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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*

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, the George Washington University Public Policy 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.

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.

The Current Crisis

The first side heading of the lead article in the *Economist* of August 18, 2007 asserts "The new financial order is undergoing its harshest test." The opening sentence of the last paragraph is "Because this crisis taps so deeply into the newly devised structures of finance, anyone who says the worst is definitely over is either a fool or someone with a position to protect."

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."

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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.

Other sources reveal that the slicing and dicing of mortgage loans into tranches with descending claims in order to price different risk levels, accompanied by excessively generous credit ratings contributed to unrealistic risk assessments by investors. Some of those investors, typically hedge funds, leverage the purchase; say at 4:1 of borrowed money. The declines in the value of the derivatives may wipe out the equity of the leveraged investor.

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 change 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.

The role of the mortgage lender should not be underestimated. A *New York Times* story of August 26, 2007 by Gretchen Morgenson reports "Such [high risk] loans were made, former employees say, because they were lucrative – to Countrywide. The company harvested a steady stream of fees or payments on such loans and busily repackaged them as securities to sell to investors. As long as the housing prices kept rising, everyone – borrowers, lenders, and investors – appeared to be winners." The article continues with a later quote from a former sales representative, "The whole commission structure in both prime and subprime was designed to reward sales people for pushing whatever programs Countrywide made the most money on in the secondary market."

An understanding of the historical perspective of how this all developed is provided by John C. Weicher in a paper "The Long and Short of Housing: The Homeownership Boom and the Subprime Foreclosure Bust. He wrote, "The subprime market is new, and it has grown very fast. It barely existed 20 years ago; now, it constitutes about 15 percent of the home mortgage market, and may have accounted for 20 percent of home mortgage originations last year." He writes that 20 years ago the subprime mortgages were generally refinances or debt consolidation loans. They were at low loan to value ratios and when there were foreclosures there were losses to the lender.

Dr. Weicher also reports that by 2002, when he was FHA Commissioner he "had occasion to take a further look at the subprime market, it had changed from its early years. Home purchase loans moved to become about one-third of subprime originations, a much larger share, but still a minor fraction [of the total of subprimes]. LTVs [loan to value ratios] were also quite a bit higher, but still nearly all were 90 percent or less; by comparison, nearly all FHA borrowers had LTVs above 95 percent. By 2006, the home purchase share was up to 44 percent, but more importantly subprime loans now carried very high LTVs and were generally riskier in other respects as well."

His paper contains a discussion of the growth indicating that it stemmed from three public policy changes; [1] the 1986 Tax Reform Act, Financial Institutions Reform, [2] Recovery and Enforcement Act of 1989 (FIRREA), and [3] the "federal encouragement of a conventional mortgage-backed securities market."

The first generated its influence by ending deductibility of consumer interest; IRS regulations encouraged home equity lines of credit. The second public policy generated its influence through an increase in the stringency of regulations that encouraged the financial intermediaries to shift to mortgage banking activities rather than focusing on being long term holders of mortgages. That increased activity in the secondary market, especially with purchases by Fannie Mae and Freddie Mac. The regulatory changes to the traditional lenders encouraged them to move "away from making relatively risky loans, [and so] they left an opportunity for the consumer lenders." The third policy "was more amorphous: federal encouragement of a conventional mortgage-backed securities (MBS) market. For many years the financial markets were only willing to accept MBS with an explicit or implicit federal guarantee. Market acceptance of MBS backed by conventional mortgages and issued by fully private institutions came slowly, but by the late 1980s conventional MBS were being successfully issued. During the early 1990s, subprime MBS were beginning to earn market acceptance." Weicher notes "Each policy served important public purposes. Taken together, they had the unintended consequence of facilitating the subprime mortgage market. From $3 billion in subprime mortgages in 1988, as best the market could be measured, originations increased to $38 billion in 1996 and then to over $500 billion by 2004."

Weicher provides substantial data in his paper and indicates "…the charts suggest to me that the current problem is likely to be limited to the subprime market. It is not likely to be contagious and infect the prime market, although some prime lenders, and especially Wall Street analysts and the media, are expressing the opposite view. It seems clear, moreover, that the problems are concentrated in the loan cohorts of 2004 to 2006. Before 2004, loans were less risky, and borrowers enjoyed the double-digit home price appreciation of 2004 and 2005."

Weicher's charts may be giving the right impression about the containment of the problem to the subprime sector, but although is paper is tremendously helpful in providing a historical perspective of subprime mortgage lending and is allaying some fears about the incidence of hardship through foreclosure, and it is especially informative in the reporting on forbearance, it does not focus on the broader systemic changes.

While the impression may be correct, there is a risk that conditions could further deteriorate and the hardships could spread beyond the borrowers that made poor decisions. Some were victims of predatory lending, others simply were overly optimistic about the continuation of the rising prices in their local housing markets. But still others, while stretched at the margin were doing no more that what was a common practice of buying as much house as they could foreseably afford.

Relationship to the Housing Market

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.

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.

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.

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.

