

## Chapter 5: The Request for Proposal Story

The request for proposal story is built upon a vision that started with what the thinking at HHI was as to what the research program should address, but progressed to what the Subprime Crisis Research Council thinking was, particularly after a symposium held in January. The problems with the feasibility of some of the early thinking were discussed in the preceding chapter. This chapter shows what unfolded.

### The Initial Draft of an RFP

Preparatory to the symposium a request for proposal (RFP) transmission memo was sent to the Steering Committee Co-chairs & selected HHI board members. Here is the transmission and the draft.

Dear Colleagues,

Several recent newspaper reports have further raised my concern that the players in the subprime fiasco are short in understanding the gravity of the current situation and have not been applying strategies that provide forecasts of outcomes close enough to reality to stem the tide of the destruction of asset values, especially homes. Stemming that tide is critical to avoiding a severe recession or worse.

Since the Homer Hoyt Institute is an organization dedicated to developing and disseminating the body of knowledge in real estate and closely related areas, and is not and has no intention of becoming a lobbying group, it is imperative that we focus on asking the right questions rather than advocating what some of us might see as the right answers. By fostering the most relevant research the players in the subprime debacle may get the joy of discovery that the outcomes can be improved with the enhanced understanding of how the system works.

Our original plan was for us to design the research agenda and invite selected researchers to do specific projects. The research strategy is built upon a triage approach to stemming the tide in local housing markets. Thus far, we have no one committed to the research in the level of detail that I believe necessary to get good enough forecasts of outcomes to justify interventions to a broad spectrum of concerned parties. In order to deal with that situation, I have drafted a request for proposal (RFP) document that is more detailed than my earlier comments.

Since that research is complex, I have broken it down to components doable by different researchers. Additionally, while I was at it, I took note of the other areas of research that are appropriately included in the package. Obviously, we do not have enough funding for all of it. But we will do what we can within the budget that we have and try to get others to join in to expand the research project selection.

The triage workshops with state agencies are one such effort. It would be good to get an update on whether the governor's association received approval from FNMA for using their grant for that purpose. Also, it would be good to get an update on Patrice McCoy's project. My knowledge of law, such as it is, is not strong enough to be confident that the drafting of the issues is sufficiently accurate for our purposes. Perhaps Susan will ask Pat to take a look at that section.

As I've written elsewhere, "The strategic process does well to consider the following: location, timing, balance, leverage, control, vision and relationships.<sup>1</sup>" The Subprime Research Program strategy, and hopefully that of the Subprime Research Consortium, is to, within the allotted year, working with our relationships, share the research vision, leveraging through these relationships the development of a research program balanced to match the timing of the crisis. The reward we seek is that the decision makers (players) will with the enhanced knowledge improve their decision making.

Earlier memos have noted that there is a commonality of research items for the strategy pursued by different players. We are hoping to have selected the components most critical to better decision making. In order to enhance that performance, it would be helpful to better understand their strategies. Since they are not likely to spell it out for us, we need to infer it. That is discussed in the draft. While comment is requested on the entire draft, counsel is needed on how and who might do well at tracking players' strategies.

P.S. The series of newspaper stories that further raised my concern, starting from Saturday, was as follows: Saturday, NYT, "Slowing Growth in Jobs Seen as Ominous Sign for Economy; Saturday/Sunday WSJ, "Evidence Grows that Consumers are Pulling Back," November Job Reports Brings Little Cheer," and "Are Plan's Critics Also Investors?" and a piece about failed regulation on overpricing securities (buried somewhere in the stack). Then today's WSJ "UBS's Subprime Hit Deepens Credit Worries." Then, a story in the local paper today headlined "Fed set to lower rates today," that I suppose might be encouraging in that they are getting more worried.

P.P.S. Since people tend to see information in their own paradigm, the draft will be interpreted differently – probably in people seeing what they want to see. That ambiguity is okay in that it enlists support. In editing, we want to stay away from advocacy of specific policies and focus on understanding the system. We will rely on the power of knowledge and let others use it in resolving their differences.

### **Request for Proposals – INITIAL DRAFT December 11, 2007**

**THIS DRAFT IS INTENDED ONLY FOR COMMENT BY THE RESEARCH TEAM**

The Homer Hoyt Institute has allocated \$100,000 for research and related support activities to assist in forecasting outcomes of various strategies of those involved in the subprime mortgage crisis. The effort started with the research roundtable reported in the most recent issue of the ASI/HF newsletter. Information is on the Hoyt website, [www.hoyt.org](http://www.hoyt.org)

The January session of the Weimer School will have an afternoon devoted to a forum that will discuss research components underway and additional research contemplated. The highest priority is for a prototype model that forecasts turning points in local market house price declines; and, identifies properties that would become foreclosures because of subprime mortgages, and thereby add to an excess supply of inventory on the market. The idea is that by identification of those submarkets that are most vulnerable to a cascading of house prices, assistance may be directed on triage basis.

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<sup>1</sup> See "Strategy in Bridge, Real Estate, and Life."

The focus is on reducing the excessive destruction of wealth that will reverberate to hardships in the economy affecting people not directly involved in the subprime mortgage fiasco. The concern extends to those who were direct victims of predatory lending as part of the endeavor to seek justice. Although the short term is the primary concern, the research extends to long term issues of institutional structure, including regulation, which would improve the performance of markets, is serving societal functions.

#### The Market Model

The latest industry plan, sparked by Treasury discussions with a coalition of mortgage-industry participants, focuses on about twenty percent of the subprime mortgages due for resetting in the near term. The selection is based upon the likelihood that foreclosure is the alternative. Keeping those houses off the market is a step in the right direction, but may not be sufficient to stave off a cascading of housing prices and deleterious effects to the economy as a whole in the form of a recession or worse. The focus of that program is the specific short term interests of the mortgage holders rather than that of pursuing justice appropriate to the situation.

This request for proposals divides the comprehensive model into component models to make the overall effort more doable. The result anticipated is a team effort with separate projects being funded individually.

The prototype model will be applied to numerous areas. Some of the areas are in states that had rapidly rising prices, e.g., California, Arizona, Nevada, and Florida. Others are in the rust belt. Third group is in the northeast. One or more metro areas may be selected for development of the prototype. The top candidate is Cleveland because of the Maple Heights case and Ohio's governmental actions.

The start is the easiest part. It is a model for forecasting dwelling unit demand over the next five years. That forecast provides a time series of disaggregated demand by submarkets including tenure, type of housing, price categories, and delineated geographical areas reflecting major submarket competitive areas. A fine tuning may not be the easiest part of the whole project, but the data for communities such as Maple Heights where a cascading caused movement from the area even though there was no problem with the mortgage. The idea is to focus on those areas that have a large percentage of subprime mortgages that are candidates for foreclosure or otherwise adding to an excess supply.

The second blade of the scissors is a supply forecast. That supply starts with an existing stock, some of which contains households. Additions to the stock through construction and conversion are to be considered in the time series as are deductions from conversions and demolitions. The occupancy by households is a starting point in calculating vacancy, but occupied units on the market also count as available supply. Some amount of available supply is necessary to deal with friction in the marketplace. The objective of the study of this blade is to come up with an excess inventory figure by submarket with some description of the submarket character. This excess supply needs to be presented in a time series. The character of the excess supply in the submarket of a high percentage of subprime mortgages is of concern as to greater detail than the character of areas of lesser exposure to risk in the remaining metro area.

