Chapter 9: Unfolding Events and Underlying Thesis

Underlying Thesis

The thesis underlying the funding by HHI of the Subprime Crisis Research Program (SCRP) was identified in the opening paragraphs of Chapter 2 with reference to the HHI internal memo of August 17, 2007. The relevant quote from the memo to the Executive Committee was as follows: "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….

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?"

The opening paragraphs in Chapter 2 are as follows:

Newspaper reports, during the latter part of August 2007, on the subprime mortgage crisis, and its side effects, prompted Hoyt Group leadership in an exchange of e-mails to discuss the idea of the Homer Hoyt Institute taking the lead in developing a research program to develop and disseminate knowledge that would improve the quality of decisions being made in dealing with the subprime crisis issues.

The opening e-mail quoted an op-ed piece that focused on the need for assistance to those consumers injured by the market failure in contrast to the mortgage instrument investors. The federal policies were focused on the capital markets rather than the impact on the housing markets. The idea was to foster workouts.

The following is a discussion of perspectives held at that time in approaching the problem. Part of the problem in focusing on the workouts is that many of the mortgages were securitized and the role of the mortgage servicer is unclear. The idea of a conference that included the government sponsored financial institutions and the organizations representing the mortgage lending institutions was put on the table. Also the idea of a white paper was advanced. All of this was in the context of getting at a program of sponsoring the most relevant research for effective strategies to deal with the issues.

The idea of mitigating the housing market crisis that was developing from the fallout of the subprime debacle included some analytical ideas to assist the borrowers from avoiding foreclosure and contributing to avoiding a downward price spiral in the market. It is based on a strategic approach to housing markets rather than simply avoiding the chaos in the capital market by bailouts.

The events that have unfolded since attest to the prescience of the HHI SCRP. A September 30 NY Times op-ed piece by David Brooks on the"Revolt of the Nihilists," while dealing with the ineptitude of political leadership, supported my contention from the beginning of the debacle that we need to focus on the housing markets. The quote from

his op-ed piece is as follows: "Leaders need to add provisions that would shore up housing prices and directly help mortgage holders. Martin Feldstein and Lawrence Lindsey both have good proposals of the sort that could lead to a plausible majority coalition."

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Here is a quote from Laurence B. Lindsey in his "Why We're Floundering and a Better Way Forward" published September 24, 2008 in *The Weekly Standard.* "One likely way the new folks could proceed is to stay away from the tar pit of trying to bail out institutions directly and instead opt for an indirect approach. Specifically, the government might choose to bail out homeowners instead. Suppose all homeowners were allowed to refinance their existing mortgage at some low subsidized rate that was also extended to all new buyers, say 4 percent. One catch--the government would have recourse to the borrower and not just the house in the case of default. This is a huge broadening of the plan originally suggested by Martin Feldstein. Not everyone would take this up because it would mean they would have to pay the money back and not just default on their mortgage. So, it would quickly separate the good mortgages from the bad ones that are creating problems in the system."

This morning's NPR news (October 3, 2008) quoted a university dean making a similar suggestion using 5 ¼%. It also quoted George Soros advocating focus on the housing market. I have not been able to get through his gatekeeper so I don't know if he read my stuff, but more people are coming around to the idea.

Bear in mind that Lindsey, "a former governor of the Federal Reserve, was special assistant to President Bush for economic policy and director of the National Economic Council at the White House," is a conservative (which you might have guessed by the venue for his article). There are two additional paragraphs from the same article that indicate the disarray of political leadership. Here they are: "First, it is now obvious that the Thursday consensus to pass a bill was not backed by the reality of legislation, or even a coherent plan of action. When Washington let Lehman Brothers fail (after a century and a half of operations), many in Washington said that Lehman had had six months to get its problems revolved--since being put on notice when its sister firm Bear Stearns was bailed out--and had not done so. Hence it was denied the assistance Bear had gotten. But what had Washington been doing in the intervening six months to get ahead of the developing financial crisis? By the weekend it appeared that the answer was: about as much as Lehman.

Second, when the first details emerged, the focus of the plan was for the government to buy the assets in the financial system that were not easily valued and therefore could not be sold. They were clogging up the books and thereby consuming most of the spare capital in the system. Those that could be sold were being sold out of desperation at fire sale prices. For example, Merrill Lynch had sold assets at 22 cents on the dollar, and had to lend three-quarters of that amount to the buyer. Trouble was, if the government bought at those prices, the financial industry would take massive losses and many firms might go under. That meant that the only way the plan made sense was for the government to buy assets at prices well above current market values. Not even the most talented wordsmith could find a way of getting around the word "bailout" for this type of action. This meant bailing out the same gigantic firms which government regulators and prosecutors had been saying for months had used shady accounting

practices and paid their CEOs tens of millions of dollars per year. I'm just an economist, but that hardly seems like a political winner to me."

