



TEXAS HOMEBUILDING AND THE GLOBAL FINANCIAL COLLAPSE

Rather than artificially prop up the housing industry with home buyer tax credits that will make the problem worse, HOT seeks legislation reforms to address the root causes of the problem.

Reforming the homebuilding industry is as important as reforming the financial industry, because homebuilders were deeply involved in the global financial collapse and are about to cause another one. Their substandard homes and subprime loans were both enabled by the repeal of the Glass-Steagall Act and a lack of regulatory oversight and accountability of mortgage companies, investment banks, credit default swaps, builders, and inspectors.

ABOUT US: Homeowners of Texas, Inc. (HOT) is a non-profit corporation, formed in May 2008 to enhance the homebuilding industry and restore consumer trust. We are developing and promoting legislation to protect the public and make builders accountable to homeowners. Our aim is to ensure that new construction and remodeling projects are properly engineered and built by skilled and licensed professionals with regulatory oversight.



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TEXAS HOMEBUILDING AND THE GLOBAL FINANCIAL COLLAPSE

Executive Overview

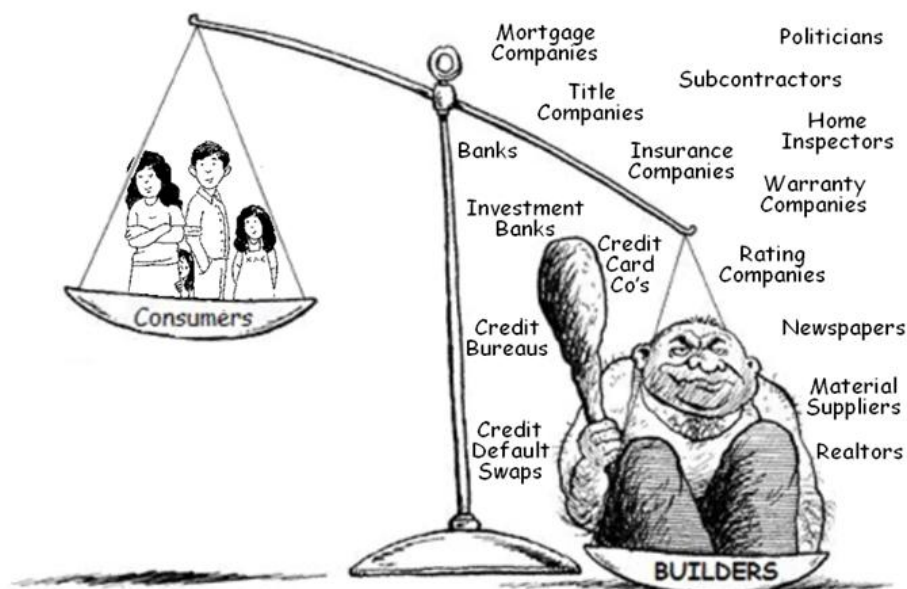
Over the past 30 years, due to the political influence of one party or another and one industry lobby or another, Congress eroded the regulatory oversight and consumer protections that were established in the 1930s during the Great Depression. With the Glass-Steagall Act repealed and accountability removed, the banks, mortgage companies, brokerage houses, insurance companies, and homebuilders were allowed to behave in an extraordinarily irresponsible manner. Our economy overheated and attracted foreign capital faster than we could spend the money or manage growth. The result was trillions of dollars in losses and a global financial collapse, triggered by a bursting housing bubble. Who's to blame?

- **CNN** cites 10 "Culprits of the Collapse" (<http://ac360.blogs.cnn.com/category/culprits-of-the-collapse>).
- **TIME** cites "25 People to Blame for the Financial Crisis" (www.homeownersoftexas.org/blame.pdf).

This paper describes the role Texas and large homebuilders played in the collapse. It argues that our laws made the \$35B Texas homebuilding industry a magnet for unscrupulous builders, including many from out-of-state. We allowed (and even encouraged) bad builders, substandard construction, and tort reform, thus destroying the life savings of countless Texans, causing the demise of entire subdivisions, and contributing to the economic collapse.

We now find that substandard construction has plagued all segments of the Texas homebuilding industry, from starter homes built by volume homebuilders to multi-million dollar custom homes. The remaining good builders with solid reputations complain that they can't compete against bad builders who cut corners, use substandard materials and undocumented workers, and hide behind laws that protect them more than the public. They too are victims of increasingly relaxed accountability.

In our informal survey of large national homebuilders operating in Texas, we found that ALL of them own their own mortgage companies. Most also own title and insurance companies and have cozy relationships with subcontractors, material suppliers, home inspectors, and realtors, among others. This vertical integration is a conflict of interest. It allows substandard homes and subprime loans to feed "the financial beast" that we call a *Residential Construction Conglomerate* rather than a homebuilder. And Texas laws tip the scales of justice in favor of builders rather than consumers.



The Pending Collapse

Texas homebuilding and the bursting US housing bubble triggered a global economic collapse that, economists tell us, would eventually happen anyway. Any other market bubble could have been the trigger, but it ultimately was housing. The other bubbles included everything from Indian antiquities and Chinese art to land anywhere, forestry, metals, infrastructure, junk bonds and blue chips.

