

# Deflating Bubble II Conference

October 11, 2007

Desmond Lachman  
American Enterprise Institute

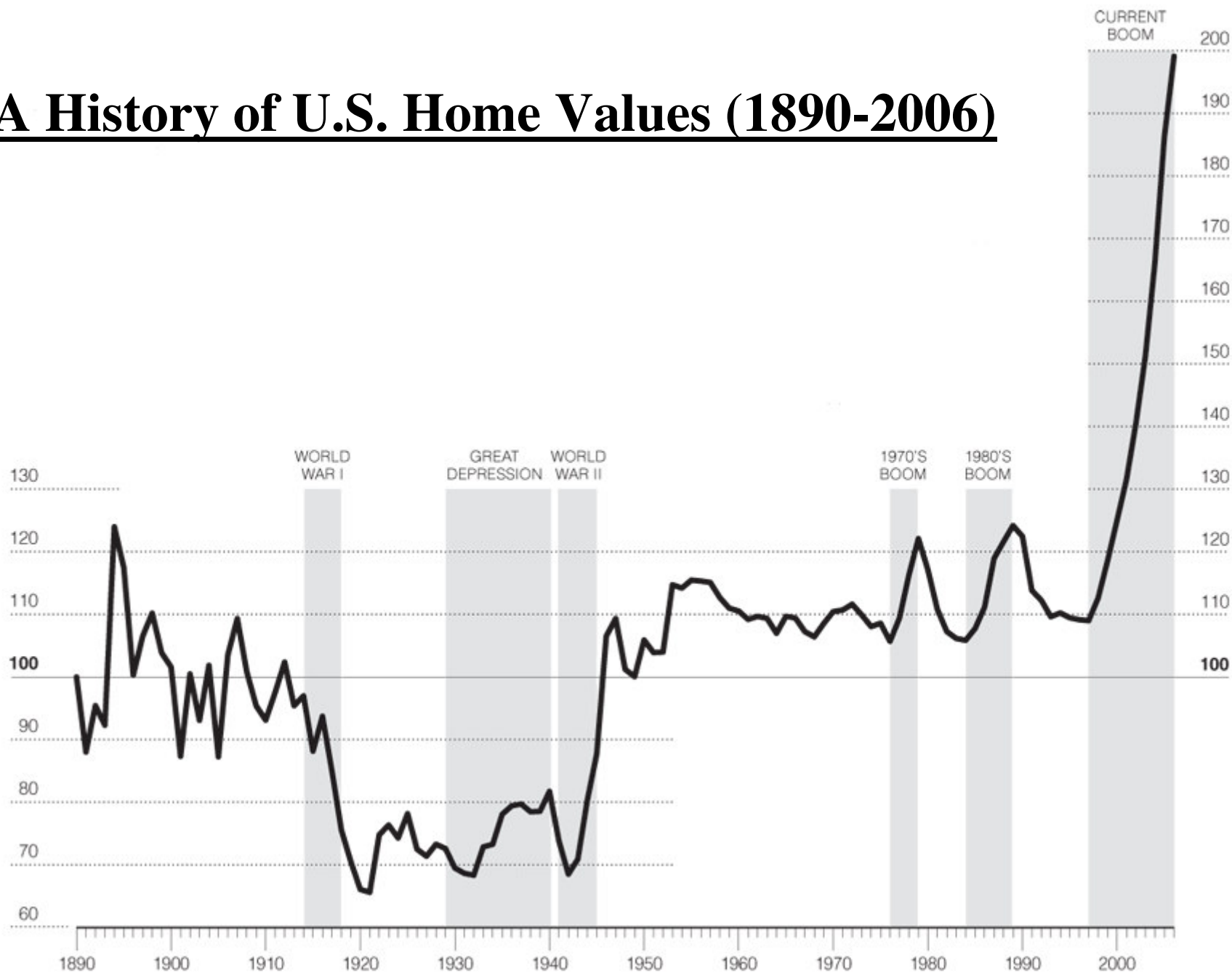
# Outline of Presentation

- Where is the U.S. housing market headed?
- How did the sub-prime crisis arise?
- What needs to be done about the sub-prime mess?

