

Housing Finance and Crisis

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for the Center for Political Education

Agenda

Outline: June 23, 2008

- Guidelines for Participation
- Suresh Naidu:
 - Some definitions
 - Re-cap from previous class: how we got here, herding, finance and housing
 - Finance and housing in detail
 - The government's role in housing and finance
 - Take away lessons on housing and finance
- Amie Fishman from East Bay Housing Organizations (EBHO)
- Kevin Stein from California Reinvestment Coalition
- Discussion and Q&A

Guidelines for participation

- Step up, step back.
- Raise your hands, please don't interrupt.
- WAIT (Why Am I Talking?)--thanks to SOUL for this.
- During the initial presentation, please only ask clarifying questions at appropriate times, and save your other comments and questions until the end of the class.
- Remember our shared interests.
- Respect the facilitators.
- Respect the presenter and the other participants.
- Turn technology to off or vibrate.

Some Definitions

- **Mortgage** – loan to buy a house
- **Subprime Mortgage** – mortgage to a person with a high chance of default (e.g. bad credit history)
- **Mortgage-backed security (MBS)** – a financial asset that promises a flow of payments to the asset owner from the mortgage repayments
- **Tranches** – breaking up an asset into different risk categories
- **Securitized loan** – A loan that can be bought and sold. (E.G. an MBS or bond).

Recap from the last class: *Recession, housing and finance* herding, finance, and housing

- **Summary of current economic downturn and how we got here...**
- Dot-com was part boom, part bubble
 - Some seriously productive new technologies
 - Some pure hype (herding!)
- Housing prices started going up because some people were richer
- After dot-com bust, interest rates kept low by Fed
- This means that investors can keep borrowing money
- This money goes into the housing market (more herding!)
- A lot of lending to the financially insolvent (subprime mortgages)
- Those loans get securitized and traded on Wall Street and around the world

Finance and Housing in a nutshell *Understanding housing and finance*

- Securitization means the housing market is tied to a complex financial market (buying & selling) of mortgage-backed securities
- Bad regulation means nobody is checking for the underlying chance of default
- Some people realize they can't make their mortgage payments
- They default on mortgages and get foreclosed
- Defaults bubble throughout the financial system
- Everyone starts selling off their assets, stock prices fall, investment falls, potential for economic downturn

Understanding housing and finance **Buying and defaulting on a mortgage**

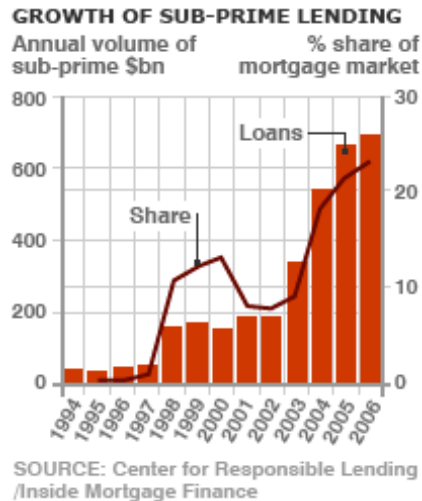
- House costs 100\$
- You only have 30\$
- Borrow 70\$ to buy the house, promise to pay back 80\$ (which includes interest on the 70\$), otherwise the lender gets the house
- House price falls to 10\$, but you still owe 80\$
- Doesn't make sense to keep paying the mortgage
- You default on the mortgage, and the lender gets the house
- But the house isn't worth enough to cover the loan (lender still gets burned)

Understanding housing and finance **Subprime Mortgages: Banks to Buyers**

- What do you think of when you think of the "American Dream"?
- What if you have a low income and/or bad credit?
- No prob, we can sign you up for a mortgage!
- Going to charge you a high-rate, though, because you might default or because we think you might default cause you're nonwhite.
- But we get the house if you default
- We'll give you a low rate today, and crank it up in 5 years. Don't worry about it...for now.
- Q: Is this predatory lending? Or is it giving opportunities to low-income folk to own housing?-depends on the details...K + A.

Subprime madness

Understanding housing and finance



Banks to Financial Market

Understanding housing and finance

- Hey look, we've got all of these income streams coming in from these mortgage loans we've made
- We can securitize them and sell them on the market
- Part of broader "financialization" of economy.
- Yeah, they are risky, but we can repackage that risk
- How? With "Tranches" or different risk categories for the mortgage that will be traded as an asset

Senior vs. junior tranches

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- Idea: take the high-risk, high-rate mortgage and create a couple of new assets:
 - **Senior tranche:** first to get paid if mortgage payer defaults and has to sell house. Less risk. Gets good credit rating.
 - **Junior tranche:** last to get paid. High-risk.

