

Preventing the Next Housing Bubble

The pain of the deflation of a housing bubble cannot be avoided by trying to keep the bubble inflated, or by trying to deflate it slowly.¹³⁷ The only way to avoid these problems is to prevent the bubble from inflating in the first place through some form of intervention in the mortgage market. Intervention can take the form of a market-based intervention demanded by investors and ratings agencies, and it can also come about through direct government regulation.¹³⁸

Necessary Intervention

The regulated free-market system in place at the turn of the millennium allowed the creation of the Great Housing Bubble. Some combination of market-based and regulatory reforms is necessary to prevent the same circumstances that created the bubble from creating another one; it is imperative to prevent the next bubble in order to avoid the problems from the bubble's deflation.¹³⁹ The kind of intervention proposed here is not a bailout plan. A substantive bailout plan to rescue homeowners would be fraught with problems and unintended consequences. In September of 2008, the banking system neared collapse due to the problems of the fallout, and a banking system bailout became necessary. This outcome argues more forcefully for an intervention to prevent future bubbles from occurring in the housing market.

Economic Problems

The foremost problem resulting from the deflation of the Great Housing Bubble was the imperilment of our banking and financial system. The Great Depression was precipitated by the collapse of margin trading and the subsequent decline of the stock market beginning in 1929; however, this decline is not what made the Great Depression so severe. The policies responding to the upheaval caused many banks to fail, and it was the failure of banks that led to the dramatic decline in business activity and asset deflation of the Great Depression. To prevent a repeat of those problems, Congress passed a number of bank-

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ing reforms granting the Federal Reserve broad powers over our currency and effectively abandoned the gold standard. One of the most successful of these policies was the establishment of the Federal Deposit Insurance Corporation (FDIC) to guarantee the safety of deposits in banking institutions and prevent panic-induced, mass depositor withdrawals (aka “bank runs”) from decimating our banking system. Since the FDIC has been in effect, mass depositor withdrawals at American banks have been relatively uncommon. Just as the deflation of the stock market asset bubble of the Great Depression imperiled the banking system, the deflation of the Great Housing Bubble endangered the banking system because the bank losses were so severe that most became insolvent and many went bankrupt or were taken over by other lenders. Whenever the banking system is put in jeopardy, economic growth is curtailed, and other major economic problems develop.

Another source of economic problems caused by housing market bubbles is the immobility of workers. These problems were witnessed in the deflation of the coastal bubble during the early 1990s, and they occurred again in the deflation of the Great Housing Bubble. When people owe more on their mortgage than their house is worth, they could not move freely to accept promotions or work in other areas. In such circumstances the borrower had limited options. The borrower could have tried to rent the property, but those who bought at bubble prices paid in excess of its rental value so renting the property did not cover the costs of ownership. They were losing money each month trying to keep the house. If they tried to sell the house to avoid the monthly loss, they could not get enough money in the sale to pay off the debt. The borrower would either pay the lender the difference or accept the negative consequences of a short sale or foreclosure. Most often they chose the latter option. Since none of the options available to borrowers were very palatable, many passed on promotions or other opportunities because they were trapped in their homes. Employers also faced difficulties when house prices were much higher than local incomes. When an employer wanted to expand and hire new people, the potential new employee was repelled by the high house prices and either demanded a higher wage or refused to accept employment. Both circumstances were detrimental to the economy when an employee was trapped in their home and could not move and when an employer could not attract new employees because local house prices were very high.

Like all financial bubbles, the bubble in residential real estate caused the inefficient use of capital resources. When prices rose, it signified an increase in demand, and the supply chain went to work to deliver more supply to meet this demand and capture the profits from increased prices. When the demand was artificial, as was the case in a bubble, the market became oversupplied, and this supply was not of the type or quantity the market really needed. For instance, in the NASDAQ stock market bubble, billions of dollars of investment capital flowed into internet companies. This money went into all forms of unproductive uses which ultimately provided little or no return on the investment capital. In the Great Housing Bubble, the inflated prices prompted builders to construct many large houses known as McMansions. The economics favored this because

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the largest homes had the lowest cost per-square-foot to construct, and these houses obtained some of the highest revenues per-square-foot on the market. The result was entire neighborhoods of homes that were very resource wasteful. If the construction resources had been allocated based on true market need, which would have happened in the absence of price bubble distortions, fewer construction resources would have gone into each home, the ongoing cost of maintenance would have been reduced, and fewer total homes would have been built. The temporary demand of construction resources in a financial bubble also impacted human resources. There was a nationwide increase in construction employment to meet the bubble demand. When the bubble burst, many of these people were laid off causing both economic and personal turmoil.

