Chapter 6: Stage III Activities

Research support is the spinal chord of the Subprime Crisis Research Program. The grant program is the most obvious component of the program; and, it is the most expensive. It is essential, but there are methods of leveraging the efforts.

Learned Journals

Academicians are heavily motivated by publication credit in learned journals. Such published research is a significant consideration in rank and tenure decisions. Knowing that, the first stage allocated funding for a special edition of a learned journal. By the spring submissions were arriving. The publication should be out before the end of the year, but here is the announcement that went out.

Journal of Housing Economics
ACADEMIC PRESS

Call for Papers
Special Issue : Subprime Lending Crisis

The Journal of Housing Economics invites submissions to a special issue on subprime lending and the subprime lending crisis, a timely research issue which carries important public policy implications. Because investors from around the world have invested in sub-prime mortgages, and because the subprime issue is potentially contagious to other financial markets, the topic is also of interest to JHE's international audience.

We welcome papers that discuss any aspect of the crisis, including asymmetric information and adverse selection issues, disclosures, RESPA and the Truth-in-Lending Act issues, best estimates of likely foreclosure rates, geographic or spatial patterns in subprime delinquencies and default, externalities created by foreclosures, including neighborhood externalities, implications for ratings agencies, and implications for securities structures going forward. Policy related papers are welcome, but they must be of sufficient analytical rigor to meet the customary standards of the journal. Timeliness is of the essence, because the editors are looking to produce an issue that will help inform the current policy debate, which has profound implications for the macro-economy. By January 15, 2008, authors should notify one of the editors of intention to submit, and submissions should be made to http://ees.elsevier.com/jhec/ , with a cover letter indicating that the submission is for the special issue by April 15, 2008.

Special editors are Richard Green (drgreen@gwu.edu), Anthony Sanders (sanders.12@gmail.com), and Susan Wachter (wachter@wharton.upenn.edu). The Homer Hoyt Institute is sponsoring this special issue.

The progress report from the Journal of Housing Economics is as follows:

We are planning to publish the special issue as the December 2008 issue of the Journal of Housing Economics. We have narrowed the field to 8 papers, of which I believe we will publish 6. All papers are authored by excellent, widely-recognized scholars. As of today, we have final acceptance of one paper, with the others in process. The accepted paper is authored by Major Coleman, Michael Lacour-Little, and Kerry Vandell:

"Subprime Lending and the Housing Bubble: Tail Wags Dog?"

Abstract: The cause of the "housing bubble" associated with the sharp rise and then drop in home prices over the period 1998-2008 has been the focus of significant policy and research attention. The dramatic increase in subprime lending during this period has been broadly blamed for these market dynamics. In this paper we empirically investigate the validity of this hypothesis vs. several other alternative explanations. A model of house price dynamics over the period 1998-2006 is specified and estimated using a cross-sectional time-series data base across 20 metropolitan areas over the period 1998-2006. Results suggest that prior to early 2004, economic fundamentals provide the primary explanation for house price dynamics. Subprime credit activity does not seem to have had much impact on subsequent house price returns at any time during the observation period, although there is strong evidence of a price-boosting effect by investor loans. However, we do find strong evidence that a credit regime shift took place in late 2003, as the GSE's were displaced in the market by private issuers of new mortgage products. Market fundamentals became insignificant in affecting house price returns, and the price-momentum conditions characteristic of a "bubble" were created. Thus, rather than causing the run-up in house prices, the subprime market may well have been a joint product, along with house price increases, (i.e., the "tail") of the changing institutional, political, and regulatory environment characteristic of the period after late 2003 (the "dog").

This is one of the projects funded through SCRC and the Homer Hoyt Institute.

The report on the January symposium that appeared in the newsletter is reprinted at the end of the preceding chapter. While presentations at such meetings, including those at the research roundtable, are prestigious, as is publication in learned journals, presentations of papers at academic meetings rank very high in the motivational scale.

Academics Session in January

Among the most prestigious venues for presenting professional papers is the Weimer School of Advanced Studies in Real Estate and Land Economics. On the day following the January symposium the Weimer School held an open forum on the subprime crisis. It was reported on the front page of the same newsletter. Here is a copy.

Weimer School Open Forum:
The Subprime Crisis
Friday, January 18, 2008

A highlight of the January Weimer School was an Open Forum on the subprime crisis chaired by Dr. Susan Wachter, Friday afternoon, January 18. Preceding the Open Forum, Weimer Fellow candidate Dr. Robin Dubin (Case Western Reserve University) presented the findings from her on-going research on "Foreclosures in Cleveland". Areas of Cleveland are experiencing large numbers of foreclosures, and Dubin concludes that in some cases a significant volume of foreclosures lowers the prices of nearby houses (cascading effect) and in such cases falling prices can in turn cause a further increase in foreclosures, an undesirable feedback loop. (See page 9 for summaries of presentations by Dubin and other finishing Weimer Fellow candidates.)

Professor Dubin's research suggests that significant foreclosure rates adversely affect neighborhood house prices. Attendees pointed out that lenders must analyze alternative NPV scenarios for the minimization of loss and these alternatives include loan modification or foreclosure. But the contagion effects on the neighborhood would require a portfolio perspective that is not currently considered. Part of the problem may be that lenders do not have sufficient concentration of loans to care about the spillover effects. This question remains unanswered and more research is needed on the volume or threshold of foreclosure rates in a neighborhood that would cause a cascading of prices. Limiting the contagion, both the depth and breadth of price declines, is of concern as is the implementation of institutional changes that would prevent future crises while preserving the homeowner's access to credit and loan options.

Professor Patricia McCoy (University of Connecticut) outlined recent legal developments resulting from the subprime crisis, including loan modifications permitted by the Paulson negotiated industry agreement. Only 10% of subprime mortgages have been estimated to qualify for assistance. To qualify for modification, the unit must be owner-occupied and the mortgage must reset this year or later. The owner-occupants do not qualify unless they are able to pay the reset rate, are more than 60 days delinquent in the past year, have more than a 3% equity, or a FICO score above 660. Participation by servicers is voluntary. Several major lenders are supporting this approach including Washington Mutual and Wells Fargo among others.

Servicers' participation in loan modifications can face practical and legal constraints, including pooling and servicing agreements, concern about lawsuits by investors and the federal bankruptcy law. The low staffing levels in loss mitigation departments slow the modification process. Professor McCoy suggested that a latterday HOLC or RTC may be needed to buy distressed loans at a discount and refinance them on more favorable terms. Professor McCoy also outlined pending legislation, proposed underwriting reforms, and other reforms.

Dr. Vanessa Perry (George Washington University) provided an overview of data sources for modeling the effects of subprime foreclosures in the local housing market. Professor Perry pointed out that data ideally would incorporate borrower characteristics, property characteristics including local economic factors, and loan characteristics and performance, as well as information on lender, servicer and investor characteristics. No single data set includes all variables.

Existing public and private data sets that could contribute to research on the mortgage problem are the Home Mortgage Disclosure Act (HMDA) data, the American Housing Survey (AHS), First American Loan Performance (LP) data (proprietary), Applied Financial Technology (AFT)–Fidelity National Information Services (FNIS), (proprietary), McDash Analytics (proprietary), Moody's, DataQuick (ShareData) and various public records data including the Census. These and other data sources have been used in various combinations to perform mortgage market research. AFT, now part of FNIS, has responded with pledges of data support for qualified research.

Dr. Richard Green (George Washington University) and co-author with Susan Wachter (University of Pennsylvania) of "The Housing Finance Revolution" (presented at the Kansas City Federal Reserve's 31st Annual Economic Policy Symposium) discussed the information asymmetries between borrowers and lenders and between originators and investors, who rely on different information in making decisions. These asymmetries have contributed to the mortgage market crisis. Other contributing factors discussed were inefficiencies in the securitization process and the associated fees that are charged in the gap between loan origination and the ultimate investor in the CMO.

The Weimer School Open Forum on the Subprime Crisis continued the dialogue among players in the mortgage market and academics that was begun October 2007 in Washington and the Thursday afternoon symposium preceding the Weimer School. These meetings are sponsored by the Subprime Mortgage Crisis Consortium, comprised of the Homer Hoyt Institute, Hudson Institute, Institute for Urban Research at the University of Pennsylvania and the George Washington University Institute for Public Policy. Substantial efforts are being made by the Consortium to broaden the dialogue among all parties affected by the crisis, whether private industry, government, or the public. The Consortium functions as the link between these groups and the academic community and will be funding research relevant to the problem (See the Consortium RFP, page 11).

As noted earlier, the Weimer School changed the original plan for the May 2008 session to postpone the greening topic in favor of focusing on the subprime crisis. Here is the newsletter report for that meeting.

