The Stamford Review

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HOUSING & THE CREDIT CRISIS

MANHATTAN'S OFFICE LEASING MARKET

BUILDING A NATIONAL RAIL SYSTEM

edmonds sofa ROMAN THOMAS New York 2008 MAHOGANY, SPRINGS, HORSEHAIR, FEATHER, DOWN H 32 W 72 D 36
broken prose ROLY FENWICK Canada 2006 OIL ON LINEN H 48 W 72
chair JACOB KJAER Denmark 1930s OAK, COTTON, NIGERIAN LEATHER H 32 W 23 D 23
samuel table ROMAN THOMAS New York 2006 TEAK, STONE H 18 W 36 D 18
floor lamp G. SARFATTI Italy 1940s BRASS, MAHOGANY, MAPLE H 55 D 18

The Stamford Review

2009: VOLUME TWO

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APRÈS LE DÉLUGE

THE TRAJECTORY OF OUR BOOM ECONOMY masked systemic weaknesses that led to a resounding crash, its magnitude surpassing a mere cyclical problem. To regain some measure of economic preeminence and credibility, America must chart a new course.

The economic terrain is far more complex than during the Great Depression. When one sector of the economy—an overheated home mortgage market—collapses, new financial vehicles, new technologies, and an intricate global economy now spread the pain.

IT WORKED, UNTIL IT DIDN'T: WHY THE BUBBLE BURST

In this issue, three authors illuminate various aspects of the subprime mortgage debacle, analyzing what went wrong and what reforms are needed. Hugh Kelly, Sarah Gerecke and Robert Van Order unravel the complex factors that created the bubble and its subsequent burst. In addition, a panel of real estate experts discusses the impact of the financial crisis on the Manhattan office market, discerning some hopeful signs amid the chaos.

The securitization of sub-prime mortgage loans masked a risky foundation. Seduced by high yields in an overheated market, investors ignored the escalating risk. Predatory lending misled borrowers, rating agencies, and investors. Lack of transparency—and lacunae in the regulatory framework—led to a disastrous void of judgment. When the risk reached intolerable levels, the market imploded, leading to the current financial crisis, negative equity and an avalanche of foreclosures.

Fannie Mae and Freddie Mac, hybrids of private ownership and public responsibility, provide guarantees that are a double-edged sword: imperative to the financial system, they also enable greater risk taking. Their role in the sub-prime market problem was dwarfed by that of the private institutions; effective reform must include tighter regulation of these government-sponsored entities, as well as the issue of moral hazard in the broader market.

The impact of foreclosures is profound for neighborhoods and families. The pernicious effect of widespread dislocation on the cohesion and character of communities can be wrenching. To restore the confidence of consumers and investors in the lending industry, standards should be reset closer to the criteria typical of prime mortgages. Reforms must also unravel the maze of securitized debt, to clarify property ownership and help neighborhoods recover. Trust and transparency are imperative.

THE SERENDIPITOUS DIVIDEND: ENVISIONING A MODERN AMERICAN RAILWAY SYSTEM

The stimulus package borne of economic chaos presents a new opportunity to launch America into the twenty-first century in rail transportation, a serendipitous dividend to a national trauma. Because of our love affair with the car, we have lagged behind other nations in public transit. The Obama administration's new initiatives herald robust investment. In addition to high-speed rail, John Philip highlights the need for several lower-cost, near-term improvements to the basic rail system.

ECONOMIC REFORM MUST BE COMPREHENSIVE

As Americans, we have taken for granted our miraculous economy, trusting that, despite cyclical vicissitudes, the market would always self-correct. The staggering meltdown of recent months has been a sobering wake-up call.

Effective reform must be comprehensive. Confidence cannot be restored without ensuring accountability, transparency, higher fiduciary standards, appropriate capital reserves and meaningful oversight throughout the financial industry.

All financial institutions must be brought under the regulatory umbrella: new institutions created in recent decades competed with banks, while escaping proper oversight. The reforms must extend beyond the banks, Fannie Mae and Freddie Mac, and brokers; rating agencies share culpability, for assigning rosy ratings to increasingly questionable debt. As securitization became progressively exotic, exquisite slicing and dicing of the original loans camouflaged their true nature. The credibility of the rating system depends upon better standards.

CAPITALISM, TO SURVIVE IN THE NEW CENTURY, MUST UNDERGO A PARADIGM SHIFT

The economic meltdown was precipitated by a perfect storm of systemic problems, plunging the housing market, the stock market, financial institutions and other major companies into an abyss, prompting unprecedented public finance to the rescue. Our authors' analyses reveal that, throughout the system, despite all the talented professionals, the essential ingredient of judgment—that of consumers, investors, bankers, brokers, rating agencies and even regulators—was put in escrow. This suspension of disbelief was exacerbated by insufficient checks and balances.

If there is an underlying thread connecting these essays, it is that economics cannot be reduced to mere mathematical formulae. Judgment, moral values, and human nature have a role in how we construct and implement our economic system. The reforms undertaken cannot be cosmetic; recovery demands fundamental change.

We are at a defining moment: a paradigm shift must occur, to re-engineer capitalism if it is to survive the new century. Our economy, and the public interest, demand greater protections against recurrent crises of this depth. American taxpayers have assumed a heavy burden in bailing out a private sector which lacked prudent self-restraint. A multi-trillion-dollar bailout makes the citizenry substantial shareholders, expecting a return on their investment.

Therein lies the controversy: those resistant to change perceive any checks on the private sector as abandonment of the very capitalist system, the great economic engine of American success. The reform measures championed by Theodore Roosevelt, and later by Franklin D. Roosevelt's New Deal, were met with cries of heresy, warning of capitalism's demise. Instead, corrective measures restabilized it. Today's crisis similarly demands visionary reform. Adjustments are clearly needed to thwart the downward spiral: to save it from itself, the current model of capitalism must be modified.

Neither *laissez-faire* capitalism in its extreme, nor an overly intrusive regulatory scheme will foster a thriving economy for our future. Balanced reforms are needed, with stronger intervention to ensure stability and accountability, without stifling the opportunity and individual drive which have traditionally been the hallmark of America's economic prowess.

As the ancient Chinese curse cautions, "May you live in interesting times."

– Gail Shaffer, Associate Editor

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TEN COMMANDMENTS FOR 21ST CENTURY REAL ESTATE FINANCE

I. WRITE UPON THY HEART THE LAW THAT 'REWARD' AND 'RISK' SHALT ALWAYS APPEAR IN THE SAME SENTENCE. **II.** MAKE NEITHER MARKETS NOR REGULATORS INTO IDOLS, AND FOLLOW NOT FALSE PROPHETS OF SIMPLISTIC BIAS. **III.** BE SOBER AND WATCHFUL, LEST THE ENEMY OF MASSIVE LOSS APPROACH LIKE A THIEF IN THE NIGHT. **IV.** HONOR THY FATHER AND THY MOTHER'S ANCIENT COUNSEL: KEEP IT SIMPLE, STUPID! **V.** IF THOU WILT NOT DO THY OWN CREDIT ANALYSIS, THEN VOW TO INVEST NOT AT ALL. **VI.** THOU SHALT NOT ADULTERATE THY PORTFOLIO WITH EXCESSIVE LEVERAGE. **VII.** THOU SHALT NOT BEAR THE FALSE WITNESS OF HIDDEN ASSUMPTIONS IN THY INVESTMENT UNDERWRITING. **VIII.** THOU SHALT NOT COVET FOR THE SHORT TERM, YEA, BUT SHALT LAY UP THY TREASURES FOR LENGTH OF DAYS. **IX.** IN ALL THINGS, YIELD NOT TO THE TEMPTER'S SNARE OF PANIC. **X.** REMEMBER THAT, AFTER THY EXILE IN THE WILDERNESS, IF THOU HEEDEST THESE COMMANDMENTS, THOU SHALT ONCE AGAIN RETURN TO THE LAND OF MILK AND HONEY.

