

Center for American Progress



SPECIAL PRESENTATION

**“MOVING ON: THE ECONOMIC AND POLICY
IMPLICATIONS OF THE HOUSING BUBBLE”**

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MS. SARAH ROSEN WARTELL: Welcome. My name is Sarah Rosen Wartell. I'm an Executive Vice President here at the Center and it's my pleasure to welcome you here today for today's event on the economic and policy implications of the end of the housing boom.

It's also my great, personal honor to introduce today's featured speaker, Senator Paul Sarbanes. It looks as if today and perhaps late tonight and early tomorrow morning may be the senator's last days in session as a sitting United States Senator. In characteristic style, he just told me he's not making a big deal of it today. But we are honored that he was willing to take time out on this important day – and we think it's an important day – to be with us.

First, let me say a brief word about the program that we have today and the work of my colleagues and our guests. Homeownership has long been viewed as a passport to the American dream. For many low and moderate American families in America, home equity has represented the primary means of wealth accumulation. The Center's Economic Mobility Program, led by our moderator today, Derek Douglas, is examining the extent to which mobility is more myth than reality in today's economy. We want to find policy solutions to address mounting debt burdens, predatory lending and abusive credit practices, and the growing economic insecurity of America's middle class.

Homeownership should represent a path towards family security, not greater vulnerability to the ups and downs of the economy. CAP senior economist Christian Weller helps all of us to understand the trends in the economy and try out its policy consequences. He's written a paper for today's event that spells out the consequences for American families and the economy at the end of the housing boom. Christian is not known by his peers for being Mr. Merry Sunshine; perhaps pessimism is a hazard of his profession, but we take seriously the consequences when he tells us that half of all homeowners exhibit signs of financial vulnerability because of high mortgage payments, variable interest rate debt, home equity below homes' values, and homes accounting for 90 percent of more their total assets. Lower income and minority homeowners are most severely exposed. What does this mean for families in an uncertain economy? What consequences will these facts have on the prospects for our consumption-driven economy overall, its capacity to create jobs and allow families to get ahead? That's what Christian and our terrific panel today will help us make sense of.

The Center for American Progress' mission is to think about the lives of everyday Americans and help find solutions to the challenges they face. And there's probably no one who has worked harder at that mission more consistently than our keynote speaker today, Senator Paul Sarbanes. In his five terms in the United States Senate, Senator Sarbanes has been the most dogged advocate for average Americans. Sitting on the

Banking Committee as he has for many years, powerful financial institutions bring to him their interests, yet in every word, every speech, every debate, the senator has made clear that his primary concern is with the everyday Americans, the average working families, and those with the least among us who must navigate their own fortunes in our complex financial system.

Over the last 20 years, I've had the pleasure of watching the senator's career first from a perch at HUD, and then the Clinton White House, and then more recently here at CAP. I've seen that Senator Sarbanes has been an effective advocate for creating and funding federal housing programs and ensuring that they provide a decent home for millions Americans, especially when such programs fall from popular favor. He sought to expand homeownership, fought to improve access to credit for low-income residents, and strengthen neighborhoods through his unrelenting efforts to preserve and protect the Community Reinvestment Act.

From my own experience, I know that average American consumers of financial services and small investors have few powerful friends in Washington, but for the last 30 years they've had Senator Sarbanes. The senator approached complex financial legislation like the Sarbanes-Oxley legislation that bears his name, financial privacy, predatory lending, CRA, and so many other issues with his own special trademark style. He combined a deliberative, methodical and fair-minded approach to policy with a deep, abiding and passionate commitment to people.

And so it's my pleasure to introduce a man whom I consider the epitome of the progressive statesman; a man who's both an enormous intellect and a tenacious fighter. Please join me in welcoming and in thanking the Honorable Senator Paul Sarbanes.

(Applause.)

SENATOR PAUL SARBANES: Well, thank you all very much. I'm going to move very quickly because we may have a vote at any moment, at which point I have to flee the premises I guess would be the way to describe it. First of all, I want to thank the Center for inviting me to participate in this what I regard as a – can you hear in the back? Okay. I do forums in high schools across the state, or used to; I'm sort of fading out of that now. And one night I got up on this high school auditorium and there were about 300 people there, so it was quite a large audience, and I said, "Can you hear me in the back?" And a woman in the back of the auditorium shouts, "We can't hear you." (Laughter.) And a woman sitting right in the front, sort of like where Sarah is, leapt to her feet, turned to the lady in the back of the hall and said, "I'll trade places with you." (Laughter.) I knew at that moment it wasn't going to be an easy evening ahead of me.

This is an important discussion: the economic and the policy implications of the housing bubble. In fact, we held a couple of hearings in the Senate Banking Committee earlier of this year which embraced a good look at this issue and others.

I do want to express my appreciation for the work of Derek Douglas, the Associate Director for Economic Policy here at the Center, for putting this program together. And I want to thank Sarah Rosen Wartell, one, for her gracious introduction, but for the terrific work she did when she was at HUD and then at the National Economic Council in the previous administration. We worked closely with Sarah on a number of very important issues with very serious implications for the American consumers, and she was an absolute champion on their behalf. And, Sarah, we really appreciate all that you did and all that you are continuing to do.

Now, Sarah's already made the observation that homeownership is considered to be an essential part of the American dream. That's a view that I subscribe to. Public policy has long promoted homeownership as an important tool for individual families to build wealth, for neighborhoods to catalyze economic development. It's the equity in our homes the people turn to to finance their children's education, to help ensure secure retirement, or to help smooth out financial problems they may face along the way. And common sense would tell us, and research supports, that homeownership leads to many good outcomes for families: higher civic engagement, better school outcomes, lower crime, healthier neighborhoods. It's just a win-win proposition any way you look at it.

I think we have to say that the national commitment to homeownership has been marked by many successes: home construction has boomed, permits for single family home construction grew from just over 1.1 million – an annualized rate – at the end of 2000, to close to 1.8 million at an annualized rate in 2005. And of course, along with that came hundreds of thousands of jobs and all the economic activity that accompanies housing construction. John Maynard Keynes advised Roosevelt back in the 1930s, he said, just focus all your attention on housing if you want to get the economy out of its depression. And he says, you get the benefits of the housing and you get all the jobs that go with building the housing.

The success of the industry has been the American people's success. I think it's fair to say that the housing sector has performed impressively over the past ten years, with home values consistently outpacing inflation, and of course that translates into wealth for those that already own their house. In the increase in total home equity from 2000 to the middle of this year has been \$4.5 trillion, and the homeownership rate has gone up. We're now almost at 70 percent.

But part of this growth in the housing market is proving to be unsustainable. Alan Greenspan at one point called it froth. The market has been experiencing serious turbulence over the past two months. Prices in some areas have fallen – home prices – 10, 15, 20, 25 percent or more. Florida, the Northeast, Arizona, parts of California, a lot of the Midwest are now experiencing distress, and I think it's fair looking forward to predict that steep down turn in the housing market will probably be a major drag on jobs and the economy over the next year.

New permits for single family homes have been in a freefall, dropping every month in the last year now for a total 31 percent decline. In other words, a one-third

decline over the course of the year in new permits for single family homes. Leading business economists expect the downturn in construction to subtract 15,000 jobs a month in the next six months. They also believe that the downturn in housing will reduce consumers' ability to borrow against their homes, and they're talking about a cut in GDP growth of 1 to 2 percent. Indeed, home construction alone cut last quarter's GDP growth by over one percentage point. But you've got some very accomplished economists who are going to be on this panel, so I'll leave it to them to draw out the implications of these facts.