2008 Hoyt Fellow Session and 2008 Weimer School
– Not to Be Missed!

Paige Mueller (HF 2003, GIC Real Estate, Inc.) has again assembled an outstanding Hoyt Fellow session for May 15, 2008. Presenting in the session are Mark Zandi (HF 2006, Chief Economist and Co-Founder, Economy.com), "*U.S. Economy and Housing Market Outlook*"; Richard Langhorne (HF 1999, CB Richard Ellis Commercial Asset Recovery and Restructuring Services) *"Survivor - Who Gets Immunity at The Tribal Council – Florida and other Sand States";* David Lynn (HF 2007, Managing Director, ING Clarion) *"Land – the Next Big Opportunity or a Long Wait?*"; Jun Han (HF, Principal, Barclays Global Investors) "*Commercial Debt Markets – Opportunities and Risks"*; Andrew Davidson (HF 2005, President, Andrew Davidson & Co.) *"Opportunities in the Debt Markets – Spreads, Pricing and Players – How Has Borrowing Changed?"*; David Watkins (HF 2003, Senior Vice President, Heitman Capital Management) Panel Moderator: *"2007 Corrections in US REITs and the UK Market – an Indication of 2008 Private Market Performance?"*; Robert Zerbst (HF 2005, Chairman, CB Richard Ellis Investors) *"UK Market Correction and What We Can Learn from Derivatives"*; and Hans Nordby (HF 2007, Director of US Markets, PPR) *"US Private Market Return Forecasts"*; Scott Westphal (HF, Managing Director – Securities, Cornerstone Real Estate Advisors LLC) *"U.S. REIT Markets – Change in Sentiment or Indication of Upcoming Private Market Pricing?."*

This session is exceptional and not to be missed!

The May 16-18 session of the Weimer School of Advanced Studies in Real Estate and Land Economics will be devoted to the mortgage and credit crisis. Weimer School faculty member Richard Green is completing the agenda, which will be sent with registration materials early in March. On the program at this time are Paul Hillen (Boston Federal Reserve), Ann Schnare (AB Schnare Associates LLC), Deniz Igan (IMF), Karen Spence (Federal Reserve), Ben Keys (University of Michigan), Anthony Pennington-Cross (Marquette University) and Tony Sanders (Arizona State University). As always, Hoyt Fellows are encouraged to attend the Weimer School and Weimer School Fellows are invited to the Hoyt Fellows session on Thursday. A large attendance is expected. Please register early!

Some of the presentations are summarized in the newsletter. Here are a couple of summaries.

"Foreclosures in Cleveland"

Dr. Robin Dubin

It is plausible that foreclosures lead to a decline in local property values, because the property may become blighted. It is also plausible that falling property values may lead to an increase in foreclosures, because, if house prices fall sufficiently, the borrower may owe more than the house is worth. If both of these propositions are true, this would cause an undesirable positive feedback loop in which increased foreclosures caused property values to fall, which in turn, caused more borrowers to default on their mortgages. I investigate these relationships using data from the Cuyahoga County Recorder and the Cuyahoga County Auditor. I find that foreclosures do lower the prices of nearby houses and that falling prices do cause an increase in foreclosures.

"The Information Content of REIT Short Interest"

Dr. David Downs

This paper evaluates the relation between publicly traded real estate returns and short interest levels. The sample is comprised of NYSE-traded Real Estate Investment Trusts (REITs) covering the period from 1990 through 2005. The data and results offer some surprising findings. First, it may not be widely known that the level of short interest has grown dramatically over the sample period. In fact, in recent years the level of REIT short interest – as measured by median relative short interest - has eclipsed the short interest level of firms in the broader market. Second, while conventional wisdom associates short interest with bearish sentiment, even highly shorted REIT in the sample have positive returns. However, and far more interesting, the spread between low and high short interest portfolios is significantly positive. This finding holds with persistence and across robust risk adjustment schemes. The results may be of particular interest to investors given the recent surge in hedge fund-related real estate investment.

The next academic set of meetings after the January Session of the Weimer School of Real Estate and Land Economics was at the annual meetings of the American Real Estate Society (ARES), held in April.

<u>The SCRC Panel Presentation and Meeting at ARES</u>

The use of professional meetings, and especially the Weimer School, was envisioned early on. But also considered were the meetings at ARES and AREUEA. A gap in attention to the issues at the ARES meetings was noted as indicated by excerpts from the following e-mail:

Hi Ron,

The notice of the ARES Annual Meeting in 2008, April 16-19, arrived. In it was a partial list of topical areas, 17, that did not include the mortgage market crisis and potential fallout. The multiple simultaneous sessions over 2 ½ days provides virtually unlimited time for papers.

My question is, what if anything ought HHI be doing to foster a series of sessions relating to include the mortgage market crisis, especially local market activity? Since the Weimer School Session is only one month later, the question of duplication arises. The big difference, however, is that the Weimer School is an invitation only set of papers with a select group to hear and discuss the presentations while the ARES will draw from a variety of applicants, most accepted, with whatever composition emerges. That can be advantageous in that some pleasant surprise additions to thought may emerge.

One thought, built upon the local market impacts and variations, is to have a session with presentations on different local markets. If a prototype analysis is conducted, a series of papers could be invited from academics in different locations. It is a no budget item for HHI for the papers because many will do it just to present at ARES. There may be a later budget item if they are included in a special edition of an ARES journal devoted to the mortgage crisis with a section devoted to differential impacts on local markets.

As I noted in the draft to communicate the need for a research roundtable, perspectives of the issues will vary. The major issue, as HHI is framing it, is to avoid a catastrophe in the market that affects people not directly involved in the creation of the subprime mess. That potential catastrophe as noted in the draft is the cascading of defaults within a local market and then from market to market. Attached is an update of what I faxed to you noting the additions of local info we discussed for Ohio. I talked with Chuck Shinn about the methodology he used in his doctoral dissertation that sharpened the characterization of local markets and hope to hear from him soon with some detail. I see it as a strategic issue, and to elaborate on how I see strategy applied in a general sense I am attaching another piece, "Strategy in Bridge, Real Estate, and Life."

In developing a plan, if HHI wants to do anything, it will be important to talk with Richard Green since he is in charge of the May Session. As yet, it is not yet clear to me how Susan and John are working him into the research roundtable. I know that both Susan and John have been under heavy commitments this week and will be next week, so it is best to give them the time to sort it out on their own schedule. That might be the first stop on the critical path for developing a plan…

If we are to pursue this route, we should before going very far clear with John, Susan, Richard, and probably Dave Ling as Dean. We should also check with Norm Miller as a past president of ARES in paving the way for the suggestion of the series of sessions…

Beyond that, I expect that Susan and John will have worked out with Richard how the roundtable and May Session will inter-relate. The question at hand is back to what, if anything, do we want to do to encourage related programs at ARES? When and through whom? And, would we look to a special issue of an ARES journal or some other or any other publication of results?

Your decision on what to do, if anything, will probably result in an executive committee action that relates this to the strategic plan process…

Maury

As a result, a panel presentation emerged from the Subprime Crisis Research Council. It was as follows:

ARES 2008 Plenary Meeting

SUBPRIME CRISIS: NATIONAL-STATE-LOCAL PERSPECTIVES

In this panel, sponsored by the Homer Hoyt Institute and co-chaired by **John Weicher**, Director of Hudson Institute's Center for Housing and Financial Markets and **Susan Wachter**, Professor of Real Estate and Finance, The Wharton School, University of Pennsylvania, participants from government, industry and academia will present their perspectives on this critical issue in the economy and housing markets.

PANELISTS

THE NATIONAL PERSPECTIVE:

Marsha Courchane
Vice President
CRA International

Amy Crews Cutts
Deputy Chief Economist
Freddie Mac

Andrew Davidson
President
Andrew Davidson & Company

Richard Green
Chair of Real Estate Finance
George Washington University

THE STATE AND LOCAL PERSPECTIVES:

Stephanie Casey Pierce
Policy Analyst
Center for Best Practices
National Governors Association

John Ryan
Executive Vice President
Conference of State Bank Supervisors

Tony Sanders
Professor of Finance & Real Estate
W.P. Carey College of Business
Arizona State University

Jack Tatom
Director – Research
Networks Financial Institute
Indiana State University

APRIL 17, 2008: 10:00 AM – 12:00 NOON

South Seas Island Resort, Captiva Island, FL

The slides from the presentations are on the Hoyt website, www.hoyt.org.

The Decision to Expand Web Postings

The Steering Committee of the SCRC met immediately after the panel presentation and among the decisions was one to expand the postings on the Hoyt site to include other relevant research where permissions could be obtained. Also, links to selected papers were to be included.

It took a great deal of time to get a proposal and the idea expanded to provide interaction among researchers. As of this drafting, the latest thinking is summarized in the following draft.