The cut of the scissors is obviously price. The two models then need to be integrated in order to reflect the price trend as a price series. The objective of this model

is to forecast prices in the absence of any jolt from an excessive supply generated by excessive foreclosures occasioned by reset interest rates and mortgage payments. The key to this model is the time necessary to work off the excess inventory. That will indicate the turning point.

Some of this may be done by judgmental models, but econometric models might be used if there are enough historical patterns. The next component model is built from scratch. It starts with an identification of the subprime mortgages in the submarket, those with reset dates, and other variable rate mortgages. The idea is to identify the quantity and time pattern of properties that would come on the market because of financing.

The identification of that quantity and time pattern will depend on three sets of variables. One is the ability of the home owners to continue to own with changed interest costs and payments. The second is the market prices which comparable property is bringing. The third is the attitudinal situation of the homeowners in willingness to stay assuming that they could handle the increased interest and payments. This speaks to those who have the described mortgages. There are others in the neighborhood, who seeing prices decline, boarded up houses, and other undesirable conditions, decide that their equity (if any) doesn't make it worth staying in the house. They may sell to recover what they can, or abandon the house.

This far, the discussion has focused on the owner occupied housing unit. Some of the subprime finance properties are by investors or speculators. In the case of rapidly rising prices the 2/28 or 3/27 loans were taken with no intention of holding beyond the reset date; a resale being the plan. In some instances, a stretch in the time may make the investment worthwhile, but in others there is no hope. This is a great introduction to some related issues of a moral nature, especially on how to keep the house off the market.

An even tougher case of keeping the house off the market is where the financing was so attractive that the alleged homeowner bought the house knowing that it was well beyond their means, but the occupancy cost was less than renting comparable accommodations.

One these models are integrated into a single model, variations in assumptions as to foreclosures, resulting prices, and turning points, will indicate adjustments to existing strategies of players. These players obviously include the lenders and borrowers. It is also obvious that government is concerned on a number of counts.

Justice and the Law

Legislation, regulation, law enforcement, and the courts are intended to provide justice. Sometimes industry self regulates through its trade and professional associations and sometimes business enterprises self regulate with an eye toward long term interests. The system is less than perfect and so the abuses cause reactions in which the pendulum swings too far in the opposite direction. Research is needed to better forecast outcomes of different policies and players would be wise to consider revision of strategies in order to mitigate swings of the pendulum.

What went wrong? A brief treatment of market and regulatory failure will serve as a good backdrop to the tough issues. The newspapers abound with tales of industry predatory lending. There are even stories of regulatory shortfall, including the pricing of securitized mortgage interests.

This may be the easiest area in which to produce some results, and while useful it is not the most critical topic for doing something about the triage problem in the current crisis.

Who gets protected? A major protection for investors is in the code for protection of “holders in due course.” The holders in due course legal practice protects an investor who in good faith acquires a debt instrument from another party rather than originating it. Thus, while a defrauded party has recourse to an originator, the defrauded party is estopped by the holder in due course code from remedies against the holder in due course. Thus, a mortgage borrower is denied a remedy of stopping foreclosure even when he or she has been defrauded.

Relief for the borrower would undermine the system, but may be justice under the circumstances. Court actions in Ohio have defacto given relief in tightening the foreclosure processes. It is uncertain where all this will go. Some research needs to be done to see how society’s costs and benefits are balanced as well as how there is justice to the parties involved. There may be incommensurate values involved. Issues of equity, due diligence, and innocent parties should be considered.

Is bankruptcy being properly handled? The usual way in which creditors are treated under some bankruptcy procedures is to permit the court to cram down the creditors’ interest. That is, the asset is devalued by the court in order to arrive at a solution that makes sense for the parties concerned. It is not voluntary on the part of the asset holder, although there are cases where the creditors negotiate a voluntary agreement rather than relying on the results of bankruptcy.

Real estate mortgages are exempt from this cram down procedure under bankruptcy practices. States may change their bankruptcy laws and might do so in order to avoid the disastrous effects of the fallout from excessive loss in value from the housing debacle as well as a matter of justice to the homeowner who was defrauded by predatory lending.

This may be uncharted territory, but should be investigated through research. Once some states break the pattern, others may follow with the result that the whole mortgage industry undergoes dramatic change and the cost of mortgage money rises and home ownership declines.

How are costs and benefits treated? Institutional changes will be made to get a better system of market operation in the mortgage and housing markets. There will be cost/benefits analysis, but those who bear the costs may not be the same as those who reap the benefits. Reparations may be considered in the societal approach so that short term solutions may be justified that are not good long term solutions. Some research needs to be done on how the overall system can be better balanced.

#### Strategic Approach

Various players have been operating with strategies that do not appear to be in their long run interest or that of their constituents in business and government. The request for proposals is designed to elicit research that would enhance the forecasting of outcomes. The parties involved in the strategy determine their own strategy, but many could benefit from better understanding of outcomes through the proposed research.

In order to develop a comprehensive research program it would be useful to have a clear statement of the strategy being pursued by the relevant parties. Getting them to provide it is not likely. Therefore, the best approach appears to be to examine what they

do and what they don't do and infer from that what they are likely to be thinking as a strategy. That is not likely to be accurate, but it will be close enough to identify most issues relevant to what would be a good strategy.

The research program has planned that the final group meeting, ending the research program officially launched with the research roundtable, will provide a discussion of imputed strategies. The players whose strategies are being inferred may be present and make their own presentations, if they wish. The key is that the most relevant research, with results, will be on the table for all to see.

The proposals requested are to provide descriptions of what appears to be strategies being pursued by players.

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### **Some More of the Early Stuff**

The story continues with a memo to the leadership of SCRC and HHI.

Colleagues,

The weekend edition of the WSJ, 1/15/07, carried a front page story, "In Capital, Steps Weighed to Fix Mortgage Mess." [see box] Attached please find excerpts that I faxed to Ron Racster on Monday (not wanting to disturb his weekend).

In Capital, Steps Weighed to Fix Mortgage Mess

Some Draw Inspiration From Depression Era; The Do-Nothing Option

By MICHAEL M. PHILLIPS, JAMES R. HAGERTY and GREG IP

December 15, 2007; Page A1

Washington's leaders have been pushing many policy buttons to stem the worsening housing and credit crisis. They've yet to find the off button, however, and that's prompting a search for more-aggressive solutions.

This week's decision by Citigroup Inc. to bail out seven investment entities and bring \$49 billion in assets onto its balance sheet effectively killed one of the centerpieces of the Bush administration's approach. Treasury Secretary Henry Paulson has pushed a giant rescue plan for off-the-books funds saddled with mortgage-backed debt, but banks have mostly done the painful work themselves.

Some other policy moves are getting under way, including a plan to freeze interest rates for some subprime mortgage borrowers and the Federal Reserve's move to offer banks special funding at lower-than-usual rates so they can lend more. The Fed has cut its key short-term rate by a full percentage point since August, and markets expect it to continue.

Still, if those steps fail to calm homeowners and markets, as some investors expect, debate is likely to grow about what levers remain. Some with an interventionist bent are raising proposals amounting to federal bailouts for homeowners facing foreclosure and the revival of New Deal-era programs. Earlier this month, the Mortgage Bankers Association said home foreclosures in the third quarter hit their highest rate since at least 1972.

