
Subprime Crisis and Housing Market Crash: Learning from the Past

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Overview

- A severe national housing downturn in a slowing economy
- Illiquidity in financial markets
- Potential for self-reinforcing downward spiral
- Lessons from the past, how do we get out?

Risks to the Nation's Economy

- GDP increased .6% in the 4th quarter of 2007 vs. 5% in 3rd quarter – sputtering economy
- Mild recession or slowdown current forecast
- 1/3 of the country is in a recession
- National recession may occur this spring or summer
- However, a darker scenario is possible

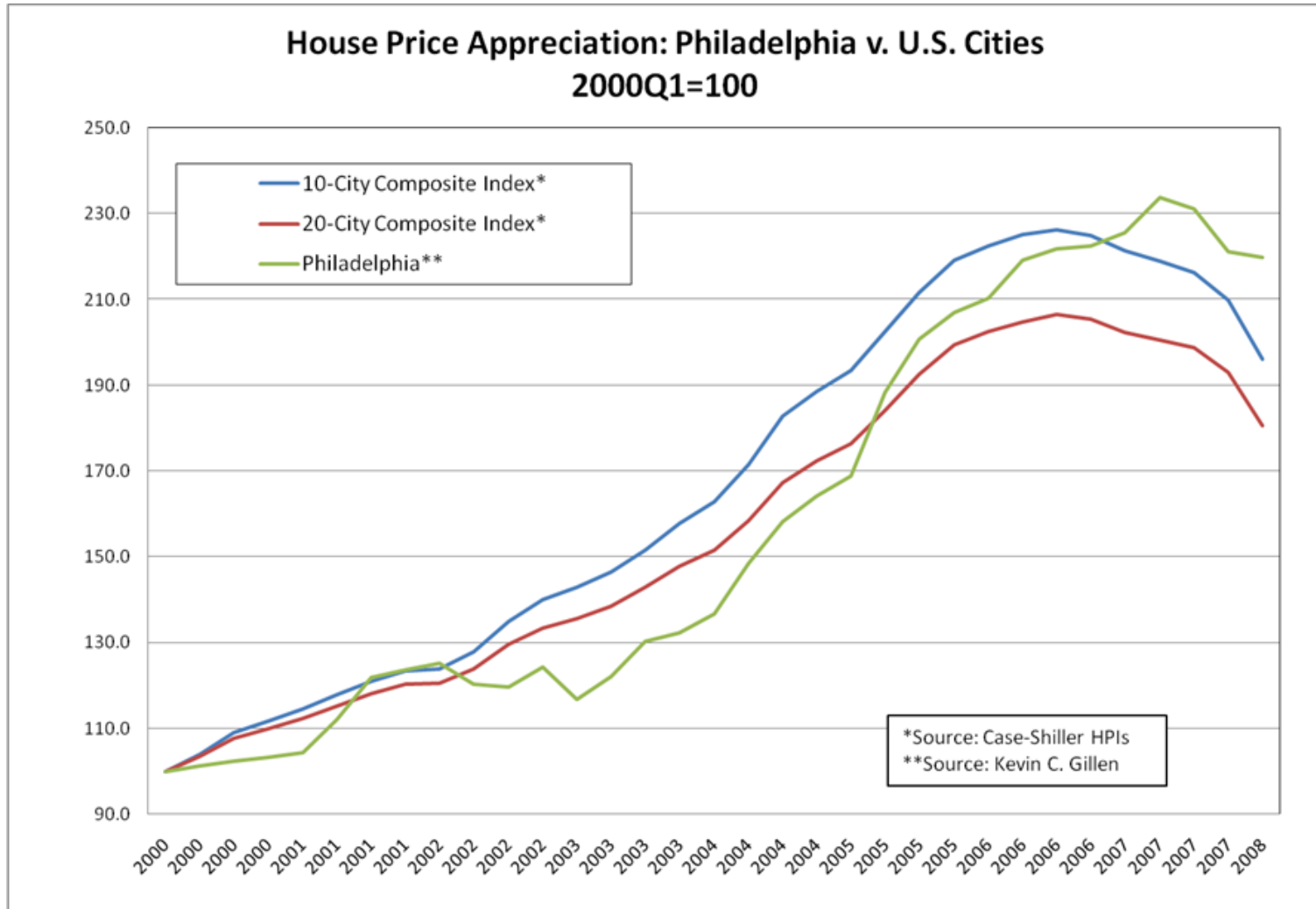
The Darker Scenario

- The national economic downturn is severe
- Due in part to a worsening credit crunch and to expectations of continuing price declines in the housing market
- Additional threats: oil, commodity prices, inflation
- Housing market downturn becomes widespread and is reinforced by national recession

