DOES REGULATION MATTER?

INSTITUTIONAL DIMENSION OF THE 2008 FINANCIAL CRISIS

Dissertation presented to the Escola Brasileira de Administração Publica e de Empresas for obtaining a master degree in International Management

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Rio de Janeiro, March 2010
ABSTRACT

Why did house prices fall in 2007-2009? 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. How much did regulation or lack thereof play in the role of the devastation? To what degree did greed and unrealistic consumer expectation have on the real estate bubble?

Using existing literature as well as face to face interviews of experienced leaders within the real estate industry in California who experienced both the up and down of the real estate cycle, the overarching purpose of this study is to investigate the opinions and beliefs of the leaders and drivers within the real estate industry about the cause of the real estate bubble that occurred sharply in 2008. Specifically, this project will focus on the opinions of real estate industry leaders who worked in the center of the subprime universe located in Irvine, California, during 2004-2008.

Comparing the mainstream beliefs with the interviewees it is fair to say that the main finding in the mainstream beliefs are reflected very well with the finding of the subject’s opinion.

The thesis is divided into 6 chapters starting with “introduction”, followed by chapter 2 “Literature Review”. Chapter 3 is “Research Methodology” followed by chapter 4 “Data Presentation”. Finally, the results are discussed in chapter 5 “Analysis and Discussion” and conclusions in Chapter 6.
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1. Introduction

Why did house prices fall in 2007-2009? This is the most fundamental question to most Americans, and to those who lent them the money. Most of the homeowners did not really pay attention for the underlying reasons for why the price of real estate kept rising. By assuming that the price always rose, they thought they could enjoy good fortune indefinitely. It was not until prices began to fall that people were left searching for answers. Even though the decline may not be over, the great housing devastation we have seen is the largest decline in house prices since the Great Depression. The asset bubble for the Great Depression was the stock market while the asset for the real estate bubble was residential real estate.

Alan Greenspan and Ben Bernanke sent a message for everyone who thinks the Federal Reserve isn't to blame for the housing bubble and Great Recession: It wasn’t our fault. In a 48-page paper that Greenspan presented the Brookings Institution on March 9, 2010 called "The Crisis," the former Fed chairman wrote that it was low long-term rates, not the Fed’s easy money policy from 2002-2004 that caused the spike in home prices. These comments echo remarks made by current Fed chairman Bernanke in a speech earlier this year. Bernanke stated in January 2009 that “the increasing use of more exotic types of mortgages and the associated decline of underwriting standards” was the main cause for the housing boom, not low short-term rates, also known as through their current and previous history of free market and deregulation.

The Fed is not completely at fault for the economic downturn. The blame has to be shared by greedy banks and mortgage lenders, short-sighted investors who were willing to turn a blind eye to risk and keep buying mortgage-backed securities and overzealous consumers who thought it was a divine right to own a home even if they couldn't really afford one. Yes, long-term rates remained stubbornly low -- even falling -- after the Fed finally started tightening in the summer of 2004. That led to the famous bond "conundrum" that Greenspan often
lamented. But it’s hard to imagine how long-term bond rates and mortgage rates would have ever fallen so far, and stayed so low, if short-term rates weren’t so low for a lengthy period of time to begin with.

However, "Greenspan and Bernanke may be missing the point. All the deregulations and free markets policies may not be the cause of the current financial mess. You will see through this paper that both stricter regulation and tighter governmental intervention that are so commonly suggested as a cure by the mainstream opinion and furthermore by my subjects that are believed to be the main causes of the financial and housing crisis. In an article written by Steven Horwitz, 2008 (An open letter to my Friends on the Left), he appropriately poses several considerations, which contrast the mainstream views of the diagnosis and the cure of the real estate bubble. He demonstrates to us that one of the biggest confusions about this crisis is what the mainstream and my subjects refer to as greed. The problem with letting greed justify the real estate devastation is that greed is constantly a feature of human interaction, meaning that greed exists in every part of the economy, not only within financial and real estate industry.

Another suitable argument posed by Steven Horwitz (2009) is that the failure of the “the free market” and the product of unregulated greed is to overlook the countless number of government regulations, policies, and political pronouncements that have both reduced the “freedom” of this market and channeled self-interest in ways that have resulted in disastrous consequences, both intended and unintended.

We all know and remember Dr. Doom, Nouriel Roubini, an economics professor at New York University, who on Sept. 7, 2006, stood before an audience of economists at the International Monetary Fund and announced that a crisis was brewing. In the coming months and years, he warned, the United States was likely to face a once-in-a-lifetime housing bust, an oil shock, sharply declining consumer confidence and, ultimately, a deep recession. He laid out a bleak sequence of events: homeowners defaulting on mortgages, trillions of dollars of mortgage-backed securities unraveling worldwide and the global
financial system shuddering to a halt. These developments, he went on, could cripple or destroy hedge funds, investment banks and other major financial institutions like Fannie Mae and Freddie Mac. Of course, the audience seemed skeptical, even dismissive. Why wouldn’t they be? At the time, unemployment and inflation remained low, and the economy, while weak, was still growing, despite rising oil prices and a softening housing market. We all know now how right Dr. Doom was in his speech and predictions.

The author is a former Vice President at California’s largest former land brokerage company’s, located in the City of Irvine, California where he represented both land owners as well as private and public developers and homebuilders acquire and dispose of real estate assets for residential development purposes. The position was held from 2001, when the twin towers in New York City were attacked, through early 2007, as the real estate market had begun its steep decline. It was a period when the housing market experienced an incredible and unprecedented expansion where almost regardless of what valuation was used in acquiring real estate assets, a rise in future expectations and values was both expected and factual. However, beginning of 2007, our financial world began to self-destruct in what the International Monetary Fund soon acknowledged to be “the largest financial shock since the Great Depression.” Did the crisis of 2007–2008 happen because American companies had gotten worse at designing new products? Had the pace of technological innovation or productivity growth suddenly slackened? The proximate cause of the economic uncertainty of 2008 was likely financial. A crunch in credit markets triggered by mounting defaults on up till then incomprehensible species of housing loan known euphemistically as “subprime mortgages.”

The concentration of the deterioration of the real estate bubble was located in Irvine, California. As one of the most famous real estate bogglers in the United States Chuck, Ponzi (2007) stated; “one the most significant reasons for the bubble was the lowering of lending standards and the extension of credit
to people who could not afford handle the responsibility”. They are referred to as subprime borrowers. The word “subprime” has now forever become linked to the real estate bubble. It was one of the main factors that made this bubble unique, and the collapse of subprime is widely regarded as the slight puncture, which began the bubble’s deflation. The center of the subprime universe is located in Irvine, California, as three of the top ten subprime lenders, New Century, Ameriquest and Option One, have or had their headquarters in Irvine.

High volatility in the real estate market is not new to California. Real estate prices detached from typical evaluations of three to four times yearly income seen in the rest of the country. Once the landowners realized they could push up prices in the their real estate markets to inflated heights, they have been doing it ever since. This real estate bubble is the third such bubble in the last 30 years, and it’s the largest of them all. The removement and detachment from traditional measures of valuation was so aggressive that it is difficult for many to understand.

2. What is a bubble?

According to Chuck Ponzi (November 19, 2007), a financial bubble is a temporary situation where the asset prices become elevated beyond any realistic valuations because the general public believes current pricing is justified by likely future price increases. If this belief is widespread enough to cause significant amount of individuals to purchase the asset at inflated prices, then prices will continue to rise. This results to even more buying. Once initiated, this reaction becomes 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, the primary motivating factor to purchase is eliminated; prices fall. The temporary mentality is summed up in three ways:

1. The expectations 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 and furthermore the exploitation of these beliefs, not only by the general public, but also by the entire real estate industrial complex, particularly the sales mechanism. There is normally no single factor, but rather a combination of factors which leads to a stimulation of prices resulting in a speculative spiral. The real estate crash resulted mainly by creative innovation in the finance and expansion of the secondary mortgage market, the growth of subprime spending, the lowering of lending standards.

There are a number of reasons behind popular beliefs that real estate prices would keep rising or, conversely, that a decline in prices was highly unlikely. These reasons refer to the perceived shortage of housing units and the assumption that prices were justified by current or future economic conditions. These were not the sole reasons for the decline, but did confirm the beliefs and attitudes about the future of real estate market and it’s pricing.

Market pricing is a function of supply and demand. One of greatest reasons many house price bubbles get started may be due to a temporary shortage of housing units. This pertains particularly to the problem in California because the real estate residential entitlement process is very slow and challenging. The author witnessed this first hand brokering several real estate transactions, when a developer was in the process of entitling raw land into entitled or approved land. This process ranged from a few months to several years. Supply shortages can become intense, and prices can rise very fast. In other parts of the U.S. new supply can quickly come to the market when prices rise, but since supply is slow in California, these temporary shortages can result in conditions necessary to create a housing crash. Every asset bubble will claim that the prices are supported by fundamentals, even at the peak of the market.
Comparing it to the stock market in 2000, when analyst were issuing buy recommendations on technology stocks with so extreme valuations that it lead to a technological bubble in the tech market. Analysts were applying new evaluation techniques to justify the market prices (The author also worked in a technology company in 2001, and as a result of the technology bubble, lost his job). As we all witnessed, the market ended up doing a massive correction. Unfortunately, similar mindset played a major role in the housing market. When rental rates stop covering the cost of the mortgage during the peak of the housing cycle, the result was doomed to be devastation. Even with an extremely aggressive analysis and buying promotions within the real estate community, prompting the general public into buying, there is no real fundamental analysis done by the average homebuyer since so very few understand the complexity valuation of property.

Usually, during a real estate rally, rental cash flow models fail and the arguments about price justification result into an owner’s ability to make payments. Arguments suggest that people are rich and that people make enough money to support the inflated prices. Indeed, it seemed people were believing in their contents of the loan applications which was unrealistic and many times entirely false. Even when the purchasers were confronted with data showing that “everyone is rich” argument, they still believed it was accurate. This let to one of the most important reasons for the collapse of the housing market; the phenomenon of creative or exotic financing which allowed homeowners to own a temporary very large sum of money with small payments. The author was a victim to this reasoning in Irvine, California in 2005-2006.

What is different about this bubble many analysts speculate? Each time an asset bubble is being created, people believe the rally of prices is justifiable by fundamentals. When proven otherwise, people have the tendency to invent new ones with a change of heart. The stock market bubble had its own set of valuation methods as we mentioned above. Instead of approaching with suspicion the loan programs, most participants in of the bubble were eager to
embrace new financing methods as a new advanced way of lending money. When “everyone” is making large sums of money, and the government is encouraging the activity, it is easy to ignore potential problems. An example is when Alan Greenspan, FED chairman during the bubble, endorsed the usage of adjustable mortgage rates which led to an further expansion of home ownership (William Fleckenstein and Fred Sheehan Jan 16, 2008)

2.1 House Financing Overview

When an individual decides to buy a house, he or she try to figure out how much they can afford relative to the price of the house. The individual purchasing power depends entirely on how much the lender is willing to loan. Lenders apply debt-to-income ratios and other affordability criteria to determine how much they can borrow to avoid default. The majority of the residential homes sales have financing. The interest rates and numerous loan terms have evolved over time. After World War II, a number of governmental programs to encourage home ownership spawned a surge in construction and the evolution of private lending terms, resulting in the 30-year conventionally amortized mortgage. The type of mortgage usually requires 20% down payment, and allowed the borrower to consume no more than 28% of their gross income on housing. These conservative terms became the standard for 50 years. Lending under these terms resulted in low default rates and a high degree of market price stability.

Furthermore, mortgage rates are the single most important factor for determining the borrowing power of a potential house buyer. When rates are very low, a borrower can service a large amount of debt with a relatively small payment, and when the interest rates are high, a borrower can service a small amount of debt with a relatively large payment. Mortgage interest rates are determined by market forces where investors in mortgages and mortgage back securities bid of these assets. The rate of return demanded by these investors determines the interest rate the originating lender will have to charge in order
to sell the loan in the secondary market. Some lenders still hold mortgages in their own investment portfolio, but these mortgages and mortgage rates are subject to the same supply and demand pressures generated by the secondary mortgage market.

Figure I, displays the basic component of Components of Mortgage Interest Rates (SOURCE: www.Mortgagebrokercalculator.org)

Mortgage Interest Rates = Base rate + inflation Expectation + Risk Premium
Risk Premium = Mortgage interest rate – 10 year Treasury note yield
Inflation Expectation = 10 year Treasury note yield – Federal funds rate
Base Rate = Federal Funds rate

It is further suggested that mortgage interest rates are determined by investor demands for risk-adjusted return on their investment. The return which investors demand is determined by three primary factors: the riskless rate of return, the inflation premium and the risk premium. The riskless rate of return is the return as investors could obtain in an investment like short term Treasury bill. Treasury bills range in duration from a few days to as long as 26 weeks. Because of their short duration, Treasury Bills contain very little, if any allowance for inflation. A close similarity to this rate is the Federal Funds Rate controlled by the Federal Reserve. It is one of the reasons the activities of the Federal Reserve are watched so closely by investors. The closest risk-free approximation to mortgage loans is the 10 years Treasury Note. Treasury Notes earn a fixed rate of interest every six months until maturity issued in terms of 2, 5 and 10 years. The 10-year Treasury Note is a close approximation to mortgage loans because most fixed rate mortgages are paid off before the 30 year maturity with 7 years being a typical payoff timeframe.

The difference between in yield between a 10-year Treasury note and a 30-day Treasury bill is a measure of investor expectation of inflation, and the difference between the yield and on a 10-year Treasury Note and the prevailing
market mortgage interest rate is a measure of the risk premium. Inflation reduces the buying power of money over time, and if investors must wait a long period of time to be re-paid, as is the case in a home mortgage, they will be receiving dollars that have lesser value than the ones the provided when the loans was originated. Investors demand compensation to offset the corrosive effect of inflation. This is the inflation premium. The risk premium is the added interest the investors demand to compensate them for the possibility the investment may not perform as planned. Investors know exactly how much they will get if they invest in Treasury Notes, but they do not know how exactly how much they will get back if they invest in residential home mortgages or the investment vehicles created from them. This uncertainty of return results in them to ask for a rate higher than that of Treasury Notes. This additional compensation is called the risk premium. Mortgage interest rates are a combination of the riskless rate of return, the risk premium and the inflation premium.

The fluctuation in mortgage interest rates has implications for when it is the best time to buy and when is the best time to refinance a home mortgage. It is a popular misconception that low interest rates make a good buying opportunity. When interest rates are declining, borrowers can finance larger amounts, and this can result in many people buying homes and home prices to rise, but when interest rates are low is also when prices are the highest. A buyer in a low interest rate environment may obtain an expensive property, but the resale value of that property will decline when interest rates rise because future buyers will not be able to finance such large sums. A low interest rate environment is an excellent opportunity to refinance because a conservative borrower can either obtain a lower payment or shorten the amortization schedule and pay the loan off earlier. The best time to purchase a house is when the interest rates are very high. Again, this is counterintuitive because interest rates are so much greater, but this will also mean the amount financed will be much lower and house prices will be relatively low. It is better to buy when the interest rates are high and later refinance when interest rates decline. A
borrower can refinance into a lower payment, but without additional cash, a borrower cannot refinance into a lower debt.