"There needs to be a bias towards activism," said Lawrence Summers, secretary of the Treasury under President Clinton, in an interview. "Policy has been behind the curve for months now. The dangers of doing too little are much greater than the dangers of doing too much in this context."

Others on the conservative or libertarian side say the best move may be to do nothing. They contend the government must be careful about anything that props up home prices because it would delay the point at which investors -- in both real estate and mortgage-backed securities...

The WSJ article is such a relevant piece that I sent Ron a transmittal memo and numerous additional attachments. Included was a revised draft of the request for

proposals dated December 15 (the earlier one sent to some of you was dated December 11). The following is a copy of the transmittal memo.

**Cooperative Effort of HF & M<sub>s</sub>ASI      December 15, 2007**

Hi Ron,

This morning's WSJ had a front page story that reaffirmed my belief that we need to develop an analysis of the policies of the various players and infer their strategy. Attached is a copy of an excerpt from that WSJ story.

Our strategy is to identify the most relevant research needs based upon what we see as the best comprehensive strategy, considering what we believe to be the strategy being pursued by the various players, and to provide the research in components that they could use to reconsider their strategies. Our reliance is on their using reason in forecasting outcomes. There isn't much that we can do about emotion and politics except as behavioral economists I suppose we could apply a minimax strategy, i.e., we could allow for the chance that fear would drive the housing price fall into a panic and include that in the analysis, so for example, the downward price spiral was stopped or slowed before it reached an equilibrium price level, but at least it wouldn't overshoot the equilibrium point. Any equilibrium point is short lived because pressure for rise will resume and if there is a gap it will change in time. The key to the strategy is to avoid the cascading.

Inferring someone else's strategy is no small task and is subject to the analysts predispositions. The process starts with identifying policies as well as pronouncements. It is helped by interviews or informal discussions. Once the information is assembled it is probably better to have a number of analysts make the interpretation. People are selective in the information that they choose to process. That applies to both gathering info on policies and inferring strategies.

The great thought that occurred to me (well it may not be great – the last one with that label didn't fly) was that this is a superb opportunity to get a combined effort of the Hoyt Fellows and Weimer School Fellows.

If you like that idea, it might best be pursued after the bulk mailing of the newsletter has been received by the fellows. In any event, I have attached a proposed revised RFP.

Maury

I waited until Wednesday to phone him. There were 16 pages in total. Some of you received a copy of his written response that followed our discussion. As a result of that, I have prepared the following, which is also sent as an attachment because the e-mail loses the format.

Maury

**Research Agenda Discussion Draft of December 20, 2007**

This research agenda discussion draft has two purposes. One is as an input to the Friday afternoon forum at the Weimer School. The other is as an input to the development of requests for research proposals (RFPs).

The agenda might be divided into four major parts reflecting a logical organization of thought in the development of a research program. Since funding is limited, the priority of funding will influence the sequence of RFPs. Additionally, the

discussion at the Friday forum will focus on issues selected as examples for inputs from the Weimer School Fellows.

The overview of topics, in outline form, is as follows:...

That document underwent further revisions. In order to save space, here is the revised copy:

Subprime Research Program Agenda:  
Ron's Draft Revised by Maury on January 8, 2008

The Homer Hoyt Institute (HHI) is ahead of the curve in the search for knowledge that would aid in averting, or at least diminishing, the severity of a recession springing from the subprime debacle. The NY Times reported on January 8 in two articles that the Democrats and Republicans were looking at different approaches to dealing with the recession that appears to be on the horizon. The Wall Street Journal, on the same day, reported that Secretary Paulson in advocating additional relief for homeowners threatened with foreclosure through adjustable rates noted "It will take additional time for markets to regain confidence. We will likely have further indications of slower growth in the weeks ahead. The overhang of unsold houses will contribute to a prolonged adjustment, and poses by far the biggest downside risk."

Over the past few months the Homer Hoyt Institute has been pursuing the theme of research to identify concentrations of such high risk loans and pursuing justice in order to avoid a cascading of house prices triggered by excessive foreclosures. HHI now has an allocation of \$125,000, of which \$25,000 is a grant from Freddie Mac, to fund the research program effort. Additional support is contemplated from other interested parties.

The thrust of the research program is to gain knowledge of likely outcomes of different actions that may be contemplated by various parties to the subprime debacle. These parties include states and various federal authorities as well as the parties to the mortgage contracts.

HHI is currently seeking expressions of interest and proposals from researchers interested in pursuing topics within the broad agenda described in this communication. The budgetary allocation for this stage is \$50,000 to cover an undetermined number of high priority projects.

An overview of a research agenda is provided in the discussion that follows.

Research Agenda Overview

The research agenda is divided into five major parts reflecting a logical organization of thought in the development of a research program. Since funding is limited, the sequence of grants and contracts will be prioritized. Some of the research, especially the literature review and the data availability study has already been completed and was funded out of the first \$50,000 that included an allocation for publishing research results in two separate professional journals as well as cost for cosponsoring a series of meetings.

In order to provide a big picture context, an overview of topics is provided in outline form.

- I. Research Support Information
  - A. Literature review
  - B. Subprime mortgage information survey



1. Location of loans
  2. Classification of reset, option loans, and other
  3. Classification of originator held, securitized, SIV
  4. Dates for reset
  5. Originators, servicers, and servicer authority
- C. Other data availability survey
  - D. Summary of selected proposals for remediation
  - E. Summary of industry and other research efforts underway

## **II. Market Model Development**

- A. Selection of pilot areas for prototype model development
- B. Classification of mortgage borrowers in study area with site location
- C. Housing market forecasts by sub-area without added supply of foreclosed resets
- D. Housing market forecasts by sub-area with added supply of foreclosed resets
- E. Selections for foreclosure avoidance sufficient to avoid cascading of prices

## **III. Justice and the Law: Impediments and Tools**

- A. Holder in due course code
- B. Mortgage exemption from bankruptcy cram down
- C. Federal income tax treatment on forgiven mortgage debt
- D. Criminal investigations
- E. Prioritizing and determining depth of assistance
- F. Tools and self regulation of industry

## **IV. Feasibility of Mortgage Modifications**

- A. Designing a Best Practice for Servicer Authority
- B. Designing Models of Default, Foreclosure, and Modification Impact
  1. Pool as a Whole
  2. By Tranch
  3. By Pool Subset Buying out Senior Interests in Order to Modify
  4. By Risk of Cascading Effects
  5. By Risk of Draconian Regulation
- C. Feasibility of Association Leadership in Generating Best Practices by Members

## **V. Forecasting Outcomes of Strategies being Pursued**

- A. Lenders and servicers
- B. Federal regulators
- C. State regulators
- D. Consumer organizations
- E. Exploring options as variations of the proposal of the Center for American Progress.

Comments on the proposed research agenda are invited from all parties affected by the subprime crisis, from Weimer School Fellows, Hoyt Fellows, and government agencies. Comments on the development of specific research projects in support of the

program can be made as “pre-proposals” for consideration for funding by the Program Coordinators and the Steering Committee.

While the above framework is useful to get the big picture, it is necessary to develop a work plan that places the potential projects in context and prioritizes the research effort.