The Feldstein proposal was one of many that focused on the housing market assistance. His article appeared in the Wall Street Journal back on March 7, 2007 with the title 'How to Stop the Mortgage Crisis. Bear in mind that Feldstein was Chairman of the Council of Economic Advisers under President Ronald Reagan. The opening sentence "The potential collapse of house prices, accompanied by widespread mortgage defaults, is a major threat to the American economy" supports the premise from which HHI has been proceeding.

Three additional paragraphs lead to the major issue, renegotiating mortgages. They are as follows: The unprecedented combination of rapid house-price increases, high loan-to-value (LTV) ratios, and securitized mortgages has made the current housing-related risk greater than anything we have seen since the 1930s. House prices exploded between 2000 and 2006, rising some 60% more than the level of rents. The inevitable decline since mid-2006 has reduced prices by 10%. Experts forecast an additional 15% to 20% decline to correct the excessive rise. The real danger is that prices could fall substantially further if there are widespread defaults and foreclosures.

Irresponsible lending created new mortgages with LTV ratios of nearly 100%. By the end of 2006, the fall in prices caused 7% of mortgages to have LTV ratios above 100%. A further 20% of mortgages had LTV ratios over 80% and will shift to negative equity as prices decline.

Most mortgages are no longer held by originating lenders, but are securitized and sold to investors world-wide. More significant, mortgages are used to create complex, asset-backed securities that are central to current credit-market problems. Investors no longer own specific mortgages, but only have rights to certain conditional payment streams. So generally, it is no longer possible to prevent foreclosures by negotiations between borrowers and lenders.

Although cram downs were proposed in one of the versions of the "rescue" legislative package they are not in the latest version. As this is written, the House is in a 90 minute debate on the rules committee position that there are no further amendments.

While I await the disposition by the House I am inserting some more of the David Brooks op-ed piece. Here it is: In 1933, Franklin Roosevelt inherited an economic crisis. He understood that his first job was to restore confidence, to give people a sense that somebody was in charge, that something was going to be done.

This generation of political leaders is confronting a similar situation, and, so far, they have failed utterly and catastrophically to project any sense of authority, to give the world any reason to believe that this country is being governed. Instead, by rejecting the rescue package on Monday, they have made the psychological climate much worse.

George W. Bush is completely out of juice, having squandered his influence with Republicans as well as Democrats. Treasury Secretary Henry Paulson is a smart moneyman, but an inept legislator. He was told time and time again that House Republicans would not support his bill, and his response was to get down on bended knee before House Speaker Nancy Pelosi…

And let us recognize above all the 228 who voted no — the authors of this revolt of the nihilists. They showed the world how much they detest their own leaders and the collected expertise of the Treasury and Fed. They did the momentarily popular thing, and if the country slides into a deep recession, they will have the time and leisure to watch public opinion shift against them.

House Republicans led the way and will get most of the blame. It has been interesting to watch them on their single-minded mission to destroy the Republican Party. Not long ago, they led an anti-immigration crusade that drove away Hispanic support. Then, too, they listened to the loudest and angriest voices in their party, oblivious to the complicated anxieties that lurk in most American minds.

Now they have once again confused talk radio with reality. If this economy slides, they will go down in history as the Smoot-Hawleys of the 21st century. With this vote, they've taken responsibility for this economy, and they will be held accountable. The short-term blows will fall on John McCain, the long-term stress on the existence of the G.O.P. as we know it.

I've spoken with several House Republicans over the past few days and most admirably believe in free-market principles. What's sad is that they still think it's 1984. They still think the biggest threat comes from socialism and Walter Mondale liberalism. **They seem not to have noticed how global capital flows have transformed our political economy [Emphasis added]**….

What we need in this situation is authority. Not heavy-handed government regulation, but the steady and powerful hand of some public institutions that can guard against the corrupting influences of sloppy money and then prevent destructive contagions when the credit dries up.

The point of this is that we need to influence the role of academia. As Senator Biden said in the debate, he does not question motives of his colleagues, but he does question judgment. Well, the Senate's pork barrel additions make me wonder about motives, but academia should help with judgment by improving forecast of outcomes.

Thus, the question is what should we do as part of our strategic plan in process to further enhance the development and dissemination of the body of knowledge in real estate and closely related areas? What is apparent by the operation of the administration over the time of the building of the debacle, the deliberations of Congress in handling the proposal by the Administration, and by the called in comments of the public, that there are precious few in and out of government that understand enough to craft responsible regulation and legislation.

The rules committee's restriction on amendments held up and the legislation is now in a 90 minute debate. This is not a position on the legislation; it will be whatever it will be, and probably passed. The position is on what HHI should do in the future, and of course not in the area of lobbying, bur rather in improving the forecasts of outcomes.

The outreach mechanism is critical. We already have a superb mechanism for academia in the form of the Maury Seldin Advanced Studies Institute. The revamping of the web can broaden the reach to academia and others with enough intellectual interest to get the understanding to better understand a changing system.

