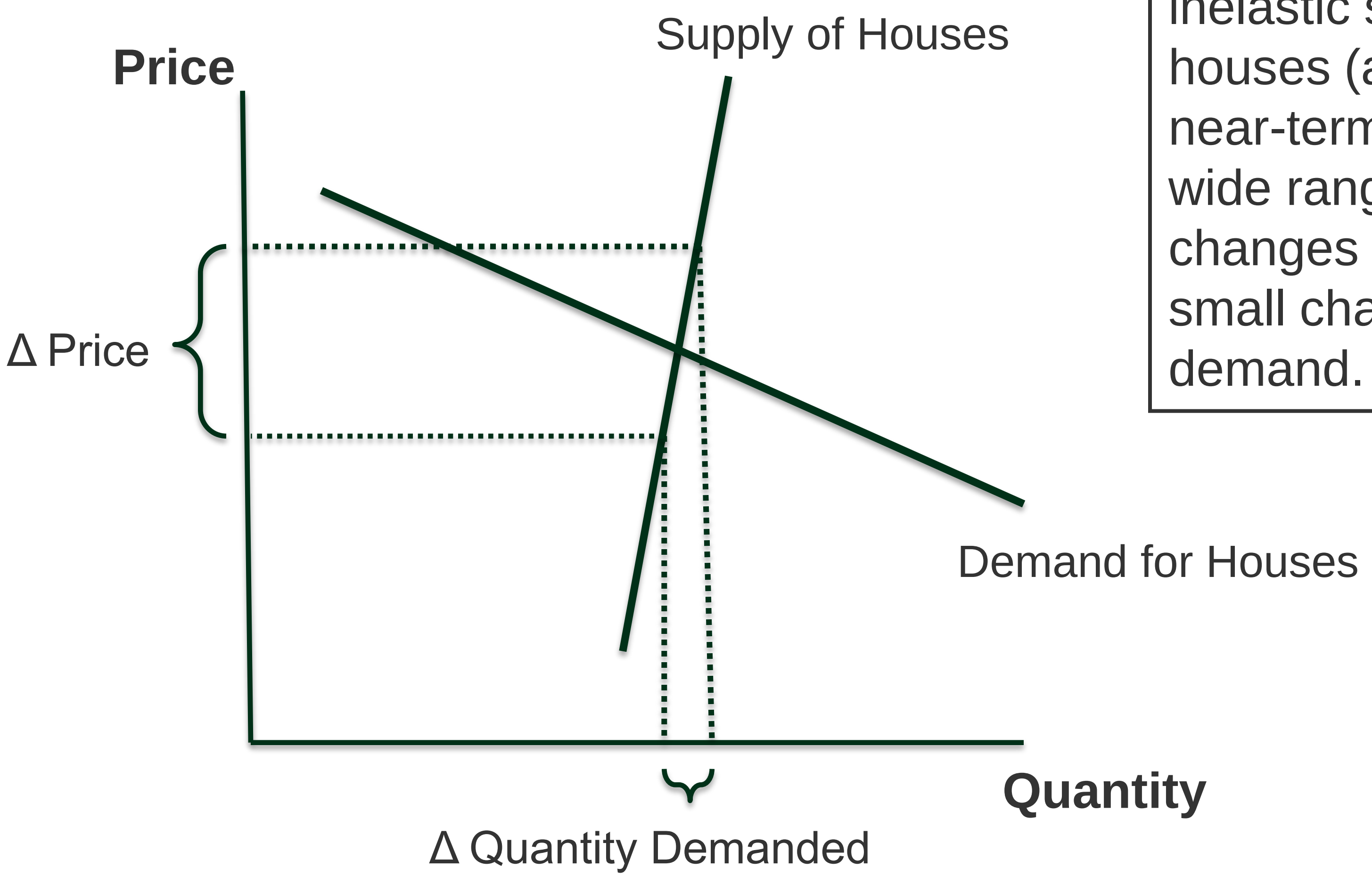
MORTGAGE BANKERS ASSOCIATION®
Investing in communities

Housing Bubbles, Detecting and Prevention

Emile J. Brinkmann*
Chief Economist and
SVP, Research & Education

*Comments and opinions are solely those of the presenter and do not necessarily represent official positions of the MBA or its members.



