Chapter 4: The Beginning of Stage II Activities

The Research Roundtable held October 24, 2007 worked out to be the right way to go. The development and dissemination of the body of knowledge affecting real estate decisions is what HHI is about; and we needed a research agenda. But, as always, relevance is required, and the best way to start with assessing relevance may be to get some information on what the various participants are thinking.

Ideally, we would understand their strategies and improve the forecasting of outcomes by fostering the relevant research, sometimes funding it directly, but sometimes just facilitating it. Thus, HHI needed a game plan [link to previous chapter]; and that game plan started with the research roundtable as the foundation.

Shortly after the Research Roundtable concluded, the Research Roundtable leadership team, Susan Wachter, John Weicher, Richard Green, and Maury Seldin changed venue, going to the Cosmos Club for an early dinner meeting. Also present was Andrey Pavlov, a visiting faculty member at Wharton who was working with Susan.

The First Round of Grants

The outcome of that meeting was a proposed budget for the first $50,000 of the $100,000 that was expected to be authorized by HHI at its board meeting later that same week. Some of the budget had already been spent on the roundtable. Also, some had been spent for the literature review. The next grant priority was to get a survey of available data so as to provide that information to researchers as an economy of scale.

Understanding that professional publication is a strong motivator for researchers, the allocations included funding for professional publication in a learned journal [link]. Also, in order to stimulate research some activity at the academic associations was considered; the ARES meeting in April and the AREUEA meeting in May. But, the key presentations were to be at the Weimer School once the May Session topic was shifted from greening to subprime. That was facilitated by Richard Green having been previously designated as Chair of the 2008 Weimer School May Session. And some funds were left for a grant to be determined, probably for a high priority item because it would take time to develop the research agenda and obtain supplemental funding.

In a two minute conversation at the elevator at the Hudson Institute, as the participants were leaving, Maury Seldin in speaking with Amy Crews Cutts, Deputy Chief Economist at Freddie Mac, who was an active participant at the roundtable, asked about Freddie Mac's interest in joining with HHI is supporting the research. The response indicated that a recommendation for a $25,000 grant was likely. (It came to fruition.) But more contact with other organizations was needed.

A breakfast meeting the next day with some staff from NAHB did not yield any funding. But, a plan for a symposium, primarily of industry representatives, was to later emerge. Again, flavor and detail are best reported with some selected excerpts of internal communications within HHI and within leadership of what became the Subprime Research Consortium and later became the Subprime Research Council (SCRC).

Shortly after the HHI Board of Directors meeting, Maury Seldin sent the following e-mail to SCRC leadership. Only excerpts are provided.

Subj: Research Agenda and Next Step

Great news! The HHI Board of Directors approved the $50,000 budget and allocated the whole $100,000…

At the board meeting, one of the directors, sensing my enthusiasm and commitment to the project asked for assurance that we would not get carried away and exceed the $100,000. This is critical because the project is much larger and we have no reasonable estimate of what cooperation we will get in funding or with in-kind participation. I gave Tom Howard, the director that raised the issue, my personal assurance that we would not exceed the $100,000. Now I need a strategy for the strategy, i.e., how do we get a viable strategy developed and disseminated, and acted upon in some degree, in a timely manner. Our time frame is one year.

At the board meeting, Norm noted that the $18,000, or even $20,000 if we invade the second $50,000, would not be enough for two special issues of journals to publish critical projects. I recalled $10,000 as an ARES figure, but that was years ago. Norm was president of ARES within the past few years so I take as real the costs [as] $15,000 or more. One board member suggested that a regular issue of one of the journals just be refocused. Later, I thought that maybe an organization that wants to participate might buy-in by allocating the contribution for journal publication, with credit to the organization. I don't know how it will sort out, but we should not promise more that one journal for publishing research results in hard copy because no more than 20% of the HHI contribution will go to hard copy publication **However, we can electronically publish on the HHI website whatever we see appropriate, within reason. [Emphasis added.]**

If this were twenty or thirty years ago (maybe even forty) I would have a better handle on contacts in Washington. At NAHB (Mike Sumichrast), FHLB (Hal Smith), and the Mortgage Bankers the, chief economists, including Ollie who became executive director at MBA were on my part-time faculty at The American University. So was Jerry Pickard who was head of ULI research and the first head of research at HUD. I had the Realtor Chair so NAR contacts were great including having a past president of IREM on my Faculty and great contact with Appraisal Institute whose courses our faculty taught. But, I retired from AU seventeen years ago. Some of my contacts are dead, others have been succeeded many times. I made an effort with contacts while in Washington and am pleased to report on my results. But, we need to figure out how to make the contacts. Our best bet may be through the Hoyt Fellows who are incredibly well connected and might dedicate their part of the May Session with the Weimer School to the subprime mortgage fiasco, probably with a look at consequences for the commercial side. Page Mueller is in charge of the Hoyt Fellows program again; and, Jeff Fisher who chairs the Hoyt Fellows will discuss the focus with Page and my recommendation that she include Mark Zandi, possibly as co-chair for the session.

I have included Mark on this e-mail in part because he is a Hoyt Fellow and is likely to be part of the May session (and I hope part of the Hoyt fellows leadership over the long run), but also because I want him to see the ambitious data requirements for the local market studies. Attached is the piece labeled "Housing Market Triage Conference: An Exploration of Best Practices at the State Level for Dealing with the Subprime Debacle." (That is provided later in this chapter.) [link]

That attachment and the attachment of what John sent, "Don't Panic Yet: Strategies Emerging to Deal with Subprime Crisis," outlines our strategy for enhancing the research component of the approaches to be taken by various players in the mortgage and housing market issues. We will talk about this more later, but the bottom line is the Triage Conference with the state reps is the next budgeted item, including the workshops and what we need to spend for the local market studies.

The Federal Reserve of Boston has some stuff on behavioral finance that may fit into the picture, and should be pursued. But, we may get some in-kind help this calendar year from NAHB.

David Crowe and two of his staff joined me for breakfast Thursday morning. I approached the meeting as providing counsel on behalf of their constituency. A basic approach is that we can help the various players with their strategy to deal with the situation since there is a great commonality of research needed to forecast outcomes of alternative policies.

A cash grant this year from NAHB to participate in the program is not optimistic, but possibly next year. However, they seem willing to provide information and analysis in-kind. There are overlaps in what they need for their strategy and what the states need for theirs.

I have discussed with David some things learned from the roundtable and provided some general counsel as to research that would help them. I thought it useful to spell out detail but to do so for them would require their expression of further interest.

But, I did spell some of it out, in the context of what the states need for policy. I got as far as the market analysis but stopped short of the value system and public policy issue before I got on the plane. Since then I modified it to include the workshops dealing with the value system and public policy issues and the point Norm made about latitude in renegotiating the mortgages. I did not include the sledge hammer approach of moratoria of foreclosures in crisis areas or legislation defeating holders in due course law. (As an aside, about 35 or 40 years ago I was testifying before the House and Congresswomen Lenore K. Sullivan said to me something to the effect of now professor Seldin don't you worry about the constraints of law – we make the laws and we can change them. So, I continued my testimony on that basis.)