COUNSELORS OF REAL ESTATE
ETHICS COMMITTEE PANELISTS
OCTOBER 2008

MORTGAGES, FINANCE MARKETS, AND THE IMPERATIVE OF GROWTH

HUGH F. KELLY

ORIGINALLY I CONSIDERED THE SUB-PRIME MORTGAGE DEFAULTS TO BE 'PRODUCT FAILURE' RATHER THAN 'INDUSTRY FAILURE.' In August 2007, sub-prime defaults were a small percentage of the U.S. residential market. The total of sub-prime mortgage loans outstanding was $1.5 trillion, even after several years of explosive growth, and delinquencies among sub-prime loans were 13%—indicating trouble with about $195 billion of this risky debt. Losses appeared to be 'containable' within the context of the $10 trillion residential mortgage system. I was not alone in my judgment. The contagion of fear that traveled through global financial markets arose with stunning speed and power was initially transmitted by a limited amount of ill-advised U.S. housing debt.

METASTASIS

Like higher-quality forms of residential debt, sub-prime mortgages were packaged into Residential Mortgage-Backed Securities (RMBS). The prior history of RMBS gave investors some confidence in the safety and soundness of such investments. But the new securities depended on the repayment performance of 'non-conforming' loans not eligible for Fannie Mae and Freddie Mac guarantees. They were therefore issued as 'private label' securities. Securitization of non-prime housing loans represented an important shift in risk, since non-agency securities carried risks of both prepayment and default. Fannie Mae or Freddie Mac securities were guaranteed against default.

From 2000 to 2005 non-agency issuance rose from a 25% market share to approximately 56% of all RMBS. Moreover, the credit quality of these 'private label' securities was dropping, with the high-risk sub-prime component growing 20% per year after 2003, and sub-prime pools constituting 80% of non-agency RMBS issuance by 2006. Offshore holdings of U.S. mortgage debt increased fourfold in the fifteen years beginning 1990, and were above $1 trillion at the middle of the present decade.

For investors, the attractions were yield and volume. The amount of money seeking investment grew monumentally after 2000. Anthony Downs, of the Urban Land Institute and the Brookings Institution, identified several sources of increased capital: the economic expansion of China, India, and other Asian nations; changing demographic patterns such as aging populations with impressive accumulated savings; sovereign wealth funds; the startling rise in U.S. corporate profits; arbitrage of the low Japanese lending rate of 1.5% into risk-free U.S. Treasuries at 4.5%; and the rising profits of oil producing countries.

Huge levels of new demand caused rising asset prices and reduced yields. Yet investors of all stripes—pension funds, insurance companies, private equity funds, hedge funds, sovereign wealth funds, banks, mutual funds—clamored for enhanced returns. Securitization, through the bundling of sub-prime mortgages, offered such yields, since the underlying sub-prime mortgages typically yielded 3% more than a prime mortgage loan. Regrettably, that higher yield was not appreciated for its significantly higher risk.

DISGUISING AND SELLING RISK

Securitization disguised risk. The pooling of the mortgages afforded the illusion of diversification. Diversification, the foundation of mod-

ern portfolio investment theory, is based on the sound premise that the combination of diverse assets can reduce the level of risk. What remains however is 'systematic risk,' that is, the risk that is common to all assets in a marketplace. For sub-prime loans, systematic risk is very high. And systematic risk was severely mispriced for RMBS.

Also masking risk was the flawed performance of the major rating agencies. It is common sense to question how 80% of high-risk mortgages, bundled as a security, were rated AAA, and 95% were rated A, AA, or AAA. A relatively new product, the sub-prime RMBS had a thin and recent history of low defaults and rising home values, and the rating agencies modeled the assumption of a roughly 6% default rate. Investors could have resisted that assumption. But the investors had significant incentives—in compensation and management fees—to accept a favorable rating for an investment that would boost their overall yield.

...mortgage brokers are a highly cost-effective field force for lenders. Brokers were given incentives to originate a large number of deals and to push them toward the highest possible loan amount. This made them behave differently from salaried loan officers.

At the end of 2007, an estimated $600 billion in sub-prime mortgage bonds were outstanding, worldwide. (The balance of total sub-prime mortgage indebtedness was still being held on the books of financial institutions, and most of this was intended for eventual securitization.) But this volume of weak RMBS was just the start. Sub-prime loans were then repackaged in Collateralized Debt Obligations (CDOs), described in financial engineering jargon as 'asset-backed synthetic securities.'[1] Issuance of CDOs more than tripled from 2004 ($157 billion) to 2006 ($521 billion), before being caught in the shutdown of the credit markets that the CDOs themselves helped to cause.

CDOs were commonly issued by an investment bank, through a special purpose entity (SPE) created to acquire mortgage loans, auto loans, credit card receivables, or corporate loans. The SPE then issued bonds, with a tranching structure[2] for cash flows and credit losses, similar to RMBS. Like the mortgage bonds, the CDO allowed the originators to transfer the risk to other investors. Investment banks earned substantial fees while retaining (they thought) little residual liability. Their financial incentive was a function of volume, rather than the quality of the loans themselves.

A primer issued by Nomura Securities in 2004 was candid about the typical capital structure of a CDO: a pool of underlying bonds with an average rating of single-B-plus (by definition: speculative grade; poor credit quality) was 'sliced and diced', largely to investments rated triple-B or higher, with the largest share in the AA and AAA categories. This was financial alchemy of the most mysterious kind. Nomura specifically attributed the ratings transformation to 'diversification,' explaining that the ratings agencies attributed higher correlations of risk within a single asset sector (such as mortgages) than between asset sectors (such as mortgages and auto loans).

The growth of the Credit Default Swap (CDS) market, which had critical interactions with the CDO and markets, was even more astronomical than the swift rise of sub-prime mortgage, private label RMBS, and CDO instruments. The 'swap' involves an agreement by one party to cover the losses of a counterparty, in the event of default or other 'credit event', in exchange for an upfront payment. The first CDS was fashioned by strategists at JPMorgan Investments in 1995, and these swaps grew to an estimated $43 trillion market in 2007 and possibly as much as $62 trillion in 2008. This is a multiple of the size of the world's equity markets; world GDP in 2009 is computed to be $54.9 billion dollars by the International Monetary Fund.[3]

With the spotlight on American International Group (AIG), where the CDS product failed so spectacularly, it is now clear CDS is an 'insurance-like product' that lacks two key elements of 'insurance.' One is a sound actuarial basis for estimates of expected loss. The second missing ingredient is cash reserves set aside to fund such losses. CDS contracts are negotiated instruments, not established risk products where premiums were calculated based upon hard, historical, statistically reliable evidence. Though 'sold' as insurance, CDS are called 'swaps' precisely to avoid the statutory reserving requirements that traditional insurance products must satisfy.

Until the credit collapse, AIG was one of the few companies in the U.S. that had an AAA rating, indicating a likely default rate of virtually zero in the eyes of the ratings agencies. Credit default swaps covering securities backed by sub-prime mortgages, were placed under the mantel of its AAA rating—providing investors with the assurance that these very weak-credit mortgage securities would be backed, in the case of default, by AIG's enormous resources. After September 2008, many were surprised to find that AIG's primary financial products regulator in the U.S. was the Office of Thrift Supervision (OTS).[4]

In all of this, there was insatiable appetite, a 'hunger for more' that drove homebuyers, lenders, financial institutions and investors well beyond the bounds of prudence. The result may well be called a mania, or a bubble, euphoria, or irrational exuberance. To understand this phenomenon more deeply, it helps to ask the underlying cause. There is such a fundamental driver, and it goes by the ordinary and innocent name of 'growth.'

