The Housing Market Going Forward: Lessons Learned from the Recent Crisis
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(Applause.)

ERIC BELSKY: Thanks, Dave, thanks Sandy, thanks to Allen Fishbein, who I guess will wrap up the day, who were instrumental in organizing this conference, and I'm just really honored to be part of it. It's an incredible, I think, line-up of people on the podium. But I'm looking around the audience and it's a remarkable group of people in the audience.

You could argue that the best way to approach this day would just be to turn it open to a free-for-all and have people ask questions and make comments, and we would all, I think, learn a lot from it.

A lot has been, I think, packed into the day, including my talk and what I was asked to cover in it.

So I apologize if I'm going to be going at a relatively fast clip to cover these things. And also, I think it's going to be a challenge, but it's a challenge that all the moderators, I know, are serious about making sure we meet, which is to have time for audience to make some, to ask questions or make some comments.

I think the one thing that I'm sure Sandy is correct in predicting is that there will be disagreements today. I don't think this will come as much of a shock or surprise to the people in this room that there isn't a unanimity of opinion about almost anything about this crisis, about why we had this crisis, about what to take away from this crisis, about how to drive forward beyond this crisis, and frankly, even whether we are really fully through this crisis.

On virtually every level and at every point, there is going to be disagreement. There is to me actually a surprising lack of consensus on a number of the most, what you would think, key points. There is ongoing debates and disputes. I think we are going to hear that today. There is bickering over the meaning of data. People will look at the same data and interpret it differently.

Then there is, of course, the other category of people, who don't look at the data at all. But even people who are looking at the data are arguing over what exactly to take from that data, and they are using different data to make different arguments.

Obviously, weighing the evidence, I've reached my own conclusions. I don't know how interested you all are personally with what I've concluded, but I'll give you a little insight into that towards the end of my remarks.

There really are a lot of open questions, and in my mind, and why I'm so excited that this conference is happening, and I expect others like this to happen, and perhaps in more focused ways, is that the kinds of decisions that are going to be made based on people's understanding of what causes crisis and what to do about this crisis is going to be very, very important moving forward.

And there are not enough forums in which really systematic attention is being paid to very critical points, so that you get a real, full airing to the policymakers who really have to sort through this, can reach their own conclusions about all the evidence and the data.

I'm going to do three things. I'm going to start by describing what happened, in my view, understanding this boom and bust, in partly the housing market but especially in nonprime lending.

I think there is a tendency among many people to view housing as sort of the proximate cause of everything. To me it has a lot to do with the capital markets, and has a lot to do with the level of capital and capital flows. I'm going to make that argument, and follow that through in through the housing market and how it played out in the housing market, but point out that it played out in many other markets as well, and in many other countries as well, in not exactly the same fashion, but in a similar fashion.

Then I'm going to talk for a minute about, or ten minutes about, the ten lessons I take away from all of this. And I could take away 30 or 40, but I've decided I would limit it to ten; and then talk about what I consider to be the key issues moving forward about what you are going to hear a lot about today.

So what happened in my view? Let me start with saying this. This time was not different. I don't know how many of you are familiar with the book that Ken Rogoff and Carmen Reinhart wrote called "This Time Is Different."

The point of the book is every time there is a financial bubble, an asset bubble driven by a lot of liquidity and low interest rates and leverage, every time that's happened, around the globe, it's very common for it to end in a banking crisis; and that what to us is a singular event because it happens not very frequently in the life of a single country, but happens with actual considerable frequency across countries over time, is not a singular event. They have a similar kind of defining characteristics.

They studied this over two centuries of banking crises, and eight centuries, that is actually right, eight centuries of financial crises. Banking crises are harder to trace, so they only went back 200 years. This is a meticulously researched book. Obviously, they understand that not every event plays out exactly the same way, and policy responses to these kinds of crises are different, contexts are different, situations are different. But nevertheless, there is a remarkable similarity to what happens, and the process of trying to pick up the pieces afterwards is a long process. It is a painful process.

What is this process that they talk about? They talk about international capital mobility. I'll describe it as a lot of global liquidity. This is certainly something that the Chairman of the Federal Reserve has commented on more than once.

The reason that they comment on this so often, so many people, is that it does seem to be very significantly a factor in what came next. You had three large, very large, countries climbing up the steep part of the industrialization growth curve. And when countries move up that steep part of the curve, they do it really for decades. They do it at double-digit rates.

