

Preventing the Next Bubble

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June 14, 2010

*Disclaimer: The thoughts expressed here are solely those of the author and should not be considered as official views of the Mortgage Bankers Association

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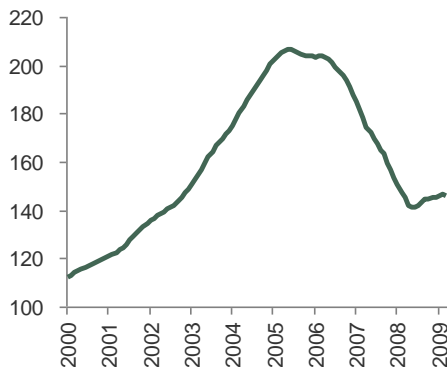
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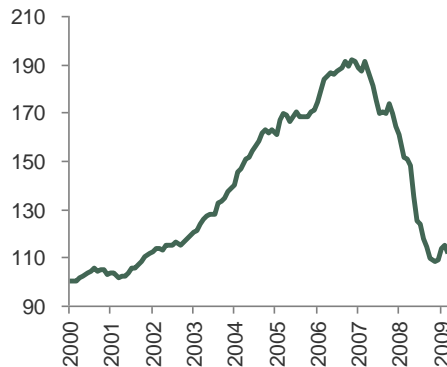
Pick Your Bubble

Indices of Selected Prices

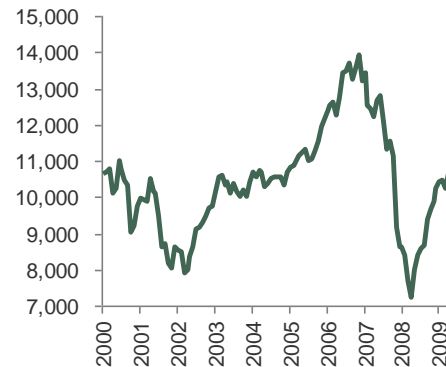
Homes



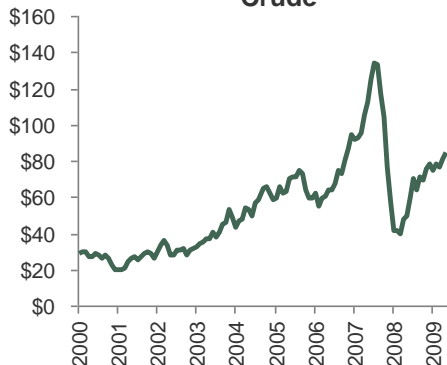
Commercial Real Estate



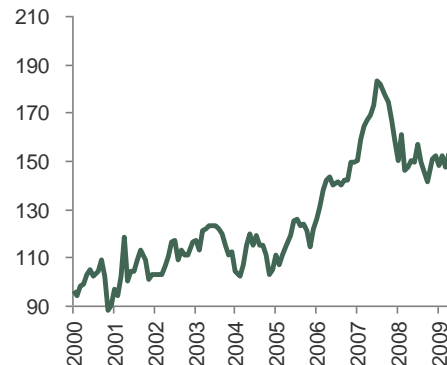
Dow Jones Industrial Avg



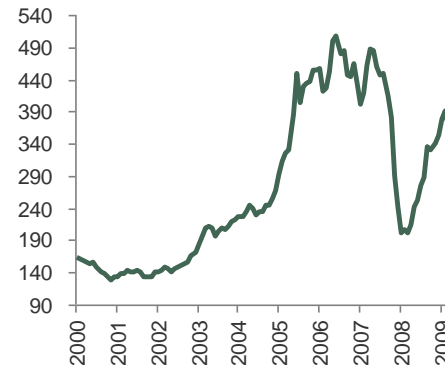
West Texas Intermediate Crude



Agricultural Crops



Industrial Metals (GS)



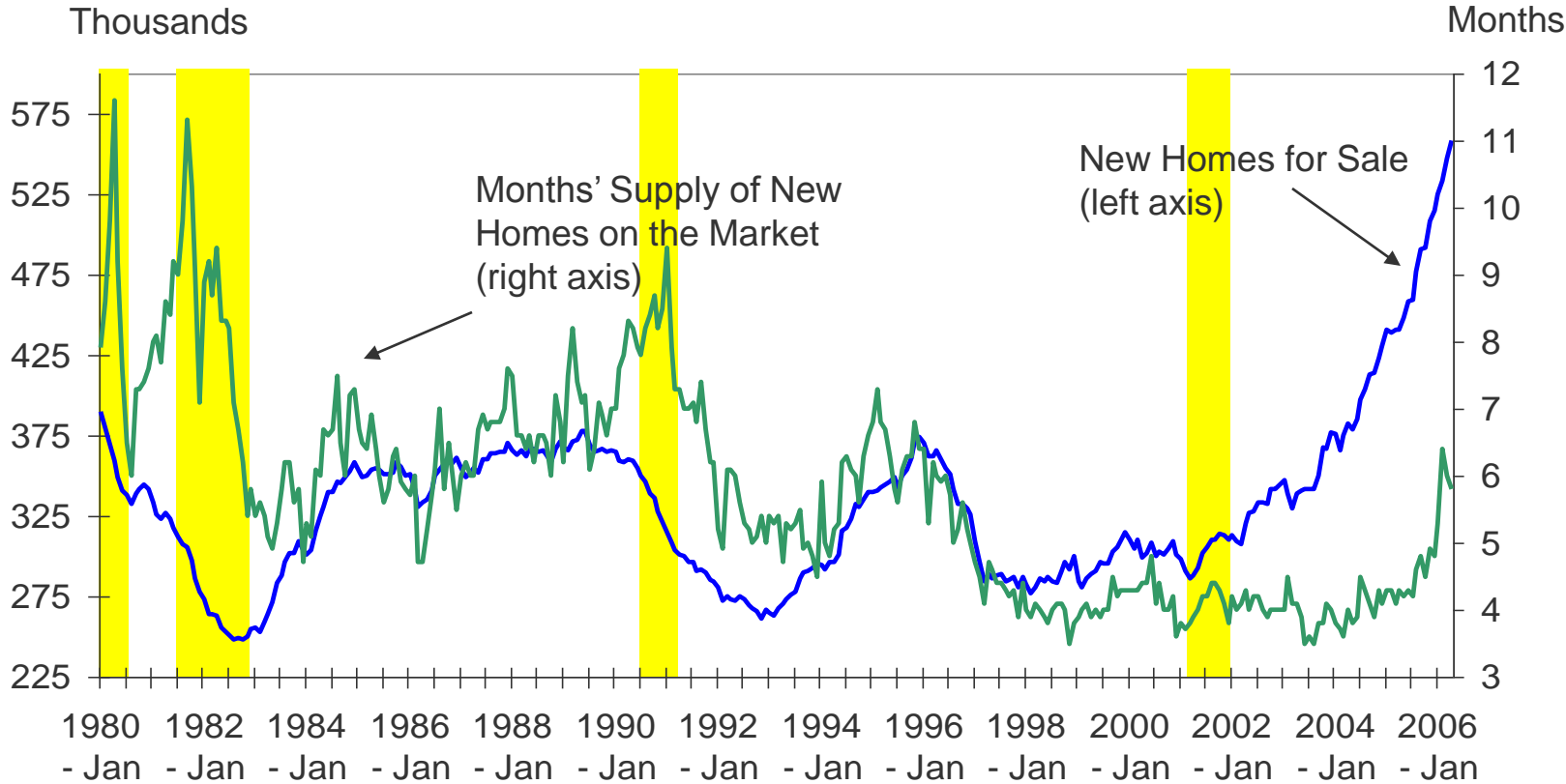
Two Keys to the Bubble “Problem”

- Demand and supply elasticities
 - Why is the system suddenly seeking equilibrium at a much higher price?
- Leveraged bubbles cause far more damage than equity bubbles.
 - See Reinhart & Rogoff's [This Time is Different](#), Princeton University Press