#### The Approach to the Problem

HHI is a (501) c (3) dedicated to developing and disseminating real estate related research as a means of improving the quality of decisions. HHI is not a lobbyist, and will not engage in lobbying.

Our strategy is to identify the most relevant research needs and to provide the research in components that the various players could use to evaluate their actions. We can visualize a critical path that prioritizes the research. It is based on avoidance of a freefall in house prices and disastrous side effects as the top priority, but simultaneously explores a variety of parallel issues.

#### Critical Path or Flow Chart for Project Selection

**The first research stream** in the critical path is item II, **Market Model Development**. The first item, (II (A)) “Selection of pilot areas for prototype model development,” could be picked judgmentally or statistically by taking the highest ranked areas according to concentration of loans. One possibility is an output from Vanessa Perry’s study as to the location of subprimes with resets due in the next couple/few years. A prototype model will be sought that can be applied to numerous areas as funding permits. Some of the areas would be in states that had rapidly rising prices, e.g., California Arizona, Nevada and Florida. Others would be in the rust belt. A third group would be in the northeast. The objective of this model is to forecast prices in the absence of any jolt from an excessive supply generated by excessive foreclosures occasioned by reset interest rates and mortgage payments. The key to this model is the time necessary to work off the excess inventory, which will indicate the turning point. One or more metro areas may be selected for development of the prototype. The next item, (II (B)) “classification of mortgage borrowers in study area with site location,” probably requires surveying the borrowers with a questionnaire or interview, unless there is a surprisingly detailed source of data available. A parallel study would be to develop a classification system for mortgage borrowers and the criteria for classification. Visualize a classification system as a three dimensional matrix. One dimension is owner occupants or investors. For each of these categories there are two more dimensions. One is financial. On the financial dimensions there are the classifications of extent of equity (positive, negative, or approximately nil), ability to afford a reset, ability to afford a refinance, ability to continue on current teaser rate, no ability to continue equity position with any reasonable financing. The other dimension is non-financial, including the classifications of naiveté of not seeking an understanding of the terms, acceptance of poor advice on loan term selection where the advice was generated by the agents self interest in escalating commissions for higher spread mortgages, misrepresentation, and fraud. Two additional classifications are emotional commitment to the property, especially in refinanced situations, and intent as speculation (may be the case for owner occupants as well as investors).

A simpler system might be used. But even if a complex system is used not all of the boxes need to be tallied and arrayed by priority. A grouping system might be

something more than a few groups arrayed in a priority of not needing help, helpable, and not deserving of help. Within the helpable there may be categories of legal help because of violations of the law when the mortgage was created and financial help in transforming an unworkable contract to a workable arrangement.

The application of such a classification system on a nationwide basis would take a different form than its application in a triage system. The triage system selects the high risk locations and goes after the most readily averted foreclosure. The priority for Consortium funding is getting a first cut at a workable system, considering more than one set of underlying values, and applying it to the pilot areas.

The Second Research Stream. Simultaneous with this Market Model Development is the exploration of tools, as a second stream, which brings us to the third section (III), “**Justice and the Law: Impediments and Tools.**” Illinois has started on criminal proceedings and Ohio has used judicial requirements in foreclosure more strict than some other states. The Colorado Attorney General has started an investigation of option arm practices. Precedents in personal property law are not the same as precedents in real property law as with use of a borrowed car to commit a crime. Foreclosure is a state regulated procedure and subject to change. Thus, areas selected for triage may get regulatory changes that make term revisions a lot more attractive to lenders. The experts’ workshop being planned with the National Governors Association is looking to find best practices for states which would be included in this second stream. Essentially, this is an exploration of what might emerge in some states in order to deal with the crisis in that state. This should be supplemented by comparable analyses at the federal government level.

The Third Research Stream. A third stream (IV), feasibility of mortgage modifications, is dependent on progress in the second stream (Classification System) and may be heavily influenced by what is learned in the third (The Exploration of Tools). The participants in the mortgage industry may seek to avoid the draconian regulation that would cripple the industry even after the subprime crisis is over.

The Fourth Research Stream. The fourth stream (V), forecasting outcomes of selected strategies, can start with the earliest streams but will run longer. It is an interdependent situation because strategies pursued by one classification may influence strategies of the other classifications.

#### Modifications

Based upon comments received from earlier drafts of the preceding approach, an alternative approach is under consideration. The alternative is summarized in the following discussion.

The two major sets of projects are related to (1) preventing an excessive spillover of house price declines to deepen and prolong a recession and (2) developing institutional changes that deal with the market operation, including remedial action for victims of predatory lending.

As to the first, so far we have been exploring the feasibility of local market analyses using traditional judgmental models and/or econometric models. It seems that the judgmental models could produce greater detail but with less rigor with the risk of lesser acceptance of validity of forecast of outcomes. The econometric models, while seemingly more rigorous, will probably not be capable of the level of detail that will pinpoint the priorities for triage action.

No decision has been made as to accepting either of the preceding options except that feasibility of both will continue to be explored. Comments on both and additional pre-proposals and/or proposal concepts are solicited.

An alternative approach, not mutually exclusive, is to start with the lenders rather than the locations. In the location approach, once the pilot locations are selected the process looks at all subprime loans in the study area scheduled to reset within three years and seeks to identify those in which intervention would reduce the excess supply of houses on the market. The intent there is to by forecasting the timing of turning points, with and without intervention; the benefits may be assessed as input to the choices of intervention. Such intervention may be by specific loan renegotiation or general regulatory changes, or some combination.

In starting with the subprime loans, the process is to select some number of the eight originating organizations that led the subprime loan business and identify the geographical locations of the subprime loans that are scheduled to reset within three years. For the selected organizations the locational clusters will be ranked to obtain a number of leading concentrations in terms of subprime loans as a percentage of total loans in the submarket. Those clusters of loans will be the focus of the next step.

If there is evidence of danger to the market in the form of potential cascading of prices beyond what has already occurred, then the first option of forecasting turning points needs to be added. If, however, the danger is sufficiently assessed without that analysis, or the pursuit of justice is sufficient, then the next step is remediation of some sort.

Remediation can come in two forms; one is individual action, while the other is regulatory action. Both options speak to tools.

If there has been fraud or misrepresentation, the classic remedies are in law suits, individual or class action. Where such violations of the law occurred, there are likely to be clusters because the perpetrators are likely to have had multiple victims in clustered locations. There are two problems with remedial action. The first is that we are not in the business of providing legal representation and are not interested in expanding the beyond provision of research.

That first problem is easily handled by distributing the results of the research to appropriate parties. Determination of what would be appropriate is an open question. The range of options run from sharing the information with the perpetrators peers, possibly the trade organizations, to the attorneys general of the relevant state governments. In either case, this brings us to the second problem.

The second problem is that because of the code of “holder in due course,” the remedy is limited to the perpetrators leaving the investors who purchased slices of the mortgage immune from restitution liability. In some cases the originating organization has gone out of business; besides criminal action against the perpetrators without resources, companies or agents, does not deal with the problem of cascading house prices.