THE IMPERATIVE OF GROWTH

One of the simple and powerful equations underlying market pricing is the Gordon Dividend Growth Model (GGM), which says that the expected price of an asset is equal to its periodic yield, divided by its rate of return *minus* the rate of growth.[5]

$$E_p = DIV_i / r - g$$

In other words, the higher the expected rate of growth, the greater is the multiplier on income. The marketplace thus favors public and private companies with strong growth potential, rewarding them with higher values per unit of income. The imperative of growth is that capital flows to assets with the brightest future.

Income growth is actually achieved in three critical ways, all of which played in the housing finance market earlier in this decade:

Increasing market size and share
Increasing margins
Increasing price

MARKET SIZE AND SHARE

Expanding market footprint is especially powerful when the market itself is getting bigger. In housing finance, the increase in homeownership was a powerful force. In 1988, 63.8% of American households owned their dwelling place; by 2004, that figure had increased to 69.0%, adding 6.1 million housing units. The population of the United States had also continued to grow in absolute terms (by over 49 million persons); even with a stable homeownership rate, there would have been demand for approximately 12.5 million units. The numbers were solidly on the side of the housing industry: homebuilders, real estate agents, mortgage brokers, bankers, furniture and appliance manufacturers, landscapers, and retailers like Lowes and Home Depot.

In the context of demographic growth, increasing market share is an especially difficult task. Competitive firms all respond to the expansion in the customer base. An above-average rate of growth in an expanding market means a sustained commitment to aggressive sales. Increasing the value of the enterprise in such an environment is a daunting task, so companies seek alternative strategies for improving the growth rate. A firm's superior market penetration, vis-à-vis its peers, is taken to be evidence of better products, more skilled management, more effective advertising, or other entrepreneurial attributes. But it may also simply involve taking on more risk.

The track record of the largest firms—those successfully moving to the top of the market size/share pyramid in recent years—has been questionable. Countrywide Financial was the nation's largest home mortgage lender. Lehman Brothers and Bear Stearns were, respectively, the fourth and fifth largest investment banks. AIG is still the world's largest insurance company. Citigroup and Bank of America are two of the nation's three largest banks.

GROWTH ON THE MARGIN

Laser-keen attention to earnings provides another avenue to growth. Mortgage lenders effected a tremendous cost reduction and improved profits by adopting automated underwriting. Not only was the productivity of loan officers multiplied by reducing the amount of interviewing and credit investigation required, but also the primary reliance on FICO[6] scores took out that pesky element of personal subjectivity known as 'judgment.'

The number of mortgage brokers in the United States increased from about 30,000 in 1990 to 147,000 at its peak in early 2006 (The number is now back down to 73,000). As commission-based contractors, mortgage brokers are a highly cost-effective field force for lenders. Brokers were given incentives to originate a large number of deals and to push toward the highest possible loan amount. This made them behave differently from salaried loan officers. In 2001, an AARP consumer survey revealed that mortgage brokers were twice as likely as bank lending officers to originate sub-prime loans. "Churning" of refinancing [7], high upfront fees, asset-based lending without regard to income-capacity to repay, and 'push marketing'[8] were all margin-enhancing in the short run. In the end, these tactics amounted to nothing less than predatory lending.

Financial institutions booked lucrative fees, from origination of the home loan (such as 'points' on the mortgage and application fees) through the entire chain of securitizations and derivatives (as each step in the process involved 'transaction costs'). These fees improved earnings in the short run, while reducing the burden of holding long-term mortgages in the longer term.

The ability to arbitrage risk in the secondary markets and in derivatives also lowered the cost of funds and improved margins, especially since the total value of the MBS issuance could be higher than the sum of the underlying mortgages. The very existence of robust secondary securities markets reduced the illiquidity premium embedded in the mortgage interest rate, lowering costs for everyone. Thus, if banks could depend on short-term capital for mortgages with the expectation of selling into the secondary market quickly, they could take advantage of the normal shape of the yield curve, where short-term money is cheaper than long-term money. The ability to create off-balance-sheet special purpose vehicles meant that capital reserve requirements could be mitigated, again raising overall margins on measures such as return on assets, since capital freed from reserving obligations could be used to support additional lending.

Consumers learned to play this game sharply, seeking mortgage credit and shopping for the best available deal. They refinanced frequently as interest rates and housing prices shifted in their favor. They learned that fees could simply be added to the principal amount of the loan and that the required down payment was a negotiable figure.

On the business side, the improvement in margins worked through the GGM as predicted. The S&P Financials Index rose from 372 in May of 2004 to 508 in February 2007, a 37% increase in 33 months. It worked—until it didn't: by March of 2009, this index was down to 82.

PRICING

One of the classic definitions of inflation (attributed to Milton Friedman) is 'too much

money chasing too few goods." Inflation has often been viewed as favoring real estate assets. Housing prices reflect changes in household incomes as well as the impact of the cost of production of new homes. The power of leverage, especially higher levels of leverage, enables rather small changes in income or in interest rates to be magnified into much greater changes in home prices. Unfortunately, changes in a negative direction are also magnified by the same process of leverage.

Nevertheless, the separation of asset values from underlying economic fundamentals was identified relatively early, by Robert J. Shiller in 2005, long before the bubble reached its maximum magnitude.[9] In the world of stocks, the ability to grow earnings based on rising home prices affected a multitude of firms, in housing, in housing-related finance, in retailing, and even in manufacturing. All enjoyed the boom of growth, but all were subject to the consequences of the subsequent bust.

CONCLUSION

Having examined the metastasis of sub-prime mortgage lending, the disguising and selling of risk, and the bias toward growth, we have still not fully answered how we arrived at the present sorry condition.

The recurrence of bubbles over the course of history has been the subject of instructive and entertaining narrative.[10] But, as it turned out, this was not merely of historical interest. Many recent events should have been considered warning signs betraying weakness in our financial system. Since 1990, we have had the savings and loan crisis, a related bank capital crisis, and a series of 'derivatives crises' associated with the collapse of the Mexican peso in 1995, and of the Thai Baht in 1997, which led to the fall of Long Term Capital Management. Then there was the 'dot-com' collapse in 2000 and the shakeout in the telecom industry.

The weakness was clearly not due to a lack of technical skills or analytical capabilities. Nor was it for want of information (although incomplete information did play a role in selling of sub-prime loans to unsophisticated borrowers and the selling of AAA paper to investors). For at least two decades, the 'best and brightest' have flocked to our business schools, and the top graduates have disproportionately gone into the 'investment industry'.

Our shortcomings have been less due to the quantitative skills taught in our universities and deployed in finance than to our inattention to developing good judgment.[11] Though there have been failures in applying what is available in financial theory (e.g., an understanding of systemic risk; the fundamental relationship between household income and housing affordability; the basics of underwriting credit), these have not been failures of knowledge, but of behavior.

Some of our choices could be better, were we to commit to a broader understanding of decision-making, good and bad. The case study method of learning is intended to promote this, but it often devolves to mere calculation. Decisions should not be just the application of mathematical formulae, but activities of a personal intelligence. In solving a mathematics problem, everyone should come to the same conclusion; insightful decisions should enable a person to break away from the herd.

Judgments also require standards. A panel of Counselors of Real Estate prepared the ten rules which precede this article. I commend them to you.

NOTES

1. The CDO has a suspect pedigree. The first collateralized debt obligation was issued in 1987 by Drexel Burnham Lambert for the Imperial Savings Association. Drexel Burnham collapsed in 1990 in the wake of insider trading scandals that sent financier Michael Milken to prison. Imperial Savings became insolvent in the summer of 1990 and was taken over by the Resolution Trust Corporation.

