

THE FUTURE OF HOUSING FINANCE: ECONOMIC AND POLICY INSIGHTS

EXECUTIVE REPORT



THOUGHT LEADERSHIP
ROUNDTABLE SERIES 2013

CALIFORNIA ASSOCIATION OF REALTORS®

PREFACE



Janice Eberly

Richard Green

Edward Leamer

David Min

Joel Singer

This executive report summarizes analysis from a roundtable with four leading economists and finance experts convened by the CALIFORNIA ASSOCIATION OF REALTORS® in September 2013. This report is the second installment of C.A.R.'s 2013 Roundtable Series, which brings together thought leaders for substantive conversations, and on this occasion, participants addressed the most pressing economic and regulatory issues facing the industry.

We were gratified to have such distinguished discussants join C.A.R. CEO Joel Singer for this event. Special thanks to Janice Eberly, Edward Leamer, David Min, and Richard Green for sharing their invaluable expertise with the membership of C.A.R.

Led by Singer, the wide-ranging conversation covered market conditions, the financial recovery, mortgage finance, the regulatory environment, and housing policy. Actively pursuing such dialogues in order to elevate the best of industry thinking is reflective of C.A.R.'s commitment to promoting the highest standard in real estate. The conversation also fulfills the goals of C.A.R.'s new Thought Leadership program, which advances intellectual engagement to maintain C.A.R.'s position as a leading housing organization.

01

THE FUTURE OF THE 30-YEAR MORTGAGE

Housing finance's future under the 30-year mortgage may be a function of politics rather than economics, as the sway of voters may suggest the 30-year fixed-rate mortgage is a product that's here to stay. The political pressure and conventional wisdom after decades of familiarity support the tenability of the 30-year mortgage. The country's mentality about the mortgage market may be informed by voters' short memories, with the 2008-2009 downturn being forgotten in the course of a few years.

02

FINANCE REFORM REQUIRES CLARITY

A great deal of uncertainty remains about the future of America's housing finance system, and this lack of certainty about the government's role has impacted credit availability and access to low interest rates. As the American public and its political leaders consider various legislative proposals, Americans must consider the value of a consumer-friendly loan, and by extension, the government backstop it requires. Discussions about finance reform thus far have struggled to differentiate the government's role with respect to a backstop versus a subsidy, as a government role has been necessary to prevent onerous mortgage terms from the pre-New Deal era.

03

HOUSEHOLD FORMATION FALLS BEHIND

While the country is indeed experiencing a housing recovery in terms of price and volume of building, housing starts are way below normal. The lack of a solid economic recovery has hindered household formation, which came to a crashing halt around 2007. Overall, there are about 3 million missing households.

PARTICIPANTS

Janice Eberly

Professor of Finance
Northwestern University

Janice Eberly is the James R. and Helen D. Russell Professor of Finance and former Chair of the Finance Department at Northwestern University. Before joining the faculty at the Kellogg School of Management, she was a faculty member in Finance at the Wharton School of the University of Pennsylvania.

Eberly served as the Assistant Secretary for Economic Policy at the U.S. Treasury from 2011 to 2013. In that capacity, she was the chief economist at the Treasury, leading the Office of Economic Policy in analysis of the U.S. and global economies and financial markets, and in development of policy recommendations on micro and macroeconomic issues.

Her research focuses on finance and macroeconomics. Eberly studies firms' capital budgeting decisions, household consumption, and portfolio choice. She also examines the interaction of these spending and investment choices with the macroeconomy. Her current research emphasizes household finance and wealth portfolios. Her work has been published in the *American Economic Review*, the *Journal of Political Economy*, *Econometrica*, and the *Quarterly Journal of Economics*, among other academic journals.

She has received a Sloan Foundation research fellowship and grant funding from the National Science Foundation and the CME Trust.

Eberly has been an associate editor of the *American Economic Review* and other academic journals, as well as senior associate editor of the *Journal of Monetary Economics*. Previously, Eberly served on the staff of the President's Council of Economic Advisors, and on the advisory committees of the Bureau of Economic Analysis (BEA) and the Congressional Budget Office (CBO). She was elected to the Executive Committee of the American Economic Association in 2008.

She received her Ph.D. in Economics from MIT.

Richard Green

Director and Chair of the USC Lusk Center for Real Estate
Professor, University of Southern California

Richard Green is the Director of the USC Lusk Center for Real Estate. He holds the Lusk Chair in Real Estate and is a professor in the USC Sol Price School of Public Policy and the Marshall School of Business.

Prior to joining the USC faculty, Green spent four years as the Oliver T. Carr, Jr., Chair of Real Estate Finance at the George Washington University School of Business. He was Director of the Center for Washington Area Studies and the Center for Real Estate and Urban Studies at that institution. He also taught real estate finance and economics courses for 12 years at the University of Wisconsin-Madison, where he was Wangard Faculty Scholar and Chair of Real Estate and Urban Land Economics. He also has been principal economist and director of financial strategy and policy analysis at Freddie Mac.

More recently, he was a visiting professor of real estate at the University of Pennsylvania's Wharton School, and he continues to retain an affiliation with Wharton. He is or has been involved with the Lincoln Institute of Land Policy, the Conference of Business Economists, the Center for Urban Land Economics Research, and the National Association of Industrial and Office Properties. Green also is a Weimer Fellow at the Homer Hoyt Institute, and a member of the faculty of the Selden Institute for Advanced Studies in Real Estate. He was recently President of the American Real Estate and Urban Economics Association.

His research addresses housing markets, housing policy, tax policy, transportation, mortgage finance, and urban growth. He is a member of two academic journal editorial boards and a reviewer for several others. His book with Stephen Malpezzi, "A Primer on U.S. Housing Markets and Housing Policy," is used at universities throughout the country.

The NATIONAL ASSOCIATION OF REALTORS®, the Ford Foundation, and the Lincoln Institute for Land Policy have funded grants to support some of Green's research. He consults for the World Bank.

Green earned his Ph.D. and M.S. in economics from the University of Wisconsin-Madison. He earned his B.A. in economics from Harvard University.

PARTICIPANTS

Edward Leamer

Director of the UCLA Anderson Forecast
Professor, University of California, Los Angeles

Edward Leamer is the Chauncey J. Medberry Professor of Management, Professor of Economics and Professor of Statistics at UCLA. He received an M.A. in mathematics and a Ph.D. in economics from the University of Michigan. After serving as assistant and associate professor at Harvard University, he joined UCLA in 1975 as Professor of Economics, and served as Chair from 1983 to 1987. In 1990, he moved to the Anderson Graduate School of Management and was appointed to the Chauncey J. Medberry Chair.

Leamer is a Fellow of the American Academy of Arts and Sciences, and a Fellow of the Econometric Society. He is a research associate of the National Bureau of Economic Research, a visiting scholar at the International Monetary Fund, and a member of the Board of Governors of the Federal Reserve System.

Leamer has published more than 100 articles and four books. This research has been supported by continuous grants for more than 25 years from the National Science Foundation, the Sloan Foundation, and the Russell Sage Foundation. His research papers in econometrics have been collected in *Sturdy Econometrics*, and published in the Edward Elgar Series of Economists of the 20th Century. His research on international economics and econometric methodology has been discussed in a chapter written by Herman Leonard and Keith Maskus in "New Horizons in Economic Thought: Appraisals of Leading Economists."

His recent research interests include the North American Free Trade Agreement, the dismantling of the Swedish welfare state, the economic integration of Eastern Europe, Taiwan and the Mainland, and the impact of globalization on the U.S. economy.

David Min

Assistant Professor of Law
University of California, Irvine

David Min is a nationally recognized expert on financial markets regulation. His research interests focus on the law and policy of banking, real estate finance, and capital markets.

Before joining the faculty of UCI Law, Min spent a decade working in financial regulatory law and policy, including as a staff attorney at the Securities and Exchange Commission, as an associate in the Securities Litigation practice group of the Washington, D.C., law firm WilmerHale, as Banking Committee counsel for Sen. Charles E. Schumer (D-NY), and as the senior policy advisor and counsel for the Joint Economic Committee of Congress.

Min was most recently the Associate Director for Financial Markets Policy at the Center for American Progress, a policy think tank, where he oversaw the efforts of the Mortgage Finance Working Group, a collection of leading mortgage market experts responsible for, among other things, one of the leading proposals on housing finance reform that was described by the *Wall Street Journal* as "influential" and "one of the most detailed road maps yet for the creation of a housing-finance structure to succeed mortgage giants Fannie Mae and Freddie Mac."

He holds a J.D. from Harvard Law School and received his undergraduate degrees from the University of Pennsylvania. He received a B.S. in economics from the Wharton School of Business, and a B.A. in philosophy at the College of Arts and Sciences. He graduated magna cum laude and Phi Beta Kappa.

Joel Singer

Chief Executive Officer
CALIFORNIA ASSOCIATION OF REALTORS®

Joel Singer is chief executive officer of the CALIFORNIA ASSOCIATION OF REALTORS® (C.A.R.), a statewide trade organization with 160,000 members dedicated to the advancement of professionalism in real estate. He also is president and chief executive officer of zipLogix, whose software is used by more than 600,000 REALTORS® in 48 states.