# Housing Market Outlook

- Following a spectacular 80 percent run up in real home prices between 2000 and 2006, the housing bust is in full train
- Sub-prime mortgage lending has all but evaporated
- Adjustable rate mortgages are scheduled to reset at increasing rate
- Mortgage lending standards are being tightened dramatically
- Future house price contracts suggest a double digit decline in home prices at the national level over the next two years

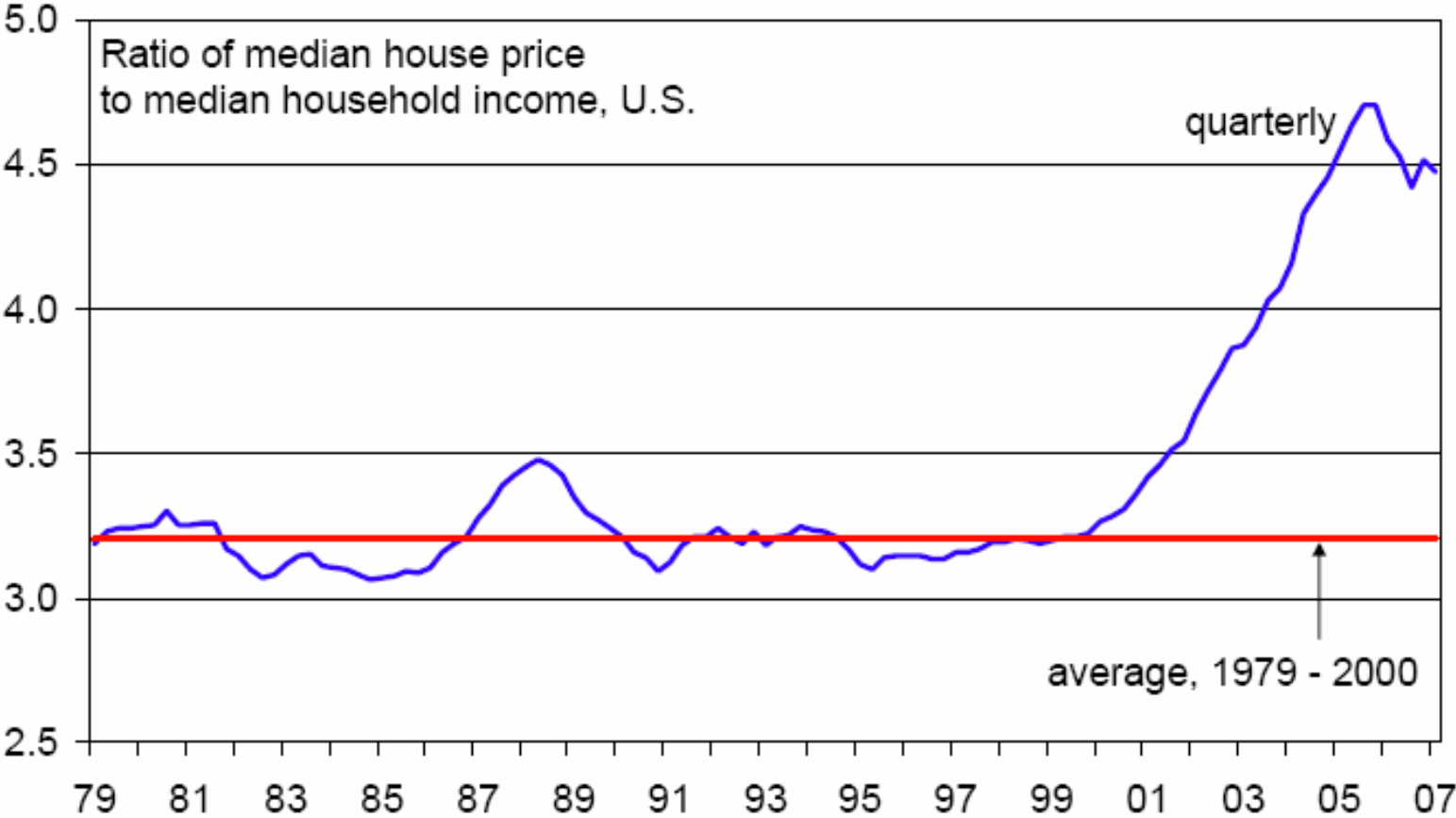
# A History of U.S. Home Values (1890-2006)