Markets with an inelastic supply of houses (at least in the near-term) result in a wide range of price changes for relatively small changes in demand.

Bubble Defined

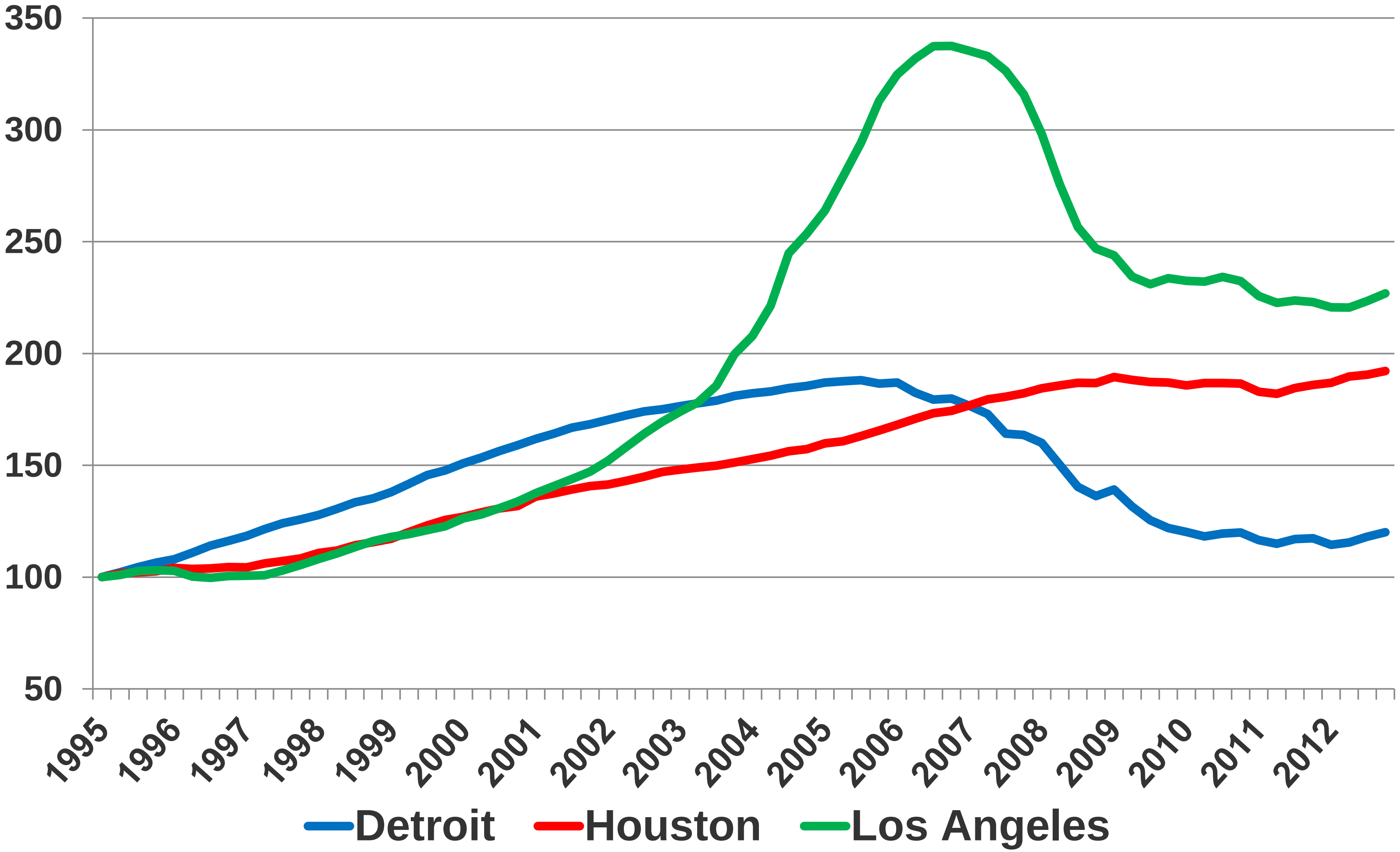
- Supply and prices will adjust to long-term sustainable changes in demand and incomes. Just because prices increase as part of a new equilibrium does not mean that there is a bubble.

