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Anatomy of the Housing Market Boom and Correction

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Anatomy of the Housing Market Boom and Correction

The housing market in the past five years has been in an unsustainable boom caused by the lowest interest rates and easiest credit conditions in 50 years. While initially it produced desirable results by enabling many more households to afford homeownership, it morphed in the past three years into a speculative bubble in many locations. The for-sale housing market, including both the single family and the condominium market, is especially vulnerable to speculative activity because of low or no down payment loans which allows investors to leverage up substantially. Unlike stock margin requirements, which limit leverage to 50%, there is no such limit on housing. In fact, investors or homebuyers can put up very little down payment and control delivery of the house or condominium for up to two years in the future. This creates a huge incentive to speculate as the liability of the investor/buyer is limited to the initial deposit. The homebuilder claims and books a sale and his sold-out project is financed by a financial institution which has really created a very risky loan. At present the market is seeing “cancellation” of sales from the previous years and the inventory of completed or partially completed homes and condominiums for sale is skyrocketing.

We estimate that 20% to 70% of all sales in some markets were driven by speculative activity that is now coming home to roost. The mistaken belief by policy makers, homebuilders, mortgage lenders, stock analysts, and academics that the housing boom was driven by virtuous demographic demand is now being exposed for its true nature—a speculative boom based on easy and cheap credit. An institutional structure that allowed speculators to have a cheap option contributed to this bubble. It is critical that all players understand the true dynamics of the past five years and the present condition so that appropriate policy and business responses will be taken. Macro policy makers should not loosen monetary policy and lower interest rates to protect the housing speculators. Business players should not count on a quick recovery of this speculative demand. We need to permanently change the housing finance system by changing regulatory and business practices to prevent excessive credit creation in this sector to fund speculative bubbles. Not only are the speculators hurt by the burst, but a large number of first-time homebuyers will also be casualties of the excessive house price appreciation. They paid and borrowed too much to catch the train which now will run them over.

For the past few years, policy makers and pundits have attributed the very strong level of for-sale housing activity to demographics and the intrinsic investment value of housing. Population growth, immigration, and the “fact” that housing prices only go up have been extolled in the media as explanations for the housing boom. Even in early 2007 Federal Reserve Chairman Bernanke and industry pundits talked about the orderly slowing of the housing market. It is our view that for-sale housing will show a sharp drop in sales and starts. We expect new single family housing starts to drop from an annual rate of 1.7 million in 2005 to 750,000 units in 2008 (see Figure 1). We expect existing home sales to drop from over 7.0 million in 2005 to 5.3 million in 2008 (see Figure 2). Housing prices, which have grown at double digit rates the last two years, will drop in 2007 and 2008. In certain hot markets house prices could decline 10% to 25%. This correction in the housing market will create a cascade of mortgage defaults and foreclosures in hot markets as the speculative excesses affect not only speculators but first-time homebuyers who stretched too far and got caught in the house price decline. The excesses of the housing market should be allowed to play out. The excessively easy monetary policies of the early part of this decade, combined with institutional inadequacies of the mortgage finance system, and the excessive greed of speculators, will cause a hard landing in many markets. The sharply lower level of sales, starts, and prices will move the market to a more sustainable level over the course of two to four years. The hype that led policy officials, pundits, and homebuilders to believe that the levels of activity of the last few years was the new sustainable level of activity will be proven wrong.

Single Family Housing Construction

The homebuilding industry has a long history of cyclical volatility. Figure 1 shows single family
housing starts for the past 35 years (1972 to 2007). The booms of the late 1970s, 1980s, 1990s and mid-2000s were always followed by a large drop in new construction averaging -35% from peak to trough. These boom-bust cycles in new housing construction have been well documented, and in fact this author’s first academic paper, “Cyclical Fluctuations in Residential Construction and the Housing Finance System,”¹ was on this very topic. These cycles in single family housing construction are highly correlated with the overall economic cycle. Each boom in housing construction is accompanied by a very strong economy, while each bust in single family home-buying is accompanied by a national recession. This is not an accidental correlation. Housing, counting its direct construction impacts and indirect contributions through related industries and the wealth effect on consumers, is a big part of the economy. Also, the same basic underlying forces of exceptionally easy monetary policy, followed by a strong economy and a burst of inflation, followed by a sharp tightening of monetary policy has been the main cause of this cyclical behavior. While the details of each cycle differ, the outcome is the same—a period of excess is followed by a period of sharp correction. Each time “pundits” during the boom talk about strong demographic demand or a changing industry structure, that ends with a view that “this time is different.” Each time a recovery starts, the industry vows to avoid speculative building and the buying of too much land that got them in trouble in the downturn. The lenders that survive the downturn vow to use tougher lending standards and to avoid “risky” loans. As the recovery proceeds and a boom develops, the builders, lenders and consumers believe that housing “only goes up” and the fundamentals are great and then they make the same mistakes as the last cycle. The 2007 to 2008 housing correction is just the latest, though it may be the worst, cyclical downturn in the industry.

**Single Family House Prices**

The boom in demand for and supply of housing often do not proceed in tandem. Because of the lags in land development, especially in markets on the East and West Coasts, house prices tend to rise sharply in times of booming demand. The supply inelasticity of new housing production is the main culprit. Figures 3 and 4 show the nominal and “real” median price increases for the overall U.S. market. The “real” price increase from 2002 to 2005 is unprecedented. Nominal prices showed a similar surge in the late 1970s, however, inflation rates were at 12% and so the 2002 to 2005 period with low economy-wide inflation appears highly unusual. As Figure 3 also shows, we expect to have a national house price decline of a cumulative 12% between 2006 and 2008. Many hot markets, such as Florida, Arizona, Las Vegas, and the Central Valley of California, will likely show cumulative declines of 15% to 25%. As Figure 5 shows, new home sale prices have already declined 18% on a national basis.

**Affordability of Housing**

One consequence of the rapid real house price increase is the dramatic erosion of affordability in “hot” housing markets. As Figure 6 shows, the percentage of median-income households able to afford a median-priced house has dropped to less than 15% in California.² The same trend has occurred in other markets with rapid house price inflation. Perhaps one-third of U.S. housing markets are affected by this affordability crisis.

**Risky and Flexible Mortgage Lending as Fuel to the Housing Market Bubble**

The major cause of these housing market excesses was easy and cheap credit, not demographics. The underwriting was so lax in residential real estate that “anyone who could fog a mirror” could get a 100% home loan. The proliferation of risky mortgage instruments that were offered to high credit risk borrowers was an accident sure to happen. The “option ARM,” a negative amortization loan, the proliferation of “stated-income” or “liar’s loans” (100% loan to

² Assumes a 20% down payment and a 30-year fixed-rate mortgage, with households spending 33% of their adjusted gross income for mortgage payments, insurance, and property taxes.
value loans), helped boost house demand to unsustainable levels. In 2006, 40% of all loan
originations were risky subprime or Alt-A loans (Option ARMs or low documentation loans). One-
half of all new homebuyers in 2006 put down no down payment when buying a house. The vast
majority of those loans were aggregated into mortgage-backed securities. These in turn were
resecuritized into CDOs (collateralized debt obligations). The alchemy of financial technology
turned highly risky loans into 90% AAA paper in the form of CDOs slicing and dicing of cash flow.
Normally staid investors such as insurance companies, banks, pension funds, and endowments,
flocked to the higher yielding “safe” paper. Hedge Funds rushed to buy the risky tranches of this
paper and added leverage, provided by prime brokers and banks, to instruments that were
already highly leveraged. All were assured by “rating agency” models and the false belief that
housing prices could not decline on a national basis. (They had not since the Great Depression).

This “ponzi scheme” of credit attracted a large number of speculators and house “flippers” to the
for sale housing market. While homeownership rates did rise to records levels (69.2% of
households in 2005), in hot markets such as Phoenix, Florida, Las Vegas, and the Central Valley
of California speculators were 20% to 30% of all purchases, taking advantage of easy credit
conditions. House prices doubled in four to five years in those markets, caused by both
demographic demand moving forward in time (that is, potential future buyers using easy credit to
buy without a down payment) and speculative activity.

We correctly warned that this toxic brew of easy credit, risky mortgage instruments, massive
speculation and a highly leveraged mortgage investor base, would lead to a big correction in the
housing and mortgage markets.

In the first half of 2007 we have seen the consequences of this reckless behavior: rising
delinquency rates and foreclosures, plunging housing starts and sales, and declining house
prices in a number of markets. In the past few months, we have seen some of the systematic
risks emerge: hedge fund losses and the rush to get out of the paper that is just beginning to go
bad. With the potential of $2 trillion of risky loans going bad, the financial panic that appeared in
the past week is not surprising. However, the injection of liquidity into the banking system and
the cut in the discount rate on August 17, 2007, as well as the Federal Funds rate cut in
September, may halt the panic but will not solve the problem of bad loans that need to be worked
out.

In the past month, the liquidity of the residential mortgage market has been dramatically reduced
as the market for privately backed mortgage securities has frozen up. Since 30% to 40% of all
residential mortgages have in recent years been securitized privately (outside of FNMA and
FHLMC) this withdrawal of capital has had a dramatic impact on the mortgage finance system,
investors in mortgage loans such as hedge funds, pension funds and banks, homeowners and
the homebuilding industry.

