bank of America, creating the world's largest brokerage with more than $2.5 trillion in assets and 20,000 “financial advisers.” Merrill, whose symbol was an optimistic though ferocious black bull, had also invested billions in tainted subprime securities. Government regulators also forced the sale of Bear Stearns Companies, another major mortgage securities player, to JPMorgan Chase for a bargain-basement sale

price of $10 a share (the initial price was $2 a share). Like Lehman, Bear effectively evaporated.

- The U.S. government seized Freddie Mac and Fannie Mae, the two largest mortgage issuers and guarantors, and promised to infuse the companies with cash to keep them afloat. Their liabilities vastly exceeded their assets and they were losing a total $50 billion in the third quarter of 2008 alone. Since they insured, loaned, or sold securities representing $5 trillion—about half of the U.S. mortgage market—they were deemed “too big to fail.”
- Caught in the opaque business of insuring mortgage securities through the shadowy and then-unregulated world of credit default insurance, the government effectively took over AIG, the world’s largest insurer. The Federal Reserve lent it more than $80 billion by early 2009, part of a $150 billion bailout. It, too, was deemed too large to go bust, because its mortgage and derivatives positions threatened the global financial system.
- Seeking refuge in the regulated banking system, the remaining Wall Street investment banks morphed into old-fashioned, deposit-oriented banks. Goldman Sachs and Morgan Stanley applied to become regulated banking companies with federal oversight. American Express followed later in the year. The Age of Froth was truly over as the cowboy operations that thrived on 30-to-1 (and higher) leverage became history.
- The mother of all bailouts came as wintry storms arrived with an Old Testament vengeance in the autumn of 2008. With rancorous and reluctant Congressional approval, Treasury Secretary Henry Paulson and Fed Chairman Ben Bernanke on October 1 ushered through a sketchy $700 billion bailout package called the Troubled Asset Relief Program (TARP), which would pump money

into banks, possibly buy bad mortgages, and prop up the financial system for a short time. This massive cash transfusion was designed to prevent credit markets from shutting down and avert a global depression. Meanwhile, the Fed was lending some $2 trillion to banks, attempting to break a credit freeze that threatened to shut down all institutional lending. Paulson later backtracked on his earlier proposal to buy mortgages, triggering even more concerns that his master plan was ill conceived and ineptly managed. Sensing that the real purpose of all of the bailout measures was to stem the foreclosure crisis, the Federal Deposit Insurance Corporation announced its own mortgage bailout plan on the heels of the Paulson announcement. Several large banks said they would do voluntary loan modifications to reduce the cost of adjustable-rate loans, although they were under no legal obligation to do so.

- After more dithering over how TARP funds would be allocated, Secretary Paulson and Fed Chairman Bernanke moved to prop up Citigroup, one of the largest global lenders, with a $20 billion cash infusion and guarantee of more than $300 billion of its loans. Within days, responding to criticism that banks were the exclusive benefactors of the government's bailout, the Fed moved to guarantee certain mortgage, credit-card, and student-loan securities.

Enter Obama

Although the Barack Obama administration-in-waiting moved quickly following the election by announcing its economic team and various stimulus proposals, it was clear the calamity hadn't subsided nor had Congress finished adding economic incentives of its own. Obama's team, consisting of former New York Federal Reserve Bank

President Timothy Geithner (Treasury secretary), former Treasury Secretary Lawrence Summers (National Economic Council head), and former Federal Reserve Chairman Paul Volcker (chairman, Economic Recovery Advisory Board), were given immediate marching orders to halt the carnage left from the housing bust. Even as the lame-duck Congress and the failed Bush administration threw every resource possible at the crisis (including a flimsy cash handout to General Motors, Ford, and Chrysler), it seemed intractable going into 2009. Home prices had fallen the most on record through the end of 2008 with an eighteen-month supply of houses sitting unsold. Since none of the myriad bailout measures had shut down foreclosures, the number of people defaulting on their mortgages continued to rise. The U.S. home market remained hobbled.

Obama's actions reflected widespread concerns that the global economy was on the brink of repeating the horrors of 1930, when fear dominated every market across the world. Although it was necessary that Congress stem the crisis and fortunate that it did with its relatively swift actions of late September and early October 2008, it acted with almost no meaningful oversight of who was getting taxpayer funds and why. Bloomberg News had to file a federal lawsuit to obtain the list of banks receiving $2 *trillion* in Fed loans. It wasn't clear how AIG was spending its bailout funds nor were there any strings attached to the money given to major banks. Meanwhile, it wasn't clear whether any of the massive realignments on Wall Street or the various Washington bailout measures would halt the pace of foreclosures, get buyers back into the market, or drastically reshape the U.S. housing market. It may take years for the most troubled markets to recover, barring an aggressive program to shut down foreclosures and jump-start home buying.

The Causes

What triggered this fool’s-gold rush and subsequent crash? When prices peaked in July 2005, the torrent of new adjustable loans—often provided with little or no credit or income verification—hit a wall when the bubble burst. Wall Street also stopped buying and bundling these mortgages into exotic vehicles called “collateralized debt obligations” and into other vehicles, which dried up the supply of cheap money greasing the home-finance machine. New home sales fell more than 60 percent from that summit. The great, sure-thing investment of American homes, which in the new century had been outperforming everything save for corporate bonds, commodities, and preferred stocks—things middle Americans didn’t really understand—got abandoned by Wall Street the same way the money men lost interest in telecommunication stocks in 2000. They discovered how much risk was concentrated in their pools of mortgage securities and fled the toxic debt like people running from a burning building.

Once the easy money from Wall Street dried up, the bad news on Main Street got worse by the day. By November of 2007, home prices dropped in thirteen of the twenty largest markets surveyed for the S&P/Case-Shiller home price index, reaching “another grim milestone,” according to Robert Shiller, the Yale Law School professor who co-created the index and who would become the Jeremiah of the housing bust.

As 2008 dawned, double-digit declines continued. The leaders in losses were Las Vegas, Miami, and Phoenix, each posting about 20 percent drops in year-over-year prices. Southern California was well represented, with San Diego and Los Angeles showing 16 percent dips. Detroit, Tampa, San Francisco, Washington (DC), and Minneapolis rounded out the list. All but one of the cities—Charlotte, North Carolina—was on the list of losers.