Source: "Irrational Exuberance," 2nd Edition, 2006, by Robert J. Shiller

Bill Marsh/The New York Times

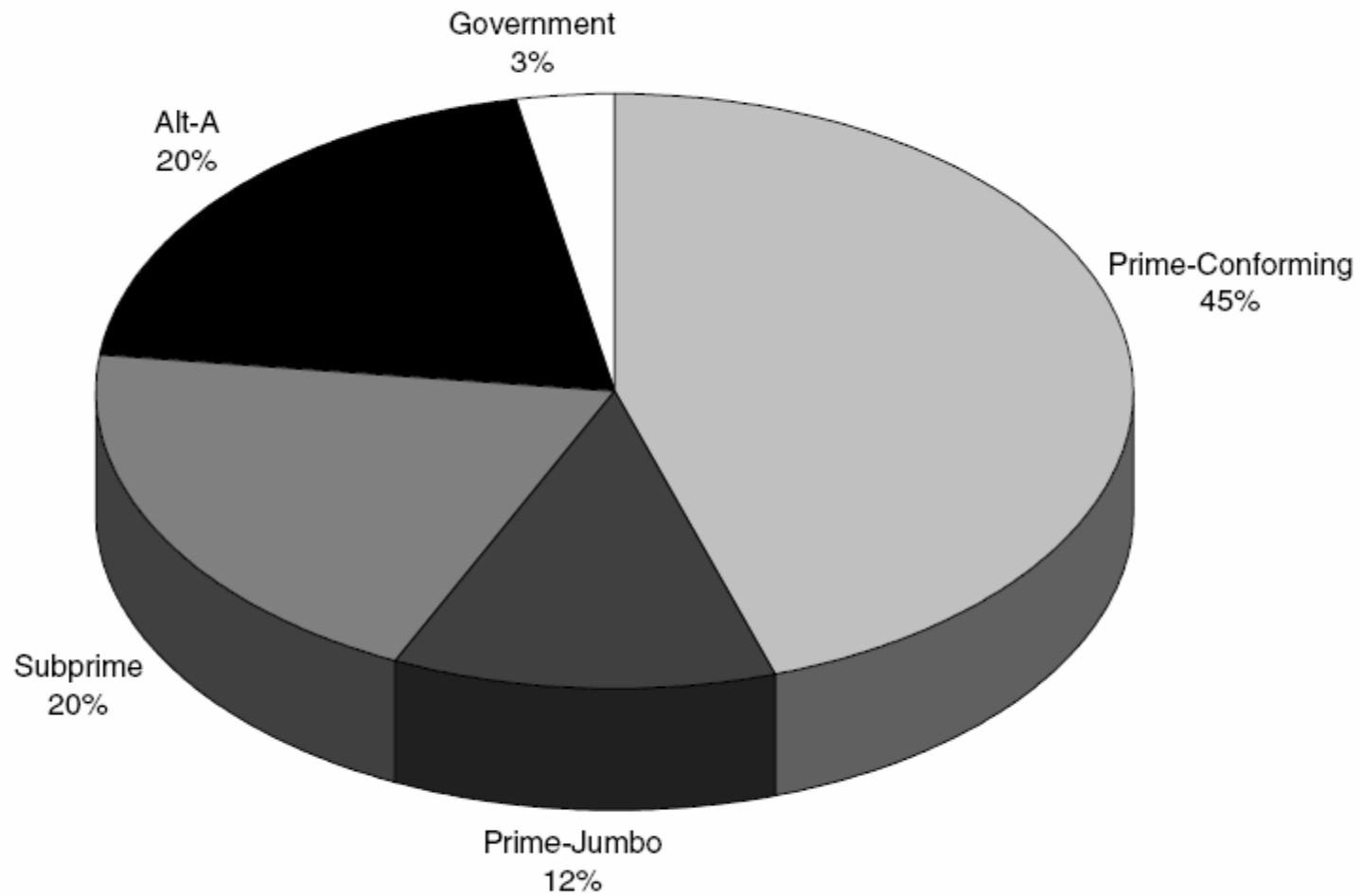
# Affordability Went Bust During The Housing Boom