Macro economists started predicting the crisis years ago, after noticing an imbalance of trade and budget that didn't seem sustainable. Outsourcing of work and trade with Asia was at all time highs. American consumers couldn't buy enough products produced there. Externally-dependent Asian economies happily funded our deficit spending so we could buy more products from them. China spent so much money on US Treasuries, corporate bonds and other assets that the US Federal Reserve lost its ability to steer the economy and restore equilibrium.¹

Old guard economists, politicians, and business leaders strongly believed that market forces in free-market economies would self-regulate. They defended that conventional wisdom, treated the warnings as disruptive anomalies, and continued to deregulate. The beliefs were so strong that their ability to chart a new course was like an alcoholic or drug addict that has to hit bottom before being able to renounce their self destructive ways.²

Capital and credit was cheap and widely available and, with little regulatory accountability, investor risk was low. Opportunity was everywhere. Extreme optimism was reinforced by the exuberance of others, including the finance industry, which makes more money when optimism and activity is high. Opportunities, especially in housing, were too hot to ignore. Everyone everywhere was making money and reinforcing each other's fervor.³

How Good Intentions for Homeownership triggered a Meltdown⁴

Government good intentions to promote homeownership, and the "perfect storm" of regulatory and external conditions, are often cited as primary causes of the collapse. These conditions include:

- **Oversupply** – The hot market and mounting inventories precipitated a downward price spiral.
- **Consumer Confidence** – Optimism in the hot housing market was reinforced by the profits of others, causing people to over extend, flip, and buy vacation or rental property, expecting to sell at a profit.
- **High Profits** – Investors almost always got high rates of return, especially compared to the stock market.
- **Easy Money** – Widely available and inexpensive capital for loans made home buying easy. After the 9/11 terrorist attack, the Federal Reserve lowered interest rates further to promote economic recovery.⁵
- **Tax Incentives** – The IRS still promotes homeownership with tax deductions for mortgage interest, property taxes and points. They also exempt capital gains from up to \$250,000 of profit from the sale of a primary residence. And first time home buyers can get a \$7,500 tax credit, or higher with the stimulus.
- **Lax Lending Standards** – HUD promoted the homeownership dream by relaxing lending practices to reduce discriminatory lending (redlining) among federally insured banks and thrifts, encouraged by the Community Reinvestment Act (CRA).⁶ They pressured banks to offer mortgages with little or no collateral, low interest rates, and flexible payment terms.
- **Vertical Integration** – Builder-owned mortgage companies integrated the building and finance industries with dangerous conflicts of interest and natural incentives to make riskier loans than banks.
- **Derivatives** – Lenders were allowed to sell mortgage-based securities to secondary markets and transfer the risk to investors who didn't originate the loan or know how secure it was.
- **Inflated Values** – After learning how to transfer risk to others, lenders next started getting artificially inflated appraisals, even including a free Mercedes in the mortgage.

¹ Stephen Roach, *The Funding of America*, 8/23/2004, www.suite101.com/discussion.cfm/investing/94532/998231

² Yves Smith, *If Only Central Bankers Would Hit Bottom*, www.nakedcapitalism.com/2008/08/if-only-central-bankers-would-hit.html


³ Jeremy Grantham, *It's Everywhere in Everything: The First Truly Global Bubble*, 4/26/2008, www.scribd.com/doc/7257647/Jeremy-Grantham-Letter-Q1-07

⁴ "The Roots of the Disaster," <http://www.statesman.com/search/content/business/stories/personalfinance/10/21/1021burns.html>

⁵ [http://en.wikipedia.org/wiki/9/11_\(attack\)#Economic_aftermath](http://en.wikipedia.org/wiki/9/11_(attack)#Economic_aftermath)

⁶ http://en.wikipedia.org/wiki/Community_Reinvestment_Act

- **Lobbying** – Large volume builders bought political influence to enact laws that blocked lawsuits and removed accountability at state and national levels.
- **Concealed Defects** – With protection from lawsuits, no regulatory oversight, and the ability to transfer of warranty responsibility, volume builders and their builder-owned mortgage companies pressured inspectors to overlook construction defects and code violations.
- **Uninhabitability** – Texas homeowners with serious defects can't sell because they must disclose the problems. If forced to move out of an unsafe home because of structural defects, toxic mold or other problems, their only option is to default on the loan. Just a few of these homes in one subdivision drags down the value of others and causes entire neighborhoods to decline.
- **Seller DPA** – Builder-financed Down Payment Assistance programs helped renters buy homes.
- **No Collateral** – Buyers with no down payment, however, have no skin in the game and easily default when home values fell below mortgage commitments, increasing the foreclosure rate and price spiral.
- **Mortgage Innovation** – Predatory lenders sold subprime, interest-only, and adjustable rate mortgages (ARMs), knowing that adjustments would increase mortgage payments beyond what buyers could afford.
- **Urbanization** – In the name of economic development and extending the homeownership dream, cities expanded onto land that was unsuitable for building due to expansive soils or contamination.
- **Unemployment** – Homeowners with no income can't make payments and are forced to move out. When they can't sell for enough to pay off their loan, they default and further the oversupply problem.



