Chapter 7: The SCRC White Paper Meeting that Wraps-up the Year's Events

Preparing for the 'SCRC White Paper Meeting that Wraps-up the Year's Events" was an arduous task for the principle researchers at the Haas School of Berkeley. Maury Seldin said in an e-mail (late in the week before the meeting) to Bob Edelstein, who is the leader of the task force, "Thank you for the slide presentation. It is impressive! The job of the Task Force is greater than even I envisioned. The detail in your preparation for presentation of a strategy based on a selection of policy recommendations is greater than I envisioned. The process, however, revealed an adjustment to my earlier thinking with regards to relying on local market data built upon loan specific data."

Most of that e-mail was as follows:

Subj: Game Plan Discussion

Hi Bob,

Thank you for the slide presentation. It is impressive!

The job of the Task Force is greater than even I envisioned. The detail in your preparation for presentation of a strategy based on a selection of policy recommendations is greater than I envisioned. The process, however, revealed an adjustment to my earlier thinking with regards to relying on local market data built upon loan specific data.

The adjustment results from your comments on the phone about applying a regression analysis to deal with locational differences. The data presented indicated that the grand strategy, we are looking to come up with, is segmented into two different dimensions. The first, which as you note from my draft report on the first year activities, is by blending strategies of the different parties. This is described with uncharacteristic brevity on my part in the e-mail to Steve at CNBC; you received a copy on Wednesday. It is the essay on "Intervention" [That essay is in the box that follows.]

Intervention

By Maury Seldin

The takeover of Fannie Mae and Freddie Mac by the federal government is the latest of a series of interventions by the Federal Government[1] in dealing with what has become known as the subprime crisis. This may be viewed as a de facto nationalization, although a temporary one. The greatest danger with such interventions is that short term solutions if left to endure as long term institutional changes may create even greater problems. The market is a wonderful tool, if appropriately regulated. What is appropriate depends on the situation.[2]

The problem in the capital markets was built upon the easy monetary policy of the last decade, fed by mortgage loans that should never have been made, resulting in unsustainable increases in housing prices. The mortgages (that financed the purchase of housing at excessive prices and the construction of houses too early for a stable market) that were securitized were sliced into tranches with varying priority of claims. Some of those tranches were then bundled and again securitized. Leverage for investors got as high as 33:1 making for great profit, if there was a profit, but rapid loss for even modest

[1] This is an opportunity to open a discussion of capital market and other interventions. Detailed discussion might be provided.

[2] See the discussion of cancer in the essay published in the ASI newsletter.

declines. The debt created in the process far exceeded the value of the underlying security, houses that were excessively priced.

When house prices started to adjust, the increase in foreclosures fed further price declines that began a downward price spiral that will overshoot what would be a normal trend line in housing prices. The problems in the capital markets exacerbated the decline in house prices because the availability of mortgage money was unduly constrained. That constraint was in part as a result of destruction of wealth, but in part because of a change in perception of risk.

Appropriate intervention to reduce the overshooting of the price trends by the downward spiral is the challenge facing the regulators, but also the other participants in the market. Some states and local governments have already intervened.[3] What would make the most sense is a coordinated effort among state and local governments, along with the federal government; furthermore, the lenders and the servicers would do well to provide voluntary cooperation rather than being coerced by some new legislation. Additionally, the borrowers need to be more responsive in dealing with their default. It is amazing that many do not try to work out their problems.

Ideally, the regulators would have good forecasts of turning points in the local markets as the staring point for the decision to intervene. The great difference in the intervention decisions for the capital markets and the housing markets is that the scale is different. The capital markets are national and international and have homogonous institutions as players. Failure of such institutions, given their links to other institutions, could be disastrous. Thus, it makes sense to intervene to avoid disaster. It would help if their scale of institutions were reduced, which is the plan for Fannie and Freddie. But the critical decision is to be sure that the intervention is temporary. Such interventions, if permanent, would sacrifice the use of market mechanisms for market discipline. But, market discipline is a necessary condition, but not sufficient. The proper regulatory environment must be present. A great cause of the debacle has been the mismatch of risks and rewards in the securitization of mortgages. It was a failure in regulation.

The housing market situation is of an entirely different scale. The markets for the housing are predominantly local. The lenders, through the securitization, are fractionated and represented by servicers who have fiduciary responsibility to holders of different priorities of claims. The borrowers, even if defrauded, have no recourse to holders in due course of the tranches created by securitization. Thus, reworking the mortgage loans become exceptionally complex. Furthermore, the incentives for the servicers may be counterproductive in reaching the solution.

Some of the intervention may require overriding private contract. That is a scary step, especially when one considers that precedents of such intervention could adversely affect the future flow of funds to the mortgage market.

There are no simple solutions. This is a complex situation dealing with the strategies pursued by different players. These strategies are developed by the parties in pursuit of their own interests with their forecasts of outcomes.

The thrust of the research supported by the Homer Hoyt Institute, with additional funding from industry, is to improve the forecast of outcomes. Hopefully, by the players having better forecasts they will have better strategies. But, it is essential that there be a

[3] Examples should be provided.

blending of the strategies of the various players in or to arrive at a grand national strategy.

During World War II there was such a blend because of the common concern for survival of our free society. [Emphasis added.] Mustering a coalition of diverse interests for a common goal is no small matter. We do not know how great the danger is of a catastrophic result from the debacle. But what we do know is that the closer we get to really knowing, the more difficult it is to avert. Given what is at stake, it makes sense to treat the cancer before it spreads further. This can be done, but we need to improver the quality of our decisions, and that means improving the forecasts of outcomes. That is what we do at the Homer Hoyt Institute, and that is what we are doing in the current situation through the development of the Subprime Crisis Research Council, which has leading academics in the field and has reached out to industry, government, and consumer representatives. The September 15 meeting is an interim report of the centerpiece research project, a white paper on "Policy Analyses for a Strategic Approach to Deal with the Subprime Crisis."

The output of that meeting will be some guidance in developing the final report of the Task Force of the Subprime Crisis Research Council and a prioritization of research to be funded with the small amount of unallocated funds, but hopefully supplemented by additional external support. It may also generate research by other organizations, including governmental organizations.

The second dimension is the refinement of what we initially saw as three classes of state situations; (1) rapid growth states, (2) weak economy states, and (3) other. My vision on that was that some states policy might declare some local markets areas as "economic disaster areas" and have available special foreclosure intervention authority to reduce the downward spiral in house prices. What I see now from your presentation is that the scale of focus most workable for our SCRC efforts is at several levels. Some is regional, some is state, and some is local. This is in addition to national and international.

The national scale is obviously dealing with the strategy of the federal government, with its implementation through various components; and the policy of the components. The international dimension is of great concern as a source of capital. Both the national and the international dimensions have capital market issues, but the national obviously has additional concerns, especially those relating to the health of the economy.

