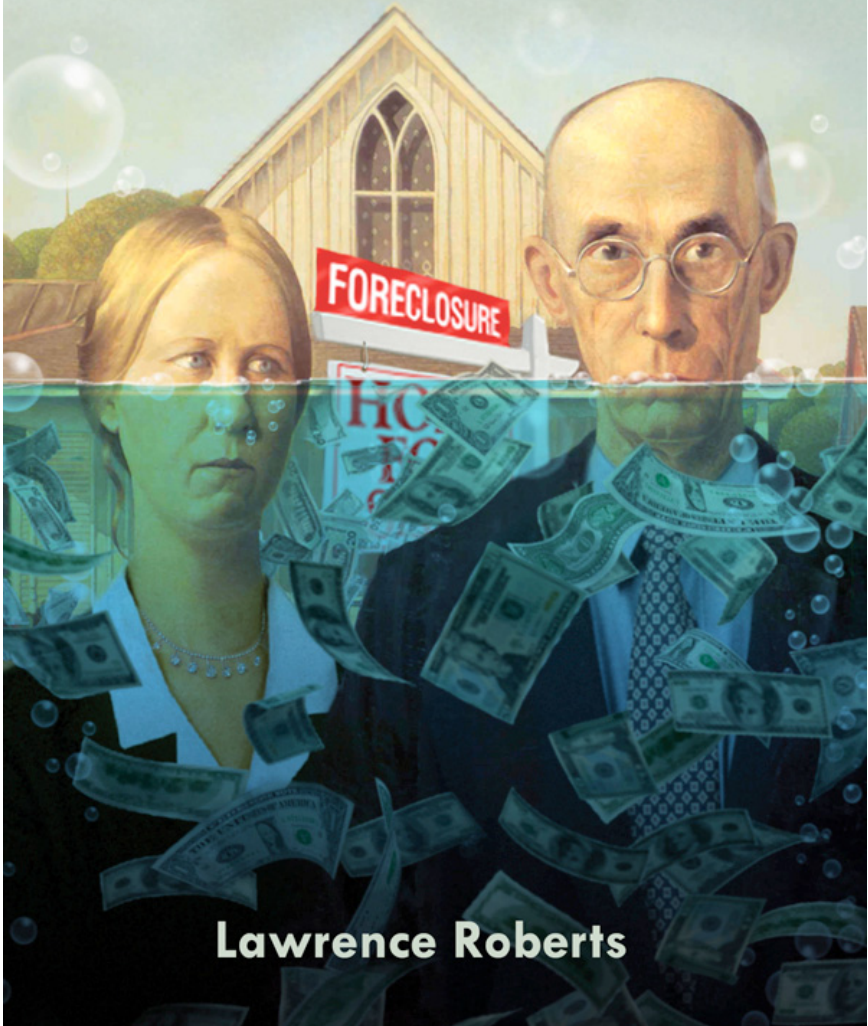


THE GREAT
HOUSING BUBBLE
Why Did House Prices Fall?



Lawrence Roberts

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The author's work can also be found at the Irvine Housing Blog where he has been the primary writer since February of 2007.

<http://www.irvinehousingblog.com/>

The Irvine Housing Blog has become noted for its unique delivery of real estate market analysis in Slate Magazine, the Washington Post, and Newsweek Magazine. The blog reaches an average of 3,500 unique visitors a day, and it received over 2,000,000 page views in its first year of operation.

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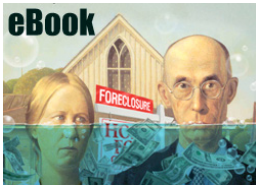
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Preface

I work as a development consultant in the real estate industry in Southern California. My education and experience has acquainted me with a variety of real estate markets, but residential real estate is the one with which I am most familiar. I am not a realtor or a mortgage broker, and my livelihood, though dependent upon the real estate industry, it is not dependent upon facilitating a home-sale transaction. What is presented here is both historical account and unbiased analysis. My observations of the residential real estate market are not tainted by any need or desire to convince anyone they should buy a house. In fact, one of my motivations for writing about the Great Housing Bubble is to convince people *not* to buy a house when prices are inflated and save them from financial ruin. It saddens me to watch homebuyers get caught up in the bubble mythology and enter into a financial transaction that will have a strongly negative impact on their financial lives. People who have already made that decision cannot be helped except at the expense of a naïve buyer. Sellers have the marketing machine of the National Association of Realtors to help them. Buyers have few sources of unbiased information to assist their decision. Part of the purpose of this writing is to educate both buyers and sellers on the realities of the residential real estate market.

One of the difficulties of writing a book on the Great Housing Bubble in 2008 is that the bubble has not played itself out yet. There is a necessary change in tense required when speaking of events prior to 2008 and those projected to occur during and after 2008. Someone reading this in 5 years may look back on it as history, but for those of us living it now, it is a history not yet lived. Much of what is presented here may not come to pass, or it may not happen in the way hypothesized in this book. History will judge whether this is prescient, or if it is “a tale told by an idiot, full of sound and fury, signifying nothing.”¹

Irvine Housing Blog

I discovered Real Estate Bubble Blogs in November of 2006.² Many were in existence much earlier, but I was not a big reader of blogs prior to this time. I

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first discovered the Irvine Housing Blog when my wife found a series of interesting posts on people who were attempting to sell properties for a quick profit (flipping,) and they were getting burned. I was quickly hooked. From the blogroll (links to other blogs) I was able to locate several other bubble blogs, and I quickly became a regular reader and commenter on several blogs in this community.

In February of 2007, I was asked to write for the Irvine Housing Blog. I had a great deal of pent-up energy for writing about the housing bubble. Over the months that followed I wrote a series of analysis posts which became the structure of this book. Daniel Gross, a freelance writer published in Slate Magazine, the Washington Post and Newsweek, characterized the writing as follows (Gross, *The Real Morons of Orange County*, 2007): "IrvineHousingblog, brilliantly drives home the same point with daily dispatches. The blog is a guide to the seventh circle of real estate hell – people who buy houses on spec with no money down. A typical entry chronicles the purchase price, tracks down the amount of debt on the property, and then calculates how much each party – the buyer, the first mortgage holder, the second mortgage holder – stands to lose assuming the seller receives the asking price."

The Reservoir of Schadenfreude

The readers of the Irvine Housing Blog have a voracious appetite for profiles of losing properties. They are not alone. Why do people get so much pleasure from seeing would-be real estate moguls lose a great deal of money? I can think of no other human endeavor that has engendered so much pleasure in the misfortune of others by otherwise caring, compassionate people. In my opinion, the outpouring of schadenfreude we are seeing as the housing bubble deflates is a mixture of Greek tragedy and bad karma. In short, bubble participants should have seen it coming, and they are getting what they deserve.

Schadenfreude is not a spiritually uplifting emotional response. Most religious traditions would counsel us against it. In Buddhist teaching, people are taught to cultivate feelings of compassion for the misfortune of others – feeling empathy and sadness for the slings and arrows of outrageous fortune when they impact another.³ The near enemy of compassion is pity: it masquerades as compassion, but it has an element of separateness which detracts from the sense of Oneness with all things. Joy is good: Sympathetic joy, the joy in the happiness of another, is another pillar of a spiritual existence; however, joy in the misfortune of another – schadenfreude – is not a skillful behavior leading to happiness. Even knowing that, many of us feel this joy anyway. Why is that?

I recognized financing terms were creating artificially high prices early on. By 2004, I was telling people I knew that this was a problem which would cause a market crash. Most people looked at me like I was crazy. "Real estate always goes up," I was told. "The government would never allow prices to crash," I was told. "If you do not buy now you will be priced out forever," I was told. This is the intoxicated language of real estate junkies who have overdosed on the real-estate-appreciation kool aid. If these statements had been offered in a defensive

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manner of someone who is being made to realize they made a serious mistake, I could have felt sympathy for them; I would have been able to disarm their defensiveness and helped them see the light. However, what I generally got was a smug assuredness of someone who truly believed he was right and I was wrong; not just that I was wrong; I was a stupid, cowardly fool who did not have the brains or the bravery to take the free money being given out. This was particularly surprising given my line of work. It was as if a patient after getting a diagnosis of cancer told the doctor that the physician did not understand the tissue growth was a natural, healthy process. The buyers caught up in the Great Housing Bubble did not recognize the financial cancer even when an expert in the field told them how dangerous it was.