10 MOST WANTED CULPRITS OF THE COLLAPSE

1. **YOU**, the consumer, because you couldn't constrain yourself when bombarded by offers of easy credit and low interest loans on cars and homes you couldn't afford
2. **Franklin Raines**, CEO of mortgage giant Fannie Mae, the government backed company that bought up subprime mortgages and sold them to investors while hiding known problems.
3. **James Cayne**, former CEO of Bear Sterns, a subprime lender who sold his stake in the company for \$61 million after its collapse and subsequent sale to JP Morgan Chase.
4. **Angelo Mozilo**, founder & CEO of Countrywide Financial, a mortgage giant known for subprime loans, will collect \$115 million after selling to Bank of America.
5. **Beazer Homes**, a large homebuilder and mortgage broker that made it too easy to buy a home. 20% of its homes are now foreclosed, dragging down the value of others.
6. **Alan Greenspan**, former Federal Reserve Chairman, who manipulated interest rates to encourage investment and curb inflation.
7. **Phil Gramm**, former U.S. Senator who introduced laws that deregulated Wall Street and allowed banks to merge with insurance companies, creating a permissive atmosphere of risk taking with no oversight or penalties.
8. **Richard Fuld**, former CEO of Lehman Brothers, which invented the financial instruments that avoided regulation and, after the collapse, filed for bankruptcy protection.
9. **Chris Cox**, current SEC Chairman was supposed to be the "sheriff" of the New York Stock Exchange. He since said he just "didn't have the authority" and has asked Congress to give the SEC more power.
10. **Joe Cassano**, CEO of AIG, which insured high-risk subprime loans. He kept his \$35 million bonus after his company's collapse and bailout.

Source: <http://ac360.blogs.cnn.com/category/culprits-of-the-collapse/>

Observers have cast blame widely. Some highlighted subprime lending practices without enough government oversight. Others blamed mortgage companies for steering borrowers to unaffordable loans, or realtors and appraisers for inflating housing values, or Wall Street investors for buying derivatives without verifying the

underlying strength of the underlying mortgage loans, or individual homeowners for buying homes they couldn't afford.

In the video series, *Culprits of the Collapse*, CNN places blame too but, in reality, the blame extends back some 30 years. Regulatory oversight was systematically relaxed and interlocking directorates expanded over many years.

We completely disagree with putting the consumer at the top of CNN's *Culprits of the Collapse*. Consumers never lobbied for less industry accountability and consumer protection. Homebuilders (or rather Residential Construction Conglomerates) did lobby for relaxed regulations. Beazer Homes, an Atlanta based builder operating in Texas, made CNN's list, but many other big out-of-state builders qualify as culprits too.

Texas has the most lucrative homebuilding market in the U.S., with over 15% of all 2007 single family housing starts, (118K in Texas vs. 776K overall)⁷. Texas also had a less dramatic drop in 2008 home starts, experiencing a 35% drop versus 49% nationwide. What's not well known is how our great state contributed to the collapse.

Homebuilders flock to Texas because it's so lucrative and easy to get started. Texas homebuilding is a large \$35B industry according to the Texas Association of Builders. The state's business-friendly political climate provides no regulatory accountability and has no licensing, capital or insurance requirements. Tort reform laws provide lawsuit protection. And land and labor are plentiful and cheap.

Good Intentions or Sinister Objectives?

Like they say, *"The road to hell is paved with good intentions."*

Fostering homeownership is noble, but good intentions can evolve into sinister objectives, especially without regulatory oversight and firewalls to separate companies and industries.

The biggest and wealthiest players can influence political policies to gain advantages or remove disadvantages. Maybe that explains why Texas consumer protections of the Deceptive Trade Practices Act (DTPA) were replaced by the Residential Construction Liability Act (RCLA) and Texas Residential Construction Commission Act (TRCCA).

Henry Cisneros, the former San Antonio mayor and HUD Secretary under Clinton, is proud of his work to *"make the dream of homeownership come true for low-income families."* He pushed for low down payments, low interest rates, and flexible financing but *"has misgivings over what his passion has wrought."*⁸ Unwittingly, Cisneros helped to create the housing bubble that eventually imploded. He promoted his own industry, served on the boards of directors of KB Homes and Countrywide Financial, and made millions from his own development and homebuilding companies. It was a clear conflict of interest.

Like Cisneros, homebuilders may start with the good intentions of offering affordable housing and encourage legislation to make homebuilding quicker and easier. But laws that allow conflicts of interest and limit liability and regulatory oversight come with a high price to consumers.



Erich Schlegal
THE NEW YORK TIMES

Builder-Financed Down Payment Assistance

Down payment assistance (DPA) is promoted as a way to help renters achieve the dream of homeownership. Without collateral, however, that goal can have a downside – increased foreclosures. Even the U.S. Department of Housing and Urban Development (HUD) criticized the DPA concept. With no skin in the game, homeowners could easily default on mortgages. That happened when adjustable interest rates rose, mortgage payments ballooned, and inflated home values fell below what was owed.

⁷ US Census Bureau (www.census.gov/const/soldann.pdf AND www.census.gov/const/C40/Table2/tb2u2007.txt)

⁸ "Henry Cisneros helped build the flawed American Dream," [http://www.homeownersoftexas.org/10-19-08-Henry-Cisneros-helped-build-flawed-American-dream-\(Statesman\).html](http://www.homeownersoftexas.org/10-19-08-Henry-Cisneros-helped-build-flawed-American-dream-(Statesman).html)

The vertical integration of builder and finance companies was a conflict of interest just as bad as Cisneros'. Seller-financed DPA and closing costs were added to the mix, and we had a recipe for disaster.