The grant to Haas for the related project, obviously encompassed by the white paper, focuses on a model for dealing with diverse interests and criteria in evaluating a few policy alternatives. I still think that is the way to go in order to set the pattern for evaluation of additional potential policies. In the meantime, of course, we have agreed to rely on the best judgment we can muster from our task force membership in order to present a balanced picture of a grand strategy.

Obviously we were too optimistic about the time frame. Fortunately, however, we hold a reserve of $25,000 in allocations and we can extend the time of a final report from the task force and allocate that funding with only a smaller reserve.

I was looking to get that report by the time of the HHI board meeting at the end of October. That would still be great, but we can adjust the game plan.

The way we should view the September 15 meeting is as a "Research Roundtable Encore" featuring a progress report of the SCRC White Paper Task Force on Policy Analyses for a Strategic Approach to Deal with the Subprime Crisis. The panel, by containing a consumer advocate, will work out well in order to get greater diversity of input. As yet, I haven't received the current list of attendees, but I expect that there will be representation from government, industry, and consumer interests. Of course there will be some academics, but rather than going to another widely distributed RFP I think we should just select the individuals whom we believe can best respond to whatever we come up with at the meeting that follows the general session of the "Research Roundtable Encore."

If John and Susan agree, John can re-label the session. You will get whatever inputs result, and I believe John is having it taped, except the recorder will stop for any comments by congressional staff. (John, any chance for a congressman or senator to be present?) John has reserved a small meeting room that will accommodate the membership of the Task Force and SCRC Steering Committee that is in attendance, plus any special guests. I think we should include Stephanie Rauterkus because she is playing an important role in the web project that will be used to encourage further research not funded by us; hopefully, some government agency that has loan specific data will deal with turning points and related issues. We might also consider inviting Stephanie Casey Pierce to that meeting. I would like to get a fundable proposal from the NGA Best Practices group. That proposal would need to tie closely to what you are seeing as clusters for intervention. (Susan, you can send Stephanie a copy of the latest draft of the first year report and tell her that it would be worthwhile for her to read it in order to get a better picture of our thinking. I was disappointed that the Triage workshops and conference idea to be at Penn did not get proposed by them. It is discussed in the draft report of the first year activities.)

I still don't have a really good number of the additional funds HHI can provide out of the remaining portion of our, but I am hoping that we can raise some money as a result of the Research Roundtable Encore. I will see what I ca do on Monday, and any help from you, Susan and John in furthering the process will be appreciated.

I used to be fond of saying that money is not a problem; it is a symptom of some problem. Obviously the scale of the subprime crisis is beyond our capability for detailed solutions with the resources we have available. But, we can do better that any other group in scaling out the issues and outlining an approach. Others have the resources but not the vision and academic talent. So we will do whatever we can and invite other participants to work with us however they can. And those that want to go it alone are to be encouraged by us; which we will do by posting our reports and progress and by facilitating web communications among qualified interested parties.

I have no clue as to the new time table. We will get a better picture on Monday.

If any of you have any comments on this revision of the game plan and want to reach me, I will leave my cell phone on… Today, Thursday I am at a Hampton Inn, (717) 261-9185, room 229. Any of you are welcome to phone up to 10 P.M. Eastern Time.

I will have computer access tonight and then Friday afternoon.

Maury

The emphasis added in the essay on intervention, "**During World War II there was such a blend because of the common concern for survival of our free society,"** referred back to **"**But, it is essential that there be a blending of the strategies of the various players in or to arrive at a grand national strategy." Interestingly enough, after sending off the e-mail just quoted I started reading Tom Friedman's new book, *Hot Flat, and Crowded,* in which he discusses in the opening chapter that "In some ways, the subprime mortgage mess and housing crisis are metaphors for what has come over America in recent years…"[4] Later in the same chapter he discusses the contrast in contemporary communal attitude with that prevailing with the generation that experienced getting out of the Great Depression and fighting WWII, using a quote that ended "That generation understood how bad things could get.[5]

The idea relevant to dealing with the subprime crisis and a variety of greening issues is that the dangers are great enough that we need to adjust our attitudes. But that is only part of it. I agree with the George Soros position that we need to develop a new paradigm for viewing how the capital market functions. That paradigm will depend on how we see and act upon our values.

As I have written elsewhere, my mentor, Art Weimer, once said to me something to the effect that a justification for studying real estate at the graduate level is that what we can learn from it will apply to other areas, and I think there was some reference to real estate's characteristics as making things easier to see.

It is with this perspective that I, and my leadership colleagues at HHI who are decedents of two or three generations from Art Weimer may be viewing the development of the strategy. The SCRC leadership is quite diverse, and desirably so. Part of the beauty of this effort is bringing the diversity together.

Back in chapter 2 the photograph shows Dr. Weimer, at the head of the table with his back to us. It looks like some of his second generation educational offspring [check with Ron Racster – I think he is on Art's right. Hal may be farther to Ron's right.], via Bob Harvey, are to his right. I am at the other end of the table. The original HHI research roundtable was Art's idea, so the series goes back along way.

Now for a discussion of the contemporary effort, the Research Roundtable in October of 2007, held at the Hudson Institute in Washington, D.C., developed the heart of the first year's program of SCRC. Almost a year later, in September 2008, again at the Hudson Institute in Washington, D.C., SCRC met to for the wrap-up session.

The Report on the Session

The centerpiece of that wrap-up session was a presentation of the progress on developing the White Paper, "Policy Analyses for a Strategic Approach to Deal with the Subprime Crisis." The balance of the program and the Steering Committee meeting that

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[4] The paragraph on page continues with a discussion of borrowing from the future and lack of accountability. The last two sentences are as follows: "They were simply betting that the housing bubble would keep driving up prices the prices of homes and that mortgage rates would keep falling – that the market would bail everybody out forever. It did – until it didn't. AS with our houses , so with our country: We have been mortgaging our future rather than investing in it."

[5] The quote, on page 9, is from Michael Mandelbaum, a "Johns Hopkins foreign policy expert."

followed immediately provided guidance to HHI in allocating the remaining funds from the first year's budget of $180,000.

Here is the agenda for the program:

HUDSON
INSTITUTE

The Center for Housing and Financial Markets
In conjunction with the Homer Hoyt Institute
and the Wharton School, University of Pennsylvania
Cordially invite you to…

The Subprime Mortgage Crisis: What's Next?

Monday, September 15, 2008
9:00 AM – 2:00 PM

8:30 a.m.	*Registration and Continental Breakfast*	
9:00 a.m.	Welcome:	
	John Weicher	Hudson Institute
	Maury Seldin	Homer Hoyt Institute
	Susan Wachter	Institute for Urban Research, the Wharton School
9:30 a.m.	*Keynote Speech:* ***The Unseen Elephant in the Mortgage Crisis*** *(co-authored with Igor Roitburg)*	
	Jack M. Guttentag	"The Mortgage Professor" columnist Professor of Finance Emeritus The Wharton School, University of Pennsylvania
10:00 a.m.	Presentation of White Paper: ***Towards Solving the Sub-prime and Other Financial Crises***	
	Robert Edelstein	Professor, Fisher Center for Real Estate and Urban Economics Hass School of Business University of California at Berkeley
10:45 a.m.	*Coffee Break*	
11:00 a.m.	Panel Discussion	
	David Crowe	National Association of Home Builders
	Conrad Egan	Center for Housing Policy
	Brent Ambrose	Pennsylvania State University
	Julia Gordon	Center for Responsible Lending
12:30 p.m.	*Lunch*	
1:00 pm	Closing Discussion: ***Perspectives from Capitol Hill***	
	Mark Calabria, minority staff, Senate Banking Committee	

Betsy and Walter Stern Conference Center
1015 15th Street, NW, Sixth Floor
Washington, DC 20005 Tel: 202-974-2400

The Hudson Institute taped the session and that is on its website. John Weicher advises us that "It's accessible from the main Hudson page – www.hudson.org – on the right-hand side you'll see that we're the first event under "New @ Hudson," that takes you to the event description and you click on "Media Clips" and have a choice of audio or video. We will not remain "new @ Hudson" forever, of course, and so it is also available by clicking on "Policy Centers" and then "Housing & Financial Markets," etc. As you'll see, we've split both audio and video into two segments, because it was a long event and the different presentations should be more accessible that way."

Here is the summary report from Stephanie Rauterkus:

The Subprime Mortgage Crisis: What's Next?
September 15, 2008

On September 15, 2008 the Hudson Institute's Center for Housing and Financial Markets co-sponsored an event with the Homer Hoyt Institute and the Wharton School of the University of Pennsylvania.

Welcome

John Weicher, Susan Wachter and Maury Seldin opened the event welcoming attendees and providing general remarks about the crisis and the purpose of the roundtable.

John Weicher explained that there are two major issues relative to the subprime crisis that need to be addressed:

1) What do we do now (with respect to curb foreclosures)?
2) What do we do going forward (to implement policy)?

Susan Wachter discussed what we have learned from the crisis:

- We can't lend without controls.
- We can't fund lending with securities that cannot be priced.
- We shouldn't use mortgages that people can't understand.

Maury Seldin outlined two key reasons for the roundtable:

1) To present the White Paper by Edelstein et al.
2) To identify future research needs.

Keynote Speech

Jack Guttentag, emeritus professor of finance at Wharton and syndicated columnist as "The Mortgage Professor" presented the keynote speech based on his paper with Igor Roitburg, "The Elephant in the Mortgage Crisis". In it, the authors proposed a new form of private mortgage insurance that they argue would reduce interest rates for homebuyers and losses for mortgage lenders and investors.

Guttentag explained that while the housing bubble and its subsequent burst led to the current housing crisis, the 'elephant in the room' is the method used to price default risk.

In the current system of traditional mortgage insurance (TMI), borrowers pay for default risk by paying a higher rate over prime for mortgage insurance. The problem is that these risk-based premiums are not reserved for losses but accounted as income. The solution that the authors propose – mortgage payment insurance (MPI) -- is one in which all risk-based dollars would be subject to reserving.

The authors argue that their MPI system would result in wider reserving, a lower cost to subprime borrowers, greater cooperation between insurers and borrowers and a strengthening of the private mortgage insurance industry.

Thus, Guttentage and Roitburg argue that insurers should insure the payments and not the collateral and that this system will have the greatest impact on subprime borrowers because of the lower cost/rates and greater affordability.

Presentation of White Paper

Robert Edelstein, Professor in the Fisher Center for Real Estate and Urban Economics at the University of California at Berkeley presented a White Paper, "Toward Solving the Sub-Prime and Other Financial Crises". The White Paper was developed with Ashok Deo Bardhan and Cynthia A. Kroll. In it, the authors describe the current situation in the housing and mortgage markets, listing the major policy issues, and discussing major research issues that need to be addressed as the government attempts to wrestle with both the problems of current homeowners in danger of losing their homes, and the future structure of the housing finance system to prevent the same thing from happening again.

The authors outline the fundamental problems as follows:

1) The inability to forecast
    a. Inadequate credit risk spreads
    b. Changing yields
2) Asset bubbles financed by cheap debt
3) Slowing of the general economy.

When combined, the authors argue that these elements create nearly a 'perfect storm'. Also, with respect to policy issues, the authors raised the question, "Which needs to be stabilized first: the financial market or the housing market?" They also emphasized that going forward, policymakers need to understand that not everyone needs to be a homeowner.

Panel Discussion

A panel comprised of David Crowe, National Association of Home Builders; Conrad Egan, Center for Housing Policy; Brent Ambrose, Pennsylvania State University and Julia Gordon, Center for Responsible Lending discussed the Edelstein et al White Paper and related issues. David Crowe added a discussion of recent changes in the availability of ancillary credit for home builders. Conrad Egan offered additional future research questions to consider including:

- To what extent is this a "push me" or a "pull me" phenomenon where borrowers are being pushed up into more expensive homes or brokers are being pulled to write more loans?
- What are/should state, local and federal entities do to work toward market stabilization?
- What additional information can we provide about mortgage brokers and their involvement in this crisis?

Brent Ambrose cited numerous policy implications such as those related to:
- Default option mortgages;
- The impact of housing bubbles; and
- Nationalized standards for default/foreclosure laws.

Julia Gordon noted that she represents a subprime lender but their annual loss rates are less than 1%. She defended subprime lending because of the importance of homeownership for building wealth in low-income communities. Further, she gave the following breakdown of subprime mortgages:
- 50% refinances
- 40% moves
- 10% first-time loans

Closing Discussion

Finally, the session closed with a panel discussion of perspectives from Capital Hill with Mark Calabria, staff member for the Senate Banking Committee and Andrew Jakabovics from the Center for American Progress.