Draft of September 5, 2008

**An Open Letter to Participants in the
Open Forum for Real Estate Finance and Market Research**

Dear Participant,

Consider the aspiration to a "mirror world" information system [1] for real estate finance as part of building a new paradigm for real estate finance. That paradigm would integrate behavioral economics and behavioral finance[2] as well as reflexivity.[3]

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[1] See David Gelernter's M*irror Worlds, or: The Day Software Puts the Universe in a Shoebox... How It Will Happen and What It Will Mean* ,Oxford University Press, 1992. "In *Mirror Worlds* Gelernter envisioned us mustering the resources and implementation efficiencies to allow us to build grand software simulations of government, economic and social systems. Then, by cleverly instrumenting the simulations to be real-time reflections of the system being modeled... your get a BIG BANG!" is what one website says (http://www.sohodojo.com/ribs/mirror.html). Three paragraphs (including the one from which the preceding quote was taken) from the sohodojo site that are important for the background to understanding the relevance of the simulation representing what is happening real time as part of a parallel model for forecasting outcomes are as follows: (1) "Ten years after its publication, the really impressive about *Mirror Worlds* is what Gelernter and all the rest of us didn't foresee. *The Mirror World is a magical Looking Glass; a transforming two-way mirror*. The rapid growth of the Internet and its associated impact on the emerging global economy means that **the model has become the system itself**. The outside world is changing to reflect our lives inside the wired, network world we live in... not the other way around. (2) "In *Mirror Worlds* Gelernter envisioned us mustering the resources and implementation efficiencies to allow us to build grand software simulations of government, economic and social systems. Then, by cleverly

Consider that in building such a paradigm relevant research will be required; and, the determination of relevance will be highly dependent on strategies employed by

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instrumenting the simulations to be real-time reflections of the system being modeled... your get a BIG BANG! (3) “The simulation becomes something qualitatively different. It is a Mirror World. As more and more of our value exchanges and communication take place purely in cyberspace, the model is the system... we don't have to build the simulation and instrument it... the model and the system are one and the same.” Obviously, we don’t have the data inputs to run a mirror world of housing finance. However, the closer we come to a realistic model of the system and to an information system, that though not real time, is as prompt as feasible the better forecasts of outcomes we are able to make. For a good summary of the book and introduction to the world wide web see Comments from the Associate Editor of Computers & Geosciences, Volume 21, Number 10, 1995 (http://www.uh.edu/~jbutler/anon/mirror.html).

[2] According to Wikipedia, “**Behavioral economics** and **behavioral finance** are closely related fields which apply scientific research on human and social cognitive and emotional biases to better understand economic decisions and how they affect market prices, returns and the allocation of resources. The fields are primarily concerned with the rationality, or lack thereof, of economic agents. Behavioral models typically integrate insights from psychology with neo-classical economic theory.

“Academics are divided between considering Behavioral Finance as supporting some tools of technical analysis by explaining market trends, and considering some aspects of technical analysis as behavioral biases (representativeness heuristic, self fulfilling prophecy).[1]

“Behavioral analysts are mostly concerned with the effects of market decisions, but also those of public choice, another source of economic decisions with some similar biases.” (http://en.wikipedia.org/wiki/Behavioural_economics.)

[3] The theory of reflexivity, the term used by George Soros, was expounded on in a presentation he made on April 26, 1994 to the MIT Department of Economics World Economy Laboratory Conference Washington, D.C. (http://www.geocities.com/ecocorner/intelarea/gs1.html). An excerpt of my comments in an e-mail to Mr. Soros, as shared with my colleagues in leadership positions with SCRC & HHI in a memo of July 18, 2008 (Some Notes on an Emergent Real Estate Finance Paradigm Shift) is as follows:

“I see your reflexivity theory as an extension of game theory.[3] The theory of games, as you know, uses the idea of reflexivity in that the opponent’s actions and one’s own interactions are not independent of each other. I believe that you made a significant contribution in focusing on the world as the “opponent” in that in trying to understand it we are handicapped by being part of it and in the process we alter it.

“In my discussion of the White Paper I write of using research to improve the forecast of outcomes and sharing it with the participants (industry, government, and consumer) in an effort to get them to improve their strategy.[3] That speaks to your interest in developing policy recommendations, but is an application of social science.

“I have also written that my colleagues in academia have a physics envy in their attempt to emulate the methodology of the physical sciences. I have advocated their inclusion of behavioral economics and behavioral finance because the traditional models are inadequate. I have also touted cognitive science because a better understanding of how and what others think is essential to a better forecast of outcomes.

“Although we agree on different methodologies for the social sciences as compared to the physical sciences I am an advocate of Edward O. Wilson's view of consilience.[3] My advocacy is based on the belief that there exists a common set of underlying principles for the social sciences as for the physical sciences, but, it is just that when you add the reflectivity, as with decision making, the interaction comes into play. A similar thing happens in the physical sciences when one expands the paradigm. It is a complexity revealed in paradigm shifts, and you have shifted the paradigm in financial markets not only by noting the reflexive aspects, but also by noting the manipulative aspects based on political intention. Your thinking is useful in our improving our prospects for dealing with the mess that has been created.”

various players and underlying principles of the system.[4] The idea is to improve the forecast of outcomes.[5]

Understanding the substance of the preceding two paragraphs is no small matter. Terms and ideas are footnoted and linked in order to facilitate the reader in a quick study to grasp a deeper meaning. Also, for the readership that is interested in an intensive study, the links provide a road map to relevant literature.

It would be nice to have a roadmap to the organization of the body of knowledge for the new paradigm, but that body of knowledge is being built as an emergent endeavor upon the foundations of what we think we know. This site contains an electronic library and links to literature focused on research dealing with the subprime crisis of the early 21st century. Building that library and generating additional research is a project of the Subprime Crisis Research Council [add link to *About SCRC*]; it is an endeavor supported through the Homer Hoyt Institute's Subprime Crisis Research Program [add link to Hoyt site]. The introductory note [here shown as a footnote, but to be linked][6] tells more about

[4] Understanding strategies of others starts with understanding their decision-making process. The following set of excerpts from an essay, "The Mind, Brain and Heart: A Paradigm for Predicting Outcomes" in the ASI newsletter (http://www.hoyt.org/asi/) shed some light on the process.

"As Wilson suggests, the framework for the integration of information within the mind is the paradigm within which one interprets the observation. The perspective imbedded in the paradigm influences the forecast of outcomes. People see things differently depending upon the culture in which they developed, among other factors.

"The ability to see things is, in some measure, dependent upon how well the neural connections have been developed. Just as languages are easier to learn at earlier ages than at maturity, dealing with abstract reasoning early on will facilitate one's ability to grasp more abstract concepts in later life." [P. 3.]

"The essence of the process of human choice is that the mind, by using the brain, processes selective information in the ways it has learned through biological development and culture (nature and nurture). This process is in a paradigm that is based on values, also learned through biological development and culture (nature and nurture). However one chooses to classify emotions as related to reason, the intelligence of the mind deals with both the forces of tightly or loosely reasoned logic melded with emotional force that is significantly affected by culture. The blends may be different for different people and for different circumstances, and errors in reasoning do occur, but reason alone is not as good an indicator for understanding or forecasting behavior as is a combination of reason and emotion. But, both reason and emotion are rooted in the values of individuals and groups. Thus, the big issue is to identify the values and the way in which the individuals or groups deal with the information. [P. 6.]

"Add to this the errors in reasoning as discussed earlier, and the role of emotion, and we see that the habits of the heart and mind make forecasting outcomes more difficult than if it were all governed by reason. On top of this is the group behavior which may be generated from bottom-up responses, such as emergence, and group behavior as a result of network cascading, and the complexity is compounded. The complexity adds an additional uncertainty to forecasting outcomes. This added uncertainty calls for a strategic approach. That is the subject of the book in progress." [P.8.]

[5] "The Homer Hoyt Institute is supporting the research so that the forecasted outcomes of strategies can be enhanced in quality over what would it be without the rigorous research. It adds credibility because the quality of knowledge is really improved." That is a quote from an essay, "Panic Doesn't Help - Strategy Does: A Personal Perspective" in the ASI newsletter. See http://www.hoyt.org/asi/.

[6] Draft of August 31, 2008: **An Open Forum for Real Estate Finance and Market Research**

The Open Forum for Real Estate Finance and Market Research is a web based activity that deals with issues, policies, and strategies. The initial set of concerns is built around the subprime crisis that flowered in 2007-08 and triggered the creation of the Subprime Crisis Research Council.