Volume builders with builder-owned mortgage companies subsidized loans, inflated appraisals, and concealed construction defects. FHA rules allowed them to "give" buyers the required 3% down payment through third-party non-profit corporations. One example is Nehemiah Corporation in California. Builders would give money to Nehemiah, who would then "gift" the funds to the buyer for a small fee paid by the builder.

According to Nehemiah, this program, or loophole, ended on 10/1/08, and builders can no longer front the down payment for new home buyers using FHA to finance their homes. They can still, however, contribute up to 3% towards closing costs.⁹

Texas, which was at the center of the global financial collapse, had the nation's largest share of DPA benefits. Lennar Homes, the nation's 2nd largest builder with major operations in Texas, was reportedly using DPA programs to fund 33% of its sales.

Most banks learned an expensive lesson and now want 10-20% down before they grant a mortgage loan, but the FHA insures loans with as little as 2.5% down. Add on the home buyer tax credit, and we're back to nothing-down – a problem that started this mess. Between the FHA, VA, Fannie Mae and Freddie Mac, American taxpayers now insure some 80% of all outstanding home mortgages. A soon to be released audit is expected to show that the FHA's capital reserves are dangerously low and at risk of falling below the 2% minimum as required by Congress, and with a leverage ratio of 50 to 1, the FHA is carrying more risk than Bear Stearns did just before its collapse.

<http://www.homeownersoftexas.org/10-05-09-MARKET-Homebuyer-Tax-Credit-and-FHA-Loan-Guarantees-put-Taxpayers-at-Risk.html>

2000-2005 Down Payment Assistance (DPA) Benefits by State per Nehemia Corporation (www.dpagroundswell.org)

	# DPA Homes	Total DPA Gifts	DPA Mortgages	S/L Tax Revenue
AZ	42,742	\$189,400,537	\$5,454,109,161	\$527,446,393
CA	24,093	\$152,860,141	\$4,107,376,148	\$4,107,376,148
CO	52,358	\$319,708,470	\$9,565,176,106	\$646,112,634
FL	50,370	\$219,629,633	\$6,202,618,644	\$621,583,490
GA	146,217	\$576,614,879	\$18,764,686,373	\$1,804,375,053
IL	52,391	\$201,950,990	\$5,959,723,668	\$646,527,847
IN	82,805	\$249,531,880	\$7,792,734,474	\$1,021,847,236
KY	22,398	\$75,525,611	\$2,335,082,783	\$276,401,504
MI	63,269	\$242,468,900	\$6,483,136,823	\$780,758,032
MO	28,666	\$101,427,714	\$2,821,685,936	\$353,748,257
NC	78,094	\$284,600,784	\$8,981,054,070	\$963,703,584
NV	14,368	\$85,750,712	\$2,580,444,023	\$177,301,076
OH	137,746	\$439,679,792	\$439,679,792	\$1,699,829,431
PA	15,837	\$47,585,857	\$1,249,986,375	\$195,434,310
SC	20,917	\$71,041,470	\$2,290,533,649	\$258,122,151
TN	43,906	\$157,267,368	\$4,934,737,578	\$541,817,161
TX	178,712	\$808,172,067	\$21,812,672,706	\$2,205,372,686
VA	72,765	\$243,311,784	\$7,860,508,796	\$7,860,508,796
USA	1,000,000	\$3,800,000,000	\$130,000,000,000	\$12,300,000,000
TX%	17.9%	21.3%	16.8%	17.9%

⁹ <http://www.dpagroundswell.org>

Building on Contaminated Land

Another example of seemingly good intentions is the Small Business Liability Relief and Brownfields Revitalization Act.¹⁰ President Bush signed it into law in 2002. The Brownfields Law has a sinister side because it allows builders to develop neighborhoods on cheap land with contaminated soils, only asking that they “*voluntarily*” cleaned it up and essentially “*releasing them from liability and duty to disclose.*”

The Brownfields Law prompted a building boom on flat Texas farmland that puts the health of homeowners at risk. Pesticides used since the 1920s have left the soil in Huttoparke and Hutto Square neighborhoods with dangerously high levels of arsenic.

Arsenic (**As** on the Periodic Table) is a notoriously poisonous chemical element. It was used for centuries to discreetly murder rivals and earned a reputation as the *Poison of Kings* and the *King of Poisons*. Texas cotton farmers used arsenic to kill their rival, the boll weevil. They also used it, at higher concentration, as a defoliant to make cotton picking easier.

Arsenic is common in nature but not in such high concentrations as found in Hutto neighborhoods. Arsenic in nature is usually combined with other elements such as oxygen, chlorine and sulfur and is called inorganic arsenic. The inorganic version is far less harmful to people than the organic arsenic used in pesticides.

Arsenic poisoning can occur from eating tainted foods, drinking water, breathing dust, or digging in the garden. Children are especially susceptible because of their size, the amount of time they spend outside, their hygiene, their habit of putting hands or fingers in their mouth, and intentionally eating dirt. Their relatively small size means children eat drink and breathe more per body weight than adults. Very small children can also contact pesticides by crawling on contaminated carpets. The bad thing about arsenic poisoning is that symptoms can take decades to show up.