The fundamental problem facing the housing finance system is that $2 trillion of risky loans have
been made to risky borrowers in the last four years and those loans are beginning to go bad.
Figure 7 shows delinquency rates for the major categories of home loans. Figure 8 shows the
foreclosure rates of these categories of loans. It is the delinquency rates, and the fear of much
higher foreclosure rates in the future that has been the catalyst for the mortgage market liquidity
crises that has developed. The actual foreclosure rate is still small. It is the highly leveraged
mortgage securities market that has magnified this relatively small foreclosure rate into a crisis.
The vast majority of the risky mortgages made have been packaged into mortgage-backed
securities (RMBS) and have been repackaged into collateralized debt securities (CDOs). The
CDOs have typically taken the risky slice of RMBS, the BBB- piece, and put them in a CDO
structure. As the foreclosures and predicted foreclosures rise, there has been a meltdown in the
value of the CDO and RMBS securities held by mortgage companies, banks and other investors.
Hedge funds in particular have often highly levered their investments so are especially sensitive
to a decline in security values. Figure 9 shows the decline in the BBB- tranche has been over
56% since January 2007. Even the value of the AAA tranche has declined 9%. Figures 10 and
show that this contagion has spread to the jumbo residential mortgage market and the commercial real estate mortgage market, neither of which have any significant credit issues...at least at this time. Other sectors of the financial market have also seen smaller but serious signs of this contagion. As the value of these asset-based securities has declined, the leveraged investors have received margin calls and have tried to sell these often illiquid investments pushing the prices down further and creating a “vicious cycle” of illiquidity and price declines.

How big is the problem? Figures 12, 13 and 14, show that this is a huge problem. Forty percent of new mortgages securitized in 2006 were either subprime or Alt-A. Together they represent more than 20% of all mortgages outstanding. Many of these RMBS were then repackaged and put into CDOs. The explosion of CDOs is shown in Figure 15. It is conservatively estimated that 20% of the collateral in those CDOs is BBB- residential RMBS paper. The erosion of lending standards of the underlying collateral is shown in Figure 16. A shockingly high portion of these loans have little or no down payment, lack full income verification (liar loans) and are negative amortization or interest-only (see Figure 17). Nearly 40% of subprime loans, and 65% of Alt-A loans appear to have large payment resets coming in the next 18 months (see Figure 18). Anecdotal evidence suggests that many of the delinquencies and foreclosures seen in the past six months have been caused by payment shock rather than the usual suspects of job losses, medical and family issues. If the scheduled resets occur, the problems in the mortgage foreclosures in the next 18 months will be an order of magnitude greater than what we have seen already. Except for Ohio and Michigan the unemployment rate is low and incomes and jobs are growing. Traditionally, the mortgage delinquency and foreclosure problem is caused primarily by a job loss or family issues. If the economy were to go into a recession in 2008, the mortgage credit problem would be overwhelming and could create a deeper and longer downturn than we have seen in some time.

How to Mitigate the Present Housing and Mortgage Market Cycle

The key to controlling this crisis is preventing massive foreclosures that are likely to occur as payments are reset on subprime and Alt-A loans over the next two years. Resets should be phased in over time with annual payment increases capped at 7.5%. Additionally, tighter lending standards, which are appropriate going forward, should not be applied to the $2 trillion of risky loans in the system. We have to give the consumer a chance if they are willing and able to make their existing payments with perhaps a modest increase of 7.5% per year to stay in their home, or to refinance even if the loan to value is over 100% and their income is not fully verifiable. The essence of what we are proposing is a loan modification and forbearance plan that might forestall the foreclosure onslaught. Since most of these mortgages are held in RMBS and in CDO structures which usually restrict loan modifications, it will require some creative negotiating and path breaking legal solutions. A meeting of the top mortgage servicers, securities packagers and rating agencies, and perhaps community groups—moderated by Washington—could come up with a solution in short order.

The goal would be to minimize damage to the real economy of the bursting of the mortgage credit and housing bubble. It would not be a bail-out of investors, lenders, and other industry actors who facilitated unsound lending. However, they may indirectly benefit from the mitigation of credit losses and return of liquidity to the market.

We would not provide a bailout for the borrowers who participated in the bubble as speculators. We do not view loan modification by which borrowers may remain in their homes while paying a “fair” monthly payment as a subsidy or bailout.

We must restore liquidity to the mortgage and housing markets by allowing a transition period to tighter and more sound lending standards. Two trillion dollars of mortgage loans were created that would not meet the tighter underwriting standards that all would agree should be implemented. We have to have a way out for these borrowers or the collateral damage to the economy and the “innocents” (prime borrowers) will be substantial. We must allow FNMA and
FHLMC to play their historic role in the market by temporarily lifting the cap on their growth and allowing them to buy jumbo mortgages up to $617,000.