The intent of the Forum is to generate academic research that improves the forecasting of outcomes at both the level of individual policies and strategies that seek to blend policies of one or more the Forum and its organizational structure. The purpose of this letter is to inspire participants to study in the linked broader arrange of disciplines that come to bear on the issues. I have been working at this through the Advanced Studies Institute in Real Estate and Land Economics (from which I recently retired), and its Weimer School of Real Estate and Land Economics, for some time. That constituency is an elite academic group consisting of the vast majority of leading academics real estate and closely related fields of study. The Forum, this new endeavor, is in effect an "open university" that has virtually unlimited participation as to numbers; but, active participation in building the

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players in the system. Furthermore, the intent of the Forum is to communicate to decision makers the results of the research in a usable fashion and to receive inputs from such players in order to focus on the research most relevant to the issues.

The players are industry, government, and the public (especially consumers). They may be represented by recognized organizations and/or individuals with recognized expertise and/or authority in policy making or implementation at an organizational level. Access to the site for viewing, linking, and downloading, except where restrained by copyright limitations, is open to the public. The public may also send messages to a referee that will automatically acknowledge receipt, but which may or may not post on the website, or may or may not forward to parties authorized to make posting or responses in specific areas of analyses.

Players that have been screened as to qualifications may be provided with passwords that permit them to automatically post their comments or research provided that warrant that they have copyright authority for the items to be posted. The postings may be stored in a post office box pending review, if deemed appropriate by the Forum representative.

Chat rooms and/or blog sites for selected topics may be provided for selected players. Some may be open to the public for viewing only, but others may be limited to selected members of a group qualified on the issues. In the latter case, outputs may be later put on viewing for the public.

The initial focus of the site will be on the Subprime Crisis Research Program of the Homer Hoyt Institute and the resulting program of the Subprime Crisis Research Council, especially the White Paper Task Force Report, "Policy Analyses for a Strategic Approach to Deal with the Subprime Crisis." Within this focus will be an array of topics, including reports on roundtables, symposia, and the like, as well as research funded by the program and other research deemed relevant to the issues.

The array of topics will provide a drill down capability. For example, in the case of meetings, the list of meeting is provided with drill down capability to the reports as published in the ASI/HF newsletter and where appropriate, the papers presented or slide presentations, and sometimes to the list of attendees. In the case of some research reports, beyond the report itself there will be a drill down capability to the reports discussed, or possibly just cited, providing that copyright permissions are obtained. Additionally, extensive links will be provided. The idea is to make it more efficient for the researchers to produce their research and for the users of the research to understand the basis of the conclusions. Where feasible, the drilldowns will include the data bases or links sources where the data may be leased if only available on a commercial basis.

Instead of drilling down, it may be useful to move up from the system to the larger system of which the former is a part. Thus from housing finance the research may move to the general capital markets. The essence of that is already on the Hoyt website as "The Real Estate Capital Flows Research Program." Other areas will be identified in the White Paper, especially the international nature of the system in which the crisis exists.

The middle ground of interacting with the players has been well paved with the series of meetings in the first year program. The great challenge for the second year is in three parts. First to see what is feasible in the web system. The second part is to see what can be done toward building the new paradigm in real estate finance. Obviously the system is not understood well enough by academia, and certainly not the players, except for those who see there small part well enough to capitalize on the imbalances. The third part is for academia to make a difference in understanding the system, and communicating it well enough that better decisions are made; not only to work our way out of this mess, but to minimize the recurrence of similar debacles.

paradigm is limited to those qualified by experience and/or education. All are welcome to access the site. Those wishing to be active participants should contact the webmaster.

The relationship of the Open Forum to other Hoyt Group Activities is shown in the accompanying figure. [Provided as an attachment.]

Sincerely,
Maury Seldin
Chairman of the Board
Homer Hoyt Institute.

The attachment is a draft of the relationship of the newly proposed structure for the website that would give greater prominence to the subprime crisis research and be suitable for interaction. See Figure 6-1

The May Session of the Weimer School

The next opportunity for the academics was the invitation only May Session of the Weimer School and its industry counterpart Hoyt Fellows meeting in May. The program for those meetings was reported in the ASI/HF newsletter. Here is some of the published story.

From VOLUME XXIV, ISSUE II (FALL 2008) of the MS ASI HFLLC Newsletter

The May 2008 Hoyt Fellows - Weimer School Session

The May 15-18 Hoyt Fellows and Weimer School sessions were attended by more than 50 Hoyt Fellows, Weimer School Fellows, Post Doctoral Honorees and invited guests. As customary, Weimer Fellows were encouraged to attend the Hoyt Fellow session and Hoyt Fellows to attend the Weimer School session.

May 2008 Hoyt Fellows

The May 15, 2008 Hoyt Fellows session was again most ably organized by Paige Mueller (GIC Real Estate, Inc.) and chaired by Dr. Jeff Fisher (Indiana University), the Managing Member of Hoyt Fellows, LLC. Presenting were Hoyt Fellows Dr. Mark Zandi (Chief Economist and Co-Founder, Economy.com), who spoke on the "U.S. Economy and Housing Market Outlook"; Richard Langhorne (First Vice President, CB Richard Ellis, Commercial Asset Recovery and Restructuring Services) "Survivor - Who Gets Immunity at the Tribal Council - Florida and Other Sand States"; Dr. David Lynn (Managing Director, Research and Investment Strategy, ING Clarion Real Estate) "Land - the Next Big Opportunity or a Long Wait?"; and Dr. Jun Han (Principal, Barclays Global Investors) "Commercial Debt Markets - Opportunities and Risks."

A panel consisting of moderator David Watkins (Senior Vice President, Heitman Capital Management) addressed "2007 Corrections in US REITs and the UK Market - an Indication of 2008 Private Market Performance?" Panel members Dr. Robert Zerbst (Chairman, CB Richard Ellis Investors) spoke on "UK Market Correction and What We Can Learn from Derivatives"; Scott Westphal (Managing Director -Securities, Cornerstone Real Estate Advisers LLC) "US REIT Markets-Change in Sentiment or Indication of Upcoming Private Market Pricing?" and Hans Nordby (US Strategist, PPR) "US Private Market Return Forecasts".

May 2008 Weimer School

The mortgage and credit crisis was the theme of the May 2008 Weimer School. Program chair Richard Green (George Washington University - now at the University of Southern California) with the assistance of Marsha Courchane (CRA International) organized a session of excellent presentations by Dr. Ann Schnare (AB Schnare and Associates, LLC) "GSEs and the Liquidity Crisis in the Jumbo Market"; Dr. Anthony Pennington-Cross (Marquette University) "Mortgage Product Substitution and State Predatory Lending Laws"; Dr. Karen Pence (Federal Reserve Board) "The Subprime Mortgage Crisis: Underwriting, Mortgage Innovation, and Defaults"; Dr. Jacob L. Vigdor (Duke University) "What Should Government Do

About the Subprime Mortgage Market? A Taxpayer's Guide"; Dr. James D. Shilling (DePaul University) "Moral Hazard and Adverse Selection for Subprime Lending and Securitization: Priced or not Priced?"; Dr. Dennis Capozza (University of Michigan) "Subprime in Shambles: New Indices for Underwriting Quality & Local Economic Conditions"; Dr. Paul Willen (Federal Reserve Bank of Boston) "Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures"; Deniz Igan (International Monetary Fund) "Credit Booms and Lending Standards: Evidence from the Subprime Mortgage Market"; Benjamin J. Keys (University of Michigan) "Did Securitization Lead to Lax Screening? Evidence from Subprime Loans, 2001-2006"; Dr. Anthony Sanders (Arizona State University) "Housing Prices and Alternative Mortgage Concentrations" and Dr. Amy Crews Cutts, (Freddie Mac) "Interventions in Mortgage Default: Policies and Practices to Prevent Home Loss and Lower Costs".

Post Doctoral Honorees

Each year the faculty of the Weimer School honors colleagues who have achieved recognition for their research early in their careers. These individuals are given the opportunity to present their research at the May Weimer School session and are invited to return to subsquent May sessions. Over time, several former Post Doctoral honorees have become Weimer School Fellows and Faculty. Dr. Richard Buttimer (University of North Carolina - Charlotte) and Dr. Charles Ka Yui Leung (City University of Hong Kong) were honored in 2008. Richard discussed “A Generalized Real Options Model of Residential and Commercial Development," and Charles presented "Do the Equilibrium Correlations of Asset Price Change with Monetary Policies?"