The changing system engenders changes in both space and capital markets. Our space market focus for the subprime crisis has been on housing and obviously we have

included an ongoing effort in that area as part of our web based program currently under design. We will soon see a crisis in equity markets for investment real estate because there is a credit crunch and an emerging inflation which will drive up the cost of debt and that accompanied by a recession will reduce returns. We have a start on this sector with our REIT efforts of at least a decade and a half.

The HHI "Real Estate Capital Flows Research Program," as described on the Hoyt website, opens as follows: The purpose of the Homer Hoyt Institute's Capital Flows Research program is to identify and quantify the sources and costs of funds available for real estate investment during various phases of the economic cycle. This research program is part of HHI's continuing effort to gain a better understanding of the system and in order to help improve the quality of decisions. The program addresses the long-term problem that the real estate industry experiences with over and under supplies of capital as the economic environment changes.

These changes in flows of funds have, at times, exacerbated space market imbalances, leading to overbuilding and extreme price volatility. At other times, the changes have led to a devastating shortage of funds. During the real estate debacle of the late 1980s and early 1990s, properties lost approximately 30% of their value on average, while many properties suffered losses of 50% or more. Through research, we can gather data and develop models that will contribute to better results for those who participate in the process and for society as a whole.

The HHI was on track with the Real Estate Capital Flows Research Program. Unfortunately, HHI did not have the resources to proceed much farther and support from industry was not forthcoming. Perhaps we ought to see what the Hoyt Fellows see as appropriate in moving that program forward with specific attention to investment real estate.

I thought George Soros would be interested in our efforts since his innovation with reflexivity fits in with our program of understanding the changing system. But, there must be others who have the resources to support further efforts. While further efforts will include research support, the roundtable and other meetings are fruitful, and the web based project can be especially fruitful.

Quantifying results from our efforts with the subprime project is not feasible, but I believe that the Board will see it has been quite appropriate and endorse the continuation with such funds that have not as yet been allocated and may be added by support from others.

The debate proceeds as this is written and while they did not go with as much of foreclosure reduction as is justified, they are talking about some efforts in this area. Some progress will probably be made because Treasury is by congressional discussion being pointed in that direction.

The bill looks as though it will pass. There is going to be a lot more to do in improving the forecasts of outcomes. This is to solicit input on future plans for HHI.

Forecasting Outcomes in a Changing System

The bill passed and the Speaker of the House said that there will be hearings to follow. No one claimed the legislation to be perfect; one comment was that they passed it holding their noses. We can reasonably conclude that further legislation will be forthcoming.

Ronald R. Racster, the President of HHI, is fond of saying something to the effect that academics do well in explaining the past, but are not especially attuned to dealing with the future. My latest response was that we can probably find enough academicians to deal with the future to warrant an activity of HHI to call forth a contribution from academia that would otherwise not be made.

In this light, an unfolding event of the revamping of the Hoyt website may become the vehicle for improving the forecasting of outcomes in a system that is changing.

There is a sea change underway from an almost unfettered market economy with an incredibly easy monetary policy, all related to conservative values, to greater government activities in the marketplace countering the credit crunch hangover of the previous policies with somewhat more liberal values. The specifics of the changes are unfolding, but there are vestigial remnants of the excesses of government as with the pork barrel amendments that the Senate included in its version of the rescue legislation.

The role that might be played by academia, with the assistance of HHI, may well be getting better forecasts of outcomes from potential policy changes. The centerpiece for this effort may well be the White Paper in progress. However, the focus of that paper is on housing and mortgage markets, although it necessarily expands the view to consider broader capital markets and the international economy.

That centerpiece may be set on the table of the web project that builds on the capital flow project and expands from housing to commercial real estate so that both types of the space market are considered along with the capital market. At some point we might include corporate real estate uses, especially in the globalization era. but for now the focus may well be to see what research development and dissemination may be fostered by redesigning the website to accommodate housing and investment real estate space markets in the context of capital markets.

Given the global trends, environmental as well as economic, along with exploring the expansion of the website includes commercial real estate from an investment perspective; we may explore further the integration of Weimer School presentations. These presentations include prescient perspectives of societal concerns impacted by real estate decisions.

Among recent presentations that were prescient was the devotion of the May 2006 Weimer School Session to Predatory Lending, a precursor to the subprime crisis. [We should have links to these presentations or summaries.] The preceding Weimer School May Session, 2005, focused on “Measuring and Managing Risk.” It was a combined session with the Hoyt Fellows that included topics such as modeling mezzanine debt risk.

The “Green and Sustainable” topic, originally scheduled for May 2008 was postponed to May 2009 in order to make way for the subprime crisis topic. That session will again riding the crest of a wave of societal change. The really interesting thing about picking up on these trends is that the topics are interrelated. The real estate is a significant link.

In a January Session in the midst of all of this there happened to be some presentations dealing with urbanization in the global scene and ties among local economies. The web offers an excellent opportunity to show linkages.

The “Green and Sustainable” program, now in preparation for May 2009 may be a uniting theme in that gaining an understanding of the impact on the environment requires an understanding of economic development that is expanding the demand on resources. Real estate, as a key resource in its own right, will play a critical role in this economic growth. While the current focus is on access to the capital market and resolution of the credit crunch, the next focus may well be on the externalities required to make real estate function and the externalities of the impact on the environment from the real estate providing its services.