Financial bubbles also witnessed the birth, growth and death of unsustainable financial models. The NASDAQ bubble had internet companies, and the Great Housing Bubble had subprime lending. The subprime lending model was profitable despite a 10% to 15% default rate among its customers. The industry was able to sustain this rate of default because the default losses they sustained were small as long as prices were rising. As soon as prices stopped rising, their loan default rates increased, and their default losses drove the entire industry into oblivion.¹⁴⁰

In the aftermath of the coastal housing bubble of the early 90s, the economy experienced a period of diminished consumer spending because many homeowners who bought during the bubble and did not go into foreclosure were making payments that represent a high percentage of their income. The extra money going toward their mortgage payment, the money in excess of normal debt-to-income guidelines was money the borrower did not have available to spend on other things. The diminished discretionary spending income from this population of borrowers slowed economic growth in an economy heavily dependent upon consumer spending such as the United States.¹⁴¹ Many borrowers during the Great Housing Bubble became accustomed to supplementing their income through mortgage equity withdrawal. When house prices fell, mortgage equity withdrawal was curtailed. This forced many to adjust their lifestyles to live within the money provided by their wage incomes after paying the large debt-service payments. This loss of spending power was not just difficult an economic problem, it was a deeply personal problem for those who wished to spend freely.

Personal Problems

The economic problems caused by asset price bubbles often lead to personal problems in the wake of the deflating bubble. Statistics about unemployment, foreclosure and bankruptcy are impersonal. The events that result in any one of these outcomes was anything but impersonal: these things happened to real people who had very real emotional responses. Many people during the fallout of the Great Housing Bubble experienced all three. Any one of these outcomes can lead to depression, suicide, divorce and a whole host of traumatic personal

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problems. All of it was preventable if the bubble was not allowed to inflate in the first place.

The volatility of price action during a bubble had a profound and capricious impact on people's financial lives. Many people became enriched by fortuitous timing. Some of these people were market savvy individuals who knew when to buy and sell in a volatile market; however, since the mindset of a successful trader was rare, and since most housing market participants were amateurs with emotional responses almost guaranteed to produce a loss, the majority of bubble participants lost a great deal of money. Some were lucky. Some people bought and sold at the right time due to life circumstances beyond their control. Those who transferred out of bubble markets for their careers and sold their houses at the peak reaped huge windfalls. Of course, for every seller who reaped a windfall, there was a buyer who faced major financial difficulties. The unequal distribution of gains and losses from bubble market volatility is not a positive feature.

Another group of people deeply impacted by bubble market volatility are those who chose not to participate. Some of these people recognized the bubble for what it was, and some could not set aside common sense to accept the fallacious beliefs of bubble mentality. This group was forced to rent during the bubble and subsequent decline. Many of these people would have preferred ownership, preferred to have the freedom to customize a property to their liking, and preferred to obtain the intangible benefits of ownership such as a feeling of community and belonging. These people had to endure the patient "waiting game" and feelings of groundlessness renting can entail.

Addressing the Cause

Before a doctor prescribes a treatment, the patient must first be evaluated and a disease must be diagnosed. Similarly, implementing a new policy in either the public sector or private sector to prevent future housing bubbles can only take place after the causes of the housing bubble are accurately identified. If the root causes are not identified correctly, policy initiatives may not have the desired effect. The Great Housing Bubble was a credit bubble, and some form of restriction of credit must be part of any policy initiative. A common criticism of past initiatives restricting credit availability to homeowners is that these initiatives tended to limit opportunities for home ownership without properly addressing problems with lending practices.¹⁴² The goal of any policy initiative with regards to preventing future housing bubbles is to limit or constrain irrational exuberance without impacting the smooth operation of the financial market. It is no easy task.

Before a policy can be formulated, there needs to be an open discussion of the goal of maximizing home ownership. Owning a home has become synonymous with the American Dream. Every Presidential administration has had the expansion of home ownership as one of its goals. The tax code is structured to give tax breaks to home owners to encourage home ownership. The idea of home ownership is deeply embedded in our culture.

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Managing the rate of home ownership is analogous to managing the rate of economic growth. It is not the policy of our government or the Federal Reserve to maximize economic growth. Instead, the Federal Reserve balances economic growth with inflation and tries to manage economic growth to keep it on a sustainable path. This policy grew out of our painful history of economic cycles of boom and bust. It was realized that economic growth must be tempered to a sustainable level to minimize the damage of economic downturns. Similarly, the rate of home ownership should not be maximized. Home ownership will never reach 100%, and this should not be the goal of housing policy. Just as economic growth is tempered by the rate of inflation, home ownership rates are tempered by the rate of default of mortgage loan programs.

The harsh reality is that a certain percentage of the population lacks the desire, discipline or responsibility requisite to be a homeowner. There is a percentage of the population who do not want to be homeowners. Many people require mobility to pursue career opportunities or other goals. Some people like the freedom of renting and do not want the responsibilities of home ownership that go beyond monthly payments. There are some people who simply do not make housing payments consistently. This group is not capable of sustaining home ownership. There may be opportunities for policy initiatives to increase education to make this group smaller, but there will always be some people who cannot or will not do what is necessary to keep a house: make their payments. There is a percentage of the general population who should be renters.