During the bubble rally, those of us who chose not to participate were labeled as “bitter renters.” It was suggested we were envious of the good fortune of homeowners as their property values rose, as they took on insane amounts of debt, and as they blithely financed a lifestyle well beyond their means. This was undoubtedly true for some, but in my opinion, this is not the primary reason so many derive so much pleasure from the misfortune of those now suffering from declining property values. These same people who chided us for being envious actually wanted us to be envious: they wanted us to know they were the winners in our competitive society; they wanted us to view them as superior. This act of putting themselves above us created a separation which prevented us from feeling sympathetic joy for their good fortune, and it prevented us from feeling compassion for them when they fell.

In our collective unconscious which manifests in our dreams and our mythology, water is often symbolic of our emotions or our emotional state. Have you noticed people are often categorized as deep or shallow? If you are in debt you often feel “underwater.” Anger is much like water: if not given an outlet, it will fill a reservoir until it reaches a breaking point and is expressed in a flood of emotional rage. Each encounter with a pathologic, kool-aid-drinking housing bull during the bubble rally has added to this reservoir, and reveling in failed flips is an outlet for this pool of toxic emotional waste.

There is an element of tragedy in every disaster, but financial bubbles are some of the most interesting because they are completely man made. They are created by the accumulation of individual decisions of buyers who are motivated by greed, foolish pride, and a false sense of security. Each of these people should have known better. Many of them were warned of their impending doom by those who saw trouble brewing, and yet, many chose to go down the path to the Dark Side. Newton’s Third Law states, “For every action, there is an equal and opposite reaction.” The Law of Karma states, “For every event that occurs, there will follow another event whose existence was caused by the first, and this second event will be pleasant or unpleasant according as its cause was skillful or unskillful.” It became obvious as the crash began; the behavior of buyers during the bubble rally was not skillful. Whether it is Newton’s Third Law, Karma, or a Calvinist form of retributive justice, as this bubble deflates, many of the participants in this bubble are about to experience a great deal of hardship. Like many others, I will enjoy their suffering until my reservoir of schadenfreude is emp-

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tied. For the sake of my own personal spiritual well being, I hope this happens soon so I can regain my normal emotional balance and rekindle my feelings of compassion for my fellow human beings.

Introduction

Why did house prices fall? This is the fundamental question to most Americans, and to those who lent them money. Most homeowners did not care why residential real estate prices rose; they assumed prices always rose, and they should simply enjoy their good fortune. It was not until prices began to fall that people were left searching for answers. This book examines the causes of the breathtaking rise in prices and the catastrophic fall that ensued to answer the question on every homeowner's mind: "Why did house prices fall?"

Even though the decline is nowhere near over in 2008, already the Great Housing Bubble witnessed the largest decline in house prices since the Great Depression. The asset bubble for the Great Depression was the stock market while the asset bubble for the Great Housing Bubble was residential real estate. The title of the book, the Great Housing Bubble, is an allusion to the Great Depression of the 1930s. Both of these dramatic events were the result of a wild expansion of credit and a subsequent crash in asset prices that stressed the banking system and led to a dramatic economic slowdown.⁴

The book is arranged into 10 chapters. The first 4 chapters provide background information and are used to define terms and provide a broad conceptual understanding of residential real estate economics, chapters 5 through 8 discuss the structural and psychological factors that inflated and deflated the bubble, and the final two chapters describe methods of coping with the housing bubble. Chapter 1 is a general description of financial bubbles as a psychological phenomenon and the unique beliefs of residential real estate bubbles. Chapter 2 details the financing environment surrounding residential real estate. It defines and categorizes the types of borrowers and the types of loan programs available, and it illustrates how financing impacts the wealth of individual owners and the economy as a whole. Chapter 3 summarizes the mathematics determining the value of residential real estate and examines issues pertaining to the rent-versus-own decision, and chapter 4 delves into the fine points of determining the value of individual lots and raw land. Chapter 5 illuminates the credit bubble (which was largely responsible for the real estate bubble) with rigorous detail on the structure of the secondary mortgage market and how the expansion of credit

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through this market inflated the housing bubble. Chapter 6 looks at the housing bubble, its various measurements, and explains why the bubble burst. Chapter 7 is a review of the psychology of real estate bubbles. Financial bubbles are primarily psychological phenomenon, and the various aspects of investor psychology are explored to see how they shape the market. Chapter 8 is a projection of future house prices based on the data and conditions as they existed in early 2008. Chapter 9 contains advice for both sellers and buyers who plan to be active while prices are declining. Chapter 10 is a review of the causes of the bubble and proposals for reforms to prevent residential real estate bubbles from happening again.

The examples and data used in the analysis are national in scope, and they are also focused on the local residential real estate market in Irvine, California. The Great Housing Bubble is a national phenomenon; however, the national statistics soften the extremes and make the rise and fall look less remarkable. In some local markets, the prices changes are truly extraordinary, and it is through examining these markets that the story of the bubble is best told. A fine exemplar of the Great Housing Bubble is Irvine, California. Irvine is a large, master-planned community of over 200,000 residents. The high incomes of Irvine residents are reflected in the rental rates for properties which are consistently near the highest in the nation. High incomes and rents translate into high real estate prices, even at the bottom of down cycles. When reviewing the properties in Irvine and the price tags attached to them, it is not uncommon for outsiders to believe a decimal point has been misplaced. The lessons learned from the Irvine experience are universal. Though many the examples from this work focus on Irvine, this is a book about the Great Housing Bubble of which Irvine was both a catalyst and one of its biggest participants.

Table 1 - Top Subprime Lenders 2006

Rank	Lender	Market Share %
1	Wells Fargo	13.0%
2	HSBC Finance	8.3%
3	New Century	8.1%
4	Countrywide Financial	6.3%
5	CitiMortgage	5.9%
6	WMC Mortgage	5.2%
7	Fremont Investment	5.0%
8	Ameriquest	4.6%
9	Option One	4.5%
10	First Franklin	4.3%
11	Washington Mutual	4.2%
12	Residential Funding	3.4%
13	Aegis Mortgage	2.7%
14	American General	2.4%
15	Accredited Lenders	2.3%
Top 15 Lenders		80.2%

Source: Inside B&C Lending

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The epicenter of the Great Housing Bubble is located in Irvine, California. One of the primary causes of the bubble was the lowering of lending standards and the extension of credit to people who could not handle the responsibility: Subprime borrowers. The word “subprime” has become indelibly linked to the Great Housing Bubble. It is one of the causal factors that make the bubble unique, and the collapse of subprime is widely regarded as the pin-prick which began the bubble’s deflation. Irvine, California, is the center of the subprime universe. Three of the top ten subprime lenders, New Century, Ameriquest, and Option One, are (or were) headquartered in Irvine. Most subprime lenders have processing offices in Irvine due to the large number of trained personnel living in the area. Irvine’s New Century Financial, formerly the second largest subprime operator, is heralded as the poster child of the bubble. The company name “New Century” implies a new era and a new paradigm. It embodies the fallacious beliefs and ideas that inflated the Great Housing Bubble.

Volatility in real estate prices is not new to California. During the 1970’s, real estate prices detached from typical valuations of three-times yearly income seen in the rest of the country. Once residents realized they could push up prices in their real estate markets to dizzying heights, they have been doing it ever since. Greed springs eternal. The Great Housing Bubble is the third such bubble in the last 30 years, and it is the largest of all. The detachment from traditional measures of valuation was so extreme that it is difficult for many to comprehend. Each time the bubble bursts, the crash is incorrectly blamed on some outside force, and each time the rally is thought to be different than the rally in previous cycles. It never is.

What is a Bubble?

A financial bubble is a temporary situation where asset prices become elevated beyond any realistic fundamental valuations because the general public believes current pricing is justified by probable future price increases. If this belief is widespread enough to cause significant numbers of people to purchase the asset at inflated prices, then prices will continue to rise. This will convince even more people that prices will continue to rise. This facilitates even more buying. Once initiated, this reaction is self-sustaining, and the phenomenon is entirely psychological. When the pool of buyers is exhausted and the volume of buying declines, prices stop rising; the belief in future price increases diminishes. When the remaining potential buyers no longer believe in future price increases, the primary motivating factor to purchase is eliminated; prices fall. The temporary rise and fall of asset prices is the defining characteristic of a bubble.

The bubble mentality is summed up in three typical beliefs:

1. The expectation of future price increases.
2. The belief that prices cannot fall.
3. The worry that failure to buy now will result in permanent inability to obtain the asset.