The resource demands necessary to really capitalize on the role that HHI has the potential to fulfill will require a substantial infusion of resources. Some of that is obviously financial; but, the companion requirement is human resources of a diversity of academic expertise.

Among the disciplines, beyond the obvious economics, finance, political science and so forth, we need more legal and philosophical expertise in order to better deal with the behavioral sciences.

The approach is to study the current crisis and its predecessors that are relevant to forecasting institutional changes that would serve our society well. The methodology would be to create a web counterpart to the Maury Seldin Advanced Studies Institute for Real Estate and Land Economics.

<u>The Revamped Hoyt Website</u>

The component of the website under discussion was noted in a footnote in Chapter 6. Here is that footnote:

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 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.

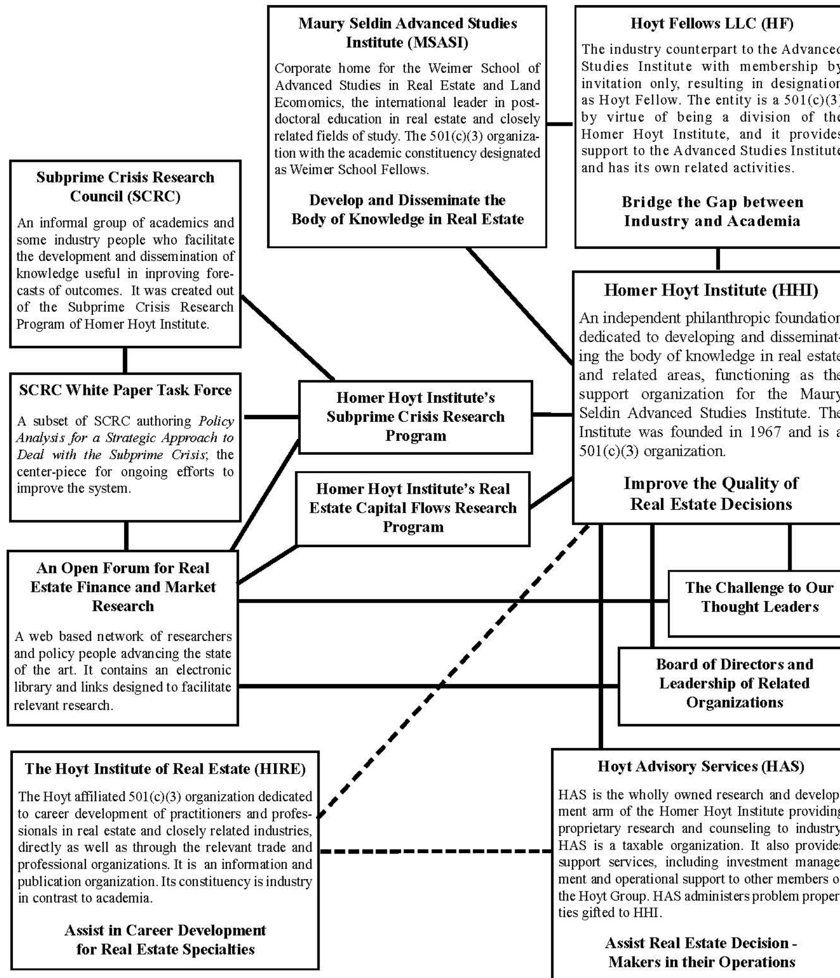
The array of topics will provide a drill down capability. For example, in the case of meetings, the list of meeting is provided with drill down capability to the reports as published in the ASI/HF newsletter and where appropriate, the papers presented or slide presentations, and sometimes to the list 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.

The latest overview of the website integrating the SCRC activities is as follows:

Some Ideas for the HHI Strategic Plan



The minutes of the latest SCRC Executive Committee Meeting included the following:

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.

As of this writing the revised proposal has not been received. However, there is some work by HHI that needs to be done in getting an appropriate mapping of the site. The chart of the strategic plan shows the overall picture. The relevant portion here is for the "Open Forum for Real Estate Finance and Market Research."

Based upon a communication from Jeff Fisher, the approach is likely to be a threaded structure. Jeff wrote, "The discussion is organized by topic and subtopic with each person's comments tacked on to the previous one. That way you just have to look at the comments relevant to the particular topic or subtopic you are interested in. So the topics of interest are "threaded" or tied together." Furthermore, it is likely to be in a hierarchical structure, which is described in Wikipedia as, "A discussion forum, e-mail client or news client is said to have "threaded topics" if it groups messages on the same topic together for easy reading in this manner. Moreover, threaded discussions typically allow users to reply to particular posting within a topic's thread. As a result, there can be a hierarchy of discussions within the thread topic. Various types of software may allow this hierarchy to be displayed in what's called Threaded Mode."