The two presenters in the co-sponsored research roundtable that were selected to give a range of views of the subprime crisis problem agreed on a couple of long term changes in regulation. Their agreement, as reported in the ASI/HF newsletter, is as follows: “Both Professor McCoy and Dr. Guttentag recommended amending the Truth in Lending Act (TILA) and the Real Estate Settlement Procedures Act (RESPA) so that

borrowers would understand the terms of their loans before they made a commitment, and lenders would make firm offers, including rate locks.” Both of these fall into the long term changes and are not a high priority for the next stage of our research agenda.

The high priorities dealing with this issue of insulation from remedies may fall into two areas. One is varying the “holder in due course” code; and the other is offsetting it by impediments to collecting on the debt through foreclosure.

The first of changing the code would have severe long term effects on the securitization industry and not provide a short term remedy. The second was already implemented in a form by the judiciary in Ohio requiring documentation by slice owners, difficult to obtain because of the way the securitized mortgages are packaged and information kept. The states could go even farther because they control the foreclosure process. Of course, draconian regulation will cut off future funding of mortgages, but the states may be willing to worry about that later.

We do not have a complete list of potential institutional changes from which to select research projects. Building a list is worthwhile. It would include accounting and tax issues in mortgage write downs and changes in cram down limitations on mortgages under foreclosure situations.

It makes a lot of sense for industry to be part of the process of framing these research issues and possibly moving toward self regulation. The process may get some relief for the victims and avert a further excess supply of houses coming on the market through foreclosure. In any event, here are some thoughts on developing the next stage of the research agenda. Your inputs are earnestly solicited. They may be routed through the co-chairs (Susan and John), through our grants chairman (Hal), or sent to me, or whatever you wish.

#### In Summary

The research agenda is in the process of being developed. Research contracts/grants will be made on those projects that fit into the priority system based on extent of funding available. Further information on the priority of projects is in the discussion that follows.

Comments are requested on the research agenda and interested researchers are invited to indicate areas in which they would like to submit proposals. Sole source grants/contracts will be considered as well as competitive proposals.

The intent is to develop the most effective research program within budgetary constraints that are expected to expand during the year through industry and/or government support.

A literature search has been completed, but might be updated. It is on the Hoyt website. A survey of available data is now available in draft form and will shortly be posted on the Hoyt website.

The effort started with the research roundtable reported in the most recent issue of the ASI/HF newsletter. Information is on the Hoyt website, [www.hoyt.org](http://www.hoyt.org). The general plan is discussed in the most recent HF/ASI newsletter. After the roundtable and since the newsletter went to print there has been a modification that added a symposium on the Thursday afternoon preceding the Weimer School January Session.

The January session of the Weimer School will have an afternoon devoted to a forum that will discuss research components underway and additional research contemplated. The highest priority is for a prototype model that forecasts turning points

in local market house price declines; and, identifies properties that would become foreclosures because of subprime mortgages, and thereby add to an excess supply of inventory on the market. The idea is that by identification of those submarkets that are most vulnerable to a cascading of house prices, assistance may be directed on triage basis.

The focus is on reducing the excessive destruction of wealth that will reverberate to hardships in the economy and affects people not directly involved in the subprime mortgage fiasco. The concern extends beyond those who were direct victims of predatory lending. Although the short term is the primary concern, the research extends to long term issues of institutional structure, including regulation, which would improve the performance of markets.

The discussions led to a document prepared for consideration at the January symposium that was essentially an excerpted version. Here it is.

### **Subprime Research Program Agenda**

The Homer Hoyt Institute (HHI) has allocated \$100,000 for research and related support activities to assist in forecasting outcomes of various actions of those involved in the subprime mortgage crisis. That budget has been supplemented by a grant from Freddie Mac of \$25,000 to HHI. We can now plan on \$125,000 and potentially more for the research and related support activities.

An overview of a research agenda is provided below as a prelude to development of proposals for allocation of \$50,000 in research support. Further research will be contingent upon additional funding, which HHI will continue to seek.

Comments on the proposed research agenda are invited from all parties affected by the subprime crisis, from Weimer School Fellows, Hoyt Fellows, and government agencies.

Comments on the development of specific research projects in support of the program can be made as “preproposals” for consideration for funding by the Program Coordinators and the Steering Committee.

#### Research Agenda Overview

The research agenda is divided into five major parts reflecting a logical organization of thought in the development of a research program. Since funding is limited, the sequence of grants and contracts will be prioritized.

In order to provide a big picture context, an overview of topics is provided in outline form.

### **I. Research Support Information**

- A. Literature review
- B. Subprime mortgage information survey
  - 1. Location of loans
  - 2. Classification of reset, option loans, and other
  - 3. Classification of originator held, securitized, SIV
  - 4. Dates for reset
  - 5. Originators, servicers, and servicer authority
- C. Other data availability survey
- D. Summary of selected proposals for remediation

- E. Summary of industry and other research efforts underway

## **II. Market Model Development**

- A. Selection of pilot areas for prototype model development
- B. Classification of mortgage borrowers in study area with site location
- C. Housing market forecasts by sub-area without added supply of foreclosed resets
- D. Housing market forecasts by sub-area with added supply of foreclosed resets
- E. Selections for foreclosure avoidance sufficient to avoid cascading of prices

## **III. Justice and the Law: Impediments and Tools**

- A. Holder in due course code
- B. Mortgage exemption from bankruptcy cram down
- C. Federal income tax treatment on forgiven mortgage debt
- D. Criminal investigations
- E. Prioritizing and determining depth of assistance
- F. Tools and self regulation of industry

## **IV. Feasibility of Mortgage Modifications**

- A. Designing a Best Practice for Servicer Authority
- B. Designing Models of Default, Foreclosure, and Modification Impact
  1. Pool as a Whole
  2. By Tranch
  3. By Pool Subset Buying out Senior Interests in Order to Modify
  4. By Risk of Cascading Effects
  5. By Risk of Draconian Regulation
- C. Feasibility of Association Leadership in Generating Best Practices by Members

## **V. Forecasting Outcomes of Strategies being Pursued**

- A. Lenders and servicers
- B. Federal regulators
- C. State regulators
- D. Consumer organizations
- E. Exploring options as variations of the proposal of the Center for American Progress.

While the above framework is useful to get the big picture, it is necessary to develop a work plan that places the potential projects in context and prioritizes the research effort.

### The Approach to the Problem

HHI is a (501) c (3) dedicated to developing and disseminating real estate related research as a means of improving the quality of decisions. HHI is not a lobbyist, and will not engage in lobbying.

Our strategy is to identify the most relevant research needs and to provide the research in components that the various players could use to evaluate their actions. We can visualize a critical path that prioritizes the research. It is based on avoidance of a freefall in house prices and disastrous side effects as the top priority, but simultaneously explores a variety of parallel issues.