2. "Tranching" (*tranche* means "slice" in French) is a financial structuring device whereby a securities issue is divided into several classes, paying different interest rates, having differing maturities, and bearing different risk levels, with a sequential order of priority for payments and exposure to default.

3. International Monetary Fund, *World Economic Outlook,* (April 2009).

4. There has been a wealth of good reporting on AIG's use of regulatory and rating arbitrage, notably by The *New York Times*' Joe Nocera ("Propping Up a House of Cards," February 28, 2009), The *Washington Post*'s Dennis Brady ("Senators Call AIG 'Lost Cause', March 6, 2009), and Daniel Wagner of the *Insurance Journal* (How AIG Fell Through the Regulatory Cracks, March 9, 2009). The *Washington Post* has also noted that the very compliant OTS was the regulator of Countrywide Financial and Washington Mutual, two of the most aggressive of the sub-prime lenders. (Binyamin Appelbaum and Ellen Nakashima, "Banking Regulator Played Advocate Over Enforcer," November 23, 2008).

5 Named after Myron J. Gordon, and published in ""Dividends, Earnings and Stock Prices," *Review of Economics and Statistics,* 41 (May l959), 99-105

6. FICO is an acronym derived from the Fair Isaac Corporation, which first devised this credit measure in 1958. It is used by the major credit reporting companies (Experian, Equifax, and TransUnion) to rate consumer credit histories, and widely relied upon by banks and credit card companies in evaluating customer creditworthiness.

7. The practice of repeatedly returning to a client to reconfigure debt, often without benefit to the borrower; HUD issued anti-churning regulations in 2004, in reaction to widespread abuse.

8. Marketing where the message is controlled by the marketer and where the customer is presumed to be relatively unknowledgeable about the product. Aggressive tactics such as frequent contact, excessive claims, and indications that the customer was 'pre-qualified' (even without any previously-indicated interest in the product) were used in push marketing of mortgages.

9. Shiller posted a 'blog' about this on April 12, 2005 on http://housingbubble-blogspot.com/2005/04/housing-bubble-will-pop.html.

10. See, for example, the classic John A. Mackay, *Extraordinary Popular Delusions and the Madness of Crowds,* Harmony Books (New York, 1980), originally published in 1841. See also John Kenneth Galbraith, *A Short History of Financial Euphoria,* Penguin (New York, 1994). More recently, Charles P. Kindleberger and Robert Z. Aliber, *Manias, Panics, and Crashes: A History of Financial Crises,* John Wiley & Sons (Hoboken, NJ, 2005).

11. Previous writing on this subject have included, Hugh F. Kelly, "Can Universities Teach Real Estate Decision Making?", *Real Estate Review,* v20, n.2, Summer 1990; "Dimensions in Real Estate Research," *Real Estate Review,* Fall 2001; and "Judgment: Imagination, Creativity, and Delusion," *Existenz.* v.3, n.1, Spring 2008.

BURNING DOWN THE HOUSE

– Talking Heads

SARAH GERECKE

BEFORE 1999, if homeowners faced foreclosure it was typically due to a life event—medical bills, divorce or unemployment. In the past decade, millions of homeowners have been unable to pay back their mortgage debt because of the terms of the mortgage itself—little or no money down, negative amortization, or rapidly increasing payments. To prevent the fire of exotic loans from burning down the house, we must restore the traditional mortgage to its central role in the housing market.

I work for Neighborhood Housing Services of New York City, part of a national network of 235 nonprofit housing groups chartered by NeighborWorks® America. NHS was founded in 1982 partly as a response to redlining by banks. Our eight offices throughout New York City invested $185 million last year in affordable loans for low-income New Yorkers and educated over 11,000 residents in home buying, home repair, foreclosure prevention, and basic saving and budgeting.

Foreclosure prevention is our fastest growing activity, and the most disheartening. The threat created by aggressive mortgage lending is the greatest NHS has faced since its creation.

THE GOOD OLD DAYS OF THE PRIME MORTGAGE

The traditional 30-year, fixed-rate, self-amortizing mortgage is a beautiful thing. Invented during the Great Depression, these loans were generally underwritten to standards set by Fannie Mae and later Freddie Mac, government sponsored enterprises (GSEs) that purchased or guaranteed the loans from lenders. While GSEs provided capital to the mortgage market at low cost, they did not generally participate in the exotic mortgage market. Consequently, in recent years, they lost market share to private label securities and their stock prices dropped. According to American Banker, the GSE share of residential mortgage bond issuance fell to a low of 44% in 2007; from 1995 through 2003, their share was in the high 70s and low 80s.

During the decades when the traditional prime mortgage flourished, the typical young family saved for the 20% down payment and closing costs. By their mid-30s, they were ready to buy a house; their family size and income were stable, and they did not expect to move. The bank examined their application using the "5 C's" of underwriting: credit history, collateral (the value of the home), cash (income), capital (savings in the bank for downpayment) and character (This could be a basis for discrimination, but the banker or broker actually knew the borrower). Purchasers made the same monthly payment for thirty years, providing certainty and stability. Housing costs were fixed and incomes rose over time, increasing the ability to save. At about age 65, the home was paid off and household expenses dropped just as the family transitioned to a fixed-income retirement.

This was the model for working class neighborhoods around the country. Owners lived in their homes until they passed away. Turnover was rare; often the estate sold the home, or it was left to a family member. One street block, in a working class Bronx neighborhood, tells this story. Of its 16 homes built in the 1960s, thirteen had the same ownership from 1966–1986. Four of the owners died in their homes and passed their homes to the children. The affordable fixed payments and high transaction costs associated with moving minimized the turnover of families on the block. Homeownership

under these conditions contributed to happiness, wealth-building, high school graduation rates, economic growth, and lower incidents of teen pregnancy.[1]

EXOTIC LOANS

In the 1990s, lenders began offering loans that required little or no money down, used a variable interest rate, and were subject to less underwriting (usually only 2 C's, credit and collateral). Some had negative amortization, where the loan balance grew over time. These loans were sold disproportionately to minorities concentrated in large metropolitan areas. Beginning in the late 1990s, 21 different mortgage companies originated loans on the Bronx block. By 2008 only three of the original sixteen owners remained. Eleven of the homes had nontraditional or sub-prime loans, seven for more than the home was worth; five were owned by investors rather than owner-occupants. One of the two-family homes had five mailboxes on the door.[2]

Families on blocks like this now risk losing their homes, their savings and their credit. At NHS we now are flooded with these families, providing foreclosure prevention assistance to 2,500 families in 2008 alone. The overwhelming majority did not obtain homeownership education from a lawyer or a HUD-certified housing agency prior to signing the mortgage. How can it be possible that so many did not have the good sense to take the time to read and understand their mortgage?

calls, infomercials) targeted to minorities who distrusted traditional banks with their reputation for saying "no." I have met many families who were told that they were getting a traditional loan when in fact on page 20 of the mortgage document it disclosed an adjustable, negative-amortizing rider. But even this disclosure was opaque; the mortgages typically refer to obscure indices and points, instead of laying out the best- and worst-case payment schedule in simple language.

The need to refinance and take money out of the home often coincided with an unexpected illness, divorce, or job loss—traditional reasons for mortgage default. And greed certainly played a part by both borrowers taking cash out of their homes and brokers who earned commissions from loan churning. However, the mortgage terms now magnified the impact. The cash received was often much less than promised, after commissions and fees were deducted, and the refinanced mortgage rarely had terms as favorable as the original one. Parents took on additional jobs to try to keep up with the rising payments. Other household needs—food, medical care, school—were skirted in order to pay the mortgage.

Eventually many families like those on this Bronx block were forced into distress sales. Some couldn't escape the debt through sale and were forced to decide between foreclosure or bankruptcy. (Bankruptcy does not eliminate the debt due on a

vided by the 30-year mortgage evaporated, hurting property values, quality of life and the tax base.