There is a natural, sustainable level of home ownership. Home ownership rates in the United States increased markedly at the end of World War Two as the 30-year fixed-rate mortgage became the commonly accepted vehicle of home finance. In the 60 years that followed, home ownership rates stabilized between 60% and 65% through good economic times and recessions and interest rates ranging from below 6% to above 18%. Subprime lending demonstrated that increasing the home ownership rate through the widespread use of lending programs with high default rates is inherently unstable. Managing the home ownership rate is not a subject of governmental policy. Any legislative initiative to specifically limit home ownership rates would be politically unpalatable; however, either a market-based initiative or a legislative initiative that prevents the widespread use to loan programs subject to high rates of default rates would effectively manage the home ownership rate and prevent painful declines in that rate. Home ownership rates decline as homeowners become renters, a painful process known as foreclosure.

What did not cause the bubble?

There are a wide variety of ideas for preventing future housing bubbles, and all the ideas in the public forum are not discussed here. Some of the more popular are examined to demonstrate why they would not be successful. Most of the ideas that will not work are some form of direct regulation of interest rates, secondary mortgage market activities, price-to-income ratios or investment of equity capital. All regulatory initiatives carry a common problem: there is little

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enforcement once a bubble starts inflating. When times are good, there is immense political pressure for regulators to look the other way. When there is no apparent, immediate harm from a given practice, there is only a vague memory of a time long ago when circumstances were quite different and some restrictive law was passed. The law may seem quaint and old-fashioned or simply an obstruction to the wheels of progress. The rationalizations and justifications for ignoring laws are many, and the pressure to do so is intense when powerful lobbying interests are pressuring Congressmen who subsequently pressure government regulators.

Many believe that lower interest rates created the Great Housing Bubble, and the regulation of interest rates would prevent future bubbles. This is wrong on both counts. The lowering of interest rates did help precipitate the bubble by reducing borrowing costs and increasing home prices; however, once house prices started to rise, prices went much higher than the lower interest rates alone can account for. At most, one-third to one-half of the national price increase was due to lower interest rates, and less than 10% of the increase in coastal areas can be attributed to these lower rates. The direct regulation of mortgage interest rates would disrupt the free flow of capital in the mortgage market. If the regulated rate was too low, no money would be made available, and if the rate was too high, excess money would flow into real estate working to create another bubble. No form of mortgage interest rate regulation would prevent a future bubble because interest rates were not responsible for the Great Housing Bubble.

Much of the responsibility for the bubble can be attributed to the flow of funds into the market from hedge funds through collateralized debt obligations. There have also been calls for greater regulation of hedge funds and the secondary mortgage market. Any kind of regulation would likely restrict the flow of money to all mortgages and disrupt the secondary market. Also, regulating hedge funds themselves will prove problematic, if for no other reason, it is difficult to define exactly what a hedge fund is. Also, hedge funds are simply investment vehicles, and it is unclear exactly what they do that other investment entities do not do that causes problems resulting in financial bubbles. Much of the demonization of hedge funds is demagoguery and looking for someone to blame. Many of the problems with the secondary markets will correct themselves as investors stop investing in products that lose money. In fact, one of the greatest challenges in the aftermath of the Great Housing Bubble is going to be getting investors back into the secondary market. One of the market-based solutions proposed herein addresses these issues. Direct legislative intervention to hedge funds and collateralized debt obligations would be more disruptive than productive.

Another proposed solution is to regulate the loan-to-income ratio of the borrower. When 30-year fixed-rate mortgages first came out, mortgage debt was limited to two and one-half times a borrower's yearly income. It was an artificial limit that made sense when interest rates were higher and people were accustomed to putting less money toward housing payments. A legislative cap on the loan-to-income ratio would prevent future housing bubbles, if it was enforced. This would not work for the same reason lenders went away from the two-and-

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one-half-times-income standard years ago: it does not reflect changes in borrowing power due to changes in interest rates. This idea of regulating loan-to-income ratios is actually an evolution of the idea of regulating interest rates. If the total loan-to-income ratio is limited, very low interest rates do not cause dramatic price increases, but since low interest rates were not really the cause of the bubble, limiting the loan-to-income ratio is not addressing the real cause of the bubble. Plus, there are ways to get around a cap on home loan borrowing by obtaining other loans not secured by real estate. It would be relatively easy for a borrower to obtain bridge financing to acquire a property and then obtain a HELOC to pay off the bridge financing. In the end, the borrower would have borrowed more than the cap amount thus rendering any cap meaningless. To close the various loopholes, more regulations would be required, and a regulatory nightmare would ensue. A better and more effective method of limiting borrowing is to regulate the debt-to-income ratio. This idea is explored in the next section.