- A price bubble is a price increase caused by unsustainable or transitory increases in demand.

- Short term shocks to supply caused by natural disasters can also cause temporary price bubbles.

Home Prices – A Tale of Three Cities

Price Index: Year 1995 = 100



Source: Federal Housing Finance Agency

Causes of Transitory Changes in Demand

1) Sudden changes in credit availability and/or lower barriers to homeownership
    a. Lower downpayment requirements.
    b. Reduced documentation requirements.
    c. Reduced credit history requirements.
    d. Increase in direct subsidies, including cash subsidies and tax credits.
    e. Easier payment terms, such as pay-option adjustable rate mortgages.

- All are transitory. We eventually re-learn the credit lessons of the past.
- The expanded use of low documentation loans did the greatest damage to the US housing finance system.

Causes of Transitory Changes in Demand

2) Speculation
    a) Speculators are attracted to markets with rising prices.
    b) If they are required to put down very little cash, the leveraged returns can be very high.
    c) Demand lasts only as long as prices go up, and if speculators do not have the cash to carry the investment long-term, forced selling causes a rapid drop in prices.

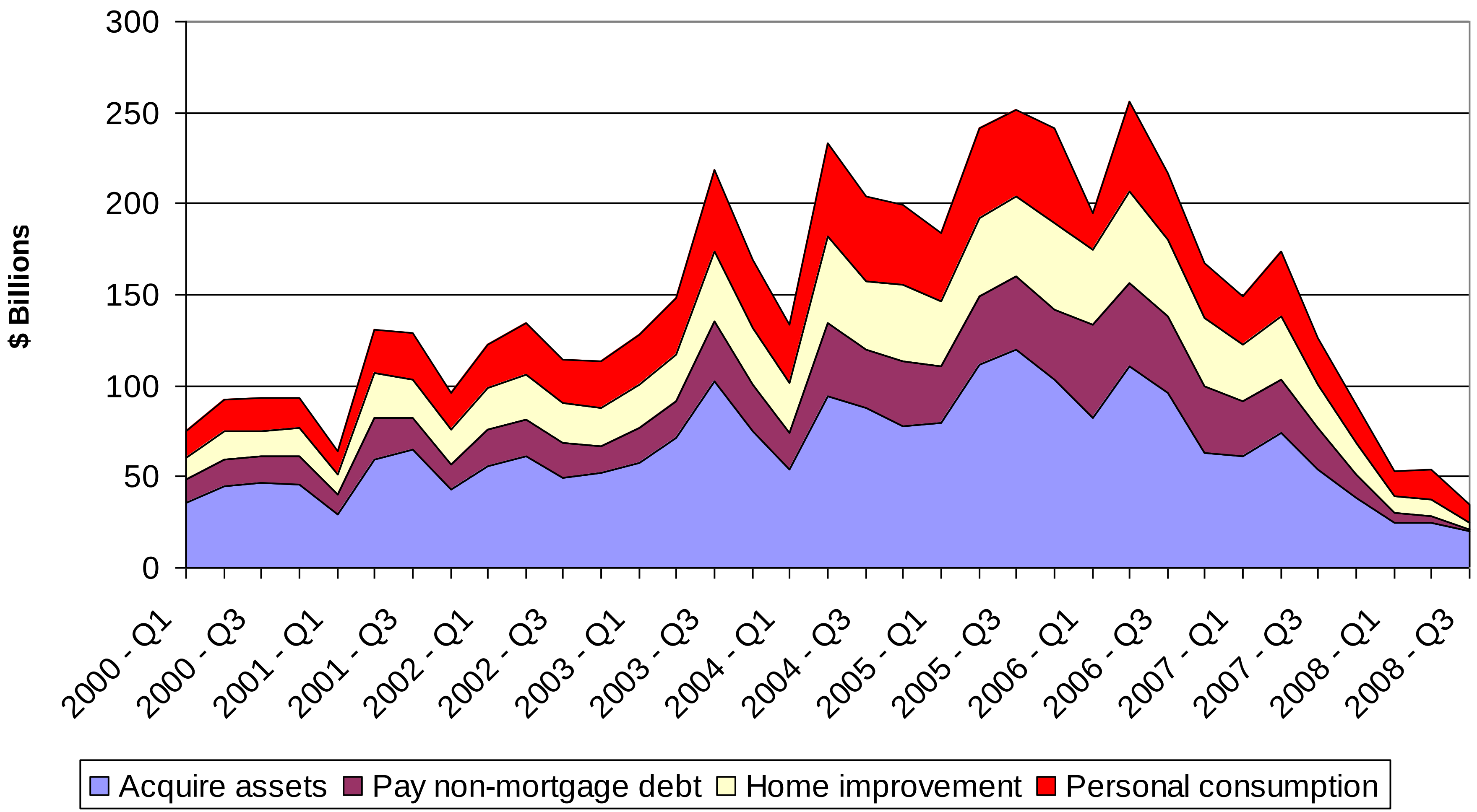
3) Fraud
    a) Occupancy fraud
    b) Documentation and appraisal fraud.