The Great Housing Bubble was characterized by the acceptance of these beliefs by the general public, and the exploitation of these beliefs by the entire real estate industrial complex, particularly the sales mechanism of the National Association of Realtors.

Speculative bubbles are caused by precipitating factors.⁵ Like a spark igniting a flame, a precipitating factor serves as a catalyst to begin the initial price increases that change the psychology of market participants and activates the beliefs listed above. There is usually no single factor but rather a combination of factors that stimulates prices to begin a speculative mania. The Great Housing Bubble was precipitated by innovation in structured finance and the expansion of the secondary mortgage market, the lowering of lending standards and the growth of subprime lending, and to a lesser degree the lowering of the Federal Funds Rate. All of these causes are discussed in detail in later sections.

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Real Estate Only Goes Up

The mantra of the National Association of Realtors is “real estate only goes up.” This economic fallacy fosters the belief in future price increases and the limited risk of buying real estate. In general real estate prices do increase because salaries across the country do tend to increase with the general level of inflation, and it is through wages that people make payments for real estate assets.⁶ When the economy is strong and unemployment is low, prices for residential real estate tend to rise. Therefore, the fundamental valuation of real estate does go up most of the time. However, prices can, and often do, rise faster than the fundamental valuation of real estate, and it is in these instances when there is a price bubble.

Greed is a powerful motivating factor for the purchase of assets. It is a natural response for people to desire to make money by doing nothing more than owning an asset.⁷ The only counterbalance to greed is fear. However, if a potential buyer believes the asset cannot decline in value, or if it does, it will only be by a small amount for a very short period of time, there is little fear generated to temper their greed.⁸ The belief that real estate only goes up has the effect of activating greed and diminishing fear. It is the perfect mantra for creating a price bubble.⁹

Buy Now or Be Priced Out Forever

When prices rise faster than their wages, people can obtain less real estate with their income. The natural fear under these circumstances is to buy whatever is available before there is nothing desirable available in a particular price range. This fear of being priced out causes even more buying which drives prices higher. It becomes a self-fulfilling prophecy. Of course, the National Association of Realtors, the agents of sellers, is keen to exploit this fear to increase transaction volume and increase their own incomes. If empirical evidence of the recent past is confirming the idea that real estate only goes up, the fear of being priced out forever provides added impetus and urgency to the motivation to buy.

Just before the stock market crash signaling the beginning of the Great Depression, Irving Fisher, a noted economist at the time, was quoted as saying “Stock prices have reached what looks like a permanently high plateau.”¹⁰ Of course, stock prices dropped significantly after he made this statement. This sentiment is based on the idea that inflated prices can stay inflated indefinitely. However, when valuations cannot be pushed up any higher, prices cannot rise at a fast rate. In residential real estate markets, the rate of price increase would only match inflation because wages and inflation are closely correlated. If the rate of price increase does not exceed ordinary investments, people lose their enthusiasm for residential real estate as an investment, and they begin to look for alternatives: people choose to rent rather than own. Also, when the quality of units available for rent at a given monthly payment far exceeds the quality of those available for sale at the same monthly payment level, people choose not to bid on the property and they rent instead. One sign of a housing bubble is a wide

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disparity between the quality of rentals and the quality of for-sale houses at a given price point. People choosing to rent curtails the rapid rise in prices and thereby lowers the demand for real estate. This puts downward pressure on prices, which eliminates the primary motivation speculators had for purchasing the asset. Greed created the condition of rapidly rising prices which in turn spawns the fear of being priced out. When greed ceases to motivate buyers, prices fall.

Once prices begin to fall, the fear of being priced “out” forever changes to a fear of being priced “in” forever. A buyer who overpaid and over-borrowed will be in a circumstance where they owe more on their mortgage than the property is worth on the open market. They cannot sell because they cannot pay off the mortgage. They become trapped in their homes until prices increase enough to allow a breakeven sale. This puts the conditions in place to reverse the cycle and causes prices to drop precipitously.

Confirming Fallacies

There are a number of fallacies about residential real estate that either affirm the belief in perpetually rising prices or minimize the fears of a price decline. These fallacies generally revolve around a perceived shortage of housing or a belief that the higher prices are justified by current or future economic conditions. These misperceptions are not the core mechanism of an asset price bubble, but they serve to affirm the core beliefs and perpetuate the price rally.

They Aren't Making Any More Land

All market pricing is a function of supply and demand. One of the reasons many house price bubbles get started is due to a temporary shortage of housing units.¹¹ This is a particular problem in California because the entitlement process is slow and cumbersome.¹² Supply shortages can become acute, and prices can rise very quickly. In most areas of the country, when prices rise, new supply is quickly brought to the market to meet this demand, and price increases are blunted by the rebalancing of supply and demand. Since supply is slow to the market in California, these temporary shortages can create the conditions necessary to facilitate a price bubble.

The fallacy of running-out-of-land plays on this temporary condition to convince market participants that the shortage is permanent. The idea that all land for residential development can be consumed ignores one obvious fact: people do not live on land, they live in houses, and land can always be redeveloped to increase the number of housing units. Basically, builders can build “up” even if they can’t build “out.” If running-out-of-land were actually a cause of a permanent shortage of housing units, Japan and many European countries where there is very little raw land available for development would have housing prices beyond the reach of the entire population (Japan tried it once, and their real estate market experienced a 64% decline over a 15 year period until affordability returned).¹³ Since prices cannot remain permanently elevated, it becomes ob-

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vious that the amount of land available for development does not create a permanent shortage of dwelling units.

Over the long term, rent, income and house prices must come into balance. If rents and house prices become very high relative to incomes, businesses find it difficult to expand because they cannot attract personnel to the area. In this circumstance, one of two things will happen: businesses will be forced to raise wages to attract new hires, or business will stagnate and rents and house prices will decline to match the prevailing wage levels.¹⁴ During the Great Housing Bubble, many businesses in the most inflated markets experienced this phenomenon. The effect is either a dramatic slowing of population growth or net out-migration of population to other areas.

Everyone Wants To Live Here

Everyone believes they live in a very desirable location; after all, they choose to live there. People who make this argument fail to understand that the place they live was just as desirable before the bubble when prices were much lower, in fact, probably more so. What is it about their area that made it two or more times as desirable during the bubble? Of course, nothing did, but that does not stop people from making the argument.¹⁵ There is a certain emotional appeal to believing the place you chose to call home is so desirable that people were willing to pay ridiculous prices to live there. The reality is prices went up because people desired to own an asset that was increasing in price. People motivated by increasing prices do not care where they live as long as prices there are going up.

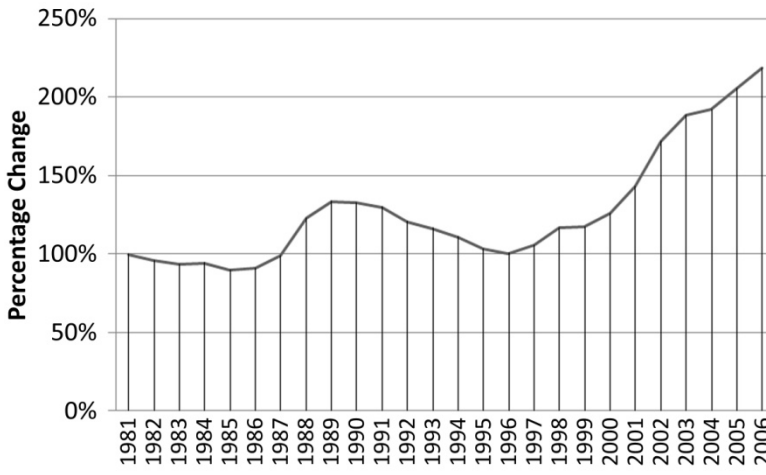
Prices Are Supported By Fundamentals

In every asset bubble people will claim the prices are supported by fundamentals even at the peak of the mania. Stock analysts were issuing buy recommendations on tech stocks in March of 2000 when valuations were so extreme that the semiconductor index fell 85% over the next 3 years, and many tech companies saw their stock drop to zero as they went out of business. Analysts even invented new valuation techniques to justify market prices. One of the most absurd was the “burn rate” valuation method applied to internet stocks.¹⁶ Rather than value a company based on its income, analysts were valuing the company based on how fast it was spending their investor’s money. When losing is winning, something is profoundly wrong with the arguments of fundamental support. The same nonsense becomes apparent in the housing market when one sees rental rates covering less than half the cost of ownership as was common during the peak of the bubble in severely inflated markets. Of course, since housing markets are dominated by amateurs, a robust price analysis is unnecessary.¹⁷ Even a ridiculous analysis, if aggressively promoted by the self-serving real estate community, provides enough emotional support to prompt the general public into buying. There is no real fundamental analysis done by the average homebuyer because so few understand the fundamental valuation of real property. Even simple concepts like comparative rental rates are ignored by bubble

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buyers, particularly when prices are rising dramatically and such valuation techniques look out-of-touch with the market.