When families get sick from arsenic, toxic mold or other contaminants and are forced to move out of their homes, the financial impact can be as bad as the physical one. Unlike builders, homeowners must disclose serious defects and health concerns, so they can't sell the house for anything close to what they paid or owe. Their only option may be to default on the mortgage and face the economic consequences of bad credit.

Resolving serious health concerns and economic damages from homebuilding on contaminated soils will require both state and national initiatives. Texas officials need to require soil testing; and Congress needs to repeal the Brownfields Law.

Urbanizing Farmland and Building on Expansive Soil

Very few consumers know about the structural integrity risks of buying homes built on rich farmland. Builders won't tell them.

The expansive clay soil that is so good for farming is bad for building. One of the most difficult places to build a sound home is in the Blackland Prairie – a belt of fertile black clay that is bounded on the west by the Cross Timbers and Prairies Region and in the east by the Post Oak Savannah Region. These soil conditions extend southwesterly along Interstate-35 from the Red River to San Antonio – about 12 million acres in all.

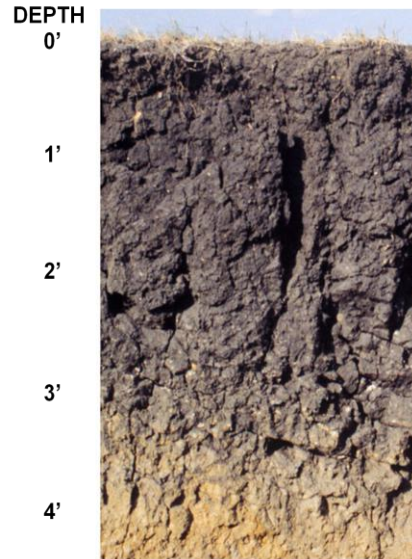
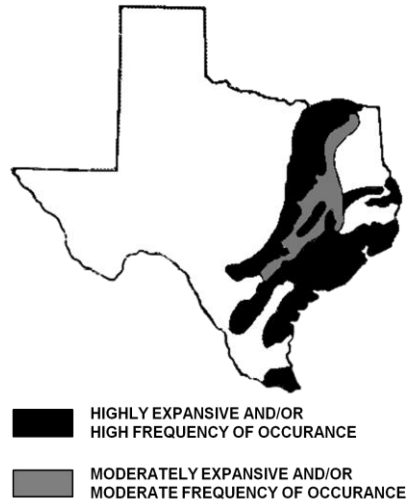
The Blackland Prairie region gets its name from the rich, black, waxy, alkaline and calciferous soil that retains water and yields highly productive farmland. The clay soil expands up to 30% when wet and can easily cracks foundations with enormous pressure. Walls and floor tiles crack, windows and doors don't close, other defects appear.

Try selling a house with a cracked foundation.

The urban development of Texas farmland, combined with access to immigrant workers, helped lower the building costs in our state; but the lack of regulatory oversight and accountability has attracted irresponsible builders from out of state – builders who ignore soil conditions when developing neighborhoods.

¹⁰ “Arsenic in Huttoparke & Hutto Square,” <http://www.homeownersoftexas.org/09-15-08-Arsenic-in-Huttoparke-&-Hutto-Square.html>

EXPANSIVE SOIL AREAS



The City of Hutto has recently become one of the fastest growing small towns in America, enjoying a growth rate of about 880% between 2000 and 2005 (per Wikipedia). But their land is better suited for growing crops than communities. Hutto is located in the middle of the Blackland Prairie and was known for ranching and cotton farming before its recent urbanization.

The U.S. Department of Agriculture Natural Resources Conservation Service says most of the land in Hutto is made up of the most expansive type of clay and describes the soil as “*very limited for building,*” with weaknesses that “*generally cannot be overcome without major soil reclamation, special design, or expensive installation procedures.*” This explains why so many homes in new Hutto communities have had serious foundation problems. Apparently, builders developing the area didn’t take proper engineering precautions, because no regulations required it. As a result, the slabs have cracked and the neighborhoods are in rapid decline¹¹.

During the 2009 legislative session, we supported House Bill 2649¹², which passed and has now become law. It requires special engineering of slab foundations for homes built on expansive soil.

See *Soil Issues for Residential Construction in Texas* (http://www.homeownersoftexas.org/Soil_Issues.pdf) for detailed information on why foundations fail.

Vertical Integration of Industries

Large and vertically integrated volume builders own their mortgage and finance companies. These “*residential construction conglomerates*” expanded homeownership with risky loans that were then pawned off onto secondary investors as mortgage-backed securities, insured with credit default swaps. The conglomerates became quite adept at selling homes to people with questionable credit, working with their finance companies to promote zero-down mortgages with subprime and adjustable interest rates or interest-only payment plans. Anything and everything was attempted to sell more homes and make more money.

The conglomerates avoided the due diligence normally associated with good loans and transferred the risks to third party investors who also made money – as long as home prices continued to rise. But one wonders how these investors, without originating the loans themselves, could fully understand the risks they were assuming. They didn’t – until the housing bubble burst and the loans defaulted.