As a start to the hierarchical structure here is an outline for an open forum, bearing in mind that this is a linked system so that some pages are accessed in numerous ways:

I. The White Paper (subheads according to paper outline)
II. Academic Papers (including working papers) THIS IS THE HEART OF THE PROJECT

One set of options is built on the RFP

A. Historical Perspectives and Causes of the Problem

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

B. Policy Proposals and Anticipated Responses

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

C. Economic Analysis and Expected Outcomes

1. Analysis of differences in regional mortgage performance outcomes. Housing markets are local, and both the evidence to date and projections for the future indicate that there are wide disparities in subprime foreclosures across markets. The Institute is interested in analysis of market characteristics that led to geographical variation in the severity of the crisis. We anticipate that the work would involve using micro-data from a select number of markets divided into those with large numbers of defaults and those with small numbers of defaults.
2. Analysis of the impact of foreclosures on neighborhood property values. The Institute is particularly interested in work attempting to separate the impact of foreclosures relative to other regional economic activity in determining property values. We anticipate that this work would also involve using micro-data from a select number of markets divided into those with large numbers of defaults and those with small numbers of defaults.

An alternative classification is as follows:

I. Research Support Information

A. Literature review

B. Subprime mortgage information survey

1. Location of loans
2. Classification of reset, option loans, and other
3. Classification of originator held, securitized, SIV

    4. Dates for reset
    5. Originators, servicers, ad servicer authority
- C. Other data availability survey
- D. Summary of selected proposals for remediation
- E. Summary of industry and other research efforts underway

II. Market Model Development

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

III. Justice and the Law: Impediments and Tools

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

IV. Feasibility of Mortgage Modifications

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

V. Forecasting Outcomes of Strategies being Pursued

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

An additional classification is as follows:

- Consumer education and protection
- Globalization and capital flows
- Institutional change and regulation
- Unstable markets and side effects

- Underlying values/philosophy and public policy
- Action responsibility by industry and government, federal and state
- Alternative strategies for current crisis and institutional change

Some work needs to be done on this with a volunteer committee from SCRC. We may wind up with a number of classifications depending on focus. For example, one just received from Norm Miller is an excellent framework for structuring discussions of what went wrong. Here is his one page listing:

How did we get in the financial mess? By Norm Miller USD SBA BMC Oct. 5, 2008

Key Factors (Several simultaneously occurring)

Factor	Who to Blame?
1. Housing prices driven by hype, greed and false expectations, especially in CA, FL, NV, AZ. 2000-2005 in most markets	Home buyers
2. Mortgage lenders encouraging risky loans by choosing appraisers who verified contract prices 95% of the time. Mortgage brokers who worked merely for fees were among the worst, sometimes encouraging lying on loans and initiating predator loans which were not affordable.	Mortgage lenders and broker, appraisers, home buyers.
3. Implementation of Basel 2 risk based pricing agreement and reserve requirements delayed at the request of lenders and accommodated by the Federal Reserve. 2004, 2005 should have taken effect 2006-2007 and would have required more capital reserves for loans in housing markets poised for bubble trouble, thus it would have increased the rates on loans in most CA. markets. If Basel 2 were fully implemented much of the mortgage mess may have been avoided.	Federal Reserve Bank who censored warning research by James Follain and others.
4. The subprime market exploded allowing homeowners previously unable to qualify for homeownership to buy homes. 2000-2006. Predatory lending accelerated.	Lender's like New Century, Countrywide and many others.
5. Fraud detection tools ignored by most lenders. Appraiser rating systems were available as well as fraud detection systems. Only FICO scores were considered and collateral risk and fraud was ignored by most lenders. These loans were packaged into securities and sold in traunches based on security ratings.	Appraisers, lenders who planned to sell off the loans.
6. Rating agencies rated mortgage pools with a focus on history ignoring the fundamental collateral risk warnings and indicating great safety to investors. These same rating agencies also ignored predatory lending practices.	Moody's, S&P, Fitch ignored market warnings by many economists.
7. CDOs made the problem worse by combining low rated paper and somehow creating higher rated paper. These were sold globally.	Moody's, S&P, Fitch etc.
8. Easier mortgage qualification and low interest rates helped sustain home price increases. Appraisals based on unsustainable prices justified loans while LTVs increased. Ignorant home buyers signed teaser and adjustable rate loans.	Home buyers, Federal Reserve, Predatory Lenders, Rating Agencies.
9. Fannie Mae and Freddie Mac (GSEs) which prior to 2003 claimed they would never knowingly buy subprime mortgages accelerated purchase of subprime loans without a parallel increase in capital reserves, thus increasing dramatically the risks borne while providing highly leveraged and temporarily profitable returns to shareholders.	Fannie Mae, Freddie Mac, OFHEO, Federal Reserve Bank, Congress for allowing GSEs to be exempt from normal audit standards.