Figure 1 - Ratio of House Price to Income in California, 1980-2006



Source: California Association of Realtors; US Census Bureau

When rental cashflow models fail, which they do during the rally of a housing bubble, the arguments justifying prices turn to an owner's ability to make payments. The argument is that everyone is rich, and everyone is making enough money to support current prices. It seems people began believing the contents of their "liar loan" applications during the bubble, or perhaps they counted on the home-equity-line-of-credit spending to come from the inevitable appreciation.¹⁸ Even when confronted with hard data showing the everyone-is-rich argument to be fallacious, people still claim it is true. One unique phenomenon of the Great Housing Bubble was the exotic financing which allowed owners the temporary luxury of financing very large sums of money with small payments. There was some truth to the argument that people could afford the payments. Unfortunately, this was completely dependent upon unstable financing terms, and when these terms were eliminated, so were any reasonable arguments about affordability and sustainable fundamental valuations.

It Is Different This Time

Each time the general public creates an asset bubble, they believe the rally in prices is justifiable by fundamentals.¹⁹ When proven methods of valuation demonstrate otherwise, people invent new ones with the caveat, "it is different this time." It never is. The stock market bubble had its own unique valuation methods as described previously. The Great Housing Bubble had proponents of the financial innovation model. Rather than viewing the unstable loan programs of the bubbles with suspicion, most bubble participants eagerly embraced the new financing methods as a long-overdue advance in the lending industry. Of course, it is easy to ignore potential problems when everyone involved is mak-

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ing large amounts of money and the government regulators are encouraging the activity. Alan Greenspan, FED chairman during the bubble, endorsed the use of adjustable rate mortgages in certain circumstances (Greenspan, Understanding Household Debt Obligations, 2004), and official public policy under the last several presidential administrations was the expansion of home ownership.²⁰ When everyone involved was saying things were different and when the activity was profitable to everyone involved, it is not surprising events got completely out of control.

The Importance of Financial Bubbles

Why should anyone care about financial bubbles? The first and most obvious reason is that the financial fallout is stressful. People buying into a financial mania too late, particularly in a residential housing market, will probably end up in foreclosure and most likely in a bankruptcy court. In contrast, stock market bubbles will only cause people to lose their initial investment. It may bruise their ego or delay their retirement, but these losses generally do not cause them to lose their homes or declare bankruptcy like a housing market bubble does. In a stock market collapse, a broker will close out positions and close an account before the account goes negative. There is a safety net in the system. In a residential housing market, there is no safety net. If house prices decline, a homeowner can easily have negative equity and no ability to exit the transaction. In a housing market decline, properties become very illiquid as there simply are not enough buyers to absorb the available inventory. A property owner can quickly fall so far into negative territory that it would take a lifetime to pay back the debt. In these circumstances bankruptcy is not just preferable; it is the only realistic course of action. It is better to have credit issues for a few years than to have insurmountable debt lingering for decades.

The real problems for individuals and families come after the bankruptcy and foreclosure. The debt addicted will suddenly find the tools they used to maintain their artificially inflated lifestyles are no longer available. The stress of adjusting to a sustainable, cash-basis lifestyle can lead to divorces, depression and a host of related personal and family problems. One can argue this is in their best interest long-term, but that will be little comfort to these people during the transition. The problems for the market linger as well. Those who lost homes during the decline are no longer potential buyers due to their credit problems. It will take time for this group to repair their credit and become buyers again. The reduction in the size of the buyer pool keeps demand in check and limits the rate of price recovery.

Summary

The Great Housing Bubble, like all asset bubbles, was driven by the belief in permanent, rapid house price appreciation, an unrealistic perception of the risk involved, and the fear that waiting to buy would cause market participants to miss their opportunity to own a house. These erroneous beliefs were

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supported by groupthink; if everyone else believes it, it must be true. As with any mass delusion, it is difficult to see beyond the comforting fallacies to understand the deeper truth; however, it is essential to do so because the cost in emotional and financial terms of getting caught up in the mania is very high. Foreclosure and bankruptcy are bad for individuals, bad for families, and bad for society.

Preventing the Next Housing Bubble

The pain of the deflation of a housing bubble cannot be avoided by trying to keep the bubble inflated, or by trying to deflate it slowly.²¹ The only way to avoid these problems is to prevent the bubble from inflating in the first place through some form of intervention in the mortgage market. Intervention can take the form of a market-based intervention demanded by investors and ratings agencies, and it can also come about through direct government regulation.²²

Necessary Intervention

The regulated free-market system in place at the turn of the millennium allowed the creation of the Great Housing Bubble. Some combination of market-based and regulatory reforms is necessary to prevent the same circumstances that created the bubble from creating another one; it is imperative to prevent the next bubble in order to avoid the problems from the bubble's deflation.²³ The kind of intervention proposed here is not a bailout plan. A substantive bailout plan to rescue homeowners would be fraught with problems and unintended consequences. In September of 2008, the banking system neared collapse due to the problems of the fallout, and a banking system bailout became necessary. This outcome argues more forcefully for an intervention to prevent future bubbles from occurring in the housing market.

Economic Problems

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

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

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

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

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

Financial bubbles also witnessed the birth, growth and death of unsustainable financial models. The NASDAQ bubble had internet companies, and the Great Housing Bubble had subprime lending. The subprime lending model was profitable despite a 10% to 15% default rate among its customers. The industry was able to sustain this rate of default because the default losses they sustained were small as long as prices were rising. As soon as prices stopped rising, their loan default rates increased, and their default losses drove the entire industry into oblivion.²⁴

In the aftermath of the coastal housing bubble of the early 90s, the economy experienced a period of diminished consumer spending because many homeowners who bought during the bubble and did not go into foreclosure were making payments that represent a high percentage of their income. The extra money going toward their mortgage payment, the money in excess of normal debt-to-income guidelines was money the borrower did not have available to spend on other things. The diminished discretionary spending income from this population of borrowers slowed economic growth in an economy heavily dependent upon consumer spending such as the United States.²⁵ Many borrowers during the Great Housing Bubble became accustomed to supplementing their income through mortgage equity withdrawal. When house prices fell, mortgage equity withdrawal was curtailed. This forced many to adjust their lifestyles to live within the money provided by their wage incomes after paying the large debt-service payments. This loss of spending power was not just difficult an economic problem, it was a deeply personal problem for those who wished to spend freely.

Personal Problems

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

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

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

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

Addressing the Cause

Before a doctor prescribes a treatment, the patient must first be evaluated and a disease must be diagnosed. Similarly, implementing a new policy in either the public sector or private sector to prevent future housing bubbles can only take place after the causes of the housing bubble are accurately identified. If the root causes are not identified correctly, policy initiatives may not have the desired effect. The Great Housing Bubble was a credit bubble, and some form of restriction of credit must be part of any policy initiative. A common criticism of past initiatives restricting credit availability to homeowners is that these initiatives tended to limit opportunities for home ownership without properly addressing problems with lending practices.²⁶ The goal of any policy initiative with regards to preventing future housing bubbles is to limit or constrain irrational exuberance without impacting the smooth operation of the financial market. It is no easy task.

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

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

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

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

What did not cause the bubble?

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

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

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

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

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

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

What did cause the bubble?