Singer has held the Association's top staff position since November 1989. He previously served as C.A.R.'s chief economist and headed the Association's Public Affairs Department. He also has been directly involved in the development of key business technologies and significant housing legislation in California.

Before joining C.A.R., Singer spent several years as a Chancellor's Intern Fellow at UCLA and a Fulbright Fellow in West Germany.

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PUBLISHED BY:
CALIFORNIA ASSOCIATION OF REALTORS®

Primary Writer/Researcher:
Jeannette Brown, Communications Specialist

Editor: Anne Framroze, Vice President

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BACKGROUND

The CALIFORNIA ASSOCIATION OF REALTORS® (C.A.R.) is a statewide trade association dedicated to the advancement of professionalism in real estate. C.A.R. celebrated its centennial anniversary in 2005. The Association works in conjunction with 120 local associations of REALTORS® throughout the state, as well as with the NATIONAL ASSOCIATION OF REALTORS®. Serving nearly 160,000 members statewide, C.A.R. provides a wide array of products and services to meet its diverse member needs. Additional background on C.A.R. and its services can be found at car.org

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Part I

Economic Recovery

“In our personal ambitions, we are individualists. But in our seeking for economic and political progress as a nation, we all go up or else all go down as one people.”

— FRANKLIN D. ROOSEVELT

The financial crisis, the recession, and the critical policy decisions that followed these disastrous events unfolded just five years ago when Lehman Brothers Holdings Inc. filed for Chapter 11 bankruptcy protection on September 15, 2008, thereby marking the biggest bankruptcy in U.S. history. While the circumstances leading up to the collapse of Lehman Brothers didn't happen overnight, its seismic failure is widely considered to be the trigger prompting the country's financial crisis, as it greatly exacerbated the downward spiral of the economy. Lehman Brothers – and soon thereafter, insurance giant American International Group (AIG) – were among the falling dominoes in a string of events fueled by toxic mortgages, low interest rates, easy credit, and regulatory issues. All of which contributed to the inevitable burst of the housing bubble.

The passing of five years has afforded the CALIFORNIA ASSOCIATION OF REALTORS® roundtable participants perspective on the unraveling of the financial system and the economy. As panelists sat down with C.A.R. CEO Joel Singer, they were presented an opportunity to reflect upon the long-anticipated “Great Recovery” as the wounds of the financial crisis continue to heal.

Singer asked the panelists to consider where the economy is headed in the next two to three years by examining the current strength of the market, as well as the extent to which the country has weathered the perfect storm that tested the political-economic force of the financial system. To frame the discussion on the recovery, Singer began by positing that from a price appreciation standpoint, California has served as a particularly intriguing market because, in the past nine months, it’s been one of the quickest moving markets in his 35 years as a market observer. Panelists contextualized Singer’s comments by examining current market conditions through a broader understanding of the U.S. economy, and the recovery’s current growth trends.

Edward Leamer remarked that the story of the U.S. economy is that there has not been a recovery at all. He bases this

conclusion on the fact that the economy has not grown rapidly enough to put people back to work—stating the country is 11 or 12 percent below normal as far as employment figures are concerned. Leamer essentially posited that the so-called “Great Recovery” has failed to materialize, or else payrolls would grow monthly by at least 250,000. The UCLA professor blamed the insufficiency of the recovery on two important shifts shaping the U.S. economy that could spell trouble for the housing industry:

“We have two structural adjustments that the U.S. economy is going through. One is from a spending society to a saving society, and we’ve hardly made any progress with regard to that. In fact, Uncle Sam has taken us in the wrong direction as far as the need for much greater savings in this country. But the other transition is from an industrial to a post-industrial world in which high school graduates don’t have a whole lot to do because the jobs in manufacturing are not there. We’re not going to have a recovery because we have too

many essentially unemployable people whose productivity is so low that they can’t get any kind of decent wages.”

Leamer’s comments come on the heels of the most recent UCLA Anderson Forecast, which indicates the U.S. economy is underperforming, and has just barely managed to keep ahead of population growth. Leamer is director of the quarterly forecast that is widely followed for its ability to accurately capture economic conditions. Specific to California, the forecast notes that the state’s unemployment was 8.7 percent in July (the latest statistics available), and that percentage is expected to fall to an average of 7.9 percent next year and 6.9 percent in 2015.

The latest results of the Anderson Forecast and Leamer’s remarks suggest California, in particular, is experiencing a bifurcated recovery, with inland California’s performance falling far below that of tech-oriented coastal cities. As a result, the recovery will not be felt evenly, with a split along socioeconomic classes.

“I think this recovery really does look quite different than previous ones because the nature of the downturn was quite different, not only in its depth and how long it lasted, but also in what was driving it.” — JANICE EBERLY

Following Leamer's comments, Janice Eberly stated, "I think this recovery really does look quite different than previous ones because the nature of the downturn was quite different, not only in its depth and how long it lasted, but also in what was driving it."

The depth of the downturn described by Eberly is evident in the latest annual report from the Census Bureau on incomes and poverty. Alarming, the median American household income was \$51,017 in 2012; in 1989 it was \$51,681 in current dollars. This means 24 years ago, a middle class family was earning more than a middle class family in 2012. This represents a lost decade of economic gains.

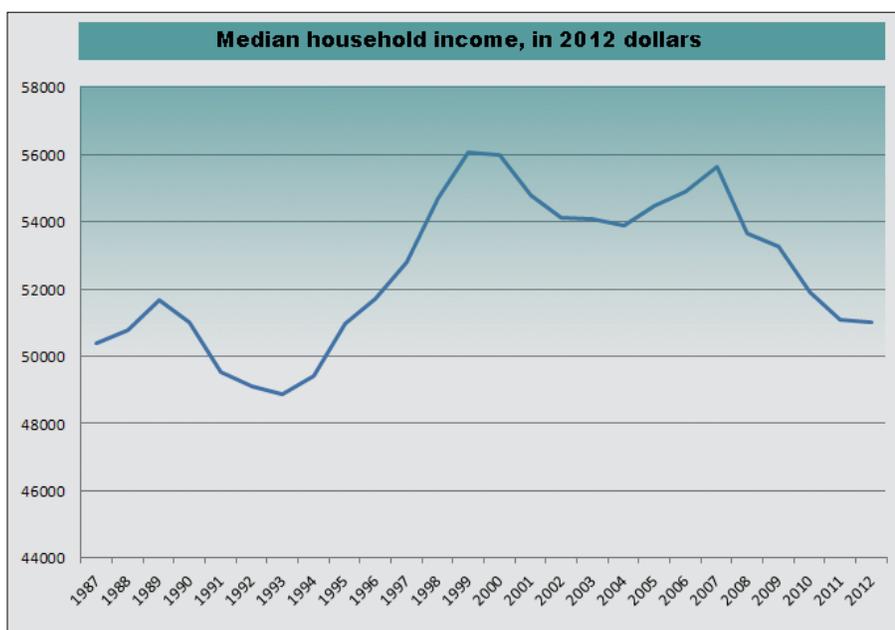
To tie discussion on the recovery to housing, USC economist Richard Green turned from a macroeconomic outlook to consideration of the dynamics and interplay of the business cycle and housing cycles. For example, the ways in which housing not only is an accurate presage of oncoming recessions but also how business cycles have allowed housing to lead the rest of a recovery. Green sought clarification about Leamer's aforementioned statements on the recovery in the context of a widely cited report Leamer wrote asserting the housing cycle **is** the business cycle, an excerpt of which can be read here:

"Housing is the most important sector in our economic

recessions, and any attempt to control the business cycle needs to focus especially on residential investment. But housing presents a special control problem because monetary policy affects mostly the timing of the building but not the total building. After a surge of building there has to be a time-out before building can get back to normal and before this channel through which monetary policy affects the real economy is operative again. The Fed can stimulate now, or later, but not both."

Green queried how the current economic recovery has conformed (or not) to the housing cycle leading the business cycle, as articulated by Leamer's report. The UCLA economist pointed out that, normally, the downturn in housing begins three or four quarters before the official recession, and then after three or four quarters of a recession period, there typically is a housing turnaround. He stated, "It's the first element in GDP to really turn around."

So what's different with the most recent recession and recovery? Leamer stated that there were two years of downturn before the official recession hit, and that housing has simply been late in fully turning the corner. In Leamer's estimation, the turnaround was early but long in scope due to financing, and



Source: U.S. Census Bureau

the need to reform a preponderance of bad debt in the housing market. He explained:

“You had unusual subprime loans that were issued to individuals who really didn’t believe in those and didn’t belong in those units. They couldn’t really afford them. They afforded them with the teaser rates. But when the reality came at the end of the first two years, and the interest rates were elevating, and they couldn’t refinance, that was the end of that market. So that’s what produced a real early turnaround. And then you just have to wait, wait, wait until you get household formation.”

