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How Texas escaped the real estate crisis

By Alyssa Katz
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It's one of the great mysteries of the mortgage crisis: Why did Texas -- Texas, of all places! -- escape the real estate bust? Only a dozen states have lower mortgage foreclosure and default rates, and all of them are rural places such as Montana and South Dakota, where they couldn't have a real estate boom if they tried.

Texas's 3.1 million mortgage borrowers are a breed of their own among big states with big cities. Fewer than 6 percent of them are in or near foreclosure, according to the Mortgage Bankers Association; the national average is nearly 10 percent. The land in Texas might look an awful lot like its Sun Belt sisters Arizona (with 13 percent of its borrowers in foreclosure) or Nevada (19 percent) -- flat and generous in letting real estate developers sprawl where they will. Texas was even the home base of two of the nation's biggest bubble-era homebuilders, Centex and D.R. Horton.

Texan subprime borrowers do especially well compared with their counterparts elsewhere. The foreclosure rate among subprime borrowers in Texas, at less than 19 percent, is the lowest of any state except Alaska. Part of the reason is that Texas didn't experience the stratospheric run-ups in home prices that other states did. On average, the home-resale prices of the 20 metro areas in the Case-Shiller Home Price Index peaked in 2006 after more than doubling since 2000. In Dallas, one of the 20 areas, they rose just 25 percent, gradually, and have barely declined.

But there is a broader secret to Texas's success, and Washington reformers ought to be paying very close attention. If there's one thing that Congress can do to help protect borrowers from the worst lending excesses that fueled the mortgage and financial crises, it's to follow the Lone Star State's lead and put the brakes on "cash-out" refinancing and home-equity lending.

A cash-out refinance is a mortgage taken out for a higher balance than the one on an existing loan, net of fees. Across the nation, cash-outs became ubiquitous during the mortgage boom, as skyrocketing house prices made it possible for homeowners, even those with bad credit, to use their home equity like an ATM. But not in Texas. There, cash-outs and home-equity loans cannot total more than 80 percent of a home's appraised value. There's a 12-day cooling-off period after an application, during which the borrower can pull out. And when a borrower refinances a mortgage, it's illegal to get even a dollar back.

Texas really means it: All these protections, and more, are in the state constitution. The Texas restrictions on mortgage borrowing date from the first days of statehood in 1845, when the constitution banned home loans.

"Delinquency and foreclosure rates are significantly lower in Texas," says Scott Norman of the Texas Mortgage Bankers Association. "The 80 percent loan-to-value limit -- that's the catalyst for a lot of this."

Research from the Federal Reserve Bank of Dallas backs up Norman. Texas's low-ish unemployment rate, 8.6 percent, is a help. But so is the fact that fewer Texans took cash out of their home equity than did borrowers in any other state -- and took out less when they did. The more prevalent cash-out refinances are in a state, the more likely it is that mortgage borrowers there will run into trouble. For every 1 percentage point increase in a state's share of subprime mortgages that are cash-out refinances, the likelihood of foreclosure in that state goes up by one-third of a percent.

During the boom, cash-out refinancings were the unofficial currency of bubble states from Florida to California, beloved by mortgage brokers as a way to persuade existing homeowners to take out new loans repeatedly. As home values surged, the sales pitch was a slam-dunk: Borrowers could refinance their homes at extremely low interest rates, and based on newly reappraised property values, they could get more cash in their hands than they might earn in a year. Sure, these were teaser rates that would adjust upward after two years, but brokers routinely assured borrowers they could just refinance again before that happened.

Subprime cash-out refinancings became a standard way for borrowers drowning in credit card debt to pay it off, boost their credit scores so they could qualify in a few months to refinance into a lower-rate prime mortgage, and get a big tax deduction in the bargain. Edmund L. Andrews recounts in his underappreciated book "Busted" how he conjured $50,000 this way.

Homeowners and mortgage brokers weren't alone in their addiction to the cash that flowed from homes-as-ATMs. The entire U.S. economy was right there with them. One of Alan Greenspan's lesser-known contributions to the annals of the credit crisis was a pair of studies he co-authored for the Fed, sizing up exactly how much Americans borrowed against their home equity in the bubble and what it was they were spending their newfound (phantom) wealth on.

Greenspan estimated that four-fifths of the trifold increase in American households' mortgage debt between 1990 and 2006 resulted from "discretionary extraction of home equity." Only one-fifth resulted from the purchase of new homes. In 2005 alone, U.S. homeowners extracted more than half of $1 trillion from their real estate via home-equity loans and cash-out refinances. About $263 billion of the proceeds went to consumer spending and to pay off other debts.

As home prices skyrocketed in many markets, cash-out refinancings became standard, even in the relatively sober world of Fannie Mae and Freddie Mac. By 2006, Freddie Mac reported that 88 percent of refinance mortgages it purchased were for amounts at least 5 percent higher than borrowers' previous loan balances. Subprime lenders, in insane pursuit of risk, piled on with cash-out refinances for high-risk borrowers, often approaching the appraised value of the home.

But not in Texas. A borrower there can secure a home-equity line of credit from a bank. And she can refinance her mortgage or take out a home-equity loan. But the total amount of debt on a home cannot exceed 80 percent of its appraised value, and any proceeds cannot be used to pay off other debts.

Until 1998, Texans couldn't take out home-equity loans at all. The roots of this fierce resistance to debt's temptations go deep in Texas history. Seven years before the republic joined the Union in 1845, many homesteaders lost their property because of a bank panic and the resulting foreclosures. Drawing from Mexican codes protecting landholders, the new constitution of the state of Texas forbade lenders from peddling mortgages to homesteaders.

The home-equity restrictions have not only helped keep cash-out refinances a rare breed in Texas; other risky mortgages were scarce there, too. The home-equity borrowing restrictions helped keep home prices from overinflating, and home buyers therefore didn't need to turn to exotic mortgages with such features as 2/28 ARMs, interest-only payments, or negative amortization in order to buy a home. Even when they did, Texas law requires these risky features to be clearly disclosed. Fewer than 20 percent of Texas subprime mortgages included any of them.

That's not to say that Texas borrowers didn't get into bubble trouble. Plenty bought overpriced houses, which is why one in eight Texans now owe more than their home is worth. And it was easy enough for lenders to get around the home-equity borrowing limits by using creative appraisals that pretend a home is worth more than it really is. But the casualties are orders of magnitude less than they would have been without the home-equity limits.

Mimicking Texas would be the perfect opportunity to get our home-equity debt addiction under control and learn to live as an 80 percent nation.

-- The Big Money

Alyssa Katz is the author of "Our Lot: How Real Estate Came to Own Us."

Courtesy of JB Goodwin