The attendance list was as follows:

Last	First	Affiliation
Barnes	Evelyn	Family Resources, Inc
Barnett	Larry	Braddock Holdings
Bennet	Taylor	Edelman
Blanchard	Rachel	Center on Budget and Policy Priorities
Brozdun	Gub	
Cramer	Reid	New American Foundation
Crowley	Sheila	National Low Income Housing Coalition
DeCell	Halle	NeighborWorks America
DeQuoy	Elise	International Business-Government Counsellors
Dimitri	John	NAHB
Feinberg	Robert	
Gilbert	Andrew	FDIC
Goldhaber	Mark	Genworth Financial
Guarino	Anthony	Genworth Financial
Haskins	M. Grace	GAO
Hengstler	Nella	Commercial Attache, Austrian Embassy
Higgins	Lindley	NeighborWorks America
Hunter	Joe	GAO
Krusemark	Amanda	National Alliance to End Homelessness

Marzano	Fabio	Embassy of Brazil
Nation	Chris	Accuracy in Media
Pantages	Jeff	Alaske Permanent Capital Management
Patrabansh	Satyendra	Abt Associates
Petrou	Basil	Federal Financial Analytics, Inc
Pollard	Robert	GAO
Price	Sharon	National Housing Conference
Rautakus	Stephanie	University of Alabama
Reither	Eric	FDIC
Richardson	Megan	National Housing Conference
Rogers	Claire	Hudson
Rosenberg	Robert	
Schuh	Christine	Inside Mortgage Finance
Schuster	Philip	GWU
Schut	Hendrik	Embassy of Holland
Seyferth	Allison	Monument Policy Group
Shlaes	Amity	Bloomberg
Torgerson	David	USDA
Witajewski	Robert	State Dept

SCRC Executive Committee Meeting that Immediately followed the Session

The Executive Committee of SCRC met immediately following the session which highlighted the White Paper. The minutes of that meeting are as follows:

SUBPRIME CRISIS RESEARCH COUNCIL
MINUTES OF THE EXECUTIVE COMMITTEE MEETING
SEPTEMBER 15, 2008

A meeting of the Executive Committee of the Subprime Crisis Research Council (SCRC) was held September 15, 2008. The meeting was called to order by Maury Seldin. Committee members present in addition to Dr. Seldin were Bob Edelstein, Susan Wachter and John Weicher. Cynthia Kroll and Stephanie Rauterkus were also present.

Funding

The Committee discussed the priorities for the remaining SCRC funding. Maury Seldin explained that he does not know yet exactly how much funding is remaining because some costs are still outstanding. Maury Seldin believes that the remaining funding is approximately $30,000. These remaining funds need to be spent – possibly allocated by the time of the Homer Hoyt Institute (HHI) Board meeting at the end of October.

Comprehensive Strategy

Maury Seldin explained that the strategy of the SCRC going forward should be comprehensive in nature – with the White Paper as the centerpiece. Initially, the SCRC planned to allocate $20,000 to publications, of which $10,000 was subsequently allocated to fund a special edition of the *Journal of Housing Economics.* The remaining $10,000 has bee allocated to publishing and distributing the White Paper in hardcopy and electronic form. The $10,000 allocated at the Captiva Island meeting for electronic publication on the web project turns out not to be sufficient, so some of the original

$20,000 publication budget will be used to defray some of the web publication project's costs. The most critical issue is to distribute the White Paper in hard copy and on the Web and to develop an interactive communication to facilitate research continuing even after the grant funds are all gone.

Website Project

The Committee discussed the proposed website project at length. Maury Seldin updated the Committee on several developments/discussions that have transpired regarding this project.

- Several Committee members have endorsed the idea that the website should have interactive capability.
- Cinda Smith's proposal for revamping the Hoyt website was for $15,000. The Committee asked questions about the details of this proposal. Committee members want to be certain that the proposal includes ensuring that the website has interactive capability and 'webinar' capability. If these items cannot be achieved at this price, the Committee would like to see a proposal for a finished product that would have the capability of adding these options in the future. Bob Edelstein asked if all committee members (or possibly a subcommittee comprised of John Weicher, Susan Wachter, Bob Edelstein, Norm Miller, Jeff Fisher and Ron Donahue) could receive a one page summary of the proposal that explains:
    - The objective of Cinda's proposed work;
    - A description of how she will achieve that objective; and
    - A cost estimate for the proposed work.
- This new/updated interactive SCRC website will house a variety of scholarly papers on the subprime crisis including the literature review written by Norm Miller, Stephanie Rauterkus and Michael Sklarz. For that reason, Norm Miller, on behalf of HHI, asked Stephanie Rauterkus to consider taking responsibility for coordinating the collection of documents to be posted to the website and other related tasks. For this service, Stephanie Rauterkus proposed a price of $10,000. In order to keep the website project costs at a manageable level within the SCRC funding constraints, Stephanie Rauterkus agreed to accept $5,000 for these duties.
- The next newsletter – due after the January meeting – will be posted on the Web.
- The total cost of this project is currently $20,000.
- The Committee discussed what will be different about this website and listed the following items:
    - The ability for researchers to communicate with one another;
    - A 'chat room';
    - The ability for the public to have a dialog; and
    - The potential to 'webinize' events.
- John Weicher agreed to obtain average cost data from the Hudson Institute for facilitating 'webinars'.

- The overarching belief of many of the Committee members present was that the successful completion of this project will enable HHI to attract more support for continuing the grant program because of this comprehensive view of the issue.

September 15, 2008 Research Roundtable

The Committee discussed the research roundtable that took place earlier that day. Maury Seldin reported that he spoke with Conrad Egan of the National Housing Conference about funding a stabilization study possibly in conjunction with the mortgage data that we hope to receive access to from the Federal Reserve Bank of Atlanta. The Committee was also impressed with Julia Gordon from the Center for Responsible Lending.

Research Grants

The Grants Committee is looking for recommendations from the SCRC on additional projects to fund. However, the SCRC needs to know the current funding status in order to do so. Maury Seldin reported that he expects to have a draft of this report by October 1st. The Committee discussed the "Triage" project, a Susan Wachter idea that was to elicit a proposal from Stephanie Pierce of the National Governor's Association. Maury Seldin explained that a different proposal came forth from NGA's Center for Best Practices at a shade over $25,000. Susan Wachter agreed to contact Stephanie Pierce to discuss a proposal for a lesser amount more sharply focused to dovetail with the White Paper.. The Committee endorsed the possibility of truncating the project to fit into the White Paper at a grant level of $10,000 for this project.

Adjournment

Maury Seldin adjourned the meeting thanking all Committee members for their time. Stephanie Rauterkus agreed to type the minutes of the meeting and distribute them to all Executive Committee members.

The SCRC Executives Committee's guidance to the HHI Subprime Crisis Research Program's future direction is supportive of the idea of continuing to facilitate academic contributions to enhancing the quality of decisions being made in dealing with the subprime crisis. Since HHI does not engage in lobbying, it is up to the participating organizations not estopped from lobbying and individuals, as individuals, espousing their own views. The next section contains a series of essays that relate getting out of the mess using research and better analyses of the problem.

Academia's Role in the Need for More Research

Dramatic events with the subprime crisis continue to unfold. The problems are not going away as fast as most people thought they would. The historical study of the events will provide many academic papers. But, what is needed now, is more research that will get us out of this mess sooner that would otherwise be the case and that will not have unwanted side effects that linger beyond that necessary for the wise choices. The following short essay is one view.