---

Estimated Purchase Dollar Originations, 2006

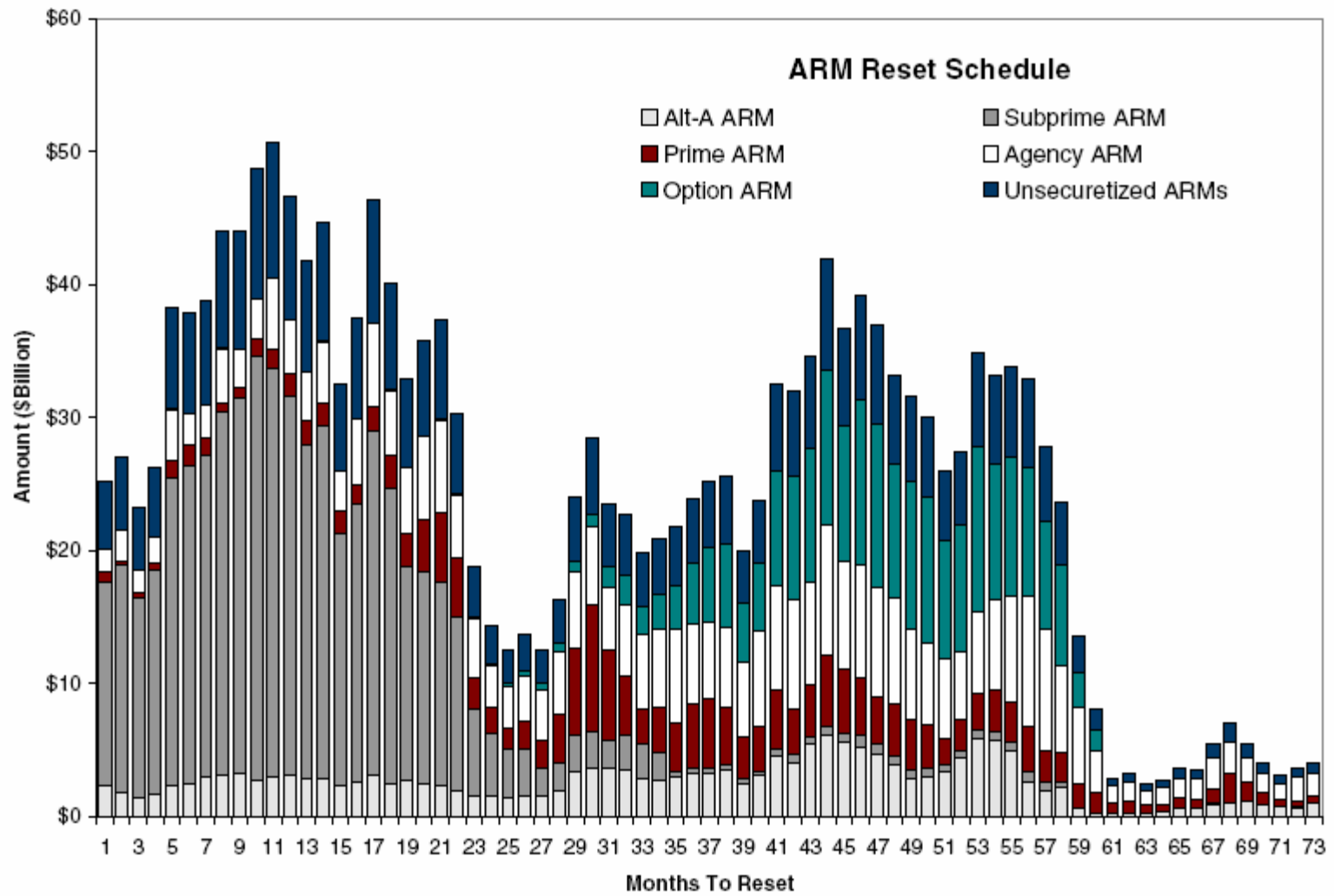
---



---

Source: Inside Mortgage Finance, MBA, LEHC, Credit Suisse U.S. Mortgage Strategy, Credit Suisse analysis.