### Critical Path or Flow Chart for Project Selection

#### The first research stream in the critical path is item II, **Market Model**

**Development.** The first item, (II (A)) “Selection of pilot areas for prototype model development,” could be picked judgmentally or statistically by taking the highest ranked areas according to concentration of loans. One possibility is an output from Vanessa Perry’s study as to the location of subprimes with resets due in the next couple/few years. A prototype model will be sought that can be applied to numerous areas as funding permits. Some of the areas would be in states that had rapidly rising prices, e.g., California Arizona, Nevada and Florida. Others would be in the rust belt. A third group would be in the northeast. The objective of this model is to forecast prices in the absence of any jolt from an excessive supply generated by excessive foreclosures occasioned by reset interest rates and mortgage payments. The key to this model is the time necessary to work off the excess inventory, which will indicate the turning point. One or more metro areas may be selected for development of the prototype. The next item, (II (B)) “classification of mortgage borrowers in study area with site location,” probably requires surveying the borrowers with a questionnaire or interview, unless there is a surprisingly detailed source of data available. A parallel study would be to develop a classification system for mortgage borrowers and the criteria for classification. Visualize a classification system as a three dimensional matrix. One dimension is owner occupants or investors. For each of these categories there are two more dimensions. One is financial. On the financial dimensions there are the classifications of extent of equity (positive, negative, or approximately nil), ability to afford a reset, ability to afford a refinance, ability to continue on current teaser rate, no ability to continue equity position with any reasonable financing. The other dimension is non-financial, including the classifications of naiveté of not seeking an understanding of the terms, acceptance of poor advice on loan term selection where the advice was generated by the agents self interest in escalating commissions for higher spread mortgages, misrepresentation, and fraud. Two additional classifications are emotional commitment to the property, especially in refinanced situations, and intent as speculation (may be the case for owner occupants as well as investors).

A simpler system might be used. But even if a complex system is used not all of the boxes need to be tallied and arrayed by priority. A grouping system might be something more than a few groups arrayed in a priority of not needing help, helpable, and not deserving of help. Within the helpable there may be categories of legal help because of violations of the law when the mortgage was created and financial help in transforming an unworkable contract to a workable arrangement.

The application of such a classification system on a nationwide basis would take a different form than its application in a triage system. The triage system selects the high risk locations and goes after the most readily averted foreclosure. The priority for Consortium funding is getting a first cut at a workable system, considering more than one set of underlying values, and applying it to the pilot areas.

The Second Research Stream. Simultaneous with this Market Model Development is the exploration of tools, as a second stream, which brings us to the third section (III), “**Justice and the Law: Impediments and Tools.**” Illinois has started on criminal proceedings and Ohio has used judicial requirements in foreclosure more strict than some other states. The Colorado Attorney General has started an investigation of



option arm practices. Precedents in personal property law are not the same as precedents in real property law as with use of a borrowed car to commit a crime. Foreclosure is a state regulated procedure and subject to change. Thus, areas selected for triage may get regulatory changes that make term revisions a lot more attractive to lenders. The experts' workshop being planned with the National Governors Association is looking to find best practices for states which would be included in this second stream. Essentially, this is an exploration of what might emerge in some states in order to deal with the crisis in that state. This should be supplemented by comparable analyses at the federal government level.

The Third Research Stream. A third stream (IV), feasibility of mortgage modifications, is dependent on progress in the second stream (Classification System) and may be heavily influenced by what is learned in the third (The Exploration of Tools). The participants in the mortgage industry may seek to avoid the draconian regulation that would cripple the industry even after the subprime crisis is over.

The Fourth Research Stream. The fourth stream (V), forecasting outcomes of selected strategies, can start with the earliest streams but will run longer. It is an interdependent situation because strategies pursued by one classification may influence strategies of the other classifications.

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A literature search has been completed, but might be updated. It is on the Hoyt website. A survey of available data is underway and should be available in a timely manner.

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The focus is on reducing the excessive destruction of wealth that will reverberate to hardships in the economy and affects people not directly involved in the subprime mortgage fiasco. The concern extends beyond those who were direct victims of predatory lending. Although the short term is the primary concern, the research extends to long term issues of institutional structure, including regulation, which would improve the performance of markets.

### **The RFP Finalized**

After the symposium the SCRC met and decided on the following RFP:

Request for Proposal  
From the Subprime Mortgage Research Consortium  
Short-term Research regarding the Subprime and Foreclosure Crisis  
Homer Hoyt Institute

The Homer Hoyt Institute invites research proposals on issues relating to the current subprime and foreclosure crisis. The Homer Hoyt Institute is an independent, non-profit research and educational foundation established in 1968 which contributes to improving the quality of public and private real estate decisions. While we welcome any proposal relating to subprime issues, the Institute is particularly interested in the following:

#### Historical Perspectives and Causes of the Problem

- (1) Research on the history of past mortgage crises, with particular attention drawn to the antecedents and policy responses (such as the development of the HOLC and the RTC) to those crises. The vision is to develop a set of lessons learned from this economic history.
- (2) Investigation of the underlying causes of the increase in mortgage defaults. While the media have focused attention on resetting interest rates, various mortgage data have shown that foreclosures are rising for all types of mortgages, and recent books of subprime ARM mortgages are experiencing unusually high defaults before interest rates reset.

#### Policy Proposals and Anticipated Responses

- (3) Research on potential policy responses to the apparent seizure in capital markets with respect to mortgages, including both subprime loans and non-conforming (jumbo) mortgages as well as the potential for developing markets for distressed asset resale.
- (4) Analysis of pending policy proposals to deal with the current sub-prime crises. In particular, the Institute is interested in research that would perform economic analysis of the costs and benefits (both intended and unintended) of legislation proposed in the House, the Senate and the states. Given the urgency of the issues, the Institute will consider proposals whose anticipated deliverable is limited to qualitative results based on rigorous analysis.

#### Economic Analysis and Expected Outcomes

- (5) Analysis of differences in regional mortgage performance outcomes. Housing markets are local, and both the evidence to date and projections for the future indicate that there are wide disparities in subprime foreclosures

across markets. The Institute is interested in analysis of market characteristics that led to geographical variation in the severity of the crisis. We anticipate that the work would involve using micro-data from a select number of markets divided into those with large numbers of defaults and those with small numbers of defaults.

- (6) Analysis of the impact of foreclosures on neighborhood property values. The Institute is particularly interested in work attempting to separate the impact of foreclosures relative to other regional economic activity in determining property values. We anticipate that this work would also involve using micro-data from a select number of markets divided into those with large numbers of defaults and those with small numbers of defaults.

Researchers should be able to communicate to academic, professional and public audiences.

For proposals involving (1)-(4), the Institute is seeking rapid turnaround, so that preliminary findings might be presented at the Homer Hoyt Institute Spring meeting on May 15-18 in North Palm Beach, FL, or the American Real Estate and Urban Economics Association mid-year meeting in Washington, DC on May 27-28, 2008. We envision researchers summarizing their results for broad audiences at some point in the late spring of 2008.

Proposers may submit budgets for between \$3,000 and \$25,000. As total funds are limited to \$75,000 at present the proposed budget size will be one criterion the Institute uses to determine the distribution of funding. If part of the budget is for data, please make this explicit, as the Institute may be able to provide the data itself. Note that we do not support indirect overhead costs.

Investigators interested in pursuing the research described above, or other subprime and foreclosure related research, may submit a proposal, which will include a budget, CVs of investigators, and proposed schedule of deliverables, to:

Research Grant Subcommittee  
Homer Hoyt Institute  
760 US Highway One  
North Palm Beach, Florida 33408  
weimer@hoyt.org

### **The January Symposium**

The best way to describe the development of the January Symposium is to provide excerpts from the invitation letter.

On HHI Letterhead and with enclosure of the newsletter reporting on the research roundtable.