Types of borrowers

Borrowers are broadly categorized by the characteristics of their payment history in their FIC score (Fair Isaac Corporation credit scoring model). FICO risk scores are developed and maintained by the Fair Issac Corporation utilizing a proprietary predictive model based on an analysis of consumer profiles and credit histories. These models are updated frequently to reflect changes in consumer credit behavior and lending practices. The FICO score is reported by the three major credit reporting agencies, Experian, Equifax, and TransUnion. Borrowers with high credit scores have generally demonstrated a high degree of responsibility in paying their debt obligations, as promised. Those with lower credit scores either have little or no credit history, or they have a demonstrated track record of failing to pay their financial obligations. There are 3 main categories of borrowers: Prime, Alt-A, and subprime. Prime borrowers are those with high credit scores, and subprime are borrowers are those with low credit scores. The Alt-A borrowers make up the gray area in between. Alt-A tends to be closer to Prime as these are often borrowers with high credit scores which for one or more reasons do not meet the strict standards of Prime borrowers. In recent years one of the most common non-conformities of Alt-A loans has been the lack of verifiable income. In short, “liars loans” are generally Alt-A. As the number of deviations from Prime increases, the credit scores decline and the remainder are considered Subprime.

Types of Loans

There are mainly 3 types of categories of loans: Conventional, Interest only, and Negative Amortization. The distinction between these loans is how the amount of principal is impacted by monthly payments. A conventional mortgage includes some amount of principal in the payment in order to repay the original loan amount. The greater the amount of principal repaid, the quicker the loan is
paid off. An interest only loan does just what it describes; it only pays the interest. This loan does not pay back any of the principal, but at least “treads water” and does not fall behind. The Negative Amortization loan is one in which the full amount of interest is not paid with each payment, and the unpaid interest gets added to the principle balance. Each month the borrower is increasing the debt. Two of the features of all interest only or Negative Amortization loans are an interest rate reset changes or loan balance comes due either in the form of a balloon payment or an accelerated amortization schedule. In any case, borrowers often must refinance or face a major increase in their monthly loan payment.

**Conventional 30-year Amortizing Mortgage**

A fixed rate conventionally amortized mortgage is the least risky kind of mortgage obligation. If borrowers can make their payment, a payment that will not change over time, they can in theory keep their home. A 30-year term is the most common, but if bi-weekly payments are made (for example two extra per year), the loan can be paid off in about 22 years. If borrowers can afford a larger payment in the future, they can increase the payment and amortize over the 15 years and pay off the mortgage quickly. The best way to deal with unemployment or other loss of income is to have a house that is paid off. Stabilizing or eliminating a mortgage payment reduces the risk of losing a house or facing bankruptcy. Unfortunately, payments on fixed-rate mortgages are higher than other forms of financing, so borrowers often opt for the riskier alternatives.

**Interest-Only, Adjustable-Rate Mortgage**

Adjustable-rate mortgage (IO ARM) became popular early in this real estate bubble when fixed rate mortgage payments were too large for buyers to afford. In the market downturn of the late 80’s, these mortgages did not become as common, and the bubble did not inflate far beyond people’s ability to make fixed-rate conventional mortgage payments. This is also why prices were slow to correct in the deflation of the early 90s. The correction was a market characterized by large number of inventories, but this inventory was not
composed of calamitous numbers of must sell homes. The few must sell homes that came on the market in the early 90s drove prices lower, but not catastrophically because the rally in prices did not get too far out of control. The devastation in the housing market was different.

Interest rate adjustable rate Mortgages, also known as IO ARM’s are risky because they increase the likelihood of borrowers losing their home. IO ARM’s generally have a fixed payment for a short period followed by a rate of and payment adjustment. This adjustment is almost always higher; sometimes, it is much higher. At the time of the reset, if a borrower is unable to make the new payment (salary does not increase), or if the borrower is unable to refinance the loan (home declines in value below the loan amount), the borrower will lose the home. The risks are all real, as many homeowners have already discovered. People try to minimize the risk by extending the time to reset 7 or even 10 years, but the risk is still present. If a house were purchased in California 1989 with 100% financing with a 10-year, interest only loan, at the time of refinance the house would have been worth less than the borrower paid, and they would not have been given a new loan. (Fortunately 100% financing was unheard of in the late 80's). Even a 10-year loan term is not long enough if purchased at the wrong time. As the term of fixed payments gets shorter, the risk of losing the homes becomes even greater.

William Fleckenstein, in his book Greenspan’s Bubbles: The Age of Ignorance at the Federal Reserve (Jan. 16, 2008) also states that the most egoistic examples of predatory lending occurred when these interest only loans were offered to subprime borrowers whose income only qualified them to make the initial minimum payment (assuming the borrower actually has this income). This loan program was commonly known as the two-twenty-eight (2.28). It has low fixed payment for the first two years, then the interest rate and payment would reset to a much higher value on a fully amortized scheduled schedule for the remaining 28 years. According to McBride, seventy percent of subprime loans in 2006 were two year adjustable rate mortgages. Anecdotal evidence is that most of these borrowers were only qualified based on their ability to make
the initial payment (Credit Suisse, 2007). This practice did not fit the traditional definition of predatory lending because the lender was not planning to profit by taking the property in foreclosure. However, the practice was predatory because the lender was still going to profit from making the loan through origination fees at the expense of the borrower who was sure to end up in foreclosure. There were feeble attempts at justifying the practice through increasing home ownership, but when the borrower had no ability to make the fully amortized payment, there was not chance of sustaining those increases.

The advantage of IO ARM’s is their lower payments. Or put another way, the same payment can finance a larger loan. This is how IO ARM’s were used to drive up prices once the limit of conventional loans was reached. A bubble similar to the last bubble would have reached its zenith in 2003/2004 if IO ARM’s had not entered the market inflated the prices further. In any bubble, the system is pushed to its breaking point, and it either implodes, or some new stimulus pushes it higher: the negative amortizations mortgage (Option ARM).

Negative Amortization Mortgages

The Negative Amortization mortgage (aka, Option ARM or Neg Am) is the riskiest loan imaginable. It has all the risks of an IO ARM, but with the added risk of an increasing loan balance. Using this loan, there is the risk of not being able to make the payment at reset, and the borrower is much more at risk of being denied for refinancing because the loan balance can easily exceed the house value. In either case, the home will fall into foreclosure. The option ARM is one of the most complicated loan programs ever developed. It was heralded as an innovation because it allowed people greater control over their monthly payments, and it provided greater affordability in the early years of the mortgage. Twenty-nine percent of purchase originations nationwide in 2005 were interest only or option ARM (Credit Suisse, 2007). The percentage in California was much higher. The proliferation of this product is largely responsible for the extreme prices at the bubble’s peak
An Option ARM loan provides the borrower with 3 different payment options each month: minimum payment, interest only payment, and a fully amortizing payment. In theory, this loan would be ideal for those with variable income such as sales people seasonal workers. This assumes the borrower has months where the income is more than the minimum, the borrower sees a need in good times to make more than the minimum payment and the borrower understands the loan. None of these assumptions proved to be true.

**Downpayments**

The risk management measure not related to the mortgage terms is the downpayment. Most people do not think of downpayments as a way of managing risk, but lenders do. Downpayments reduce the risk in two ways: first, they lower the monthly payment, and second, the provide a cushion ensuring the borrower can refinance (if necessary) should the house value decline. The problem with downpayments is obvious: few people save enough money to have one. Eliminating downpayments through the use of 80/20 combo loan was an massive stimulus to the housing market. Subprime loan originations in 2006 had an average loan-to-value ratio of 94%. That is an average downpayment of just 6%. Also, 46% of home purchases in 2006 had combined loan-to-value ratios of 95% or higher (Credit Suisse, 2007). Lenders used to require downpayments because they demonstrated the borrower’s ability to save. At one time, having the financial dicipline to be able to save for a downpayment was considered a reliable indicator as to a borrower’s ability to make timely mortgage payments. Once downpayments became optional, a whole group of potential buyers who used to be excluded from the market suddenly had access to money to buy homes. Home ownership rates increased about 5% nationally due in part to the elimination of the downpayment barrier and the expansion of subprime lending.
**Equity Components**

In simple accounting terms, equity is the difference between how much money is owed on it (Equity – Assets – Liabilities). People who purchase real estate use the phrase “building equity” to describe the overall increase in equity over time. However, it is important to look at the factors which either create or destroy equity to see how market conditions and financing terms impact this all-important feature of real estate. Equity can be broken into several component parts: Initial equity, financing equity and speculative equity. Initial equity is the amount of money a purchaser puts down to acquire the property. Financing equity is the gain or loss of total equity based on the decrease or increase in loan over time. Inflation equity is the increase in resale value due to the effect of inflation. This kind of appreciation is the “inflation hedge” that provides the primary financial benefit to home ownership. Finally, there is speculative equity. This is the fluctuation in equity caused by speculative activities in a real estate market. This can cause wild swings in equity both up and down. If life’s circumstances or careful analysis and timing cause a sale at the peak of a speculative mania, the windfall can be dramatic. Of course, it can go the other way as well. If a house is purchased at its fundamental valuation where the cost of ownership is equal to the cost of rental using a conventionally amortized mortgage with a downpayment, the amount of owner's equity is the combination of the above factors.

**2.2 Fundamental Valuation of House**

The fundamental value of all housing prices is equivalent to rental income. Rental income determine the fundamental value of real estate because rental is a direct proxy for ownership: both rental and ownership provide for possession of property. Equivalent rents are a major component of the Unites States Government’s Consumer Price Index (CPI). According to the US Department of Labor, “This approach measures the change in the price of the shelter services provided by owner-occupied housing. Rental equivalence
measures the change in the implicit rent, which is the amount a homeowner would pay to rent, or would earn from renting, his or her home in a competitive market. Clearly, the rental value of owned houses is not an easily determined dollar amount, and Housing survey analysts must spend considerable time and effort in estimating this value. “Prior to the first California housing bubble in the late 1970’s, the housing cost component of the CPI was measured using actual price changes in the asset. When this bubble created an enormous distortion in the index, the rental equivalence model was constructed. It has been used to smooth out the psychologically-induced housing price bubbles ever since. The argument can be made for the real cost of construction as the fundamental valuation of houses. If house prices in a market fall below the cost of new construction, no new houses will be built because a builder cannot make a profit. If there is continuing demand for housing, the lack of supply will create an imbalance which will cause the price to increase. When new construction becomes profitable again, new product will be brought to the market bringing supply and demand back into the balance. If demand continues to be strong, builders will increase production to meet this demand keeping prices near the real cost of construction.

Based on theory of rational market participants, William Fleckenstein (Jan. 16, 2008) one would expect that when prices go up and the cost of ownership exceeds the cost of rental, people choose to rent rather than to own, and the resulting drop in demand would depress home prices: The inverse would also be true. Therefore, the proxy relationship between rental and ownership would keep home prices tethered to rental rates. However, this is not the case as there were only a consumptive value to real estate, the cost of ownership and the cost of rental probably would stay closely aligned; however, since there is an opportunity to profit from speculative excesses in the market; rising prices can lead to irrational exuberance as buyers chase speculative gains.

Ownership Cost Math

A useful way to look at the cost of housing is to evaluate the total monthly cost of ownership. There are 7 costs to owning a house. Although some of these
costs are not paid on a monthly basis, they can be evaluated on a monthly basis with simple math. These costs are:

1. Mortgage Payment
2. Property taxes
3. Homeowners insurance
4. Private Mortgage Insurance
5. Special Taxes and Levies
6. Homeowners Association Dues or Fees
7. Maintenance and Replacement Reserves

**Mortgage Payments**

The mortgage payment is the first and most important obvious payment because it is the largest. It is also an area where people take risks to reduce the cost of housing. It was the manipulation of mortgage payments that was the focus of the lending industry “innovation” that inflated the housing bubble. The relationship between payment and loan amount is the most important determinant of housing prices. This relationship changes with loan terms such as the interest rate, but it is also strongly influenced by the type of amortization, if any. Amortization loans, loans that require principal repayment in each monthly payment, finance the smallest amount. Interest only loan terms finance a larger amount than amortizing loans because none of the payment is going toward principal. Negatively amortizing loans finance the largest amount because the monthly payment does not cover the actual interest expense.

**Property taxes**

Property taxes have long been a source of local government tax revenues. Real property cannot be moved out of a government’s jurisdiction, and values can be estimated by an appraisal, so it is a convenient item to tax. In most US states, local and governments add up the cost of running the government and
divide by the total property value in the jurisdiction to establish a millage tax rate. California is forced to things differently by Proposition 13 which effectively limits the appraised value and total tax revenue from real property. Local governments are forced to find revenue from other sources. Proposition 13 limits the tax rate to 1% of purchase price with a small inflation multiplier allowing yearly increases. The assessed value is set to market value when the property is sold. Often the lender will compel the borrower to value when the property is sold. Often the lender will compel the borrower to include extra money in the monthly payment to cover property taxes, homeowners insurance, and private mortgage insurance, and these bills will be paid by the lender when they come due. If these payments are not escrowed by the lender, then the borrower will need to make these payments. The total yearly property tax bill can be divided by 12 to obtain the monthly cost.

**Homeowners Insurance**

Homeowners insurance is almost always required by a lender to insure the collateral for the loan. Even if there is no lender involved, it is always a good idea to carry homeowners insurance. The risk of a loss from damage to the house can be a financial catastrophe without the proper insurance. A standard policy insures the home itself and its contents. Homeowners insurance is a package policy which covers both damage to property and liability or legal responsibility for any injuries and property damage by the policy holder. The most significant exceptions are damage caused by floods, earthquakes and poor maintenance.

**Private Mortgage Insurance**

Mortgage against real property take priority on a first recorded, first paid basis. This is known as their lien position. This becomes very important in instances of foreclosure. The first mortgage holders get paid in full before the second mortgage holder get paid and so on through the chain of mortgages on a property. In a foreclosure situation, subordinate loans are often completely wiped out, and if the loss is great enough, the first mortgage may be imperiled. Because if this fact, if the purchase money mortgage (first lien position) exceeds
80% of the value of the home, the lender will require the borrower to purchase an insurance policy to protect the lender in event of loss. This policy is of no use to or benefit to the borrower as it insures the lender against loss. It is simply an added cost of ownership. Many of the purchases transactions during the bubble rally had an 80% purchase money mortgage and a “piggy back” loan of up to 20% to cover the remaining cost. These loans are often referred to as 80/20 loans, and they were used primarily to avoid private mortgage insurance. There were very common during the bubble.

Special taxes and Levies

Several areas have special taxing districts that increase the tax burden beyond the normal property tax bill. Many states have provisions which allows supplemental property tax situations. The State of California has Mello Roos fees. A community Facilities District is an area where a special tax is imposed on those real property owners within the district. This district is established to certain public financing through the sale of bonds for the purpose of financing certain public improvements and services. These services may include streets, water, sewage and drainage, electricity, infrastructure, schools, parks and police protection to newly developing areas. The taxes paid are used to make the payment of principal and interest on the bonds.