In the '90s if you recall, we had China, India and Brazil all moving along that curve. We had countries like Russia that were stepping up their economic growth, a whole series of countries in southeast Asia. There was a lot of global liquidity. And global liquidity drove interests rates down. Now there is a debate among economists as to whether monetary policy caused interest rates to go so low or at least was a contributing factor, and perhaps it was. But whatever occurred, you had interest rates at very low levels. When interest rates get to that low level, it is because there is a lot of liquidity.

And when interest rates get to that low level, in order to get returns, people take that cheap debt, and they leverage up, and this causes asset bubbles to form. You get asset inflation.

So when you have that amount of debt that is looking for a home, it creates pressures all throughout the system. It allows people to chase asset prices higher. So a lot of capital is flowing back into the United States, as you know, because of the balance of trade issues, coming back to the United States as investment, as lending.

This combination of low interest rates and leverage allowed everybody to chase prices higher. We tend to focus on homeowners and home-buyers and house prices. But of course, it wasn't just home-buyers and house prices. If you look at the multifamily space, property values actually inflated more than they did in the single family space. And they were very significantly growing at a time when net operating income was actually falling.

So rents at that time were soft because of the flow into home ownership, and yet you had multifamily property values going up because cap rates were going down.

Clearly, this was not just a home buyer phenomenon. As you look at the stock market, of course, the stock market went up. If you look at every financial institution, their leverage ratios went up. I'll talk about this in a moment when I talk about causes that relate to regulation. But I will say now that in 2004 the SEC allowed investment banks to voluntarily set their own capital, leverage ratios. They had to be reviewed. But they went from a 15 and 1 ratio in the case of an extreme of Merrill Lynch to 40 to 1.

So this is what you call a lot of liquidity, and lot of leverage. And the story rarely ends well. It ends with a boom. It takes a long time to pick up the pieces.

I think it's really important to understand this, to really get to the heart of what was going on and what needs to be done about it.

These higher prices as they went up, and people could bid up prices because they could take their income and stretch it further, it gave investors a sense and it turns out a false sense of comfort, because if prices were going up, asset values were going up, their collateral values were going up. Anything that was secured lending looked more secure.

But this sense of protection that investors had was aided and abetted by three other things. One was that a lot of the things they were buying were structured finance, and therefore, the subprime issues had overcollateralization. They issued bonds in an amount less than the bonds, than the mortgages backing it. They had excess spread accounts.

Probably the coup de grace was they were getting AAA ratings on 80 percent of the issues from the ratings agencies, and if they took all the B pieces, the risky pieces, the triple B mezzanine rated pieces and put them into a collateralized debt obligation, then they could get 60 percent of AAA rated. To the investor it looks like “wow, I've got overcollateralization, I’ve got excess spread. The ratings agencies are telling us it's AAA rated, and this is a good AAA rating because I actually get a slightly higher yield on this AAA rated thing than another AAA rated thing,” which should have been a sign. But nevertheless, you start to think, “ Wow, I'm pretty well protected.” Plus, there were monoline insures, so people were insured, then people were taking out credit default swaps against these things. So they look pretty protected. It felt like you were being protected.

In this environment, dollars poured in. What happened is to drive volume with all these dollars, and you can talk to people on Wall Street and they will tell you this is sort of what happened, underwriting was increasingly relaxed. Documentation was loosened and affordability products, payment option interest only kind of loans, adjustable rate mortgages with deep discounts, they proliferated, to a degree we had never seen. And I mean to a degree we had never seen. There were purchase option and interest only mortgages for a long time; even in the late 1980s, there was somewhat of an expansion of them in some markets. We are talking about going from 1 to 2 percent of the market to 20 percent of the market, for example, just on those two. In subprime mortgages, now these are mortgages where people have had past problems paying their bills, 44 percent of them in 2005 were 228 adjustable rate mortgages with deep teaser. We are talking about underwriting that, in my mind, often didn't justify that label.

It is kind of hard to imagine. If you were a business and you went in and said, “I'd like a loan for $5 million,” and they said, “how much does your business make,” and you say, “it makes about, well, let me think, $10 million a year.” “Good, here is your loan.” That just wouldn't happen. But you had people doing these loans with extremely little documentation; didn't verify incomes in many cases, did not require escrowed reserves in many cases. And they allowed especially excessive layering of risk. They took all these things, people with poor credit scores, people with high debt to income ratios, low down payments, put it all together and made loans to them.