¹¹ See *Soil Issues for Residential Construction in Texas* (http://www.homeownersoftexas.org/Soil_Issues.pdf) for detailed information on why foundations fail.

¹² <http://www.legis.state.tx.us/BillLookup/history.aspx?LegSess=81R&Bill=HB2649>

Is it possible that the residential construction conglomerates (large homebuilders) had more to do with the collapse than the banks, private mortgage companies, and Wall Street combined? The banks, at least most of them we contend, had less opportunity and incentive to cheat the system. Those that did only offered risky loans in response to competition from builder-owned mortgage companies. That would explain the generally more conservative lending practices of banks.

Following the lead of HUD and FHA, conservative banks demanded at least some down payment as collateral, required realistic appraisals, and expected stringent home inspections. It's only when they were allowed to resell the loans and offload the risks that their conservative behavior changed, and only then did they move away from the conservative lending practices established decades ago. Those practices ensured that homes were well made and were able to maintain their value over time.

Texas Building Conglomerates and their Associates

The "vertical integration" of homebuilding and finance is a serious conflict of interest made worse when owned by the same corporation. Texas has more than its fair share of such companies. In our informal survey of large out-of-state volume homebuilders operating in Texas, we found that ALL of them owned their own mortgage, title and insurance companies. Maybe *Residential Construction Conglomerate* is a better descriptor than homebuilder.

But the builder influence doesn't stop there. It also includes subcontractors, material suppliers, home inspectors, realtors and politicians.

Using favored real estate appraisers, construction conglomerates have been known to artificially inflate appraised home values as a way of selling more homes. And with home inspectors beholden to them for repeat business, they often overlooked and intentionally concealed serious construction defects and building code violations. The result was a mixture of substandard homes and subprime loans.

OUT-OF-STATE VOLUME BUILDERS OPERATING IN TEXAS

HOMEBUILDER	HQ LOCATION	BUILDER-OWNED MORTGAGE COMPANIES
Beazer Homes	Atlanta	Beazer Mortgage
Capital Pacific Homes	Newport Beach, CA	Capital Pacific Mortgage
Drees Homes	Kentucky	First Equity Mortgage
KB Home	Los Angeles	KB Home Mortgage
Lennar Homes	Miami	Universal American Mortgage Company (UAMC) is part of Lennar Financial Services and specializes in supporting the financing needs of Lennar homebuyers. UAMC also operates as Universal American Mortgage Company of California.
Mercedes & Newmark Homes	Florida	Parent, TOUSA Inc. filed bankruptcy (1/29/09)
Pulte Homes	Bloomfield Hills, MI	Pulte Mortgage
Ryland Homes	Calabasas, CA	Ryland Mortgage
Standard Pacific Homes	Irvine, CA	Standard Pacific Mortgage
Toll Brothers	Horsham, PA	TBI Mortgage

Interlocking Directorates

The term *interlocking directorate* refers to a situation where a member of the board of directors of one corporation also serves on the board of another corporation. The term also applies when a top executive or close relative of a board member serves on the board of another corporation. Although not illegal, interlocking directorates have long been used to maintain or expand power, control suppliers and customers, influence the political system, form cartels, or conspire to restrict output and increase prices.

As with vertical integration, this practice concentrates a lot of power in relatively few hands and creates serious conflicts of interest, negating the checks and balances of regulation, or removing regulation altogether. Even without actual abuse, the appearance of improprieties causes citizens to distrust business and government and tighten spending. Corporate decision making is also affected, because myopic directors can more easily get blindsided by changes in their industry.

Regulators finally are looking into the relationship between the CEOs of Citigroup and AT&T as well as Standards & Poor's AAA rating of Lehman Brothers just two months before the economic collapse. Maybe they should also look into links with large builders, especially in Texas.

- Homebuilders
- Home Inspectors
- Subcontractors
- Material Suppliers
- Realtors
- Mortgage Companies
- Title Companies
- Insurance Companies
- Banks, Investment Banks & Warranty Companies
- Credit Default Swaps
- Credit Bureaus, Credit Card & Ratings Companies
- Newspapers
- Politicians beholding to Lobbyists
- TRCC

Homebuilders

In the homebuilding industry, the biggest potential for abuse comes from large volume builders with their political clout and financial resources to influence public policy and build integrated relationships with adjoining industries. Without licensing and regulatory enforcement, builders can act with total impunity.

Home Inspectors

Most people don't realize the difference between real estate inspectors and home inspectors. Real Estate Inspectors need a license to operate in Texas, but home inspectors do not, even though they are the ones who confirm that buildings conform to industry standards. Without licensing them as well, it's too easy for home inspectors to overlook defects rather than anger the builders that hire them.

Subcontractors

The relationship between builders and subcontractors is decided on "scratch my back and I'll scratch yours." Except for some trades, such as electricians and plumbers, subcontractors are not licensed by the State of Texas.

Material Suppliers

Appliance and building material suppliers can also become indebted to builders and give them discounts or other favors. It's only when that relationship goes further that it's a problem. It's too common for general contractors to commit to using high quality materials when selling the house but resorting to substandard materials when building it, assuming that those materials will be hidden by walls and floors.

Realtors

Builders often have a symbiotic relationship with realtors, paying commissions for selling new or replaced homes. That makes realtors less likely to endorse new regulations placed on their builder partners, including licensing.