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

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

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

The 30-year fixed-rate conventionally-amortizing mortgage with a reasonable downpayment is the only loan program proven to provide stability in the housing market. Many of the “affordability” products used during the Great Housing Bubble and many of the deviations from traditional underwriting standards created the bubble. Mortgage debt-to-income ratios greater than 28% and total indebtedness greater than 36% have a proven history of default. Despite this fact, debt-to-income ratios greater than 50% were common in the most extreme bubble markets.²⁷ Limiting debt-to-income ratios is critical to stopping loan defaults and foreclosures. Lower FICO scores was the hallmark of subprime lending. FICO scores provide a fairly accurate profile of a borrower’s willingness and ability to pay their debts as planned. Low FICO scores are synonymous with high default rates. Limiting availability of credit to those with low FICO scores was a historic barrier to home ownership because these people default too much. The free market solved this problem. Subprime was dead. High combined-loan-to-value (CLTV) lending including 100% financing is also prone to high default rates. In fact, it is more important than FICO score. FICO scores are very good at predicting who will default when downpayments are large, but when borrowers have very little of their own money in the transactions, both prime and subprime borrowers defaulted at high rates. Many prime borrowers are more sophisticated financially, and the unscrupulous recognized 100% financing as a perfect tool for speculating in the real estate market and passing the risk off to a lender. The primary culprits that inflated the housing bubble were the negative amortization loan and interest-only loans where lenders qualified buyers on their ability to make only the initial payment. As the Great Housing Bubble began to deflate, Minnesota and some other states passed laws restricting the use of negative amortization loans and required lenders to qualify borrowers based on their ability to make a fully amortized payment. The Minnesota law is a good template for the rest of the nation.

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

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

Market Solutions

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

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

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

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losing huge sums, and nobody clearly understood why. There was a widespread belief these losses were caused by some outside factor rather than a systemic problem enabled by the lenders and investors themselves.²⁸ For investor confidence to return to this market, investors must first ascertain a more accurate evaluation of potential losses due to mortgage default. This requires an accurate appraisal of the fundamental value of the residential real estate serving as collateral for the mortgage loans that comprise the CDOs. Since the fundamental value of residential real estate, the value to which prices ultimately fall during a price decline, is determined by the potential for rental income from the property, revaluing properties using the income approach would provide a more accurate measure the value of the mortgage note and thereby the CDO.

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

The main objection with the rental approach is the difficulty of evaluating market rents, particularly in markets where there may not be many (or any) comparative properties for rent in the market. This is an old problem, one that has been studied in great detail by the Department of Labor Bureau of Labor Statistics.²⁹ Comparative rents have been collected by the DOL since the early 1980s as part of their calculation of the Consumer Price Index. The problem of irrational exuberance in the late 1970s in coastal markets, particularly California, caused the consumer price index to rise rapidly. Since the CPI is widely used as an index for cost-of-living adjustments, volatility in this measure caused by the resale housing market needed to be urgently addressed. After over a decade of study, the DOL decided to value the change in housing costs by a comparative rental approach rather than a change in sales price approach used previously. This smoothed the index and reduced volatility because the consumptive aspect of housing services were tethered to rents and incomes rather than being subject to the volatility caused by irrational exuberance in the housing market.

The Department of Labor Bureau of Labor Statistics measures the market rental rate in markets across the United States. It breaks down the market into subcategories based on the number of bedrooms, and it does a good job of estimating market rents in the various subcategories. These numbers are updated

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

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

Regulatory Solutions

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

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

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

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

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

Another pillar to the system is the documentation of income as part of the loan document package – the "*borrower's documented income*" from the proposed legislation. One of the most egregious practices of the Great Housing Bubble was the fabrication of income by borrowers that was facilitated and promoted by originating lenders. Stated-income loan programs were widespread, and they were the cause of much of the uncertainty in the secondary mortgage market during the initial stages of the credit crunch in the deflation of the bub-

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ble. Basically, investors had no idea if the borrowers to whom they had lent billions of dollars were capable of paying them back. Without proper documentation of income, investors lost all confidence in the secondary mortgage market. Stated-income loan programs were one of the first casualties of the credit crunch. These programs should be eliminated totally due to the inherent potential for fraud and the undermining of confidence in the secondary mortgage market stated-income loans create. If lenders can be sued based on the content of the loan documents, and if borrowers can be fined or go to jail for committing fraud or misrepresentation on loan documents, both parties have strong incentive to prepare these documents completely and correctly. Originating lenders will argue this adds to their costs and will result in higher application fees. The amount in question is very small, particularly relative to the dollar amount of the transaction. A small amount of additional expense here will provide huge benefits by assuring investors the borrowers to whom they are loaning money really have the income to pay them back. The benefit far outweighs the cost.

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

The poor quality of loan documentation during the bubble was a mistake of originating lenders; therefore, in this proposal much of the burden of paperwork and liability for mistakes falls on the lenders. During the deflation of the bubble, lenders paid an enormous price for some of their lax paperwork standards, but much of the problem was also due to borrowers misrepresenting themselves in the loan documents. There were instances where lenders encouraged this behavior, but in the majority of cases, the document fraud was perpetrated by the borrowers. The only recourse available to a lender is a civil suit as there are few criminal penalties associated with loan documentation and almost no enforcement. It can be very difficult and costly for lenders to pursue civil damages, and few lenders attempt it even when they have a strong case. To create a more balanced set of responsibilities, the borrowers must face criminal penalties for fraud and misrepresentation on loan documents. If borrowers know the lender can turn documents over to a prosecutor who will charge the borrower with a crime if they make false material statements, borrowers will be much less likely to commit these acts.

PREVENTING THE NEXT HOUSING BUBBLE

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

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

For the lending provisions to have real impact, they must apply to both purchases and to refinances, thus the clause, “*Loans for the purchase or refinance of residential real estate.*” If the rules only applied to purchases, there would be a tremendous volume in refinances to circumvent the regulations. The caps on debt-to-income ratios, mortgage terms and combined-loan-to-value only have meaning if they are universally applied. The combined-loan-to-value standard is based on the “*appraised value of the property at the time of sale or refinance.*” The new appraisal methods will have impact here. It is important that the records need only be accurate as of the time of the transaction. If a borrower

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experiences a decline in their income or if the property declines in value to where they no longer meet the loan standard, it does not mean they can go petition for debt relief.

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

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

Since one of the goals of regulatory reform is to inhibit the behavior of irrational exuberance, the sales tactics of the National Association of Realtors should be examined and potentially come under the same restrictions as securities brokers through the Securities and Exchange Commission. After the stock market crash which helped precipitate the Great Depression, Congress created the Securities and Exchange Commission to regulate the sales activities of securities brokers. There are strict regulations in place governing the representations made concerning the future performance of investment opportunities. These protections were put in place to protect the general public from the false promises made by stockbrokers in the 1920s which many naïve investors believed. The same analogy holds true for Realtors. The National Association of Realtors has launched numerous advertising campaigns suggesting erroneously that residential real estate is a great investment and appreciation will make home buyers wealthy.³⁰ The mantra of all realtors is that house prices always go up. There are currently no limits to the distortions and outright lies realtors can tell prospective buyers with regards to the investment potential of residential real estate. Buyers are already prone to believe the fallacies of unlimited riches in real estate, and these fallacious beliefs lead to housing bubbles. Realtors should be prevented from making representations concerning the investment potential of real estate. Since the regulatory framework for this kind of regulation and oversight is already in place under the auspices of the Securities and Exchange Commission, Congress would merely need to make Realtors subject to these regulations in order to solve the problem.

The result of these restrictions will be that all homeowners will have at least 10% equity in their properties unless they have borrowed from a government program like the FHA where the combined-loan-to-value can exceed the limits. This equity cushion would buffer lenders from predatory borrowing and a huge

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increase in foreclosures if prices were to decline. Home equity in the United States has been declining since the mid 1980s, and it actually declined while prices rose during the Great Housing Bubble due to the rampant equity extraction. The lack of an equity cushion exacerbated the foreclosure problem as many homeowners who owed more on their mortgage than the house was worth simply stopped making payments and allowed the house to fall into foreclosure.