Dear (industry leader to be addressed by name)

The Subprime Consortium (consisting of Homer Hoyt Institute, the Institute for Urban Research at the University of Pennsylvania, the Hudson Institute, and the Institute for Public Policy at George Washington University) is holding a symposium of real estate industry organizations to help in the development of a research agenda that will assist players in the mortgage and housing crisis enhance their strategies. This will be held on Thursday afternoon of January 17, 2008 at the Hoyt Center in West Palm Beach, FL.

Included in this mailing is the latest newsletter, which reports on the Subprime Crisis Research Roundtable recently co-sponsored by the consortium members. Previously, you should have received a copy of the Advanced Studies Institute's Silver Anniversary Commemorative Book, which was sent to you as a means of introducing the Fellows of the Weimer School of Advanced Studies in Real Estate and Land Economics and the Hoyt Fellows. The Weimer School will devote Friday afternoon to reviewing the research agenda in the process of being developed. An indication of your interest in participation in that is hereby requested. The Thursday meeting is focused on developing strategies. The relevant research will flow from strategies rather than what is easiest to get published.

This is a win-win relationship. Your expertise would be of great value as the Subprime consortium develops and modifies its research agenda. At the same time, your relationship with the Homer Hoyt Institute may lead you to conclude that it is your organization's best friend in this crisis. The Thursday afternoon program is in the planning stage. Thus far, we see Mark Zandi (Chief Economist of Moody's Economy.com and one of our Hoyt Fellows) as making the lead presentation – he is in my opinion the brightest light in knowing what is going on. The session will be introduced by Susan Wachter and John Weicher who are leading the effort which is described in the enclosed newsletter...

The purpose of the Thursday symposium is to discuss industry strategies for dealing with the subprime crisis. Real estate organizations are losing membership and income and the players that are still around are calling themselves survivors. My read of the tone of industry association strategies is that they are circling the wagons, at least until the recent discussion with Treasury started. The defensive approach, as far as I can see, is not what many major corporations do when caught with a downturn. Instead of cutting the cat's tail off an inch at a time, they take the whole hit at once and proceed from a new platform. My view is that the industries would do well to look at ways to self regulate to avoid the mismatch in risks and rewards of the institutional structure that got us into this mess.

The Homer Hoyt Institute's game plan is to work with this Subprime Consortium for the year to see what research we can facilitate that will help in better forecasting outcomes of different policies. The academic program is to support some research (some grants having already been made) and to vet a research agenda at the January session of the Weimer School. That will take place Friday afternoon, Jan. 16, 2008. If you are included in the Thursday meeting (and space is limited), you are invited to stay for the Friday session and as much of the Weimer School as you would like to attend. If you request it, we will send you an advanced copy of the agenda. In any event, there is a reception on Thursday night that launches the session of the Weimer School, to which you are invited.

The academic program continues with a plenary session at the American Real Estate Society in April. That will be followed by the May session of the Weimer School, which will present the key research papers on the topic. That will be followed ten days later by presentations at the mid-year meeting of the American Real Estate and Urban Economics Association meetings in Washington D.C. As you may have noticed, the Homer Hoyt Institute is networked into academia in a unique relationship. Visit

[www.hoyt.org](http://www.hoyt.org) to get a more detailed picture of who we are and learn more about the subprime crisis research program.

The travel expenses of the industry representatives are the responsibility of the respective industry organizations, although we can get you the Institute's hotel rates if your reservations are made early enough. We will start the meeting with a lunch at the Hoyt Center in North Palm Beach. There is no charge to our guests for in-group meals, receptions or educational activities. If you choose to stay over the weekend and participate in the school's recreational activities (golf or fishing), it is at your expense.

We are planning to wind up the year with a conference in late September or early October of 2008 in Washington D.C. that discusses strategies being pursued in resolving the crisis and the relevance of the research inputs. The \$100,000 allocation by HHI is among the highest in the institute's history. We very much value the relevance of research and improving the quality of decisions. So we will want to assess the contribution made by the large expenditure. Part of that process will involve assessing how well industry has done and what the outlook for future institutional changes might be.

#### Your Participation Is Crucial

We would welcome some industry representatives (within a workable scale) participating in the Consortium Steering Committee, which is chaired by Susan Wachter and John Weicher. Each was an Assistant Secretary for Policy and Research at HUD under different administrations (one Democratic and one Republican). The Homer Hoyt Institute is non-partisan and not a lobbying organization. HHI is devoted to developing and disseminating information through research and focuses on research relevant to the real estate related issues facing our society. The chips fall where they may.

We can provide you, at your request, with an executive summary of the working document leading to the final report. If you desire further detail, we will provide the latest working draft of the sections of the report. Obviously, that document is just in the beginning stage.

I started in the real estate business between my sophomore and junior year in college, fifty-six years ago. Thus, I am not a stranger to industry concerns and culture. As a counselor of real estate (I am an emeritus member of the CRE) I found that the more I charged the more they listened. Since my counsel here is free, it may not get the attention it deserves. My best clients were three Harvard MBSs who wanted counsel before they were in trouble, and they did well. Most waited until they were in trouble.

The industry is in trouble – and we may be your best friend.

Please let me know of your interest. My e-mail is [mseldin@tampabay.rr.com](mailto:mseldin@tampabay.rr.com) ...

Sincerely

Maury Seldin

At the end of the symposium the Mortgage bankers Association committed \$25,000 is supplemental support. In a follow-up, through the good graces of one of the Hoyt Fellows, the National Association of Realtors also joined in at the \$25,000 level.

The following is the report on the symposium as it appeared in the newsletter.

Symposium:  
The Subprime Crisis  
Thursday, January 17, 2008

A diverse group of industry, government, consumer and academic representatives with divergent interests and opinions spoke openly about the subprime mortgage crisis and the policies that their organizations are pursuing. The Symposium continued a dialogue begun at the Research Roundtable in Washington, D.C., October 24, 2007. Both this Symposium and the Research Roundtable were sponsored by the Subprime Mortgage Research Consortium. Dr. John Weicher chaired the Symposium.

Symposium attendees were: Jonathan Kempner and Sheryl Pardo (Mortgage Bankers Association), Stephanie Casey Pierce (National Governors Association Center for Best Practices), Richard A. Brown (FDIC), Robert Caruso (Bank of America), Dr. David A. Crowe (National Association of Homebuilders), Dr. Peter Zorn and Dr. Amy Crews Cutts (Freddie Mac), Thomas Goyda (Wells Fargo Home Mortgage), Forrest W. Pafenberg (OFHEO Office of Policy Analysis and Research), Dr. Vanessa Gail Perry (George Washington University), Sharon Price (National Housing Conference), Sylvia Shelnutt (REEA), Dr. Robin Dubin (Case Western Reserve University), Andrew Davidson (Andrew Davidson and Company), Sean Begley (Applied Financial Technology), Dr. Norm Miller (University of San Diego and Hoyt Group), Dr. Ann Schnare (AB Schnare Associates LLC), Dr. Marsha Courchane (CRA International), Dr. David Ling and Dr. Wayne Archer (University of Florida and Hoyt Group), Dr. Hal Smith, Dr. Ron Donohue and Dr. Ronald Racster (Hoyt Group), Dr. Max Biasin (University of Macerata, Italy), Richard Langhorne (CB Richard Ellis) and Dr. Brent Smith (Virginia Commonwealth University), Dr. John Weicher, Consortium co-chair, (Hudson Institute), Dr. Susan Wachter, Consortium co-chair, (University of Pennsylvania), Dr. Richard Green, Consortium member, (George Washington University) and Dr. Maury Seldin, Consortium member (Homer Hoyt Institute).