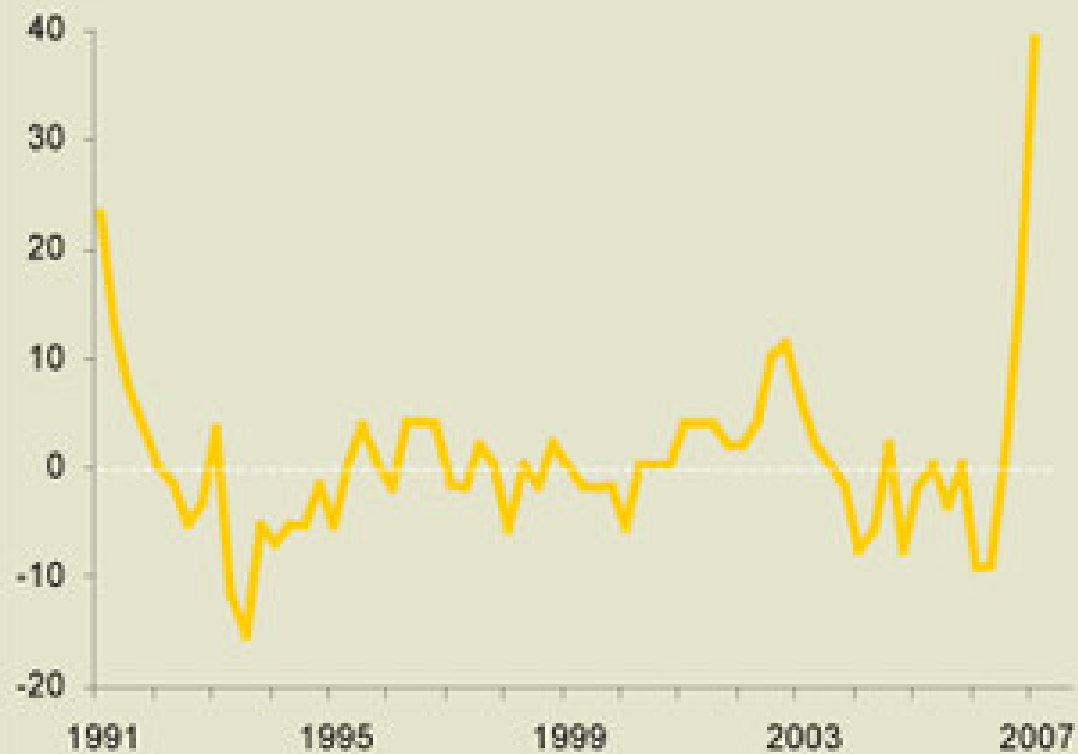
## Adjustable Rate Mortgage Reset Schedule



Note: Data as of January 2007.

Source: Credit Suisse Fixed Income U.S. Mortgage Strategy.

### Net Percentage of Senior Loan Officers Reporting Tighter Lending Standards for Mortgages to Individuals



Source: US Federal Reserve Board

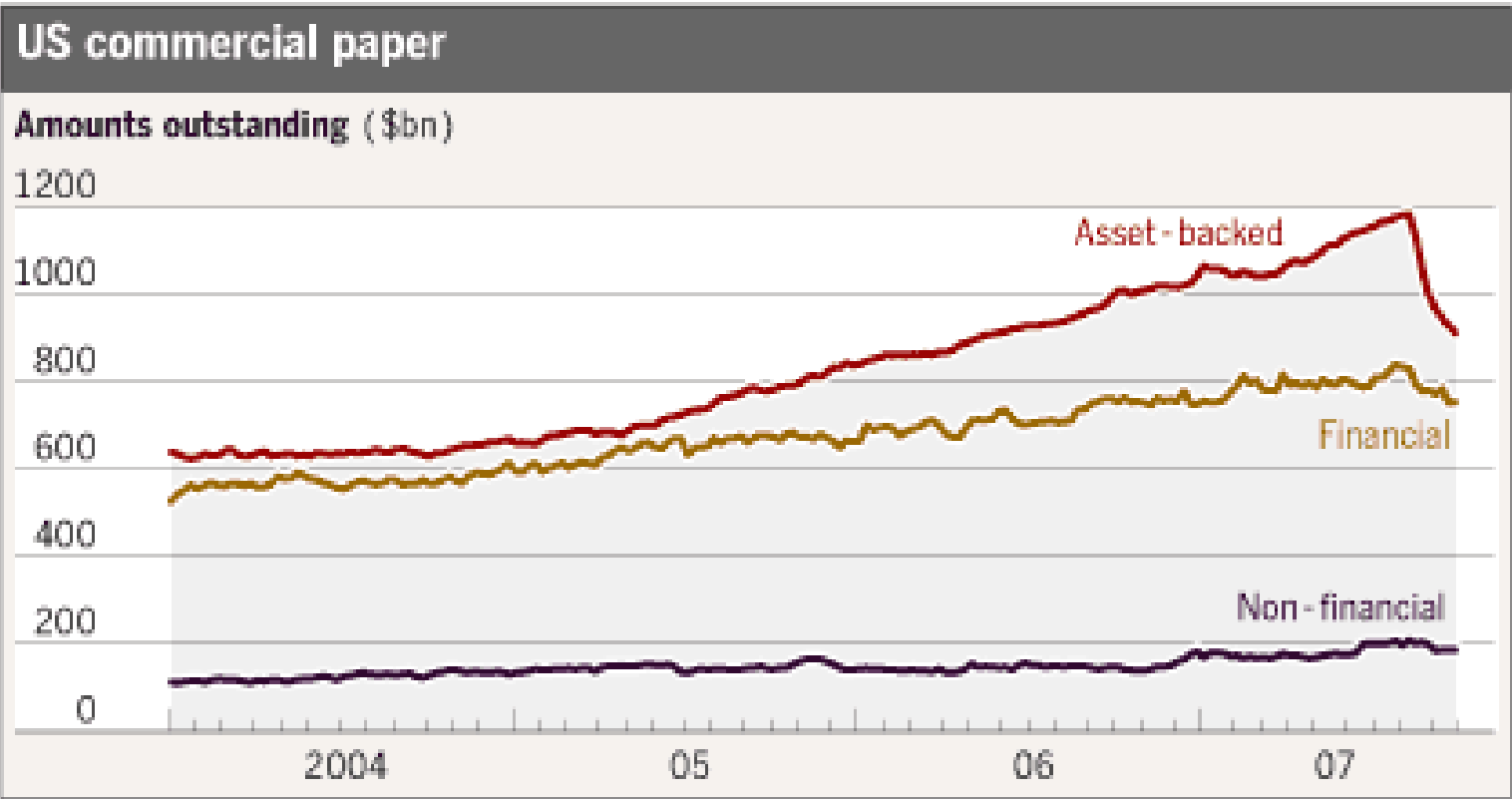
## House price Declines Implied by Case-Shiller Future Contracts