This was seriously a problem. This is what I call the origination of risk. This is how risk got originated in the market, but it was created in a backdrop against the capital market issues that I just described a second ago.

But they all talk about the multiplication of risk on the capital markets. Risks were literally compounded and multiplied by what happened on the capital markets. I talked about these collateralized debt obligations, credit default swaps, synthetic collateralized debt obligations, which are packages of credit default swaps. They were often what were called squared or cubed. I don't have time to explain this all to you, but it probably doesn't sound good to you, and it wasn't. It was almost impossible to figure out what you had in some of these pools of loans, and yet people were making bets on them.

There was such an appetite to be exposed to this kind of risk, that not only did they take all this risk and expand underwriting to do it, but then they created synthetic instruments to mirror that in amounts that were multiple times. The Federal Reserve at one point estimated in 2006 that the face amount of triple B rated mezzanine pieces that ended up in CDO, was 98 percent greater than the actual face amount of the loans themselves. They were literally taking more and more risks, more and more bets on this exposure. I'm not making this up.

Basically, you have a situation in which you have an incredible amount of money parked on very risky, risky kinds of assets.

This again is something that was a serious problem. I call it the multiplication of risk. On top of everything else there was little transparency. There were, because of the way that a lot of the CDS was written, you don't have to reserve particularly against the risk, and the way that you would if you were an insurance company that was considered insurance, so people didn't necessarily have the cash under certain circumstances to cover all the promises that they were making.

So, what we really ended up with on, also underneath all this, was a modeling of home prices that assumed home prices would just never decline nationally, so you could diversify away from this risk by diversifying geographically. That turned out not to be the case.

So what happened to home-buyers? Home-buyers wanted to get in on this act, and they could to a degree that they were unable to before.

They saw prices going up. They didn't want to be locked out of it. They wanted to be part of it. They assumed rents would go up. They would rather be part of an inflating house price environment than an inflating rent environment. Speculators wanted to get in on it, and to an extraordinary degree. Back in the '80s, if you wanted to get in on this kind of market, you were the “dentist or lawyer,” and you put 50 percent down. You could put essentially no money down and get loans. And so the speculative share went up dramatically and loan performance, now CoreLogic can give you data on those things. I don't have time to get into all the specific numbers. But obviously that is what occurred.

People wanted to get into it. It wasn't a simple kind of want to get into it. I think of it like “Let's Make a Deal.” Behind door number 1 is this house, if you get a 30-year fixed-rate mortgage, and it is not the greatest house because prices are going up, and it’s not in the nicest neighborhood. Behind door number 2, you can get this really nice house, in this really nice neighborhood, with this kind of product. And I think a lot of people decided, I'm going for door number 2.

To avoid mortgage insurance, a lot of people got second mortgages that were marketed right with the first. This became a very common phenomenon. It was large percentages of the loans in 2005 and 2006. They turn out to bite you on the back end, which I'll talk about later, of the mortgage.

What else happened? People think they have this equity. They cash out on the equity they think they have. They are loading up on debt; even if they are not buying homes, they are refinancing.

Then it turns out when you pull back the curtains on all this, there was an incredible amount of fraud, more fraud than it was imagined. And predatory lending practices had proliferated.

Where were the regulators in all this? I might charitably say they were bystanders. There were some guidance, there was voluntary issued, but it was not until 2008 and 2009, which is, of course, after the fact, that we got a real Truth in Lending Act (TILA), Home Ownership and Equity Protection Act (HOEPA), rule changes.

But bystander may be charitable, and here is why. One of the things that we did in the country was, through the Modernization Act in 1998, is the banking system was opened up so that banks could make a lot of money off of acting like investment banks, and trading. And a lot of people would say we need to get back to a banking system that really is focused on banking.

You had, as I said, the Commodities Futures in Modernization Act of 2000, which basically enshrined regulations on derivatives which had sort of been developing, but didn't require a lot of disclosure on them. In 2004, the SEC let investment banks petition, as I said, to set their own leverage ratios.

Then banking regulators were claiming increasing preemptions over a lot of state laws that were intending to try to curb predatory lending practices.