Causes of Transitory Changes in Demand

4) Unsustainable local macroeconomic environments
   a) Temporary increases in local economic activity, such as a local housing market supported by an economy heavily driven by home construction.
   b) Expanding but undiversified local economies such as those dependent on oil and gas exploration, auto manufacturing or perhaps even financial services.
   c) Cash-out refinances played a major role in stimulating the local economies in areas in the United States that were already seeing large increases in home prices, causing an unsustainable feedback loop.

Equity Withdrawals from Housing Contributed to the Home Price Bubble

Uses of cash-out refinances and other equity withdrawals from housing:



Source: Greenspan & Kennedy, Federal Reserve

Declining Market Bubbles

- It is also possible to have a price bubble in declining markets caused by lenders or the government intervening to temporarily reverse a natural decline in demand due to declining local economies.

- In US cities like Detroit and Cleveland, weaker credit requirements brought in home buyers who did not have the long-run financial strength to support owning a home.

- The result was a stall in the decline of home prices, but, once resumed, the price drop was even more dramatic.

Why Lenders and Markets Have a Difficult Time Dealing with Bubbles

1) Credit models are based on an individual's credit history and financial resources and are not viewed in the context of the local economy. The assumption is that performance is averaged out across the entire nation so local conditions do not matter.

2) Similarly, all loan types are offered in all markets so the size of downpayments are not based on local market conditions.

3) Appraised values are based on the most recent sales and are not based on likely future developments in the local economy.

Why Lenders and Markets Have a Difficult Time Dealing with Bubbles

4) Tremendous earnings pressure on lenders to keep up with the competition and not voluntarily pull back from over-heated markets.

5) It is very difficult for an individual lender to determine whether a concentration of weaker credit loans, speculation or fraud is driving local market conditions. Yet the value of that lender’s collateral is equally at risk from a bubble bursting, not just the collateral of the lenders making the riskiest loans.

Why Government and Regulators Have a Difficult Time Dealing with Bubbles

1) The construction of new homes is an important source of economic growth and jobs in any economy. No official wants to be seen artificially holding back that growth.

2) The housing industry is often politically powerful and will fight efforts to curtail growth even in overheated markets.

3) Every government likes to talk about improvements in housing and the increase in homeownership for its population.

What Can Be Done by Lenders?

1) Build local economic factors into credit models.

2) Be willing to increase downpayment requirements and tighten other credit requirements if they see a local overheating, even if it means giving up market share to competitors in the near-term.

3) Develop better information on the degree of speculation in a market and the degree of occupancy fraud.

What Can Be Done by Regulators?

1) Support efforts by lenders to be counter-cyclical with mortgage lending and follow the same practices with any government-sponsored lending programs.

2) Require lenders to build credit models that incorporate local economic factors.

3) Employ even rudimentary regulatory triggers like housing construction starts per capita in regulating construction and mortgage lending by banks.

4) Resist political pressure from those groups whose income is derived from real estate transactions rather than long-term real estate performance.

Emile J. Brinkmann

Chief Economist and

Senior Vice President for Research and Education

Mortgage Bankers Association

1717 Pennsylvania Ave., NW

Washington, DC 20036

jbrinkmann@mortgagebankers.org