We need to realign the incentives in the securitized home finance system to reduce “moral hazard” in the process. Unlike a portfolio lender, the securitization process has a large number of players collecting fees, who have no stake in the safety and soundness of the loan. The mortgage originator (banker, broker, etc.) the investment banker packager, the CDO originator and manager, and the rating agencies all collect fees based on the volume of the activity. Often the riskier the loan product, the higher the commissions and fees received. Fees in the process should be escrowed and paid out when the loan has successfully seasoned (say three years) or is repaid.

We need to dramatically reduce the leverage in the home finance system. A borrower should have “skin in the game” and put a minimum 5% down payment except for special limited first-time home owner government or quasi-government related programs. The vast majority of loans, home equity loans and refinances should have a maximum of 90% loan-to-value ratio. Recognizing the volatility of the underlying assets, mortgage securities should have margin requirements - say at 50% - much lower than the 20 times leverage available until recently. Loans to investors/speculators in single family homes should have a maximum 70% loan-to-value ratio and those borrowers should not be allowed to abuse the mortgage financing system.

Finally, sensible lending standards should return on a going-forward basis. These include full income and employment verification, full physical appraisal of the property, and suitability of lending products so borrowers encumber no more than 40% of their income for mortgage payments on a fully-indexed and amortized basis. Also, borrowers’ payment increases should be limited to 7.5% on all ARM’s. Option ARMs (negative amortizations ARMs) should be limited to high income, prime borrowers, who put a minimum of a 20% down payment.

Large losses in the system are inevitable but an active loan modification and forbearance program can prevent a substantial problem from mushrooming into a much more severe economy-wide recession.
Figure 1: U.S. Single Family Housing Starts

Note: Seasonally adjusted annual rate
Source: US Census Bureau, RCG
Figure 2: U.S. Existing Single Family Home Sales

Units (millions)

Note: Seasonally adjusted annual rate
Source: National Association of Realtors
Figure 3: Existing Nominal Median Home Price Appreciation - United States

*4Q06 vs. 4Q05
Source: National Association of Realtors, RCG
Figure 4: Existing Real Median Home Price Appreciation - United States

*Change in annual median home price appreciation minus the annual change in CPI
Figure 5: Public Builder Change in New Order Price, 2001-2Q2007

Source: Company data, Credit Suisse, RCG
Figure 6: Housing Affordability
United States and California

% Able to Afford Median-Priced Home

United States
California

*As of June, 2007
Source: National Association of Realtors, California Association of Realtors
Figure 7: Loans Delinquent Over 60 Days

*As of 2Q07
Source: Mortgage Bankers Association, UBS, SF Chronicle
Figure 8: Foreclosures In Process by Loan Type

Note: As percent of total mortgages in individual pool
Source: Mortgage Bankers Association
Figure 9: ABX Month-end Price Summary

*As of August 31, 2007
Source: Markit, UBS
Figure 10: Pricing Spreads: Jumbos vs. FNMA

Source: Bankrate.com
Figure 11: Pricing Spreads
Commercial Mortgage Rate vs. 10-Year T-Bond

*Basis Points

*As of July 25, 2007
Source: Morgan Stanley, RCG
Figure 12: Subprime Loans
As Share of Total Outstanding Loans

*As of 2Q07
Source: Mortgage Bankers Association of America
Figure 13: Subprime Share of Securitized Purchase Mortgage Originations, 2001-2007

Source: Loan Performance, Credit Suisse U.S. Mortgage Strategy, RCG
Figure 14: Alt-A Share of Securitized Purchase Mortgage Originations, 2001-2007

Source: Loan Performance, Credit Suisse U.S. Mortgage Strategy, RCG
Figure 15: Global CDO Issuance

*As of 2Q07
Source: SIFMA
Figure 16: Erosion of Lending Standards

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<th>Traditional</th>
<th>Subprime</th>
<th>Alt-A</th>
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<tr>
<td>Down Payment</td>
<td>20%</td>
<td>6%</td>
<td>12%</td>
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<td>Zero Down Payment</td>
<td>0%</td>
<td>30%</td>
<td>18%</td>
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<tr>
<td>Full Income Verification and Documentation</td>
<td>64%</td>
<td>50%</td>
<td>19%</td>
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<tr>
<td>Fully Amortized</td>
<td>100%</td>
<td>63%</td>
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Source: RCG, Credit Suisse
Figure 17: Interest Only and Negative Amortization Share of Total Purchase Mortgage Originations by Loan Type, 2003-

Source: Loan Performance Credit Suisse RCG
Figure 18: Subprime Mortgage Payment Reset

Source: Deutsche Bank, LoanPerformance