So in the community, what was happening is, you had a lot of lenders who were part of what was later called the shadow banking system, which weren't closely supervised and regulated by federal banking regulators who were supported by a network of people originating loans and going through Wall Street private label securitizations out there making loans, especially in low income and especially low income minority communities.

They made it easy. Encapsulated in a great ad I saw: When others say no, we say yes. You could just go in and they would say yes.

Now CDCs, in the middle of this, community development corporations were sticking to their knitting, and what did they see? Market share migrate across the street to someone that said, "you have to have your financial life in order. We are going to give you counseling. In a certain amount of time, you can go buy a house." They are going, "yes, but next week the house is going to be $2,000 more, and there is somebody across the street waving at me with a pile of cash."

That is kind of what happened. To summarize, we had borrowers on the margins with past problems making payments, getting products with heavy reset risks, high payments that they may not even understand, no property tax escrow, too complicated to understand, reset risk, and surprises at closing.

Eventually, what happens is interest rates rise to a point, and house prices rise to a point, that you can't financially come up with a gimmicky product to get out of the fact that it's just become unaffordable.

Of course, builders are building houses to meet demand. They get an order. They build a house. They were getting a lot of orders, as it turned out from speculators. If you looked at the share that had gone to investor loans, as best it's been measured, which again is by CoreLogic, it went up several percentage points, but that translated into hundreds and hundreds of thousands of additional home purchase loans. When you think about what hundreds of thousands of loans are at the margin in terms of how many homes get built a year in the United States, it's a nontrivial number. In the end you had a market that was building into a level of demand that couldn't be sustained. Yet interest rates are going up, house prices are going up, and as prices started to fall, things really collapsed with stunning speed.

Loan performance just went out the window. Part of this was because the products, loan products were so risky that when there was a problem, speculators were likely the first to peel off. You had early payment default within the first couple months. No one expected to see that, but they saw these early payment defaults happen quickly. Likely it was people that didn't intend on living in the home anyway. They saw prices fall. They walked away from the mortgages. But they still had their home because their other mortgage was on the primary residence.

In the end, you have a situation where you had a lot more distressed sales than we have ever seen in the market. I'm looking at Chip Case, a good friend and an extraordinarily thoughtful person on these issues. We had a conversation early on when this happened. He said if distressed sales go up, I don't know how to call this thing, because prices are typically sticky. Homeowners wait for a buyer that they think is really going to pay them a price, and distressed sales don't follow that logic.

House prices fell well beyond what any analyst thought, quicker, faster, more dramatically. That was a serious problem. Then the financial seizes up. You know the history here. Subprime market shuts down. No capital mortgages unless implicit or explicit federal guarantee to show they stand behind implicit guarantees. Therefore, the Federal Government steps in, taking

Fannie and Freddie into conservatorship over a weekend. The dramatic events that were so dramatic, you couldn't fathom them. I remember seeing a secretary of the treasury on bended knee begging for a trillion dollar check, with a T, to the Speaker of the House. These were extraordinary events.

The broader financial crisis, which was tied to these broader capital market laxity and failure of regulators to act soon enough, made the downturn severe, and in turn made the housing downturn more severe. This financial collapse had many mothers and many that were quite specific to housing. But it certainly wasn't all about housing. The result was we have overleveraged population, people in over their heads, facing trigger events, payment shocks on their mortgages, loss of job, loss of income. It's going to end badly.

What have we learned? Have we learned anything? It will be interesting to see whether people agree. I'm going to do them quickly in the order of which I think they are more likely to be agreed to than less.

My first one, a simple one, national house price declines are possible. If someone gets up and tells me house price declines are not possible, then I know people will argue just about anything. National house price declines are possible. This is important because you can't diversify away from this risk. This is critical when you think about public policy, so that’s why I raise it first. When price to income surge well above long-term trends, the risks of a downturn escalate. But when people model these things, because they model interest rates into it, they are not modeling long-term interest rates, it looks like these prices are going up for a reason, and part of the reason is interest rates. That can reverse quickly.

Another sign of an overheated market is price to rent ratios go up dramatically. That basically shows that price to rent ratios are going up because people have an expectation that prices are going to keep going up in a market where actually housing costs are not inflating on rent. That is often a sign that we need to pay attention to, and some people were talking about this extensively, and it really shot up in '04 and '05, and that is where you saw probably some of the most significant damage.