Homeowners Association Dues and Fees

Many modern planned communities have homeowners associations formed to maintain privately owned facilities held for the exclusive use of community residents. These HOA’s bill the owners monthly to provide these services. They have foreclosure powers if the bills are not paid. It is given the authority to enforce the covenants, conditions, and restrictions (CC & R’s) and to manage the common amenities of the development. It allows the developer to legally exit responsibility of the community typically by transferring ownership of the association to the homeowners after selling off a predetermined number of lots. Most homeowners’ associations are non-profit corporations and are subject to state statutes that govern non-profit corporations, and homeowners’
associations. In cases where a large number of houses are unsold, in foreclosure, or are owned by lenders, remaining homeowners may encounter large increases in assessments. In some cases, the additional cost can become unaffordable to remaining homeowners pushing more of them to sell or be foreclosed on by their own homeowners association.

2.3 The Credit Bubble

The devastation in the real estate market was not really about housing; it was more about credit. Most financial bubbles are the result of an expansion of credit, and this real estate downturn was no exception. Housing just happened to be the asset class in to which this capital flowed. It could have been stocks or commodities just as easily, and if the government gets too aggressive in its action to prevent a collapse in housing prices, the liquidity yet another asset price bubble. The root of the real estate downturn can be tracked back to four factors:

1. Separation of origination, servicing, and portfolio holding in the lending industry.

2. Innovation is structured finance and the expansion of the secondary mortgage.

3. The lowering if lending standards and the growth of subprime lending

4. Lower FED funds rates as an indirect and minor force.

The Federal Home loan Mortgage Corporation, also known as Freddie Mac, was created in by Congress in 1970 to make possible a secondary mortgage market to provide greater liquidity to banks and other lending institutions to facilitate home mortgage lending. The Federal National Mortgage Corporation, as knows as Fannie Mae, was originally created by the Federal Housing Authority (FHA) in 1938. In the beginning, Fannie Mae would securitize FHA loans, and it was the first to create a secondary mortgage market. In 1968, the company was privatized to remove its debt from the balance sheet of the Federal Government. Fannie Mae’s role in purchasing FHA loans was replaced by the Government National Mortgage Association, also known as Ginnie Mae. Both Freddie Mac and
Fannie Mae are private corporations that have the implied backing of the Federal Government even though their activities are explicitly not guaranteed (until they were taken into conservatorship in September 2008). Collectively Freddie Mac and Fannie Mae and Ginnie Mae are known as Government Sponsored Entities or CSE’s, and they are responsible for maintaining a secondary market for mortgage backed securities.

Fannie Mae and Freddie Mac buy and sell mortgages loans to create a secondary market. Mortgage originators bring groups of loans to the two companies which will either buy the loans to hold in their own portfolio, or they will bundle these loans together into securities in a process known as a “swap”. In a swap program, the originator provides the group of loans, and Fannie Mae and Freddie Mac promise the originator they will receive payments from the pool-whether Fannie Mae and Freddie Mac receive said payments on not. This guarantee is tantamount to insurance as the two companies are taking on all the risks of default for a small annual “guarantee fee”, usually they equal to 20 basis points (0.2% of the guarantee amount). Fannie Mae and Freddy Mac have strict loan origination guidelines because of the insurance they are providing. In the terms of the mortgage industry, “conforming” loans are those loans which meet the underwriting standards of Fannie Mae and Freddy Mac. In the later stages of the great rally in the Great housing bubble, more and more mortgage loans were being originated that did not conform to Fannie Mae’s and Freddie Mac’s standards. The asset-backed securities (ABS) market packages these non-conforming loans into collateralized debt obligations and garnered significant market share. Despite the their more conservative lending standard, Fannie Mae and Freddie Mac guaranteed many loans that performed poorly in the fallout of the great housing bubble. They guaranteed many exotic loan types with inflated appraisals and committed many of thee same errors as asset-backed securities (ABS) issuers during the bubble.

As the secondary mortgage markets continued to grow, lending instructions began to see the loans they originated rather than keeping them in their own portfolios. The banks began to make money by originating and
servicing loans rather than by keeping them and earning interest. This was a radical change in lending practices and incentives; lending institutions stopped being concerned with the quality of the loans because they did not keep them, and instead became very concerned with the volume of loans originated and the fees these generated. The originators were only concerned with meeting the parameters set forth by buyers of mortgage backed securities in the secondary market. When then parties purchasing these loans reduced standards to the point where everyone qualified, loan originators gave everyone loans. Lower lending standards opened the door for lenders to provide loans to those with low FIO scores in great volume: subprime borrowers. When combined with the widespread belief that home prices would never go down, the combination inflated the great housing bubble.

Subprime lending as an industry barely existed prior to 1994. There were few lenders willing to loan to people with poor credit, and there was no secondary market to purchase these loans if they were originated. The growth of subprime was the direct result of incentives brought about by the creation of the secondary market. These factors alone were not enough to create the Great Housing Bubble, but they provided the basic infrastructure to allow the delivery of capital that caused house prices to escalate. The catalyst of precipitating factor for the price rally was the Federal Reserve’s lowering of interest rates in 2001-2004. Many mistakenly believe the lower interest rates themselves were responsible by directly lowering mortgage interest rates. This is not accurate. Mortgage interest rates declined during this period, and this did allow borrowers to finance somewhat larger sums with the same monthly loan payment, but this was not sufficient to inflate the housing bubble. The lower Federal Funds rate caused an expansion of the money supply, and it lowered bank savings rates to such low levels that investors sought other investments with higher yields. It was this increased liquidity and quest for yield that drove the sums of money into mortgage loans.
Systematic Risk in the Housing Market

Credit ratings and analysis of collateralized debt obligations and all structured finance products are integral to the smooth function of the secondary market for mortgage loans. A credit rating agency is a company that analyzes issuers of debt and debt-like securities and gives them an overall credit rating which measures the issuer’s ability to satisfy its debt obligations. There are more than 100 major ratings agencies around the world, thereof the largest and most important ones in the United States are Fitch Ratings, Moody's and Standard & Poor's. A debt issuer’s credit rating is very similar to the FICO score of an individual rated by the Fair Issac Corporation widely known in the United States by institutional lenders. Of greater importance to the housing market, the credit rating agencies also analyze and rate the creditworthiness of the various tranches of collateralized debt obligations traded in the secondary mortgage market.

Credit ratings are widely used by investors because they provided a convenient tool for comparing the credit risk among various investment alternatives. The analysis of risk is crucial in determining the interest rate a syndicator will need to offer to attract sufficient investment capital. From the other side of the transaction, it is important to the investor who is comparing the interest rates being offered by various investments. The ratings agencies provide this critical, third party analysis both sides of the transaction can rely upon for unbiased, accurate information. When the agencies are doing well, there is greater efficiency in capital markets as syndicators of securities are obtaining maximum market values, and investors are minimizing their risks. This efficiency in the capital markets leads to better resource utilization and stronger economic growth.

Unfortunately for many investors in collateralized debt obligations during the great housing bubble, the ratings agencies did not provide an accurate or credible rating of many collateralized debt obligations tranches. When the housing market pricing declined, many collateralized debt obligations tranches were subsequently downgraded. In defense of the agencies, they were providing
an analysis of risk based on existing market conditions. Their reports contained caveats concerning downside risks in the event market conditions changed, but this list of risks is standard in any analysis and widely ignored by investors who are counting on the rating to be a market forecasting tool rather than the market reporting too it really is. Credit rating agencies are not in the business of market forecasting or evaluating systemic risks.

There is a deeper problem with the rating agencies that began to surface in the great housing bubble. Ratings agencies used to charge investors for their risk analysis, but there was a transition to charging the issuers instead. As one might imagine, there are reports that ratings agencies were concerned if they gave collateralized debt obligation’s poor ratings, their primary source of income would go elsewhere. This puts pressure on the agencies to overlook certain problems or merely list them as footnotes to their reports rather than lower a rating due to a foreseeable contingency such as a decline in house prices.

**Mortgage Default Losses**

There is risk of loss in any investment, losses in collateralized debt obligations arise form the difference in the book value of the underlying mortgage note and the actual resale value of the collateral on the open market, if this collateral is subject to foreclosure. There is an important distinction that must be made between the default rate on a mortgage loan and the resultant loss incurred when a default occurs. High mortgage default rates do not necessarily translate into high mortgage default losses and vice versa.

Subprime loans have had comparatively high default rates since their introduction. When Subprime mortgages began to capture broader market share starting in 1994, the rate of home loans and the subsequent increases in home ownership rates put upward march, the default losses from subprime defaults began to fall because the collateral was obtaining more resale value, or was being sold by the associated high default rates, look less risky to investors because these defaults rates were not translating into default losses. At time went on and prices continued to rise, subprime lending established a track record or investor
safety which drew capital into the industry. However, since the relative safety of subprime lending was entirely predicated upon rising prices, it was an industry doomed to fail once prices stopped rising.

Taking this phenomenon to its extreme and its instability becomes readily apparent. Imagine a time when prices are rising, perhaps even due purchases by subprime borrowers, and imagine what would happen is 100% of the subprime borrowers defaulted without making a single payment. It would take approximately one year for the foreclosure and relisting process to move forward, and during that year, the prices of resale houses would have increased. When the lender would go to the open market to sell property, it would obtain enough money to pay back the loan and the lost interest so there would be no default loss. What just happened? Lenders became de facto real estate speculators profiting from the buying and selling of homes in the secondary market rather than lenders profiting from making loans and collecting interest payments. This profiting from speculators is the core mechanism that disguised the riskiness of subprime lending. When these speculative profits evaporated when prices began to decline, the subprime industry imploded and its implosion exacerbated the decline of home prices.

Resale Value Risk

The biggest risk faced by buyers of collateralized debt obligations is the default loss risk of the underlying mortgage when the collateral for the mortgage (the house) is overvalued in markets characterized by low affordability. The greatest risk of default is based on changes in the resale value of homes. All other default loss risk factors are masked when prices are increasing, and they are amplified when prices decline. Valuation risk is the ultimate synergistic factor.

There are three methods for appraising the resale value of residential real estate: The comparative-sales approach, the cost approach, and the income approach. The comparative-sales approach uses recent sales of similar properties in the market because comparable sales reflect the behavior of typical ties in the marketplace. The cost approach determines market value by
calculating the replacement cost of an identical structure plus the cost of the land or lot upon which the house would sit. The income approach determines market value by analyzing market rents of comparable properties and applies the gross multiplier of expected rents. Most lenders give the greatest weight to the comparable sales approach when establishing market value before applying any loan-to-value limitations to the loan amount. The income approach is generally only considered for non-owner occupied homes. The three-test approach to appraising market value as used during the Great housing bubble is fraught with risk and is seriously flawed.

2.4 Responsibility for the Bubble

As the author pointed out in the introduction, there are respected and well-known academics whom have pointed out that the financial crisis and the housing devastation was caused by the failure of the free market and deregulation, and not the opposite as the mainstream opinion believe. Furthermore, there are arguably a majority who believe that greed and significant government intervention also led to the housing. Steven Horwitz, from the department of economics at St. Lawrence University wrote an article in September 2008 challenging these believes. He argues that greed is a feature of human interaction, and that the issue of greed does not necessarily result in such harm and devastation especially since greed is not located in only one sector of the economy, in this case pertaining to the financial and real estate industry. After all, isn’t there plenty of greed everywhere? Firm’s objective is and has always been to seek profit, and they are seeking profit in a free market, where the institutional incentives are such that profit is available. However, regulations and policies and even the rhetoric of powerful political actors can change the incentives to profit. Regulations can make it harder for firms to minimize their risk by requiring that they make loans to marginal borrowers, meaning that those individuals with wealth and power are in a position where they are potentially able to rig a new or existing regulatory process in their favor.

In a free market environment, we are used to thinking that institutions that play to the self-interest of private actors by rewarding them for serving the
public, not just themselves. We genuinely believe that is what free markets do, and that market exchanges are mutually beneficial. When the law messes up by either poorly defining the rules or try to override them through regulations, self-interest behavior is no longer economically mutually beneficial. The private sector ends up being able to profit by serving narrow political ends rather than serving the public. These are cases when greed leads to bad consequences. This, is what lead us into the trouble with are in now, according to Steven Horwitz, and to quote further; “To call the housing and credit crisis a failure of the free market or the product of unregulated greed is to overlook the myriad government regulations, policies, and political pronouncements that have both reduced the "freedom" of this market and channeled self-interest in ways that have produced disastrous consequences, both intended and unintended.

Horwitz (2008) states that so many of us committed to free markets oppose the bailout. It is yet another example of the long history of the private sector attempting to enrich itself via the state. When it does so, there are no benefits to the rest of us, unlike what happens when firms try to get rich in a competitive market. Moreover, these same firms benefited enormously from the regulatory interventions they supported and that harmed so many of us. The eventual bursting of the bubble and their subsequent losses are, to many of us, their just desserts for rigging the game and eventually getting caught. To reward them again for their rigging of the game is not just morally unconscionable, it is very bad economic policy, given that it sends a message to other would-be riggers that they too will get rewarded for wreaking havoc on the US economy. There will be short-term pain if we don’t bailout these firms, but that is the hangover price we pay for 15! years or more of binge lending. The proposed bailout cannot prevent the pain of the hangover; it can only conceal it by shifting and dispersing it among the taxpayers and an economy weakened by the borrowing, taxing, and/or inflation needed to pay for that $700 billion. Better we should take our short-term pain straight up and clean out the mistakes of our binge and then get back to the business of free markets without creating an
unchecked Executive branch monstrosity trying to "save" those who profited most from the binge and harming innocent taxpayers in the process.

According to Horwitz, “I can ask of you is that you continue to think this through. Explaining this crisis by greed won't get you far as greed, like gravity, is a constant in our world. Explaining it as a failure of free markets faces the obvious truth that these markets were far from free of government. Consider that you may be mistaken. Consider that perhaps government intervention, not free markets, caused profit-seekers to undertake activities that harmed the economy. Consider that government intervention might have led banks and other organizations to take on risks that they never should have. Consider that government central banks are the only organizations capable of fueling this fire with excess credit. And consider that various regulations might have forced banks into bad loans and artificially pushed up home prices. Lastly, consider that private sector actors are quite happy to support such intervention and regulation because it is profitable”.

Another view pertaining to the housing bubble is from Nobel Prize winning economist Paul Krugman in his paper in the NY Times May 29, 2009, who blames lax regulation for the financial crisis. He said that unless there is an agency that has the sole responsibility of protecting consumers, we will not be immune from similar crises in future. The paper showed that unlike what some people seem to believe, the crisis was not caused by exotic financial derivatives or the greed of investment banks. Instead, it blamed simpler reasons like consumer exuberance and executive incentives for the problems.

A major reason of the real estate bubble, the paper said, was that there was irrational exuberance among the consumers. Although real estate prices were already at their historical highs, people refused to believe that prices could fall significantly. This led to continued demand for property, further inflating the bubble. And when the nasty price shocks came, most people were taken by a surprise. At the same time, there was too much cheap money in the system. The
interest rates were low, and the Chinese were practically funding U.S. consumer demand by buying treasury bonds.