Summary

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

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

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End Notes

¹ "Out, out, brief candle! Life's but a walking shadow, a poor player that struts and frets his hour upon the stage and then is heard no more: it is a tale told by an idiot, full of sound and fury, signifying nothing." Macbeth Quote (Act V, Scene V).(Shakespeare, 1603)

² Partial list of prominent real estate bubble and related blogs:

The Irvine Housing Blog – <http://www.irvinehousingblog.com/>
Patrick.net – <http://patrick.net/housing/crash.html>
The Real Estate Bubble Blog – <http://www.thehousingbubbleblog.com/index.html>
The House Bubble – <http://housebubble.com/>
Implode-o-meter – <http://ml-implode.com/>
Bubble Markets Inventory Tracking – <http://bubbletracking.blogspot.com/>
Housing Doom – <http://housingdoom.com/>
Southern California Real Estate Bubble Crash – <http://www.socalbubble.com/>
Calculated Risk – <http://calculatedrisk.blogspot.com/>
Housing Panic – <http://housingpanic.blogspot.com/>
Professor Piggington – <http://piggington.com/>
Dr. Housing Bubble – <http://drhousingbubble.blogspot.com/>
Bubble Meter – <http://bubblemeter.blogspot.com/>
Priced Out Forever – <http://pricedoutforever.com/>
The Bursting Bubble – <http://www.theburstingbubble.com/>
The Real Estate Bloggers – <http://www.therealestatebloggers.com/>
Housing Bubble Casualty – <http://www.housingbubblecasualty.com/>
Housing Bubble Bust – <http://www.housingbubblebust.com/>
Real Estate Realist – <http://www.realestaterealist.com/>
Housing Wire – <http://www.housingwire.com/>
Sacramento Area Flippers In Trouble – <http://flippersintrouble.blogspot.com/>
Seattle Bubble – <http://seattlebubble.com/blog/>
Westside Bubble Blog – <http://westside-bubble.blogspot.com/>
Marin Real Estate Bubble – <http://marinrealestatebubble.blogspot.com/>
Sonoma Housing Bubble – <http://sonomahousingbubble.blogspot.com/>
New Jersey Real Estate Report – <http://njrereport.com/>
New York City Housing Bubble – <http://nychousingbubble.blogspot.com/>

THE GREAT HOUSING BUBBLE

- ³ Much of the author's personal study of Buddhism comes from the writings and recordings of the author Jack Kornfield (Kornfield, *The Roots of Buddhist Psychology*, 1996), (Kornfield, *The Inner Art of Meditation*, 1993), (Kornfield, *A Path with Heart: A Guide Through the Perils and Promises of Spiritual Life*, 1993), (Kornfield, *After the Ecstasy, the Laundry: How the Heart Grows Wise on the Spiritual Path*, 2000). The audio recordings of the *Roots of Buddhist Psychology* have been particularly influential.
- ⁴ The stock market experienced a 500% gain in a five year period before its infamous crash. Much of the reason for the wild increase in pricing was very low margin requirements. People were allowed to buy 10 times as much stock as they had money due to 10:1 margin trading. This expansion of credit through the broker's margin is what drove prices up, and when prices started to fall, margin calls cascaded through the market and resulted in a crash.
- ⁵ Robert Shiller in his book *Irrational Exuberance* (Shiller, *Irrational Exuberance*, 2005) discusses precipitating factors at length from pages 31 -54. Most of the factors he mentions are macro-factors or more specifically related to the stock market.
- ⁶ According to data from the US Census Bureau and The US Department of Labor, wage growth since 1976 has averaged 4.62% and inflation has averaged 4.42%.
- ⁷ From 2002-2006 in Irvine, California, the median house price increased by an amount *each year* equal to the median income.
- ⁸ Karl Case and Robert Shiller noted that a buyer's willingness to pay high prices depended in part on their perception of risk of price decline (Case & Shiller, *The Behavior of Home Buyers in Boom and Post-Boom Markets*, 1988). Very few buyers in the markets they surveyed during the coastal boom of the late 1980s though prices could go down.
- ⁹ Psychologists have noted narrative-based thinking is extremely important in human decision making (Shiller, *Historic Turning Points in Real Estate*, 2007). When realtors or anyone working in sales creates a compelling narrative, it is very effective in motivating buyers.
- ¹⁰ The author could not find the source for the widely cited quote from Irving Fisher where he said, "Stock prices have reached what looks like a permanently high plateau." It is held as the standard for incorrect market prognostications.
- ¹¹ Robert Shiller has noted there is a tendency among investors to overestimate how unique an investment they favor is. These investors fail to take into account the supply response to higher prices (Shiller, *Understanding Recent Trends in House Prices and Home Ownership*, 2007). Supply shortages are never permanent. The ends of booms are almost always associated with an unexpected glut of supply. Also, the idea of there being "not enough land" was cited in surveys going back to 1988 (Case & Shiller, *The Behavior of Home Buyers in Boom and Post-Boom Markets*, 1988).

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- ¹² William Jaeger studied the issue of land use control limiting local housing supply in his paper *The Effects of Land-Use Regulations on Property Values* (Jaeger, 2006). His conclusions are as follows: "Land-use regulations can affect property values in a variety of complex ways. In the context of laws like Oregon's Measure 37, requiring that landowners be compensated if regulations reduce property values, the economic effects of land use regulations on property values have been widely misinterpreted because two very different economic concepts are being confused and used interchangeably. The first concept is "the effect of a land use regulation on property values" which measures the change in value when a regulation is added to many parcels. The second concept is "the effect of an individual exemption, or variance, to an existing land use regulation," which measures the change in value when a regulation is removed from only one parcel. The effect of a land-use regulation on property values can be positive or negative, whereas removing a land-use regulation from one property can be expected to have a positive effect. Indeed, many land-use regulations actually increase property values by creating positive "amenity effects" and "scarcity effects." "As a result of these differences, a positive estimate for removing a land-use regulation cannot be interpreted as proof that the other concept was negative. Despite this, a positive value for an individual exemption to a land-use regulation continues to be interpreted as proof that compensation is due under Oregon's Measure 37. Indeed, this mistaken interpretation may be partly responsible for public sentiment that land-use regulations tend to reduce property values."
- ¹³ In the paper, *Asset Price Bubble in Japan in the 1980s: Lessons for Financial and Macroeconomic Stability* (Shiratsuka, 2003), the author reached the following conclusion, "Japan's experience of asset price bubble is characterized by euphoria, that is, excessively optimistic expectations with respect to future economic fundamentals, which lasted for several years and then burst. Under such circumstances, policymakers are unlikely to take an appropriate policy response without evaluating whether asset price hikes are euphoric or not, and forecast a correct path for the potential growth rate. In so doing, it is deemed important to assess the sustainability of financial and macroeconomic stability." The paper is more history than analysis, but it provides a good background understanding of the Japanese housing and stock market bubble.
- ¹⁴ Karl Case and Robert Shiller mentioned a report in the *Harvard Business Review* that spoke of businesses in boom regions were unable to attract labor due to the high cost of housing. (Case & Shiller, *The Behavior of Home Buyers in Boom and Post-Boom Markets*, 1988)
- ¹⁵ Karl Case and Robert Shiller noted (Case & Shiller, *Is There a Bubble in the Housing Market*, 2004) overwhelming agreement with the statement "Housing prices have boomed in [city] because lots of people want to live here." Another recurring idea in the "everyone wants to live here" meme is the "rich Asians are buying." This fallacy is promoted in every real estate bubble. (Case & Shiller, *The Behavior of Home Buyers in Boom and Post-Boom Markets*, 1988)

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- ¹⁶ Michael Wolff wrote the book *Burn Rate: How I Survived the Gold Rush Years on the Internet* (Wolff, 1998) describing the strange investor behavior of the internet startup era.
- ¹⁷ Robert Shiller's surveys have demonstrated most home purchasers have little real knowledge or agreement about the underlying causes of price rallies. Most would cite clichés, images or popular fallacies rather than hard evidence or analysis of data with correspondence to prices. (Case & Shiller, *The Behavior of Home Buyers in Boom and Post-Boom Markets*, 1988)
- ¹⁸ Stated-Income Loans also known as "liar loans" were widespread during the bubble. People frequently fabricated their income.
- ¹⁹ One of the more interesting phenomenon observed in the scholarly literature during a financial bubble is the number of analysts who look at the data and are unable to form an objective opinion about what the data shows them. In the paper *Bubbles, Human Judgment, and Expert Opinion* (Shiller, *Bubbles, Human Judgment, and Expert Opinion*, 2001), Robert Shiller examines this phenomenon. In his introduction he noted, "There are many who have been arguing in effect that the market (or major components of it) has been undergoing a bubble. It would seem that it is essential to their notion of a bubble that investors' actions are, in one way or another, foolish. Others sharply disagree with these bubble stories, and it is precisely this intimation of foolishness that seems to bother them. It seems to them just implausible that investors at large have been foolish." The tone of many of the journal articles seems rather defensive and dismissive of the idea of a bubble even when the evidence is clear. One can surmise this tone is the result of the "foolishness" Dr. Shiller describes. In his conclusion he writes, "human patterns of less-than-perfectly rational behavior are central to financial market behavior, even among investment professionals, while at the same time there is little outright foolishness among investors. It is hard for writers in the news media, who describe financial markets, to convey the nature of any essential irrationality, since they cannot all review the relevant social science literature in their news article. They are left with punchy references to pop psychology that may serve to discredit them in many eyes. That is part of the reason why we have been left with a sense of strong public disagreement about the nature of speculative bubbles." It is amazing to this author how so many academics along with the general public can completely miss financial bubbles and deny their existence past the point where it is obvious to everyone. Ben Stein was the poster child for this behavior during the Great Housing Bubble. One of the scholarly references showing this dismissal of the obvious is *The great turn-of-the-century housing boom* (Fisher & Quayyum, 2005) by Jonas D. M. Fisher and Saad Quayyum. In it they reach the following completely erroneous conclusion right at the peak of the bubble, "To the extent that the quantities can be understood by considering the underlying economic fundamentals, such as productivity growth and the evolution of the mortgage market, then the recent growth in house prices is probably not due to excessive speculation in the housing market, such as occurs in a bubble. We argue that our findings point toward

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the high prices being driven by fundamentals.” Even at the very peak of the insanity, there are well-educated market observers that miss the signs or believe the fallacies which serve to inflate the bubble.