Stress testing for national price declines now is likely to be demanded by investors and insurers, and that is going to cause mortgage costs to go up. But ultimately I think it's regulators that will have to set the reserves, because the market left on its own can still gravitate towards inadequate reserves and insufficient pricing to cover risk.

That is kind of what they do. Peter Zorn wrote a great paper with Marsha Courchane that says at the top of the market, people tend to charge the least for credit risk when it's the most, and they charge the most for credit risk where it's the least. And we are probably at that point here today.

That is the first lesson.

Second is, the jury is in on home ownership. People want it. Despite elevated defaults and foreclosures, multiple surveys confirm that the vast majority of Americans still aspire to home ownership. Even most homeowners that have been in financial distress say they would prefer home ownership. An interest in home ownership is not purely financial as more and more surveys are showing. Many that now see it as a risky investment still see up sides and want to be homeowners.

That is lesson 2.

Lesson 3 is home ownership entails both risks and potential rewards. I think a lot of people stopped thinking about the risks and focused on the potential rewards. But the potential rewards are compelling. If you look at the driving through a normal time in history, they really are quite compelling. It doesn't mean we don't have house price cycles in places from time to time. We do. But on average, most people come out, and have come out, ahead in home ownership. It is the only leveraged investment most consumers can make.

The risk is asymmetric. There is a huge up side, but except in rare cases where your deficiency judgment gets pursued, there is a limited down side risk to it. Borrowing against home equity is cheaper, and at lower interest rates, all else equal, than borrowing in other ways, although it does have the unfortunate other characteristic of not being dischargeable in bankruptcy, so it’s not all good, but it’s pretty good because you get a low interest rate. So unless you are in a situation filing for bankruptcy, the ability to borrow against your home equity is a plus. A fixed-rate mortgage, if you get one, is a hedge against rent inflation. A prepayable mortgage is a hedge against interest rate risk going up. The option to default on a mortgage it turns out may have been the single most valuable feature in this downturn, which I wouldn't have anticipated, but there it is.

The average homeowner who is in foreclosure is 547 days, on average, past due on their mortgage. Would you rather be a renter where you get evicted, or you are in some kind of limbo for I don't know how long with home ownership. I don't know it will happen forever, but that’s certainly what happened this time. Though not much studied, it appears that the 1985 to 2003 period, which is the period I studied, people who were homeowners, all else equal, came out ahead relative to renters because of this leverage issue.

The recent downturn was a low frequency event. Moving forward, homeowners may again come out ahead in wealth accumulation.

Fourth important lesson: the lowest common denominator problem is real. Left unchecked, a race to the bottom in mortgage lending standards is a serious risk. Private label issuers packaged loans with excessive risks, without regulation constraining them. By lowering standards, private label securities gained a dramatic share of the mortgage-backed securities market. It's a social experiment, and it ended very badly.

I was in a meeting with someone from PIMCO, and they basically showed this chart and said this was not a good experiment. The private label securities market went from 20 percent of mortgage-backed securities in 2001 to over 50 percent in 2006, and it was a much larger market.

Fannie and Freddie stepped in, stepped up their aggressive lending at least in part in response, and also without regulation constraining them, and some people argue regulation nudged them forward, especially after 2005, when the sub goals that they were under were established, so they had to meet a goal in the single family marketplace, couldn't do it through multifamily housing. They were trying to meet this goal in a market that had basically gone over to subprime lending practices. That’s my fourth lesson.

Fifth is when the pendulum swings back, it swings back hard in the other direction and can overcorrect. Formulaic solutions to avoiding excessive risk-taking can needlessly restrict access to credit and stifle innovation. Under the right conditions, and I’ll tell you what they are in a minute, several underwriting flexibilities essential to credit access can lead to acceptable and insurable risks.

Those are things like low down payments. Look at the experience at FHA and VA, for example, and housing finance agencies, higher debt to income ratios, lower credit scores, nontraditional scores. But you can't do it haphazardly and willy-nilly. The right conditions, it looks like, involve not layering all the risk on top of each other, which is how they had been treated when there was an expansion and opening of credit to these borrowers during much of the 1990s before things went really badly astray. Properly documenting income and assets, and using traditional products that don't expose borrowers to additional steep repayment risks. These are fixed-rate products where interest rate mortgages, adjustable rate mortgages that are underwritten to fully indexed rates, so you understand what people can really afford.