What did cause the bubble?

The Great Housing Bubble was caused by an expansion of credit that enabled irrational exuberance and wild speculation. The expansion of credit came in the form of relaxed loan underwriting terms including high debt-to-income ratios, lower FICO scores, high combined-loan-to-value lending including 100% financing, and loan terms permitting negative amortization. Addressing the conditions of expanding credit is a legitimate focus for intervention in the credit markets. Another major lending problem is unrelated to the terms: low documentation standards. The credit crunch that gripped the markets in late 2007 was exacerbated by the rampant fraud and misrepresentation in the loan documents underwriting the loans packaged and sold in the secondary mortgage market. It is essential to an evaluation of the viability of a mortgage note to know if the borrower actually has the income necessary to make the payments. When investors lost confidence in the underlying documents, the whole system seized up, and it was not going to work properly until the documentation improved to reflect the reality of the borrower's financial situation. Any remedy for the housing bubble must address the issue of poor documentation in order to facilitate the smooth operation of the secondary market.

There are some factors that created the Great Housing Bubble that cannot be directly regulated. One of these is the lax enforcement of existing regulations as described previously. Even though lenders and investors lost a great deal of money during the price crash, their behavior during the bubble was still predatory. Lenders peddled unstable loan programs to borrowers who could not afford the payments. They did not do this to obtain the property as is ordinarily the case with predatory lending; they did it to obtain a fee through loan origination. Since they felt insulated from the losses to these loans being packaged and sold to investors, they were in a position to profit at the expense of borrowers – the definition of predatory lending. Another factor that cannot be regulated is the crazy behavior of borrowers caught up in a speculative mania. It is not possible

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to stop people from overpaying for real estate, but it is possible from preventing them from doing so with borrowed money. If people wish to risk their own equity in property speculation, it is their money to lose, but when lender money is part of the equation, the entire financial system can be put at risk, which it was during the Great Housing Bubble. The fickle nature of borrowers became apparent during the decline of the bubble when many borrowers behaved in a predatory manner refusing to make payments on loans they could have afforded to make because the property had declined in value. Borrowers who were grateful to receive 100% financing and what was perceived at the time to be favorable loan terms were not hesitant to betray the lenders when their speculative investment did not go as planned.

The 30-year fixed-rate conventionally-amortizing mortgage with a reasonable downpayment is the only loan program proven to provide stability in the housing market. Many of the “affordability” products used during the Great Housing Bubble and many of the deviations from traditional underwriting standards created the bubble. Mortgage debt-to-income ratios greater than 28% and total indebtedness greater than 36% have a proven history of default. Despite this fact, debt-to-income ratios greater than 50% were common in the most extreme bubble markets.¹⁴³ Limiting debt-to-income ratios is critical to stopping loan defaults and foreclosures. Lower FICO scores was the hallmark of subprime lending. FICO scores provide a fairly accurate profile of a borrower’s willingness and ability to pay their debts as planned. Low FICO scores are synonymous with high default rates. Limiting availability of credit to those with low FICO scores was a historic barrier to home ownership because these people default too much. The free market solved this problem. Subprime was dead. High combined-loan-to-value (CLTV) lending including 100% financing is also prone to high default rates. In fact, it is more important than FICO score. FICO scores are very good at predicting who will default when downpayments are large, but when borrowers have very little of their own money in the transactions, both prime and subprime borrowers defaulted at high rates. Many prime borrowers are more sophisticated financially, and the unscrupulous recognized 100% financing as a perfect tool for speculating in the real estate market and passing the risk off to a lender. The primary culprits that inflated the housing bubble were the negative amortization loan and interest-only loans where lenders qualified buyers on their ability to make only the initial payment. As the Great Housing Bubble began to deflate, Minnesota and some other states passed laws restricting the use of negative amortization loans and required lenders to qualify borrowers based on their ability to make a fully amortized payment. The Minnesota law is a good template for the rest of the nation.

Any proposal to prevent bubbles from reoccurring in the residential real estate market must properly identify the cause, provide a solution that is enforceable, and allow for the unhindered working of the secondary mortgage market. The solutions outlined below are both market-based, meaning it does not require government regulation, and regulatory based, meaning it entails some form of civil or criminal penalties to prevent certain forms of behavior leading to market bubbles. All changes are difficult to implement and the solutions presented here

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would be no exception. Any policies which prevent future bubbles will be opposed by those who profit from these activities and homeowners who are in need of the next bubble to get out of the bad deals they entered during the Great Housing Bubble. Despite these difficulties, it is imperative that reform take place, or the country may experience another housing bubble with all the pain and financial hardship it entails.