The paper also highlighted the fact that most bank executives had no incentive to be risk averse. When things were good, they made huge bonuses, and when things went horribly wrong, they still got their bonuses – though a little lesser than before. It meant that there was no penalty for making bad decisions, while if their actions were proved right, they could take home astronomical amounts. However, the most important reason that the paper cited, was that there was no one looking after the consumers. There is currently no central consumer protection body to oversee the acts of large banks. The Fed is supposed to keep a check on the system, but it already has too many other responsibilities like interest rate decisions. Krugman argued that it is very important to have such an agency that has only one responsibility – to look after the interests of the consumers. The need for a consumer protection agency has also been felt by the Obama administration, which had initially showed some intent of bringing in legislation for its creation. But with constant opposition from some lawmakers, especially from the Republicans, those proposals seem to have been nipped in the bud.

Another view is shared by one of my interviewees, and represents the mainstream opinion about causes of the bubble. The Federal government realized this basic fact years ago when they passed predatory lending laws. This does not make the borrower any less responsible, but by definition, subprime borrowers are irresponsible. If they took responsibility for their debts, they would not be subprime. So, if large amount of money is lent to their most irresponsible among us, it is reasonable to expect them to spend it irresponsibly and no worry about paying it back. In this case, past performance is an indicator of future performance. It should come as no surprise that the subprime experiment ended badly.

Despite the low expectations of subprime performance, people need to be held accountable for their actions. It seems our entire culture is based on having
victim status and being irresponsible. Borrowers should not be bailed out by
government program as it would create more dependence and greater risk
taking. People who paid too much and cannot pay it back have to be allowed to
loose their homes. That is life. The responsible should not pay to subsidize the
irresponsible. This is one of those instances where irresponsible will be made to
take responsibility.

As stated by one of the subjects, mortgage lenders provide a service
because without them most people would be dead but the time they had saved
enough money to buy a home for cash. However, when lenders start handing out
home equity lines of credit for consumption, they are as bad as the credit card
issuers preying on people's reckless irresponsibility. Once mortgage lenders
crossed that line, they ceased to be serving the needs of homebuyers and instead
began serving the wants of the credit addicted: shame on them.

Of course, none of this would have happened without the
contributions of the enablers at the Federal Reserve and on Wall Street. The
Federal Reserve lowered rates and the Alan Greenspan told borrowers to take
out adjustable rate mortgages under certain circumstances. As one might
suspect, he did this so his fellow bankers would not be stuck with low-interest
rate loans for 30 years, but he gave the world of homebuyers the green light for
taking on high risk loans. The Wall Street investors, flooded with liquidity from
cheap money from home and overseas, started chasing returns. High-interest,
subprime loans looked attractive, and as long as house prices went up and
nobody defaulted, everything was fine. Who is to blame for that situation? The
Bank of Japan for creating the carry trade? The Federal Reserve for lowering the
interest rates to avoid a recession? The financial wizards who invented
collateralized debt obligations? The ratings agencies who labeled these
investments “AAA”. The investors who were chasing high yields? Or all of them?

The borrowers are certainly at fault; if for no other reason than they
signed the papers and took the money. The lenders are also at fault because they
should have known better than to give borrowers loans they could not afford,
provide loans with no income documentation, and ignore proven guidelines for
loan-to-value and debt-to-income. Lenders simply cannot abdicate responsibility in this matter for financial, legal and moral reasons. The Federal Reserve and Wall Street investors are also at fault for creating the situation and enabling this to occur. In the end, all the responsible parties were ruined: borrowers lost their houses and went bankrupt, lenders like New Century went out of business and/or lost billions, Wall Street investors shared in the losses with the largest, most painful financial bubble in history. In assigning responsibility, it is also important to recognize that many innocent people were victims of the housing bust: children of the overleveraged and dishonest, neighbors of homes with dead lawns and graffiti, taxpayers whose money was used in a bailout, responsible depositors who have to endure returns less than the rate of inflation, condo owners who have to pay the gap left in condo dues on foreclosed units, government employees who were hired in the optimism of rising budgets who are now laid off when tax revenues decline, and bubble buyers who were not motivated by speculative gains but merely looking to shelter their family. The decline of house prices punished sinners and saints alike.

The real estate bubble was a credit bubble. It was enabled with the widespread use of structured finance and collateralized debt obligations, and it was inflated by the irrational exuberance of buyers. The infrastructure for delivering capital to inflate the bubble was put in place years prior with the development and evolution of the secondary mortgage market. The system for delivering capital was greatly enhanced by the creation of collateralized debt obligations. Errors in the evaluation of risk to mortgage capital caused money to flow into this market that should have been invested elsewhere. The freedom of capital inflated the real estate bubble.

2.5 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. 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 regulations.

**Economic problems**

The foremost challenge posed by the deflation of the real estate 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 was not what made the great depression so severe. The policies responding to the upheaval caused many banks to fail, and is was the failure of banks that led to the great the dramatic decline in business activity and asset deflation of the great depression. To prevent a repetition of those problems, Congress passed a number of banking 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 from decimating US's banking system. Since the FDIC has been in effect, mass depositors withdrawals at American banks have been relatively uncommon. Just as the deflation of the stock market asset bubble of the great depression endangered the banking system, the deflation of the real estate downturn 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. (Fleckenstein, 2008). Whenever the banking system is put in jeopardy, economic growth is curtailed, and other major economic problems develop.

**Addressing the cause**

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 United States culture.

Managing the rate of home ownership is analogous to managing the rate of economic growth. It is not 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 or 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.

There is a percentage of the population who does not want or can’t afford the responsibilities of home ownership that go beyond monthly payments. There are some people who simply do not make housing payment on a consistent basis. 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 in the end of the 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% (Fleckenstein, 2008). 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 of 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.

The housing market, which already has been battered by the worst collapse since the Great Depression, could be setting itself for another bubble, well-known economist Robert Shiller (2010) With home affordability at a 40-year high, there is "absolutely" a possibility that the housing market will face another bubble in the next five years, said Shiller, an economics professor at Yale, co-founder of Macro Markets and co-developer of the monthly Case-Shiller home price index.

"It's clearly not over yet," he said. "It's not obvious that people are really ready to spend again. That may take years to rekindle that normalcy." With the exception of a government-injected stimulus, the Great Depression draws a strong corollary to today’s market, and Shiller fears it will struggle through a similarly slow recovery, he said. Though the stock market doubled in 1933 and rallied for about four years, unemployment numbers continued to sag and the economy didn’t return to prosperity.

"That's what I worry could happen," Shiller said. "We'll have a recovery and it will be exceptionally weak for years to come."

3. Research Methodology

This methodological chapter was designed to spell out the process of how the research has been planned and realized. It is divided into four parts. First it explains the objective and sub-objectives of the study. The second part consists of the methods. The third chapter consists of procedure and the last chapter will give an overview about the used sources of evidence as well as describing how
the data were collected. Finally, the last chapter will describe the evaluation process.

3.1 Objective: The overarching purpose of this study is to investigate the opinions and beliefs of the leaders and drivers within the real estate industry about the cause of The Great housing bubble that occurred in the United States/Southern California. Specifically, the project will focus on the opinions of real estate investors who worked in the center of the subprime universe located in Southern California.

Sub objectives/Sub hypothesis: (specifically, these are the reasons why the bubble occurred) I hypothesize that leaders in the real estate industry will report that The Great housing bubble occurred for some very specific reasons, namely:

1. Overeager buyer/unrealistic expectations: At one point, it was hard to buy a house unless you had good credit. At the very beginning of the housing boom, lenders changed all of that, making it easy for risky borrowers to get a 'subprime loan'. The banks loaned money recklessly because they made lots of money by charging borrowers higher interest and were able to transfer the risk onto organizations like Fannie Mae and buyers of mortgage backed securities.

2. Loose Credit Regulations: Fixed rate loans used to be the loan of choice for most homebuyers. The problem was that many borrowers didn't qualify for these loans because they couldn't afford the loan payments. Lenders found a way around this by offering new mortgage products like interest-only loans and ARM loans with exotic features, which had lower initial payment than the traditional 30-year fixed. These products allowed borrowers to qualify for huge loans they had no business getting and no way of affording once the interest only period was over or once the rate adjusted.

3. The Federal Reserve: In order to prevent the internet/tech bubble from dragging the entire economy into the toilet, the Federal Reserve began to lower interest rates. They dropped rates to historically low levels, and everyone used this action as an indicator that it was a good time to buy a house. In reality, all the
Fed did was create a new bubble in their eagerness to escape the bursting of the dot.com bubble.

3.2 Methods

Participants will include 13 real estate experts whom have lived in Southern California before, during and after the housing crisis. The subjects range in age from 31 to 58 and are all male. The Participants are key performers related to the real estate industry in Southern California such as leaders and drivers from the private and public real estate developers, financial lenders, real estate brokers, real estate landowners and investors. Participants are relevant, credible sources in the real estate industry with most positions ranging from CEO, Principal and/or senior positions within their respective firms focused on the geographical area of Southern California.

3.3 Procedure

To test the study hypotheses, participants will complete a 13 question/survey will be based on open-ended questions, and the answers will then be interpreted and presented by the author regarding what were the main causes for the real estate collapse. The research is comparative and will focus on finding differences existing research investigating the causes of the housing bubble to determine whether the opinions of this sample are consistent or inconsistent with the finding of the mainstream beliefs. As much as possible, the interviews will try to enrich and enlighten some of these findings. The interviews are to be seen as supplementary to the core literature research.

3.4 Data collection

As for data collection methods, the research will be made up of critical analysis of existing literature, complemented by qualitative analysis of interviews of thirteen “real estate experts” in California. The questionnaire can be found in the appendix. These methods were adopted because they fit best for
the research objective. The interviews were all in-depth and face-to-face. All analysis is qualitative and interpretive. Caution was taken in order to phrase the questions in the best possible way as to avoid confusion and in order to stay as straight to the point as possible. The interviews were recorded and later written down word by word. This material can be found in the appendix of this thesis.

All questions were the same and were given in the same order. The questions were all read exactly as they are written on the questions sheet (see appendix A). Most of the interviews where done at an office, café or similar, always in a “neutral” location. The interviews were usually done in 20-30 minutes, and a tape recorder was used so that the interviews could be written down word by word at a later time.

Strength associated with using interviews as evidence is the fact that they are targeted and focus directly on the case study topic. Interviews can also be insightful, as they provide perceived causal inferences. On the other hand weaknesses associated with interviews are that they can be biased (for example due to poorly constructed questions), there can be a response bias or inaccuracy due to poor recall or just plan reflexivity where the interviewee just replies what interviewer wants to hear. Also, there is a chance that interviewees might feel uneasy about the anonymity of their responses when they interact in face-to-face interviews.

3.5 Limitations

Limitations for the research methods used in the project are for example the fact that perceptions are, by definition, personal and subjective and the interviewees may provide information that is not applicable for the larger population and only relates to him/her specifically. All the interviewees were only male. All the subjects are live, work and are raised in California, thus they are naturally exposed to the California real estate market in greater extent than the events covering the rest of the United States. In addition, most of the interviewees are considered to be very successful entrepreneurs, particularly up
until 2007, and several of them originate from large and well know real estate families with long background within the real estate industry in California.

3.6 Discussion/Data Presentation

This chapter will start by giving some general information on the interviewees. Then the questions and the responses will be presented on a question-by-question basis.

The interviewees are all American men born in the U.S. and Middle East, whom have lived most of their lives in the State of California. Most of the subjects are owners of large residential real estate companies. Two of the subjects are owners of small to medium lending corporations, and three subjects are former land brokers. One is a business and political consultant in Orange County, California. They have all lived and breathed the tremendous rise in the real estate cycle, and the crash. The questions (see appendix) are 13 in total and the number of interviewees is 13 in total. The questions are related to 5 overall topics that have been chosen by the thesis author. These topics are “lack of regulatory oversight”, “Fed’s impact”, “Rating agency’s impact”, “Homebuyers responsibility”, “Freddie & Fannie Mae’s impact”.

4.1 Question 1 - How much impact did the Fed’s policies have on the real estate bubble?

Every single interviewee thought the Fed’s policy and specifically, former Fed Chairman, Alan Greenspan’s policy to keep the interests rate low for a long period of time was the most significant reason. A few of the subjects stated that was the primary reason for the crash. As a result of the Fed’s low interest policy, many fewer people would’ve been aggressive in the home-buying market, housing prices would’ve stayed much more in line with historical norms (in price/income terms), far fewer new homes would’ve been built, and far fewer mortgages would have gone south.
4.2 Question 2 - How much impact did Freddie and Fannie Mae policies have on the real estate bubble?

Also on this question, there was unanimous agreement that both Fannie Mae and Freddie, both created by the government gave a false sense of security to its potential consumers. Since everyone so to speak started qualifying for loans, the market did not adequately account for the risk of recession. Some of the subjects did not think that Freddie and Fannie Mae were the core of the problem, but certainly a big part of it, and went a very long way towards extending the timeline of the bubble, and increasing the severity of the fall. Due to the rapid demand for housing Freddie and Fannie were also able drive up the housing prices as well as incentive sing investors to buy 2nd home and investment homes.

4.3 Question 3 - To what degree did lawmakers’ lack of regulatory oversight and management of the lending community impact the continuation/expansion of the real estate bubble?

Many argue that the lack of oversight was the main reason for the housing bubble. As we saw in the attention and answers from the subjects, the lack of regulatory oversight were in their mind arguably the most significant reason for the housing bubble. As one subject put it, “allowing unregulated mortgage back securities to be packaged and sold to unsuspecting buyers was eventually the straw the broke the camels back”. Almost all the subjects raised attention to the fact that the housing laws which were passed many years ago were well meant, and in the beginning had a positive effect, but lenders very quickly realized they were able to sell these loans to borrowers who were unable to service the debt. These loans were then aggregated into AAA papers and sold on the open market. As one subject explained, “the investment banks and foreign investors were buying this paper, which was rated AAA simply because it was made up of government-backed loans and originated by big consumer banks. It’s not that lawmakers could have changed everything with legislation, it’s that they could
have called Fannie to accountability for delinquencies MUCH sooner than they did, and that might have blunted the sheer volume of bad debt problems investors faced later”. Another interviewee stated that one can look at is as misguided interactions between the government and the market.

4.4 Question 4 - How big of an impact did the rating agency system have?

This question raised one of the largest responses from the interviewees. The rating agencies had a crucial impact on the housing bubble according to almost all the subjects. One subject clearly thought that the Fed policies and Congress (with lack of oversight) were clearly the number one contributor to the real estate bubble, although the same subject voiced the lax of real estate debt securities which led to allot of easy money. Another subject stated that is tremendous amounts of loans were sold to overseas investors until the true quality became apparent by default levels rising and investor demand declining. We were able to witness numerous examples of how investors and institutions outside the United States were thus affected by the events in the United States. Another subject stated that the rating agencies were only doing their job, but since the rating agencies were paying paid to rate securities by the people who were scrutinizing the loans. The following subject stated an appropriate summary: “The entire system, starting with government induced environments, became irrational. Rating agencies weren’t clear headed because no one else was. The "irrational exuberance", to borrow a phrase, was endemic”.