<b>CUMULATIVE % CHANGE IN HOME PRICES, NOVEMBER-NOVEMBER</b>				
<b>CITY</b>	<b>2007-2008</b>	<b>2007-2009</b>	<b>2007-2010</b>	<b>2007-2011</b>
<b>Boston</b>	-5.0%	-10.3%	-13.3%	-16.3%
<b>Chicago</b>	-6.2%	-6.2%	-10.1%	-3.2%
<b>Denver</b>	-5.0%	-11.0%	-14.5%	-18.1%
<b>Las Vegas</b>	-13.5%	-13.5%	-16.4%	-8.2%
<b>Los Angeles</b>	-6.8%	-10.9%	-11.9%	-13.4%
<b>Miami</b>	-8.3%	-15.1%	-19.7%	-25.6%
<b>New York</b>	-6.3%	-11.6%	-11.5%	-10.6%
<b>San Diego</b>	-7.3%	-13.5%	-15.7%	-17.6%
<b>San Francisco</b>	-6.8%	-14.2%	-20.3%	-24.4%
<b>Washington, DC</b>	-6.8%	-11.7%	-16.3%	-19.4%

Data as of September 20, 2007. Note that these contracts cover prices with a two-month lag, and that they average prices over three months, so the November 2007 contract actually covers prices from July-September 2007.

# Sub-prime Mortgages and the Global Credit Crunch

- Defaults on sub-prime mortgages could lead to financial sector losses of the order of U.S.\$200 billion
- Packaging of sub-prime mortgages increases mistrust as banks do not know where the sub-prime losses reside
- The seizing up of U.S. commercial paper market is causing Structured Investment Vehicles and conduits to return to bank balance sheets
- Credit Crunch is keeping Libor interest rates above official interest rates
- The prospective continued fall in home prices will aggravate the present credit crunch



Source: Wolf, M. "Securitisation: life after death," *Financial Times*, October 2, 2007