Market Solutions

The secondary mortgage market was created in the 1970s by the government sponsored entities, Freddie Mac, Fannie Mae, and Ginnie Mae. This market was expanded by the creation of asset-backed securities where mortgage loans are packed together into collateralized debt obligations (CDOs). This flow of capital into the mortgage market is a necessary and efficient tool for delivering money to borrowers for home mortgages. This market must remain viable for the continued health of residential real estate markets. The problem during the Great Housing Bubble was that the buyers of CDOs did not properly evaluate the risk of loss through default on the underlying mortgage notes that were pooled. The reason these risks were not evaluated properly is due to the appraisal methods used to value real estate serving as collateral backing up these loans.

There is one potential market-based solution that would require no government regulation or intervention that would prevent future bubbles from being created with borrowed capital: change the method of appraisal for residential real estate from valuations based exclusively on the comparative-sales approach to a valuation derived from the lesser of the income approach and the comparative-sales approach. Both approaches are already part of a standard appraisal, so little additional work is necessary – other than appraisers will have to focus on doing the income approach properly. In the current lending system, the income approach is widely ignored. This change of emphasis in valuation methods could come from the investors in CDOs themselves. When the fallout from the Great Housing Bubble is evaluated, it is clear that the comparative-sales approach simply enables irrational exuberance because the past foolish behavior of buyers becomes the basis for future valuations allowing other buyers to continue bidding up prices with lender and investor money. Prices collapsed in the Great Housing Bubble because prices became greatly detached from their fundamental valuation of income and rent. This occurred because the comparative-sales approach enables prices to rise based on the irrational exuberance of buyers. If lenders would have limited their lending based on the income approach, and if they would not have loaned money beyond what the rental cashflow from the property could have produced, any price bubble would have to have been built with buyer equity, and lender and investor funds would not have been put at risk. There is no way to prevent future bubbles, and the commensurate imperilment of our financial system, as long as the comparative-sales approach is the exclusive basis of appraisals for residential real estate.

Investor confidence in the market for CDOs and all mortgages was shaken during the decline of the Great Housing Bubble – and rightly so. Investors were

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losing huge sums, and nobody clearly understood why. There was a widespread belief these losses were caused by some outside factor rather than a systemic problem enabled by the lenders and investors themselves.¹⁴⁴ For investor confidence to return to this market, investors must first ascertain a more accurate evaluation of potential losses due to mortgage default. This requires an accurate appraisal of the fundamental value of the residential real estate serving as collateral for the mortgage loans that comprise the CDOs. Since the fundamental value of residential real estate, the value to which prices ultimately fall during a price decline, is determined by the potential for rental income from the property, revaluing properties using the income approach would provide a more accurate measure the value of the mortgage note and thereby the CDO.

The ratings agencies who rate the various tranches of CDOs must adopt the method of valuation utilizing the lesser value of the income approach and the comparative-sales approach. The ratings agency's recommendations and ratings carry significant weight with investors, and the ratings agencies clearly made a tragic error in their ratings of CDOs during the Great Housing Bubble. If the ratings agencies properly evaluate the underlying collateral backing up the mortgages that are pooled together in a CDO, investors will regain confidence in the ratings, and money will return to the secondary market. If investors in CDOs recognize the chain of valuation as described, they would be unwilling to purchase CDOs valued by other methods. If investors are unwilling to purchase CDOs where the underlying collateral value is measured using the comparative-sales approach and instead demand a valuation based on the income approach, the syndicators of CDOs will be forced to respond to investor demands or they will not be able to sell their syndications. Investors and the ratings agencies can mandate a new valuation method for residential home mortgages.

In September of 2008, the Federal Government took "conservatorship" of the GSEs responsible for maintaining the secondary mortgage market. With the collapse of the asset-backed securities markets and CDOs, the GSE swaps were the only viable market for mortgage paper. This provides a unique opportunity for changing the market dynamics with limited government intervention. If the government in its role as conservator were to decide to mandate a change in appraisal methods, the secondary market would be forced to accept this change. Like any sweeping change in methodology, it could be phased in over time to properly train appraisers and work out the details of implementation. If the GSEs lead, the rest of the market will follow.

The main objection with the income approach is the difficulty of evaluating market rents, particularly in markets where there may not be many (or any) comparative properties for rent in the market. This is an old problem, one that has been studied in great detail by the Department of Labor Bureau of Labor Statistics.¹⁴⁵ Comparative rents have been collected by the DOL since the early 1980s as part of their calculation of the Consumer Price Index. The problem of irrational exuberance in the late 1970s in coastal markets, particularly California, caused the consumer price index to rise rapidly. Since the CPI is widely used as an index for cost-of-living adjustments, volatility in this measure caused by the resale housing market needed to be urgently addressed. After over a dec-

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ade of study, the DOL decided to value the change in housing costs by a comparative rental approach rather than a change in sales price approach used previously. This smoothed the index and reduced volatility because the consumptive aspect of housing services were tethered to rents and incomes rather than being subject to the volatility caused by irrational exuberance in the housing market.

The Department of Labor Bureau of Labor Statistics measures the market rental rate in markets across the United States. It breaks down the market into subcategories based on the number of bedrooms, and it does a good job of estimating market rents in the various subcategories. These numbers are updated each year. The figures from the DOL would serve as a basis for evaluation of market rents, and it may be the only basis in areas where there are few rentals. In submarkets where there is sufficient rental activity, the income approach can use real comparables to make a more accurate evaluation. Appraisers will decry the lack of available data on rentals as many rentals, particularly for single-family detached homes are done by private landlords who do not report these transactions; however, if this method of appraisal were the standard, private companies would spring up to track these transactions and maintain an up-to-date database. Valuing properties based on the income approach may be more difficult than the comparative-sales approach, but when the latter method is fundamentally flawed, ease-of-use is not a compelling reason to continue to rely on it.

There is also the objection that the income approach method of valuing residential real estate has the same problems as the comparative-sales approach because both approaches rely on finding similar properties and making an estimation of market value by adjusting the values of comparative properties. In both approaches the appraiser must explain their reasons for the adjustments to justify the appraised value of the subject property, and this is a potential source of abuse of the system. No system is perfect, but the potential to inflate prices through manipulating appraisals based on the income approach is far less than the potential problems emanating from the comparative-sales approach because the basis of adjustment in the income approach is a properties fundamental value whereas the basis of adjustment in the comparative-sales approach is the prices paid by buyers subject to bouts with irrational exuberance. If lenders start accepting appraisals where the income approach contains adjustments to value that increase the appraised amount 100% – something that would have been required to justify pricing seen during the Great Housing bubble – then the system is hopelessly broken. The main argument for using the income approach is that its basis is the fundamental value whereas the basis for the comparative-sales approach is whatever price the market will currently bear. Prices are not likely to decline below a properties fundamental value where as a property may decline significantly from a point-in-time estimate of market value. Using the income approach lessens the risk to lenders and investors and ensures the smooth operation of the secondary mortgage market. Using the comparative-sales approach exclusively results in the turmoil witnessed during the price decline of the Great Housing Bubble.

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Regulatory Solutions

The regulatory solution proposed herein is simple, yet far reaching. It comes in two parts, the first is to limit the amount lenders can loan to borrowers with a rather unique enforcement mechanism, and the second is to increase the penalties for borrowers who commit mortgage fraud. The following is not in legalese, but it contains the conceptual framework of potential legislation that could be enacted on the state and/or federal level. A detailed discussion of the text follows:

Loans for the purchase or refinance of residential real estate secured by a mortgage and recorded in the public record are limited by the following parameters based on the borrower's documented income and general indebtedness and the appraised value of the property at the time of sale or refinance:

- 1. All payments must be calculated based on a 30-year fixed-rate conventionally-amortizing mortgage regardless of the loan program used. Negative amortization is not permitted.*
- 2. The total debt-to-income ratio for the mortgage loan payment, taxes and insurance cannot exceed 28% of a borrower's gross income.*
- 3. The total debt-to-income of all debt obligations cannot exceed 36% of a borrower's gross income.*
- 4. The combined-loan-to-value of mortgage indebtedness cannot exceed 90% of the appraised value of the property or the purchase price, whichever value is smaller except in specially sanctioned government programs.*

Any sums loaned in excess of these parameters do not need to be repaid by the borrower and no contractual provision is permitted that can be interpreted as limiting the borrower's right to exercise this right, make the loan callable or otherwise abridge the mortgage agreement.

This last statement is the most critical. This is how the enforcement problem can be overcome. Regulators are pressured not to enforce laws when times are good, and decried for their lack of oversight when times are bad. If the oversight function becomes a potential civil matter policed by the borrowers themselves, the lenders know exactly what their risks and potential damages are. Any lender foolish enough to make a loan outside of the parameters would not need to fear the wrath of regulators, they would need to fear the civil lawsuits brought by borrowers eager to get out of their contractual obligations. If any borrower could obtain debt forgiveness by simply proving their lender exceeded these guidelines based on the loan documents, no lender would do this, and regulatory oversight would be practically unnecessary. One key to making this work is to prohibit lenders from introducing a "poison pill" to the loan documents that would make borrowers hesitant to bring suit, otherwise lenders would make their loan callable in the event of a legal challenge forcing the borrower to refinance or sell the property. Basically, if the borrower brought suit and won, they would see principal reduction equal to the deviation from the standards, if they brought suit and lost, they would have no penalty. Most of these cases would be decided by

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summary judgment based on a review of the loan documents thus minimizing court costs.

Another pillar to the system is the documentation of income as part of the loan document package – the “*borrower’s documented income*” from the proposed legislation. One of the most egregious practices of the Great Housing Bubble was the fabrication of income by borrowers that was facilitated and promoted by originating lenders. Stated-income loan programs were widespread, and they were the cause of much of the uncertainty in the secondary mortgage market during the initial stages of the credit crunch in the deflation of the bubble. Basically, investors had no idea if the borrowers to whom they had lent billions of dollars were capable of paying them back. Without proper documentation of income, investors lost all confidence in the secondary mortgage market. Stated-income loan programs were one of the first casualties of the credit crunch. These programs should be eliminated totally due to the inherent potential for fraud and the undermining of confidence in the secondary mortgage market stated-income loans create. If lenders can be sued based on the content of the loan documents, and if borrowers can be fined or go to jail for committing fraud or misrepresentation on loan documents, both parties have strong incentive to prepare these documents completely and correctly. Originating lenders will argue this adds to their costs and will result in higher application fees. The amount in question is very small, particularly relative to the dollar amount of the transaction. A small amount of additional expense here will provide huge benefits by assuring investors the borrowers to whom they are loaning money really have the income to pay them back. The benefit far outweighs the cost.

If such a law were passed, agency interpretation and court case precedents will end up defining adequacy in loan documentation. A single W2 does not establish a work history, but 2 years worth is probably excessive documentation. One of the most contentious areas will likely be documenting the income of the self-employed. In theory, the self employed must document their incomes to the US government either through Schedule C reports or corporate K-1s. The argument the self-employed have traditionally made is that these documents understate their income. Since many self employed take questionable tax deductions, there is probably some truth to the claim that tax records understate their income; however, why should the self-employed get to have both benefits? If the self-employed had to use their tax returns as loan documentation, they probably would not be quite so aggressive in taking deductions. A new business without a tax return or with only one year of taxable receipts probably is not stable enough to meet standards of income necessary to assume a long-term debt.

The poor quality of loan documentation during the bubble was a mistake of originating lenders; therefore, in this proposal much of the burden of paperwork and liability for mistakes falls on the lenders. During the deflation of the bubble, lenders paid an enormous price for some of their lax paperwork standards, but much of the problem was also due to borrowers misrepresenting themselves in the loan documents. There were instances where lenders encouraged this behavior, but in the majority of cases, the document fraud was perpetrated by the borrowers. The only recourse available to a lender is a civil suit as there are few

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criminal penalties associated with loan documentation and almost no enforcement. It can be very difficult and costly for lenders to pursue civil damages, and few lenders attempt it even when they have a strong case. To create a more balanced set of responsibilities, the borrowers must face criminal penalties for fraud and misrepresentation on loan documents. If borrowers know the lender can turn documents over to a prosecutor who will charge the borrower with a crime if they make false material statements, borrowers will be much less likely to commit these acts.

The parameters of the forming limitations on the debt-to-income ratio and combined-loan-to-value are essential to prevent bubbles in the housing market and to prevent the banking system from becoming imperiled in the future. People will commit large percentages of their income to house payments when prices are rising quickly; however, they do this out of fear of being “priced out” and greed to make a windfall from appreciation. These are the beliefs that inflate a bubble. Borrowers cannot sustain payments above the traditional parameters for debt service without either defaulting or causing a severe decline in discretionary spending. The former is bad for the banks, and the latter is bad for the entire economy. This must be prevented in the future. There are a number of reasons why high combined-loan-to-value lending is a bad idea: it promotes speculation by shifting the risk to the lender, it encourages predatory borrowing where borrowers “put” the property to a lender, it promotes a high default rate because borrowers are not personally invested in the property, it discourages saving as it becomes unnecessary, and it artificially inflates prices as it eliminates a barrier to market entry. This last reason is one of the arguments used to get rid of downpayment requirements. The consequences of this folly became readily apparent once prices started to fall.

The payment must be measured against “*30-year fixed-rate conventionally-amortizing mortgage regardless of the loan program used.*” One of the worst loan programs of the Great Housing Bubble was the 2/28 ARM sold to large numbers of subprime borrowers. These borrowers were often qualified only on their ability to make the initial payment, and these borrowers were generally not capable of making the fully amortized payment when the loan reset after 2 years. Regulations like this would prevent a recurrence of the foreclosure tsunami triggered by the use of this loan program. It is also important to ban negative amortization because it would allow the loan balance to grow beyond the parameters of qualification, and it invites property speculation. Perhaps borrowers would not be concerned because they would receive debt forgiveness of the expanding balance. Lenders should be wary of these loans after their dismal performance in the deflation of the bubble, but institutional memory is short, and these loan programs could make a comeback if they are not specifically outlawed. This provision is careful to allow interest-only loans. They are still a high-risk product, but an argument can be made that these loans have a place, and there is no need to completely ban them. They will not have a future as an affordability product capable of driving up prices if the borrower must still qualify for the fully amortized payment.