But there's another consequence of the falling housing market that I want to draw your attention to, and spend a few minutes on this afternoon: the impact on black, Hispanic, and lower income, more marginal homeowners. Now, black and Hispanic homeowner rates have climbed over the last decade with a vast majority of those gains coming in the late 1990s. That's the good news. The bad news is that the gap between white and black homeownership has not budged since 2000 after significant improvement in the 1990s. The gap between white and Hispanic ownership has continued to close, although at a much slower rate than during the decade of the 1990s.

What this means, of course, is that the amount of wealth per capita that minorities have built up in home equity continues to lag significantly behind the build-up for whites. Moreover, the recently released Home Mortgage Disclosure Act, the HMDA, data tell a truly disturbing story: nearly 55 percent – over half – of black homebuyers were given high-cost home purchase loans in 2005, defined as loans with an APR Treasury yield spread of more than three percentage points.

For Hispanics the figure of those receiving these high-cost home purchase loans is 46 percent. By comparison, only 17 percent of non-Hispanic whites got these high-cost mortgages. A Federal Reserve study looked at a host of data other than race, including income, in an effort to explain this striking contrast in treatment. That study found that borrower related factors accounted for only about one-fifth of the disparity of higher priced home purchase loans among the blacks, non-Hispanic whites. So race indeed seemed to play a significant role in determining what people pay for their mortgage credit. In other words, the progress we've made in minority homeownership may indeed rest on a very shaky foundation.

Several years ago, Freddie Mac took its portfolio of subprime loans and studied whether the borrowers who took out these loans could have qualified for the traditional prime Freddie Mac products. They found that 20 percent of these borrowers did in fact qualify as lower cost prime customers, and yet they were being placed in these high-cost home purchase loans. I think these statistics obviously reflect the fact that in part more and more families, especially minority families, have purchased or refinanced their home with exotic or what *Business Week* has called toxic, subprime, high-cost mortgages. These are interest-only payment option adjustable rate ARM – mortgages ARMs – are 2-28 exploding ARMs, all of which feature a low initial payment, after which the borrowers are hit with significant payment shock that can increase monthly payments by as much as 40 percent or more.

So they give these 2-28 things, and you get a rate for two years and then the rate is tied to the LIBOR, the London Interbank Offered Rate. The last time I was in a difficult neighborhood in Baltimore talking with the people who resided there about their housing problems and financing their housing, we had an extended discussion about the London Interbank Offered Rate. So you tie it to this index, and then they usually tie to – they give them six points above the index, so you can take people and move them into – you can jump their rates at a very rapid pace, so they're paying 11, 12, 13, 14 percent before they know it.

In many cases, lenders and mortgage brokers have qualified borrowers for these loans based on the initial rates alone without giving any sufficient consideration to the ability of the borrowers to pay the mortgage once it resets to the higher figure. Indeed, as the regulators noted in new guidance issued to rein in the use of these mortgages, these exotic products were initially designed to meet the needs of sophisticated borrowers with special circumstances. Regrettably, they have increasingly been used as affordability products intended to help people keep pace with quickly rising home prices. Unfortunately, research by the Federal Reserve and the Consumer Federation of America shows clearly that low-income borrowers who were put into these products simply did not understand what they were getting into – my reference earlier to LIBOR.

So the existence of these loans encouraged buyers to chase after rising house prices, pushing them up even further. When a loan reset and the payment jumped, a borrower could refinance the loan with another teaser rate so long as prices created more equity for borrowers to tap into. So if you had the rising housing prices, it could all take place under that cover – under that umbrella.

Now, while these products therefore once contributed to inflating the housing bubble, they will, I fear, now help hasten its demise. As prices stabilize or fall, homeowners will no longer have the equity against which they can refinance and thereby delay the day of reckoning. We're already seeing the consequences: CNBC reported just yesterday that the delinquency rate on subprime loans for example has doubled in the last year to 3.9 percent.

Ironically, even as this cycle of refinancing pushes borrowers deeper and deeper into debt, lenders and investors cheer the process on. From their point of view – at least for some of them – I want to be careful because there are many people who try to do their business according to the standard rules and I respect that, but there are a number – there are too many out there. Each financing represents a successful transaction because a previous loan was paid off and new fees were generated and collected. In the end, of course, the consumer pays the price, and of course so will the communities in which they live, and indeed the economy as a whole.

We need to remind ourselves that the American dream is founded on the principles of hard work, opportunity, and fairness. These are far from being simply abstract ideas. In practical terms, they're the operating principles that make it possible

for Americans to live in security, to prosper, to raise a family, and to have confidence in the future. They're really the bedrock of a decent and just society.

These lending practices, the ones *Business Week* called toxic, threaten these principles of fairness and undercut the ability of Americans to achieve prosperity and security despite their hard work. We need to put an end to these abusive mortgage practices.

To start with, we need to understand that it does nobody any good to put a family into homeownership that cannot sustain the homeownership. It's not good for the family and it's not good for the neighborhood. We also need to address the serious problem of predatory lending. A number of states have passed strong anti-predatory lending laws, protect their citizens against the worst abuses, while ensuring that a productive and wealth building credit can continue to flow. It's often asserted that, well, you'll simply cut off all credit, and careful study has shown that that's not the consequence.

In my view, we should pass stronger anti-predatory lending laws at the federal level. For a number of years I've introduced legislation to strengthen our nation's lending laws, to protect homeowners' equity by prohibiting certain predatory practices. We would limit the amount of points and fees that could be financed into a mortgage. Actually, it's the financing of these fees that strips the equity and pushes up the mortgage balance. We'd limit to prepayment penalties that could be charged – they often trap borrowers into high cost mortgages; prohibit single premium credit insurance. Actually, we held hearings on that issue and essentially at least most of the leading actors have done away – it won't withstand scrutiny in terms of the benefit to the consumer. Prohibit certain terms that are abusive when used on high-cost, subprime mortgages such as balloon payments and prohibited mandatory arbitration. Freddie and Fannie agreed that they would no longer buy subprime loans with mandatory arbitration clauses, and many of you in this room help to push along and have them see the appropriateness of that position.

This is very important because you can develop a system of laws which protect the consumer, provide them recourse and remedies through the legal system, which is the way most of us sort of protect our rights, but then they come along and they can override everything by putting in these mandatory arbitration clauses so that people are caught into this thing at the very outset. And then as they move down the path, all of a sudden they discover that the protections that are available to most people are not available to them. They've given them away in signing the mandatory arbitration provisions.

Going forward, the key challenges we need to confront is: how can we ensure that consumer protection in this area keeps pace with a fast evolving market? Now, one suggestion that's been made, and I think it's worth examining, is the idea of establishing a suitability standard in the mortgage business. That's a standard that already exists in the securities industry. In the securities industry, a stockbroker could not sell – not appropriately sell at least – a highly risky derivative instrument to a retired woman of

modest means on a fixed income. Such a sale would be considered unsuitable and they're not supposed to do that.

Establishing a suitability standard in the mortgage lending business would be controversial because it represents a real change in the way this lending is done. However, when you consider that a family's home is the most significant asset that family will ever own for the overwhelming number of families in this country, when you look at the increasing complexity of the mortgage market, and the lag and the regulatory and legislative responses to market changes, I think this kind of consumer protection should be given serious consideration.

Let me close finally by quoting from a speech given by Sheila Bair, the new chairman of the FDIC to the Consumer Federation of America just last week. Sheila said, and I quote her, "A financial system should allow people to achieve economic progress and financial security through the traditional values of hard work and thrift. A financial system that strips wealth and locks hardworking families into an endless cycle of debt and financial distress promotes feelings of exclusion," end of quote. I very strongly endorse those views. Our financial system should be a way by which people can attain the American dream; it should not be a tool by which that dream is turned into the American nightmare. And I intend to continue to work towards that goal.

Thank you all very much. (Applause.) So do you want me to take questions? I think –

MS. WARTELL: If you'd want to, we'd be thrilled. It's up to you. (Off mike) question? Let's take one question.

All right, if I could ask for someone to stand and (off mike).

Q: (Unintelligible) from Arlington, Virginia. I'd like just to ask if you'd considered any regulations on the realtor industry. With the rising home prices, are there concerns about the amount of money that they making on purchases of homes?

SEN. SARBANES: Well, we tried to change RESPA, remember? So there are some changes that HUD could do there that would be helpful. Of course, a lot of the regulation here is at the state level rather than the federal level, and I want to be very careful about that.

We're constantly now in the Congress hearing these arguments that they want to pass a legislation on some regulatory matter, and it happens in a lot of fields, and in the course of doing that preempt the states from having anything to do with it. The argument that's made for this is, well, it would give us a national standard. We don't have to go through all the administrative difficulty of adjusting to the requirements in different states. The problem with it is invariably when you look at the substance of the consumer protections that would be in such legislation, they're substantially less than what is being done by the better states – above those states that are lagging far behind or not doing

anything, but not close to what the better states were doing. My standard position has always been – if you're going to get preemption, it's got to be at the substantive standard that's at the level – either at or very close to where the very best states are.

Even if you do that, one of the problems you have is of course, with fast changing practices you no longer have the states as a potential laboratory of innovation and experiment, which has traditionally been one of the roles and has been carried out by some of the more progressive states. California does it all the time on environmental matters because of the particular environmental issues they have in California, so they're always ahead of the nation, and they're such a huge market that that has a substantial impact.

So we have to be very careful about that, so I'm reluctant to negate or significantly limit the states' abilities to do some good things. And there's no reason why the two can't work in tandem – federal and state – to give us a higher level of protection. But I'm anxious to stop people from exploiting other people. I want them to be very successful and to prosper and so forth, and good businesses can do that. They don't have to engage in these practices.

One of the consequences of these practices taking place is it drives good businesses downward in terms of their behavior because of the competitive environment in which they find themselves. When we did Sarbanes-Oxley and we did those hearings – of course the people of Mike Oxley's district in Ohio are wondering why he changed his first name to Sarbanes, and the people of Maryland are wondering why I have a hyphenated last name, but one of the consequences – let me just tell you: WorldCom had these completely phony financial statements. The people working at AT&T – this actually happened – would get called in – the middle managers – and berated by the top management because they weren't doing a good job. They said, you're not really producing. And they said, you know, we think we're doing a good job and everything. They said, well, look at this financial statement from WorldCom, and we're not coming close to what WorldCom is doing. Well, of course they weren't coming close. WorldCom was completely phony figures, and yet it had a marked impact on how AT&T was conducting its business, and some other people lost their jobs as a consequence because this comparative standard they were being held to was with WorldCom, and that standard was not a real standard; it was a phony standard.

All of this activity has to take place at a reasonable level. Now we get all – I want to just close with this. We get all of these comments about regulation that come at us all the time. And I was reading some articles the other day, so I wrote – I didn't bring the hand written statement. I wish I would remember some of it, so my response to this was: I am against needless regulation. I am for needed regulation. How to determine what is needed and what is needless is the essential question, and the answer to that depends on hard analysis, clear thinking, and wise and sound judgment, and I don't have a better answer for it than that.

Thank you all very much.

(Applause.)

MR. DEREK DOUGLAS: Thanks again, Senator, for those incredibly insightful remarks. We couldn't have asked for a better way to, I think, set the stage for the discussion we're about to engage in. Because the senator and Sarah did such a god job at teeing it up, I think I'm going to move straight into the very brief introductions of the panelists.

First, just a couple of housekeeping things. My name, by the way, is Derek Douglas. I'm the Associate Director for Economic Policy at the Center, as well as the Director of the Economic Mobility Program. You should have all received packets that have in them the background materials on the Center, some information on the Mobility Program, and most importantly a new paper that we're releasing today that was authored by Christian Weller, one of the panelists, called "The End of the Great American Housing Boom." I'd also ask you to turn your phones to vibrate because we are recording the program this afternoon.

One thing I would just say to put into context why we decided to do this event: over the last several years, the way that industry and in some respects the current administration have been selling us on this incredible, unsustainable run-up in the housing markets was really more of an ends-justifies-the-means philosophy. It was homeownership is good; that's something we all want. We want people's housing prices – the values of their homes to rise and equity to increase. Focus on that; don't focus on the way we're getting to that point. So the results were the things that Senator Sarbanes talked about with the adjustable rate mortgages proliferation, the stated income on loans, that sort of thing.

The reason why we had this session today is that an ends-justifies-the-means approach doesn't work when you're focusing on the wrong end. The end that we really have is an unsustainable level of housing values, and we're starting to see the slowdowns already, and they're starting to have significant consequences not just for American families who have these loans, but also for the economy at large. And our panelists today are going to discuss what these ramifications are and help us walk through some of the ways in which we can work through the difficult times that are ahead and maybe prepare better for the future.

I'll introduce the speakers in the order that they'll appear. Their full bios I should mention are your packets, so I'm just going to give the names and the titles. The first speaker will be Christian Weller, who is a Senior Economist at the Center for American Progress. And as I mentioned before, Christian is also the author of the new report entitled "The End of the Great American Housing Boom." He was one of the driving forces to help organize today's session.

The second speaker today will be Mark Zandi, who's the Chief Economist and Cofounder of Moody's Economy.com. Our third speaker will be Dean Baker, who is the

Co-director of the Center for Economic and Policy Research. And our fourth speaker will be Kimberly Warden, the Vice President of Federal Affairs at the Center for Responsible Lending. Following the comments, the presentations from our panelists, we will have some time for question and answer from the audience. With that, I'll turn it over to Christian.

MR. CHRISTIAN WELLER: Well, thank you very much, Derek. Thank you for coming and braving the coldest day of the season. I want to go very quickly here through the report. Our media people have told us – well, I've made it a practice to start with the message point.

I think the important piece here is that when you look at the housing boom, it's important to keep in mind what it was and what it wasn't. It was a house price boom, but it wasn't a homeownership boom, and I'll go through the numbers there. To afford more costly homes, families went deeper into debt. They took on more risky loan products, and ultimately leaving them more vulnerable to financial and economic changes that we currently see. And in addition, the economy was basically becoming addicted to the housing boom and the refinancing boom and driving consumption growth over the last few years. That addiction is now coming home to hurt it because there's nothing else to replace it. We've just got the new employment numbers and we really don't see anything that's replacing the declining construction sector.

Let me just go very quickly through the numbers. This is the ratio of house prices to rents. They basically should move in tandem. Ultimately, they are measuring the same thing: they're measuring the roof over your head. And they did historically, but since the mid 1990s they have diverged. The early run-up in the 1990s you can explain: it's like, well, we're recovering some of the losses of the earlier 1990s. But the last few years have driven us to heights we've never seen before.

These data go back to 1975. If you relate house prices relative – or home values relative to income, what you see is – we've also seen a run-up that we've never seen before at least in the postwar period. But that's pretty much the story of the house price boom. It was a boom in prices, it wasn't a boom in homeownership rates. The boom in homeownership rates, at least as far as we know from the data, was truly in the late 1990s. That's really when we increased homeownership, especially for minority owners; specifically, African-Americans and Hispanics.

However, the growth rate in homeownership has been cut in half in the last five years relative to the previous five years. We still went up for most of the years except for 2004 to 2005. That's actually when homeownership rates dropped, and especially pronounced are the declines both in the growth rate, but ultimately in the decline of overall homeownership rates for African-Americans. That's where we see the biggest drop. So anybody who's telling you that this was a great time for homeownership: it wasn't. The great time for homeownership was actually in the late 1990s.

Part of the explanation is that higher home prices ultimately – especially we had a fairly weak labor market recovery the last years few years – forced people to take on more debt. The latest numbers are that total debt relative to disposable income stands at 131 percent. We've never seen anything like that. We've never been there before. The run-up in debt in the last five years was four times, close to five times, as fast as the increase in debts-to- income in the 1990s. So not only are we at the highest levels, we're also seeing an acceleration in household debt.

However, this debt boom is not just – debt is not equal to debt. It left families much more vulnerable than it did before. Mortgage payments relative to income rose, so the increase in mortgage levels and total debt levels compensated – overcompensated for the decline in interest rates, ultimately raising the costs of borrowing money. The use of variable interest rate debt, both adjustable rate mortgages and home equity lines, has also increased, leaving families particularly vulnerable to increases to interest rates, especially the adjustable rate mortgages are beginning to reset next year.

Moreover, families are extremely vulnerable because of the debt boom. Because the debt run-up was faster than the run-up in house prices, families are particularly vulnerable to declines in home values. Because they're owning a smaller and smaller share of their own houses, if the total value of the house declines, the hit to home equity is larger than ever before.

And, overall, that same logic holds to total wealth. More and more of total wealth is tied up in your home because of the run up in both assets – house prices, but also the increase in total debt, meaning people have less money to put away elsewhere. That means that as house prices are beginning to fall, people are taking a bigger hit to their total wealth that they did before.

Let me just see whether I can – mortgage payments, as I said, rose. They rose particularly for low and moderate-income households, for minority families, and for (young income?) families. However, overall, mortgage payments generally out of total debt payments still were a little bit declining over the last – from 2001 to 2004, but that's only a relative change. That means that other forms of credit were just simply more costly, but that can change very quickly as especially these adjustable rate mortgages are beginning to reset.

As I said, the variable interest rate – and here you really have to look at the number of the share of adjustable rate mortgages plus home equity lines because they are really one of the growing products in the market, leaving families much more vulnerable in 2004 by 25 percent of total mortgages were variable interest rate debt forms. More recent numbers put the numbers higher than that, meaning the boom continued definitely in 2005, possibly in 2006. So as you see now, rising interest rate – interest rates have largely as a trend been growing the last two years – more and more families will find themselves facing much larger mortgage payments than before.

I'm going to address one counterargument from some of our conservative friends who say, well, this is so wonderful because people really invested. It contradicts financial economics because it would basically say people in mass droves went out there to buy high and sell low. It's just contradicting basic financial economics. People bought homes because they needed to live where they work, by and large. By my estimates, only 20 percent of the pricing of the mortgage increase in the last few years can be explained by investment. That's meaning the other 80 percent really were driven by people having to buy a home where they live.

As I said, families owned less of their own homes. If you look at the blue bar here, which is from the flow of funds, we're down at 55 percent. So the average family owns 55 percent, and this includes people who have already paid off their homes, this is all homes in the country. That's the lowest level we've ever seen. It's the lowest level since 1952. The other number is from the Survey of Consumer Finances, which is a little bit higher this year, but also has been in a declining trend.

The other argument here is that homes are making up a large real estate – and it really doesn't matter which data source you're looking at, it doesn't matter how you define homes as the one that you own or the one that you own and live in plus the ones that you have as investment products. Real estate is becoming a growing part of assets. That means lack of diversification in your total assets, greater vulnerability to declining house prices.

In the paper I identify four measures – we use four measures of vulnerability. I think if you look at the data, they kind of jump out. Mortgages – mortgage payments greater than one-third of income; variable interest rate debt greater than 50 percent of income; home equity less than 25 percent of home value; or houses are more than 90 percent of their total assets. What I find is that one-third of families meet at least one of the vulnerability measures; 12 percent had two vulnerability indicators, and 4 percent have three vulnerability measures. Close to half – 49 percent of families – in 2004 met at least one of those vulnerability measures. And as I said, by all indications the trends suggest that the situation only got worse in 2005 and 2006. That is a substantial increase in the vulnerability of families. The share of families with vulnerabilities in the financial market due to the housing boom has risen sharply. There was only 39 percent in 2001.

And it sharply reverses a trend towards more financial security that we saw in the 1990s. We released a paper in September called “Middle Class in Turmoil,” where we basically look, for instance, at the share of families that had at least three months of their income in wealth, and what you see is that share declined dramatically after 2001 after growing over the 1990s. In fact, the erosion of financial security since 2001 was large enough to completely wipe out any gains made during the 1990s. We already talked about the economic effects overall the – like this one; let me stick with this one.

Overall, the economy has been driven – it's kind of the battery of the Energizer bunny of the consumer the last few years. This is the housing market. It creates jobs. It explains about two-thirds of private sector job growth in the last few years, but also it has

been driving consumption through these home equity cash-outs. I just looked at the numbers yesterday: we're down to maybe about a tenth of where we used to be. So we're losing that kind of new fuel to consumption, and that's the line here that is dropping very sharply.

What that means is we have to shift away from the housing-boom driven economy to something else, and the only something else that we can think of and would hope for is an investment boom. Unfortunately, that so far hasn't really happened. We haven't really seen an investment boom that has been driving, for instance, employment growth in nonresidential construction or in the manufacturing sector. So I think the big question for us is: in the short run, how do we replace the fuel of the economy? How do we get the economy growing forward? How do we improve homeownership at this point? While we have lower prices, we'll probably have also less access to credit for many people who want to move into homeownership. And the longer term consideration is: do we want to avoid a bubble like the one we had, and how would we do that? And the other part is: should we tighten financial market regulations along the lines outlined, for instance, by Senator Sarbanes to avoid some of these more exotic and toxic products for consumers to have more consumer protection, but I'm sure my colleagues will comment on that.

MR. MARK ZANDI: Thank you, Christian. Thank you, Derek. Thank you for the opportunity to be here today. I have 23 points to make. I'm only kidding. (Laughter.) I have ten minutes, so I have five points to make.

Point number one: the housing bubble is correcting in an orderly way. The correction is in full swing. The market peaked a year and a half ago, home sales are down 20–25 percent from their peak, construction is off 30–35 percent, and now house prices are declining. National house prices, at least as measured by median existing price, is about 3.5 percent from a year ago, which suggests that prices in certain parts of the country are off more. We're seeing high single digit price declines in parts of the Northeast. Your housing values in Washington are a bit lower than they were a year ago, but my home in Philadelphia is still rising in value; it's appropriately priced. (Laughter.) Florida, California, Arizona, and Nevada experiencing some price declines.

The spillover effects into the rest of the economy, however, have been very, very limited. Consumer spending growth has not been materially affected; at least not yet. Christmas sales are perhaps not as buoyant as we might like to see, but they're solid. Christmas is going to turn out to be pretty good. There are effects in the job market. We saw that today: construction laid off 35,000 workers, close to the end of the month of November and we'll see further construction job losses. But outside of construction and the auto industry, there is no sign that the job market is weakening. It's still creating lots of jobs and we're seeing steady growth in lots of different industries. So the housing market is in a severe correction. It has another year to go, but so far it's been a very orderly process. I don't think we could have asked for more orderly correction, at least to date. That's point number one.

Point number two is that there will be some further downside to the housing correction. I do think it will extend through most of 2007, at least as measured by house prices. Home sales are going to bottom out pretty soon, if they haven't already bottomed out. Construction will bottom out mid-year. House prices probably will decline for most of '07.

But one of the more negative things that will happen in 2007 is that mortgage credit quality will erode very substantially. I think that's very clear. We collect good data from Equifax Credit Bureau, with a 5 percent (unintelligible) sample all the credit files in the country at the end of every quarter, and based on that we can construct estimates of delinquency and default in different kinds of mortgages in every corner of the country. We look at it by zip code. And it's clear that credit quality has measurably weakened since the end of last year.

Just to give you a statistic, the delinquency rate on all residential mortgage debt, first and second liens, on a dollar basis is up 30 basis point, which is a big change in a statistic that doesn't move very quickly. And it's up in all corners of the country. In fact, here's an interesting factoid for you: the metropolitan area that has experienced the largest increase in delinquency since the end of last year is Las Vegas. It's up 150 basis points. What makes that interesting is that is arguably the strongest economy in the country, at least as measured by job growth: it's 5, 6 percent-plus job growth compared to the national job growth is about a point, a point and a half. And that goes to very aggressive lending. That's all that subprime lending, ARM lending, optional ARM lending, and it's now resulting in very high delinquency despite what is a stellar economy.

And does that suggest that as we move forward into '07, if you mix this very aggressive lending with falling housing values with a softer market with mortgages – ARM mortgages that are hitting payment resets, that we will see a measurable weakening in credit conditions all throughout '07 into 2008. And in fact, by my estimate there's roughly \$750 billion of mortgage debt outstanding, and there's \$10 trillion roughly outstanding that is at significant risk of delinquency or default over the next couple of years, so about 7 to 8 percent of mortgage debt outstanding. That's point number two.

Now turning to policy, point number three is what we shouldn't do is use monetary policy to weigh against bubbles. The federal funds rate target is a very blunt instrument; it would be futile, I think, to use that to directly work against bubbles in any asset market – stocks or in housing. I don't think it's effective, I don't think it will work, and the unintended consequences or something like that would be a difficult to gauge. I think it's fair to use monetary policy to weigh against the perhaps indirect effects of a bubble if it shows up in the form of (what are?) inflationary pressures. Then you'd respond, but I don't think there's any way you can use monetary policy directly to weigh against any bubble in any asset market. I think that would be a very significant mistake. That's point number three.

Point number four is I do think there is room for a regulatory response in really two ways. One is – Senator Sarbanes made an excellent point – I don't think a lot of the folks that took on these aggressive mortgage loans truly understood what they were getting into. I looked at a negative AM loan just to look at it, to understand what it was, and to this day I don't really understand it. To really effectively know what's going to happen to you in coming years, you need a spreadsheet – a good one – and you need someone to walk you through it. I think it's important that lenders educate and inform borrowers, and I think that there is some room for regulatory or a legal guideline with respect to informing and educating borrowers, particularly those that are – clearly don't have any financial background. I mean, I pride myself knowing something about finance, and I've had trouble with these negative AM loans.

A second type of regulatory response is more difficult, and that is that regulators need to be more aggressive in weighing against aggressive lending practices. Now, a CEO of a major bank told me recently that if it's growing like a weed, it probably is a weed. (Laughter.) Now, that's easy to say and it rings true, but to actually operationalize that statement is extraordinarily difficult because exactly how do you define a weed with data? And I don't think we have the intellectual capability to do that properly just yet, but I think that's where our attention should lie because we need better tools, because it is important that regulators are able to gain the intellectual upper hand when things are going fabulously well.

A year ago, where there wasn't a single mortgage in San Diego in delinquency, it was pretty hard for a regulator to say to a lender, "You need to tighten up." In fact, there was no possibility that they could because since they did the lender would be on the phone to their congressman saying, "This guy – this regulator is just nuts," and there would be no intellectual basis for the regulator to say anything. But if the regulator had some effective tools that would were proven to work historically and said, "Here, look. This is what happens if we don't weigh against these things before they get out of hand, we have these kinds of problems." So we need better tools, but I think that's an area that should employ economists for many years to come (off mike). You might grow wealthy on that particular topic.

Point number five, and this is also very important I think, is that we need to tread very carefully with respect to any policy response. With all due respect to the senator, Sarbanes-Oxley is a great example of that. You can't get caught up into the emotions of the moment and make bad policy. We need to consider the unintended consequences of anything that we do, and think long ahead into the future when we do make a policy.

In fact, I'll end on a very sort of controversial point, and that is there are some positives to bubbles. I think to some degree homeownership has risen, and it is because of the so-called democratization of credit – the availability of credit. Homeownership would not be 69 percent today if there wasn't innovation in the mortgage market. And we can't cut that off, otherwise homeownership rates will fall, and so we need to be very, very careful when we regulate a set of legal standards that we don't short-circuit the thing

that has made this housing market as strong as it is and as important to our economy as it is become.

MR. DEAN BAKER: I'll be more critical than Mark. I want to point out the last time I was on a panel with Mark, we were – we were also on the housing market and he said – this is about four years ago – that house prices would continue to rise in the next three years and I said, oh, no, we're in a bubble and it's going to crash. And he was right, so we'll see where we stand now.

I promise to be more heretical than him, though, in a moment –

MR. ZANDI: (I may?) take him to all my talks, right? Wow, that's great.

MR. BAKER: Just hand me the check here. (Laughter.) I want to make three points here. First, and I don't think we'd really dispute this, but I want emphasize that there was a housing bubble. It should have been recognizable, and I think larger than perhaps Mark would suggest. I still disagree with him on that, even though he proved right for three years.

Secondly, I will say, and again disagreeing with Mark, that I think the Fed could and should have done something. I think housing bubbles, or any financial asset bubbles, are very serious.

And third, my heretical part, I want to talk about the idea of homeownership. I just simply do not see that as an appropriate goal on public policy. So I'll come back and say a little bit about each of those.

First off, the case for a housing bubble – Christian showed you half the picture. I ordinarily have a slide to go further back, going back to the early '50s. If you look back over the postwar period – I'm picking that because that's the period where we have good data – house prices very closely track the overall rate of inflation. Robert Shiller, a very good economist, Yale University, went further back: he found some data from the 1890s and makes that claim going back from the 1890s up until the recent period. So you have this long empirical regularity: house prices move at the same rate as the overall rate of inflation. What happens beginning in the mid '90s up to the present? House prices have increased by about 50 percent adjusted for the rate of inflation. That is huge. That's not a small bubble. That creates over \$5 trillion in bubble wealth. By definition, bubble wealth is the difference between house prices today versus what the value would be if they had followed their trend level.

Now, to my mind this is very recognizable back in the early part of this decade. It wasn't like this was a secret thing. Again, I think back to the stock market in the late '90s. It amazes me that everyone wasn't jumping up and down by '98, '99 saying we have this huge bubble; I know in retrospect every one was saying that they were jumping up and down, but they were not; but they should have been. And I think it was recognizable at the time.

The two other points just as logical matter – I always prefer logic to empiricism because it's easier – but as a logical matter, if you have house prices – and these are quality adjusted house prices – outpacing your rate of inflation, the implication since housing is a normal good – as we get richer we purchase more housing – the implication is the savings rate, because this is the wealth effect of housing – I can explain this later if people want to follow through the logic – the implication is the savings rate will get ever more negative. I don't know anyone who thinks that the economy works that way: that as we get richer we're going to save an ever more negative share of our income. It's a bizarre thing to say, but that's one implication.

The other part of the story – because rents also, and this is basically Christian's charts, rents do track the rate of inflation, going back however far you want to. The implication is you have an ever greater increase in houses prices – the ratio of house prices to rent – kind of nuts in my view. So I think it should have been very evident several years back that we had a serious bubble. So step one, and again I don't think we dispute there was a bubble question, simply how large?

Second point: what should we have done about it? Well, I don't see bubbles as being as malign as Mark. I think they're very pernicious. I think the stock bubble created very serious problems. It obviously led to the recession in '01 and we continue to have problems with our defined benefit pensions. Needless to say, a lot of people lost a lot of money from their own savings because of that, and if you're an older worker you're not able to make that up. So I think that was the problem, but I think it's going to be much, much worse with housing because on the one hand if you buy a house at the peak of the bubble – and we know a lot of people do. Last year we sold 7 million existing homes, so 1.5 million new homes – a lot of people buying homes at the peak of the bubble and house prices fall – and, again, a part of this depends on how big you view the bubble as being, but if you accept my sort of explanation here, you're looking at on average a decline in price on the order of 30 percent. That is a very big hit for someone. And of course it could be more in some of the most inflated areas. So you are going to have some people that buy high and sell low with the biggest investment they're going to make in their life time. That's a very, very serious matter.

Second part of the story: people borrow against their homes under the belief that they're going to continue to rise in value. Again, this is largely a story Christian was talking about: the mortgage equity withdrawals going on at an incredibly rapid pace. People are in some cases spending for necessities and in some cases they're buying cars, taking vacations because they think their home is worth 400,000 this year, it will be 500,000 next year, and 10 years from now it will be 800,000. So it's a reasonable thing to do if that's true. If that's not true, it's a very dangerous thing to do. And I'm arguing it's not true.

Third point – again, Christian was making this – again here I'm differing with Mark, I think we have not seen – I think Mark's right: we haven't see yet much of a spillover from the housing market to the rest of the economy. I'm less optimistic that

will continue to be the case. Basically, I look at Christian's numbers and see the same thing he does. I don't really see how consumers can sustain the rates of borrowing – the rates of consumption which they are doing by borrowing – once they no longer have the home equity to borrow against.

There was a huge run-up in credit card debt earlier this year, which I attribute to the fact that people lost the ability to borrow against their home. Mortgage interest rates have since fallen, quite to my surprise – I don't know if Mark was surprised, but I was surprised by this. They've fallen quite a bit in the past three or four months to quite low levels, so that has brought back mortgage borrowing in the last few months. But I wouldn't bet on that staying. At least to my mind I can't quite understand why someone holds a 10-year U.S. Treasury that pays you 4.5 percent when the dollar is falling very rapidly against European, Japanese, and other currencies. Seems like a bad bet to me, so I'm not quite sure why that's happening.

But in any case, I expect that at some point consumption will be seriously curtailed simply due to the fact that people can't continue to borrow with a negative savings rate that's allowed because of the home equity borrowing. That won't continue.

So to my mind we're looking at probably a recession, probably a very bad recession. We got out of the last stock crash recession by promoting the housing bubble. I'm not sure what bubble comes after that, so in other words I think we might have a very severe recession. So to me, I look at what the Fed does and we have Alan Greenspan, now Ben Bernanke, very concerned about a 2.5 percent inflation rate. I don't get very concerned about a 2.5 percent inflation rate; I get very concerned about the disappearance of \$5 trillion in housing wealth. So that bothers me much more.

And what should be their first job? I would be very concerned about asset bubbles. What should they do? I'm a big fan of talk as the first measure. If Alan Greenspan instead of insisting there was no bubble, which he did, and encouraging people to get adjustable rate mortgages in 2003 when the fixed rate was at the lowest level in 50 years, which he did – instead of doing that, if he'd made a big point – I have lots of nice charts; he can produce better ones at the Fed – if he said, "Look, we have a really big problem with the run-up in housing prices, the bubble," I think that would have had a big impact. Maybe I'm wrong about that, but I'd like to have seen him try. Talk is cheap, give it a try. Same thing with the stock bubble.

Regulation, Mark and Christian both alluded to this. I think we could talk more about that, but I think certainly the Fed can and recently has tried to push for tighter regulation on this. I know it's not easy; there are a lot of problems, but I would certainly like to do that.

And lastly, as I said, I would – again, differing with Mark – I think bubbles are a big deal. I would use interest rate policy if need be. That would not be my first choice because I don't think we want to give a hit to the whole economy to deal with an asset bubble, the stock bubble or the housing bubble, but I think the repercussions, particularly

the housing bubble – the repercussions of that getting out of line are far, far larger than the damage you have by raising interest rates and slowing the economy as a whole. So as a last recourse, if talk and regulation didn't work I would go the route of raising interest rates.

The last point: homeownership as a policy goal. I mean, I know everyone talks about housing the American dream and if you're running for office you'd better say that, but I don't think anyone here's running for office, and as policy people I just don't think that that's the issue. What we want to have is on the one hand people to have good, decent, safe, and secure housing. We want that. That can be done through rent.

Secondly, we want people to be able to save for their retirement, for their kids' education, or whatever it might be. Obviously one way to do that is through homeownership, but that's not the only way to do that. I would point out that homeownership is not always going to be the best thing for people. Think about it: there's about 10 percent roundtrip transaction cost. Now, imagine you have someone that buys a home and has to move after four years, which in fact there was a study done a few years ago that looked at moderate-income new homeowners and their median period of homeownership was four years. Why did they have to move? They get a new job, they have to leave. We're a very mobile society. People go to different parts of the country. Families break up. You could afford a home if you have a two-earner couple: suddenly the family breaks up and you can't afford it. Or people get sick: families or someone dies. That happens. These are things that happen.

So a lot of people, and particularly lower-income people, moderate-income people without a cushion, they're often going to have to leave a home. Well, thing about those 10 percent roundtrip transaction costs. Is that a nice thing to do to a moderate-income family? Take someone who buys a \$300,000 house. They have to bear \$30,000 in transaction costs over a four-year period. You've added \$7,500 a year to their living expenses. That's not doing them a favor in my book. So this idea that we always want people to be a homeowner – that to my mind just doesn't make sense, and that's in the best of times. You really have not done them a favor if you've encouraged them to buy a home in a hugely overvalued market, which in a lot of cases we have been doing the last few years. In that case, I think you've turned the American dream into the American nightmare.

So this idea that we always want higher homeownership rates, people always should be homeowners, I think it's very wrongheaded. I think as policy people we have to think about this more seriously and maybe over time we could change the politicians' views, but first we have to think about it seriously.

MR. DOUGLAS: Thank you, Dean. And we'll go to Kimberly.

MS. KIMBERLY WARDS WARDEN: Thank you. I just want to piggyback on a couple of points made by (off mike) by Senator Sarbanes and just respond to a couple of the points that were made here from my perspective. I'm not an economist. I'm a

lobbyist with the Center for Responsible Lending, which is a nonprofit, nonpartisan research and policy organization. We're affiliated with an organization called Self Help, which provided loans to low wealth borrowers, primarily subprime loans, so we essentially are the policy arm of a subprime lender.

I'm going to focus my talk on how the housing bubble and declining appreciation rates – how we've seen them affect the subprime borrower. Specifically, in recent years the subprime market has been flooded with highly risky loans that have been and will likely continue to be the cause of a flood of forecloses, and we've begun to see that already. I'm so grateful that Senator Sarbanes discussed the 2-28. That is actually – first I want to give you an idea of the scope of this subprime market.

The subprime market – thanks. (Laughs). This is a sense of – this is subprime volume over the past eight years. So eight years ago we wouldn't be here talking about subprime. Our organization didn't exist and we didn't lobby federally eight years ago simply because the number percentage of loans was relatively small. As seen in the past eight years, there has been a significant boom. The subprime loans in 2005 totaled \$671.8 billion and now one in every four home owners has a subprime loan. So the market – when we refer to subprime, I want to be really clear that it's not just a small sort of discrete fringe of people with very, very, very bad credit. It represents 25 percent of all Americans. And I think that's important to keep things in perspective.

Also I want to emphasize that 83 percent of all subprime loans are these 2-28 loans or similar: they take two – sometimes they're 3-27s, but there's some form of a hybrid ARM. So these products that Senator Sarbanes's raised that I'm going to talk a bit more about – it's not a fringe product. It's the dominant subprime product that most of our subprime borrowers are receiving, so it's happening. It's very – many regulators that we met with hadn't heard of it yet. They're not advertised as such, and that's part of the problem: they're advertised as affordability loans and they're underwritten that way as well, which makes it particularly tricky. These loans begin, as Senator Sarbanes mentioned, with a low sort of two-year teaser rate. Regardless of whether interest rates stay the same or whether they go down, they automatically jump up after the two years.