What happened?

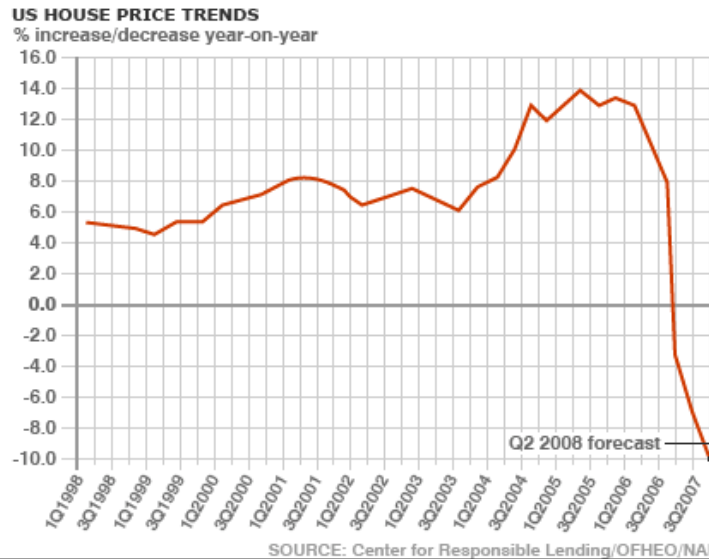
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- Markets/rating agencies thought the senior tranches were a lot less risky than they actually were...were counting on defaults happening, at best, one at a time.
- Turns out a whole bunch of defaults happened at once
- Ratings agencies downgraded the senior tranches
- Everyone starts selling the senior tranches off
- Classic herd behavior like last class.
- Fire! Sale! Falling asset prices

If you were an investment agency using your senior tranche as collateral to finance purchasing other stocks...you've got a problem...

Housing Prices

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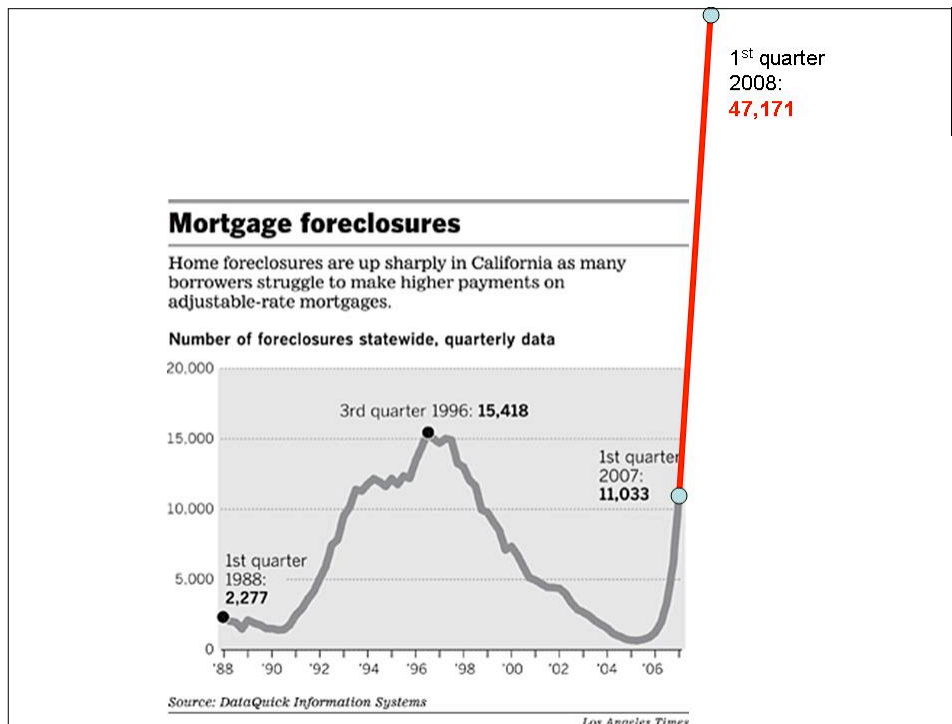
Why did a bunch of people default at same time?

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- A) Timing of rate increases
 - A lot of people defaulted when their rates went up on adjustable rate mortgages
 - Increased the number of houses on the market, driving house prices further down
- B) A lot of new housing purchases (25%) were by owner-investors (i.e. Landlords)
 - means they are quick to sell once it looks the house isn't worth so much
 - Also increased the number of houses on the market, driving house prices further down.