PREVENTING THE NEXT HOUSING BUBBLE

For the lending provisions to have real impact, they must apply to both purchases and to refinances, thus the clause, "*Loans for the purchase or refinance of residential real estate.*" If the rules only applied to purchases, there would be a tremendous volume in refinances to circumvent the regulations. The caps on debt-to-income ratios, mortgage terms and combined-loan-to-value only have meaning if they are universally applied. The combined-loan-to-value standard is based on the "*appraised value of the property at the time of sale or refinance.*" The new appraisal methods will have impact here. It is important that the records need only be accurate as of the time of the transaction. If a borrower experiences a decline in their income or if the property declines in value to where they no longer meet the loan standard, it does not mean they can go petition for debt relief.

The regulations would only need to apply to loans "*secured by a mortgage and recorded in the public record.*" People can still borrow money from any source they wished as long as the lender knows they will not have any claim on residential real estate. If a lender wanted to issue a loan secured by real estate outside of the outlined standards, the borrower would not have to pay back that money. If a borrower has non-recorded debts which create a totally indebtedness requiring more than 36% of their gross income, they would not be eligible for a home equity loan even if they met the other qualifications. In such circumstances, it is better to limit borrowing than increase the probability of foreclosure.

Many states have non-recourse laws on their books. These laws serve to protect the borrower from predatory lending because the lender cannot go after other assets of the borrower in the event of default. In theory this should make lenders more conservative in their underwriting; however, the behavior of lenders in California, a non-recourse state, during the Great Housing Bubble was not conservative. These laws do serve to protect borrowers, and they should be enacted for purchase-money mortgages in all 50 states.

Since one of the goals of regulatory reform is to inhibit the behavior of irrational exuberance, the sales tactics of the National Association of Realtors should be examined and potentially come under the same restrictions as securities brokers through the Securities and Exchange Commission. After the stock market crash which helped precipitate the Great Depression, Congress created the Securities and Exchange Commission to regulate the sales activities of securities brokers. There are strict regulations in place governing the representations made concerning the future performance of investment opportunities. These protections were put in place to protect the general public from the false promises made by stockbrokers in the 1920s which many naïve investors believed. The same analogy holds true for Realtors. The National Association of Realtors has launched numerous advertising campaigns suggesting erroneously that residential real estate is a great investment and appreciation will make home buyers wealthy.¹⁴⁶ The mantra of all realtors is that house prices always go up. There are currently no limits to the distortions and outright lies realtors can tell prospective buyers with regards to the investment potential of residential real estate. Buyers are already prone to believe the fallacies of unlimited riches in real estate, and these fallacious beliefs lead to housing bubbles. Realtors should

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be prevented from making representations concerning the investment potential of real estate. Since the regulatory framework for this kind of regulation and oversight is already in place under the auspices of the Securities and Exchange Commission, Congress would merely need to make Realtors subject to these regulations in order to solve the problem.

The result of these restrictions will be that all homeowners will have at least 10% equity in their properties unless they have borrowed from a government program like the FHA where the combined-loan-to-value can exceed the limits. This equity cushion would buffer lenders from predatory borrowing and a huge increase in foreclosures if prices were to decline. Home equity in the United States has been declining since the mid 1980s, and it actually declined while prices rose during the Great Housing Bubble due to the rampant equity extraction. The lack of an equity cushion exacerbated the foreclosure problem as many homeowners who owed more on their mortgage than the house was worth simply stopped making payments and allowed the house to fall into foreclosure.

Summary

A future bubble in the housing market must be prevented. The economic and personal problems resulting from the deflation of the Great Housing Bubble must not be inflicted on another generation. Just as those who endured the Great Depression struggled to understand what went wrong and prevent its reoccurrence, we must prevent another bubble in the housing market. There are both market-based alternatives and regulatory-based policies that could serve to prevent the next housing bubble. The market based solution proposed herein is to expand the use of the income approach to property appraisal to tether prices to fundamental values. The regulatory solution proposed herein is a multifaceted approach that limits lending to within certain standards. The policing mechanism is a shift to civil enforcement through allowing borrowers to obtain debt forgiveness for amounts lent outside of the approved parameters.

The Great Housing Bubble was an epic event impacting the lives of nearly every household in the United States and around the world. At first it was a giant house party fueled by excessive borrowing and spending by homeowners. The hangover was not pleasant. As of the time of this writing the full history of the fallout is not yet recorded. The decline in prices to this point has been breathtaking and unprecedented. When the full history is written, and the final impact of the bubble is measured, many will remember the Great Housing Bubble as one of the most important historical events of their lifetime.