A Severe National Housing Downturn

- In a market self correction:
 - Prices decline
 - Demand increases
- In a dynamic disequilibrium and self-reinforcing decline:
 - Prices decline
 - Supply increases fueling further price decline
- Credit crunch contributes and reinforces
- Inventories of new homes are declining, nonetheless, overall inventories are increasing again due to rising foreclosures

A Severe National Housing Downturn



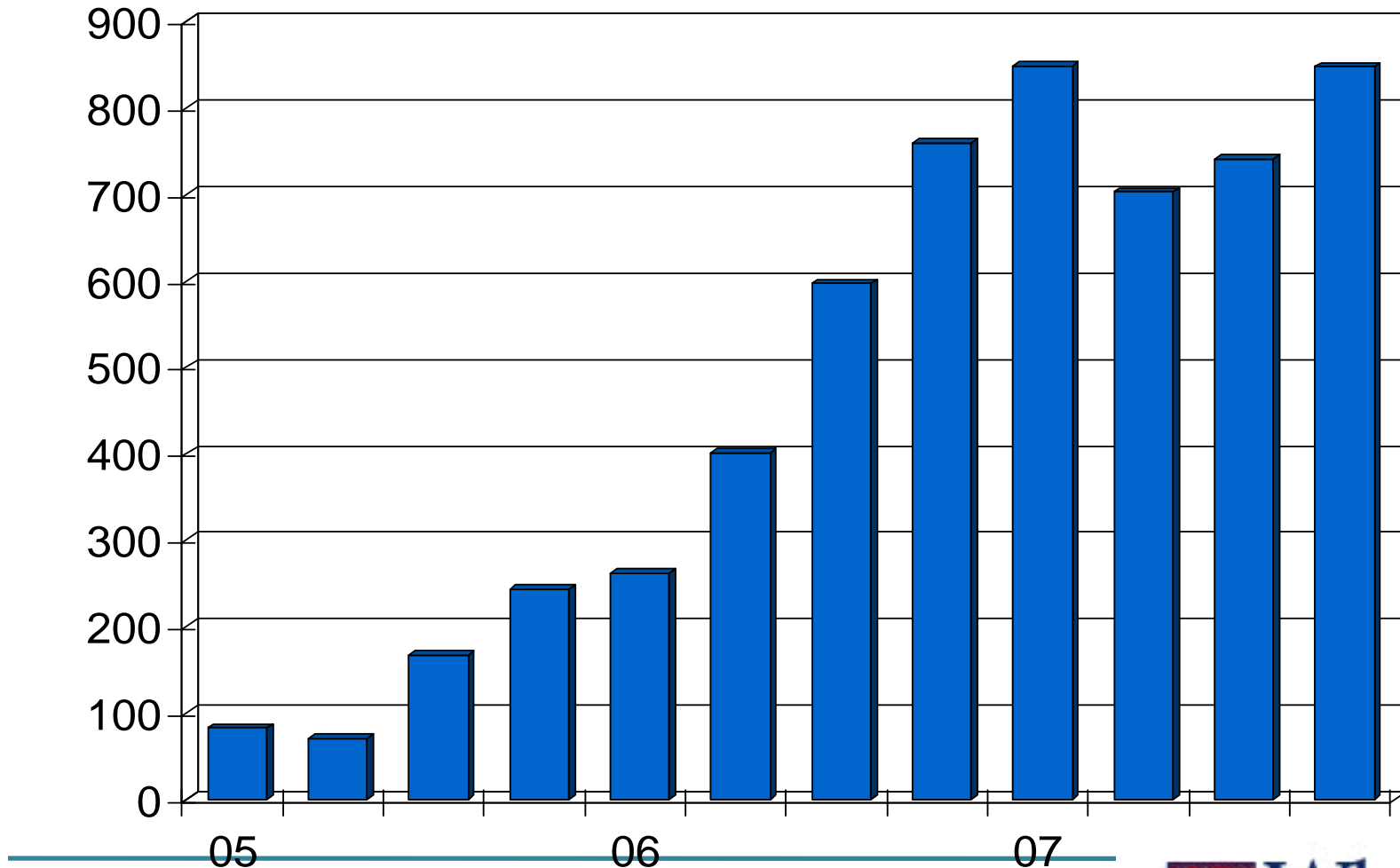
Self-Correction or Downward Spiral?

- To return to fundamentals prices need to decline on a national basis 25%
- Prices have already declined 15% from peak, forecasters expect an additional 10% price decline
- Downward price expectations can build and become self-fulfilling

Housing Market Awash in Inventory

of excess unsold homes for sale, ths

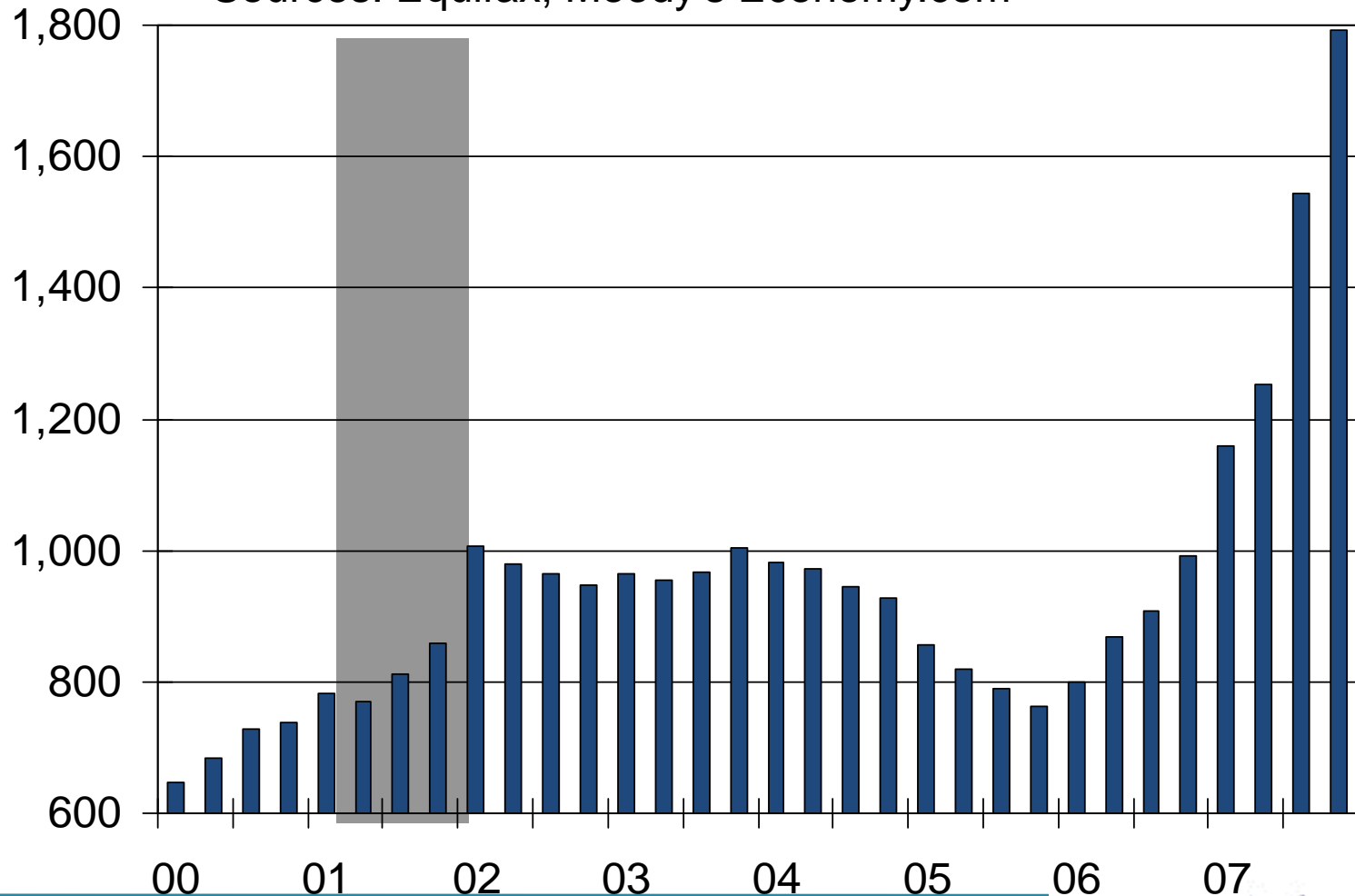
Sources: Census, Moody's Economy.com



Unprecedented Surge in Defaults

First mortgage loan defaults, ths, SAAR

Sources: Equifax, Moody's Economy.com



\$500 Billion Loss vs. \$200 Billion Recognized Loss

- The current credit crunch may just be the beginning
- Bank and financial institution decapitalization can worsen
- Subprime and private label securitization markets are closed
- Agency debt has not filled the gap yet

How do we get out? We've been here before

- During the Great Depression, prices fell 25% and foreclosures reached disaster levels
- During the Savings and Loan crisis, the banking system was at risk with the potential for a self-reinforcing crisis with national recession in 1990-1991
- Then, as now, illiquidity and the potential for self-reinforcing price declines were the problem
- Nonetheless, how did we get out?
 - Home Owners' Loan Corporation (HOLC)
 - Resolution Trust Corporation (RTC)

Lessons from the Great Depression

- Federal Home Loan Bank Board and subsidiary Home Owner's Loan Corporation to provide liquidity going forward and to purchase foreclosed properties
- From 1933-1936, HOLC acquired and refinanced one million delinquent mortgages
 - Federalized private loans
 - Restructured loans to make them affordable
- Created to stem the tide of loan defaults and foreclosures
- Modified terms to reduce loan payments
- Limited mortgage market practices that contributed to high default rates and created a 30-year self-amortizing mortgage

Context: Similarities and Differences

- Similar to the current context, the increase in mortgage defaults during the Great Depression was preceded by a period of extensive home building, rising house prices, and an increasing use of debt
 - Balloon loans that could not be refinanced
 - Defaults rose sharply in the early 1930s when house prices and household incomes collapsed
 - The tidal wave of mortgage defaults and foreclosures prompted calls for government help

Lenders and HOLC

- Although private lenders took a loss on the nominal value of the loan, they preferred to recover losses through HOLC rather than to foreclose
 - HOLC's appraised market value was generous, based on long-run value
- HOLC benefited financially from an expanding economy, rising house prices, and falling interest rates, especially during WWII
- In turn, the economy benefitted from HOLC because it put a floor on prices and stemmed the tide of loan defaults and foreclosures
- In 1951, HOLC was liquidated with no cost to taxpayer (recouped its initial \$200 million capitalization)

Context: RTC

- Savings and Loan crisis was the result of fundamental vulnerability of the savings and loan system, which was to lend long and borrow short
 - Exacerbated with inflation and interest spikes of the 70s and 80s
 - Interest income from long-term mortgages was less than what was needed to pay out to borrowers with rising short-term rates
 - Collapse resulted from moral hazard of no net assets encouraging risky lending based on demand deposit guarantees → moral hazard

Background: RTC

- Created with the passage of Financial Institutions Reform Recovery and Enforcement Act (FIRREA) in August 1989, which passed on conservatorship of ~250 failed thrifts from the Federal Savings and Loan Insurance Corporation (FSLIC)
- By 1990, the RTC had taken over 531 thrifts with \$278 billion in assets
- RTC received its final funding from Congress in 1993 and closed in 1995

Process of Asset Disposition: RTC

- Disposal through a variety of channels: Direct sales, auctions, securitization
- Relied heavily on private firms to evaluate, package, and sell assets
- RTC engaged local nonprofits to speed the disposition of its assets and improve outcomes to buyers

Rescue: Secondary Market and RTC

- Going forward, depositories would lend long funded by secondary market
- Bad assets sold off by Resolution Trust Corporation (RTC)
- RTC acted quickly to reliquify the banking system
- **In contrast to HOLC, RTC was created for commercial real estate asset disposition**

Frank-Dodd Bill

- Provides up to \$300 billion in insured mortgages under a special FHA fund
- Eligibility:
 - Borrower must certify no intentional default
 - Requires a debt-to-income (DTI) $> 30\%$
 - Excludes borrowers with ARMs that have reset
- Loans, not to exceed 90% LTV, fixed rate, 30-year term
- Owners of the mortgage take a haircut loss
 - Prepayment fees and penalties are waived

Frank-Dodd Bill

- Appraisals based on current value, conducted by independent appraisers
- Shared appreciation:
 - Borrower's share of appreciation increases 10% per year for the first five years
 - Afterwards, equity is split 50/50 (In Frank bill, borrower gets full upside)
- Auctions establish a procedure to do wholesale or bulk transfers

Preventing a Future Crisis



Result

- Unprecedented rise in defaults and foreclosures
- Not distributed proportionately
- Place-based local solutions will matter

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