It's our belief that if Texas realtors who sell existing homes must be licensed and use State-approved sales contracts, builders who sell new homes should as well.



Mortgage, Title & Insurance Companies

Breaking from the consumer protections established after the Great Depression, many big builders now control mortgage companies so they can offer more competitive interest rates with faster qualification.

When a new home sale was on the line, these builder/mortgage “associates” were pressured to make loans with low down payments, low interest rates and flexible terms, often to people with questionable credit. They didn’t worry much about the risks, as long as housing prices continued to rise, because they sold the mortgages in bundles to banks or investment banks, along with credit default swap “insurance.”

The lack of licensing and regulatory oversight, however, allowed builders and builder-owned finance companies to “innovate” with impunity. As builders cut corners to lower costs and increase profits, the result was often shoddy construction and serious defects, and an eventual loss of property value once the defects surfaced. As property values fell below the mortgage principal, homeowners defaulted and banks foreclosed.

Banks, Investment Banks & Warranty Companies

When builder-owned mortgage companies sold their mortgages, they were off the hook; and when they gave homeowners pre-paid home warranties they transferred their risk and warranty responsibility to companies that provided VERY limited coverage, if any.

The Texas Residential Construction Commission (TRCC) replaced “implied warranties of good workmanship” with state standards for minimum home warranties:

- 1 year for workmanship and materials items;
- 2 years for the mechanical delivery systems;
- 10 years for structural soundness; and
- 10 years for safe habitability.”¹³

The TRCC Homeowner Information Booklet said, *“It’s the law,”* but the TRCC lacked the authority to enforce it and added exceptions and exclusions that made warranties nearly impossible to enforce. Some examples include:

- *“Not taking reasonable efforts to stop damage from getting worse after a defect is found. For example, if water leaks, you (the homeowner) should turn the water off and dry the area to prevent further damage.”* One cannot survive in a home very long without water, so if the homeowner wishes to continue to live in the home, the leak must be repaired. And if the sheetrock is wet, it must be replaced, or mold will begin to grow. However, under TRCC Rules if the homeowner repairs the defects while the inspection request is pending, the case is administratively closed.
- *“Not taking reasonable action to maintain your home.”* Remember, most of the TRCC’s warranties cover a one or two-year period after the home is completed. New homes shouldn’t require much maintenance for the first year or two, so *“reasonable action to maintain your home”* is language intended to make the homeowner the violator, not the builder. If the builder caused the construction defect, the builder should be held accountable for the defect.
- *“Changes to the soil that are not a direct result of construction activities.”* This seems to rule out the effect of expansive clay soil that can damage foundations engineered for different soil.
- *“Work performed or materials supplied by someone other than the builder/remodeler.”* Can this be applied to subcontractors and material suppliers? ‘Seems so.

Don’t believe us? Pull out your home warranty and read it for yourself!

Newspapers with Builder Ads

News coverage of TRCC and homebuilder issues is hardly unbiased. Advertising for new homes has become a top source of revenue for newspapers which are threatened by Internet-based competition. Newspaper chains are reluctant to bite the hand that feeds them. Advertising dollars from homebuilders has incredible influence over

¹³ TRCC Homeowners Information Booklet, <http://www.trcc.state.tx.us/Publications/resources/FinalEZRead092507.pdf>

what stories, editorials, op-ed pieces and letters-to-the-editor are printed. It is no wonder the public worries about the increasing influence of corporate and political powers with control over news media, and why they demand Net Neutrality protections. Consumers see newspapers, radio & TV consolidating into fewer hands with that influence increasing.

Texas Politicians Beholden to Lobbyists

Also contributing to the concentration of power of homebuilders are the personal favors and campaign contributions received by politicians from the industry. According to reports from organizations such as Texans for Public Justice¹⁴:

- Texas politicians have taken \$4 million in homebuilder money in the past 3 years.
- The 10 lawmakers on the Sunset Advisory Commission have received \$223,050 from homebuilders during that period, and a staggering \$446,000 from Houston home builder Bob Perry during their legislative careers.
- Governor Rick Perry received \$649,218 from homebuilders, and Lieutenant David Dewhurst has received \$537,882.
- And to add insult to injury, Perry Homes General Counsel was one of the first TRCC Commissioners; Bob Perry and his family donated more than \$260,000 to Texas Supreme Court justices.

Is it any wonder that public trust is compromised by perceived legislative & regulatory improprieties? Individual homeowners and small businessmen often struggle to get their voices heard in policy debates when going up against large campaign contributors, advertising budgets, and “model legislation” written by industry attorneys and lobbyists who have spent years developing “trusted” relationships with policy makers.

Bad Legislation and the Defective Home Pandemic

During the home building boom days, it was a seller’s market. Competition was less intense. Builders tended to offer less home for the money – fewer standard features, higher-cost upgrades, less flexible terms, and often substandard materials and shoddy construction. To protect themselves from lawsuits, they banded together to promote legislative changes in their favor, including the TRCC and the TRCC Act.

The result of this legislation, which protects builders more than the public, has been a continuation of bad business practices and, in many cases, outright fraud. Unless builders are regulated and licensed, the “homebuilder disease” will continue to fester and spread in the next boom like a pandemic.