The Culprits of the Subprime Crisis

By Maury Seldin[6]

The list of culprits in the subprime crisis is long; but, the short answer is that we, who should understand the destruction of wealth and be able to do something about it, are among the culprits. You can pick the cast of characters for the "we." These comments are directed to understanding the destruction of wealth.

Temporary wealth in the form of rising home equity was created because home loans that should have never been made fed an unsustainable rise in house prices. It was just a question of time and circumstances until the excessive prices would adjust. The extent of the adjustments is exacerbated by excessive construction of new homes; construction that will take some time to absorb, varying with local economic growth. It is further exacerbated by foreclosures that flood the market. Part of the impact is the downward pressure on prices, but part is the costs of the process. The wealth destruction includes losses from market prices typically overshooting the longer term trend. At some point it pays to buy and hold unused inventory on the expectation of recovery; but that expectation has an interdependence with economic reaction and the emotion involved.

The ability of the market to move house prices is heavily dependent on the cost and availability of mortgage credit. The mismatch of risks and rewards in the mortgage lending process and the resulting derivatives fueled the housing boom. It also created wealth; much of which was drained from the mortgage finance system, but it also moved wealth into financial instruments that had no chance of preserving value. The process developed a capital structure in a fractional reserve system which created additional wealth. The WSJ of 8/27/08 contains several stories of difficulties resulting from the contraction of the capital market; a contraction attributable in substantial degree to the destruction of wealth triggered by default on the derivatives that are based on mortgage loans that should never have been made.

Regulation that permits the market to do its job is complex. But the paradigm in use by regulators and other players falls short of understanding how reflexivity can accelerate wealth creation and destruction. The biggest problem is that the side effects of the subprime disaster are affecting millions of Americans through the recessionary process triggered or aggravated by the subprime crisis.

I have written extensively in the essays published by the Advanced Studies Institute's newsletter and in the monograph published by Homer Hoyt Institute, *The Challenge to Our Thought Leaders,* about responsibilities of academicians for relevant research. The subprime crisis has given the Homer Hoyt Institute an opportunity to respond, which in my view it has done admirably. It has enlisted to cooperation of others, and they have done a suburb job. The problems, however, are so great, that while a dent in them has been made, a lot more repair is needed. What gets done depends on who picks up on what has been done and carries it forward, or at least joins in by facilitating the extension of the current effort.

That essay sets the context for a series of essays by Maury Seldin written after the September 15, 2008 session in which one academic's views were espoused. Here they are, thus far, including one that was written the week before the drama of the week of September 15.

[6] Dr. Seldin is Chairman of the Board, Homer Hoyt Institute

Intervention Essay September 10, 2008 Draft

Intervention

By Maury Seldin

The takeover of Fannie Mae and Freddie Mac by the federal government is the latest of a series of interventions by the Federal Government[7] in dealing with what has become known as the subprime crisis. This may be viewed as a de facto nationalization, although a temporary one. The greatest danger with such interventions is that short term solutions if left to endure as long term institutional changes may create even greater problems. The market is a wonderful tool, if appropriately regulated. What is appropriate depends on the situation.[8]

The problem in the capital markets was built upon the easy monetary policy of the last decade, fed by mortgage loans that should never have been made, resulting in unsustainable increases in housing prices. The mortgages (that financed the purchase of housing at excessive prices and the construction of houses too early for a stable market) that were securitized were sliced into tranches with varying priority of claims. Some of those tranches were then bundled and again securitized. Leverage for investors got as high as 33:1 making for great profit, if there was a profit, but rapid loss for even modest declines. The debt created in the process far exceeded the value of the underlying security, houses that were excessively priced.

When house prices started to adjust, the increase in foreclosures fed further price declines that began a downward price spiral that will overshoot what would be a normal trend line in housing prices. The problems in the capital markets exacerbated the decline in house prices because the availability of mortgage money was unduly constrained. That constraint was in part as a result of destruction of wealth, but in part because of a change in perception of risk.

Appropriate intervention to reduce the overshooting of the price trends by the downward spiral is the challenge facing the regulators, but also the other participants in the market. Some states and local governments have already intervened.[9] What would make the most sense is a coordinated effort among state and local governments, along with the federal government; furthermore, the lenders and the servicers would do well to provide voluntary cooperation rather than being coerced by some new legislation. Additionally, the borrowers need to be more responsive in dealing with their default. It is amazing that many do not try to work out their problems.

Ideally, the regulators would have good forecasts of turning points in the local markets as the staring point for the decision to intervene. The great difference in the intervention decisions for the capital markets and the housing markets is that the scale is different. The capital markets are national and international and have homogonous institutions as players. Failure of such institutions, given their links to other institutions, could be disastrous. Thus, it makes sense to intervene to avoid disaster. It would help if

[7] This is an opportunity to open a discussion of capital market and other interventions. Detailed discussion might be provided.
[8] See the discussion of cancer in the essay published in the ASI newsletter.
[9] Examples should be provided.

their scale of institutions were reduced, which is the plan for Fannie and Freddie. But the critical decision is to be sure that the intervention is temporary. Such interventions, if permanent, would sacrifice the use of market mechanisms for market discipline. But, market discipline is a necessary condition, but not sufficient. The proper regulatory environment must be present. A great cause of the debacle has been the mismatch of risks and rewards in the securitization of mortgages. It was a failure in regulation.

The housing market situation is of an entirely different scale. The markets for the housing are predominantly local. The lenders, through the securitization, are fractionated and represented by servicers who have fiduciary responsibility to holders of different priorities of claims. The borrowers, even if defrauded, have no recourse to holders in due course of the tranches created by securitization. Thus, reworking the mortgage loans become exceptionally complex. Furthermore, the incentives for the servicers may be counterproductive in reaching the solution.

Some of the intervention may require overriding private contract. That is a scary step, especially when one considers that precedents of such intervention could adversely affect the future flow of funds to the mortgage market.

There are no simple solutions. This is a complex situation dealing with the strategies pursued by different players. These strategies are developed by the parties in pursuit of their own interests with their forecasts of outcomes.

The thrust of the research supported by the Homer Hoyt Institute, with additional funding from industry, is to improve the forecast of outcomes. Hopefully, by the players having better forecasts they will have better strategies. But, it is essential that there be a blending of the strategies of the various players in or to arrive at a grand national strategy.

During World War II there was such a blend because of the common concern for survival of our free society. Mustering a coalition of diverse interests for a common goal is no small matter. We do not know how great the danger is of a catastrophic result from the debacle. But what we do know is that the closer we get to really knowing, the more difficult it is to avert. Given what is at stake, it makes sense to treat the cancer before it spreads further. This can be done, but we need to improver the quality of our decisions, and that means improving the forecasts of outcomes. That is what we do at the Homer Hoyt Institute, and that is what we are doing in the current situation through the development of the Subprime Crisis Research Council, which has leading academics in the field and has reached out to industry, government, and consumer representatives. The September 15 meeting is an interim report of the centerpiece research project, a white paper on “Policy Analyses for a Strategic Approach to Deal with the Subprime Crisis.”