So it's not what we usually think of as an ARM where if the interest rates go down, your rate may go down; if they go up, they go up. We like to refer to it as a two year balloon: regardless of interest – if you take out a loan – we're taking out one of these loans now, depending on what LIBOR is, but we'll likely see an average of a 40-percent payment increase in two years regardless of what interest rates do. And 98 percent of these loans are underwritten to the very initial teaser rate. So that's a problem: when the underwriters are looking at and when these lenders and brokers are looking at whether or not this borrower can actually pay back this loan, they're looking at it based upon the initial teaser rate, and in many cases they're not required to underwrite to any greater amount.

I'm actually going to fast forward right to the policy recommendations. I'm happy to – I brought an exhibit over there which I'm happy to discuss with anyone

afterwards if you've got questions about it, but sometimes when we talk about these numbers and we talk about these products, and as was acknowledged by Mark, it's sort of difficult to conceptualize and see practically. What I brought with me is an actual rate chart by the largest subprime lender and that's a rate chart for a 2-28, so it actually has – it's what a broker uses when they're pricing a loan. You can literally plug in a borrower's credit score, see what the interest rate will be initially, see what it will be in two years. And on the side column I also would like to point out the effective or other things like things like prepay penalties and broker fees have on the interest rates. But it's important to recognize, because not only is that borrower paying the rate at which it's indexed up to two years, but often it's even higher once you include the additional premiums they're paying for broker compensation, for stated income loans, et cetera.

But I'm going to go right to the policy recommendations. (Off mike) – to ten, I'm sorry. What was mentioned earlier – regulatorily, there's obviously – there're things that the regulators can do and have done to address the problem. It seems pretty intuitive that lenders and brokers should be required to underwrite the loans so that borrowers can actually pay them back without selling their home. So recently a group of federal regulators issued joint guidance which basically said that loans should be underwritten to the fully indexed rate. So if you are doing a 2-28 type loan, you should look at what it's going to be, when it resets in two years.

There are a couple of – we're appreciative and we commend the regulators for taking this step, but there's a big problem in that. And that is the guidance is not clear – the guidance could be read, and in fact has been read, as only applying to prime loan products. The guidance applies to nontraditional mortgages, and nontraditional mortgages have been defined as mortgages which require no payment of principle or (unintelligible) – interest-only loans. And these 2-28s or not, they don't require deferment of interest. They're not interest-only loans. So essentially it could be argued that the guidance issued by the regulators wouldn't even apply to this type of loan – the dominant subprime product.

So I think – I want to raise that in addition to the economic implications it does have civil rights implications. African-American and Latino borrowers are three times more likely to have one of these loans than a white borrower, even accounting for credit score. So a prime African-American borrower is more likely to have a higher interest rate loan than a white borrower with a lower credit score and debt-to-income ratio and all the relevant factor in considering when you borrow a loan.

So when you look at the impact of that, the omission of or the lack of clarification of guidance issued by the regulators, it's clear that the direction of (unintelligible) policymakers is (targeting?) prime. If you look at these in the media as of late, the first sort of big story about the housing bubble was – this was the cover of *Business Week*. You may have remembered it about – this was in September. This has sort of been the face of the problem. This has been the face of the borrowers who were affected by the housing bubble. And it is important: it affects all of us, but all too often policy is focused

on the prime borrowers and we really want to sort of step back and make sure that it equally has any impact – any policy has an impact on subprime borrowers.

The other problem is that 58 percent of subprime loans are given through non-regulated entities. So the other problem is that the guidance that's currently issued only applies to depository institutions, to big banks – to banks. So the subprime finance companies – 58 percent of the companies that are writing these loans aren't even affected by the guidance at all, even if it is clarified. So another thing that the legislators need to do is, the Fed needs to look at its broad authority. It does have the authority under HOEPA which was a predatory lending piece of legislation that was passed a few years ago to enact as an unfair and deceptive lending act. It does have the authority to affect some of these loans, and so we've got to really urge the regulators to go beyond the authority that it's used to using in order to cover the true lenders that are giving this type of loans.

I want to make a couple of other points: it's not sufficient to fully – to require the lenders to fully – to underwrite to the adjusted loan. As we've seen – as the Senator Sarbanes mentioned, these rates are tied into LIBOR, so a 2-28 will jump up 40 percent even if interest rates stay the same. Now in the past four years, LIBOR, which is what the subprime loans are based upon in terms of when deciding if it's going to raise, has gone up from 1.2 percent three years ago to as close to 6 percent now. So even the fully indexed rate two years ago would have still been four points lower than what a borrower was actually going to be paying in two years.

So we proposed that at least – there are different ways you can go about biting the apple, but the Center for Responsible Lending believes we should at least look at fully indexed plus a reasonable amount above to account for reasonable increases in the interest rate.

Thirdly, escrowing of taxes and the insurance: 80 percent of subprime loans to don't escrow taxes and insurance, whereas less than 20 percent of prime loans escrow taxes and insurance. As all the homeowners in this audience know, that has a major impact on the price that you pay per month for a home. Now, most subprime loans are written to about 55 percent of debt-to-income ratio before taxes, so essentially it virtually guarantees – not escrowing and therefore not including taxes and insurance in the monthly payment calculation virtually guarantees the borrowers will not be able to pay these loans once they pay their taxes and insurance. It virtually guarantees that the borrower will have to either refinance their loan or sell the home.

Now, of course, as mentioned earlier, prepayment penalties – 83 percent of subprime loans have prepayment penalties that lock them in. They're usually the same length of time as the – so in 2-28s they're two years and 3-27s they're two years. The average prepayment penalty is 3 percent, so borrowers do not have a choice once they're in the loans. You've either got to pay 3 percent of your entire loan balance just to get out if once you're in then learn that you're in a really bad product, or you've got to stand a really bad product.

And one other point I wanted to make is that more than half – last year more than half of subprime loans were made with less than full documentation. That's also a very important point because, first of all, low-doc loans or no-doc loans cost the borrowers more. Now what we found is that – and over 90 percent, it's been found – the Mortgage Research Association did a study that said that 90 percent of loans that were stated-doc or no-doc inflated the borrower's income by at least 5 percent, and over 60 percent of stated-doc or no-doc loans inflated the borrower's income by more than 50 percent.

Now, I want to be clear that in most cases it's not the borrower inflating their income. In many cases the borrower receives – a broker will come to the borrower's house with a form already filled out, with their application on there and they're told to sign these documents. So in many cases the borrowers are not even aware that they've been qualified for a loan amount based upon a salary much higher than what they had, and they're paying an extra percent for the privilege of doing a stated-doc loan. We shouldn't – the overwhelming majority of stated-doc and low-doc loans now are going to people who have regular government jobs – fully documentable jobs. Now surely a borrower who is informed would certainly bring in two weeks pay stub that they had in order to get a no-doc loan. So the perception out there when you hear talks of mortgage fraud that borrowers are sort of either choosing stated-doc so that they can inflate their income intentionally, we just found is pragmatically not the case. So we do think it's important that independent verification of income is required in order to protect the borrower.

So these were just some ideas. I think my time is running or has run out, but those were just – I have to make one more point though, and that is that as we discuss – as policymakers discuss solutions to this I have to disagree a bit that sort of disclosure on consumer literacy is sort of the major – is a major approach that we should take. I'm not against disclosure. I'm not against consumer literacy. In fact, I've got to catch a flight here to do a housing counseling program in Alabama that Congressman Artur Davis is having – we're very excited about.