The AREUEA Mid-Year Meetings

Shortly after the Weimer School session the American Real Estate and Urban Economics Association held its mid-year meeting in Washington. With assistance from Dr. Richard Green, an immediate past president of AREUEA, that program was adjusted to include a cluster of some presentations on the subprime crisis. A selection of some presenters and topics at that meeting were as follows:

American Real Estate & Urban Economics Association
Mid-Year Meeting Program

Tuesday, May 27, 2008

1:00 pm – 3:00 pm
Concurrent Sessions

“Incidence and Effects of Subprime Mortgages” **Location: Auditorium**
Session Chair: Amy Bogdon, Federal Housing Finance Board

Papers

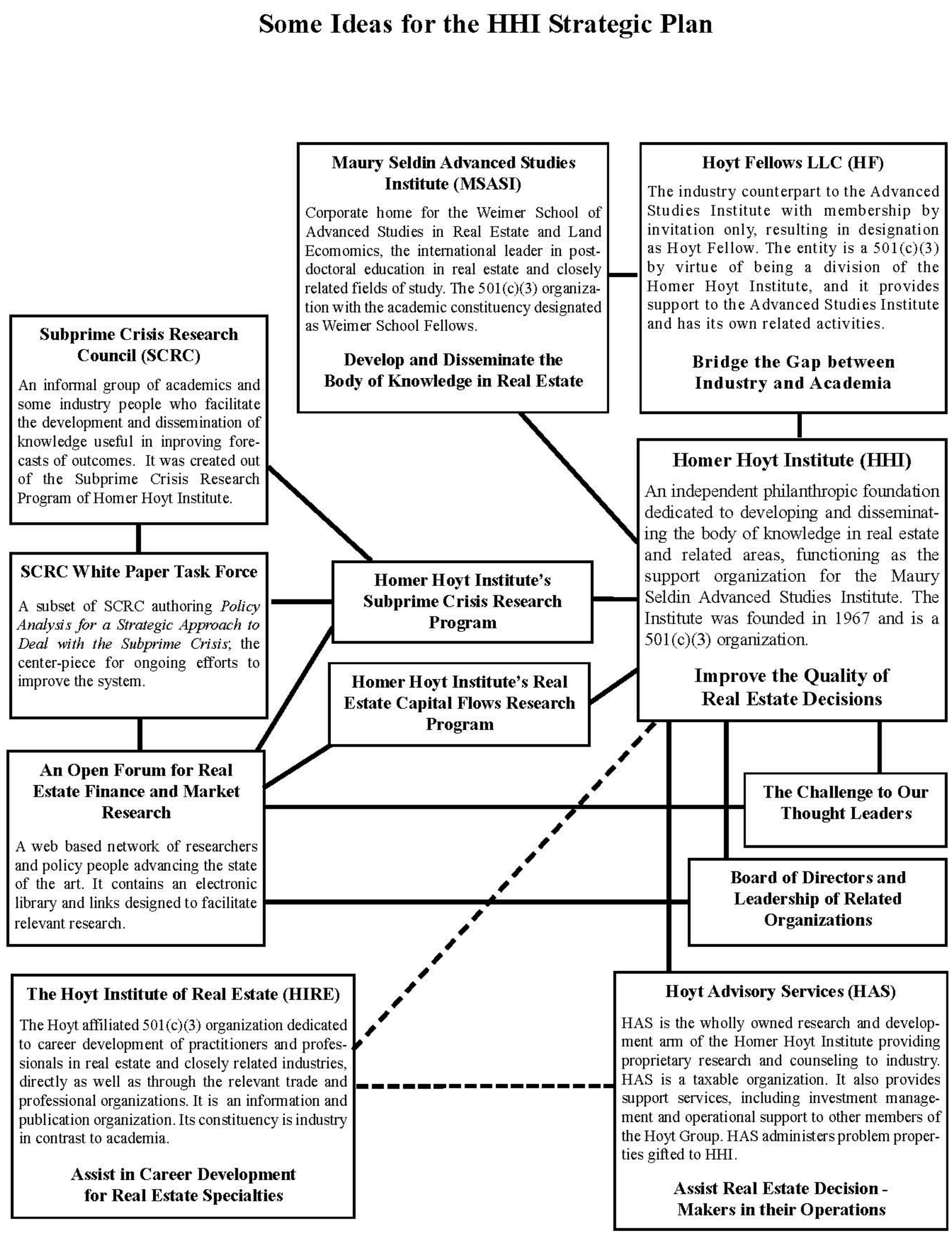
Subprime Mortgages: What, Where and to Whom?
Karen Pence, Federal Reserve Board of Governors
Chris Mayer, Columbia University

Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures
Paul Willen, Federal Reserve Bank of Boston
Kristopher Gerardi, Boston University
Adam H. Shapiro, Boston University

The Spillover Effect of Neighborhood Subprime Lending
Lei Ding, University of North Carolina at Chapel Hill
Roberto G. Quercia, University of North Carolina at Chapel Hill
Janneke Ratcliffe, University of North Carolina at Chapel Hill

Cont. on Page 14

Figure 6-1


Some Ideas for the HHI Strategic Plan
Maury Seldin Advanced Studies Institute (MSASI)
Corporate home for the Weimer School of Advanced Studies in Real Estate and Land Ecomomics, the international leader in post-doctoral education in real estate and closely related fields of study. The 501(c)(3) organization with the academic constituency designated as Weimer School Fellows.
Develop and Disseminate the Body of Knowledge in Real Estate
Hoyt Fellows LLC (HF)
The industry counterpart to the Advanced Studies Institute with membership by invitation only, resulting in designation as Hoyt Fellow. The entity is a 501(c)(3) by virtue of being a division of the Homer Hoyt Institute, and it provides support to the Advanced Studies Institute and has its own related activities.
Bridge the Gap between Industry and Academia
Subprime Crisis Research Council (SCRC)
An informal group of academics and some industry people who facilitate the development and dissemination of knowledge useful in inproving forecasts of outcomes. It was created out of the Subprime Crisis Research Program of Homer Hoyt Institute.
Homer Hoyt Institute (HHI)
An independent philanthropic foundation dedicated to developing and disseminating the body of knowledge in real estate and related areas, functioning as the support organization for the Maury Seldin Advanced Studies Institute. The Institute was founded in 1967 and is a 501(c)(3) organization.
Improve the Quality of Real Estate Decisions
SCRC White Paper Task Force
A subset of SCRC authoring *Policy Analysis for a Strategic Approach to Deal with the Subprime Crisis*; the center-piece for ongoing efforts to improve the system.
Homer Hoyt Institute's Subprime Crisis Research Program
Homer Hoyt Institute's Real Estate Capital Flows Research Program
An Open Forum for Real Estate Finance and Market Research
A web based network of researchers and policy people advancing the state of the art. It contains an electronic library and links designed to facilitate relevant research.
The Challenge to Our Thought Leaders
Board of Directors and Leadership of Related Organizations
The Hoyt Institute of Real Estate (HIRE)
The Hoyt affiliated 501(c)(3) organization dedicated to career development of practitioners and professionals in real estate and closely related industries, directly as well as through the relevant trade and professional organizations. It is an information and publication organization. Its constituency is industry in contrast to academia.
Assist in Career Development for Real Estate Specialties
Hoyt Advisory Services (HAS)
HAS is the wholly owned research and development arm of the Homer Hoyt Institute providing proprietary research and counseling to industry. HAS is a taxable organization. It also provides support services, including investment management and operational support to other members of the Hoyt Group. HAS administers problem properties gifted to HHI.
Assist Real Estate Decision - Makers in their Operations

Wednesday, May 28, 2008

8:00 am – 10:00 am
Concurrent Sessions

"Issues in Mortgage Markets" **Location: Auditorium**
Session Chair: Amy Crews Cutts, Freddie Mac
Papers
The Inefficiency of Refinancing: Why Prepayment Penalties Are Good for Risky Borrowers
Tomasz Piskorski, Columbia University
Chris Mayer, Columbia University
Alexei Tchistyi, New York University
What's a Savvy Senior to Do? A Competing Risk Analysis of HECM Reverse Mortgage Loan Terminations
Gigi Yuen-Reed, IBM
Edward Szymanoski, Jr., US Department of HUD
A Model of CMBS Spreads
Joseph B. Nichols, Federal Reserve Board of Governors
Amy Cunningham, Federal Reserve Board of Governors
Housing Prices and Alternative Mortgage Concentrations
Anthony Sanders, Arizona State University
Souphala Chomsisengphet, US Department of Treasury
Sumit Agarwal, Federal Reserve Bank of Chicago
Brent Ambrose, Pennsylvania State University

10:15 am – 12:15 pm
Concurrent Sessions

"Neighborhood Impacts of Foreclosures" **Location: Auditorium**
Session Chair: Anthony Yezer, George Washington University
Papers
Spillover Effects of Foreclosures on Neighborhood Property Values
Zhenguo Lin, Fannie Mae
Eric Rosenblatt, Fannie Mae
Vincent Yao, Fannie Mae
Homeownership, Foreclosures on Neighborhood Quality
Tammy Leonard, University of Texas at Dallas
Jim Murdoch, University of Texas at Dallas
The Impact of Foreclosures on Neighboring Housing Sales
William H. Rogers, University of Missouri at Saint Louis
William Winter, University of Missouri at Saint Louis
Foreclosures in Cleveland
Robin Dubin, Case Western Reserve University