The output of that meeting will be some guidance in developing the final report of the Task Force of the Subprime Crisis Research Council and a prioritization of research to be funded with the small amount of unallocated funds, but hopefully supplemented by additional external support. It may also generate research by other organizations, including governmental organizations.

The first essay after September 15 was imbedded in a memo to the SCRC Steering Committee, HHI Leadership, and selected others titled “Paulson on September 15 and our research program.” Excerpts follow; confusion of items included may be avoided by noting that the memo quoted is in 12 point New Times Roman and the essay integrated into the memo is in Trebuchet MS 12. The confusion may arise because there are excerpts within the essay.

MEMO

To: SCRC Steering Committee, HHI Leadership, and selected others…
From: Maury
Subj: September 15 meetings and follow-up

The September 15 meeting labeled "The Subprime Mortgage Crisis: What Next?" went very well. I preferred the label "Research Roundtable Encore," but John stayed with the more attractive label, which was fine with me. But it worked out well as the encore to the October Research Roundtable of last year. It set the stage for the SCRC Executive Committee that was held immediately after the adjournment of the White Paper presentation and the discussions that followed.

There was some miscommunication along the way in that I intended to have the post Research Roundtable Encore meeting to be of Steering Committee Members. But, we had a fine meeting of the SCRC Executive Committee members who attended the main program. Stephanie Rauterkus, one of our researchers, was kindly took minutes which will be distributed. It will provide an opportunity for you to comment on the plans that emerged. This e-mail provides some background for the game plan described in the minutes.

Unfortunately, some error occurred in the invitation list that was built upon the Hudson Institute mailing list that was used. Not all SCRC Steering Members received a timely invitation. The Hudson Institute taped the session and that is on its website. See box.

It's accessible from the main Hudson page – www.hudson.org – on the right-hand side you'll see that we're the first event under "New @ Hudson," that takes you to the event description and you click on "Media Clips" and have a choice of audio or video. We will not remain "new @ Hudson" forever, of course, and so it is also available by clicking on "Policy Centers" and then "Housing & Financial Markets," etc. As you'll see, we've split both audio and video into two segments, because it was a long event and the different presentations should be more accessible that way. Any comments you have will be most welcome.

As it turned out, on the same day of our session the stock market had the biggest decline since that following the tragic events of 9/11 seven years ago. I assume all of you are familiar with the Lehman Brothers filing for Chapter 11 after Treasury Secretary Paulson did not see it appropriate to bail them out, and the acquisition of Merrill Lynch by B of A. There was some panic in the stock market resulting in substantial destruction of wealth. The implication of stock market destruction of wealth is not as great as the implication of housing market destruction of wealth because the latter has a greater dollar for dollar impact on consumer spending which is a substantial portion of the slack of spending affecting the recession.

I checked three major papers this morning (WSJ, NY Times, and Washington Post – four if you count USA Today) and so far have not found a report on the most significant comment made by Treasury Secretary Paulson. I will make a careful check on it when I have a chance. He made the comment on the Lehr[er] News Hour and inspired me to write the following item which is relevant to our SCRC game plan for the resources that we have not yet allocated. I am putting that into the Chapter 7 draft, in some form, and will include some of the minutes that Stephanie is preparing. This is important as it influences the strategy for our decisions and that of the policy makers that can get some better forecasts of outcomes in developing their strategies, which combined are supposed to get the nation out of this mess with minimal damage in the short run and better institutional arrangements for the future.

Here is the draft. Some of it may be useful in the preparation of a news release reporting on our meetings.

Don't Panic Yet: Treasury Secretary Paulson Got it Right; Well, at Least he Added Recognition of the Impact of the Housing Market

By Maury Seldin

On September 15, on the public televisions news hour (http://www.pbs.org/newshour/) Treasury Secretary Paulson said that the root of the problem lies in the housing market correction; and, he recognized that getting stability in the housing prices was essential to getting stability in the capital markets.[10] His focus is still on the capital markets and apparently has not turned attention to the recession.

We recognized the relationship between housing and capital markets in deciding to go with the Research Roundtable of last October as means of formulating an appropriate research program. The following is an excerpt from the initial communication within HHI.

Excerpts from Exec Com Internal Communication on Mortgage Market Project
[Sunday, August 19, 2007]
To: Homer Hoyt Institute Executive Committee
From: Maury Seldin
Subj: A hot topic for HHI research support

The following quote is from an […] op ed piece by Paul Krugman titled "Market needs workouts, not bailouts." [It appeared in NY Times on August 17.]

> "…There's a serious market failure, and fixing that failure could greatly help thousands, maybe hundreds of thousands, of Americans. The federal governments shouldn't be providing bailouts, but it should be helping to arrange workouts….
>
> "…My guess is that it would involve federal agencies buying mortgages - not the securities conjured up from these mortgages, but the original loans – at steep discount, then renegotiating the terms. But, I'm happy to listen to better ideas."

The logic is that under previous institutional structures, with local lenders, many potential foreclosures could be avoided by arranging workouts. The loss to the lender could be mitigated as well as the loss to the borrower. In many cases the foreclosure results in cannibalized properties, great delays, and unrecoverable costs. It makes [sense] to avoid these when a workout can be a viable alternative to a foreclosure. Furthermore, the market prices of houses are adversely affected by increasing offerings at a time in which demand has been weakened.

A lot of money was made in the private sector when it picked up on the disposition of assets after the S & L scandal. There was substantial research on the whole

[10] Quote is as follows: HENRY PAULSON: "The root of the problem lies in this housing correction. And until we stem the housing correction, until the biggest part of that is behind us and we have more stability in housing prices, we're going to continue to have turmoil in the financial markets."

S & L situation and those results and the experience would be helpful in devising an approach to the current situation.

Krugman suggests the federal government intervention and gives the example of the intervention in a Latin American crisis. My thought is that commercial banks, and other financial intermediaries with local offices, could make a substantial profit by buying defaulted mortgages at deep discounts, but at net prices better that the mortgage holders would realize under foreclosure. These defaulted mortgages would be selected on the basis for a potentiality of becoming a workout.

The role of the mortgage servicer is unclear, but it can be developed in considering which institutions would be prime prospects. The Fed has been pumping big bucks into the system to help the lenders of the traunches in trouble. Krugman points out the help is for the wrong parties. Better provide at least some of the liquidly to the banks or others who would buy the mortgages at the deep discount. The lessons of risk taking are important.

We have access to researchers who could with some modest support provide significant results of wide societal benefit. What are your thoughts on sending out an RFP from HHI?