10. Financial derivatives (CDO's) and other instruments sold by investment bankers with very little capital reserves. Long and short trading with margins can allow 33 to 1 leverage exacerbating the volatility of prices in the securities market.	Lack of oversight by SEC, Congress, Senate, White House, Naiveté by elected officials, Fed
11. Mortgage portfolios became riskier as home prices (collateral) started to deteriorate but there was no marking to market of the underlying mortgages or securities.	All of the above.
12. Home market statistics from CAR, DataQuick, NAR, S&P Case Shiller miss-used by the media and sensationalized leading to paralysis in many housing markets and making the problem worse.	Media

III. About SCRC (subheads according to booklet outline)
IV. Literature Reviews and Data Sources

A. First General Lit Review (Brent Smith's)
B. State Bank Regulators Review if Available
C. Contagion Review
D. Data Sources (also note link to capital flows data sources)

V. Published Reports in *News from* $^{M}{}_{S}$ *ASI & HF*

A. Newsletter Stories (list)
B. Newsletter Inserts (list)

VI. Subprime Crisis Research Program Report (list by chapter)
VII. Developing the Body of Knowledge in Real Estate Finance and Market Research

A. Real Estate Capital Flows Research Program
B. The Subprime Crisis in the Housing Sector
C. The Commercial Real Estate Investment Sector

This is a humongous amount of work. The site's computer work is to be contracted to Cinda Smith. The SCRC part of it is being contracted to Stephanie Rauterkus under Norm's supervision with guidance from a committee to be determined. A volunteer committee for the selection of literature to post will be no problem. Handling the rest of it still needs to be determined, but there are parts for which volunteers are obtainable.

Underlying Thesis Revisited

Now that the legislation is passed, the Treasury needs to implement its $700 billion dollar program, the one with the big number pulled out of the air because they needed a really big number. According to the NY Times report of October 12, "The bailout legislation itself highlights the contradictory goals that the Treasury will face when it goes on its buying spree. Among the goals that it is supposed to consider are 'protecting the taxpayer,' 'preventing disruption in the financial markets' and 'the need to help families keep their homes." It sounds as though any action could be defended based on one of the goals, but so far there has been no discussion, as far as I can see, of a

comprehensive strategy and insufficient attention to stopping the downward spiral of house prices exacerbated by increasing foreclosures.

The legislation provides some oversight, but given the wisdom challenged activity, or inactivity, of the Administration, and the fact that "Most elected representatives lack financial sophistication…" at least according to a column by Joe Nocera on the same day as the related story, perhaps academia could bring some knowledge to bear. The website could be the vehicle.

There is a wide range of issues in the implementation of the program. Norm Miller provided a one brief summary. It follows without the one paragraph he is reworking and which is dealt with at length in the discussion that follows.

What can and can't the bailout accomplish?

The bailout or TARP (Troubled Asset Relief Program) has several goals. The Treasury is authorized to purchase troubled assets at "fair market value". The problem is quickly determining fair market value. For mortgage purchases or mortgage backed securities, this requires an understanding of home values and mortgage values under distressed conditions. Research suggests typical discounts of 22% on home values when under foreclosure but the discounts have been much greater in the last year up to 40% and 50% in many cases, especially when self-vandalization occurs (stolen appliances, fixtures, etc.) We also note the problem of contagion effects. That is, neighborhood home values are lower when foreclosures are concentrated. Models do exist to do such work quickly but the implementation may be a challenge. Where possible the Treasury should let the market bid for such assets right away.

When the government bails out a private firm all shareholder values should be forfeited. That is the government should be able to become the owner and re-privatize the company and sell it when stability returns. Such policies will be determined by managers of the bailout process.

TARP could turn into a bailout for counties, cities and even states in terms of a lender or guarantor of last resort. As such CA will be much more likely to need such assistance than any other state but many states and cities will be in need of help, especially as property tax revenues and sales tax revenues decline.

Because the purchase of troubled assets at fair market value may leave financial firms severely under-capitalized, the Treasury's authority should be expanded to allow purchasing, again at fair market value, new securities issued by financial institutions in need of additional capital. It does not appear that TARP allows the direct infusion of capital for financial institutions that need liquidity but are otherwise well managed.

Financial firms should be required or induced to raise capital through right offerings to their existing shareholders as a way to raise funds.

TARP does not bail out home owners by forcing forbearance. It does encourage loan restructuring and modification as a way to minimize losses but the very presence of TARP may make lenders less amenable to such write offs choosing rather to turn to the Treasury for selling troubled loans. TARP is not a panacea of solutions for home owners who have defaulted. If it is highly successful, when combined with the takeover of Fannie Mae and Freddie Mac, it will enable the capital markets to issue mortgage backed securities again and allow credit worthy borrowers to continue to buy homes. This in

turn will help add some notion of liquidity to the markets but it will take a while for spreads to return to normal and rating agencies to become trusted once again…

…While TARP is 451 pages in length only 98 deal with the bail out. Senate's pet projects fill the balance and deal with energy, deposit insurance, executive compensation and several tax rules that could make the budget deficit even worse. This bailout will in the short run cost about $7000 per household and bring our collective debt to nearly $80,000 per household beyond existing mortgage loans, car loans and credit car loans. This is certainly an added loan that rational lenders would not approve. It may not be enough

Building on the story in the NY Times, the first issue is the selection of contractors for outsourcing the acquisition and asset management of the first $250 billion in troubled assets. One problem is potential conflict of interest of the contractors because the realm of prospects typically has business with the potential sellers.

According to the NY Times report "The law stipulates that the government must prevent conflicts of interest in the hiring of firms, the decision of which assets to buy, the management of those assets…[etc.] but leaves the details to the Treasury." The next paragraph notes that the Treasury plans to publish guidelines in the next day or two and then quotes Peter Wallison who was general counsel to the Treasury in the Reagan administration, "you are never going to get past conflicts of interest, so you take your lumps." It sure sounds like the fox guarding the henhouse.

Perhaps our academic colleagues could find or produce research that indicates that control on the supply side and incentive and disincentive programs could not only deal with conflict of interest but could deal with multiple goals. In philosophy we discuss incommensurate values, *a la* Isaiah Berlin, but strike balances rather that being dominated by a single value which seems to be what drives many of the most vocal legislators.

One way to start such an approach is to have a qualification system for allowing selling financial institutions to participate in the program. Presumably, the "preventing disruption in the financial markets" calls for providing liquidity to those financial institutions whose balance sheets are laden down with mortgage backed debt and who need liquidity to resume normal operations. Maybe it is in the legislation, but I doubt it. It is the responsibility of Treasury to identify the potential selling financial institutions in the reverse auction process contemplated and then to run through a qualification process.

By using such a process the Treasury could get advance statements of willingness to comply with the restrictions of the legislation and preliminary information on the quantity and nature of the assets to be offered in the event that the class is included in the reverse auction process. If there is really going to be protection to the taxpayer then the policy on assets acquired ought to be to start with the most secure paper at prices that have the best chance for recovery after expenses, including carrying costs and administrative fees. If the goal is to help distressed home owners and avoid excessive foreclosures, "the need to help families keep their homes," then whole mortgages are to be preferred because cram downs are not viable under the legislation where the interests are divided into tranches.

Since maybe something around ten percent of the troubled mortgages are whole mortgages and most of the acquisitions are likely to be derivatives, maybe an analysis of best prospects for acquisition are in order. In the case of whole mortgages possibly priorities would be given to those with resets due in the next couple or few years and in packages that are in the most distressed localities, with the price reflecting the loss of value in those mortgages. That could deal with all three goals mentioned. It could also address the key issue of stopping the trend in foreclosures.

The discussion on derivatives will follow the discussion of whole mortgages. A market for the whole mortgages can be created by letting the contractors bid on the offered packages. The sole source in this situation is an invitation to conflict of interest. By setting a range in fees for the contractors, selecting from among those who offer the lowest minimum fee before the incentive compensation, and a sliding scale of incentive compensation with a low cap, the contractors will have an alignment of interest with the taxpayers. Since even the first $250 billion allocation is likely to be staged over time and allocated among contractors, those who do best in terms of avoiding conflict of interest are given increased allocations for the second round and those who have the greatest conflict of interest may get reduced allocations.

The incentive structure should also favor those who are able to work out debt reductions in order to avoid foreclosure. That should in most cases provide an immediate profit and could also be rewarded with an incentive payment. Some losses are likely because purchases are of packages and allocations to specific mortgages have some aspects of arbitrary decisions. So aside from individual mortgage calculations there should be a package calculation. Obviously this is a lot of work, but it is the sort of thing for which academicians love to build models.

As a side benefit, some lenders may decide to handle their own packages through their servicers and avoid selling wholesale. That would be great news.

The packages of tranches are a more complicated matter, but the same principles apply. Unfortunately, a lot of decision making does not take the bigger picture into consideration. Our society is in this mess because a lot of very bright people simply focused on “working the system” to their own advantage and those responsible for setting and administering the rules, although bright, did not truly consider the bigger picture. Academia is guilty as well with some researchers knowing more and more about less and less until they approach knowing everything about nothing.

This is relevant in that the recent transformation in the institutional structure in the capital markets is not over. Free markets were viewed by some as an idol to be worshipped when the reality is that markets are a useful tool. Americans do not relish lots of regulation but there is a need for better regulation. The recent intervention of the federal government is more akin to what one would expect in Europe than in the United States.

The issue is not only how to proceed out of this mess but how to build a better capital market structure with viable institutional arrangements. Thus, the opportunity may be looked on as building markets for derivatives, which are likely to continue in a globalized economy, and building better corporate management for the financial institutions.

In the aftermath of the stock market crash of 1929 the federal government arranged to get margin requirements imposed for the stock market. Leverage in derivatives ran as high as 33:1. That meant great profits for small rises in prices, but wipeouts for a three percent decline. It doesn't make sense to permit that to continue and then bail out the losers. Thus, why not require any financial institution that wants to qualify for selling toxic assets to set forth its plan for restoring balance to their balance sheet showing there expectations in leverage and plans to provide liquidity to the markets. This is in the context of the goal of "preventing disruption in the financial markets."

As part of the process the institutions should be required to list all there mortgage derivative assets, by class, and identify those which they would consider offering for sale in the reverse auction. That is non-binding on the offer, but should be mandatory to even qualify.

All of this is part of building a secondary market for derivatives that has transparency and permits better valuation of the assets. The measures to suspend mark-to-market requirements for the selling institutions are worthwhile not only on practical grounds, but also on sound theoretical grounds that the price of the last sale of an item is only a clue to the probable price of the next item similar to it, it is not a good clue to what a great volume would bring in the market or what would induce a great volume to be offered. The accountants are mesmerized by objective data in order to protect their liability, but are not ready to make independent judgments of value, rather choosing to rely on some objective historical basis with whatever adjustments can be made as with real estate book values.

That listing of assets is a picture of he universe from which Treasury will seek to acquire assets that will achieve the objectives. The $700,000,000,000 number has no strong foundation, but looking at all the zeros is enlightening. A start with $250,000,000,000 is a good start and can be compared to the universe from which the acquisitions will be made.

Without adequate protection the Treasury will wind up with worthless paper. Prudence in entering the market starts with buying only paper wholly composed of first claim tranches, aside from that composed of whole loans. Most of the capital represented by first claim tranches is recoverable because the percentage of houses that will yield no net proceeds on foreclosure should be very low. The discount needs to represent that expected loss, the administrative and carrying costs, and the premium for providing liquidity. The premium for providing liquidity is the return to the American Taxpayer for taking the risks in entering this venture, otherwise it is truly a bailout plan.

Buying the tranches last in line for payment is absolutely stupid or criminal. It would be a gift to the financial institutions and would be better used to simply buy a preferred stock interest or better yet, a covered bond.

The question of how deep to go in risk with acquiring other than first claim tranches, or with mixes in tranches, is best answered after first round acquisitions of bundles of whole mortgages and first tranch derivatives.

The bidding process among the contractors will establish a market price as well as deal with the conflict of interest issue, provided the compensation is properly set. In

anticipation of an acquisition, or at least after the acquisition, there should be a detailed analysis of the composition of the assets. That analysis needs to go to loan specific data, not only as to terms, especially resets, but to locations and prevailing market prices. Each of the contradictors should be obliged to provide the data as part of the retention agreement.

There are a few commercial organizations with such data and Treasury may supplement its files by subscribing. An alternative is to have the Federal Government enter the arena on the same basis that it provides statistics in related economic areas. It already has substantial data.

Essentially, the Treasury needs a strategy on being a player in the local markets along with state and local governments. The troubled loans are highly concentrated. And with acquisition of Fannie and Freddie the government can be a player in cram downs for whole loans held. Add to this the whole loans acquired by Treasury and it is a good start.

It is really better to get government out of this business, but by pushing home ownership through Freddy and Fannie it got itself in, and by the other recent rescue plans it is in even farther. The way to get out is to foster free markets on level playing fields. That includes transparency and alignment of interests. So maybe it is not free markets, it is fair markets.

With the acquisition of first claim tranches, whole loans, Fannie and Freddie, and local data the Federal Government is in position to fight the exacerbating of the recession. It needs the data on local markets where it is a player and on loan specific mortgages that are liable for resets and/or other adjustments that make them candidates for foreclosure. It can renegotiate those loans it controls by whole ownership.

It can also play a role where it is the holder of a senior tranch on mortgages that are in default or imminent danger of default. The servicer will have the authority to foreclose, but probably limited authority in a workout, probably not a cram down. Some states may com up with their own cram down legislation, and that would help. But even in the absence of cram down authority the senior tranch holder can lead the way in pursuing agreement by all tranch holders in a particular mortgage due for foreclosure by offering to take a voluntary reduction of its claim contingent on others who would also get proceeds under priority of claim.

The difference between a mortgage cram down and a mortgage foreclosure will vary widely depending on damage as well as costs. But a 20% number is a reasonable working number, plus there are great benefits in not having the house go on the market as well as the family retaining its home with a mortgage it can afford.

There are various plans for sharing subsequent appreciation to indemnify debt holders' participation, and those should be considered. But, the leadership of the primary tranch holder can benefit all tranch holdrers, even those that would not get a dime under foreclosure.

The are lots of variations such as buy/sell offers and trust agreements. But some proactive efforts at getting agreements that provide the goodwill of the American

government may bring forth some voluntary cooperation. Besides, the legislature reconvenes in January and can return with cram down legislation.

Academia can help out, especially through the new website. In the meantime, members of the Subprime Crisis Research Council are free on there own to pick up on any of these ideas, work them over as they see fit and work with Treasury to improve whatever plan is emerging. HHI has the resources to carry forward the website program and facilitate the communication among academics and other professional with expertise in the area, including government and especially Treasury. So my good colleagues, since HHI won't lobby, but you as individuals or maybe as port of your organization, are free to contact Treasury, please fell free to share any and all of this that you see appropriate.