One might argue that the housing bust has introduced new competition, and that market forces should keep the industry honest, but that perspective is dangerous. The best cure is to eradicate the disease “before” it gets a foothold again, and that means now, while builders and the trades they hire are not so overworked that they don’t have time for education and licensing.

Abolishing the Texas Residential Construction Commission

A 2008 report from the Texas Sunset Advisory Committee staff took the unusual step of recommending the total abolition of a state agency, the TRCC, saying that ***“The Texas Residential Construction Commission fails to provide meaningful oversight and public protection because of fundamental structural flaws in the current regulatory approach.”***¹⁵

Because all 10 members of the Sunset Advisory Commission received campaign contributions from homebuilders, it was tough for them to be objective and accept their staff recommendation to abolish the TRCC. They instead

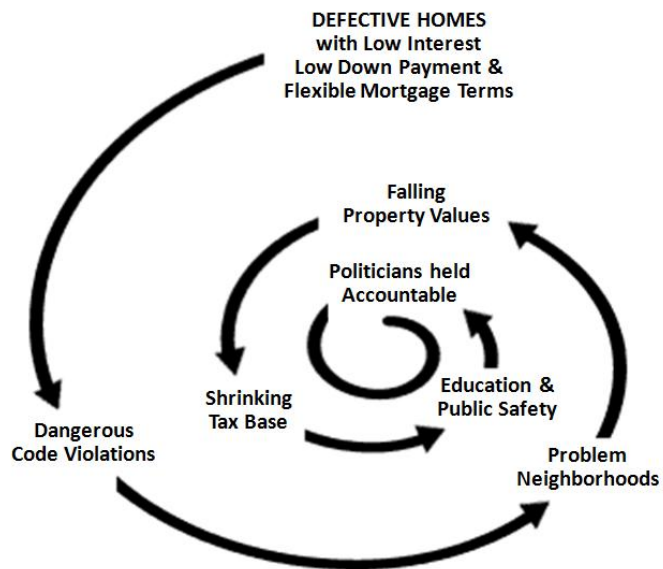
¹⁴ “Sun Never Sets On Politicians Taking Homebuilder Money,” Lobby Watch, 9/25/2008, www.tpj.org/page_view.jsp?pageid=1336&pubid=1106

¹⁵ “Sunset Advisory Commission Staff Report: Texas Residential Construction Commission,” http://www.sunset.state.tx.us/81streports/trcc/trcc_hm.pdf

submitted a bill to extend the agency for six more years. But in the end, Homeowners of Texas convinced enough lawmakers to let it die naturally under state sunset rules.¹⁶

The TRCC was a prominent example of politicians beholden to homebuilder lobbyists. The agency was “*fundamentally flawed,*” “*did more public harm than good,*” and was clearly established to protect builders from lawsuits rather than homeowners from shoddy construction and bad business practices.

The TRCC and its lack of enforcement authority contributed to an increase in defective homes and to homeowners with diminished access to legal remedies. We believe the TRCC and its failure to license builders and protect homeowners was a direct contributor to the Global Financial Collapse due to the downward spiral of home values caused by construction defects.



From a societal viewpoint, the biggest problem with construction defects is that problem homes beget problem neighborhoods and a spiraling decline of property values. That then affects the tax base that funds education and public safety, which are both critical to maintaining quality neighborhoods.

Economic models show a relationship between the numbers of homes sitting vacant or converted into rental property and the transformation of entire neighborhoods into slums. One formula suggests that a slum begins with four rental turns, i.e. when the 4th tenant moves in. Another sign of an emerging slum is when broken windows go unrepaired and “pride of ownership” is replaced by apathy and despair. Either case causes a downward spiral that attracts burglaries, drug trafficking and other crimes.

“Smart Regulation”

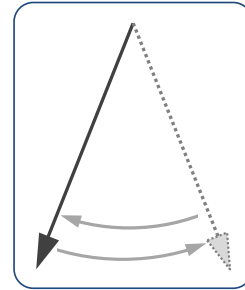
We don’t want to replace the now-defunct TRCC with oppressive regulations. Instead, we propose “smart” legislation that encourages “sustainable growth with accountability.” This will require strategic thinking and the absence of partisanship and knee-jerk reactions to special interests.

Too often legislation is passed in a crisis or reacting to special interests. But smart and sustainable public policy needs to consider the interests of all stakeholders and a strategic, “big picture” view of future needs. That’s because laws can last for years and years.

¹⁶ <http://www.homeownersoftexas.org/TRCC-Eulogy.html>

Now is the time to reform the runaway homebuilding industry and build a foundation for “sustainable growth” – here in Texas and across the nation. The economic and political damage from inaction are simply unacceptable, and the public attention and support are in place.

As the physician’s Hippocratic oath says, “First do no harm.” The proposed extension to the home buyer tax credit is a Band-Aid that helps relieve the pain temporarily. Problem is it will cause incredible harm in the long run.



Put Partisanship Aside:

Both political parties are responsible for the financial crisis, because their shortsighted and partisan legislation favored one ideology or another as political power swung in pendulum fashion from one party to the other. Where one end of the political spectrum was akin to Robin Hood (rob the rich and give to the poor), the other end of the spectrum was Hood Robbing (the opposite). Smart and sustainable legislation acts as a “shock absorber” between policy extremes.