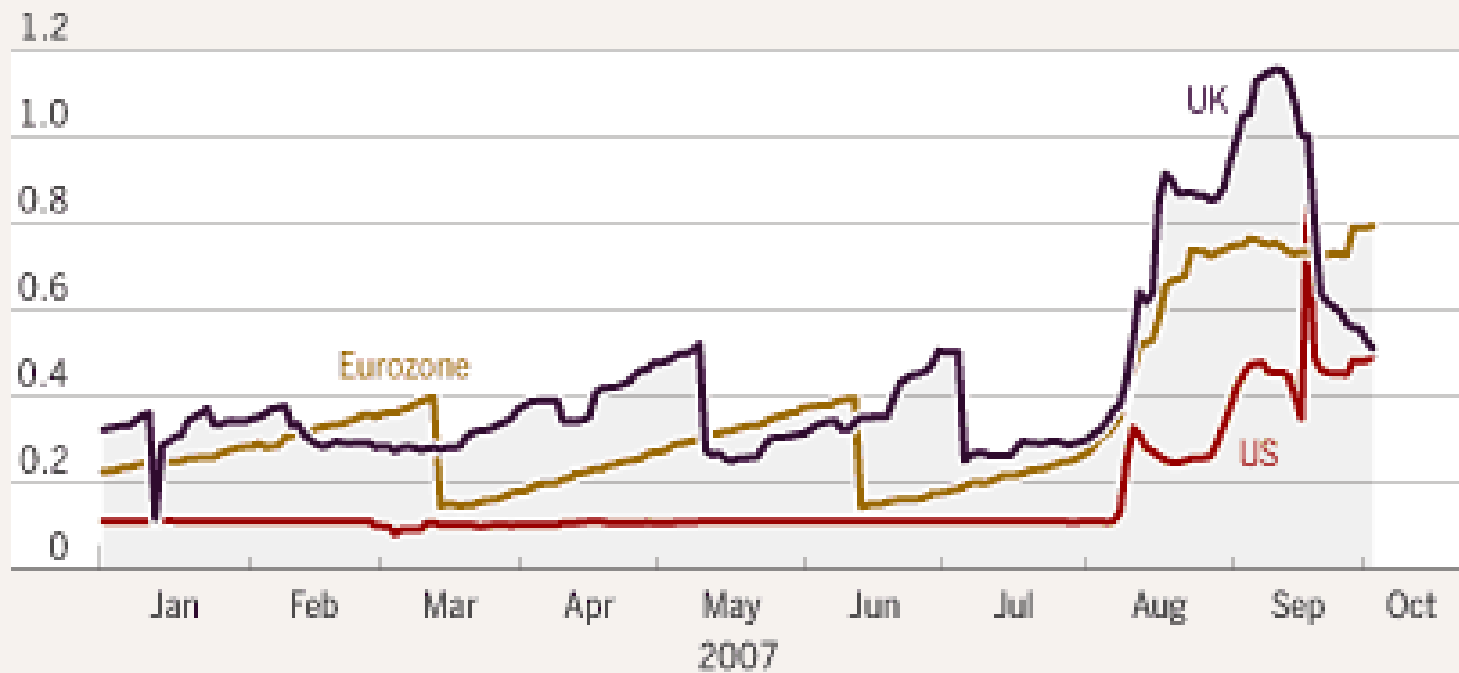
## US commercial paper and Treasury bill yields



Source: Wolf, M. "Securitisation: life after death," *Financial Times*, October 2, 2007

## Libor spreads

Three-month libor spreads over central bank policy rates (%)



Source: Wolf, M. "Securitisation: life after death," *Financial Times*, October 2, 2007

## Factors Contributing to Sub-Prime Excesses

- Securitization reduced incentives for originators to do proper credit analysis
- Investment banks came up with new instruments for packaging risk and for reducing early interest payments
- Rating agencies responded to incentives to overrate securities
- Only around 50 percent of mortgage originators were covered by federal regulation
- The Federal Reserve was asleep at the wheel as lending standards were relaxed

# How Should Policy Respond?

- The Federal Reserve should be reducing interest rates aggressively to cushion the economy from the housing market fallout, preferably in coordination with other G-7 central banks.
- Reforms should be undertaken to prevent a recurrence of the sub-prime lending problem
- Every effort should be made to resist a wholesale bailout of mortgage lenders and borrowers

# Reforming the Mortgage Market

- Educate borrowers and require simple and easily understandable explanation of loan-terms
- Fill in gaps in regulatory framework
- Require mortgage originators to hold a significant part of mortgages they originate
- Align rating agencies incentives to serve investors' rather than issuers' interests

# Resisting Bailouts

- Functioning of Markets should not be undermined
- Moral Hazard must be avoided
- Fiscal Cost of any support should be kept to a minimum
- Amend foreclosure rules to allow low-income borrowers to rent at a fair market rate