My recommendation is to use the attachment as you see fit in making the general offer to the state representing organizations to host a conference at Penn.

Another idea is that at some point you could share both attachments with Dave and ask the best inputs they could provide. It is in their interest to focus on areas with great oversupply that will dampen the need for new construction. Thus, you might consider also asking what states and issues are of greatest interest to them and what kinds of data and analyses they can provide.

I had a few minutes to talk with Amy Crews Cutts of Freddie Mac as she was waiting for the elevator. She mentioned that Freddie Mac has the precedent of cash grants and seemed interested. She was an active participant in the roundtable discussion. As yet, I haven't figured out the best approach for her involvement and Freddie Mac participation.

At this point, there are three priorities. One is the Hoyt Fellows for contacts with the Mortgage Bankers and the May program with the Weimer School (which may have a larger than usual presence of industry and government representatives and be critical in apprising them of likely outcomes of different courses of action). The second is getting some local studies. I have a call into Jim Webb to talk about his doing a "What Happened in Maple Grove" project along the lines of the attachment. That and others would be presented at the ARES April meeting. I will also talk to Brent about doing one, possibly with John if Indiana is a selection. Anyone else have ideas. HHI will move ahead with these and invade the second $50,000.

The third is with the states. Susan is carrying the ball on that. However, we need inputs on the idea of workshops and potential participants, especially those who know what is in the securitization agreements, including authority of servicers, and how modification where appropriate would best be approached.

Well, I have run out of time again. Thanks for your patience with these lengthy communications. Maury

Then an additional note as follows:

Update October 31, 2007

Hi Susan, John, and Richard,

This is an update designed to recommend some next steps, many of which you all may have done. However, I thought it useful as a summary as well as providing recommendations.

Jim Webb called this afternoon. He had lots of questions including level of detail and budget for the Maple Heights – Cleveland study. I told him that we needed to explore feasibility of the kind of detail we wanted and that there would be help in the data source as well as lit review.

Thanks Richard for lining up Vanessa. We could use her work on the level of detail available for subprime as quickly as possible. Jim also asked about budget. I gave him the overview and suggested his exploring the Ohio license fee pool which he noted is now under control of people whom I would describe from his comments as having a nodding acquaintance with research.

If we can include the NGA as a consortium member the Ohio governor's office could pave the way for the use of license fees to support research conducted by Cleveland State University led by Jim Webb. When Ron Racster was at Ohio State he administered the funds and gave grants to Cleveland State University. They now changed the system. If we can get as a precedent it will open up other states, especially Indiana…

Maury

Not all ideas come to fruition. Some of the grants were made, but other projects envisioned did not materialize. But, progress was made.

<u>Organizing Activities after the Research Roundtable</u>

Part of that progress was the drafting of the following item ten days after the HHI Board meeting. It put a program on the table for discussion.

Draft of November 5, 2007 [with minor editorial corrections]

Subprime Crisis Research Consortium

The Subprime Crisis Research Consortium (SCRC) was formed as a follow-up to the Subprime Research Roundtable co-sponsored by the Homer Hoyt Institute, the Hudson Institute, the Institute for Urban Research at the University of Pennsylvania, and the Institute for Public Policy at George Washington University. The roundtable was held at the Hudson Institute in Washington, D.C. on October 24, 2007.

The co-chairs of the Research Roundtable, Dr. Susan Wachter, a chaired University of Pennsylvania professor and Co-Director of the University of Pennsylvania Institute for Urban Research and Dr. John Weicher, Director of Hudson Institute's Center for Housing and Financial Markets continue as co-chairs of the SCRC Steering Committee. Dr. Wachter served in HUD as Assistant Secretary for Policy Development and Research under a Democratic Administration. Dr. Weicher served as Assistant Secretary for Policy Development and Research at HUD under a Republican Administration and as FHA Commissioner in a succeeding Republic Administration.

They were invited to co-chair and to co-sponsor the roundtable by Dr. Maury Seldin, Chairman of the Homer Hoyt Institute, as part of the Institute's ongoing effort dedicated to improving the quality of real estate decisions. Also participating in the creation of the Research Roundtable was Dr. Richard Green, a chaired professor at George Washington University. Drs. Green, Wachter and Weicher are faculty members of the Weimer School of Advanced Studies in Real Estate and Land Economics, the international leader in post-doctoral education in real estate and closely related areas. Dr. Green will lead the May Session of the Weimer School which will focus on presenting the papers most significant to the development of effective alternative strategies for dealing with the subprime fiasco.

Drs. Weicher and Wachter are joined in the steering committee by Dr. Green and Dr. Seldin, a chaired professor emeritus from The American University as well as the Chairman of the Board of the Homer Hoyt Institute. Additional members of the steering committee are being added as consortium membership is being expanded.

Research Agenda

The Research Roundtable was the initial effort of the consortium which is designed to be a one year effort to develop the research critical to assisting the various concerned parties creating their respective strategies for dealing with the subprime crises. Since their underlying values and perspectives because of interests are likely to differ, their strategies will differ. However, predicting outcomes is essential to effective strategies and there is a commonality of concerns which can most effectively be dealt with by rigorous research revealing relationships in the system rather that superficial rhetoric with which many players seem enthralled. The key to an effective relevant agenda is identifying the critical issues for analysis and gaining a perspective of the likely reasonable strategies that players will develop. The intent is to provide the commonality of understanding of outcomes and foster cooperative efforts so that the system will work more effectively. It is clear that the system has created a debacle because market information was asymmetrical and the risk-reward relationship was out of balance.

The change in institutional arrangements, including the regulatory situation or lack thereof is a major item. However, there are two aspects of the crisis which cry out for triage. One is relief of innocent buyers. The other is avoiding a cascading of defaults and foreclosures that could throw the economy into a recession, or worse, a depression. The extent of that risk is not known, and the more that is known the harder it will be to deter.

Given the situation, the research agenda starts with a literature review to assist those pursuing research as an externality – and that was done just prior to the Research Roundtable. The second item on the agenda is a compilation of data sources. That was authorized shortly after the Research Roundtable and is underway.

Since residential owner occupied real estate markets typically operate at a local level, the first priority after the commonality of literature review and data sources is an analysis of local markets. The most critical aspect of this entire approach is getting a really good picture of the local situations such as what really happened in Maple Heights and why.

The best way to get answers to such questions is through some very detailed research in the local market. That is best done by selecting a series of local markets representing different situations. The series of analyses for this approach requires that mortgage loans in the local market being studied to be disaggregated to reveal sub-classifications that may involve different treatment. For example, classifications might include primary residences acquired with subprime loans, primary residences refinanced with subprime loan teaser rates, second homes, rental houses. Additionally, identification of location concentrations of the loans is of importance as is the date upon which the reset is scheduled.