At the other end of the financial food chain, investors eagerly bought collateralized debt obligations (CDOs) made up of pools of mortgage-backed securities, bundling thousands of Bronx-type loans from all over the country. These investments were much riskier than the investors ever expected.

IS HELPING OUT A BAILOUT?

Imagine that a homeowner calls 911. Her stove caught fire and she needs help. Instead of getting the address, the dispatcher asks a series of questions: "How did the fire start?" "Was there negligence involved?" Fortunately, the fire company does not assess blame before it dispatches a truck. Its first mission is to put out the fire.

Why is the mortgage crisis so different? The Center for Responsible Lending projects that between 2009 and 2012 more than 9 million families will face foreclosure in addition to 2 million who already lost their homes in 2007 and 2008. Were they all to blame for their difficulties? Is moral indignation really appropriate?

It defies reason and experience that eleven million families knowingly gambled their homes, their children's stability and their financial security only out of pure greed. Fraud was rampant in the mortgage process, escalating rapidly with the housing boom. Many borrowers did not understand

Sub-prime and exotic mortgages of the past ten years are not your parents' mortgages...basic underwriting no longer protected the borrower or the lender from over-reaching.

Sub-prime and exotic mortgages of the last ten years are not your parents' mortgages. First and foremost, the mortgages did not conform to GSE standards, so basic underwriting no longer protected the borrower or the lender from over-reaching. Second, the mortgage broker used push-marketing tactics (flyers, phone

mortgage; it just modifies other debts). The family had to relocate quickly—with ruined credit, exhausted savings, and children forced to change schools mid-year. Rental tenants in two-family homes were evicted by the lender during foreclosure, even if they had been paying rent. The financial security and social stability that were pro-

the terms of their loans, and they trusted brokers to find them the best deal. Even the banks and Wall Street funded loans where they trusted the originator or the rating agency. Is misplaced trust a moral hazard, or was it also poor controls, diminished business ethics, and faulty or absent regulation?

PARALLEL HAZARDS

The attributes of homeowners who are facing foreclosure are surprisingly similar to the attributes of investors and lenders who made the loans. Both exhibited ignorance, lacked due diligence and were peppered with those taking advantage of a lax regulatory environment. Look at the parallels of homeowners and investors:

- Didn't read the fine print
- (Were) overpaid for the value of the asset
- Misjudged the risks involved in owning the asset
- Tempted by above-market returns and appreciation
- Faced contractual barriers to negotiating an optimal solution
- Couldn't liquidate as there is no market for asset
- Often involved innocent victims (university students and retirees for investors; children, tenants and neighbors for homeowners)
- Unwilling to lend or unable to borrow
- Too big to fail (The biggest institutions and nine million homeowners)

POLICY RECOMMENDATIONS

In a few short months, the Obama Administration has created many new initiatives to address the mortgage crisis by creating a market for toxic assets, giving new mortgage options to homeowners and by increasing liquidity in the markets. We are beginning to see signs of success with each program, but public and private policy makers need to keep an eye on the big picture as they design each piece of the economic recovery toolkit. In other words, they should make sure the fire is extinguished for good; even as they order more fire trucks and design better equipment.

REGULATE THE MORTGAGE

First and foremost, trust, confidence and stability must be restored in the mortgage transaction. The borrower needs to know that the mortgage will be suitable for his or her situation. Mortgage brokers should be held at least to the same standard as stock brokers. (Bernie Madoff's clients are

eligible for up to $500,000 from the Securities Investors Protection Corp; no similar fund exists for mortgage victims). Loan terms and documentation should be clear and accessible. The borrower, originator, packager and investor should all retain some responsibility for nonperformance for the entire term of the mortgage. Meaningful relief for victims of fraudulent transactions is needed. Some argue that these steps will make mortgages more difficult to obtain and more expensive. That would be a good thing for the most part: of the 9 million at-risk homeowners, many should not have received the loans in the first place. At the same time, underwriting should not be unreasonably restrictive; qualified purchasers should have access to affordable mortgages or the housing market will not be able to recover. Thoughtful regulation can create the level playing field that will allow the market to better price risk by setting basic ground rules.

REGULATE THE MODIFICATION

Even the minimal regulations governing mortgage origination (Truth In Lending Act; Real Estate Settlement Procedures Act) do not apply to the process used to modify existing loans when a borrower seeks to avoid foreclosure by calling his or her lender or a third party agency. Homeowners are frequently victims of foreclosure rescue scams or of modifications that are worse than the original loans. The Administration's Making Home Affordable plan starts from the premise of affordability: it cannot result in housing costs exceeding more than 31% of the borrower's income. But many homeowners won't qualify for this government program and, unless they have taken the initiative to find a qualified housing counselor or attorney, they are on their own in the negotiations with the servicer.

CREATE TRUSTWORTHY BORROWERS

You need a Ph.D. in mortgage finance to understand today's loan terms, and most Americans are woefully uneducated about financing, budgeting and credit. But there are HUD-certified housing agencies and counselors that work with borrowers with

a legal obligation to act in the borrower's interest. Participants in these counseling programs have a 34% lower risk of mortgage default. Yet "[m]ost counseling agencies struggle to support homeownership counseling services with funding from a variety of sources, primarily public sources. This unstable and sporadic funding rarely covers the true cost of providing sustainable counseling services. Thus, salaries for counselors are low, hours are long and turnover is frequent."[3]

Financial education should begin in childhood, and homeownership education should be a routine part of the home purchase process along with an independent inspection and appraisal. Housing counseling could be required by legislation and by the GSEs for riskier loans as it was prior to 2006. It should also be required for all loan modifications of nontraditional loans in order to ensure that borrowers understand what went wrong. Payment of counseling fees should be part of the mortgage transaction, like the lender's legal fee or the title company fee. Lenders should be required to provide performance data on different types of counseled loans, allowing pricing advantages to be linked to borrowers who have obtained effective counseling.

MAKE TRUSTWORTHY LOANS

Redlining was the norm in the mid-twentieth century. Banks and government wouldn't lend in inner cities because they did not believe that low-income, minority homeowners would pay them back. The Community Reinvestment Act (CRA) mandated lending in communities where banks took deposits. CRA coincided with the creation of our NeighborWorks® America (NWA) network of 235 nonprofit housing organizations to act as links between bank capital and "riskier" borrowers and neighborhoods. These organizations and other nonprofit housing groups worked with government and lenders to educate borrowers, transform their savings and credit profiles, and mitigate the risk.

The success of CRA lending is now, unfairly, blamed for the mortgage crisis. The Federal Reserve Board has recently studied the performance of loans to low-income,

underserved borrowers under the Community Reinvestment Act, often made in partnership with nonprofit community development institutions. The Federal Reserve study concluded: "Thus, the long-term evidence shows that the CRA has not pushed banks into extending loans that perform out of line with their traditional businesses. Rather, the law has encouraged banks to be aware of lending opportunities in all segments of their local communities as well as to learn how to undertake such lending in a safe and sound manner." It also "found that loans originated under the NWA program had a lower delinquency rate than sub-prime loans. Surprisingly, the loans in the NWA affordable lending portfolio had an even lower rate of foreclosure than prime loans."[4]

Today we have widespread networks of sophisticated nonprofit lenders who use all five C's of underwriting in their programs. They are hurt hard by today's recession, losing access to flexible and affordable capital and charitable support they need to make responsible loans. Both banks and government should invest in these networks to deploy capital responsibly in the neighborhoods that are hardest hit by the mortgage crisis—because it's a sound business decision to do so.

CREATE A MEANINGFUL SAFETY NET

While it is estimated that the Obama Administration's Making Homes Affordable program will help 4 million families avoid foreclosure, the program may help less than 50% of the families at risk. During the Great Depression, we wove a strong social safety net for the families that became the Greatest Generation, without calling Social Security or the Home Owners Loan Corporation a bailout. A good model might begin with the *New York Times* Neediest Subprime Cases Fund, launched last year, which provides basic financial assistance to those who need to move because of mortgage default.