²⁰ Alan Greenspan made the following statements at the Credit Union National Association 2004 Governmental Affairs Conference, “Indeed, recent research within the Federal Reserve suggests that many homeowners might have saved tens of thousands of dollars had they held adjustable-rate mortgages rather than fixed-rate mortgages during the past decade, though this would not have been the case, of course, had interest rates trended sharply upward. American homeowners clearly like the certainty of fixed mortgage payments. This preference is in striking contrast to the situation in some other countries, where adjustable-rate mortgages are far more common and where efforts to introduce American-type fixed-rate mortgages generally have not been successful. Fixed-rate mortgages seem unduly expensive to households in other countries. One possible reason is that these mortgages effectively charge homeowners high fees for protection against rising interest rates and for the right to refinance. American consumers might benefit if lenders provided greater mortgage product alternatives to the traditional fixed-rate mortgage. To the degree that households are driven by fears of payment shocks but are willing to manage their own interest rate risks, the traditional fixed-rate mortgage may be an expensive method of financing a home.” It is a good thing Alan Greenspan was our central banker and not a financial adviser. Many people who “benefited” from the mortgage product alternatives lost their homes in foreclosure. There is a reason homeowners like fixed-rate mortgages. How exactly are borrowers supposed to “manage their own interest rate risks” without using fixed-rate mortgages? Perhaps if Alan Greenspan had thought that statement through, his advice might have been different. Daniel Gross wrote about the folly of this speech in his weekly column on the internet magazine Slate (Gross, Alan Greenspan: ARMed and Dangerous, 2004). Mr. Gross noted the following, “Greenspan also conspicuously ignored the non-monetary benefits associated with fixed-rate mortgages. Homebuyers pay a premium for the ability to lock in a fixed interest rate – and hence have utter certainty on the size of their payment for up to three decades. But in return, they receive peace of mind, security, and the ability to plan.”

²¹ Japan endured 15 years of slow deflation from the combined stock market and real estate bubbles of the late 1980s. The 1990s are known in Japan as “the lost decade” due to the problems from the slow deflation of their asset bubble.

²² In July of 2008, the Fed made changes to Reg Z which would have been helpful in reducing the size of the housing bubble, the amount of fraud during the bubble, and the resulting pain of the bust. Unfortunately, they were at least five years too late. The changes to Reg Z were: The rule, for “higher-priced loans: 1. Prohibits a lender from making a loan without regard to borrowers’ ability to repay the loan from income and assets other than the home’s value. A lender complies, in part, by assessing repayment ability based on the highest scheduled payment in the first seven years of the loan. To show that a lender violated this

THE GREAT HOUSING BUBBLE

prohibition, a borrower does not need to demonstrate that it is part of a "pattern or practice. 2. Prohibits a lender from relying on income or assets that it does not verify to determine repayment ability. 3. Bans any prepayment penalty if the payment can change during the initial four years. For other higher-priced loans, a prepayment penalty period cannot last for more than two years. 4. Requires that the lender establish an escrow account for the payment of property taxes and homeowners' insurance for first-lien loans. The lender may offer the borrower the opportunity to cancel the escrow account after one year. The rule, for all closed-end mortgages secured by a consumer's principal dwelling: 1. Prohibits certain servicing practices: failing to credit a payment to a consumer's account as of the date the payment is received, failing to provide a payoff statement within a reasonable period of time, and "pyramiding" late fees. 2. Prohibits a creditor or broker from coercing or encouraging an appraiser to misrepresent the value of a home. 3. Creditors must provide a good faith estimate of the loan costs, including a schedule of payments, within three days after a consumer applies for any mortgage loan secured by a consumer's principal dwelling, such as a home improvement loan or a loan to refinance an existing loan. The rule, for all mortgages: Requires advertising to contain additional information about rates, monthly payments, and other loan features. The rule also bans seven deceptive or misleading advertising practices, including representing that a rate or payment is "fixed" when it can change. "

²³ In their paper *Predicting Bubbles and Bubble Substitutes* (Thompson, Treussard, & Hickson, 2004), the authors contend that certain kinds of bubble intentionally created by government authorities can have positive long-term effects.

²⁴ The subprime mortgage industry may mount a comeback in the aftermath of the Great Housing Bubble. The original business plan was to take borrowers who had good incomes and savings to put toward a downpayment, but they had low FICO scores which prevented them from getting a Prime loan. These borrowers used subprime as bridge financing until their FICO scores improved and they could refinance into Prime loans. The subprime business plan relied on capacity (income) and collateral (downpayment) to make up for the lack of good credit. Those who go through foreclosure in the bubble will end up with bad credit, but they may have good income and savings. They will be an underserved borrower class that will likely prompt resurgence in subprime lending. The problem with subprime was not that the borrowers had poor credit scores; it was that lenders ignored capacity and collateral on the loans. This is why Alt-A and Prime loans also performed poorly when prices deflated. Subprime will likely resurface, whereas Alt-A is permanently defunct.

²⁵ Much of California's lingering economic troubles of the early 90s can be linked to diminished consumer spending due to excessive mortgage obligations. Many people inaccurately point to job losses in the aerospace industry as the cause of California's economic weakness, but this sector was small, and the contraction only lasted a couple of years, whereas the economic slump persisted almost 6 years.

END NOTES

- ²⁶ This is the primary argument against any kind of legislative reform (Wallace, Elliehausen, & Staten, 2005).
- ²⁷ When credit first began to tighten in 2007, the government sponsored entities who insure mortgage loans for sale in the secondary market issued a series of guidelines on the loans they would insure. In the first version, debt-to-income ratios were limited to 50%. In a subsequent revision in late 2007, the debt-to-income ratio was limited to 45%. The tightening of credit was slow enough to keep some transactions occurring in the market, but fast enough to stop underwriters from originating bad loans. As of the time of this writing it is anticipated that the ratio will continue to fall.
- ²⁸ In his groundbreaking work *The Black Swan: The Impact of the Highly Improbable* (Taleb, 2007), the author describes how unpredictable and dramatic events shape our history.
- ²⁹ There is a great synopsis of the history and calculation of the rental components of the consumer price index contained in the report *Treatment of Owner-Occupied Housing in the CPI* (Poole, Ptacek, & Verbrugge, 2005).
- ³⁰ In 2008 the National Association of Realtors launched a commercial advertising campaign claiming that residential real estate doubles in value every 10 years. Besides the obvious inaccuracy of the claim, it is the kind of claim no stock-broker would be allowed to make.

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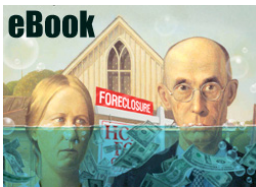
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Do you understand complicated loan programs?

Many people think they have a grasp of how these exotic new loan programs work. Most people do not, and nobody should really be using them. (Conservative House Financing, p. 8)

How do you negotiate during a price decline?

Most buyers fail to take advantage of the powerful negotiating position they have during a price decline. There are specific techniques one can use to pay the lowest possible price. (Buying and Selling During a Decline, p. 163)

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Are you buying a house as an investment?

Many people view residential real estate as a good investment, particularly during the real estate bubble. Historically, it has not been. The Great Housing Bubble tells the truth about residential real estate—the truth your realtor does not want you to know.