House prices falling means its not worth it to make your payments, cause the house isn't worth the mortgage payments anymore. Foreclose! Bubble popping!

Landlords and low-income owners do this; financially secure home-owners sit tight...moving is a pain!



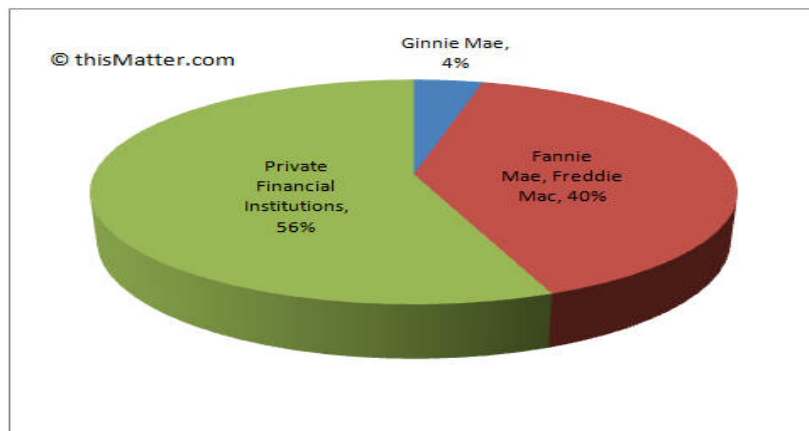
What about the government?

The role of government in housing and finance

- 1938 New Deal government sets up Fannie Mae
- 1968, privatized most of it. Created 3 separate orgs
- GNMA (Ginnie Mae), FNMA (Fannie Mae), FHMC (Freddie Mac) to do the same thing as the bank (securitizing mortgages and selling them)
- But, these are guaranteed by the government even if the owner defaults. (Or at least markets think they are....)
- A lot less risk
- Basically, these have so far proved pretty stable
- Point: Government can do a lot better job of guarantees than private sector.

2006 Distribution of mortgage backed securities

The role of government in housing and finance

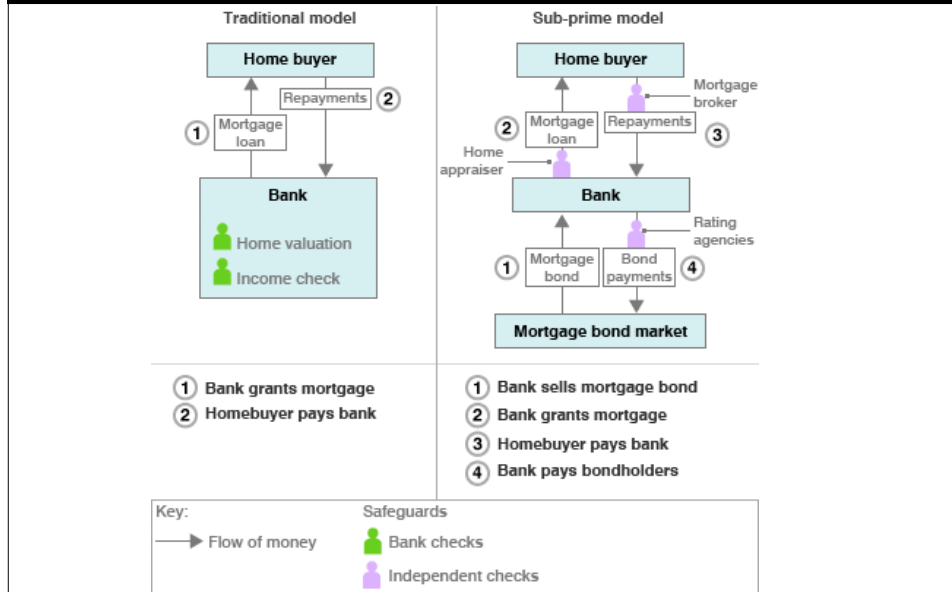


The take away

Conclusion

- Absence of oversight, careless rating agencies, and lack of regulation leads to incorrectly priced mortgage backed securities
- These securities were collectively vulnerable to nation-wide housing price falls
- Subprime mortgages were a stupid thing to securitize privately
- These things got repackaged and sold all over the world
- But just one particular version of general financial crisis
- General point: government can guarantee against big national level crisis (because they can always tax), private sector can't...
- Maybe the government should do more to guarantee people's mortgages....like buy their housing for them or subsidize NGOs to do it...
- Likely to help out finance too, albeit indirectly

The Normal Cycle:



The Breakdown:

