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Can the next housing – and financial crisis be averted?

Singapore Management University

CAN THE NEXT HOUSING – AND FINANCIAL CRISIS BE AVERTED?

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Global financial systems and economies are still far from recovering from the recent financial crisis triggered by the burst of the American housing bubble. Naturally, the investment community, the academia, and of course, the regulators would be keen to find out how to prevent history from repeating itself.

From the perspective of Susan Wachter, it is very much an on-going learning and discovery process, as the right tools and policies have to be developed for this area. Wachter, *Richard B. Worley Professor of Financial Management* at the University of Pennsylvania's Wharton School, spoke at a seminar organised by Singapore Management University's (SMU) Centre for Asset Securitisation and Management in Asia (CASA), where she is, concurrently, a senior research fellow.

First, a quick recap of the housing crisis: easy credit in America enticed new home buyers to take up mortgages even though they might not be that financially-sound. When housing prices were going north in the middle of the last decade, it was not much of an issue, given that lenders could confidently sell off foreclosed properties and get back their capital.

Some financial institutions then began to package the various less than creditworthy mortgages, known as "sub-primes" into different portfolios, which were then sold to investors all throughout the financial system. In effect, many investors were holding on to a small but shaky piece of the mortgages.

As the housing boom continued, the small pieces began to get bigger and more investors – not always clear what they got themselves into – began to hold more of such toxic investments. When more and more homeowners could no longer service their mortgages, hitherto purportedly highly-rated debts turned sour, the bubble burst and the entire financial industry got dragged down.

No clear understanding

Nearly four years on, the financial industry has yet to recover from what has been called 'The Great Recession', and neither has the American housing market.

“Housing prices are more affordable than they have been relatively to income and also interest rates on mortgages. Nonetheless, the market has not recovered – it is still bouncing on the bottom, and maybe, hopefully, if predictions including mine come true, stabilise in 2013,” said Wachter.

On the other hand, another immediate downturn is also not likely, unless the European sovereign debt problem – the current major concern – worsens severely. “So while we see improvement in the US, we don’t have yet a clear understanding of how things are changing going forward,” she said.

Regulators, preferring the light touch and whose (mis)placed trust in the financial markets to right itself, are increasingly relied on to take more active steps. More than a decade earlier, before he was appointed as chairman of the US Federal Reserve, Ben Bernanke said that Fed had no business pre-emptively deflating excessive increases in real estate prices. The risk of acting is too high and the risk of not acting is manageable, he said.

This previously accepted view, according to Wachter, is changing rapidly – not just within the Fed alone but also among the various financial institutions. Macro-prudential policies, a broad-based regulatory approach to the evolving state of the overall state of the financial system, are deemed necessary to deal specifically with real estate bubbles.

Wacher cites two areas where considerable work has to be done. First, if real estate bubbles are to be deflated as they are emerging, there has to be some measurement of the size of the “bubbles”. Next, the tools that are being developed to address this issue would have to be implemented by some agency, or agencies. Will it be the Fed, or the US Treasury Department? Such policies, involving both monetary and fiscal, have to be thought through very carefully, and not merely through education, but institutional changes, she said.

Changing Fed

Institutional changes, more likely than not, will have to take place within the Fed. The agency, which was founded in 1913, has seen its roles and responsibilities change with time: from the post-World War II role of overseeing the growth in the US economy to the inflation fighting of the 70s under Paul Volcker. “The question today is, whether we have arrived at a new beginning, where other central banks have new mandates too on financial stability,” said Wachter.

Fed and other regulators need to figure out a better model to track the relationship between debt and real estate cycles, and to also develop and identify the tools to carry out the active supervisory task. Free market proponents might feel adamant to see regulators play a bigger role. Yet, as the crisis has shown, a light touch does not work. “When left to the devices of the market, real estate debt is inherently prone to be cyclical. Real estate debt rises when real estate prices rise,” Wachter noted.

As previous cycles have shown, debt grows in tandem with prices, as mortgage pushers – paid based on how much loan they dish out – take comfort in thinking it is safe to keep on lending as long as prices increase. Investors, fearing that they will miss the boat, are less hesitant to jump in. The volume of credit thus created can be rather mind boggling and the financial sector severely exposed.

Between 1995 and 2007, mortgages went from 25 per cent of the value of houses, to 60 per cent. “This 60 per cent of the value might not sound like very much, but do understand that 50 per cent of the American households do not have mortgage loans,” said Wachter.

As the crisis has shown, the housing bubble was clearly a bad idea as the decline in real estate prices resulted in a crisis in the financial sector, which then triggers off a vicious cycle where financial institutions jam the brakes on credit, which caused real estate prices to drop even in a negative, self-reinforcing cycle.

“We will have no alternative but to have a bail out by a lender of the last resort,” she said, referring to governments. The result, by now, well known, is the flooding of liquidity by central banks printing more money. While the Americans can get away – for now – as the US dollar remains the undisputed reserve currency of the world, various European countries are paying the price for the costly bailouts of their financial institutions.

The global impact is probably something home owners of say, Tucson, Arizona or Indianapolis (two of the sickest US housing markets according to some studies), did not think of when they default on their mortgages. Wachter hopes to see a more “complete solution” to remedy the underlying “incompleteness” of the real estate market: the difficulty in short-selling real estate. Specifically, allow investors of real estate to take out put options on their loans, when they think that prices based on fundamentals will decrease, and perhaps, help to soften the movement of real estate prices.

Not simple

Since early March, the Dow Jones Industrial Average index has crossed the 13,000-point mark. It is now at a level much closer to the pre-crisis peak of just over 14,000 points recorded in October 2007, than the bottom of 6,626.94 points in the nadir of the crisis on March 6 2009. Nevertheless, the real economy – jobs, housing prices, and the likes – has yet to recover by the same magnitude. A key to the recovery is for the housing market to get back to its feet.

Yet, at the same time, nobody wants a return to the giddiness of the pre-crisis bubble. Wachter’s call is for greater availability of information to investors and regulators on each company’s assets and overall business, so as to make a better assessment on their solvency and credit risk entailed. Along the way, the regulators and the financial system need to decide the “thresholds”, and “tools that trigger not just discretionary, but rule-based implementation of macro-prudential policies,” she said.

Of course, more than anybody, Wachter knows this is not an easy undertaking. “All these will not simple. What’s required for proper implementation is information, monitoring information, and the research beforehand to know what sort of information is needed.”

The stakeholders, for now, are still finding the right weapons to wield. “We are in the infancy of developing research and tools, and the debate will continue for some time. Obviously this learning will not prevent business cycle or achieve perfect asset pricing, but, if we use these emerging tools wisely to support monetary policies but also financial stability goals, we would have learned from that crisis,” she concluded.