ENCOURAGE NEIGHBORHOOD-BASED STRATEGIES

Securitization has complicated efforts to deal with concentrated foreclosures and to stabilize neighborhoods. It is difficult to establish ownership of the loans and of the foreclosed homes, which are scattered through different investment pools and asset management companies. Some investors don't foreclose, and some borrowers move before foreclosure is completed, leaving ghost properties with titles held in limbo by zombie banks. At a minimum, states need to bring transparency and accuracy to the process of recording lien and foreclosure data, and make public the identities of the managers of foreclosed property and the owners of the mortgage.[5]

We are presently in a crisis that is prompting a dislocation far larger than Hurricane Katrina or the devastation of the South Bronx. Just as a firefighter puts out the fire first and then assesses the cause and the blame, so should our policy makers give us tools to put out the urgent fire, keep families in their homes and resume the flow of responsible credit. There will be time, after the family and the loan are stable, to address the underlying causes of default. The most important ingredients in fire prevention are public education, safety rules in building construction, and a shared commitment to the goal of reducing deaths by fire. Here too, we should unite in our commitment to preventing ansother mortgage crisis by increasing public education, imposing safety rules, and achieving the goal of a reliable mortgage process.

NOTES

1. William M. Rohe, Shannon Van Zandt and George McCarthy, "The Social Benefits and Costs of Homeownership: A Critical Assessment of the Research" (Harvard Joint Center for Housing Studies, *Low Income Homeownership Working Papers,* October 2001); Donald R. Haurin; T. Parcel; R. Jean Haurin "Does Homeownership Affect Child Outcomes?" (*Real Estate Economics,* Volume 30, Issue 4, 2002). "We find that owning a home compared with renting leads to a 13 to 23 percent higher quality home environment, greater cognitive ability, and fewer child behavior problems. For children living in owned homes, math achievement is up to nine percent higher, reading achievement is up to seven percent higher, and children's behavioral problems are one to three percent lower."

2. Author research using New York City Department of Finance Automated Citywide Records Information System, May 2009.

3. Abdighani Harad, Peter M. Zorn; "A Little Knowledge is a Good Thing: Empirical Evidence of the Effectiveness of Pre-Purchase Homeownership Counseling" (Harvard Joint Center for Housing Studies, October 2003); Doug Dylla, "The Current State of Homeownership Education and Counseling Services in New York State" (NeighborWorks® America: September 2007).

4. Randall Krozner, "The Community Reinvestment Act and the Recent Mortgage Crisis," in *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act* (Joint Publication of the Federal Reserve Banks of Boston and San Francisco: February 2009).

5. Corinne Gentilesco, Annie Myers and Abigail Westbrook, "Mitigating the Neighborhood Effects of Lender Homeownership in Eastern Queens" (*The Wagner Review,* Volume XVI 2008-2009).

RESOURCES

Nonprofit Organizations
Center for Responsible Lending
www.crl.org

Center for NYC Neighborhoods
www.cnycn.org

Neighborhood Housing Services of New York City
www.nhsnyc.org

NeighborWorks® America
www.nw.org
Foreclosure prevention best practices are available at the
NeighborWorks® Center for Foreclosure Solutions:
http://nw.org/network/neighborworksprogs/foreclosuresolutions/default.asp

New York State Coalition for Excellence
in Homeownership Education
http://cxhe.wordpress.com

A website devoted entirely to the neighborhood impact
of the mortgage crisis is www.stablecommunities.org

Government Resources
New York City Department of Housing Preservation
and Development
www.nyc.gov/html/hpd

New York State Halt Abusive Lending
Transactions (HALT) Task Force
http://www.banking.state.ny.us/cshalt.htm

US Department of Housing and Urban Development
Find HUD-Certified housing counseling at
http://www.hud.gov/offices/hsg/sfh/hcc/hccprof14.cfm

Housing counselors who have adopted National Industry Standards for
Homeownership Education and Counseling, including a code of ethics, can be found at
http://www.homeownershipstandards.com/index.shtml

Various Federal initiatives relating to the mortgage crisis can be found at the following sites:
http://www.whitehouse.gov/issues/economy
www.makinghomeaffordable.gov
http://www.financialstability.gov
http://www.hud.gov/offices/cpd/communitydevelopment/programs/neighborhoodspg

FANNIE MAE AND FREDDIE MAC

ROBERT VAN ORDER

SINCE THE GREAT DEPRESSION the U.S. has developed institutions to control financial crises. Most important has been deposit insurance, and it has worked well. Banks have been able to attract deposits during the Savings and Loan crisis in the 1980s and the stock market crash in 1987.

But insurance provides incentives for risk-taking. Because depositors know they'll get their money back, they have little incentive to evaluate banks. As a result banks raise money at low rates regardless of their risk; they get the upside, and the insurer takes most of the downside. The Savings and Loan crisis in the 1980s showed both the advantages and disadvantages of this insurance. The S and L's took too much risk, and many collapsed, but there was limited impact on the rest of economy.

FANNIE MAE, FREDDIE MAC & THE MORTGAGE MARKET

Fannie Mae and Freddie Mac (FF) are best understood within the deposit insurance model. They are government sponsored enterprises (GSEs)[1], but they are not banks. They do not originate loans, and they do not take deposits. Rather, they buy mortgages from commercial banks, savings and loans, and mortgage banks, and they fund them by raising money in capital markets. They do this mostly by securitizing mortgages, which involves pooling them and selling shares in the pools as mortgage-backed securities (MBS). Attached to the pools are FFs' guarantee to pay investors off in the event of borrower default. They also hold mortgages and MBS on their balance sheets and sell their own debt to fund them.[2] A key to understanding FF is the perception (not in law) that their MBS and debt are backed by the government, an "implicit" guarantee similar in function and incentives to deposit insurance.

While banks do sell mortgages to FF, their relationship with them is mostly one of competition because FF provide an alternative to the bank model of funding mortgages with insured deposits. When FF buy mortgages they substitute for the traditional bank function of making money by managing credit risk and earning income from the difference between the interest they earn on mortgages and their funding costs, leaving banks with just fee income from originating and servicing[3] loans. This competition has been referred to as "dueling charters."

The charters have similarities as well as differences. The key similarity is the government guarantee, but there are others. For instance, it has been argued that FF are problematic because they are neither public (because they are shareholder owned) nor private (because they have public policy objectives), but banks are not much different. While FF are required to make loans to low income and minority borrowers, banks, via the Community Reinvestment Act, have comparable public purpose goals. The key differences are that FF use their charter to access capital markets, whereas banks have traditionally been largely confined to deposit markets;

Bad as they have been, Fannie and Freddie default rates have been less than half of those of the rest of the industry.

and the two charters have different regulatory structures.[4]

RECENT HISTORY

Since the 1980s, FF on average have bought about 45% of mortgage originations. (Together with Ginnie Mae, a government agency that securitizes government insured loans, they are referred to as the "Agencies.") Over time, and especially after 2003, an increasing share of securitization was by "private label" or "non Agency" investment and mortgage banks, packaging mortgages that the Agencies did not or could not securitize. This is the market that promoted the surge in sub-prime mortgages.

The banks, FF and the private label institutions all took risks that were not clear to their stakeholders. In the case of FF and banks, their regulators were not able to assess and control risk quickly. In the private label market it was investors in private label securities who were sold poorly underwritten loans. All of these involved "moral hazard" in that they transferred costs to stakeholders that the stakeholders could not control or price.