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 a the holders of the mortgages and the derivatives where they exist.

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. Richard Green of George Washington University and the George Washington University Institute for Public Policy joined Weicher and Wachter as co-sponsors.

The Weimer School of Advanced Studies in Real Estate and Land Economics of the Maury Seldin Advanced Studies Institute has allotted some time in the January Session of the Weimer School for vetting the research agenda that emerges from the research roundtable. Additionally, Dr. Richard Green of George Washington University and Weimer School faculty, who is serving on the steering committee for the roundtable, is heading up the May Session of the Weimer School and will focus on the subprime issues.

In April, preceding the Weimer School May Session, ARES will have a plenary session reporting on the research program, and possibly additional smaller sessions reporting on research. AREUEA will allot some time in its Mid-Year meeting, late in May, to have some presentations where many industry and government people will, in addition to academics, discuss some research results.

Presumably, at some point a white paper, or series of papers, would emerge, authored by and representing a variety of interested parties. Such a paper or compilation would be suitable for wide distribution as an educational service to help people make better decisions.

Conclusion

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.

The Market as an Icon: The Case of the Subprime Mortgage Debacle

by Maury Seldin*

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

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

"What we need and do not have enough of, Mr. Paulson [Secretary of the Treasury] said are: honest disclosure about mortgage costs, better licensing for mortgage brokers, a crackdown on predatory lending practices and tougher consequences for lenders who cross the line." That was according to a Tom Blackburn editorial in the *Palm Beach Post* of October 22, 2007, reporting on the current administration's secretary of the Treasury speech the previous week at George Washington University.

The October 24, 2007 research roundtable in Washington D.C. that is the focus of this essay is designed to develop a research agenda that would (1) enhance understanding of institutional arrangements so as to **avert a reoccurrence of the debacle caused by the subprime mortgage catastrophe**; and (2), to enhance understanding that would assist in the development of a strategy to **mitigate the damage from the current catastrophe**, especially to minimize the cascading of foreclosures that would destroy some local housing markets and spread to adversely impact the rest of the economy, especially to avoid a precipitous downturn in general economic activity. This essay is focusing on the longer term institutional changes, and is a companion piece to the "Don't Panic Yet" essay focused on the cascading issue.

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

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

Real estate mortgages typically engender a mismatch of time horizons. Borrowers want long term financing and lenders want liquidity. In the early days of contemporary financial intermediaries, the bank or S & L would take proceeds of short term deposits and lend them long based on the bet that not many of the depositors would want their money at the same time. That worked as long as there was not a run on the bank. And to guard against a fiasco a banker's bank would stand ready to provide liquidity in the event of an emergency that required exceptional liquidity. The key was that the lending institution "ate its own cooking." They retained the loans in the portfolio and were thus greatly concerned with the credit risk of the borrower and the value of the collateral. The subprime debacle emerged out of a transition from those institutional arrangements to the current institutional arrangements. The issue is how to make modifications to a system that went from local housing finance to national capital markets, to international capital markets.

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Consumer education and protection is a good place to start. Sophisticated consumers know enough to consider competitive options, negotiate the terms, and assess the risks if there is adequate disclosure and honest representation. Thus, adequate disclosure and honest representation is a first step. There is a problem with naïve consumers who just take what is offered, especially when what is offered is riskier and costlier than other options available.

The compensation system for some mortgage agents has induced some to knowingly make poor recommendations to the prospective borrower because the agent's compensation is higher with the poor choices. Ethical behavior is one approach to dealing with the issue. Another is licensing requirements. A third is punishment to agent's who violate regulation. An option is to also punish the organizations charged with supervising the agents. There are other areas of business with similar problems. Research on results of different approaches would be helpful in developing strategies to deal with the agent problem. It would be a lot better than superficial public arguments.

The companies that originate the mortgages are in the next level up the chain in the system. The compensation issues are the same as with the agents as to the selection of mortgage types. But, where the originator is a packager and has no long term interest in the repayment risk, the underwriting standards may fall short of what a long term investor would expect.

As discussed in the literature review and commentary for the roundtable, there are others in the chain converting whole mortgages into partial interests of different risk characteristics. These face the same situation of obtaining great short term rewards without long term retention in the risks of holding the derived instruments. Some of this flows to international capital markets.

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

October 22, 2007

This item and other items related to the Research Roundtable on the Subprime Mortgage Crisis are on the Homer Hoyt Institute web site at www.hoyt.org. The list from the web site is as follows:

- Introduction
- Literature Review and Commentary
- Research Roundtable
- Research Projects
- Don't Panic Yet

Other ASI Newsletter inserts are on the web site. Some of these are:

- Thinking Changes Over Time
- The Mind, Brain and Heart: A Paradigm for Predicting Outcomes
- Visions and Values: Western and Islamic Heritages
- Institutional Reform to Reflect Our Values: Part I: The Current Situation
- Institutional Reform to Reflect Our Values: Part II: Moving Toward a Solution
- Education - The Notion Potion
- Developing a Strategy to Change Academic Behavior