"Volatility in Housing Markets" **Location: Session Room 2**
Session Chair: Joseph B. Nichols, Federal Reserve Board
Housing Supply, Demand and Prices: A Fifty-State Analysis
Stanley Longhofer, Wichita State University
Charles Calomiris, Columbia University
William Miles, Wichita State University
Contagion and Sunspots Surrounding Speculative Home Equity Lending Losses
Wiliam W. Lim, York University
Clientele Effects, CAP Rates, and Excess Volatility in Housing Markets
Anthony Yezer, George Washington University
Chao Yue Tian, George Washington University

2:00 pm – 4:00 pm
Concurrent Sessions

"Mortgage Lenders and Borrowers" **Location: Auditorium**
Session Chair: Frank Nothaft, Freddie Mac

Papers

Interventions in Mortgage Defaults: Polices and Practices to Prevent Home Loss and Lower Costs
Amy Crews Cutts, Freddie Mac
William A. Merrill, Wells Fargo Home Mortgage

Stochastic House Appreciation and Optimal Mortgage Lending
Alexei Tchistyi, New York University
Tomasz Piskorski, Columbia University

Dynamics of Consumer Credit History Scores: Evidence from Low-Income Homeowners
Jonathan S. Spader, University of North Carolina at Chapel Hill
Roberto G. Quercia, University of North Carolina at Chapel Hill

Conclusion of Stage III

Stage III will be concluded with the September 15, 2008 SCRC meeting which will highlight a presentation of the White Paper: Policy Analyses for a Strategic Approach to Deal with the Subprime Crisis. That is an extension of the meetings format for the year with a wind-up at the same location, the Hudson Institute in Washington, D.C. as the Research Roundtable.

The publication in the learned journal, Bureau of Housing Economics, is expected in December 2008. The list of articles is as follows:

Contents of Journal of Housing Economics
Subprime Mortgage Lending Special Issue, December 2008

Stage IV, which includes the completion of the funded research and its publication, is underway with some of the research completed. The electronic publication process is also underway and is being funded to continue into a second year and beyond for an indeterminate time.

Future additions, and the continuation of SCRC, are topics for discussion at the September 15 meeting reported on in an ensuing chapter.

Shifting the Paradigm

As a transition to Chapter 7, here is a memo to the leadership of SCRC and HHI indicating a vision of the role of academia as a player in the process of change.

MEMO

August 3, 2008

To: My colleagues in leadership positions with SCRC & HHI
From: Maury Seldin
Subj: Abridged Version of Notes on an Emergent Real Estate Finance Paradigm Shift

The subprime crisis is taking the nation into the greatest fiasco since the Great Depression. The institutional and regulatory changes in real estate finance are morphing us into a new paradigm of real estate finance. Academia has a role to play in facilitating the emergent paradigm, and especially in providing knowledge that will enhance its effectiveness in facilitating the success in progress towards achieving American ideals.

As is appropriate for a free society, there are substantial differences in the perspectives of these ideals. These differences get reflected to varying degrees in the political resolutions of issues at various levels of government. These resolutions are predicated on the underlying values of the participants as reflected in the paradigms of the power structure.

Sometimes the paradigms in use are predicated on faulty theories resulting in ineffective policies, or worse – unintended and undesirable consequences. Academia has a responsibility to enhance the quality of knowledge so as to improve the effectiveness of policy. From time to time that involves a shift in paradigms.

Such a shift is underway in the current economy because the policies, public and private, of the last two decades have led to the debacle. Many of these policies impacted institutional changes in real estate finance, and its regulation, and absence thereof, resulting in a capital market crisis that was the precursor to a recession; a recession that may be the longest and or deepest since the Great Depression.

These notes are designed to help my colleagues in designing research that will enhance the quality of the emerging paradigm. Federal policy under a conservative administration has started to shift because of the chaos in the capital markets. Those policy changes reflect an adjustment of a paradigm of those in power. However, a new administration next year, probably liberal rather than conservative, will start with a different perspective of American ideals and will pursue policies that will swing the pendulum farther to the left in order to deal with the crises. We know not to where it will shift once the short term issues are attacked, but we do know that the perceptions will impact the emergent paradigm.

While the focus is on real estate finance, the paradigm has a broader application. The idea is to articulate a paradigm that comes closer to reality than those that have led us into this mess. The most workable way to start may be to take a look at the regulatory system and examine some potential policies. The process of examining the policies utilizes a paradigm, which in this case will be articulated. The idea is to articulate a paradigm by the use of a case study.

Obviously, one or a few studies may not be representative of the whole; but, the process can reveal a theory worthy of further exploration. Thus, we need not prove the emergent theory, only to articulate its principles so that the paradigm is set forth.

Economic Theory and Real Estate Finance

"And the current financial crisis can be directly attributed to a false interpretation of how financial markets function."[7] That quotation from the new book by George Soros, *The New Paradigm for Financial Markets,* states the basic premise from which we are proceeding. That succinct statement supports what I have been expounding on in the essays relating to the subprime crisis; namely, we are in this mess because we do not have good forecasts of outcomes.[8] Why we do not have good forecasts of outcomes is on the table for discussion as is how we may improve the situation.

The spine of this discussion is a blend of what George Soros wrote in his new book and what I have written in my newsletter essays. In response to the copies of my letter to Soros which I sent to SCRC and HHI leadership, Susan Wachter expressed interest in a developing a conference at Wharton dealing with the relevance of reflexivity. The following is an excerpt from my response to Susan:

"I am copying Bob because we can treat the White Paper as the centerpiece and use some policy issue as the vehicle. It might be one that the Haas project studies in depth, but it need not be. What is important is that it fit into the strategy and that it is fertile grounds for exploring reflexivity.

"One option is to pick up on your latest comments quoted in the Associated Press by Jeanine Aversa. The reorganization of the regulatory system could become a classic case. The players may forecast outcomes based on their preferences, but different players have different forecasts. Thus, the assumptions used for any particular forecast are risky on two counts. First, they may not know the strategies of the other players, but even with good guesses what they do may alter the other strategies. Furthermore, this applies to others altering their strategies.

"This is a classic game theory situation. It would take an interdisciplinary team to have the best chance at a viable institutional structure. Furthermore, moving ahead on the process is the act of building a new paradigm. I would be surprised to find out that anyone is using this level of sophistication in developing plans."

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[7] Soros, page 50.

[8] The following is a quote from my first essay in the subprime series "Don't Panic Yet: A Strategy for Dealing with the Risk of the Emergence of a Housing Bubble Resulting from the Interdependence of Space and Capital Markets (written preparatory to the research roundtable held October 25, 2007 and published in the Fall 2007 newsletter);

"The role played by the mortgage market is centered on the rise and fall of subprime mortgages including the innovative packaging and distribution of the assets in the form of sliced and diced risk positions. The impact of the subprime mortgages was exacerbated by hedge fund investing with the use of leverage. The quant jocks that develop the sophisticated econometric models to forecast market behavior do a fine job when the structures are unchanged. When the relationships stay the same the outcomes are predictable. But, when relationships charge because of structural innovations the outcomes are less predictable. That was the story in 1998 when Long-Term Capital Management got into trouble and there was a massive rescue operation.

"The current debacle is not only attributable to sophisticated investors making errors, and to rating agencies underrating risks, but to naïve borrowers, some greedy, but others just hoping for better housing. The story of subprime mortgages is the story of mortgages that started out subprime but became "junk mortgages" as the counterpart to junk bonds. The euphemism of subprime obfuscates the reality of exceptionally high risk that would probably not be taken by a lender that intends to hold the mortgage for a long term investment. The issue may be seen as a mismatch of who bears the risk and who reaps rewards beyond risks taken."

Although most, or possibly all, of the readership of these notes received a copy of my letter to Mr. Soros, here is a relevant excerpt:

"I see your reflexivity theory as an extension of game theory.[9] The theory of games, as you know, uses the idea of reflexivity in that the opponent's actions and one's own interactions are not independent of each other. I believe that you made a significant contribution in focusing on the world as the "opponent" in that in trying to understand it we are handicapped by being part of it and in the process we alter it.

"In my discussion of the White Paper I write of using research to improve the forecast of outcomes and sharing it with the participants (industry, government, and consumer) in an effort to get them to improve their strategy.[10] That speaks to your interest in developing policy recommendations, but is an application of social science.

"I have also written that my colleagues in academia have a physics envy in their attempt to emulate the methodology of the physical sciences. I have advocated their inclusion of behavioral economics and behavioral finance because the traditional models are inadequate. I have also touted cognitive science because a better understanding of how and what others think is essential to a better forecast of outcomes.