4.5 Question 5 - What percentage of home purchasers were speculators, and did the have unrealistic expectations?

On this question, the answers were quite mixed. Some of the subjects responded by guessing that between 10 – 15 percent of the home purchases were speculative. Other interviewees thought the number was closer to 50%, and especially concentrated on four particular states. California, Florida, Nevada and Nevada. Almost everyone agreed that homebuyers had unrealistic expectations. Like one subject stated that the irresponsibility did not seem irresponsible for
many people, since everyone who wanted to buy a sensible house and use traditional financing looked like a fool. This notion also includes the author.

4.6 Question 6 - How much at fault was the consumer (homebuyer) and their willingness to accept financing that their incomes would perhaps not support?

The underlying response from all the subjects is that all past, current and future homeowners are responsible for their debt and understanding to terms of their loans and the math. A couple of the subject mentioned that though the government put in the tools, and some incredible sales pitches by the real estate agents led consumers to push the bottom, and would take the client to a different loans officers or lender if one would not give them the loan. At the end of the day, the responsibility lies with the purchaser.

4.7 Question 7 - What is the reasonable amount of leverage in the system, and where should checks and balances be focused? (Since there was so much leverage on the builder’s side, was the entire system too leveraged?)

This question was a very objective question to pose, and none of the subjects had a specific answer, except for one subject (80/20) leverage, as there is no accurate formula or math to determine what is an appropriate level. One subject thought that we should go back to the old idea that when a household should only qualify for a mortgage if their pre-tax income represents at least 32% (roughly) of the price of the home. Another interviewee appropriately stated, ”I don't know what the right amount of leverage is. Furthermore, I don't know how to figure it out. Because it's really easy to say that the consumer should be the responsible one that puts a lot of money down and 'vests' himself in the home, but homebuilders also stretched their leverage to the breaking point and frankly the builders let them do it because otherwise, the builders would have gone to other lenders. So the drive of banks to lend money at increasingly high leverage points also pushed them into risky territory".
4.8 Question 8 - How much of a factor were abnormally low deposits/down payments role on the consumer side of the real estate bubble?

All subject stated that low deposits/down payment were one of the most significant factors, but that is did exaggerate the problem. Furthermore, several few subject stated that even a 5 or 10% deposit in enough is far too less of a deposit, and may leave to much exposure to market swings and too little protection against loss of jobs and income. As one interviewee stated, “Individuals didn’t have skin in the game. The thinking was easy money when the reality is buying something like a home is and should be a large commitment”. However, as one subject stated, “Obviously the more down the less likely someone is too walk away. However with the market going down 30 to 40 percent in many markets, I don’t think larger down payments would done much to slow the foreclosure rate”.

4.9 Question 9 - What state of life is homeownership appropriate? Should someone coming out of college be able to purchase a home? (Traditionally, parent’s gifts and substantial savings were required to afford a down payment)

In an attempt to find out at what state of life is home ownership appropriate, most of the subject answered that responsibility was the most significant factor. With responsibility comes common sense as in a stable career, enough money to put down a significant deposit, creditworthiness. All subjects agreed that the stage of life is not as important as the stage of your bank account, and they are in a state of life to purchase a home.

4.10 Question 10 - What policies are needed to stabilize the housing market for long-term stability?
Some common answers and policies were reinforced by almost all the subjects. These policies included everything from requiring full disclosure of the loan and its term, larger down payment requirements, stronger regulation, and lower taxes. One subject believes that to stabilize the housing market for long-term stability one needs to fix the job market. Fixing the job market requires another set of requires like a competitive tax code, manageable health care costs, lower and stable energy prices, and finding a solutions to the government debt and deficits.

As one fittingly subject stated, “Hard and fast rules regarding down payments are required. This will have the effect of keeping price increases normalized (avoiding the boom and bust of the industry), will put the weight of RESPONSIBILITY back on the individual buying the house, and will make them so vested in the home as a more important investment, that defaults would drop almost overnight. This might not seem fair to people who make very little money... but I would argue that all of the programs put in place over the past 30 years are nothing more than entitlement programs designed to put people in homes who don’t necessarily "deserve" to own homes”.

4.11 Question 11 - What is the role of the Fed in managing the housing markets (Does the government have the right to essentially force home ownership)?

The answer to this question resulted in allot of different opinions. Some subjects clearly thought that the government are and were over involved, by providing loose lending policies which many say triggered the devastation of the housing bubble. Other subjects stated that the government should not be setting policies that artificially let people own homes. Several of the subjects clearly differentiated between encourage home ownership vs. forcing using reasonable tools and putting programs in place for those whom want to purchase. Another interesting observation was that subject thought the government should be more active is setting up programs allowing people to rent homes, rather than putting in programs to force home ownership, which several stated should be a market
driven decision according to purchasing power and jobs. All of the subjects agreed that the government does not have the right to force home ownership.

4.12 Question 12 - What prompted the general consumer to embrace a lifestyle they could not meet? (People in the United States want bigger and more, rather than being content with what they have).

This question tried to answer if the consumer's greed played a role in the decline of the real estate market, and is so to what degree. The question was answered in several different ways, but with a common parallel. Since the United States is and has been the largest economy in the world, the interviewees felt like the cultural aspect played a major role. Individuals want bigger and better, and Media/Pop cultural in the United States help fuel that sentiment, while saving and being content with the basics are a far cry from reality. Maybe the events unfolded during the last couple of years will make people think twice, and learn what is important and at the same time behaving financially responsible.

As one subject stated, “The less responsibility people have the less responsible they will. Easy money and government intervention, and escape from consequences of mistakes all create a system where people act irrationally and irresponsibly. There was too much pressure on home ownership, too much lending to at risk borrowers, and meanwhile you have ridiculously low interest rates. Bad combinations.”

4.13 Question 13 - How much did the California real estate downturn affect the rest of the country?

The most common answers were that California did not really play a significant role in the real estate bubble. However, since the State of California represents 10% of the United States population and is arguably the 7th or 8th largest economy in the world depending on what kind of measures you choose to select, the economic environment in California has an effect on the rest of the country.
The State of California experienced more speculation and some of the sharpest price declines compared to others geographical location within the United States. Furthermore, several of the largest lending and mortgage companies are and were located in California, particularly Southern California.

5. Preliminary analysis of the research findings about the results from this questionnaire and interview will compared to existing research investigating the causes of the housing bubble to determine whether the opinions of this sample are consistent or inconsistent with the finding of the mainstream beliefs. The questions are related to 5 overall topics that have been chosen by the thesis author. These topics are “lack of regulatory oversight”, “Fed’s impact”, “Rating agency’s impact”, “Homebuyers responsibility”, and “Freddie & Fannie Mae’s impact”

5.1 What were the differences found between mainstream and subjects on the issue of lack of regulatory oversight?

Hypothesis/Main Stream opinion: Fixed rate loans used to be the loan of choice for most homebuyers. The problem was that many borrowers didn’t qualify for these loans because they couldn’t afford the loan payments. Lenders found a way around this by offering new mortgage products like interest-only loans and ARM loans with exotic features, which had lower initial payment than the traditional 30-year fixed. These products allowed borrowers to qualify for huge loans they had no business getting and no way of affording once the interest only period was over or once the rate adjusted.

Based on the responses to question number 3 (lack of regulatory oversight) almost all subjects argued that the lack of oversight was the main reason for the housing bubble. As we saw in the attention and answers from the subjects, the lack of regulatory oversight were in their mind arguably the most significant reason for the housing bubble. As one subject put it, “allowing
unregulated mortgage back securities to be packaged and sold to unsuspecting buyers was eventually the straw the broke the camels back”.

Almost all the subjects raised attention to the fact that the housing laws which were passed many years ago were well meant, and in the beginning had a positive effect, but lenders very quickly realized they were able to sell these loans to borrowers who were unable to service the debt. These loans were then aggregated into AAA papers and sold on the open market. As one subject explained, “the investment banks and foreign investors were buying this paper, which was rated AAA simply because it was made up of government-backed loans and originated by big consumer banks. It's not that lawmakers could have changed everything with legislation, it's that they could have called Fannie to accountability for delinquencies much sooner than they did, and that might have blunted the sheer volume of bad debt problems investors faced later”. Another interviewee stated that one can look at is as misguided interactions between the government and the market.

Comparing the mainstream beliefs with the interviewees it is fair to say that the main finding in the mainstream beliefs are reflected very well with the finding of the subject's opinion.

5.2 What were the difference found between mainstream and subjects regarding the rating agency’s impact on the real estate bubble?

The author found no significant opinions differences with regards to credit ratings between mainstream and interviewees. The common belief is that the major credit rating agencies were significant contributors to the housing bubble and subsequent financial collapse. The rating agencies are suppose to be in the business of providing financial markets with objective and accurate appraisals as to the risk associated with purchasing any financial instrument. Instead, they consistently delivered overly optimistic assessments of assets that either carried high, or at the very least, highly uncertain risks.
5.3 What were the difference found between mainstream and subjects regarding The Federal Reserve's impact on the real estate bubble?

The Federal Reserve, in order to prevent the internet/technology bubble from dragging the entire economy into the toilet, began to lower interest rates. They dropped rates to historically low levels, and everyone used this action as an indicator that it was a good time to buy a house. The Federal Reserve's policy of keeping interest rates unusually low made property investments more attractive and the cost of financing homeownership cheap, pushing up the price of housing. Higher interest rates work to depress the price of housing. The mainstream beliefs are reflected very well with the finding of the subject's opinion.

5.4 What were the difference found between mainstream and subjects regarding Freddie & Fannie Mae's impact on the real estate bubble?

Misguided government efforts to promote homeownership were largely to blame for the bubble. 1992 legislation required the government-backed mortgage investors Fannie Mae and Freddie Mac to guarantee more loans for people with shaky credit and an inability to make substantial down payments. That legislation also created a weak regulator for Fannie and Freddie. The implementation of these regulations did not take full effect until early 2000. The mainstream beliefs are reflected very well with the finding of the subject’s opinion.

However, there are some disagreement and some confusion regarding Fannie Mae and Freddie Mac's transparent purposes. As Steven Hortwitz (2008) stated, "Fannie Mae and Freddie Mac are "government sponsored enterprises". Though technically privately owned, they have particular privileges granted by the government, they are overseen by Congress, and, most importantly, they have operated with a clear promise that if they failed, they would be bailed out. Hardly a "free market." All the players in the mortgage market knew this from early on. In the early 1990s, Congress eased Fannie and Freddie's lending requirements (to 1/4th the
capital required by regular commercial banks) so as to increase their ability to lend to poor areas.

5.5 What were the difference found between mainstream and subjects regarding Homebuyers responsibility on the real estate bubble?

It was completely their fault, but at the same time not. The fact that the government was so irresponsible to give ignorant people money is pretty infuriating, but people being so ignorant to not understand their responsibilities is also a major problem. Each individual is 100% responsible for their own actions (and subsequent loan default), but they should have never even had the opportunity to borrow in the first place. Bottom line and what both mainstream and interviewees agree upon is that homeownership is best suited to individuals that are making the decision based on lifestyle factors and ability to pay, rather than as a financial investment.

6. Concluding remarks, personal opinion and suggestions for measures needed to stabilize the real estate market.

The purpose of this study is to investigate the opinions and beliefs of the leaders and drivers within the real estate industry about the cause of The Great housing bubble that occurred in the United States/Southern California. The author outlined some a few objectives which represented the views and beliefs of the mainstream real estate expects, academics and well known leaders within the real estate industry of the causes of the real estate bubble. A few common reasons were the following:

1. Reasons such as overeager buyer/unrealistic expectations: At one point, it was hard to buy a house unless you had good credit. At the very beginning of the housing boom, lenders changed all of that, making it easy for risky borrowers to get a 'subprime loan'. The banks loaned money recklessly because they made lots of money by charging borrowers higher interest and were able to transfer the
risk onto organizations like Fannie Mae and buyers of mortgage backed securities.

2. Loose Credit Regulations: Fixed rate loans used to be the loan of choice for most homebuyers. The problem was that many borrowers didn’t qualify for these loans because they couldn’t afford the loan payments. Lenders found a way around this by offering new mortgage products like interest-only loans and ARM loans with exotic features, which had lower initial payment than the traditional 30-year fixed. These products allowed borrowers to qualify for huge loans they had no business getting and no way of affording once the interest only period was over or once the rate adjusted.

3. The Federal Reserve: In order to prevent the dot.com bubble from dragging the entire economy into the toilet, the Federal Reserve began to lower interest rates. They dropped rates to historically low levels, and everyone used this action as an indicator that it was a good time to buy a house. In reality, all the Fed did was create a new bubble in their eagerness to escape the bursting of the dot.com bubble.

To test the study hypotheses, participants will complete a 13 question/survey will be based on open-ended questions, and the answers will then be interpreted and presented by the author regarding what were the main causes for the real estate collapse. The research is comparative and will focus on finding differences existing research investigating the causes of the housing bubble to determine whether the opinions of this sample are consistent or inconsistent with the finding of the mainstream beliefs. As much as possible, the interviews will try to enrich and enlighten some of these findings. The interviews are to be seen as supplementary to the core literature research.

6.1 Personal Opinion:

The regulated free-market system in place at the turn of 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 inflation. 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 collapsed 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. The Author has a “universal” opinion regarding the solutions for fixing the housing bubble that go beyond specific measures discussed in this paper. People won’t buy homes if they don’t have jobs. So to fix the housing market, you have to fix the jobs market. The way to fix the jobs market is to incentives entrepreneurs to be entrepreneurs. A competitive tax code, flexible labor laws, energy prices, health care costs for individuals and employers, etc. all roll up to affect the jobs market. A step back is also necessary. Government debts and deficits are at all time highs. We can’t pay for what we’re on the books for. The entire mindset starts there and spreads to the private sector.

6.2 Suggestions for measures needed to stabilize the real estate market

The worst is over in the Grand Strand real estate market, with 2010 bringing continued sales increases and price stabilization, according to industry professionals, although there are plenty of data and opinions stating otherwise. The author believes it’s just going to be a slow uphill climb the rest of the year to and possibly several years before we get back to the levels of a balanced market. As the author stated above, while the real estate market has improved, it will not continue on that path until businesses start hiring and the double-digit unemployment rate drops. If interest rates continue to stay low and banks ease lending standards a bit, then things may look up. The only time we’re going to see a recovery in average sales price is if we get rid of the short sales and foreclosures. Author also thinks a lot of new buyers are jumping into the housing market because they think the recession has ended, and want to get in first which could derail the housing recovery.
The consensus is that the market has hit the bottom, and that is translating into more interest from potential buyers. One of the biggest remaining issues is the strict regulations buyers are facing when they try to get a loan so they can buy a property. Lenders have money to lend, not under the same scenarios that we had them two years ago, but there is money available to borrow. There will continue to be relatively strict requirements for borrowers, who must have good credit scores and a large down payment. The criteria bankers used a few years ago were obviously not strict enough, as is evident with the number of delinquencies and defaults during the past couple years.