Further data required includes the number of foreclosed properties available on the market, the number of homes in foreclosure, the number of mortgages in default, and the number of loans not apparently in a revealed problem.

There are two different types of problems, but related. The first relates to relief for individual borrowers on the basis of the category of their situation. For example, homeowners who finance or refinance based upon misrepresentation of the character of the loan and who will not be able to afford reset rate and payment, eventually leading to foreclosure without some intervention. At the other extreme is an owner/speculator who too took a teaser rate with knowledge of the risks but now finds the value of the home less than the mortgage. There are other categories. The workshop approach can develop the categories and make recommendations on qualification for relief. Inclusion in a relief category may vary by state depending on where in the range of liberal-conservative spectrum of values the state reps see as appropriate, or the realpolitiks of the situation.

The other problem is a locational problem in which there is a potential cascading of prices because the market reaches the tipping point.

This analysis focuses on a submarket in which foreclosed homes and homes that are in high risk of foreclosure could add enough to the supply of available product that price declines could accelerate. For the resale market, data such as average time on the market as well as price changes are important. If the area has substantial new construction, additional data are required, for example, unsold inventory and housing under construction.

The market analysis for local areas needs to forecast two closely related items. One is price trend (how much longer will the price decline continue and how low will prices go). The second deals with researching how long would it take to absorb the existing inventory, and how long to return to some specific previous price.

This information is relevant to the construction of models relative to the decision to foreclose or to renegotiate the mortgage (and to what level). On a microscopic basis it is a decision on how to play the suit rather than the hand, to use a bridge analogy. Lenders have models on how to play the suit.[1]

What they probably don't have is models that reflect aggregate analyses of other lenders making decisions. The endnote discusses the London Commons example indicating the necessity for such an analysis and measures to assure appropriate action. Such measures may be discussed in the workshop that considers the options for providing the relief and/or the strategy workshop.

On the other side of the table, the borrowers have their intuitive models of what will pay for them. Sophistication varies, as does motivation. But, the playing field is not level. There may be options to provide borrowers with better information.

The really tough question is when a tipping point would be reached. Experience with racial integration in neighborhoods may be useful. But, some educated guessing may be necessary in order to safely avert a cascading of default.

An invitation has been extended to Dr. Jim Webb of Cleveland State University to design his proposed study of the Maple Heights case, Maple Heights being a suburb of Cleveland. Exploration of potential researchers and localities is underway. At this point budgetary constraints are quite limiting because one-half of the $100,000 allocated to the project has been committed, including publication of research results in at least one learned journal. Since one Homer Hoyt Institute board member in approving the allocation expressed concern that the Institute might be drawn into a bottomless pit in funding, given the scope of the problem, the Chairman of the Board gave his personal assurance that it would not. Therefore, the pace of this series of local research projects will be seriously constrained by the extent to which other funders will join in the consortium effort.

<u>Integrated Action</u>

The research agenda is scaled for a one year effort, but some results will emerge as the year goes along. Since some states have already taken action in addressing the subprime crisis and are in the process of enhancing their program, and others are ready to start making choices, it will be useful to explore the best practice from what is already known, and thought to be known and to develop some additional ideas for demonstrative testing. Such a process will assist in guiding research projects to the most relevant issues (rather than those most easily attacked by academia because of rigor).

The salient aspect of this approach is that a comprehensive strategy will be developed for the particular state in which a selected local market is researched on its subprime issue and the housing market debacle along with the undesired consequences.

Strategies will vary by state, and representatives of the state being studied will be on the team recommending the strategy, but commonalities will exist in states with high recent house price increases partially fueled by teaser rate loans and subprime mortgages. They may be areas of historic strong growth and substantial excess inventory of foreclosed homes.

At the other end of the spectrum are those states in low growth areas in which the market has been weak in recent years. However, subprime mortgages to lower income residents who are approaching interest rate and payment resets bear exceptionally high risk of foreclosure.

Since the states are key players in the process, and two state organizations were represented at the research roundtable (National Governors Association {NGA} and Conference of State Bank Supervisors), work has already started on a cooperative effort.

Stephanie Casey Pierce, the staff member of NGA that prepared the survey of actions taken by states – now being placed on the Homer Hoyt website, is discussing with her supervisor the idea of a conference at University of Pennsylvania sponsored by the National Governor Association and the Conference of State Bank Supervisors and along with University of Pennsylvania Institute for Urban Research, the Hudson Institute, George Washington University Institute for Public Policy, and the Homer Hoyt Institute as a follow-up to the Research Roundtable. A variation of the conference idea is to have a series of workshops dealing with issues such as which mortgage borrowers are entitled to relief from some of the terms of the mortgage, what are the options for providing the relief, and what institutional changes should be made to remedy the market practices that fueled the debacle.

The variation of workshops generates some additional research topics. For example, the holder in due course problem which reflects limitations on mortgage servicers renegotiating loans because of the rights of holders of securitized instruments having rights as holders in due course. At the Research Roundtable Professor Patricia McCoy of the University Of Connecticut School of Law discussed the concept she didn't use the phrase "holders in due course." The idea is to explore borrower remedies since in some cases the borrower cannot even sue for fraud because of the holder in due course legal limitations... We need to give attention to borrower remedies in securitized mortgages and to the general regulatory issues, including regulatory framework. Professor Wachter is exploring with Professor McCoy the possibility of her exploring the issues as a research project that would be the centerpiece of a workshop to consider best practices under the existing uniform commercial code and potential changes. Also, if disaster were to be imminent in a local area one option is to explore extreme measures such as moratorium on foreclosure or regulatory delays such as cooling off period as in labor management disputes where averting a strike is critical to the public interest.

Another example of a research project feeding into a workshop relates to relief for individual borrowers on the basis of the category of their situation. For example, homeowners who finance or refinance based upon misrepresentation of the character of the loan and who will not be able to afford reset rate and payment, eventually leading to foreclosure without some intervention. At the other extreme is an owner/speculator who too took a teaser rate with knowledge of the risks but now finds the value of the home less than the mortgage. There are other categories. The workshop approach can develop the categories and make recommendations on qualification for relief. Inclusion in a relief category may vary by state depending on where in the range of liberal-conservative spectrum of values the state reps see as appropriate, or the realpolitiks of the situation.

The list of workshop topics has not been explored. Adding worships will require funds well beyond that available from the cash subsidy of the Homer Hoyt Institute and the in-kind contribution of co-sponsors including their cash outlays for the Research Roundtable.

In addition to these workshop topics designed to help the states with their strategies, which may vary among the states, there is the whole array of research projects for national concern. As yet, these have not been identified but the co-chairs of the consortium have been working on such issues and will come up with their list of additional projects.

Academic Review of Research Results

A key element in academic research is that it should be replicable so that other researchers with the same information get the same results. That provides a great credibility to the use of research results in forecasting outcomes.

Since this is of great importance to industry and government in their developing their strategies to deal with the issues, the game plan for the consortium is to vet the research agenda and to present research results in forums available to industry and government.