"Although we agree on different methodologies for the social sciences as compared to the physical sciences I am an advocate of Edward O. Wilson's view of consilience.[11] My advocacy is based on the belief that there exists a common set of underlying principles for the social sciences as for the physical sciences, but, it is just that when you add the reflectivity, as with decision making, the interaction comes into play. A similar thing happens in the physical sciences when one expands the paradigm. It is a complexity revealed in paradigm shifts, and you have shifted the paradigm in financial markets not only by noting the reflexive aspects, but also by noting the manipulative aspects based on political intention. Your thinking is useful in our improving our prospects for dealing with the mess that has been created."

Returning to the "…false interpretation of how financial markets function," we have several areas of concern. One to which we will give some attention is reflexivity. The second one, usually the focus of academia, is the rigor of analysis; that is alluded to. The third one is a confusion between what some see as what ought to be and what is reality; which is another way of saying that values differ and some people think that the market functions the way that they believe it ought to because of underlying values. Our focus is on the shift taking place.

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[9] My favorite reference on the theory of games is a book I read as an undergraduate at UCLA in 1953. The reference is McDonald, John. *Strategy in Poker, Business, & War*. New York: W. W. Norton & Company, 1950. As will unfold, I see the application of reflexivity to public policy as a potential application of the theory of games.

[10] The quote from page 15 of the May 8 draft of *About SCRC* is "The premier product of the White Paper task Force will be a readable assessment of potential policies combined in a generic strategic fashion so as to have a balanced approach to the crisis. It will be generic in the sense that although middle ground, something more aggressive or conservative may be preferred by some decision-makers. They can then adjust the strategy to suit their preferences. The key is that the components of the strategy will utilize the state of the art analyses so that outcomes are forecasted with greater reliability than provided by the less rigorous methods that prevail, especially when policy makers are under pressure. Furthermore, the selection of policies will contain a strategic balance, maximizing benefits within constraints of minimum acceptable risks and other costs. Where drastic measures may be called for to deal with short term situations, but which measures are not suitable for long run situations, sunset provisions will be recommended."

[11] See Wilson, Edward O. *Consilience: The Unity of Knowledge*. New York: Vintage Books, 1998.

Shifts in Predominant Value Systems. The following quote from the book, *The Trillion Dollar Meltdown: Easy Money, the High Rollers, and the Great Credit Crash,* by Charles R. Morris notes a shift in values of those providing leadership in the power structure; "Ronald Reagan's election in 1980 signaled that Keynesian liberalism was dead. Vaguely, inchoately, but unquestionably, voters had signaled their readiness for a change of ideological horses. The theorists of the free market would get a run for their race." [Page 18.] That book, published by PublicAffairs (the publisher of the Soros book), along with the Soros book gives a good description of how the mess was created. There is lots of literature to describe it, and someone might want to make a thorough assessment. But, the salient point here is that the shortfall in regulation predicated on reliance of market discipline with regulation that turned out to be inadequate went through at least a couple of decades based upon a conservative view of liberalism; but, a different view of liberalism is emerging.

How far it goes to the left is a matter of speculation. Chances are that it will overshoot a middle ground before it stabilizes in a new pattern. Liberalism is an ambiguous term. Its meaning has changed over time and it means different things to different people at the same time.

In the interests of enhancing the clarity of the shift that is in process, some attention is warranted in exploring the different meanings attributed to liberalism. This doesn't mean that we can't get a dictionary definition that pulls out a salient concept such as "a political philosophy advocating personal freedom for the individual, democratic forms of government, gradual reform in political and social institutions, etc." as in *Webster's New World College Dictionary.*

The differences, sometimes heated, may reflect differences in underlying values. A dictionary of important theories, concepts, beliefs, and thinkers, which is the subtitle of the book *A World of Ideas,* is more informative as to the differences. The first two sentences of the one page definition are as follows: "Political, social, and economic doctrine that in its classic construction emphasizes individual FREEDOM, limited government, gradual social PROGRESS, and LAISSEZ-FAIRE commerce, and in its modern incarnation favors STATE involvement in social WELFARE and economic policy while upholding personal liberty and opportunity. The term has the same root as 'liberty' and implies freedom of conscience and action." [The caps refer to other entries in the book.]

Contrasts in Views. If you want to go back as far as Aristotle, [this is where the abridged part starts] the view of liberalism is built out of government emerging as natural for man resulting in a top-down perspective – a collective view.[12] If you move only to Locke, government is derived from the authority of the individuals and the authority is derived from a bottom-up perspective.[13]

[12] Consider this excerpt from Plato's *Politics,* "Further the state is by nature clearly prior to the family and to the individual, since the whole is of necessity prior to the part;…" This is the major clue to the hierarchical structure advocated by Aristotle. In short, Aristotle takes a collective view.

[13] All of this is tied to a quote from Locke, "But justice is the bond of men in states,…" This will all tie to underlying values, especially the concepts of liberty (or freedom) and justice (especially social justice). The relevance is the identification of some underlying values that give rise to particular concepts of liberalism.

John Locke, Locke makes the point that man is naturally free[14], and though he may use force to protect his rights he has reason to join with others in society for the "mutual preservation of their lives, liberties and estates, which I call by the general name – property." [Note the use of the word property.] To Locke, government is the establishment for this purpose and should function on the basis of "known law," administered on an impartial basis, and so enforced. This transfer of power to the government is deemed to improve one's individual position.[15]

Further to the relevance, beyond the derivation of government's power being derived from the governed is the idea that there may be different views as to the range of powers as regards various policies adopted by government. The position on various options is the subject of liberalism and its alternatives.

However you want to use the term liberalism you can see a shift in the paradigm underway, in part because of a shift in power structure, and in part because an improvement in understanding the system.[16] We need to work on improving our understanding of a changing system.

<u>The Functioning of the Market</u>

The market is a tool. The following is a series of excerpts from "The Market as an Icon: The Case of the Subprime Mortgage Debacle," the second part of the insert to the Fall 2007 Newsletter:

"The current subprime mortgage debacle is a failure of the market. The institutional arrangements need to be modified if we are to buttress our faith in the system in which the market represents a good way to induce production and provide distribution using price as a vehicle.

"Perfect market systems have sets of conditions such as a level playing field with symmetric rather than asymmetric information and equal bargaining power among players. In the absence of some of these conditions, or with some shortfall, governments intervene with regulation in order to make the system work better…

...The October 24, 2007 research roundtable in Washington D.C. that is the focus of this essay is designed to develop a research agenda that would (1) enhance understanding of institutional arrangements so as to **avert a reoccurrence of the debacle caused by the subprime mortgage catastrophe**; and (2), to enhance understanding that would assist in the development

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[14] See Locke's Of the State of Nature, Second Treatise of Government.

[15] The quote The quote from Locke's Chapter VII titled "Of Political or Civil Society" is as follows:

> "Sec. 87. Man being born, as has been proved, with a title to perfect freedom, and an uncontrouled enjoyment of all the rights and privileges of the law of nature, equally with any other man, or number of men in the world, hath by nature a power, not only to preserve his property, that is, his life, liberty and estate, against the injuries and attempts of other men; but to judge of, and punish the breaches of that law in others, as he is persuaded the offence deserves, even with death itself, in crimes where the heinousness of the fact, in his opinion, requires it.

[Source: Original URL: http://www.constitution.org/jl/2ndtreat.htm Text Version
Maintained: Jon Roland of the Constitution Society.]

[16] Since I have lots more comments on the concepts and underlying values, and I wanted to move this discussion along, I put some of them in a footnote in the unabridged set of notes written a couple of weeks ago. But, I would like to make the point that thinking changes over time (see essay of that title in newsletter, "Thinking Changes Over Time," Winter 2004, http://www.hoyt.org/asi/winter2004_supplement.pdf) and there is underway a shift in predominant value systems moving away from the great reliance on the market with relatively little concern for social justice to a more managed system still predicated on individual rights but with a greater concern with social justice. The unabridged set of notes has an extensive footnote on this point.

of a strategy to **mitigate the damage from the current catastrophe**, especially to minimize the cascading of foreclosures that would destroy some local housing markets and spread to adversely impact the rest of the economy, especially to avoid a precipitous downturn in general economic activity. This essay is focusing on the longer term institutional changes, and is a companion piece to the "Don't Panic Yet" essay focused on the cascading issue.

"One would expect that the Democrats would be favoring increase in regulation while the Republicans would avoid it. It remains to be seen what the Democrats come up with, but there may be a clue in Paulson's not focusing on aid to the home owners. But, wherever one is in the liberal to conservative spectrum it makes sense to get a better understanding of likely outcome of different policies. Thus, this discussion focuses on the mechanics of the system. **Decision makers may develop their own strategies, but they may use the same understanding of the mechanics of the system**. [Emphasis added.]

"A major failing of the market in the subprime case emerged from a mismatch of the distribution of risks and rewards. Great rewards went to originators, packagers and distributors of the mortgages and investment instruments derived from their packaging and slicing-an'-dicing. The great risks were borne by borrowers and by investors who wound up holding the long term instruments.