Steven Hotwitz, in his “Open Letter to my Friends on the Left” voices an important and overall message to his audience. “Those of us who support free markets are not your enemies right now. “The real problem here is the marriage of corporate and state power. That is the corporatism we both oppose. I ask of you only that you consider whether such corporatism isn’t the real cause of this mess and that therefore you reconsider whether free markets are the cause and whether increased regulation is the solution”
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Appendix A – Interview questions

1. How much impact did the Fed’s policies have on the real estate bubble?

2. How much impact did Freddie and Fannie Mae policies have on the real estate bubble?

3. To what degree did lawmakers’ lack of regulatory oversight and management of the lending community impact the continuation/expansion of the real estate bubble?

4. How big of an impact did the rating agency system have?

5. What percentage of home purchasers were speculators, and did the have unrealistic expectations?

6. How much at fault was the consumer (homebuyer) and their willingness to accept financing that their incomes would perhaps not support?

7. What is the reasonable amount of leverage in the system, and where should checks and balances be focused? (Since there was so much leverage on the builder’s side, was the entire system too leveraged?)

8. How much of a factor were abnormally low deposits/down payments role on the consumer side of the real estate bubble?

9. What state of life is homeownership appropriate? Should someone coming out of college be able to purchase a home? (Traditionally, parent’s gifts and substantial savings were required to afford a down payment)

10. What policies are needed to stabilize the housing market for long-term stability?

11. What is the role of the Fed in managing the housing markets (Does the government have the right to essentially force home ownership)?

12. What prompted the general consumer to embrace a lifestyle they could not meet? (People in the United States want bigger and more, rather than being content with what they have).
13. How much did the California real estate downturn affect the rest of the country?
Appendix B – Interview Answers

Subject # 1: Vice President, 9 years in the real estate industry in California

1. All time lows in the fed funds rates created a loose lending framework for banking institutions.

2. Freddie and Fannie having low standards as to the quality of loans purchased created an artificial demand for mortgages.

3. Predatory lending was not addressed until two year adjustable mortgages began to roll over in 2007.

4. Bundles of loans were sold to overseas investors until the true quality became apparent by default levels rising and investors demand declined.

5. City and submarket specific but some communities were as high as 30% Bakersfield. Yes.

6. A homebuyer as well as any buyer is responsible for their debt and understanding the terms of their loan if they are not able to understand how an adjustable mortgage loan works they likely can not afford the home.

7. Yes over leveraged. 80 /20 seems appropriate

8. Large factor zero down loans set up the system to fail a slight decline in real estate values and homes are underwater and homeowners begin to walk from their investments leaving the note holders to dispose of the home on the market.

9. The Guarantor of the mortgage whether a parent or student should have 6 months of savings to cover all expenses as well as stable income to purchase a home with a loan. Age is less a factor.
10. Full disclosure of loan terms to home buyers. Larger down payment requirements with FHA financing. FHA lending is a joke and will be the next bubble to crack with a decline of home prices of 10% defaults will spike again.

11. Over involved. Assisting home buyers to purchase homes by providing loose lending policies is what started the problem.

12. It is a cultural specific pattern. Largest economy in the world, largest military power, largest net spender. If you give an American 5 dollars and tell him he can use it to borrow 100 expect the 100 to be spent.

13. California with the second largest economy in the world had an inflated affect on the country. More speculation occurred in ca and therefore more homes were purchased with easy financing. When prices declined due to a tightening of lending standards foreclosures spiked causing other homes to fall in value and reducing the availability of homeowners equity as a means of pulling cash out of a home for increasing daily spending needs.

Subject # 2: Political/Business 7rs, Consultant in California

1. A large effect. Keeping interest rates so low had the effect of individuals flooding the market, and in too many cases irrationally so.

2. A very large effect. The government gave the impression that Fannie and Freddie were "guaranteed," thereby giving a false sense of security. The false sense of security created an environment where calculated risk was absent or dangerously mitigated.

3. The aforementioned answers speak to this question. I don’t know, though, that it was a lack of oversight, per se. One could look at it as misguided interactions between the government and the market.
4. The entire system, starting with government induced environments, became irrational. Rating agencies weren't clear headed b/c no one else was. The "irrational exuberance", to borrow a phrase, was endemic.

5. I'm unfamiliar with the exact amount. But I think history shows that for those who did purchase the expectations were generally unrealistic.

6. Everyone must accept responsibility. Sure, the government helped induce a market direction and mind set, but a lot of these cases were basic math. Too many people were in homes they couldn't afford. In order to correct in the future, people must accept that mistakes were made across the board. The lesson is only learned by taking responsibility.

7. Appropriate leverage amounts differ from sector to sector. Yes, the entire system was too leveraged, but not just because of leverage on the builder side.

8. Individuals didn’t have skin in the game. The thinking was easy money when the reality is buying something like a home is and should be a large commitment.

9. When an individual has a relatively stable career, money saved up in preparation for buying a home, and low debt in general, then they are at a state of life to purchase a home. Families aren't as nuclear as they used to, therefore we're likely to see a greater necessity of individual commitments to home purchases.

10. I view this as pretty systemic. People won’t buy homes if they don’t have jobs. So to fix the housing market, you have to fix the jobs market. The way to fix the jobs market is to incentives entrepreneurs to be entrepreneurs. A competitive tax code, flexible labor laws, energy prices, health care costs for individuals and employers, etc. all roll up to affect the jobs market. A step back is also necessary. Government debts and deficits are at all time highs. We can’t pay
for what we're on the books for. The entire mindset starts there and spreads to the private sector.

11. No, they don't have a right to force home ownership.

12. The less responsibility people have the less responsible they will. Easy money and government intervention, and escape from consequences of mistakes all create a system where people act irrationally and irresponsibly. There was too much pressure on home ownership, too much lending to at risk borrowers, and meanwhile you have ridiculously low interest rates. Bad combinations.

13. A significant amount but what drew California down is largely the same attitudes and practices that drew the rest of the country down.

**Subject # 3: Principle, 18 years in the real estate industry in California**

1. Tremendous amount, this is the primary cause

2. I believe that Freddie and Fannie Mae 's policies were driven by the Fed, and subsequently the primary cause.

3. A large degree.

4. The rating agencies should have been more stringent.

5. I would estimate 10%, Max 15%. I don't think they had unrealistic expectations. They were simply taking advantage of an unsustainable market boom.

6. Absolutely, people were just too reckless.
7. I think a reasonable amount of leverage is 50%, Max 60%, but it depends on the person and family. In hindsight, yes, the system was over leveraged.

8. This was part of the problem, but not the main problem.

9. No, People need work experience and stability before purchasing a home. They should establish creditworthiness and accumulate a good cash base during this time, so they can get the best rates and have more equity (less debt) on a mortgage.

10. Lower taxes – Primary capital gains and Fed income tax.

11. Government should not be involved.

12. Pop culture and media.

13. Not much. The rest of the country is not impacted by California in my opinion; except for the divestment of capital in other states by California investors that had incurred major losses.

Subject # 4: CEO, 17 years in the real estate industry in California

1. If policies include regulations, they had a lot to do with it. Clinton’s policy of every American owning a home got way out of hand, and there were no controls. Every person qualified for a home loan, and the market didn’t adequately account for the risk of a recession. Everyone kept betting on housing inflation, and took out now loans for cars, school and play.

2. Same as number 1.
3. The lack of regulatory oversight came from lack of enforceable administrative rules and flawed policy of entitlement.

4. While the rating agencies have been scapegoats, they did not create the problem.

5. Way too many and yes. I call them the taxi cab owners – especially in Vegas, Phoenix, Florida and California. They skewed the demand curve and the market interpreted as under supply.

6. All their fault – Why wouldn’t they do it?

7. I don’t think there was too much leverage on the builders side. The builders were just reacting to a perception of undersupply. A reasonable amount of leverage is what people can afford with their current income.

8. It exacerbated the problem, but it was not the problem.

9. It depends on what type of job someone has and their resources. For some it will be appropriate, for others it will not.

10. Liquidity needs to come back into the system, especially jumbo loans.

11. The Fed should be providing a buying market for loan packages right now. Liquidity needs to be put back into the system.
12. The market allowed it, people could afford it because they were betting value increases through inflation.

13. California dominates the country. I really don’t know how that affected the rest of the country.

Subject # 5: Senior Vice President, 8 years in real estate industry in California

1. Fed policies had a huge effect on feeding and inflating the real estate bubble. Obviously there were other important factors, but if it hadn't been for the ultra-low rates Greenspan maintained for years in the wake of the dot-com crash, many fewer people would've been aggressive in the home-buying market, housing prices would've stayed much more in line with historical norms (in price/income terms), far fewer new homes would've been built, and far fewer mortgages would've gone bad. In short, the bubble wouldn't have been a bubble -- it would have just been a relatively garden-variety up-cycle, without massive negative repercussions when the music stopped playing.

2. I think Freddie Mac and Fannie Mae played important roles also, but they were minor in comparison to the Fed’s role. The erosion in lending standards was not restricted by any means to the GSEs -- it was just as bad in the case of Countrywide, Indymac, etc. And the incentives all ran the wrong way -- in favor of short-term fee-taking through securitization and OBS entities. But that's a long story...

3. See that last part of my answer in #2 above. Lax regulation played a big role. The notion of “let’s let the markets regulate themselves” is absurd on its face and brought about a very predictable cycle of excessive risk-taking -- really the privatization of profit coupled with the socialization after-the-fact of risk. And I
would add that both parties were to blame -- although the fact is the GOP held power during the worst years of the run-up to crisis and was paying literally zero attention.

4. I’m not sure the ratings agencies played a huge role in the real estate bubble/crisis per se. They clearly played a huge role in the implosion of AIG and others through the CDS markets. And indirectly their lax analysis of CDOs and other real estate-backed debt securities led to allot of easy money. So they’re absolutely culpable, but again, I think their role in the real estate crisis was relatively secondary to that of the Fed (because of easy money) and Congress (because of lack of oversight).

5. I haven’t seen any reliable stats on the percentage of speculator home buyers, and I can only speak intelligently about California, but my sense is that a very large (maybe 50%?) percentage of all buyers in the peak years of the bubble were really speculators in California. That was true not only in the metropolitan counties like LA, OC, SF, SJ, and SD, but even in the Central Valley and the far-flung areas of the Inland Empire. And yes, to say that those speculators had unrealistic expectations is an understatement. Particularly by 2005-2007.

6. I think it’s a hard question to really say how much blame individual home buyers deserve. Clearly allot of people made stupid decisions. And clearly allot of them were led into those decisions, at least in part, by some fairly deceptive sales pitches by both lenders and home builders. I tend to look at it on a case-by-case basis. Generally though, I’d say any buyers who were speculating are completely, 100% to blame for that own actions. At the same time, I think probably only 10-20% of the overall blame for the crisis itself should to home buyers as a whole.

7. Yes, the whole system was badly over-leveraged. At the home-builder level, at the lender/bank level, and at the consumer/home buyer level. I think we need to go back to the old idea that a household should only qualify for a mortgage if
their pre-tax income represents at least 32% (roughly) of the price of the house. And banks should be limited to levering up 12x or 15x, at most, instead of 30x or 40x.

8. Low down payments played a big role, especially in the new homes (home-builder) market. And I don’t just mean the insane zero-down deals or the 110% financing deals. I mean the 5% down deals and even the 10% down deals in a lot of cases. Buyers should generally have to put down 20%, period. Anything less than that leaves too much exposure to market swings and too little protection against loss of jobs/income.

9. That’s an excellent question, and one not normally posed in the debate in the US, even now. Personally, I think it should be very rare and very difficult for an individual who’s 22 years of age and just got out of school to purchase a home. The norm should be renting for at least a few years -- generally until someone gets married and starts a family. There are a whole host of reasons -- financial, maturity-based, logistical/mobility-related -- but the bottom line is I think it’s crazy that so many people in this country feel entitled to own a home at such an early stage of their adult lives. It’s a vestige of the dominant economic position America enjoyed in the world for the past 70 years, and of the legacy of almost limitless cheap land that the US has enjoyed for the past 400 years (but which is gradually coming to an end).

10. See all of my comments above. Stronger regulation, less easy money, far fewer exotic mortgages, and a lower overall homeownership rate.

11. IMO, the Fed should have no role in managing the housing market per se. The Fed should obviously set rates that are reasonable in the light of multiple variables (not just housing asset prices). And the Fed should absolutely keep close watch over the housing market for signs of frothiness. But it should not attempt, in any way, to "help" the market in the sense of pushing up prices. Steve Keen, a very sharp Australian economist, recently observed how insane it is to
try to "improve" the economy through a policy of making housing less affordable. I agree with him whole-heartedly.

12. I think Americans have always wanted bigger, better, more... It's a big country. It's still sparsely populated compared with the rest of the world (save Australia). We also got really spoiled by 70 years of lording it over the rest of the world in the wake of WWII. And our media and advertisers certainly reinforce those tendencies. Really, I think most people convinced themselves that they wanted, and deserved, more because they could. I think if people in another country were presented with the same kinds of opportunities to acquire more, more, more all the time, they'd generally do so just as Americans did. The exception, perhaps, is certain European countries which have a strong cultural memory of calamity from the two world wars and have a greater sense of shared experience and social cohesion (as well as much higher population densities).

13. I think California was important nationally, for sure. Not just because it represents over 10% of the population of the country, but because it serves as a sort of exemplar. When things starts to go wrong in California, it scares people in other parts of the country and affects their behavior. At the same time, Florida was plenty fucked without any help from California -- as were Nevada and Arizona (although allot of their problems were caused by Californians!). It's definitely true that a huge proportion of the bad paper that ended up killing AIG, Lehman, WaMu, Wachovia, and others was tied to California real estate. We were at the epicenter of it in Newport Beach, man! (along with people in Miami, Atlanta, Phoenix, and Vegas)...

Subject # 6: Principle, 12 years in the real estate industry in California

1. The Fed was fond of tinkering with financial policy during the bubble years (2000-2006). Greenspan even said he preferred small movements rapidly to large movement when you weren't sure what would happen. But the problem with small movements is they can have a large net effect over time. The smallest
rate drop or infusion of money or decrease in required reserve rates for banks doesn’t look like much if you do it once, but the Fed did a lot of follow-on changes to its policies which turned one small move (which may or may not have an effect) into the effect of a large move by having many small moves. problem was, because the changes were so small, many folks could more easily rationalize the changes (as either having no effect or being “on the way” to having a positive effect) than they would have been able to had the Fed come out with one unmistakable large policy change. So that’s the long way of saying the Fed’s policies had an oversized impact because they made changes over time in small enough doses that the regular ‘alarms’ of market forces reacting negatively to change didn’t go off.

2. Freddie’s policy of low income/no income lending and forcing banks to originate "Liar Loans" with no documentable income, went a very long way toward extending the timeline of the bubble as well as increasing the severity of the fall, when many folks who shouldn’t have been in a house anyway were able to hang on for a little bit longer before getting foreclosed.