The Weimer School of Advanced Studies in Real Estate and Land Economics, which has as its faculty and fellows the national and international leaders in scholarly work in real estate and closely related fields, has allotted some time in its January 2008 session to vet the research agenda. Then, in April of 2008, the American Real Estate Society, one of the two leading academic organizations in the field, is scheduling a plenary session for the consortium to provide an overview of the research. Additionally, papers will be presented at smaller sessions, as for example focusing on local markets. Then in May, at the Weimer School session the key research papers will be presented. Also at that May session, the Hoyt Fellows, the industry counterpart to the Weimer School Fellows will also discuss the crisis, probably relating it to commercial real estate impacts. Then, at the end of May, the American Real Estate and Urban Economic Association will at its Mid-year meetings in Washington, D.C. will present a selection of papers of particular interest to the national government agencies and the relevant industry organizations.

An item is in the budget is allocated for publication of research results. While printing delays may take to hard copy availability beyond the one year time horizon, the papers may be on the Hoyt website or linked to the website.

Conclusion

It is amazing that the Homer Hoyt Institute (HHI), and its supported Advanced Studies Institute (ASI) which is the corporate home of the Weimer School has the network to develop such a program. HHI was created forty years ago as the research arm of the then Real Estate and Land Planning and Use Program at The American University in Washington D.C. It became independent of The American University but continued support and shifted focus to creating and supporting the Weimer School of Advanced Studies housed in ASI. Dr. Weicher became a Fellow of the Weimer School in 1983, the first group after the Founding Fellows. Dr. Wachter was a few groups later, over twenty years ago. Dr. Green is a more recent addition, but all three have faculty status.

This academic network is truly remarkable. And their contacts with industry and government make for a great relevance in the research as does the sessions of the Weimer School. Additionally, ASI co-sponsors the Hoyt Fellows, a subsidiary of the Homer Hoyt Institute that is the industry counterpart to the Weimer School Fellows.

Participation in this Subprime Crisis Research Consortium is invited to those organizations that are involved in the issues. It is deemed to be a cooperative effort with government and industry. The challenge is there to not only do something about the crisis, but to do that which benefits from the best knowledge available and to add to that knowledge in order to improve the quality of decisions. The crisis is a testimony to the need. The participation is the "real thing.[1" That footnote refers to an essay published in the ASI Newsletter. The essay begins on page S-7 of that newsletter.

The highest priority was deemed to be to stop the cascading. One source of information revealed the information contained in the box that follows, Exhibit 4-1.

Exhibit 4-1: Info on Potential Areas for Study

at risk over the next six months include…:

- Memphis, Tenn.
- Detroit-Livonia-Dearborn, Mich.
- Youngstown-Warren-Boardman, Ohio-Pa.
- Warren-Troy-Farmington Hills, Mich.
- Indianapolis-Carmel, Ind.

Relative to the base period of Q1 2002, the Q4 2006 Core Mortgage Risk Index completes a year of relatively low risk, in contrast to the prior three years. A driving force behind these results is the continued decline in the unemployment rate which remains at historically low levels. At this time, the negative effects of a slowdown in housing costs are being offset by the positive effects of low unemployment.

While overall house price appreciation has stopped its slide and risen slightly from five percent in Q3 2006 to just over 6 percent in Q4 2006, many markets continue to experience house price declines. The top ten riskiest markets among all 379 markets monitored have a consistent pattern of house price depreciation, higher than average unemployment, lower than average wage growth, and higher than average fraud and collateral risk.
http://www.corelogic.com/pressroom/press-releases/archive/core-mortgage-risk-monitor153-cmrm-first-quarter-2007-forecast/

One of their other press releases notes that "seven percent of brokers account for 63 percent of early payment defaults, with the riskiest one half of one percent accounting for 70 percent of all losses." [October 23, 2006 news release.]

Additionally, the following text was in e-mails circulated internally:

Exploring mortgage broker records may be a big aid in the project. But, we are short on contacts with the mortgage bankers. (They will be at the conference next week.) If we have the governor's organization as a member of the consortium (coalition might have been a better word until it got contaminated), the mortgage bankers would have to reach the heights of being wisdom challenged not to join in and help.

The presentation we might make to the NGA is that our four institutions have formed a consortium with a steering committee of the four of us, led by the two co-chairs.

We would welcome the NGA as a member and include a representative on the steering committee. It might be the director of their Center for Best Practices.
We want to keep Stephanie involved. One way is to pair her with Vanessa in trying to get at data sources and working on data that might indicate tipping points. Vanessa is probably interested in the tipping point issue as well, and in the case of Maple Heights we want to see when it was, relative to foreclosure date, that the family decided to leave as reported in the NY Times September 2 story.

Jim will call me next week. He hasn't consented to the study yet. He wants to explore feasibility and budget; but, knowing Jim I would be surprised if he passed up the opportunity. What we need is a pattern for the research.

When Brent Smith gets back in the country, maybe John would like to offer to have him join in on a study of Indianapolis. It is worth checking the web and take note that he could do the micro stuff.

Susan might see if Andrey is interested in the micro stuff and who might he pair with for another metro area, maybe a high flyer rather than rust belt. Also, at some point we probably could use a GIS template and algorithm for handling locational data with timing of defaults and foreclosures so as to identify patterns.

Well, this e-mail is already too long, but I wanted to include the quoted items. Susan and John should decide who wants to follow-up with Stephanie and the game plan for so doing, along with a discussion with Richard, especially regarding Vanessa.

We probably need to work on developing a grand budget, beyond our current resources, and use it in enlisting outside support and/or additional consortium members with money or access to money and/or data and cooperation.

Unfortunately, despite additional efforts, the biggest stumbling block to doing the research at the micro level was property specific loan level data. The cost of the data would have taken the entire budget. We explored some compromises such as contributions in-kind but a project requiring that level of detail is not feasible because of funding limitations and possibly because we have found no takers willing to forecast turning points. This subject needs to be re-addressed.

What was clear was that additional funding would be required in order to deal with the ambitious attempts of the research program. Industry offered the best prospect so a symposium of primarily industry representatives was scheduled to precede the January Session of the Weimer School of Advanced Studies in Real Estate and Land Economics.

Stopping the Cascading of Housing Prices as the First Priority

Stopping the cascading of housing prices was set as the first priority in developing the research agenda. There was a substantial difference in opinion among many observers and players as to just letting the market work it out or providing intervention. The balance on the side of intervention seems to be gaining, especially with actions by some state and local governments. There has also been a shift at the national level.