"Real estate mortgages typically engender a mismatch of time horizons. Borrowers want long term financing and lenders want liquidity…

"…The market is a useful tool, but the institutional arrangements are in need of revision. Research is critical in the process of getting revisions that will actually improve the situation…

"…October 22, 2007."

It is not the purpose here to discuss specific regulatory changes. That is the subject of the White Paper. Nor is it the purpose here to describe the functioning of the market. Rather, it is the purpose to shed some light on improving the paradigm as will be reflected in institutional changes.

If you take the market as a goal rather than a tool, you will wind up at the right end of the spectrum of liberalism; that is away from the direction which our society is moving.[17]

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[17] Two authors, Ludwig von Mises and F.A. Hayek, make their interpretation of liberalism according to their value system as libertarians. Ludwig von Mises' claim is that the freedom of liberalism will be more productive for society than would be the results of an organization of society with lesser forms of freedom. He denies that this view is designed to favor those better off, but concedes that there is a substantial difference in distribution of income and wealth. He sees a capitalistic society built upon his concept of liberalism. Hayek follows the same path.

Obviously, both labels, liberalism and libertarian, have the same derivation in the word liberal, and by association the word freedom. At this point it is useful to deal with Isaiah Berlin's two concepts of liberty. The two concepts of liberty discussed by Isaiah Berlin in his essay "Two Concepts of Liberty." [Four *Essays on Liberty,* pages 121-122.] are as follows: The first concept, using the label of negative liberty, is

> "What is the area within which the subject – a person or group of persons – is or should be left to do or be what he is able to do or be, without interference by other persons?"

The second concept, using the label of positive liberty, is,

> "What, or who, is the source of control or interference that can determine someone to do, or be, this rather than that?"

Berlin sees a conflict in these two perspectives of liberty in that they are different values, even though they are related, and there may be some overlap in the answers. There is one long paragraph by John Gray in his book, *Isaiah Berlin,* which is especially enlightening on the comparison and contrast. It is as follows:

> "It will readily be seen that, if negative freedom as Berlin understands it presupposes the capacity for choice among alternatives, it shares a common root with positive freedom. Unlike negative

As an evaluation of the shift taking place I would build upon the Isaiah Berlin two concepts of freedom. It is one thing not to restrict one's freedom. But it is another matter to have one empowered to utilize the lack of such restriction. That empowerment is dependent upon education, cultural as well as formal. The level playing field refers to the rules, but some cognizance needs to be taken of differences in abilities, natural as well as developed. This becomes very complex because it deals with many values, some of which may be incommensurate with others. The choices one makes with regard to the mix of underlying values may on one hand reflect a liberalism that focuses on freedom; it may also take a liberalism point of view that focuses on distributive justice.[18]

My guess is that an enlightened liberalism will emerge. That is not to be confused with neo-liberalism which like neo-conservatism comes up with a doctrine that there is only one way. Rather an enlightened liberalism is likely to contain the Isaiah Berlin view of pluralism.

That view would entail a great deal of concern for social justice, and would utilize markets as a tool. The political necessity of coalitions across the aisle will be an application of the concepts of pluralism. Both major political candidates in this forthcoming national election are "across the isle" types; but my guess is that is the Democratic candidate that will lead the nation after the election.

The most critical decisions will be predicated on reflexivity in dealing with the market regulation.

Reflexivity and Market Regulation

> freedom, which is freedom from interference by others, positive freedom is the freedom of self-mastery, of rational control of one's life. It is plain that, as with negative freedom, positive freedom is impaired or diminished as the capacity or power of choice is impaired or diminished, but in different ways. An agent may be unobstructed in the choice of alternatives by other agents, and yet lack the ability or power to act. This may be because of negative factors, lacks or absences - of knowledge, money or other resources – or may be because there are internal constraints, within the agent himself, preventing him from conceiving or perceiving alternatives as such, or else, even if they are so perceived, from acting on them. Such conditions as phobias or neurotic inhibitions may close off an agent's options, even to the point that they remain unknown to him, or else he may be constrained by irrational and invincible anxiety from acting so as to take advantage of them. In this case the power of choice has been sabotaged or compromised from within. An agent may possess very considerable negative freedom and yet, because he is incapacitated for choice among alternatives that other have not closed off from him, be positively unfree to an extreme degree. What both forms of unfreedom have in common is the restriction or incapacitation of the powers of choice." [Page 16.]

An additional explanation, according to Michael Ignatieff in his book, *Isaiah Berlin*, is as follows:

> "Until Rousseau, liberty had always been understood negatively, as the absence of obstacles to courses of thought and action. With Rousseau, and then with the Romantics, came the idea of liberty being achieved only when men are able to realise their innermost natures. Liberty became synonymous with self-creation ands self-expression. A person who enjoyed negative liberty – freedom of action or thought – might none the less lack positive liberty, the capacity to develop his or her innermost nature to the full." [Page 202.]

[18] The unabridged notes have extensive footnotes on liberty/freedom. If anyone requests a copy, I will be glad to send it.

Drastic measures in dealing with the subprime crisis are being taken at the local level.[19] Thus far, the federal government has focused on the capital market problems rather than the consumer issues, although a shift has started. As the recession emerges, that will be intensified; but a new administration will bring more dramatic changes. Policies that make sense for the short run may be disastrous for the long run. Some sunset provisions are likely. The flow of capital is of great concern, especially with capital markets being an international phenomenon rather than a local one.

Reflexivity comes into play in that expectations of outcomes may be based upon historical institutional arrangements; but, the new arrangements change the structure. The problems are exacerbated because the strategies of the various players will change as the institutional structure changes.

Academia is accustomed to a rigor of analysis that deals with a constant strategies and paradigms. But, if the strategies and paradigms of some players are changing as regulation changes, forecasting outcomes becomes exponentially complex.

A minimax strategy may prove useful under the circumstances. It may not be possible to apply the level of rigor that is the idol of contemporary academic, especially economists, but it is likely to provide better forecasts.

The behavioral economists and those in behavioral finance are able to come up with better forecasts of outcomes than the rational experts because while they do not attribute reason to all behavior, they use reason to assess the probable outcome based upon past behavior. Thus, just as some gamblers apply the "gamblers fallacy" believing that the laws of large numbers apply to small numbers and figure that the chance of their luck on the next roll of the dice is altered by the recent rolls, those forecasting their bets have better information than just assuming that the players apply perfect reason. Or, consider that the behavioral finance group at the University of Mannheim in Germany believes the irrational behavior to occur in patterns that provide a basis for predictability of the irrational behavior. [20]

Dealing with reflexivity is more complicated because past patterns are not available for new structures. That poses a humongous problem for econometricians, even Nobel Prize winners as in the case of the Long Term Capital debacle. The ways to deal with it should be a topic for discussion.[21]

<u>Conclusion</u>

As noted in the beginning of these notes provided as a memo to my colleagues, I made several statements. One was "Academia has a role to play in facilitating the emergent paradigm, and especially in providing knowledge that will enhance its

[19] The sheriff in Philadelphia is not implementing foreclosures. The courts in Ohio are stifling the foreclosure process. This is not a judgment on these practices, only a reporting that the crisis is calling forth drastic action.

[20] The web description of a summer 2003 course was at http://mea.uni-mannheim.de/winter/lehre/03-ss/behav.htm which provided the statement.

[21] One approach is to use gaming techniques. In the gaming simulations a series of models are integrated. The blending of the disciplines provides an opportunity to see the resolution to interdisciplinary problems. By changing assumptions of one player, we might explore the impact on the system. My quant colleagues should be able to come up with options that would provide a basis for developing minimax strategies when dealing with proposed institutional changes. Such an approach is beyond this first stage. In this first stage we are focusing on a White Paper that will include evaluation of some proposed or recently imposed regulatory changes.

effectiveness in facilitating the success in progress towards achieving American ideals." A second was "These notes are designed to help my colleagues in designing research that will enhance the quality of the emerging paradigm." And, a third was. "The process of examining the policies utilizes a paradigm, which in this case will be articulated. The idea is to articulate a paradigm by the use of a case study."

You, my colleagues in leadership positions with SCRC & HHI, can alter the course of events by enhancing the contributions of academia. The flavor of this communication is influenced by my expectation that the notes I was developing would be useful in a discussion with George Soros. But, as I noted in my transmission e-mail, that has not materialized. Even so, the concept of reflexivity is relevant and this seemed the best way to share my thinking. What you choose to do, individually or collectively, is up to you. My view is that academia is doing less than it should and could and that circumstances have provided a unique opportunity for academia to make a significant difference.[22]

It remains to be seen what academia does.

[22] Taking a look at the monograph, *Challenge to Our Thought Leaders,* on the Hoyt website would be very useful.