MORTGAGE TYPES

Most mortgages are prime or non-prime. Prime loans are higher quality, because of the strength of the buyer, down payment, and underwriting and/or because of credit enhancements such as mortgage insurance. Non-prime loans lack some or all of these characteristics. They are mostly sub-prime loans, which are loans to borrowers with poor credit and other negatives, or "Alt-A" loans, loans that typically have prime borrower credit history and down payments, but with some flaw, most often low documentation.

For the most part FF have stayed in the prime market. Their charters require that they hold "investment quality" mortgages, which excludes sub-prime loans, but not always. Riskier loans are often accepted if they have credit enhancements, such as mortgage insurance; but risk is a matter of degree, and they hold some lower quality mortgages (like Alt-A) without enhancement. FF have also purchased sub-prime (and Alt-A) private label MBS that were investment quality. Pools of sub-prime loans can have investment quality parts or "tranches" if they are structured properly, for instance by having subordinated tranches ahead of them in the risk queue (In other words, other investors hold subordinated tranches of the same pool, absorbing losses before the senior, investment quality, tranches take losses).[5]

FF hold over $5 trillion in mortgage-backed securities and mortgages. Of this, sub-prime and Alt-A private label securities, typically purchased from investment banks, are about 4%. These securities were originally highly rated senior tranches of private label MBS. Many have now been downgraded and would trade at large discounts. They also bought Alt-A mortgages directly as well as some interest-only loans, particularly beginning in 2005. (Some of these were held as investments while others were securitized and sold.) Around 10% of the mortgages held or securitized by both companies are Alt- A. These have been the major source of loss so far.[6] Direct holdings of sub-prime loans are small, under 5%, but not easy to quantify.[7]

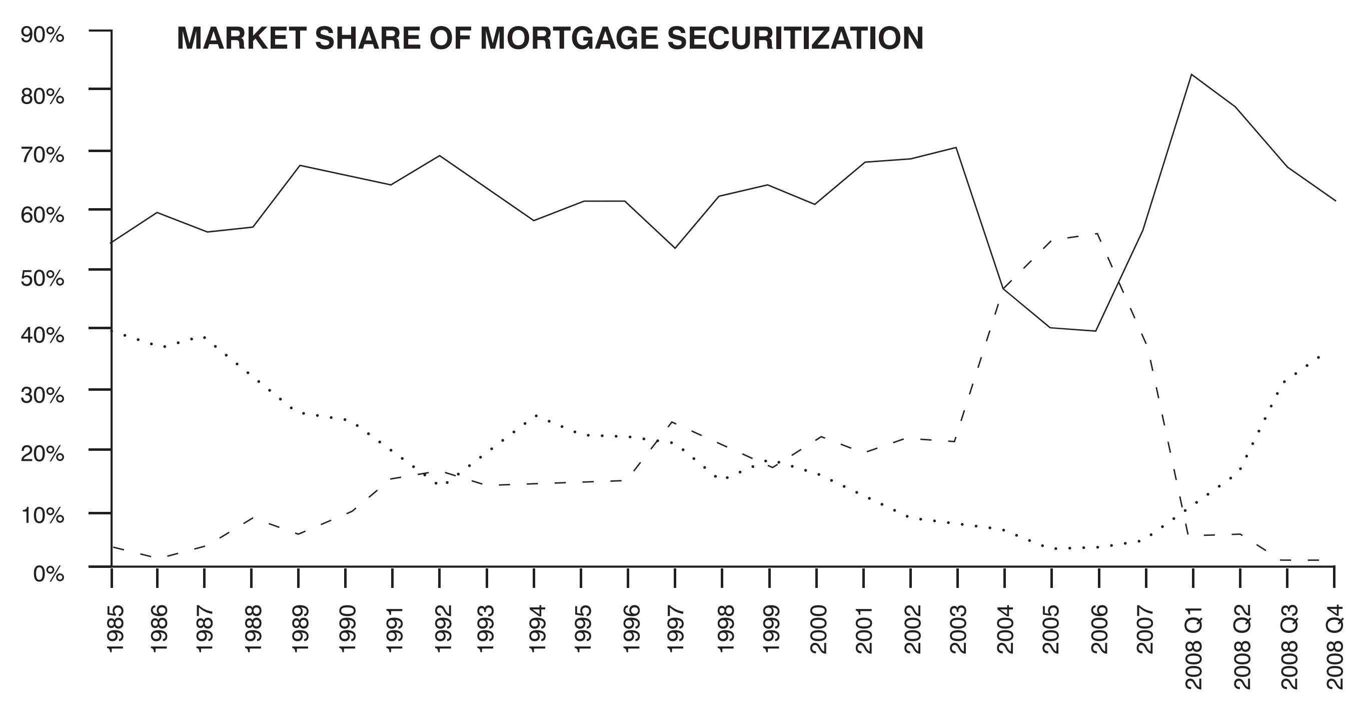
BUBBLES AND CRASHES

In 2003 strong markets turned into bubble markets in many parts of the country. At the same time, non-prime originations and private label securitization sharply increased in market share (from 10% to 33% for the non-prime share of mortgage originations and from 20% to almost 60% for the private label share of securitization). In 2006 the price bubble slowed and then burst; housing production, which had increased in response to the increase in prices, fell sharply. In 2007 the sub-prime and Alt-A markets crashed, exposing banks, FF and a range of other investors to large losses and major write downs, triggering the worldwide recession. There has been a sharp increase in mortgage default for all types of lenders on all types of mortgages, but especially for sub-prime. Defaults have risen both because of the lower quality of the mortgages originated since 2003 and the decline in house prices, which has led to unprecedented numbers of borrowers with negative equity.

Fannie and Freddie have been blamed for contributing to the price bubble and subsequent crash, but the data do not support that. If anything, their behavior was countercyclical; there was a decline in their market share (from almost 60% to under 40%) as the bubble gathered steam after 2003 and an increase after the bubble burst in 2006. That is not to say they made good business decisions; when they expanded at the end of the boom, they risked their franchise, with too little capital to survive severe stress.

FF have been losing money since 2007, and they were put into conservatorship in September 2008. Losses will be in the tens of billions of dollars for each company, due to both lower loan quality, especially the Alt-A loans, and the decline in house prices. It appears that the decline in prices, particularly in California, Arizona, Nevada and Florida, will account for most of the losses.[8] New business has tighter underwriting, but it is still risky because of likely future declines in house prices. The private label securities will be a further source of losses, though by less than the decline in their market value.

Bad as they have been, FF default rates have been less than half of those of the rest of the industry. From the third quarter of 2007 through the fourth quarter of 2008, FF had $119 billion in write-offs as compared to $145 billion for insurance companies and $747 billion for commercial



Source: "Inside Mortgage Finance", *The 2006 Mortgage Market Statistical Annual,* Volume 1

and investment banks. More recently, the IMF has estimated that overall write-downs from U.S. securities are over $2 trillion, about 20 times the write-downs for Fannie and Freddie.[9]

SYSTEMIC RISK

Unlike the Savings and Loan crisis in the 1980s, the current crisis has spread around the world. The key difference is that S and L's were funded almost entirely by insured deposits, so there was little need for depositors to worry, and there were no banks runs to speak of. That stands in sharp contrast with the complexity of the securitization of non-prime mortgages, which has made it very hard for investors to evaluate both the securities and the health of the institutions that hold them.

Banks fund with commercial paper, loans from other banks, repurchase agreements and bonds as well as with deposits. Once their ability to meet the non-deposit obligations is called into question, there can be the equivalent of a bank run, albeit not in deposits, making it difficult to make new loans. Something similar happened to FF last year as investors were unclear about the willingness of the government to back them up. Conservatorship and the promise of future capital injections have shored up the FF guarantee. As a result FF, despite being on life support, continue to function as an elastic source of funds for mortgages. The rest of the system has become more complicated.