The importance of household formation served as the basis for the panelists to move the discussion of the economic recovery to the recovery of the housing market in particular. ■

A. The Recovery and Housing

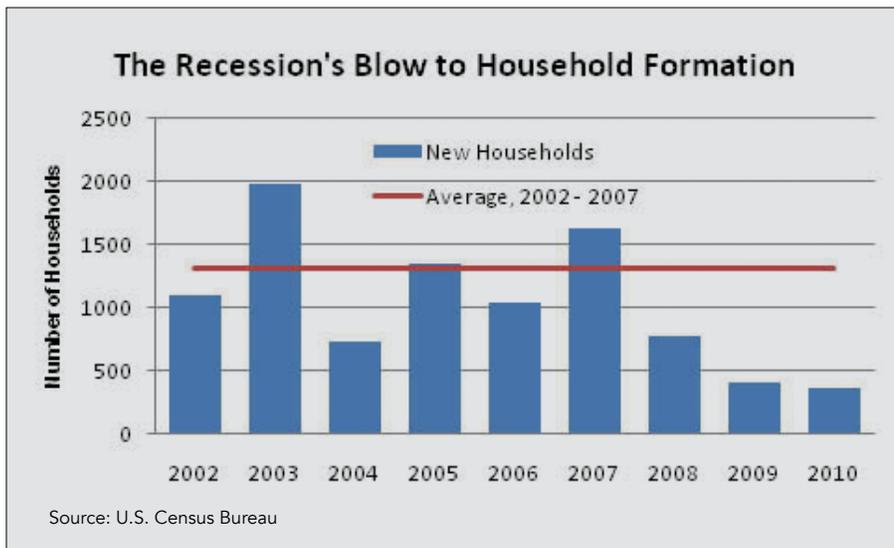
The panelists’ macroeconomic look at the structural underpinnings of the recovery provided ample background to delve into what the state of the economy means for the housing market and the future prospects of the industry.

The strength of the housing market amidst the economic conditions described by the panelists is certainly a cause for concern since without job formation it follows there will be a lack of strong household formation. To address points made by Singer, Leamer acknowledged that the country is indeed experiencing a housing recovery in terms of price and volume of building, but he noted, “We’re way below normal still. Normal housing starts are 1.5 million units, and we’re just getting near a million, meaning that we’re still under-building. To get strong, really strong, building and a really strong housing market, we need a real recovery in this country. And [the Anderson Forecast’s] take on that is we’re not going to have it this time.”

Leamer added, “The real story, from my perspective, for the housing market is that normal household formation came to a crashing halt around 2007. And it’s been very flat ever since then. So we have about 3 million missing households.”

Eberly pointed to the unemployment rate among younger Americans as a key factor attributable to the dearth of households. She noted that the jobless rate for those in their 20s is still around 13 percent, which is almost twice the national average. Eberly emphasized the need for improved job conditions to encourage the rate of household formation for Millennials, commenting, “They need both more income and a stronger labor market to get them to form new households and to even begin to think about homeownership.”

“The real story, from my perspective, for the housing market is that normal household formation came to a crashing halt around 2007. And it’s been very flat ever since then. So we have about 3 million missing households.” — EDWARD LEAMER



However, by drawing a comparison to the auto industry, Eberly cautioned that even with an improved job market, the housing industry should not necessarily expect Millennial buying patterns to adhere to those of previous generations. She noted:

“Among those with a stronger job market, even among those who have jobs, you see lower rates of household formation and homeownership. So one thing to think about even beyond a crisis is whether there’s a different set of buying patterns among younger people—the Millennials. Will they move into homeownership in the same way that previous generations did? And the automakers get this on a higher frequency than the housing industry. They’ve been really worried about young people, as they’re not even getting driver’s

licenses in some areas. So the auto market, which is also an intra-sensitive area, has picked up. But the buying patterns among young people are quite different than their predecessors. It’ll be interesting and a challenge to see how that plays out in housing as well.”

David Min expounded upon Eberly’s comments on the future buying patterns of younger Americans by pointing out that despite the far-reaching impacts of the recession, young people still have very positive associations with homeownership, according to a variety of noteworthy survey results. In terms of characterizing the overall housing market, Min posited the following:

“I think that we’re probably in the phase of what is going to be a long, extended, stagnant

recovery. Given the macroeconomic struggles that we have, combined with the large debt overhang, as well as the large housing overhang, I think that despite the lack of construction of new units, there’s a lot of shadow inventory out there—both what has been formally described as shadow inventory, as well as the people who have just been sitting on the sidelines for five years willing to sell at the moment they see a price increase. I think this last year and a half was a bit of an aberration. I would be surprised to see any extended price increase [...] but that’s sort of an anecdotal set of observations.”

Green concurred with Min on rising prices, stating that he does not believe they will continue to rise, calling the rate unsustainable. Green also spoke at length about the broader implications of rising prices with respect to inventory and the overall market:

“One thing that actually surprises me is that we haven’t seen more people putting their houses on the market because prices have gone up enough in a lot of places that you’ve had a big reduction in the share of people who are upside down on their loans. There are two reasons for that. One is the fact that house prices have gone up. And the

second is that when people were allowed to take advantage of Home Affordable Refinance Program (HARP) to refinance, a good number of them converted their 30-year mortgages into 15-year mortgages because basically the payment was the same [...] So we've had a material number of people who've been paying down their debt much more rapidly than before."

As for the future of prices, Green said, "I think we've pretty much hit the peak. That doesn't mean I think prices will fall. I just don't see how they can go up a whole lot more from here." Green explained his rationale by discussing the inflationary rate and the pressure on rental prices:

"Look at what it costs you to rent a unit, and look at what it costs you to buy a unit, compare costs, and ask yourself how much inflation do you need every year in rents or values in order for

"I think we've pretty much hit the peak. That doesn't mean I think prices will fall. I just don't see how they can go up a whole lot more from here." — RICHARD GREEN

that to be an even tradeoff. The number's about 5 percent now, whereas a year ago, you didn't even have to have any inflation. In fact, rents could go down a little bit, and you still were ahead by owning. So the question is: Do you believe that 5 percent growth in rents and values is sustainable in a housing market? Well, if we were in a 6 or 7 percent inflationary environment, then sure. But if we're really in a 2 percent inflationary environment, I don't believe real rents and real house prices, even in California, go up 3 percent a year. Beyond that, I'm having cognitive dissonance with the vacancy rates on the rental side in California [because they] are extraordinarily low. If you look at the 50 largest

metropolitan areas in the country, seven of the 10 lowest vacancy rates are in California. So that says rent should go up, right? We're below the natural vacancy rate, so that should be pushing rents. This suggests it may be sustainable to buy. But on the other hand, if you look at the share of income people are spending on rents, it is so high that you can't tell a story where landlords could push rents and still have people able to make the rental payment every month."

Green's comments on housing affordability touch on concerns about the health of the recovery and the skewed distribution of benefits that come with economic growth. He noted that people at below median incomes have been continuing to see their incomes fall, not rise, which presents a problem if rents continue to rise while incomes stay flat. Green stated, "Until the economic recovery is broader, I have a hard time seeing how it supports housing."

These points made by Green also address household formation – previously discussed by



the panelists – since rising rents should lead to more doubling up again, which creates an increased vacancy rate and then ultimately falling rents. Specific to the Los Angeles area, Green stated it would be hard to pin down where rents will go in the next couple of years and if one was to run a regression, he stated, “There’s no point from history where you’ve had this kind of rent/income relationship in which you could see what happens to vacancy in the next period.” He added, “The affordability situation is the worst it’s been in the history of Los Angeles because incomes are lower and rents keep rising. So we’re outside the support of the data.”

Eberly broadened Green’s discussion on the limiting effect of affordability when it comes to upward pressure on prices by describing the variability she has seen in data from across the country. She stated, “It’s important to remember that there is no norm. There’s so much variation in both what happened over the crisis and in the recovery as well. Though there are some places that were hit very badly that are recovering pretty impressively, they still have low levels, which I think is important to remember. But you see improvement in prices, improvements in foreclosures, and you see improvements in inventory. So some of those details are

pretty good, but the [overall] levels are still a concern.” The improvements cited by Eberly may ultimately include the ever-critical improvement in household formation, but the issue of affordability remains a pressing concern to an industry still recovering from a punishing recession.

However, in Leamer’s estimation, the market will grow more affordable because there’s still economic growth ahead, albeit not extraordinary growth. Expansion is a key point made by Leamer, as he explained future housing affordability with the following:

“The last two summers, we’ve had these worries about a recession being imminent, and we never thought the economy was positioned to produce a normal downturn, which is houses and automobiles, as [downturns historically have] unusually high levels of production of houses and automobiles. We’re not there. So we think we’ve got another couple of years of this expansion. It’s not going to be GDP growth with fours and fives, but it’ll be twos and threes, and that’ll make things more affordable. People will be able to afford rents more. In addition, the market is going to continue to factor in the incredibly low rate of interest.”



Leamer’s comments on the low interest rate were among the many overarching points on financing made by panelists, including the impact of lending standards and the credit cycle on the housing market now and in the months to come. ■

B. The Minsky Cycle

Singer and the panelists discussed the lending/credit environment in the aftermath of the recession in the context of its adherence to the Minsky Cycle. The name of the cycle is in reference to the economist Hyman P. Minsky – who taught at Brown University, UC Berkeley, and Washington University – and the cycle essentially reflects Minsky’s views on patterns of financing arrangements spurred by a capitalistic system’s penchant for instability. When it comes to economic crises in capitalist economies, Minsky utilized his model of the credit cycle as a way to illustrate a hypothesis on boom-and-bust cycles created by inevitable financial instability.

As financial markets reeled from the turmoil of the crisis, Minsky’s somewhat pessimistic prognostications gained prominence due to the way his description of a collapse of asset values reflected the fallout from the subprime mortgage debacle.

“It’s obviously a very tight credit box right now. If that box gets tighter, or if in the conforming sector it gets tighter, how will that impact housing markets going forward? I think these are the threats that we see.” — DAVID MIN

The Wall Street Journal described what has been deemed a “Minsky moment” as follows: “At its core, the Minsky view was straightforward: When times are good, investors take on risk; the longer times stay good, the more risk they take on, until they’ve taken on too much. Eventually, they reach a point where the cash generated by their assets is no longer sufficient to pay off the mountains of debt they took on to acquire them. Losses on such speculative assets prompt lenders to call in their loans. When investors are forced to sell even their less-speculative positions to make good on their loans, markets spiral lower and create a severe demand for cash. At that point, the Minsky moment has arrived.”

The four panelists were in agreement that the country has been experiencing the type of cycle espoused by Minsky. Min framed this particular discussion by posing the right questions the industry must contend with concerning lending and credit, as he stated, “I do think that this fits the classic Minsky Cycle. What we’re seeing right now with the fallout and the stagnancy of the markets is pretty consistent with the sort of post-Minsky moment that he describes. [...] On the access to credit, I think that’s another big threat, besides the macroeconomic issues, because to what extent will financing be available? It’s obviously a very tight credit box right now. If that box gets tighter, or if in the conforming sector it gets tighter, how will that impact housing markets going forward? I think these are the threats that we see.”

In reference to the market’s debt overhang and access to financing, Eberly added, “Now we’re seeing the other side of that with slowness in credit formation and a reluctance to broaden out the extension of credit beyond the very highest quality borrowers at this point.”

Leamer explained how the tightness of credit cited by Eberly and Min can be attributed to the Minsky Cycle’s impact on the market’s lending environment and why he thinks the cycle is amplified:

“Housing has always had what’s known as a ‘Minsky Cycle.’ So the Minsky Cycle has this feature that early in expansion, you give loans only to the most creditworthy people, the people who can serve the debt and also pay enough to draw down a debt. But then the banking sector loosens it up and says, well, home prices are appreciating, and we don’t have to have lending standards that are so severe. So you don’t have to have enough income to pay down the debt because the house is going to pay for that itself. You just have to have enough income to do the debt service. And then the third phase is the so-called Ponzi scheme or Ponzi phase in which loans are given to people who don’t even have enough income to do the debt service. That’s gone on over and over in the housing market. I think it has to do with a backward-looking attitude toward the banking sector. The banking sector now is looking back at 2008 and thinking another terrible crisis is going to occur. So they still have extremely strict lending standards. If they turned around and realized what was going to happen, I think they would back off on their lending standards very substantially. So I think housing is very much a Minsky Cycle kind of phenomenon. And this is more extreme, way more extreme because of sub-prime markup, particularly. It’s not that subprime didn’t exist before, but the lending standards dete-

riorated so much that we had an amplified Minsky Cycle. So now [we’re] having a kind of amplified correction.”

Richard Green drew the conversation on the Minsky Cycle to a more specific case: the market in the Los Angeles region. Green commented, “We’ve heard about the Minsky Cycle and people not lending until we’re at the top of it, and we’re still not seeing lending. But I think in terms of prices, in L.A. anyway, we’ve got to be near the top of it now because, if you looked 18 months ago, and you looked at the financial choice between owning and renting in Los Angeles, owning was a very sensible thing to do because rents were very high, interest rates were very low, and prices were, while not affordable by U.S. standards, very inexpensive by the history of California standards. If you do that same calculation today, it’s just not true anymore, particularly if you look at the west side of L.A.”

Green added that another factor further complicated by current lending standards is that people who work as independent contractors and receive 1099 income are facing hurdles at banks when it comes to getting loans because of their lack of a W-2-based salary. In this economy, more people are working as independent contractors in comparison to several years ago, which is a problem for housing because, according to Green,

“Even people who are making money can’t get access to credit, even though they have enough money, because of the nature of where their income is coming from.”

Leamer posited that he expects lending standards to weaken as the country experiences the modest economic growth he previously mentioned, and very low interest rates will work in the market’s favor.

As to what those low interest rates will mean in the broader picture of financing, Eberly commented: “The very low interest rates translating into higher asset prices are always going to be dampened by the availability, the access to those low interest rates. So the channel that goes from those low interest rates to prices requires that people can actually borrow at those low rates. Hopefully, as credit availability and access opens up a little bit, as the cycle moves forward, and as there’s more certainty about housing finance and what the housing finance regime will be, that will open up, and we’ll see those low rates better reflected in prices.”

Eberly’s comments on the need for certainty regarding housing finance to improve credit availability led the panelists to move the discussion to a broad examination of the government’s role in housing. ■

Part II

The Role of Government in Housing

“Government exists for the interests of the governed, not for the governors.”

— THOMAS JEFFERSON

Since the collapse of the housing market, debate has amplified about restructuring the government’s role in supporting mortgage credit, and there remains a great deal of uncertainty about the future of America’s housing finance system. Singer led panelists to consider the ongoing reform efforts in the nation’s capital, and more broadly, the role government should serve in the housing market. Eberly noted that when thinking of the proper role of government, economists tend to ask, “What’s the public interest being served?” Eberly’s emphasis on the public’s interest aptly followed the panelists’ discussion of Minsky, as he was a proponent of the financial system serving the rest of the economy rather than merely feeding off it to the point of destabilization.

Eberly posited that discussions about the public interest often have been limited in scope when examining the government's role. She stated, "I think economists have a hard time being very specific about the public interest in the housing market. And so we typically end up talking about the government role in the provision of credit, rather than specifically about the role in housing, with the argument being that there are particular groups that tend to have more difficulty accessing credit."

Eberly added that several arguments can be made in housing's favor when it comes to government support facilitating the greater good. For example, she pointed to homeownership as a means to support and promote stable communities, and that homeownership can encourage people to build savings.

While Eberly's comments rhetorically touched on the benefits of homeownership, reform efforts could impact the promotion of it among American consumers. It remains to be seen how legislation will develop in a gridlocked Congress, and how the market and economy will be affected if the government does not support housing finance to the extent it has under the government-sponsored enterprises (GSEs).

Arguments over reforming housing finance linger over the question of whether the private sector should have far more prominence in bearing credit risk, as well as whether funding sources for mortgage financing need to be diversified.

Eberly continued the dialogue on the government's role by acknowledging the conversation involves heated questions, as is evident by the divergent policy proposals coming out of Washington, D.C. Eberly stated, "You really see in Congress very strongly opposing views, ranging from having basically no government support for the housing market, except perhaps the FHA, to the other extreme, where there's support for a continuing role for the GSEs. So some of the legislation we've seen tries to find a bridge between those two very diverse or very different points of view."

As the American public and its political leaders consider such legislative proposals, Min also tied the conversation back to the public interest by noting that people ultimately need to ask themselves if a consumer-friendly loan is of value, and if the answer is in the affirmative, it follows that without a government backstop, such a loan would not exist, in the estimation of Min.

He went on to say that there is a need for more clarity in discussions about finance reform because the dialogue thus far has done a poor job of differentiating the government's role with respect to a subsidy versus a backstop. Min commented that when it comes to the GSEs, "It's a little bit of subsidy, but it's a lot of backstop. And so I think a lot of the arguments you hear against the government's role tend to be against subsidy. And those are

"I don't know of a housing finance system in an advanced economy in the world that doesn't rely almost entirely on intermediation—that idea of taking short-term finance and using it to fund those long-term loans. Somebody has to bear a lot of credit risk, a lot of rate risk, and a lot of other types of risk. Typically that's an intermediary." — DAVID MIN



classic economic arguments. But I think that less addressed is the role as backstop.”

In examining the history of pre-Depression financing and banking and what has been in place since then, Min commented on how a government role has been necessary to prevent onerous mortgage terms that were around in the pre-New Deal era:

“I don’t know of a housing finance system in an advanced economy in the world that doesn’t rely almost entirely on intermediation—that idea of taking short-term finance and using it to fund those long-term loans. Somebody has to bear a lot of credit risk, a lot of rate risk,

and a lot of other types of risk. Typically that’s an intermediary. And again, I think a government role has always been necessary there, or otherwise you see the alternative, which is constantly recurring panics. [...] You could expect, at the very least, to see a pretty sharp reduction in liquidity [in the absence of a government role]. [...] So to what extent can we expect to see banks, other intermediaries, or other pools of capital take on that extensive amount of rate risk and credit risk in the absence of a government wrap? I think it’s an important question.”

Min also noted that one has to consider who ultimately gets access to finance in the absence

of a government role. Facilitating access for borrowers should not necessarily be called a “subsidy,” as Min feels this term is more applicable to tax benefits like the mortgage interest deduction. In his view, requiring that the GSEs make a certain percentage of loans available to borrowers with certain characteristics is perhaps a role that should be characterized differently than the status quo; i.e., as a subsidy.

While Min examined access to finance and the history of finance in the country, personal savings were at the heart of Leamer’s thoughts on the government’s role in housing. In contrast to the previous points made by Eberly on homeownership as a

vehicle for promoting savings, Leamer posited he is reluctant about having the government involved in the housing market in large part because he is deeply concerned about the deficit of savings among the American populace. To be specific, he feels government support is misplaced in housing because it is a poor method to accrue the savings Americans will ultimately need later in life. He commented:

“Whatever appreciation there may be in housing, it seems like it’s pretty quickly turned over into a new Mercedes or something like that. So I’m not so sure housing is the best way to get people to save more. If you could really lock it in [it would be], but that’s a former generation. A generation ago, you would have parties in which you burned your mortgage because your house was all paid off. Those parties are a thing of the past. So I think that housing as a vehicle for creating savings is not the best way to do it. I think heavily subsidized retirement accounts, subsidized by the tax code, would be a good thing. But [basically] people need to be scared – scared to death – and told at the age of 40 how much they need to really accumulate in order to take care of themselves when they’re elderly. It’s an enormous amount of money, and they need to have some financial literacy to help them make wise decisions. So I think housing is

Case Study

Beyond GSEs: Examples of Successful Housing Finance Models Without Explicit Government Guarantees

This past summer, David Min submitted written testimony to the Committee on Financial Services of the United States House of Representatives in order to share his expertise on banking law and financial regulation. Min’s testimony featured seven key points for legislators to consider as they undertake housing finance reform, and those points are outlined below in the following excerpt:

- 1. Government Guarantees Are Universal:** There are three types of funding instruments that collectively account for almost all of the residential mortgage financing in the developed world: bank deposits, mortgage-backed securities (MBS), and covered bonds. Generally speaking, with only limited exceptions, investors in these instruments enjoy the benefits of either explicit or implicit government guarantees. While the United States is relatively unique in its heavy reliance on government-guaranteed MBS, it is decidedly not unique in its dependence on government guarantees to fund residential mortgages.
- 2. European Covered Bonds Are Best Thought of as Government-Sponsored Obligations:** A corollary of the previous point is that covered bonds also enjoy government backing. Contrary to the claims of some, European covered bonds are not purely private financial instruments, but rather, enjoy a myriad of government guarantees, as well as preferential regulatory and capital treatments that mirror or surpass the benefits provided to Agency obligations in the United States.
- 3. Government Guarantees Are Prevalent Because They Address Key Market Failures in Housing Finance:** Government guarantees are so ubiquitous because they address certain market failures that are inherent in financial intermediation—the use of short-term, illiquid liabilities to fund long-term, illiquid loans—which is necessary to meet the enormous long-term capital requirements that housing entails. In particular, these guarantees ensure liquidity, stability, and affordability in housing finance. In the United States and Denmark, government guarantees also facilitate the wide and affordable availability of the 30-year, fixed-rate, fully self-amortizing mortgage, a product that is pro-consumer and helps to promote financial stability.
- 4. There Is No Perfect Housing Finance Model:** In the aftermath of the problems with the U.S. housing finance system, it is of course tempting to look at other models and assume the grass is greener on the other side. But each of the three major types of housing finance models—deposits, securitization, and covered bonds—experienced major failures in the recent credit crisis. And it is clear that each of these models has its advantages and disadvantages. While the weaknesses of securitization and deposits as funding vehicles are well recognized in the United States, it is important to recognize that covered bonds come with their own problems. The issuance of covered bonds typically

increases the risk to other creditors, including the governmental deposit insurer, and can thus create a moral hazard problem, insofar as covered bond investors have reduced incentives to engage in market discipline. Perhaps most troubling, from a U.S. perspective, is that covered bonds are inherently best suited for very large financial institutions thought to enjoy a government backstop—so-called “Too Big To Fail” banks.

5. The Common Thread in Global Housing Bubbles Was Financial

Deregulation: The United States, Spain, and the United Kingdom were perhaps the countries hardest-hit by housing market issues. All three of these countries underwent significant banking sector liberalization in the decades preceding their housing bubbles. At the same time, Canada, which did not have significant financial deregulation but does have an outsized government role in housing finance, did not experience such housing problems. This suggests that financial deregulation is a primary factor in explaining international problems with housing finance.

6. Explicit, Ex Ante Guarantees Are Preferable to Implicit, Ex Post Guarantees:

The choice facing policy makers is not whether to adopt a housing finance with explicit guarantees or no guarantees, as the title of this hearing might suggest. Rather, the choice is between explicit, well-defined, ex ante guarantees with buffers against taxpayer loss, or implicit, undefined, ex post guarantees that have no protections for taxpayers. For a number of reasons, I believe that explicit guarantees are preferable as a policy matter.

7. Given U.S. Political Priorities, Improving the Status Quo May Be

Preferable to Importing Other Models: Housing finance reform efforts should consider the specific characteristics of our polity. Several are worth noting. First, the U.S. does not have a social safety net as robust as those of most other advanced economies. As such, affordability in housing finance should be a much more important policy priority here than elsewhere. Second, the 30-year, fixed-rate mortgage is both politically popular, and has an extensive track record of proven success in our country. Third, the United States has a long and storied history of populist opposition to big banks, hidden subsidies, and bailouts that has translated into a strong opposition to “Too Big To Fail” banks and the implicit subsidies they enjoy. Collectively, these characteristics point to the conclusion that rather than trying to adopt radical wholesale changes or import European models of housing finance into our country, we should consider fixing the problems with our current model of housing finance. This appears to be the conclusion reached by a growing number of experts and policy leaders on both sides of the aisle, including, most recently, the Bipartisan Policy Center and Sens. Bob Corker and Mark Warner.”

Read the entirety of Min’s testimony to Congress here: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2279371

not a good way of stimulating savings. I’m suspicious of it.”

Green was in agreement with Leamer, and as proof, he finds a key statistic troubling:

“If you look at the survey of consumer finances, and you look at people my age from 30 years ago, their mortgage balance was about the same as their average income at that time. If you look at that ratio now, it’s about two-and-a-half to one. So in the late 1980s, you could see it was actually easy for people to have their mortgage paid off before they retired. And that is a big deal, to not have to pay anything more than your property taxes and your utilities when you’re retired. Essentially, it allows you with very little risk to know you’re going to be housed for the rest of your life. But I don’t know how people are going to get there now. Although, again, with a reduction in interest rates, some people have shortened up on their maturities, and that will help a lot ... [but] I think the savings argument is nowhere near as powerful as it once was.” ■

A. The Future of the GSEs

Singer could not discuss housing finance without addressing the future of the GSEs. Consequently, he framed the discussion by posing the following questions to the panelists: “What is the role of the GSEs going forward? The GSEs have played a traditional role, and at the moment their portion of the marketplace with the Federal Housing Administration is extraordinarily high, albeit it’s a marketplace with lots of cash in it. What’s happening in that area? Where is it going, and where should it go? How should we restructure out of this, if at all?”

Addressing these points, Eberly started the discussion by noting that “The FHA and the GSEs together are really playing an outsized role in mortgage finance, so I think there’s a lot of consensus that they should pull back. But along what path and to what end is really the question.”

Eberly began by elucidating the specifics and the major terms that comprise various legislative proposals and policy discussions, such as the Corker-Warner bill, which Eberly described as “getting most of the oxygen right now.” This bill, known as the Housing Finance Reform and American Protection Act, would wind down Fannie Mae and Freddie Mac over a five-year period, but the federal government would still have a backstop role as a last resort if catastrophe strikes. The guarantor under this reformed system would be the newly created Federal Mortgage Insurance Corporation, which would regulate the entire secondary mortgage market and retain a federal guarantee for mortgage securities. In the event of a crisis, private equity would be required to absorb a 10 percent loss of the principal underlying those new mortgage-backed securities.

At the time the bill was announced for consideration, Sen. Bob Corker, R-Tenn, commented, “It lessens the footprint of the federal government in housing and winds down Fannie and Freddie, but at the same time it keeps the housing finance industry in a liquid state.”

Eberly pointed out that this legislative proposal reflects arguments frequently made for a government role in backstopping catastrophic risk,

as well as the argument that there should be private capital in front of any government guarantee. In describing the Corker-Warner legislation, Eberly stated the following:

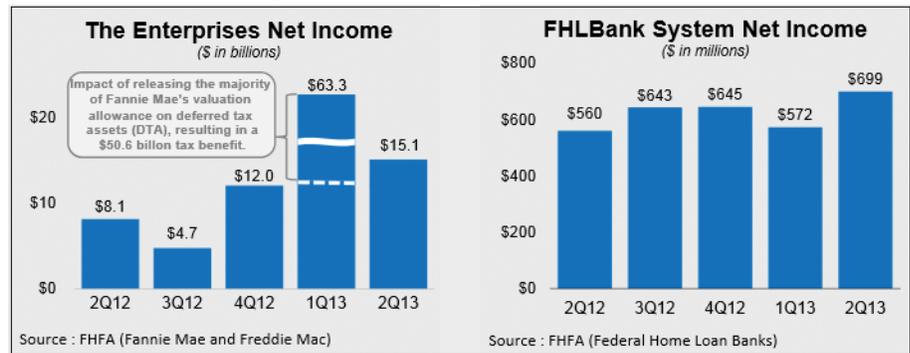
“They’ve tried to thread the needle between those who would like to see a pretty dramatic pullback of the government role and those who would like to see, not only a backstop, but even a subsidy for housing by having the private capital come in ahead of a government guarantee. They’ve explicitly identified a 10 percent level of capital—provided that [it’s] dissipated before any government support. And then explicitly a 2.5 percent government buffer built up, potentially through g-fees, accumulation of guarantee fees, and that there would actually be a fund there rather than sort of an implicit or an explicit government guarantee that doesn’t have funding behind it. So that’s what they’ve put forward, and they’ve actually gotten a pretty high amount of bipartisan support from the Senate Banking Committee.”

In response to a question from Singer about how the private sector first-loss provision would function under this system, Eberly pointed out that it’s important to consider the business model that would support having that amount of capital out in front of a government wrap. She noted

that, ultimately, the country will have to find a balance between concerns about too much private capital and concerns about either a government role per se or the cost associated with a government role. This is because in her estimation, the country has not performed budgeting well—especially when it comes to assessing potentially large, forward-looking risks and incorporating them into the decision-making process.

As for Green’s perspective on the Corker-Warner bill, he views it as relatively positive, but feels it’s important to consider the impact on race when discussing a future finance system that moves beyond the GSEs. Green pointed out that black Americans have faced incomparable disadvantages in obtaining homeownership – which remains uncorrected – and the issue of access is incredibly important when considering such an intergenerational issue. In discussing racial disadvantages over time, Green stated, “It worries me, when we talk about moving forward beyond the GSEs that I never hear in the conversation the differences in access to credit over many generations, the differences in access to owning property over many generations, and what to do to fix that going forward. And so that’s my principal concern.”

While the panelists primarily discussed the particulars of the



Corker-Warner legislation, Min pointed out that also gaining attention is a bill from Rep. Jeb Hensarling, a Texas Republican who leads the House Financial Services Committee. While Hensarling’s bill would also eliminate Fannie Mae and Freddie Mac, it would not include U.S. backing for securitized loans and would impose a purely private mortgage finance system. Min analyzed this legislative proposal as follows:

“I’m not sure I see the Hensarling bill as anything more than a poison pill. It’s a pretty effective poison pill. But they know they have no chance of passing it. What it does is unite the House Republicans behind a cause and stymie any hope that the Republicans in the Senate might push something forward. It really pushes out GSE reform at least a year, perhaps till the end of [President] Obama’s term. I know that’s 3.5 years away. But that realistically could happen if the House Republicans and their allies start to really coalesce around this idea of

no government involvement. And I think that’s potentially a problem, if you want to scale down the GSE role, because as each day passes by, Fannie Mae and Freddie Mac get more profitable. You’re already starting to see prominent politicians start to say, hey, maybe we shouldn’t get rid of [them][...] And I think you’re going to see a growing drumbeat for that.”

The profits of the enterprises cited by Min are apparent in the Federal Housing Finance Agency’s second quarter report for 2013. The report indicates that the second quarter marks the sixth consecutive quarter in which both Enterprises reported positive net income, with combined earnings of \$15.1 billion.

Eberly commented, “Given how profitable Fannie and Freddie are [it’s interesting] that the private capital is not moving in to compete for what seems to be a profitable portfolio,” which set up the panelists’ discussion on the entrance of private capital into the market. ■

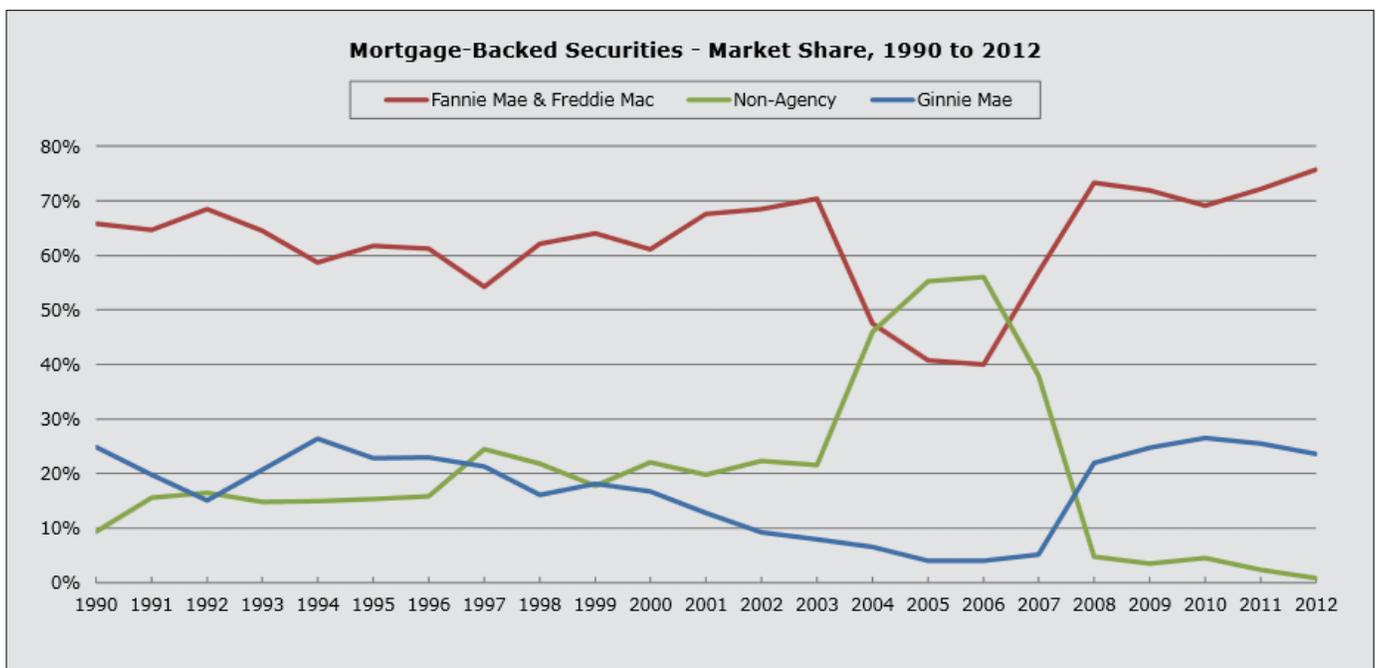
B. Private Capital

In early August, President Obama made a major speech in the state of Arizona to announce a renewed effort to reform the country's housing finance system, and among the president's comments was the statement that "private capital should take a bigger role in the mortgage market" as a key principle to drive reform. Thus, potential changes to the GSE business model could feature a greater reliance on private label residential mortgage-backed securities (RMBS) to meet the needs of the mortgage market. The particulars of private capital in this financial and political environment expounded upon the panelists' prior discussion of the government's future role and whether it may ultimately have a smaller footprint.

Singer asked the panelists to consider how to attract private capital back to the RMBS market, and how exactly private capital could assume an increasing role in financing homeownership. After all, there is a difference between private capital serving a larger share of the market versus private capital simply placed ahead of a GSE-type

MBS. As a starting point, Singer pointed out that consideration is necessary to determine how the market would handle the 10 percent first-loss provision that has characterized discussions about private capital in housing finance reform, such as the Corker-Warner bill.

Eberly remarked that focusing on the *transition* to private capital in particular is important to consider, as she commented, "If you see it going toward more private capital in front of the government guarantee, then you want to think about how we get there. So how do we get from a point where there's very little private capital to a point where people seem to think that the market will move in. But along what path?"



Source: Bipartisan Policy Center

Mortgage originations by product share of market by source, selected years					
	1990	1996	2000	2006	2012
Conforming/Fannie Mae & Freddie Mac	43.4	38.6	37.9	32.2	63.4
FHA/VA	12.7	10.7	8.8	2.6	18.9
Jumbo/private label	23.1	25.4	29.5	48.1	10.5
ARMs held in portfolio	20.8	25.4	23.8	17.1	7.2

Source: Bipartisan Policy Center tabulations of data from Inside Mortgage Finance, "Mortgage Originations by Product"

She further contextualized the effect of private capital by noting that conforming loan limits are an important factor "because right now the government is in very large mortgages, relative to what it had been historically. An advantage of taking the path of lowering those conforming loan limits is that the government doesn't get adversely selected when the private capital comes in because what you worry about, if you do it through prices, is that the borrowers who can't get private capital will stay with the government. So then the government's guarantee portfolio ends up being the riskier loans."

Conforming loan limits cited by Eberly refer to legal restrictions imposed on Fannie Mae and Freddie Mac regarding the purchase of single-family mortgages with origination balances below a specific amount, known as the "conforming loan limit." Jumbo loans are above this limit.

While Eberly posited that price and conforming loan limits are avenues to test the willingness of private capital to move into the market, Singer suggested it would be difficult to bring private capital back without a government guarantee, based on his knowledge of investors like PIMCO and experience on a recent trip to Germany. Singer stated, "I spent last summer in Germany, where I studied as a graduate student. And a couple of friends were actually German community bankers. And I talked to one who was badly burned by Wall Street MBS. And his comment was, 'My children's children will not see a Germany community banker buy a non-government-guaranteed U.S. security again.'"

Leamer pointed to ratings agencies as the main culprits for the belief espoused by Singer's German example, as Leamer said ratings agencies should be assigned far more of the blame

than the GSEs for the downturn of 2008 and the aftermath. Leamer added that the other culprit is "the [Alan] Greenspan Fed, which was asleep in a regulatory sense, but also completely asleep in the sense of interest rate-setting. So the teaser rates really came from the Fed. They could have prevented real excesses—had they been more alert and more aware of the problems that were being created. [While] I'm not a big favorer of subsidies coming out of my taxpayer dollars for Fannie and Freddie, I don't think that they are major contributors to the crisis that we had in 2008."

While Leamer chose to comment on ratings agencies, and Singer's comments concerned structured finance, Green pointed out that ratings agencies wouldn't be needed if we didn't have structured finance. Green stated that he still believes "just plain vanilla mortgage-backed securities are a terrific instrument because

they allow capital markets to fund people's homes," but adding to Leamer's points on ratings agencies, Green stated: "The level of precision that they pretended [to have] to be able to rate these [securities] was comical, if it weren't so tragic. These securities are too complicated to do a decent job rating them. I don't think anyone has sufficient information to do it well. [...] And so I'm going to suggest as a regulatory feature that you limit the amount of structuring you can do from the underlying securities."

Min added to the conversation on ratings agencies by noting that they solved an information asymmetry problem—a problem that has impacted the ability of pass-throughs to reach a broad-scale audience. The "pass-through rate" refers to a rate on a securitized asset pool "passed-through" to investors once management fees and guarantee fees have been paid to the securitizing corporation. Without the "broad-scale audience" cited by Min, he tied the conversation back to private capital by questioning who would buy all these AAA-rated private-label securities (PLS) without structured finance.

Min went on to ask, "How do you have a private-label securitization market that is more than a tiny fragment

of the market?" He pointed out that currently, the credit characteristics of the few private label deals that have happened post-crisis reflect incredibly high FICO numbers and are "pristine borrowers across the board." Case in point: The average credit score on loans to purchase homes this year is over 750, which is 50 points higher than the average credit score, and 50 points higher than the average among those who took loans for home purchases a decade ago, before the housing bubble.

Min added, "We're talking about private capital, not just ahead of GSE-type MBS, but private capital taking a significant portion of the market. I don't know that you get there with pass-throughs without a wrap because if I'm an investor living in Thailand or even in California, why do I buy North Carolina mortgages, for example, without demanding a pretty

high rate of return, not knowing the sort of credit risk associated with those?"

Leamer responded to Min's question by noting that it is a matter of transparency and that investors simply need a better idea of what they're buying. Leamer stated the following:

"Markets aren't perfect, but they're self-correcting. So the idea that you're going to have all these totally nontransparent securitized products that have a lot of junk built into them that the investors had no knowledge of, that's part of the past. And I think you're going to see the securitization market reinvigorated. Even our German friends are going to end up investing in them because they're going to realize that it's a different day and age. We're going to have appropriate credit spreads, depending on what the risks are."



Singer agreed with Leamer but noted that the lessons of the crisis have been far too slowly learned and that developing a transparent platform is easier said than done, commenting, “Transparency’s always the answer. Light inoculates everything, right? But we’re a long way away.”

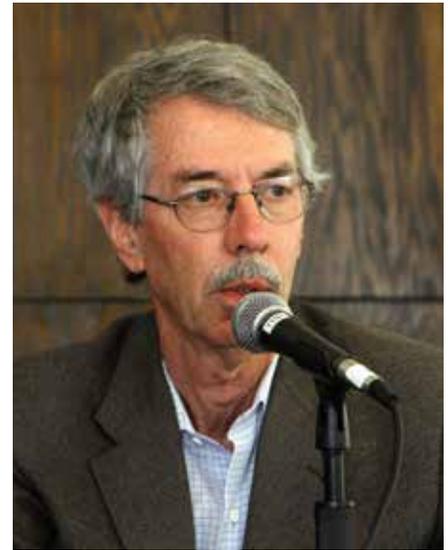
Green pointed out that a key way to encourage transparency is standardization, and an important contribution of Fannie Mae and Freddie Mac is their development of a standardized platform, as consumers fill out the same form and there is clear documentation that underpins the numbers in that form. Eberly continued the discussion on transparency and standardization with the following comments:

“We all favor transparency, but actually implementing it can be very hard. One of the things that I think even the most ardent wind-down GSE proponents want to preserve is the platform. And there’s work going on now to regularize or to harmonize the Fannie/Freddie platform and then to have that available in a post-GSE environment. And Corker-Warner and others have that in their legislation, recognizing that standardization is really important for a large and liquid secondary market.”

In the context of a discussion on private capital, Singer transitioned the conversation to what the future of the 30-year mortgage will be—especially if private capital ultimately assumes an increased role in financing homeownership. In response, Green noted that he would have to make a political and not an economic argument because he believes the political pressure would be too strong to bring back a 30-year mortgage if it were to go away. He commented, “I don’t think politically it’s going to be feasible to get rid of this. And voters matter.” Thus, Green expects to see a 30-year, fixed-rate, pre-payable mortgage in the future.

Eberly’s perspective reflected on the long history of the 30-year mortgage and the conventional wisdom that has been shaped over the years around that particular product:

“The 30-year, fixed-rate question is a really important one because the proponents of a purely private market are most worried about the ability of the market to support 30 years of credit risk. So one of the main arguments for a government backstop of some sort is to provide that product for consumers. We have decades of history with the 30-year, fixed-rate mortgage, and just looking at the premium between



a conventional mortgage and an unconventional mortgage doesn’t capture the fact that the unconventional mortgage is still priced off a huge liquid market for a conventional mortgage. You can try to model it, and you can try to look at other countries and say what would it be like if we didn’t have the thousand-pound gorilla already there, [but] we really don’t know from a market point of view.”

In Leamer’s view, it would be very difficult to guess the shape of the mortgage market in the distant future, but five years from now, he expects the country to have a totally different mentality and the 2008–2009 downturn to be forgotten, including all the concern about creditworthiness.

Leamer also chose to focus on younger Americans when examining the future of mortgages

and homeownership, as he commented, “[They will be] less interested in 30-year mortgages because they’re going to stay in their location for just a short period of time. And my guess is they’re going to be renting a lot more when you control for age [...] you’re going to see a lot more renters than you did 20 years ago.”

Finally, Min said he expects the future of mortgages and homeownership to be determined by what the government does macro-economically in terms of industrial policy and housing finance reform, adding that housing finance is equally important for rentals as it is for homeownership. ■

Case Study

Remarks by President Obama on Finance Reform

August 2013

Desert Vista High School

Phoenix, Arizona

Corroborating renewed efforts for mortgage finance reform, President Obama gave a high-profile speech in Arizona about responsible homeownership and his vision for implementing reform, including an increase in private capital. The president outlined four core principles that he believes should characterize finance reform to prevent the occurrence of another crisis. An excerpt of his speech describing these principles is below:

“First, private capital should take a bigger role in the mortgage market. I know that sounds confusing to folks who call me a socialist—I think I saw some posters there on the way in. I actually believe in the free market. [...] But in the same way that what we did with health care was to set up clear rules for insurance companies to protect consumers, make it more affordable, but still built on the private marketplace, I believe that our housing system should operate where there’s a limited government role and private lending should be the backbone of the housing market. And that includes, by the way, community-based lenders who view their borrowers not as a number, but as a neighbor. So that’s one principle.

A second principle is we can’t leave taxpayers on the hook for irresponsibility or bad decisions by some of these lenders or Fannie Mae or Freddie Mac. We’ve got to encourage the pursuit of profit, but the era of expecting a bailout after you pursue your profit and you don’t manage your risk well—well, that puts the whole country at risk. And we’re ending those days. We’re not going to do that anymore.

The third principle is we should preserve access to safe and simple mortgage products like the 30-year, fixed-rate mortgage. That’s something families should be able to rely on when they’re making the most important purchase of their lives.

Number four, we’ve got to keep housing affordable for first-time homebuyers—like all these young people. When they’re ready to buy a house, we’ve got to make sure it’s affordable. Families who are working to climb their way into the middle class, we’ve got to do what we can to make housing affordable. And that means we’ve got to strengthen the FHA so it gives today’s families the same kind of chance it gave my grandparents to buy a home, and it preserves those rungs on the ladder of opportunity.”

Part III

The Regulatory Environment

**“Good order is the
foundation of
all things.”**

— EDMUND BURKE

**“An investment in
knowledge pays the
best interest.”**

— BENJAMIN FRANKLIN

The panelists extended their discussion on the availability of financing when Singer asked for their views on the state of the regulatory environment; after all, a regulatory framework that fails to adequately support financing for the housing sector can diminish access to credit for a sizeable share of the population—thereby potentially resulting in a lower number of mortgage applications, and in the process, consequences for the housing market and the broader U.S. economy. The panelists previously discussed constrained levels of lending, and Singer questioned whether the lack of clarity around the current regulatory and political environment is to blame for dampening the recovery, as he sought greater understanding from the panelists about the appropriate balance between risk management and access to credit. There was consensus among the panelists that lenders remain concerned, and in Min’s estimation, many are “overwhelmed by the spate of new regulation, but don’t actually know what it consists of.”

To contextualize the panelists' discussion on a topic that remains contentious and fraught with misunderstanding, it's worth remembering the findings of the Financial Crisis Inquiry Commission from 2011, as they remain relevant today concerning the impact of regulatory authority on the market, or, better put, the lack thereof. The commission was created to "examine the causes of the financial and economic crisis," and it documented a systemic breakdown in regulations in a hefty document more than 600 pages long. An excerpt of the report's conclusions regarding regulation reads as follows:

"We conclude widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets. The sentries were not at their posts, in no small part due to the widely accepted faith in the self-correcting nature of the markets and the ability of financial institutions to effectively police themselves. More than 30 years of deregulation and reliance on self-regulation by financial institutions, supported by successive administrations and Congresses, and actively pushed by the powerful financial industry at every turn, had stripped away key safeguards, which could have helped avoid catastrophe. This approach had opened up gaps in oversight of critical areas with trillions of dollars at risk, such as the

shadow banking system and over-the-counter derivatives markets. In addition, the government permitted financial firms to pick their preferred regulators in what became a race to the weakest supervisor. Yet we do not accept the view that regulators lacked the power to protect the financial system. They had ample power in many arenas and they chose not to use it. [For example,] policy makers and regulators could have stopped the runaway mortgage securitization train. They did not. In case after case after case, regulators continued to rate the institutions they oversaw as safe and sound even in the face of mounting troubles, often downgrading them just before their collapse. And where regulators lacked authority, they could have sought it. Too often, they lacked the political will—in a political and ideological environment that constrained it—as well as the fortitude to critically challenge the institutions and the entire system they were entrusted to oversee."

The lack of regulatory competence before the crisis identified by the commission and the ensuing corrective measures fittingly frame Singer's additional line of questioning, since he also asked panelists to consider whether enough regulations have been imposed to address the errors that fomented the financial crisis. Min responded by noting, "The

question isn't whether we have done enough because I think right now the sort of natural procyclicality of the market is still in effect. So we're not going to see the sort of reckless behavior for at least another five years. The question is in five years will we have done enough?"

Leamer – as mentioned previously – had already posited that he expects the lessons of the crisis to be forgotten in five years, but he added that it's important to focus on timing with respect to regulation, such as the country's position in the Minsky Cycle that the panelists formerly discussed.

While both Leamer and Min touched on the next five years following 2013, in the five years since the crisis, banks have faced stronger capitalization rules and pressure to maintain buffers against losses, but analysis from Bloomberg News reveals that the six biggest U.S. banks have only gotten bigger since 2007, which perhaps has added to fears that regulators will be unable to prevent another crisis because the financial system remains "too leveraged, complicated and interconnected."

Min added that to some degree he is still waiting for the "next big shoe to drop" because he expects banks to seek ways to maintain their yield through some type of new structured product

that will require scrutiny. He also pointed to public hostility toward banks as a factor to consider when discussing regulation because “the political trends make it very hard to lean against the wind,” which is an economic term that refers to countercyclical monetary policy. Eberly expounded upon Min’s comments on political considerations by noting that his point refers to a question of macro-prudential lending, and a key issue is addressing its implementation. Eberly commented as follows:

“Trying to do [macro-prudential regulation] in an ad hoc way brings up all of these political considerations because it’s a judgment call, and if it’s a judgment call, then what forces affect your judgment is a hard problem. And so in trying to regularize regulation in a cyclical way, then what cyclical measures do you put in? Suppose you put in loan-to-value ratio, or you put in payment affordability measures, then how exactly would you want loan terms to respond to that? Actually implementing this in practice turns out to be very difficult. In principle, being counter-leaning against the wind and bringing in these macro considerations makes sense, the implementation, if you try to mechanize it, what elasticity do you use? We can try to estimate it, but we in our humility know that there are standard errors around those

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— JANICE EBERLY

estimates. Then you say, well, like in other kinds of policy we want to allow judgment to bring in lots of different factors and what’s idiosyncratic to that particular time period. Then all of the other pressures on policy come in. So it’s been a difficult discussion.”

Green added to Eberly’s comments on macro-prudential lending by citing an international example of two Asian countries that do try to “lean against the wind” with regulation, specifically Korea and Singapore. He noted these countries use two simple tools: Loan-to-value ratio, and payment-to-income ratio. Green stated that if the market’s getting too strong, and a little bit bubbly, they drop the maximum loan-to-value ratio and drop the payment-to-income ratio, and if subsequently, prices are flat or decrease for a quarter or two, they raise it. He added, “That’s the macro-prudential tool that they use. It’s a very simple one, and it seems to have kept them out of trouble. But again, I think they’ve moved up and down maybe twice. So I don’t know how much you can infer from that,

and I don’t know whether they have a policy rule that if prices do this, then the LTV does that. But in practice that seems to be what they’re up to.”

Eberly enlarged the panelists’ discussion by concluding society has systematically gotten risk wrong because it is misguided to “look for something that’s absolutely safe, when we know there really is no such thing.” She added, “Evaluating and managing risk is very hard—from the simplest homeowner making what will likely be the biggest investment of their life to sophisticated investors who have a portfolio of billions of dollars.” She added that those who did have an understanding of the risk failed to manage it.

Perhaps a prime example of a failure to manage risk, as referred to by Eberly, is the nonbank mortgage lenders that comprised the shadow banking industry, as they were greatly involved in borrowing and lending, but their financial activity faced little in the way of regulation—despite being an important part of the regulatory picture leading up to the crisis.

Min addressed this point with the following comment: “I actually think that the rules we had in place, to a large degree, worked. The problem was that the locus of intermediation shifted from traditional banks and the GSEs to a new set of institutions, where the traditional capital and leverage rules we had in place weren’t really in [operation]. [...] There’s a case for strengthening and putting in countercyclical prudential tools. But I think to some degree it’s really just about extending the regulatory umbrella out to the so-called shadow banking system.”

The effect of this, in Min’s view, is that the investment banks and the conduits weren’t capitalized, and so they weren’t holding capital, and the system didn’t have the same prudential rules in place as for traditional banks and, to a lesser degree, for Fannie Mae and Freddie Mac.

Next the panelists discussed the Taylor Rule, which is less explicitly related to bank regulation

but concerns monetary-policy guidance for the Federal Reserve; specifically, changes to the nominal interest rate in response to changes in economic conditions, such as inflation or output. The rule was devised by Stanford economist John Taylor.

Leamer in particular posited that he is an advocate for the Taylor Rule because it has the interest-rate-setting as a function of inflation and what is called an “output gap,” which has to do with determining the appropriate level of output for the economy.

In Leamer’s aforementioned working paper, “Housing IS the Business Cycle,” he writes the following of the rule: “What I am advocating is a modified Taylor Rule that depends on a long-term measure of inflation having little to do with the phase in the cycle, and, in place of Taylor’s output gap, housing starts and the change in housing starts, which together form the best forward-looking indicator of the cycle of which I am aware. This would

create pre-emptive anti-inflation policy in the middle of the expansions when housing is not so sensitive to interest rates, making it less likely that anti-inflation policies would be needed near the ends of expansions when housing is very interest rate sensitive, thus making our recessions less frequent and/or less severe.”

On the topic of housing starts and output, as described by Leamer under the Taylor Rule, he tied it back to current conditions by adding, “Right now we have incredibly low housing. And it’s getting way below where it ought to be. So we ought to encourage the banks to do more lending.”

Leamer’s emphasis on the need for more lending was symptomatic of the panelists’ expansive conversation on the continued recovery of the U.S. housing market, as well as the recovery of the broader economy. The momentum of a broad-based recovery likely will be deterred by uncertainties about the direction of rules and reforms, not to mention the constriction of credit—much to the detriment of long-term economic growth in a country that sorely needs a sustained comeback. ■

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Part IV

Concluding Remarks

The lessons of the financial crisis and the questions that remain in its aftermath require clear-eyed answers, not to mention expertise about the choices that lie ahead. C.A.R. could not have asked for a better group of panelists to address the most pressing issues facing the housing sector in relation to America's financial structure, economic conditions, reform measures, and regulatory environment.

Adding clarity to these issues – among others – is a focal point of C.A.R.'s new Thought Leadership program, as we pursue dialogues, such as this roundtable, to shed light on the challenges and opportunities that will shape housing's future.



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