3. Lawmakers only make laws and demand oversight when something bad happens from something they don’t understand. The low income housing laws they passed a long time ago had some positive effect in the beginning of the cycle, but the lenders quickly realized they could originate loans to bad borrowers (i define a bad borrower as someone who is unable or unwilling to service their debt), aggregate the loans into AAA paper, and sell that AAA paper on the open market. Where lawmakers have culpability is in the continuation of guaranteeing the loans that make up this AAA paper even when it was apparent that delinquencies and bad acts were becoming commonplace (happened even in 2005 when money was truly free to consumers). So the I-banks and foreign investors were buying this paper, which was rated AAA simply because it was made up of government-backed loans and originated by big consumer banks. It’s not that lawmakers could have changed everything with legislation, it’s that they could have called Fannie to accountability for delinquencies MUCH sooner than
they did, and that might have blunted the sheer volume of bad debt problems investors faced later.

4. See my explanation above. The ratings agencies did what they were 'supposed to' do, which is rate debt based on heuristics followed for years regarding banks' best practices and government guarantees of loans... when the banks started getting aggressive in lending (because they were protected by government loan guarantees) the ratings agencies took no notice and just figured that market practices, bank risk tolerance, and government policies were enough of a buffer to any potential problems.

5. I would say a very small percentage of home purchasers nationwide were "PURE" speculators. I don't think that was the problem. I think a very large percentage of buyers (on the order of 50%) were 'circumstantial' speculators. In other words, "let's buy a new house, let's step up and buy a house with a non-traditional financing so we can buy a much more expensive house, and let's look at it as a couple of year investment where we'll make a bunch of money." The irresponsibility just didn't look like irresponsibility for so many people, that everyone who wanted to buy a sensible house and use traditional financing looked like a fool.

6. 100% at fault, our society tends to celebrate individual achievement and then blame failures on the group, the situation, bad luck, etc. We have a society with very little personal accountability built into it. And that has come around to bite us.

7. I don't know what the right amount of leverage is. I don't know how to figure it out. It's really easy to say that the consumer should be the responsible one that puts a lot of money down and 'vests' himself in the home, but homebuilders also stretched their leverage to the breaking point and frankly the builders let them do it because otherwise, the builders would have gone to other lenders. So
the drive of banks to lend money at increasingly high leverage points also pushed them into risky territory.

8. Huge factor, since buyers were able to get into the market with essentially no money down. If I tell you, "you don't have to invest any money now, all you have to do is make a low payment every month, and the investment will increase in value essentially giving you hundreds of percent returns on the money you put in." you're going to sign up for it. Then, when the market goes south, you haven't really invested anything anyway (or more likely, you took a home equity line of credit out and cashed it in, using your house like an ATM), you're going to walk away from the house as you would any investment where you took what you could out of it and then it failed.

9. I think the stage of life is not as important as the stage of bank account. If you are 23 but have saved (or been gifted) enough to put a 20% down payment, you have a solid job and you are putting money away every month, and you have a 401k and other investments working, buying a house is the responsible things to do. At the same time, if you're 40 and you spend like a drunken sailor, and you have no savings, and no retirement investments, and you can only put down a few percent for a down payment, and you don't have a stable job situation, it doesn't matter than you're 40, you shouldn't be buying a house...

10. Hard and fast rules regarding down payments are required. this will have the effect of keeping price increases normalized (avoiding the boom and bust of the industry), will put the weight of RESPONSIBILITY back on the individual buying the house, and will make them so vested in the home as a more important investment, that defaults would drop almost overnight. This might not seem fair to people who make very little money... but I would argue that all of the programs put in place over the past 30 years are nothing more than entitlement programs designed to put people in homes who don't necessarily "deserve" to own homes. Keep in mind it wasn't so long ago that you had to buy a house for all cash. Maybe 50 years ago you had to have to whole $20,000 in cash to buy the
house... that is the genesis of the American Dream, not "let's see how much money I can qualify for to buy a house I can't really make the payments on."

11. I think you know how I feel. The fed should not be setting policies that artificially let people own homes... That sort of entitlement is entirely different than rent assistance, health care, education, etc. for one important reason. Housing policies designed to get lower earners into home ownership earlier has the effect of "gifting" an investment into the hands of someone who has not shown (empirically) that they are capable of handling an investment and the responsibilities attendant to it.

12. We want what we see, and we are very good at figuring out ways to get what we want. Frugality is something that's just not appreciated that much. Because in the US, everybody loves a winner, and the definition of a winner is not someone who saves and saves. it is someone who spends and achieves even higher numbers in spite of (or maybe because of) that spending. Sort of sad but true.

13. The majority of non-traditional loans were sourced in states like CA, NV, FL, AZ. In fact, if you look at the stats, most of the outstanding ARM and IO loans are STILL in CA. The net effect is that all banks with substantial exposure to CA mortgage assets throughout the country had to drastically tighten up their lending standards during the downturn and today. Wells Fargo, BofA, and Wachovia are some of the banks with the the largest exposure to CA. So, some of the biggest banks in the country are facing huge losses and therefore their risk tolerance for all new money out is significantly lower than it might be if CA wasn’t such a huge chunk of the population and mortgage value.

Subject # 7: Principle, 32 years in the real estate industry in California
1. It was one of several major contributors to the bubble. By leaving interest rates low for an extended period of time they created a "froth" in the market as Alan Greenspan put it.

2. Here again, they were one of several major contributors to the bubble by lowering loan standards in hopes of increasing home ownership. While it sounds like a noble cause it ended up with the exact opposite result.

3. Allowing unregulated mortgage back securities to be packaged and sold to unsuspecting buyers was eventually the straw that broke the camels back. I heard a news story of a small town in northern Norway that was in need to cash flow. I wish I could remember the town. You probably already heard the story. Anyway, the cities financial advisors convinced the town to borrow money to invest in mortgage back securities that eventually became worthless.

4. This rating system is what convinced the town in Norway to invest. They were told they were AAA. The rating agencies that were interviewed for the story said the rules for rating were such that it was relatively easy to come up with a AAA. It reminded me of how you can massage a real estate proforma to make it look better by tweaking sales rates or interest rates just a little bit.

5. I am not sure what percentage were speculators. I think a good portion of the purchasers were people looking to own a home to live in.

6. I think they share responsibility but from the people I have spoken to, they were made to think they could afford it or were convinced that if it the payments became too much of a burden they could always sell the house for more than they paid for it.

7. I don't know what the reasonable amount of leverage would be. It seemed like everyone was living beyond their means by drawing down on their home equity lines.

8. Obviously the more down the less likely someone is too walk away. However with the market going down 30 to 40 percent in many markets, I don't think larger down payments would done much to slow the foreclosure rate.
9. My first thought is that the timing of homeownership would vary greatly from person to person. The main factor would be their having the means to afford it.

10. Though the housing market has always been cyclical, I think reasonable but stricter loan qualification requirements would go a long way in stabilizing the market.

11. Government should not be pressing people into homeownership. As long as there is enough housing stock available, there is nothing wrong with renting.

12. Not sure what prompted it but it is definitely a problem. Hopefully some people will learn from this downturn that that less is more the country?

13. It affected it a lot. Take Nevada for instance. A majority of their homebuyers were Californians selling their expensive homes and buying a lower priced home in Nevada and putting the balance in the bank.

Subject # 8: CEO, 13 yrs in the mortgage industry in California

1. The real estate market was keeping the economy going at that time. Many home owners were refinancing to keep their life styles. By keeping rates low it helped increase home prices because home prices became based upon the initial payments borrowers could afford. The feds policies is one of the reasons these initial payments on loans were kept so low simply because interest rates were made cheaper which increased the money supply and made capital available easily.

2. The loose lending standards were a part of the issue and did allow buyers again to qualify for houses they maybe could not have otherwise qualified for. This drove demand for housing up as well therefore drove prices up as well. Fannie and Freddie’s lending standards for what they were willing to securitize made liquidity in the market place plentiful. The availability of money at a low payment to borrowers made many borrowers want to trade up into larger
house. This drove up the prices in all real estate markets. Because of the rapid demand for housing it drove prices up as well as made many investors buy 2nd home and investment homes to take advantage of the investment opportunity.

3. This had a fairly big impact on the real estate bubble. The lack of oversight with regards to different loan products such as loans based upon credit only with no consideration of the borrowers ability to repay the loan caused many loans to go bad when the market turned and home owners lost their ability to repay loans by selling or refinancing. If there were lending standards put into place where based upon the borrowers ability to repay it would have been beneficial to the real estate market as a whole. However, this would of tighten the availability of money to many home owners and hence reduced the demand for housing.

4. The rating agency system lacked oversight and standards for how things needed to be rated. In addition they were being paid to rate securities by the people who were securitizing the loans so if they did not give them what they wanted they would not have gotten additional work into the future. The impact was huge because without the ratings good ratings the securitization would not have been done to the same degree or would have been made with more risk protections. In addition this made the mortgage backed security (MBS) markets have huge demand for their assets which in turn caused looser and looser standards for higher ratings. In addition many of these MBS's were performing because the real estate market had been increasing in value by so much that default rates were very low. In addition if a foreclosure did happen the property had usually increased in value by such a large margin there were generally no or very low losses on the loans.

5. Based upon what was available for financing and how the market was increasing I do not think their expectations were unrealistic. However, I would have to say 75% of the people who purchased real estate had unrealistic expectation when you take into account the house of cards the system was based upon. Had lending standards been in line the market place would not have
increased in value by such a large margin in such a short period of time? The biggest unrealistic expectation was many people thinking the market would never stop going up.

6. A lot at fault however, the real estate agents were pushing them to take this financing and would take a client to a different loan officers or lender if one would not give them the loans. Home owners knew they could not afford the payments they were getting themselves into however many of them disregarded this because they knew they could just sell the house off if they got into trouble or refinance it to pull more monies out and continue their life style. However, this became standard practice in the industry because home-owners were being pushed by real estate agents to get into bigger homes then they could afford.

7. I think the entire system was too leveraged. The right amount of leverage is to hard for me to say.

8. A huge role as it was very easy to get into a larger home without or much less skin in the game. The easier it is to obtain financing the higher the demand goes for housing. If a buyer has to put his hard earned cash down they have a less likely hood of defaulting. Having to save for a down payment is a big accomplishment so when a home owner actually uses that money to buy a home they take more of a sense of pride in the ownership of that home and do more to try and keep it. If it is easy to get into a home with little money down and a low initial payment housing prices will be driven higher.

9. It is to hard to put an actual general stage of when it is appropriate. It all depends on where a person has gotten to by whatever stage they are at. With the correct underwriting standards in place (credit history, income, down payment, underwriting guidelines) someone at any stage over 18 should be able to buy a home if they can qualify. The bubble and the crash was not created by underage borrower buying homes. For first time home buyer having to put
down at least 3.5% plus loan fees is not to much to ask with regards to having skin in the game.

10. Good underwriting guides with good standards for securitizing in place. Also need underwriting guidelines for self employed borrowers that allow them to purchased homes based upon a different way of looking at their income. This used to exist and is a current gap in the financing available to borrowers. There are many gaps in the current underwriting guidelines that are too restrictive that are causing the housing market to not increase. There are loans that were full documentation a year ago with the borrower having the same income structure and earnings but now the income is calculated at thousands of dollars less per month. This is to extreme. We need guidelines in place for self employed borrowers that allow them to get loans based upon different lending standards as their tax strategies are hurting their ability to borrow money. With regards to securitizing there rating should be based upon actually statistical data with as much transparency as possible so investors can make informed decisions.

11. They should do things to encourage home ownership but not force it. The government has no right to force home ownership but should put programs in place to help with it. The Fed should management unemployment and inflation which keeping other factors like the housing market in mind.

12. The real estate agents pushed home owners to buy bigger houses then they could afford. If one lender would not due the loan they would just send their clients to another one who would. The US is a credit based society. Because we are a capitalistic society we have always wanting to strive for more. When the market was going up and rates were staying low you could always refinance or sell your home if you got in trouble. It was easy to borrow money. Our society teaches us through the media that having things gives us a sense of importance.

13. It is tough to say but being it is one of the largest economies in the world it had to have a pretty big impact
Subject # 9: Principal, 14 yrs in the Real Estate Industry in California

1. Fed policy was a driving force for real estate as it affected buying power and ability to leverage. The above market returns shown in real estate investments and home buying were a lure for investors and home buyers alike.

2. Without lax buying guidelines initiated by these agency's there would be no buyer to acquire this paper debt. It there was no 2ndary market that provided liquidity for this debt, there would not have been loose lending opportunities from the financial institutions.

3. I believe there was very little oversight. Objective was to increase home ownership ratios in the United States to it's highest level. There was a belief from home buyers they were entitled to the American dream.

4. The rating agency impacted cost and expense financial institutions or businesses paid for their debt. A decrease in a rating had a dramatic impact on competitiveness. Look at GE articles and how they had below market competitive advantages because of their superior agency ratings.

5. I would suggest 50 percent were speculators. People were bombarded with offers for creative financing vehicles that would allow anyone with a pulse to be a home buyer. People did not want to miss out on this opportunity that others were making $ on. There was a belief that prices could not go down in a supply constrained market. Now or never and never able to achieve the American dream of owning ones home.

6. In my opinion equally at fault for not prudently evaluating what they were signing up for. Incomes did not justify, on belied RE values would be higher and refinancing was available.
7. I think it comes down to having equity or skin in the game to have people vested in the investment. If playing with other peoples’ money there is a high probability for abuse.

8. Flexible loan terms were a big part of the problem. These creative terms provided unqualified buyers and opportunity to be home owners. Financial institutions were pressured to place money as the returns they were achieving were fattening their profits.

9. Home ownership is not a right, no one is entitled to ownership. It should come to individual circumstances as to whether home ownership is a dream or reality. We are the land of opportunity, not the land of entitlement.

10. It comes down to stringent underwriting requirements. Minimized risk from the 2ndary markets who buy these notes and accompanied collateral.

11. Big thing here is encourage home ownership and not force. Some people are happy renters and could live happy lifestyles with flexibility by not being a home owner.

12. Consumerism. Belief that having things will make people happier in life. The old adage of keeping up with the Jones. Belief that everybody is doing it and I should get my piece of the pie. We see advertising, billboards, tc, movies telling us what will make our lives better. People need to stop worrying about how people perceive them and just be thankful for all they are blessed with. There are so many simple things we take for granted until our worlds are turned upside down. People need to take responsibility for their actions and own up to them.

13. So the saying goes, so goes California, goes the United States. We are a huge profit center for the financial markets and home builders in the United States. California is innovated and a trendsetter. California has and will lead the USA out of the current troubles.
Subject # 10: Principal, 25 yrs in the Real Estate Industry in California

1. The Federal Reserve’s policy of keeping interest rates unusually low made property investments more attractive and the cost of financing homeownership cheap, pushing up the price of housing. Higher interest rates work to depress the price of housing.

2. Misguided government efforts to promote homeownership were largely to blame for the bubble. 1992 legislation required the government-backed mortgage investors Fannie Mae and Freddie Mac to guarantee more loans for people with shaky credit and an inability to make substantial down payments. That legislation also created a weak regulator for Fannie and Freddie. The implementation of these regulations did not take full effect until early 2000.