As this section of the draft is being written on August 14, 2008, today's WSJ reports in a front page story, *Greenspan Sees Bottom In Housing, Criticizes Bailout*, "Home Prices in the U.S. are likely to start to stabilize or touch bottom sometime in the first half of 2009." The news story continues "prices could continue to drift lower through 2009 and beyond." The report continues "An end to the decline in house prices, he explained, matters not only to American homeowners but is 'a necessary condition for the end to the current global financial crisis' he said." **This is supportive of the strategy that HHI has been pursuing with its SCRP.**

The HHI Subprime Crisis Research Program (SCRP) position of the first priority being stemming the downward spiral of house prices have been reflected in the statements by its chairman in the voluminous memos as well as the essays published as inserts to the newsletter. Further to this point, as noted in early statements the decision was to attempt to forecast turning points in local markets as a basis for intervention. The idea was to develop a model that could be applied by local authorities in order to assist them in their decision to intervene.

The nature of potential intervention was a subject deemed to be explored in a cooperative effort with the National Governors Association, especially with its Center for Best Practices.

The efforts, thus far, have not been successful. No researcher has committed to a project that forecasts turning points. Also, the funding of an NGA Best Practices project has not been provided yet. The early triage approach did not go forward and the latest proposal from NGA is still an open issue. It will probably be resolved by tying the nature of the research product to the White Paper strategy.

What follows is mostly internal communications indicating high priority projects to stem the downward spiral in house prices. Without the models the states will shoot from the hip; and without a comprehensive strategy blending various governmental authorities and industry players, with cooperation of consumers, the available synergism will be lost.

The Housing Market Model.

Consider the following which is an edited version of an e-mail in September leading to the research roundtable held in October. It was shown in an even shorter version in Chapter 3 as a boxed item.

Foreclosure? The Right Way to Play the Suit May be the Wrong Way to Play the Hand:
A Strategic Approach to Averting a Crash in the Housing Market and its Fallout

Mortgage lenders, and representatives of mortgage lenders, consider foreclosure as an option when mortgage borrowers are in default. Mathematical models used to assess the profitability of the options may consider, in addition to foreclosure costs in legal expense and time, potential damage to the property and expected price to be realized. In order to reduce the costs the lender may offer cash for keys, i.e., a payment for a deed in lieu of foreclosure.

Each case may be considered on its merits, but what may turn out to be profitable on an individual case may be less profitable when considered as part of a portfolio of mortgages. The analogy to the card game of bridge is that the right way to play the suit may be the wrong way to play the hand.

In bridge, control of the hand in terms of constraining leads of the opposition, as well as timing, is critical in making the contract by taking a sufficient number of tricks. Taking the most tricks in a suit (spades, hearts, diamonds, or clubs), by having the highest card of the suit led or the highest trump, may be influenced by the way the suit is played. But, sometimes playing to maximize the number of tricks in a suit entails the risk of losing the lead to an opposing player who can defeat the contract by leading a suit damaging to the declarer (winner of the bid for the contract).

The analogy for foreclosures is that by foreclosing, or taking a deed in lieu of foreclosure, the lender adds another house to the local market and that market may already be flooded. The result may be to further depress already depressed prices and adversely affect the some of the rest of the mortgage portfolio, even in other geographical areas not competing with the houses in the subject property's market.

One may think that one more house on the market is not going to make enough difference to negate the mathematical model used to weigh the benefits and costs of becoming the owner of the property upon which their has been a default; the right way to play the suit. However, one should consider the classic case of the London's tragedy of the commons of medieval times in which everyone was free to graze on common land. The result was overgrazing so that the land was no longer suitable for grazing. No individual had an incentive to cut back on grazing their herd (the right way to play the suit) and there was no agreement at the time restraining the grazing. In later years such land came under ownership of a group of people who regulated the use among the common owners.

The idea here comes in two major parts. The first is to avoid a crash in the local market of a subject property. The second is to avoid a cascading of local market housing crashes. At first glance, many people will consider both cases as being remote possibilities, especially the latter.

Policy makers could wait until the possibilities seem less remote. The problem is that the longer the wait and the less remote the more difficult it becomes to avert. One could make mathematical calculations that would weigh the chances against the costs, but as with catastrophic events, even low probabilities are of little comfort if the catastrophe strikes. Thus, prudent decision makers, when insurance policies are not available or realistic, may take preventive action even with probabilities not favoring the odds of caution. The "go-for-broke" strategy takes the chance. The minimax strategy constrains the level of risk and maximizes within those constraints.

In order to develop such a strategy it is essential to work with local data that identifies the high risk areas. The discussion which follows is a first step in developing such a strategy.

I have talked with AU about getting a copy of the dissertation by Chuck Shinn that contains a methodology used to better characterize local areas and the best so far is copying selected pages, and we have the methodology.

That is an approach to the first part. The second part, cascading, is more difficult to tackle because of the problem of identifying tipping points before they happen. Forecasters do well in extrapolating from the past, but the turning points may arise in different patterns because of differences in people's responses, among other things. It may be a case of emergence…

Enlisting the cooperation of industry is an important part of the SCRP strategy. The January symposium discussed in the next chapter [link] was part of that effort. However, the situation is so dire that the federal government's approach of voluntary cooperation is likely to change with the change in administrations comes January 20, 2009. In the meantime, the states have taken action. [link to be determined]

Before turning to a discussion of an approach of working with the states it is useful to consider the nature of the proposed housing market model. Here is one memo that encompasses many memos.

December 2, 2007 revised to December 3, 2007

Discussion Draft of
A Model for use in Averting Market Catastrophe
By Maury Seldin

The Wall Street Journal of December 1-2 carried a front page story regarding the criticism of the "government-led plan to freeze interest rates on certain troubled subprime home loans." The story further reports "The plan is being negotiated by the Treasury

Department and a coalition of mortgage-industry participants, including lenders, mortgage counselors and servicers -- the companies that collect mortgage payments. Many of the particulars need to be worked out, including how long the interest-rate freeze would last and which subprime borrowers would be eligible for relief." It also notes "Interest rates on about two million adjustable mortgages are scheduled to jump over the next two years, threatening many of those borrowers with foreclosure."

The Wall Street Journal of the previous day, November 30, reported "Treasury officials say financial institutions are likely to set criteria that divide subprime borrowers into three groups: those who can continue to make their payments even if rates rise, those who can't afford their mortgages even if rates stay steady, and those who could keep their homes if the maturity date of their mortgages were extended or the interest rates remained at the teaser rates. Only the third group would be eligible for help." It also noted "The creditors are likely to look at whether the borrowers have equity in their homes, despite falling house prices, and whether their incomes are holding steady."

It is an admirable effort and obviously subject to a lot of criticism, especially from those with vested interests. However, some action is critical, not only as a matter of justice to parties involved, but because the impact of the crisis is reverberating to affect many innocent people. The major risk is a recession or worse.

These comments on the program under development by the Treasury and the mortgage-industry coalition are designed to refine what seems to be a blunt instrument into something somewhat more surgical. The essence of the strategy is to prevent a cascading of the downturn in housing prices. Cascading occurs when homes not in foreclosure because of inappropriate financing are abandoned to become foreclosed upon. The widely noted case is that of "Tammi and Charles Eggleston [who] never took out a risky mortgage, never borrowed more than they could afford and never missed a monthly payment on their neat, three-bedroom colonial in the Cleveland suburbs. But that hasn't prevented them from getting caught in the undertow of the subprime mortgage mess now submerging this town." That was reported in a New York Times article of September 2, 2007 titled "Can the Mortgage Crisis Swallow a Town?

The foreclosure process results in a diminution of the value of the house both directly and indirectly. Directly it can, according to some estimates, run up to twenty percent or more depending upon stripping and/or vandalism. Foreclosure costs vary, but can be substantial leading some lenders to use a cash for keys approach, i.e., pay the defaulting borrower to go with a deed in lieu of foreclosure.

Indirectly the foreclosure causes a loss in value to the foreclosed upon house when it adds to an excess supply of housing in the neighborhood and further depresses an already depressed market. Some lenders may be prepared to take that additional loss, knowingly or unknowingly. The cascading occurs when numerous lenders are prepared to take the loss and it compounds, possibly adversely affecting their other loans. That impact is direct and significant in the neighborhood of the subject properties. It may also be significant for mortgages held on houses in other cities, but seemingly indirect, if the local downturns generate a recession and foreclosures in other cities are generated because prices there were adversely affected by recession and/or fear. The classic case of individuals looking only at their own short term interest instead of considering how others will also view their own case and the combined effect is that of grazing on the London Commons in an earlier era. Without an agreement among the ranchers or regulation limiting the grazing, the open land was overgrazed, destroying it for all. The incentive for the individual rancher was insufficient to voluntarily restrict his grazing. So it may be with mortgage foreclosures, thus requiring some intervention.

Metro areas in some states (such as California, Arizona, Nevada, and Florida) are hard hit because they were the scene of sharp price rises. Metro areas in some other states (such as Ohio and Indiana) are hard hit because the local economies are weak giving little tolerance to excess supplies of houses. Letting the market work things out is a good idea when there is a level playing field and the tools of competition provide fair results. "We are in this mess because the current subprime mortgage debacle is a failure of the market."

The surgical refinement is to identify and analyze a series of local markets that may be subject to state policy change as a supplement to "The plan [that] is being negotiated by the Treasury Department and a coalition of mortgage-industry participants, including lenders, mortgage counselors and servicers -- the companies that collect mortgage payments." That plan, worked out as best as it can, should proceed while the local analyses are conducted and the dangers of cascading are assessed by local area.

Since foreclosure practices vary by state, and occur under state law, the state has clout more surgically applicable. Ohio, after an unsuccessful attempt to get cooperation from mortgage lenders has not only gone to the path of changing regulation, but the courts are requiring evidence not always required in foreclosure procedures of other state in the case of securitized mortgages. States can use Draconian measures in regulating foreclosures and possibly in dealing with the holders in due course issue where fraud is alleged. If disaster appears imminent, any lender would be wisdom challenged, to say the least, not to be cooperative.

As to the pending agreement being negotiated between the Treasury Department and a coalition of mortgage-industry participants, "Many of the particulars need to be worked out, including how long the interest-rate freeze would last and which subprime borrowers would be eligible for relief." That however will give some breathing space to avoid an acceleration of foreclosures leading to cascading.

<u>Cascading and Model Building</u>

As academics we build models to forecast outcomes. Models as abstractions are necessarily removed from reality, but to the extent that they give good representations of relationships they may assist obtaining better forecasts of outcomes than alternative approaches.

The key is in understanding the system. In so doing it is useful to know that decisions as actually made are not necessarily rational. Furthermore, group decisions as reflected in market behavior are not simply aggregations of would be individual decisions in that decisions of others impact one's own decisions. This understanding involves an application of behavioral economics and an application of the science of networks.

We are looking to understand the system behavior that may result in a downward spiraling of house prices occasioned by a cascading of foreclosures. One foreclosure in a neighborhood adds one house to the local market, but so do a lot of other events. An excessive number of houses added to the market will not only cause prices to drop substantially because of the relationship of available supply to demand, but also may induce other homeowners to offer their houses for sale while they can still get a price better than what they think prices will sink to. It will also discourage would be buyers from entering the market because by waiting they will be able to buy cheaper.

Foreclosures come into play because they force houses onto the market and send a negative signal as to the future as well as adding to the supply of the present.

In order to understand this system it is useful to consider home owners and lenders as nodes in two systems that are subsets of a number of larger systems. These are two intertwined systems. The homeowners are players in the housing market and while they are the nodes, the linkages are the connections among the homeowners. They compete in acquisition and disposition and would be buyers are nodes in this market system. As with the stock market, when it looks hot a lot of people rush in with the price rise feeding on itself. The story is told that Bernard Baruch avoided getting hurt in the Great Depression because he started to sell out his stock holdings when the man shining his shoes gave him stock market tips.

The mortgage lenders have a more complex system than the homeowners since the mortgage originators shifted from holding the mortgages to securitizing them. The system was lucrative, in part because of the incentive pay for originating more profitable subprime mortgages – some of those mortgages should never have been created. The parallel story to the Bernard Baruch story was told to me by a colleague who told about the woman who came to clean someone's home and said something to the effect, here take my business card from my other business, I can get you a good mortgage if you are in the market.

The nodes in that system are the servicers (including their employees and agents making loans) and the players in the structure of bundling loans, slicing them into tranches, and the investors. These are sub-networks, with the investors in a larger network of capital markets. That capital market crisis is what triggered international interest in the debacle.

The science of networks deals with the commonalities of systemic structure of linkages that form networks. Networks are composed of nodes that are connected. The distribution of the frequency of connections among the nodes in a system is not random. There is an interdependency within the system with the strength of ties among nodes varying. This is significant in that the predictability of the behavior of the system is dependent on understanding the underlying principles of the system. Thus, Treasury making arrangements with the coalition of mortgage-industry participants, including lenders, mortgage counselors and servicers involves key players. Moving the leadership may facilitate the group as a whole, and then the players not in the coalition may find that attempts to enforce their contract rights meet with such resistance that they go along with the changed pattern.

If the coalition effort breaks down, and it is left to the states, the states hardest hit may take Draconian measures frustrating foreclosure such that they stave off the cascading problem, but the industry will get some long term changes that are undesirable. There is a great difficulty in avoiding situations where the solutions to short term problems linger on as long term arrangements. Thus, it is in the financial sectors interest to work something out without it being forced upon them. They would do well to consider some self regulation as an industry, increase transparency and information systems, and a variety of changes that would level the playing field. There are a lot of failed companies in the penalty box and we keep reading about top executives who have lost their lucrative positions because of the humongous financial losses by their companies.

The model under development is not focusing on that network other than identifying the critical locations in which state and local government will move to stave off cascading and identifying the players on the lending side. The measures that the state governments might take are not in the model, nor are the potential institutional reforms. The focus is on identifying the local markets at risk and the characteristics of the property owners and the identification of the mortgage holders. The analysis of the dynamics of that market, especially looking to mortgages that are scheduled to reset within a couple of years or so is the critical aspect of the model. Identifying the lenders or their representatives who control the foreclosure decision is part of the model insofar as reducing the foreclosure rate to be out of the range that excessively depresses an already depressed market.

Developing the Model

The ideal model would be one that forecasts price. The key questions are how far down will prices go and how long to the turning point. A supplemental question is how long for a recovery to some previous point, probably to where it would provide security for a lender or be comfortable enough to wait, or for a homeowner to stay with house through the drop in price.

Simplistic views would use a raw comparison of market value to debt as indicating when it pays to hold. That ignores transaction costs and emotional attachment. A further consideration is that owner has a put option at the amount of the debt and a hold option for an increase because of volatility in the market. So even if the equity isn't "in the money," even after a transaction cost consideration, there is a value to the option because of expected or potential price rise during the period of the option.

Lenders/investors ought to be at least educated enough to know that it is worth comparing the net loss on a current foreclosure option with the cost of some forbearance on what they contracted for, adjusted down to at least what would be the opportunity cost of what they could now get for the money. I expect that they have some models to determine what they could get by foreclosure and some expectation of the future, but I seriously doubt that they have any good models to forecast future prices.

I doubt that first because the difficulty of forecasting future house prices probably ranks with forecasting interest rates. Structures change and so even sophisticated econometric models have difficulty with changed underlying conditions. More importantly, the decision to foreclose is similar to the grazing decision in the London Commons. That decision along with decisions of others will reverberate back to the price. Thus, unless there is a good guess as to what others will do, it is problematic to forecast the price with any accuracy worth its salt.

I took a look at a couple of books that I co-authored a long time ago (measure in decades), but they were not useful in dealing with the science of networks approach, probably because they were written about the time the science of networks was just getting started. So, unless we can come up with a model that identifies turning points, the best at this stage may be to look for shifts in trends and judgmentally deal with the turning points by adopting a strategy that recognizes uncertainty in the turn but utilizes an acceptable level of risk of the timing of the turn in reaching the related decisions.

By doing this with a number of local areas a pattern may emerge that provides enough historical date of structural changes associated with rising foreclosure rates and the related variables that influence price and price turning points to be able to develop an econometric model that will deal with forecasting turning points bases on the variables underlying the price change. I don't know how many or how long, but the priority is to deal with it judgmentally with these variables underlying price change.

The two most common indicators used in the resale market may well be (1) the number of houses on the market as a percentage of the total number in the sub-market area and (2) the length of time on the market. Both indicators are at a point in time, but a time series will indicate a trend. The trend may be at a modest rate of change that is not increasing. But, if is there is an increase in the change in the rate of change (increase) it will not take long to get to a crash.

These two indicators, and there may be others, deal with historical and current conditions. The critical variable in forecasting future conditions is the resets of rates in mortgages that will push the houses onto the market, either voluntarily or by foreclosure. This may be the next to hardest data to get. The hardest may be the motivations of the players in the process and understanding and classification of the paradigm within which they will make the decision.

The motivations obviously refer to the home owners and the lender/investors and their representatives. But, it also refers to potential buyers. The judgmental models alluded to in the endnotes can be used to forecast the demand generated by economic growth and associated demographic activity. There are probably econometric models that may do a more accurate job, but these are based upon reason and historical patterns that included emotion that may vary over time. We could use some behavioral finance types to fine tune such models. However, the most important element in generating the turning point for a cascading is the resets that push an excessive number of houses onto an already saturated market. Thus, the other analyses may be done and integrated, but the strategy is to stop the bleeding which is an excessively increased supply of housing put on an already depressed market.

The locational focus for these models is the metro area and/or the neighborhoods within which the houses are most competitive. Neighborhood delineation can be quite a task, and data availability on that basis a severe problem. Census tract data is a good delineation for inventory of stock, but other data are most easily obtainable by zip codes, but zip codes change. The simplest approach is to assemble the data of different types using whatever geographical classifications are used by the source and then working with overlays of some sort to have a surrogate for the submarket area. That system can be refined by using a unique parcel identification system.

Returning to price, these are variables which will effect changes in offering prices. The offering price changes, and the actual price and other concessions accepted, will influence the quantity of houses taken off the market. The top down analysis of demand based on strength of the economy and willingness to commit to ownership will influence the absorption of the excess supply. Some of the previous homeowners may have doubled up, some become renters, some compromised with lesser housing in space and amenities (including mobile units), or left the market area. Some may be homeless. At attractive enough prices and reasonable financing some of the previous homeowners will with others who have been holding off return to ownership or upgrading and cause the turning point.

Econometric models can be helpful in this process. But, it will probably take more that a few cases of local area restraints and turning points to provide the data necessary for such models. Our efforts are now focused on selecting some areas to develop and apply a model that can be used to aid decision-makers in staving off foreclosures.

There are other parts of the Subprime Consortium research agenda that deal with best practices and other policy matters. At this point, we recognize that while on a level playing field the market can do a fine job of making such an adjustment; but, with the distortions of subprime loans and teaser rates, and the associated unrealistic expectations of continued rapidly rising prices, the adjustment can be unnecessarily severe. The strategy is to avoid the severity of cascading because it unnecessarily take the drop too far. The old pendulum story applies. And, just letting itself work itself out without intervention has deleterious side effects.

Strategy Development

The subject of strategy development is discussed in the two pre roundtable essays (referred to in endnote 3) and some related documents. These are available upon request.

Some of the enhancing inputs that may be included in the model are related to motivations. The series of motivations which our researchers might explore once we have sketched a model might be listed as follows: (1) continued ownership of the property became unattractive as an investment when the prices failed to continue to rise as anticipated, especially when the interest costs were scheduled to rise because of the reset., (2) continued ownership of the property became unworkable when the interest costs were scheduled to rise because of the reset (with the possibility that the borrower was naïve when making the loan or maybe misrepresentation by the lender's agent)., (3) continued ownership of the property became unattractive because of fear of what was going to happen, not only to prices, but as to the character of the neighborhood as with the Maple Heights case.

The classification of borrowers, discussed in the coalition proposal in progress, may be used to sort out where the relief goes. The strategy is to assess how much risk can be borne and provide the extent of relief necessary within that constraint. There may be others entitled to relief because of fraud or misrepresentation. That should be provided on its own merits; however, it will have the favorable side-effect of lessening further price declines.

There are also proposals around that can keep houses of the market by changing the tenure relationship. Such arrangements would help and may be considered beyond the model development under discussion.

Conclusion

The federal government is on the right track and it is substantial progress from the initial efforts focused on the capital markets reported in the lead story of the August 20, 2007 *Wall Street Journal*, "How a Panicky Day Led the Fed to Act." The state governments of some of the states hardest hit are in the picture and in a position to be the toughest on the mortgage investors because they control the investors' remedy of foreclosure and possibly could have an effect through bypass of the holder in due course issue which would affect lender liability (a topic under research).

It may be that the industry participants were "circling the wagons" until the Treasury/coalition effort got underway. If so, it is not likely that focusing on defense rather than getting proactive in solving the problem would be a productive strategy for them or the nation, aside from being unjust to some borrowers. Housing unit speculators that understood their contracts but lost out because they guessed wrong deserve the discipline of the market. Investors that that got hit because they believed the ratings of their tranches can look for their own remedies and work on bettering their own strategies.

The Fed was right to intervene to prevent disaster in the capital markets, and the Treasury is right to intervene to prevent disaster in the housing market and the economy – and the health of the economy is at stake. The states are right to intervene for justice along the same lines, but have better tools that the federal government and can supplement federal government actions as appropriate for local conditions.

We, at the Homer Hoyt Institute have a long and strong relationship with industry. We will hold a meeting at the Hoyt Center the day before the January Session of the Advanced Studies Institute's Weimer School meets. The effort is to develop research that would help in improving strategies for all parties concerned. Research is what we support and the development and dissemination of knowledge is our reason for being. Industry needs help in moving to what I see as a better strategy for their long term interests. Our research will help them as well as the government, federal and state, and we have not forgotten the consumer side and its representation.

Well, I am retired (so I thought) and it is Sunday and the Jaguar game starts shortly, so this missive has to end in time to get it out on the heels of the WSJ story that triggered it.

Now let us turn to working with the states through the National Governors Association.

<u>Working with the National Governors Association.</u>

The key approach to working with the National Governors Association on a project is outline in a memo as follows:

Housing Market Triage Conference:
An Exploration of Best Practices at the State Level for
Dealing with the Subprime Debacle
(Draft Revised November 11, 2007)

These are ideas built upon Susan's thought of a potential conference at University of Pennsylvania sponsored by Conference of State Bank Supervisors and the National Governor Association along with University of Pennsylvania Institute for Urban Research and George Washington University's Institute for Public Policy as a follow-up to the Research Roundtable on Developing a Research Agenda on the Subprime Mortgage Crisis led by John Weicher, Susan Wachter, Richard Green and Maury Seldin. It was amended after Susan suggested a workshop approach and after Norm Miller pointed out the difficulties in renegotiating securitized mortgages, which may be thought of as a holders in due course issue.

A variation of the conference idea is to have a series of workshops dealing with issues such as which mortgage borrowers are entitled to relief from some of the terms of the mortgage, what are the options for providing the relief, and what institutional changes should be made to remedy the market practices that fueled the debacle.

The subprime debacle is composed of a series of local housing market situations that make up an aggregate national problem. The danger of the greatest potential disaster is a cascading of market declines from those distressed local housing markets to other local housing markets and from housing markets to consumer spending and thence to a national recession or even depression. The great difficulty is that the probability of such a disaster is not known, but the more that is known about the risk the greater the difficulty in countering it. Thus a minimax strategic approach requires taking action to avert the cascading.

The creation of effective strategies may be a lot more complex that many people think because there are so many views of what strategy is and many of them are oversimplified. A workshop on strategy might be in the picture, or strategy might await the conference that serves as a capstone to this year's effort.

The potential sponsors of such a conference should reach a consensus of how to organize it, especially by inclusion of the various organizations representing state governors and regulators, and perhaps some selected specific state representatives that are in position to significantly impact state policy. The most critical aspect of this entire approach is getting a really good picture of the local situations such as what really happened in Maple Heights (see September 2 NY Times story and why.

The best way to get answers to such questions is through research in the local market. That is best done by selecting a series of local markets representing different situations. More is presented on this approach in the discussion of some ideas on such a conference that follows.

Since some states have already taken action in addressing the subprime crisis and are in the process of enhancing their program, and others are ready to start making choices, it will be useful to explore the best practice from what is already known, and thought to be known and to develop some additional ideas for demonstrative testing. The salient aspect of this approach is that a comprehensive strategy will be developed for the particular state in which a selected local market is researched on its subprime issue and the housing market debacle along with the undesired consequences.

Strategies will vary by state, and representatives of the state being studied will be on the team recommending the strategy, but commonalities will exist in states with high recent house price increases partially fueled by teaser rate loans and subprime mortgages. They may be areas of historic strong growth and substantial excess inventory of foreclosed homes.

At the other end of the spectrum are those states in low growth areas in which the market has been weak in recent years. However, subprime mortgages to lower income residents who are approaching interest rate and payment resets bear exceptionally high risk of foreclosure.

The series of analyses for this approach requires that mortgage loans in the local market being studied to be disaggregated to reveal sub-classifications that may involve different treatment. For example, classifications might include primary residences acquired with subprime loans, primary residences refinanced with subprime loan teaser rates, second homes, rental houses. Additionally, identification of location concentrations of the loans is of importance as is the date upon which the reset is scheduled.

Further data required includes the number of foreclosed properties available on the market, the number of homes in foreclosure, the number of mortgages in default, and the number of loans not apparently in a revealed problem.

There are two different types of problems, but related. The first relates to relief for individual borrowers on the basis of the category of their situation. For example, homeowners who finance or refinance based upon misrepresentation of the character of the loan and who will not be able to afford reset rate and payment, eventually leading to foreclosure without some intervention. At the other extreme is an owner/speculator who too took a teaser rate with knowledge of the risks but now finds the value of the home less than the mortgage. There are other categories. The workshop approach can develop the categories and make recommendations on qualification for relief. Inclusion in a relief category may vary by state depending on where in the range of liberal-conservative spectrum of values the state reps see as appropriate, or the realpolitiks of the situation.

The other problem is a locational problem in which there is a potential cascading of prices because the market reaches the tipping point.

This analysis focuses on a submarket in which foreclosed homes and homes that are in high risk of foreclosure could add enough to the supply of available product that price declines could accelerate. For the resale market, data such as average time on the market as well as price changes are important. If the area has substantial new construction, additional data are required, for example, unsold inventory and housing under construction.

The market analysis for local areas needs to forecast two closely related items. One is price trend (how much longer will the price decline continue and how low will prices go). The second deals with researching how long would it take to absorb the existing inventory, and how long to return to some specific previous price.

This information is relevant to the construction of models relative to the decision to foreclose or to renegotiate the mortgage (and to what level). On a microscopic basis it is a decision on how to play the suit rather than the hand, to use a bridge analogy. Lenders have models on how to play the suit. What they probably don't have is models that reflect aggregate analyses of other lenders making decisions. The classic London Commons example indicates the necessity for such an analysis and measures to assure appropriate action. Such measures may be discussed in the workshop that considers the options for providing the relief and/or the strategy workshop.

On the other side of the table, the borrowers have their intuitive models of what will pay for them. Sophistication varies, as does motivation. But, the playing field is not level. There may be options to provide borrowers with better information.

The really tough question is when would a tipping point be reached. Experience with racial integration in neighborhoods may be useful. But, some educated guessing may be necessary in order to safely avert a cascading of default.

The Hoyt website, http://www.hoyt.org/subprime/index.html contains more information.