California city creates yet another litigation risk for big banks

Los Angeles goes after lost tax revenue, while local government accepts no blame

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If the city of Los Angeles succeeds in its latest lawsuit against the big banks over the mortgage crisis, then financial institutions will have another area of potential risk since other municipalities could simply pile on, claims James Frischling, president of **NewOak Capital**.

Los Angeles recently filed lawsuits against **Wells Fargo** (WFC), **Citigroup** (C) and **Bank of America** (BAC) for alleged discriminatory lending, which the city says led to a wave of foreclosures that ended up causing steep property tax revenues for LA.

Like the eminent domain debate – which has certain municipalities considering the takeover of underwater mortgages for the purpose of writing down the principal – the LA suit shows the banks remain at the end of a long litigation stick that keeps wagging under the auspices of righting wrongs.

Frischling noted that the LA mortgage crisis led to 200,000 foreclosures and a $78 billion decline in home values. Yet, Southern California, and the state as a whole, is known to be in a consistent real estate bubble at times -- one created by a confluence of factors.

And with San Francisco still featuring some of the most expensive real estate in the nation, it's difficult to surmise that the boom-bust cycles in the state are caused solely by banks and not by other market forces – such as supply and demand and regulations that make it more difficult to flesh out supply.

Mark Calabria, director of financial regulation at the **Cato Institute**, told HousingWire back in April 2012 that the state's affordable housing problems should be viewed in a different light.

"They have too much housing in the wrong places," he said at the time. And the state doesn't have enough housing in the Coastal areas that are crowded with people, he explained. This creates limited supply and rising demand – two factors that eventually lead to overstretched borrowers, unaffordability and a bubble that must pop at some point.

"It's really a supply constraint," Calabria said. "They should look at trying to deregulate their land markets. In a relatively competitive market, you could build affordable housing without massive subsidies," he added.

And while the lawsuit blames the banks solely for the type of lending that caused foreclosures in California, the state's lawmakers may want to look toward Texas, where state regulations made certain types of risky lending impossible altogether. This in turn keeps demand and prices in check, creating a more natural balance in the market.

The Dallas Federal Reserve Bank pointed out in a recent study that Texas dodged the real estate crisis, not because of what the banks did, but because of what the local banking regulators did to protect home equity.

Texas voters in 1997 passed a constitutional amendment allowing closed-end home equity loans, the Fed Bank of Dallas pointed out. The rule stipulated that a home equity loan plus the primary mortgage must be less than 80% of a home's total value.

The Dallas Fed claims rules like this helped Texans shield themselves from the sensation of watching their homes dip underwater as prices fell.

So there are no lawsuits in Texas today against the banks – or at least not to the degree as there is in California. This makes the real question not just what did the banks do, but what have local governments, planning and zoning experts and those with their pulse on the local real estate markets done to ensure a home equity or foreclosure crisis doesn't bubble up again.