Nature and Causes of the Crisis

The mortgage and subprime crisis is real and far reaching. Foreclosures are both a symptom and cause of the crisis. Resets (interest rate changes on ARMs) alone, higher risk subprime mortgages and ALT A “No Doc” mortgages and interest only mortgages are not sufficient to explain the increase in defaults and foreclosure rates. Higher default and foreclosure rates are also occurring for the usual fundamental reasons (loss of employment, divorce, etc.) and unsustainable price expectations. Price appreciation rates since 2000 in many markets allowed borrowers to continually tap into home collateral ATMs and avoid default. But now a lack of residential liquidity and a more conservative securitized mortgage market on hold has reduced the ability to avoid defaults by refinancing. One industry expert suggested house prices may fall by another 20% within 2-3 years. The increased securitization of mortgages was seen as exacerbating the problem by creating a large gap between the borrower and the ultimate investor, with brokers and others operating in the gap escaping most of the risk of default and loss of capital. Many analysts feel that going out of business is sufficient for these middle players who sometimes filled in fictitious incomes on loan applications, but others feel there should be real economic risks for poor underwriting decisions. Among those blamed for the current crisis are:

- Consumers who overpaid for housing or knowingly took on risky teaser loans

- Appraisers who over valued housing
- Rating agencies that provided ratings with little correlation with actual loss risks
- Mortgage brokers who lied or encouraged puffing on loan applications
- Regulators that delayed Basel II, which would have focused more on risk-based pricing in the determination of reserves
- The Federal Reserve for not tightening up interest rates sooner
- The Chinese for buying US Treasuries and keeping rates low
- Academics that should have identified systemic problems and spoken out louder

Today, the mortgage crisis is spilling over to impact other assets and markets like the CMBS market, where rating agencies have lost credibility. Homebuilders have cut back and land values have fallen and jumbo loans are at all time premiums over conforming loans. (Recent legislation has eased financing for jumbos effective until December 31, 2008.) Forty percent of builders have reported falling sales and high inventories of unsold units, now exceeding a year in many coastal markets. Builder's problems are exacerbated by homebuyers who delay purchasing in anticipation of further price declines or based on media reports of negative stories.

Lenders are accumulating large portfolios of foreclosed properties, now REO. Present accounting rules hinder curing the problem. Auctions of foreclosed property could remove the overhang of foreclosed units and there is a price that would clear the market, but banks currently must "mark to market" and write down loan balances immediately. Individual banks may be reluctant to auction their inventory and face the huge write downs. Some instead turn the units into rentals and wait. An agency similar to HOLC or RTC may be needed to accumulate the surplus inventory and conduct an organized strategic auction at a later date.

#### Public and Private Sector Response

As one participant put it: "There will be legislative fixes to this crisis; with economic consequences." A variety of legislative and legal fixes are being suggested and implemented. Stephanie Casey Pierce of the bipartisan National Governors Association Center for Best Practices outlined some of the responses of state governments to the crisis. Pierce noted that more than 30 states have addressed the foreclosure problem in various ways. In addressing the problem of increasing foreclosures, several types of proposals or new legislation are observed, including:

- Rules aimed at the prevention of rescue scams
- Connecting the homeowners to free credit counseling
- Providing a variety of financial assistance such as temporary mortgage refinance loans
- Providing emergency payment assistance
- Stronger rules against predatory lending
- Restricting mortgage terms that accelerate payment of the debt
- Restricting teaser rates that increase too fast
- Requiring mandatory arbitration prior to foreclosure
- Insuring that the loan originator acts in the best interest of the borrower by fining abusive lenders
- Educating the prospective homebuyers on homeownership and mortgage credit and providing simpler and full loan term disclosure (Montana has had an education program in place for over 15 years and also has a smaller percentage of

subprime loans and lower mortgage defaults)

- Some states are working on neighborhood recovery programs where there are penalties for abandoning properties, and transitional assistance for displaced families.

Representatives from the mortgage industry were very interested in national regulation at the federal level to avoid what could become a patchwork of state rules. Any locationally specific rules affect the efficiency and operation of the national securitized mortgage market. Bob Caruso (Bank of America) pointed out that national standards for mortgage documents and workout guidelines would be useful. There is fear among lenders and investors in the mortgage market that legislation will be enacted that temporarily negates mortgage contracts and possibly suspends interest rate changes. This would dramatically affect mortgage interest rates as new premiums would be needed to induce investors to buy into an industry with vehicles that may be subject to unforeseen regulation.

The “HOPE Now” is an interesting initiative. This program provides assistance by looking at the entire debt issues of the customer and by providing credit counseling by a neutral non-profit agency that assists in workouts and term negotiations on modified mortgages. Jonathan Kempner pointed out that only about one-third of borrowers in trouble ever approach the lender before default and in many cases these loans are modified as a way to minimize losses and still allow the borrower to stay in the home. Lenders are frustrated when working with distressed borrowers because many “hide”, whether from embarrassment or other reasons, increasing the difficulty of counseling or workouts at the early onslaught of their credit problem. In cases where there is no communication, lenders have no choice but to foreclose. Among the help provided by lenders is an early warning to borrowers on forthcoming interest rates resets. Lenders are also classifying borrowers into groups that are capable of refinancing, those that can get a freeze on the reset, and those where a workout can be beneficial. The mortgage lender representatives pointed out that many foreclosures are due to traditional reasons: loss of job, divorce, etc. and are not due to interest rate resets. In some markets like Ann Arbor the default rates are more driven by fundamentals (loss of local jobs) and less by risky mortgages and resets, but the media does little to differentiate problems within specific markets and often blames the subprime lenders, which remain a small part of the total mortgage market.

#### What is the Effect of Foreclosures on Local Neighborhood Home Prices?

Mortgage experts explain that a NPV calculation must be made for alternatives to a current mortgage payment problem. Typical scenarios include holding or delaying interest rate changes, reducing the interest rate, or foreclosing now. This type of analysis is focused on the individual mortgage and household and does not take into account portfolio neighborhood effects. That is, if foreclosing on several homes results in a cascading of home price declines and this further exacerbates the problem, such considerations are not part of the analysis. Preliminary research by Robin Dubin, Cleveland State, suggests that such cascading does occur as evidenced by several markets in the Cleveland area. Yet it is not clear what is the tipping point or how lenders can be encouraged to consider such broader implications of foreclosing.



### Consortium Research Agenda

The research agenda developed by the Subprime Mortgage Research Consortium is shown in the Request for Proposals (see page 11 of this newsletter). The RFP reflects the presentations and discussion in the Symposium , as well as the session on Friday at the Weimer School (See Weimer School Open Forum, page 1). (Note:The complete newsletter can be found on the HHI website [www.hhi.org/ASI/](http://www.hhi.org/ASI/) under "ASI Newsletters".)

Chapter 5 is the request for proposal story

On the day after the Subprime Crisis Research Council decided on the RFP, the Weimer School met and the academic discussions continued. That is discussed in the next chapter.