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Making money in real estate is about building equity. Most people believe you simply buy and equity appears by magic. It does not work that way. What exactly is equity? And how do you build it? (Equity Components, p. 19)

Why do most speculators lose money?

Most people who speculate in financial markets lose money. Why is that? (Speculation versus Investment, p. 99)

Are houses really a good investment?

Residential real estate has historically underperformed most other asset classes. The period of the Great Housing Bubble was a notable exception to the rule. (Renting versus Owning, p. 46)

What is the investment value of real estate?

There is an investment value to real estate. How is it calculated? What is it really worth? (Investment Value, p. 37)

What readers are saying:

“The detailed investigative work and deep market analysis is very insightful and thought provoking.”

Ben in Seattle

“I feel I have been given a first-rate education in real estate analysis and valuation from this book. I have continued to rent instead of purchase real estate in Irvine due, in large part, to data presented in this book.”

Jaysen in Irvine

What are you risking if you do not buy this book?

This book can save you from financial ruin and all the personal hardships that entails. **Many people lost their wealth, their homes, their credit and their good health during The Great Housing Bubble because they did not have the information presented in this book.** *You do not want to be one of them.* It is that important.

Extreme financial hardship

Residential real estate is generally an extremely leveraged financial asset. A 20% decline in house prices can completely wipe out your downpayment or any

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accumulated equity in a property. Buying at the wrong time and paying too much can have devastating financial consequences for you.

Foreclosure/ short sale

Many people who overborrow and overpay end up losing the property in a foreclosure or short-sale. Being forced to move out of your home is never a pleasant experience.

Bankruptcy / bad credit

With the foreclosure or short-sale often comes a personal bankruptcy. If you manage to avoid bankruptcy, your credit will still be damaged for years.

Stress and health problems

Seeing hundreds of thousands of dollars of your net worth evaporate, losing your home, and being forced into bankruptcy is a very stressful set of circumstances. Many people who go through this experience have major health problems.

Can you afford to risk this?

Do you want to risk these problems? Are you willing to face these dangers without knowing what you can do to protect yourself? Your hard earned money, your credit, and your health are far too valuable to put at risk.

You need to buy this book to prepare you for the dangers out there.

What readers are saying:

“I thought I knew real estate before I read this book. I was wrong. This book opened my eyes to the truth about the real estate cycle. I was thinking of buying and investment property because prices had dropped. It wasn't until I read this book that I realized I was speculating and not investing. I almost made a very big mistake.”

Janet in Irvine

“This helped me avoid buying at the peak and losing hundreds of thousands of dollars. It saved me a great deal of grief and money. Even now, with California housing prices down over 30%, declining prices could still quickly consume your downpayment and put you ‘under water’, unable to sell your house for more than the loan value.

An excellent read, and an important one.”

Brian in Malibu

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THE GREAT HOUSING BUBBLE

Do you own your house? How did the housing bubble impact you?

Almost 70% of American households own their houses. Even those who do not plan to buy or sell are impacted by the housing bubble. Everyone who owns a house saw a dramatic change in their net worth as house prices rose then fell. Some people refinanced and increased their mortgage balances to obtain the “free money” accumulating in their homes. Some people stopped saving for retirement and other purposes and became completely dependent upon their houses for their financial future. Every owner of real estate was impacted by the bubble.

How much value is your house going to lose?

The most pressing concern of most homeowners is how much is the resale price of their property going to decline before prices stabilize. (Future House Prices, p. 130)

Why did your house lose value?

Many people are very interested in why house prices went down at all. (The Housing Bubble, p. 71)

What readers are saying:

“I loved reading this book and learning about the financial impact of this whole mess that we’re in right now.”

Joe in Austin

“I had no idea my neighbors and the lenders were so crazy. The bubble wasn’t too mad there, so I really didn’t understand what all the fuss was about until I read this book. Wow! I can’t believe what was going on.”

Gale in Nashville

Do you understand the terms of your mortgage?

Many people who took out mortgages during the bubble did not use conventional, 30-year fixed-rate financing. Many of these borrowers utilized new, innovative loan programs that very few understand. (Conservative House Financing, p. 8)

Why did the economy suffer so much?

The deflation of the housing bubble brought down the entire economy and nearly caused the collapse of our entire financial system. (Doomsday Scenario, p. 159; Lingering Problems, p. 161)

Buy this book now!

THE GREAT HOUSING BUBBLE

What every seller needs to know about the housing bubble?

The tactics sellers must use to sell a home have changed radically since the market topped and prices began to fall. Those nimble sellers who are able to make the proper adjustments will sell their houses. Those that do not adapt will fail to sell their homes and lose much more money.

What readers are saying:

“I was not able to sell my house, and I was getting very frustrated. When I read this book, I realized what I really needed to do. The truth helped me overcome my denial, and I sold my house in three weeks – once I did what was necessary.”

Kurt in San Clemente

“My house was on the market for months with no offers. I paid for professional staging, and I even bought one of those crazy St. Joseph statues and buried it in the yard. Nothing. Once I read this book, I realized why the house was not selling. I didn’t want to follow the author’s advice, but it was the only way to sell my home.”

Josue in Sacramento

What do you have to do to sell your house?

What is the number 1 thing a seller must do to sell their property in a declining market? (Buying and Selling During a Decline, p. 163)

What if you owe more than your house is worth?

Many people have loans balances greater than the resale value of their property. What are their options? (Selling for Less, p. 164)

Is the government really trying to save the housing market?

Government policy during the housing bubble was not intended to save the housing market; it was intended to save the banks. Home owners are kept in a state of denial and indentured servitude to their lending overlords. (Bailouts and False Hopes, p. 122)

What are some of the things will you learn in this book?

The Great Housing Bubble is an exhaustive analysis of the issues related to this dark chapter in American history. Even though the decline is nowhere near over in 2008, already the Great Housing Bubble witnessed the largest decline in house prices since the Great Depression. Below is a sample of the types of questions this book answers.

Buy this book now!

THE GREAT HOUSING BUBBLE

Why did house prices go up so much so fast?

With lenders quickly increasing the amounts they were willing to lend, borrowers were able to increase their bids and drive prices skyward. (The Credit Bubble, p. 54)

Why did people borrow so much money?

People borrowed so much because they could, and since prices were going up so fast, most wanted to. Lenders made huge sums available to almost anyone with a pulse on payment schedules they could afford—temporarily. (Negative Amortization Mortgages, p. 13; Stated Income Loans, p. 16)

How crazy were the lenders?

Everyone thought house prices would go up forever, so few thought there was any risk of loss. (What is a Bubble, p. 1; The Fallacy of Financial Innovation, p. 26)

Why did we have a credit crunch?

People stopped paying back their loans, so lenders stopped lending money. (The Credit Crunch, p. 93)

What readers are saying:

“Lawrence Roberts has his finger on the pulse of the housing bubble – the bursting forehead vein, I should say!”

LC in Irvine

“Lawrence Roberts is one of the best that I have seen at breaking down the complicated and confusing mortgage and real estate industry so that novices like me can understand.”

Alan in Toledo

Why did we have so many foreclosures?

People stopped making payments because they borrowed too much money and they could not afford to pay it back. (Types of Loans, p. 11; The Bubble Bursts, p. 87)

How does the secondary mortgage market work?

The activity in the secondary mortgage market provided the air that inflated the housing bubble. (Structured Finance, p. 57)

Why is real estate cyclical, and what are the stages of the cycle?

Real estate prices rise and fall due to market psychology and credit availability. (Visualizing the Bubble, p.67; Psychological Stages of a Bubble, p. 111)

Buy this book now!

THE GREAT HOUSING BUBBLE

Are most home buyers speculators?

Many homebuyers in volatile real estate markets are motivated by profit. This motivation causes a great deal of property speculation. (Trading Houses, p. 104)

How did the bubble change people's lives?

The housing bubble made and lost fortunes for its many participants. Those that lost faced both economic and personal problems. (Economic Problems, p. 173; Personal Problems, p. 175)

How do we stop future housing bubbles?

It is possible to prevent future housing bubbles. It requires a combination of market reform and government intervention. (Preventing the Next Housing Bubble, p. 173)

What experts are saying:

“Lawrence Roberts was completely right.”

“Lawrence Roberts is THE real estate guru... one of the few who knew it was coming.”

“He’s the guy that predicted the crash and year and a half before it happened.”

Johnny Wendell – KTLK 1150 AM

Buy this book now!