

Conference on  
“The Deflating Mortgage and Housing Bubble, Part III: What Next?”

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Opening Remarks

Alex J. Pollock

Welcome to our conference, “Deflating Bubble III.” “Deflating Bubble I” a year ago, and “II” last October, were both very pessimistic about the outlook for the unwinding of the great housing inflation and its accompanying efflorescence of mortgage debt—much more pessimistic than many official views. This pessimism has been proved correct by events. Now we bring you Part III: “What Next?” Are we anywhere near the bottom, or still heading downwards—and what are the interacting financial, economic and political implications?

As before, this conference is jointly sponsored by the American Enterprise Institute and the Professional Risk Managers International Association. On behalf of both, we are delighted that you all are here.

I am Alex Pollock of AEI. In a moment I will introduce our outstanding panel.

In 1994, the “National Homeownership Strategy” of the Clinton administration advocated “financing strategies, fueled by creativity...to help homebuyers who lack the cash to buy a home or the income to make the payments” buy a home nonetheless. A good deal of creativity was indeed applied and such strategies succeeded, albeit, as is now apparent, with quite different results than expected.

I do not need to review the obvious financial distress the deflation of the housing bubble has unleashed. Along with reporting multi-billion dollar losses, Fannie Mae and Freddie Mac have called this “the most severe housing dislocation in decades” and “one of the most severe housing downturns in American history,” respectively. Fannie added that now its primary focus is “protecting our capital [and] mitigating losses.”

As this statement indicates, the focus of the market has shifted, in the famous saying of Will Rogers, from return on capital to return of capital. When this view becomes widespread, as it has, markets become illiquid or even “frozen”—a term increasingly used. The remarkable special lending programs of the Federal Reserve bear witness to this effect.

A year ago, we often heard that banks and thrifts were not part of the subprime mortgage problem. But they are deeply involved in the wider deflation of the bubble. Profits of all FDIC-insured financial institutions fell 84% in the fourth quarter of 2007 from the fourth quarter of 2006. Problems with home equity loans and loans to real estate developers are increasing. Option-payment ARMs retained on financial institution balance sheets, with large amounts of negative amortization already booked into profits (representing non-cash income, of course), are likely to represent another wave of delinquencies in an environment of falling house prices.

Goldman Sachs has forecast the peak to trough fall in house prices at 20-25%. On a starting aggregate value of \$22 trillion, a 20% fall would cause a \$4.4 trillion reduction in household wealth. What would it do to bank credit?

Of all FDIC-insured financial institutions, 48% of total loans and 47% of total assets are based on real estate. For the smaller banks and thrifts, those with assets of less than \$ 1 billion, 67% of loans are based on real estate.

So let me confidently predict that interesting times will continue, financially, economically and politically, as a result of the momentous 21<sup>st</sup> century housing and mortgage bubble. For more elaboration of “What Next?” we rely on our panel.

We will hear first from Desmond Lachman, who is a Resident Fellow at AEI, having previously been a Wall Street economic strategist. His research includes global currencies, emerging market economies, multilateral lending institutions, and the housing bubble. Desmond and I have been reinforcing each other’s bearish outlook on this since 2006.

Our second speaker will be Chris Whalen, Senior Vice President and Managing Director of Institutional Risk Analytics, to which he brings experience as an investment banker, research analyst, and journalist, including working in both equities and fixed income, as well as risk management. Chris has been my partner in organizing this series of conferences.

Next will be Nouriel Roubini, who is a professor of economics at the New York University Stern School of Business, as well as Chairman of Roubini Global Economics. He has served as the senior economist for international affairs at the White House Council of Economic Advisers, among many other assignments, and written provocatively as a “super bear” on the housing bust and its economic implications.

Tom Zimmerman will be our fourth speaker, bringing us fixed income securities market and analytical perspectives. Tom is a Managing Director at UBS Investment Bank, where he manages the firm’s mortgage credit and asset-backed securities research. His research has appeared in numerous fixed-income reference works, and he is a member of the UBS team voted first in the Institutional Investor survey of fixed-income analysts.

Finally, we will hear from John Makin, who is both a visiting scholar at AEI, where he writes the insightful monthly “Economic Outlook,” and a principal at the investment firm of Caxton Associates. He has been an adviser to various U.S. government agencies, the Federal Reserve

and the Bank of Japan, and is the author of numerous books and articles, including a prediction that the housing bust would lead to a recession starting early in 2008.

Each member of the panel will speak for 12 to 15 minutes, after which we will give the panel a chance to respond to each other. Then we will open the floor for your questions. We will adjourn by 4:00.