3. Once house prices reached levels that most ordinary people couldn’t afford, Wall Street and mortgage banks responded by relaxing lending standards further with loans that kept payments very low in the initial years and let people lie about their incomes. That helped push home prices up much higher till the bubble began to deflate in 2005 and 2006.

4. The major credit rating agencies were significant contributors to the housing bubble and subsequent financial collapse. The rating agencies are suppose to be in the business of providing financial markets with objective and accurate appraisals as to the risk associated with purchasing any financial instrument. Instead, they consistently delivered overly optimistic assessments of assets that either carried high, or at the very least, highly uncertain risks.

5. Investors and speculators played a key role in creating the housing bubble and exacerbating the collapse. An important 2005 survey taken by the National Association of Realtors (NAR) found that in 2004, 23% of the 7.7 million existing residences sold throughout the country were purchased as investments rather than to be owner-occupied. This was up from 22% the previous year. Later
surveys revealed that in the three peak years of the house price bubble, investors bought 28% of all existing homes sold in 2005, 22% of all those sold in 2006, and 22% of those sold in 2007. This means that during the four bubble years of 2004-2007, roughly 7 million speculators bought existing residences for investment, not to be owner-occupied.

6. A major cause of housing market excesses was easy and cheap credit. 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. But, consumers must bear responsibility for accepting loans that were underwritten using false information that they knowingly provided. That fact that "everyone" was doing it does not justify these actions.

7. A root cause of the housing crisis was the exploiting and excessively using of financial leverage amongst all of its participants (builders, lenders, homebuyers, and investors). Investors were investing in US treasury bills since it was the safest harbor until when they found out that there was a better return in investing mortgage-backed securities. Federal Reserve Chairman Alan Greenspan lowered the interest rates to only 1% after the dot-com bust and to keep the economy strong. This low interest rate was appealing to the banks, but repelled investors. As the banks borrowed more money with low interest rates, they could use that money to buy mortgages from mortgage lenders and sell them to investors and make money out of this deal. The investors were happy as they were gaining more return than the Treasury bills. This is “financial leverage” which means borrowing money to amplify the outcome of a deal. This high financial leverage put the banks into a riskier position. Everything went well as long as the homeowners were paying their mortgages. But when mortgage defaults started excessive use of financial leverage put these money making banks into a bad situation. Homebuilders and developers, with little if any of their own capital invested in development and construction loans, gladly
accepted loans on questionable projects knowing that the down side risk was covered by equity investors.

8. Low or no down payments allowed consumers to enter into highly speculative purchases with extreme leverage. This induced many home purchases that would not have occurred if the homebuyer had more "skin in the game."

9. Homeownership is best suited to individuals that are making the decision based on lifestyle factors and ability to pay, rather than as a financial investment.

10. Less leverage (banks, consumers, builders and investors), tougher loan underwriting and enforcement, and securitization of real estate mortgages that is more regulated, conservatively rated, transparent and less exotic.

11. The goal of homeownership is an appropriate public policy, but the Fed (and other government agencies involved in housing) should not be allowed to promote or enforce quotas and regulations that are not based on sound underwriting criteria.

12. Capitalism as practiced in the US emphasizes high rates of consumption. High consumption of goods and services are a mark of success. The housing bubble provided a unique opportunity for the consumers of housing to purchase new homes that were bigger and better at a monthly mortgage amount that was exceedingly affordable (although the actual price of the house was high) and to do so with little or no down payment (i.e., high leverage) with a non-recourse loan.

13. California was the epicenter of the housing bubble in the US. California's economy is the largest of any state in the US, and is the eighth largest economy in the world. As of 2008, the gross state product (GSP) is about $1.85 trillion, which is 13% of the United States gross domestic product (GDP). Being such a large
percentage of the US economy, any downturn in California would have a major affect on the balance of the country.

Subject # 11: Principal, 9 yrs in the Real Estate Industry in California

1. A huge impact. Idiot liberals decided that the old fashion lending practices of only lending money to people who were qualified was racist against poor people (particular minorities) and so the government mandated that banks lend a certain amount to people who were not qualified. This opened Pandora box and led to the entire sub-prime fiasco.

2. A ton. The government is buying up mortgages in the secondary markets, giving all banks an immediate “flip” opportunity for their garbage sub-prime loans. Since they knew they wouldn’t have to hold them on their books, they were indentified to find ways to lend money to under qualified people since they generated fees on each loan, and they didn’t have to assume the risks of any of them since they were bundled and sold to Fannie/Freddie.

3. It’s a two part answer: if they didn't meddle in the markets so badly (see my answers to #1 and #2), then they wouldn't need the oversight since the economics of each loan/borrower/collateral would have been evaluated by the individual companies who would float, carry, and service the loans. They would make risk adjusted premiums and sound business decisions, so no oversight would be needed. But the government fucked everything up by mis-aligning the interest of the companies with the success of the borrower. The companies didn’t give a shit if the borrower defaulted since it didn’t effect them. As a result, the government would have needed a ton of oversight to manage the fiasco they created (stated-income, 100% financing, sub-prime loans, I mean come on). But if they simply left shit alone in the first place it would not have been necessary.

4. Well, it certainly screwed over the people who had A rated CMBS paper that was collateralized by a bunch of sub-prime loan pools. Even though they were A
tranche, it was really a shady thing to misinform the creditors that it was the same as an A rated muni bond or something.

5. I would say 25%, and yes I believe everyone had unrealistic expectations.

6. It was completely their fault, but at the same time not. The fact that the government was so stupid to give ignorant people money is pretty infuriating, but people being so ignorant to not understand their responsibilities is also a major problem. Each individual is 100% responsible for their own actions (and subsequent loan default), but they should have never even had the opportunity to borrow in the first place if people with brains were actually running our country.

7. Leverage is good, as long as it is collateralized/recourse/securitized on individual and case-by-case basis. It allows for growth and fosters economic activity. The problem is when debt service becomes too expensive (over-leveraging).

8. A ton. Any idiot in the world could borrow money with nothing at risk, for free, and nothing to lose (non-recourse). Down payments create barriers to entry, making it so that only people who are qualified and have a track record of making money can achieve leverage.

9. Owning a house is a privilege, not a right. To buy a home should be a huge investment in your life and future, and should only be achieved by those who have established the credit and employment history to justify borrowing money.

10. Have the government get the fuck out of the way. Freddie/Fannie should not be subsidized by the government, but should instead make actual business decisions of what mortgages to buy and bundle. All policies forcing banks to lend to people who do not meet qualifications standards should be outlawed (and to be candid, the idiots that created/passed the laws should literally be gathered
together and systematically executed. I’m not kidding. They caused more damage with their stupid policies than any serial killer or terrorist has in the last 50 years and they should be sentenced to death).

11. See #10. No they don’t have the right. No they shouldn’t be given the right.

12. Because we live in a politically correct country where no one is ever “wrong” or “stupid” or “not as good” at something. We teach kids from day one that no matter what they do they are perfect, even if they fail they still get awards for effort and for trying. in the good old days, stupid people were forced to fend for themselves. There were no consolation prizes. There was no security net. We created a system whereby everyone believes that entitlements are a right, not a privilege. Owning a home, health care, security, good jobs, nice cars, luxuries are all considered par-for-the-course and people expect to get them. In reality, luxuries are intended for only those who have established themselves financially and can afford to buy themselves luxuries. Stupid lending practices allowed people to live beyond their means for a short-to-moderate period of time, but they came crashing back down.

13. A lot. But its not California’s fault. With easy credit available, people were able to live beyond their means and afford to live in places they otherwise might not be able to. As a result, under qualified people flocked to nicer areas/warmer climates (CA, Arizona, Texas, Florida) since they could now “afford” to live there (they couldn’t; afford to live there, but they thought they could and they could afford to at least get into the market initially, just couldn’t sustain it long term). So CA RE downturn was a huge component of the national downturn, but its mostly because a large part of the boom was here, and that was driven by net-immigration to the area, not something that CA did that was uniquely risky.

**Subject # 12: Principal, 12 yrs in the Real Estate Industry in California**
1. I think the Fed’s impacted it but no more than anyone else. Unfortunately our economic genius Greenspan admittedly never saw this coming.

2. Not that much as they were primarily providing funding for loans that had more qualified borrowers. With that said, they are obviously still having there default issues.

3. This to me is the number 1 reason why we are where we are today. The people at the top were getting rich so it was easy for them to turn the other cheek. I don’t think the "mortgage" industry people like loan officers are to blame. The products were put out there because the secondary market had an appetite for it. We put people in loans that followed the guidelines set by people getting much more rich than us.

4. Again, huge issue. They were rating everything AAA so they may be the biggest crooks in this whole thing. The fact that they were able to pool a bunch direct credit level loans together and call them AAA was ridiculous. They were basically getting paid off to help the rich get richer.

5. Most of them, everyone started looking at their houses as an investment vehicle and not a home. Of course they did, everybody thought their home value was going to keep going up and up. At the time there was nothing or no one telling them any different.

6. They are very much to blame but at the same time most may still be paying on their home if they still had a job. Low introductory rates that would eventually recast weren’t an issue because they figured home values would continue to increase so they could bail themselves out.

7. Not exactly understanding the question here as I don’t have much builder knowledge but I think we have to use common sense whether it is for leverage, check & balances, regulation, etc.
8. A ton, the consumer had no real skin in the game. Buying a home was as easy as buying a car. This created a false sense of security and allowed consumers to chase the rising home values. It also allowed the consumers to refinance their way out of trouble. When prices began to fall and credit began to freeze, all of those individuals were stuck.

9. I don't think you can put an age or time frame on when or why someone should or shouldn't be able to buy a home. I do think though owning a home needs to take on a more respectable quality as it did years ago. It is the house vs. home theory. People today don't want to live in their homes for 20+ years like our parents did.

10. I think most are in place, they just need to be enforced. We cannot disclose and over regulate the industry to death though. My opinion, simplify the documentation so the average person can understand and make an educated decision.

11. No, more government is definitely not the answer. Our government over complicates things when they need to simplify. We over disclose on loans which only confuses the average consumer and at 50 to 100 pages for initial disclosures, who has time to read that?

12. Greed and the ease of it. Everyone was of the mindset that you were an idiot to be renting over owning. Most cases this may be true but you couldn't move without someone telling you that you can buy a home today.

13. On sheer numbers and size I guess we have a significant affect but overall our housing prices aren't falling that bad in comparison to other parts of the country. Our unemployment rate is probably the biggest reason our foreclosure rate and downturn is as bad as it is.
Subject # 9: Principal, 7 yrs in the Real Estate Industry in California

1. The fed’s policy of reducing the short term lending rate between banks had a huge impact on bonds which helped drive low rates on 2 and 3 year fixed rate adjustable mortgages which were a staple of higher risk mortgage lending practices, particularly in high loan to value home purchases. The combination of low or no down payment and cheap mortgage payments allowed the average person with minimal capital (typically taken from their own homes mortgage equity line) to become a real estate speculator. The entry of so many speculators skyrocketed home prices further by driving up sales prices beyond what the seller was even asking for. The faster home prices rose the more fervent speculators became in bidding up home prices.

2. Freddie and Fannie set the baseline of which all other loan products were judged as either riskier or safer. Fannie and Freddie purchased ALT-A products that were deemed relatively safe (not as much as prime), but those ALT-A products still included low or no down payment loans which further legitimized this lending practice. Banks all across the world were clamoring for these “safe” investment vehicles in which to invest their depositors money and the rate of returns far exceeded the US Treasury Bonds (because the rates had been slashed so low by the Fed). With all these banks bidding up these securities it created even more demand for mortgages. In an effort to get more loans the guidelines for lending were loosened up, yet the ratings due to Credit Default Swaps kept the securities rated as safe. For example, several large banks in other countries hold vast amounts of American mortgage backed securities, Great Britain and China being among them.

3. Actions that were taking in an effort to ease the dot.com bubble burst and 9/11 ended up making the problem worse. Ultimately lawmakers don’t understand the financial sector so they had a widely held view that “the market” will sort itself out as it typically has, this is the basis of Capitalism. With finance becoming more and more complicated it is becoming difficult to know how changes in one area will affect others so lawmakers have become increasing lax.
in making changes. Also with the world economy and globalization you have an even greater layer of complexity added to the system.

4. Huge impact, due to credit default swaps it was artificially inflating the credit rating of the subprime securities to the level reserved for A paper. Commercial lenders need to have a certain amount of reserves in safe investments or liquid assets. With these investments carrying the rating of A grade but offering a rate of return reserved for risky investments, banks were investing heavily. Once the bubble burst and housing prices crashed the reserves that banks thought they had were greatly diminished sending banks into a panic. The ensuing panic froze the credit industry almost overnight.

5. Loans are split up into several types, owner occupied purchases, second homes and investment. It is safe to say that 100% of investment loans were speculative to a certain degree but with so much financial incentive and almost no consequences for being caught, mortgage fraud and misrepresentation of facts were rampant. It is hard to say what percentage of owner occupied and second home purchases were speculative in nature but I believe any estimate over 25% would be more than a safe estimation. If you take into account the number of people who purchased homes they couldn’t afford but speculated that they could always afford that mortgage payment or that the interest only loan payment would last long enough for their income to catch up, that number might even be higher.

6. I think this is where the ultimate responsibility falls. The banks, lawmakers, and mortgage brokers may have enabled the consumer, it was still the consumers greed and subsequent acceptance that made it all possible.

7. A long time standard for home ownership is 20% down payment. Most people having saved up that much money are much more motivated to make their payments as well as place their home at risk of being lost. The guidelines of old were sufficient, they just need to be bolstered to fix the flaws that this housing bubble illuminated (verification, asset valuation, etc).
8. This was a significant factor as it allowed the entry of a greater number of speculators than would typically be in an up swinging market. Larger down payments can also be an indicator of a person's ability to manage their own finances and be fiscally responsible so they can handle the unaccounted for items that always pop up with home ownership or even downturn in income that happens as well.

9. Once a person has established themselves in life with their career and their earnings have stabilized. There needs to be earning history. The main criteria that needs to be meet is documentable and verifiable information. The single largest purchase of a person’s life can be made with surprisingly reduced documentation and verification.

10. Get rid of adjustable mortgages with large increases once they turn adjustable. A rate increase cap for the life of the adjustable mortgage should only be 2 or max 3%. This rise in mortgage payment should be able to absorbed into any homeowners budget in a year over year budget as the relative cost of money decreases but the payment stays the same.

11. They really didn't force home ownership they just changed the rules in the equation of rent versus own. The barriers to home ownership were set so low and economic incentives (at least in the short term) were so high it was a natural funnel to purchase homes.

12. With the increase in home prices people had more access to the equity in homes, couple that with low refinance rates, a person could pull $50,000 out of their home and have a lower mortgage payment. Rather than just have a lower mortgage payment and save the difference until they could buy outright the goods they wanted, people were charging up their credit cards then refinancing the credit card debt into their mortgage.

13. With California having a larger economy than most world nations the ripples of a California real estate downturn affected everyone in the US. From a dollar amount standpoint, every California loan is worth 4 times, even 10 times the amount of loss to a bank as a middle America loan because of loan size.