Supply Factors - New Homes For Sale

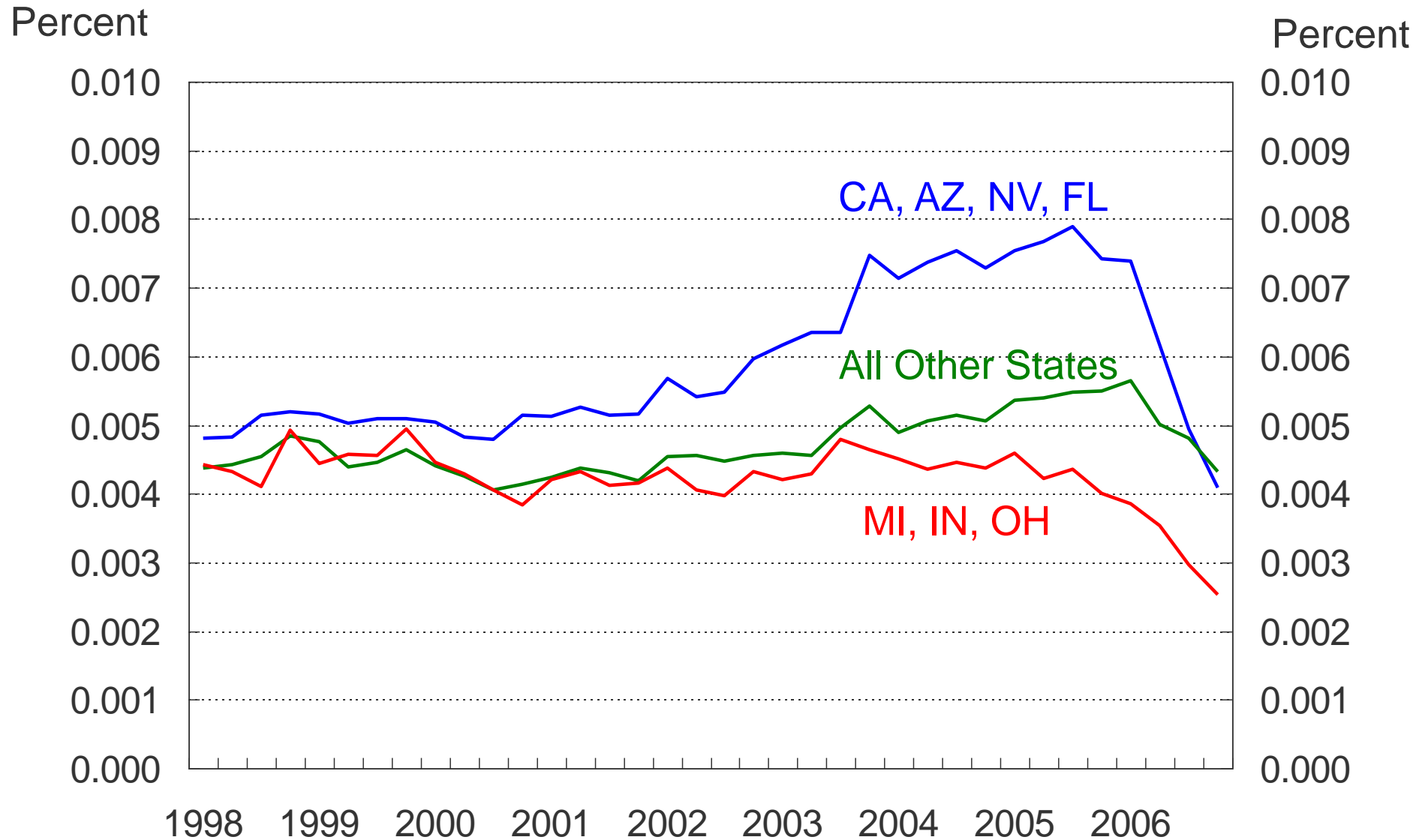


Slide from presentations in 2006



Source: Census Bureau

Supply Factors - Housing Starts Per Capita



What Drove Unsustainable Demand?

1) Underwriting to Weaker Credit Standards

- High LTV loans
- Credit spreads tightened sparking a price war among major subprime lenders
- Lower documentation standards

2) Lower Initial Payment Mortgages

- 2-28s, pay option ARMs, interest only
- Teaser rate ARMs

3. Fraud

- Borrowers (income, credit scores, intended occupancy, financial fraud involving appraisers, real estate agents, etc.)
- Brokers and loan officers, particularly on stated income loans

4. Incompetence

- The credit models that controlled the market (Moody's, S&P, Fitch, Fannie and Freddie) were backwards looking and misapplied historical performance.
- The risk-based capital model for Fannie and Freddie did not include variables for credit scores or loan documentation. Therefore the reported regulatory capital positions of Fannie and Freddie were vastly overstated.
- Risk culture in major financial institutions (see Cliff Rossi's "Anatomy of Risk Management Practices in the Mortgage Industry: Lessons for the Future", www.HousingAmerica.org)

Political and Economic

- Exemptions for CRA loans would likely be required.
- Political clout of real estate agents and homebuilders.
 - *Recall the fight over seller-paid down payment assistance programs.*
- Death by anecdote in news coverage of differences in regional and local LTV requirements.
- A strong argument can be made for higher LTVs in declining markets than rising ones.
- Unpredictable swings in demand for multifamily rental units.

Issues with the counter-cyclical down payment proposal

Technical

- All home price measures are flawed and should not be the basis of regulation. Price changes can differ significantly within local markets and at different points of the price spectrum.
- Even with the moving average component, using non-market tools to limit demand will be like adjusting the temperature of a room with an on/off switch.
- Compliance headaches for originators, particularly around “as of” dates for implementation of new LTV requirements.

The good parts of the proposal:

- Opens the door to the idea that location-based differences in credit terms and pricing are not only acceptable but desirable.
- Opens the door to counter-cyclical regulation of lending that looks at macro factors rather than just borrower level factors.

Recommendation:

Move beyond just beyond an LTV-based system since it is the most politically vulnerable and look toward a risk-layering approach, incorporating LTV with occupancy, loan structure, documentation, etc.