But two points. I think Congressman Brad Miller, who was giving a speech before the Consumer Federation conference last week said it very well, and I'm going to quote my notes of him, so it might not be entirely accurate. But he said it's not sufficient to tell me in clear and conspicuous language on page 17 that there's no way I can ever afford this loan unless I sell my house, refinance, or win the lotto. And I think it accurately captured – I mean, if the loan – if a product is inherently bad and unconscionable and one in which there is no scenario under which any informed borrower would choose that – and in fact in a 2-28 product, that same borrower who got that 2-28 loan could get a 30-year fixed for only half of percent higher than the initial teaser rate. So it's inconceivable to think that any borrower – and we've tried to come up with one borrower where it would be in their best interest to get that type of loan.

So in that sort of – so disclosure sort of seem to not be the issue there, as with literacy. And I'll just quote a recent GAO report that said even an excellent campaign of

consumer education is unlikely to provide less sophisticated consumers with enough information to properly assess whether a loan contains abusive terms. And the consumers who are often the targets of predatory lenders are some of the hardest to reach with education and information. And I think that accurately states that, so I will leave it at that and thank you for your time.

(Applause.)

MR. DOUGLAS: Thank you. Thank you all for the excellent presentations. Those were really terrific. I have a lot of questions, but I want to jump into the audience because you've all been waiting patiently for over an hour, so I want to give people an opportunity to ask questions of the panelists and then at the end you can come up and speak to them privately. Anybody have any questions for the panelists? There's one in the back.

Q: I'm Shelley Pine (sp) from Rockville, Maryland, and this could go really to any of the four panelists who's touched in and around it, which is – and it was really I think at the heart of some of what Senator Sarbanes was saying, which is the importance of standardization and standardization in market practices. He referenced a couple of times, Freddie Mac and Fannie Mae doing various things like limiting prepayment penalties in the subprime market, saying that we won't buy mortgages that have mandatory arbitration clauses, limiting the amount of prepayment penalties – that they were like (sampling in?) a mortgage eligible for their purchase; not being willing to buy mortgages that are underwritten through an initial teaser rate, but insisting that any mortgage eligible for purchase into the part of the secondary market that they act in has to be underwritten to the fully built out rate, not the initial teaser rate.

And of course, with the bubble and the erosion of their share of the market and their role, what you have is the kind of market that profit maximizing financial firms love: a Wild West market of all kinds of non standardized mortgage contracts which is the bane of the subprime market, which is that there's nothing like a standard mortgage contract, let alone standardized loan terms, which is when any profit maximizing financial firm, ethical – it has nothing to do with their ethics; they love Wild West markets because no amount of disclosure gets through.

How do we go about sort of restoring the standardization in – well, that we've sort of achieved in large portions of the fixed-rate prime mortgage market, but that share in market, as Kimberly talked about, has eroded tremendously over the last three, four, five years with the bubble and the erosion of the role of those standardizing institutions. It's market based, but it's standardized. Standards are public goods and not something that appeals to the current administration, but might be of much more interest to the new majority in Congress.

MR. DOUGLAS: Does anyone want to take that? How do you bring standardization to the subprime?

MR. BAKER: Well, I'm just going to make a quick comment on that. I mean, it's not going to be an easy task, but one of the things that I think will make it easier – it's not going to be a pretty scene – is that the fallout from this, because basically the big problem is an agency issue that you have people who are making their money on the fees from issuing the mortgage; they're not holding them. Now, I have no idea – maybe Mark or Christian or someone else has a better idea of who's sitting on this mortgages, the subprime – many of the stated-income loans that are going to go bad and people are going to take big hits on it and they're not getting the sort of interest rate that would compensate for that. So my guess is that a year or two down the road, if we're having this session – if you have a lot of people holding those polls where you have a lot of loans go bad and they've taken a real beating, so they're going to insist on some sort of standardization because simply that market's going to not exist.

Q: (Off mike.)

MR. WELLER(?): They're not. They don't have the first or the second or the third loss positions. This stuff is all securitized, all cut up in – the (unintelligible) are cut up in trunks in a million different ways and, yes, it's mostly short-term, profit maximizing hedge funds. She believes, Deborah Lucas believes, hold most of the first loss positions. But it's extremely difficult to determine through publicly available data – none of the Fed data, FDIC data – because those are highly regulated financial institutions. They don't hold a lot of those loss positions.

MR. DOUGLAS: I think that because of the hour – can we take one more maybe? Let's take one more question. The gentleman right here. There's a mike, and then we'll do the rest of it; you can come up afterwards and do it informally.

Q: I have a question but I also have a comment since Mark Zandi took on my boss, Senator Sarbanes, Sarbanes-Oxley I think it's –

MR. ZANDI: Is that how you interpreted it? (Laughter.)

Q: That's what I did. I think the audience should know, if you don't – maybe you don't – that Secretary Paulsen, Chairman Cox and the commission that came out with recommendations about our financial markets last week all said the law should not be changed. The implementation of it has been a problem and needs to be dealt with, but not the law itself. So when you people say Sarbanes-Oxley, that usually refers to the law, not the implementation of it. So there has been a big campaign the last year just talking about Sarbanes-Oxley, but carefully looking at what's in the law is very different from what's in the regulation and (unintelligible).

I have an economic question: you took a fairly sanguine view compared to the people on either side of you, and may well be right, but isn't it true that given what's happened to gasoline prices and energy prices generally, you might have expected a stronger consumption pattern in the last couple of months. And in fact you also say that, well, we don't have a problem except in housing and autos, but isn't it true that most

recession we've had except for this last in the postwar period – you could have said that six months, nine months before we had the actual recession – that things look fine except for housing and autos?

MR. ZANDI: Yes, I'm in a very unusual position. Usually when I speak, I'm the guy on the dark side. (Laughter.) It's only in this audience that I'm the guy who's sunny and bright, so in that context I agree with you, Lee, that I would have expected more of a bounce in consumer spending given the downdraft in energy prices that we've experienced in the last couple of months. And that does suggest that there is a negative wealth effect that's beginning to unfold. And I anticipate that we will see that in a more pronounced way in 2007. So I would fully anticipate that consumer spending growth will slow and that the broader economy will slow more fully as the (unintelligible).

So in effect that's by design. That's the script. That's exactly what I think Federal Reserve would like to see and I think that would be the best thing for everyone if that in fact happened.

Now, a concern obviously would be that if things devolve even further: consumers lose faith and retrench and we have recession. And there I'm optimistic we won't because outside of manufacturing and housing in *New York Times* and the *L.A. Times*, businesses – and I'm not picking on the *New York Times* or the *L.A. Times*, but just to make a point that businesses are in fantastic financial shape. They are rolling in profit: margins have never been wider, balance sheets never more pristine. It would be very surprising to me that we'd see businesses en masse retrench, pull back, cut back their work force in that context.

So fundamentally the economy is sound. The problem is in housing and in the vehicle industry and in the newspaper industry, because their model's breaking down. But other than that, the economy is in fantastic condition. It's going to slow, and I hope it does because that means that we won't have higher interest rates and that the Federal Reserve will get what they want, but (it won't cave?).

And I guess I didn't mean to push too far in my criticism but I think the legislation was a very good thing at a very important time, and it's awfully easy to criticize it several years down the road. I was a WorldCom shareholder looking at that same balance sheet, and I bought it at seven and I got zero, and I was upset. So I was very happy when that legislation was passed. My only point is, though, that we need – when things are going bad – and they will with respect to mortgage credit quality in the coming year – that we don't rush to pass legislation quickly to solve the problem that has already passed us, but to think about the policy that's appropriate for the problems that will be ahead of us. That's all.

MR. DOUGLAS: Anyone else want to comment on that? If not, we'll take questions. Okay, thank you all for taking the time to be with us today. It was excellent. If you have questions, you can come up to the front.

(END)