Rather than prescribing underwriting standards, which I think can stifle innovation, it strikes me we ought to be having a conversation around the more basal-like regulations which set a tolerable expected level of default, and you have to demonstrate that you believe that these are reasonable expectations, and then you can decide on what products to offer within that.

Number six, consumer confusion is likely, and consumer tendency to focus on monthly payments, not price, can create problems. Many consumers didn't understand the products they got. I mean, I don't know how many read through those documents. I talked to a labor attorney who said he had a funny kind of adjustable rate mortgage, it only adjusts up, and never adjusts back down. I asked how he got this mortgage. He said, I didn't read my mortgage documents and I trusted my broker.

A lot of consumers are going to get confused. Consumer protection is important. Clear, more informative risk disclosure is important.

Seven, in a pinch, the back end matters. And boy, was it a mess. Servicing was unbelievably slapdash. The foreclosure process was a mess. Capital requirements were too low. Reserving adequately against losses is important for insurers and guarantors, but wasn't always happening.

And master servicing agreements matter. They created all sorts of issues. The rights governing senior and junior mortgage-holders were issues. This whole thing has to be rethought, reengineered.

Number eight: Left unchecked, dual markets conform to the detriment of minority communities. They were served more than other communities by players that were less regulated and supervised, and that offered riskier products. 47 percent of home purchase mortgage loans in 2005 were higher priced according to HMDA data versus 30 percent in low-income white communities. But if you look at middle-income minority communities, it was 43 percent.

Clearly, there was a geographic segmentation going on. This raises a slew of issues and concerns that have not been central enough in my mind to the topology discussion that followed the boom and bust, this tendency for dual markets to form, the implications of dual markets, and more particularly implications for minorities as well as for low-income communities.

Nine, sunlight is a great disinfectant. Look at the Home Mortgage Disclosure Act and the impact it had and the Federal Reserve study had on getting discrimination out of the mortgage application process. When we started seeing higher price loans, it raised questions about price discrimination in the mortgage process, which haven't, I don't think, been adequately answered.

But those are important issues. But we need this more on originations, need it on servicing, we need data on practices. There has not been attention as to whether there is disparate impacts in treatment that has been going on in the mortgage servicing side, but there ought to be. On MBS and collateralized debt obligations for investors, there needs to be more disclosure of information.

My number ten on my list -- this is David Letterman, except I didn’t go in reverse -- counter parties have to be much more active in detecting and managing counter party risk.

Those are my ten lessons. The points of debate we will talk about today, and then I'm going to wrap, is was it low income lending and more particularly the government policies that encouraged it which led to the crisis, or something else? I have my own view on that. Was it too much regulation or too little that caused the crisis? I have my view on that. I think some of the regulations people fault for having caused it, like affirmative obligations and goals, need to be looked at how you pursue them. But to me there were a lot of things that weren't regulated that should have been regulated, many of which are now regulated.

Was it the GSEs that caused the crisis? This is a big fracas around this particular one. And what conclusions people draw about these three is really, really important, what they think ought to come next.

On the low income lending side, there have been a lot of conversations and a lot of people raised a lot of points that say, it certainly didn't cause it. It may have been wrapped up in it, may have been part of it, just wasn't big enough to be construed as causative.

When you look at my story about what caused it, it wasn't in there at all.

Lastly, in addition to points about causes and crises of the policy debate are other things about policy debate that have been sparked after the crisis. These are the four we are going to hear about today.

And then I'll turn it over back to, who should I turn it back over to? Dave? Here they are. What roles should the government play in managing mortgage risk? Should something come after the GSEs?

Should the government continue to promote, number 2, should the government continue to promote broad access to mortgage credit through regulation of private capital, through mortgage and MBS guarantees and/or subsidy programs?

Number 3, should the government support low-income home ownership, to help low-income households build assets?

And 4, what roles should rental housing play in the nation's housing policy, and how should it play it?

I appreciate your attention. And I'm now going to turn it over to Dave, who is going to move through the day where we will address I think the three still questions about what caused the crisis that are important, and the four really central policy questions. So with that, thanks.

(Applause.)