I picked up on that thought by Krugman, fleshed it out and put it in context by writing the first of the series of inserts about strategies for dealing with the subprime crisis for the HF/ASI newsletter. Here are excerpts from the first of the 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

by

Maury Seldin[11]

> This essay was prepared prior to the October 24, 2007 research roundtable held in Washington D.C. co-sponsored by the University of Pennsylvania's Institute for Urban Research, the Hudson Institute, and the Homer Hoyt Institute. It was posted on the HHI website, www.hoyt.org, earlier that week in order to put on the table one aspect of the Subprime Debacle.

Understanding the interdependence of housing space markets and the capital market is essential to developing an effective strategy to ward off a bubble in the housing market. The discussion that follows touches on the nature of the current crisis in the capital market, the role played by the mortgage market, and the relationship to the housing market. Having done so, an overview of a strategy to be developed for averting housing bubbles in local housing markets will be presented and it will be include some ideas for research that would help in designing the detail of such a strategy; and, bringing on board those who could be instrumental in the creation and implementation of programs engendered in the strategy.

[11] Dr. Seldin is Chairman of the Board of Directors of the Homer Hoyt Institute, an independent not-for-profit organization focused on real estate and urban land economics.

Such a strategy is proposed as a companion piece to measures taken by the Fed and to be taken by the Fed and other government agencies, including state agencies, to mitigate the current financial crisis in the capital market and to avert a repeat of the disruption of orderly capital and housing markets. While some reference may be made to potential long term institutional to avoid recurrence of crises in the capital market the focus of this essay is on local housing markets…

…A vignette of the current crisis is in the lead story of the August 20, 2007 *Wall Street Journal*, "How a Panicky Day Led the Fed to Act." It starts with "Strains in financial markets had been evident for weeks, but Thursday, Aug. 16, was different." The article relates the following: how $45.5 in Euro commercial paper in London was maturing, but what would normally be gone by noon was still half unsold by the end of the day; Countrywide Financial, the largest mortgage issuer in the U.S., was unable to get buyers for its commercial paper as it usually did and it used its bank credit line to borrow $11.5 billion; by the end of the day the flight of the market to more secure paper that "had been around 4%, dropped as low as 3.4%; and, the market distress was calling for some action by the Fed. Further, the WSJ noted that "On Friday morning, following a conference call the previous evening convened by Chairman Ben Bernanke, the Fed blinked."

There is more to be reported on the Feds actions, but the point is that there is enough to call it a crisis… Mortimer B. Zuckerman in his *U.S. News &World Report* editorial of August 13 / August 20, 2007 earlier identified the situation as a "Credit Crunch."

The Zuckerman editorial relates the following: [1] "With more than $1.8 trillion worth of securities backed by subprime mortgages created since 2000, banks and investors are suffering losses that are exposed every week, affecting overall confidence in the credit markets." [2] "Sales of new homes are down 22 percent below a year ago." Negative equity exists in 20% of adjustable rate mortgages and it will increase as teaser rates kick in. [4] The default rate on prime home equity loans has tripled from a year earlier. All of this is seen as part of a pattern of riskier loans…

…Thus far the actions of the Fed have gone to ease the capital market. It lends to banks, not to these other mortgage investors. So, as the WSJ reports, the paper holders bring the paper to their bank and the bank uses it as "collateral to the Fed for a 30-day loan." It is unclear what happens afterward, especially if the paper loses value – who takes the loss.

The Role Played by the Mortgage Market

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…

…However, as a relatively new student of the science of networks it seems to me that as with electric power, web communication, and fashion, that some activity goes a long way before it reaches a cascade point, but when it crosses that threshold the system crashes. The behavior of the group, in this case the participants in a local housing market, is an important element in strategy involving the avoidance of a market crisis generated by what is called cascading. The problem is that we don’t have a very good understanding of aggregate market behavior reaching a cascading point, even though we can do pretty well with individual behavior and market behavior continuing on a trend. The great difficulty is in the turning point – and that is what counts.

While there does not seem to be much concern that the housing crisis would drive a thriving economy into recession, the August 24 issue of NY Times on the first page, right hand column, has a story titled “Analysts See Dim Outlook for Growth.” The lead sentence is “The financial turmoil that began with the seemingly narrow meltdown forcing both policy makers and Wall Street analysts to scale back their expectations for growth in the overall economy.” Obviously, we should be mindful that the subprime crisis had an effect on other segments of the capital market; but, we don’t really know what the unfolding impact will be and while it is not prudent to spread an alarm, it is prudent to reduce the risk.”

The housing market underwent a boom during the low interest rate period earlier in this decade. Borrowing at low rates increased purchasing power. The booming demand pushed up prices. The rising prices gave homeowners increasing wealth.

During this period, consumer spending increased more rapidly than household income. Some homeowners, especially those who were increasing wealth from rising stock prices as well as rising values of their homes, were spending more than their income using debt to finance the living style. Some of this debt was from home equity loans that contained variable rates.

As noted earlier, the aggressive lending under new securitization of mortgages fueled the demand for real estate and contributed to rising prices. The combination of developments in ease of capital flowing from the capital markets contributed to an overbuilding. There is now an excessive supply of housing, perhaps in the neighborhood of 500,000 houses. These are, however, in local markets. The markets that boomed the most tend to have their greatest oversupply.

The crisis in the credit market is limiting the availability of money for the housing market. Lenders are being more realistic in assessing ability of borrowers to pay and some of the long term investors are shying away, especially since there may be bargains in the re-sales of imprudently made investments.

A Strategy for Averting Housing Bubbles

The strategy is to mitigate the possibility of a downward spiral in housing prices and the side effect of bringing on a recession. This paper is not focusing on the policies for dealing with the financial crisis as a whole, including preventive measures. That is for parallel work. **Rather, the focus is on the avoidance of the financial crisis generating excessive impact on the housing market and the housing market generating an excessive impact on the rest of the economy including the capital market. [Emphasis added.].**

Housing markets are generally local. The strategy is to focus on those housing markets that have the greatest risk of an addition to supply of available housing because of foreclosures or threats of foreclosures. The idea is to keep people in their houses whenever possible.

The easiest cases are where the homeowner is still employed but living expenses have eroded the discretionary income, and they are faced with an increase in mortgage payments because of a variable rate mortgage, especially teaser rate mortgages. **Using such cases as an example, a research program can be designed that would identify the geographical location of defaulted mortgages and mortgages that are high risk. [Emphasis added.]**

Such a study would have an output of market areas that may get substantial increases in supply. Along with such a study would be one that revealed the current oversupply of housing and the trend in local pricing. The result would be the selection of a series of markets which are at risk of a bubble. That could be checked against those markets that already experienced high foreclosure rates. The pattern that is likely to emerge is a concentration in a number of states. Some states have already started legislation or other action to help homeowners caught in the problem. See the HHI website, Subprime Crisis Research Program, “the Subprime Mortgage Market, a Review and Compilation of Research and Commentary,” for a discussion of state programs. This research would help them in developing programs and getting them passed. There might also be federal assistance.

A good place to start in analyzing a local market is Maple Heights, Ohio. *The New York Times* published an article on September 2, 2007, “Can the Mortgage Crisis Swallow a Town?” That story indicated that the cascading of foreclosures in that Cleveland suburb led to a particular family abandoning their home even though they were not in default because they no longer felt safe in the area with so many abandoned homes.

A related analysis is to develop model that would indicate when workouts made sense for both the security holder and the homeowner. Lenders may have such models, but buyers are at the risk of asymmetric information. Leveling the playing field may help in getting negotiations that avoid foreclosure.

Adding foreclosed property to the available supply in an overbuilt market may not help anyone and could do a lot of damage to other homeowners by further depressing prices. The lenders using models may be using micro models that look at the single case without looking at the probability of other lenders taking similar action with the combined result that the oversupply thereby created yields less in proceeds to lenders with numerous mortgages in the area than would be yielded had the market not been further depressed. This is especially true if there is a cascading in the local market.

The whole idea is to reduce the risk of a cascading price level that would reverberate throughout the local economy and perhaps the national economy in addition to helping homeowners that are in over their heads because they were led astray by aggressive marketing techniques and didn't realize the risks.

The strategy just outlined indicated some ideas for research that are focused on a single housing market. The strategy is to avoid a cancerous decline of prices in the high risk markets, not only because of the impact within the high risk market, but having the price decline metastasize to other local markets. [Emphasis added.]

While it is true that housing markets are local, there are two ways in which seemingly unconnected housing markets relate to each other. One is that local housing markets are generally tied to their local economies, and not only do downturns in local economies affect the local market, but downturns in the local housing market affects the local economies. Further to this line of reasoning, various local economies are linked by their respective economic bases such that depending upon the linkage, what happens in on local economy will generate impacts on its linked other local economies, those from which it buys and those to whom it sells. In a sense, the national economy is a series of linked local economies, some with closer ties than others, but linked. To an increasing extent this is becoming true of selected international economies which may be view as linkages of metropolitan areas.

A second way in which seemingly unconnected markets relate to each other is through the psychological impact of events. A series of downturns in various local markets will cause some alarm in other markets and may curtail home buying decisions because of the appearance of rising risk. Behavioral science studies show that many people even when told that some event resulting from behavior isn't necessary typical of most other cases because the behavior is not representative, nevertheless proceed to act on the unrepresentative behavior.

The series of research projects that may emerge in order to flesh out a strategy for avoiding rampant housing bubbles may be classified in a number of ways. One way is to starts with a national perspective that explores the relationships between a financial crisis and the spread to economic downturn in general as well as to a housing downturn in particular. Such a study would apply the relatively new science of network science and be particularly concerned with emergence.

The second group of research projects would concern itself with what policies would reduce the likelihood of further downturns in a specific local market. Part of this is relief of hardship for those households directly affected. Additionally, part of this may consider reducing the negative impact of the capital market on the local housing market, or put differently looking for measures that would get favorable influences from the capital market. But the focus is on seeing what policies would contribute to averting excessive declines in the local market. Obviously this is through a reduction in would be foreclosures. But, that raises the questions for the next set of research issues. [Emphasis added.]

The third set of research issues is highly dependent upon underlying values, or what may be thought of as philosophical views, and matters of law. On the matters of law it is not only existing law, but public policy and changes in law.

These questions require research in such issues as to how much of the problem is a result of predatory lending and how much is simply poor decision making on the part of borrowers. That, and the criteria used for relief to borrowers will influence the nature of programs to be developed as a matter of strategy. What will the courts enforce when misrepresentations were present in loans with teaser rates? Is the combination of onerous prepayment penalties enforceable if misrepresentations were made? Will it take class action suits to deal with predatory lending results or will state legislators provide relief in staving off foreclosure under certain circumstances?

This essay is not advocating any particular set of public policies. Rather it is advocating research that would assist public policy decision makers and other participants in the process, borrowers and those on the lending side including mortgage servicers as well as the holders of the mortgages and the derivatives where they exist. [Emphasis added.]

As this is being drafted, the next series of steps is uncertain, except that the research roundtable that is scheduled within the week of this draft brings together potential researchers and potential funders of research in addition to the Homer Hoyt Institute representatives. The discussion that ensues will likely have on the table a variety of ideas, and the interested parties may explore what questions are critical to get answered in tuning up a strategy. HHI has invited John Weicher and Susan Wachter to co-chair the roundtable and to have their respective institutions co-sponsor the roundtable…

…Some strategies are expected to emerge from the research that is spawned by the forthcoming roundtable. While some strategies will be addressed to institutional change that would avoid recurrence of similar debacles in the capital markets, this essay is focused on avoiding a cascading of foreclosures in some local housing markets. The concern is not only for those directly affected in such markets, but for those to which migration of default would similarly affect other markets, and for the fallout to the economy in general.

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Obviously, Secretary Paulson did not see or was not impressed by the Krugman article. Furthermore, it was unlikely that he saw my essay. But even if he did, his focus remained on the capital market and his reference to the housing market is in that context, not as it affects the recession.

As is noted in the draft report on the project, which is available to any of you upon request, we had great difficulty in getting a study of a local market because of the cost of data at a fine enough level. Finally, however, one of our researchers, using a draft of our funded project, has made an arrangement to work with the Atlanta Fed. They have the data, but could use the additional researcher. That researcher is Stephanie Rauterkus. Stephanie has also been designated as our managing editor to handle postings of research papers on the Hoyt website. Any of you who are interested in serving on the electronic publication advisory panel should let her know.

In order to have a more effective site, especially for an interactive approach that could continue to foster research beyond the current funding availability, it will take some time to redesign the site. We can post to the existing site in the meantime. But the vision, starting with Stephanie's project, co-authored with Norm Miller and Mike Sklarz, is to post and link to facilitate research that is most relevant to the issues. (Their project is on contagion effects and will be helpful in the decisions to intervene in the market. It will be available to the public.) But in addition, the site is to have a chat capability for the researchers. Thus, we can continue with our communication process electronically where we have been relying on in-person discussions.

There are some more exotic options under discussion, such as teleconferencing; but that is likely to be beyond our resources at this time. We don't know what will emerge from the SCRC program, but we have designed a minimax strategy. That is to be discussed in Chapter 7 but is touched on in the Executive Committee minutes that will be forwarded to you when available.

Maury

The point of all of this is that the local housing market was identified as the critical area for policy at the very early stages of the HHI effort and government is coming around too it very slowly. The next chapter picks up on the events arising with the proposed legislation and the series of essays that followed the drama that ensued after the September 15 research roundtable encore. It points out a suitable direction for the remaining resources consistent with the results of the SCRC Executive Committee Meeting of September 15.