POLICY AND TRADEOFFS

The *sine qua non* of the Great Depression was the collapse of the banking system, which would not have happened if deposit insurance had been in place. Guarantees are an important stabilizer, but they promote risk-taking. So there is a tradeoff.[10] But the problem is more complicated than guaranteed institutions. The least guaranteed part of the system, the private label market, took on the most risk. The private label companies and their insurers have become implicit GSEs. Even without special charters, they were bailed out in an effort to control systemic risk. The underlying problem for both guaranteed and non-guaranteed institutions is moral hazard. We cannot avoid guarantees, and we should probably not want to; but we need to control their costs.

ALTERNATIVES

Good solutions will have to address moral hazard in the market as a whole; otherwise risk-taking will simply gravitate to the cheapest and most permissive source. With the demise of the private label market, FF (and Ginnie Mae) and the banks are all that is left, and there are pluses and minuses for both. Banks tend to have better control over the risks they take because they originate their own loans, as opposed to FF who buy them from someone else; however, FF tend to have better access to capital markets (especially for long term funding for fixed rate mortgages) to fund what they buy. Neither advantage is absolute[11] Both charters have incentives to exploit guarantees.

A solution is to set regulations that control risk-taking at both the banks and GSEs and allow them to duel again. We don't know which charter is better, and having

both is a way of hedging our bets. Fixing one charter and not the other will not decrease moral hazard as much as shift it. Below are proposals for FF after the deluge, assuming that the banks are handled similarly.

MAINTAIN PRIVATE OWNERSHIP

In the short run there is little choice but to operate FF as they are; the Agencies are the only game in town. Longer run proposals range from restructuring FF as a public utility or as a cooperative, owned by their customers, to folding them into the government, perhaps as a part of Ginnie Mae. These proposals inhibit the flexibility to move with markets. More to the point, they don't do much about risk-taking: the new FF would either take too much risk, due to political and other pressures, or risk would be shifted to banks. Private ownership leads to more efficient operation, but with it there needs to be control of moral hazard, which is a problem of capital and risk regulation.

MORE AND BETTER CAPITAL

Capital provides a cushion that protects debt holders and guarantors, and it provides incentives to control risk because more investor money is at stake. Before the crisis, regulators applied two capital rules to FF: one was stress tests that simulated company performance under stressful conditions and required that enough capital be held to survive them; the other was a minimum capital requirement that applied if they passed the stress tests.

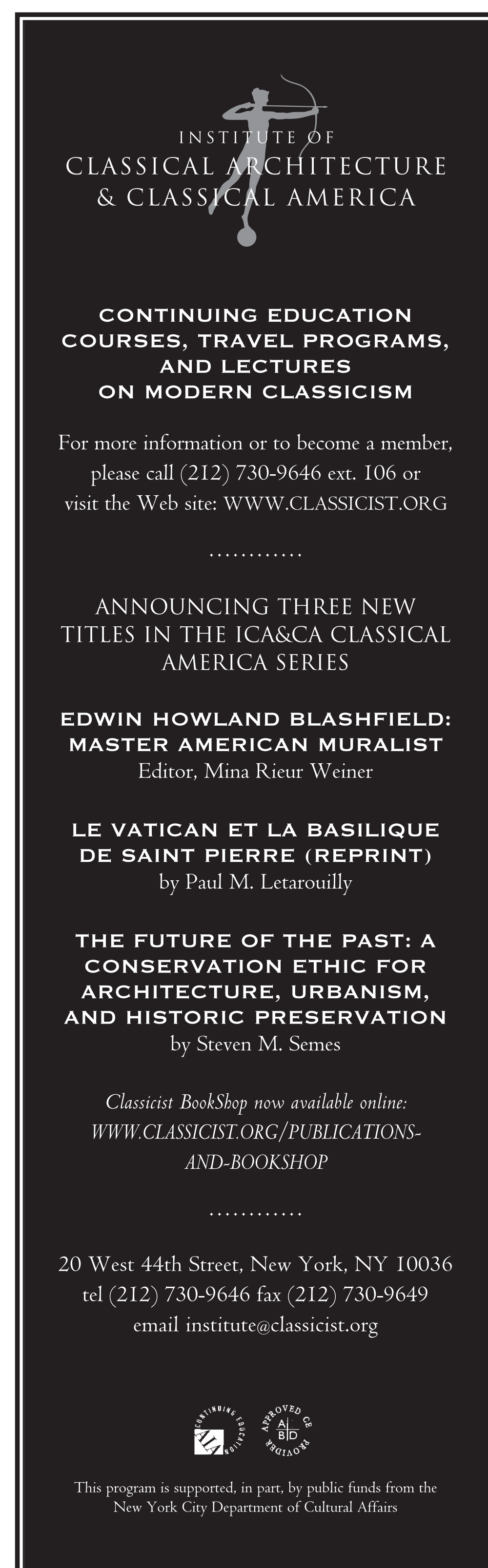
Clearly the minimum was too low. They passed the stress tests, which were tough by historical standards but less stressful than what actually happened. However, simply raising the minimum will not necessarily reduce the risk of failure; FF could ramp up their risk and still be below the minimum. The solution is to make the two tests additive (maintaining a minimum capital requirement plus the capital required by stress tests) so that they will have to hold extra capital for any increase in risk.

Regulators need more flexibility in running stress tests and ability to raise and lower capital levels as the economy changes and for newer business lines. The probability of a stressful event should also be considered in setting capital requirements; passing the stress test in 2007 was not the same thing as passing it in 2001.

Less costly, debt-like, forms of capital should be considered. A promising form is subordinated debt that can be converted into stock if stock price falls below some preset level. Such debt could have been sold relatively easily a few years ago and could have prevented the capital depletion later.

CONTROLLING FF PORTFOLIOS

FF, like banks, hold portfolios of mortgages and mortgage-backed securities. These have been widely criticized as too risky, but the criticisms have largely been misdirected. The distinction between what is kept in portfolio and what is sold (securitized as MBS) is an accounting, rather than an economic, distinction. FF take default risk on mortgages whether they are held or sold; their current levels of default losses would not have been much different if they had



securitized and sold everything. The portfolio issue is interest rate risk, a problem that arises when assets and liabilities are mismatched, for instance by funding long term mortgages with short term debt. Interest rate risk can be a problem, but the size of the portfolio is not a good measure of interest rate risk for two reasons: a very large part of the risk can be controlled, for instance by funding long term mortgages with long term debt,[12] and a large amount of risk can be taken in a small portfolio by holding interest rate derivatives. Debt funding has the economic advantage, over MBS, of being attractive to investors who prefer homogeneous assets and would rather not analyze the prepayment risk of mortgages.

There are two ways of handling the portfolios: eliminate them all together, with some exceptions for things too small or too new, or use stress tests to control risk. The latter has been the tool used since the 1990s, and it has worked reasonably well.

EXPLICIT GUARANTEES

Guarantees should be explicit so that they can be counted on to keep the market open in stressful times. FF, along with banks, should be subject to risk-based "user fees" and capital regulation to control resource misallocation. On top of that, as the private label sector re-emerges we will need a systemic risk regulator, focused on capital adequacy, to handle the risks of institutions that are not explicitly guaranteed but can spread risk and require bailouts anyway.

COMMENTS

Fannie Mae and Freddie Mac have outperformed the rest of the industry in the current crisis, but they will nevertheless need more capital injections if they are to be revived as real businesses. Recent government guarantees to FF have kept the mortgage market going, especially for fixed rate loans, while the private sector has collapsed. The dueling charter model is imperfect, even with updated capital rules, but alternatives, like relying on banks alone or pretending we have a stable, unguaranteed private sector, are worse bets.

NOTES

1. What is or is not a GSE is not always clear. For instance, European banks are essentially GSEs, though they are not always classified as such. U.S. banks can also be classified as GSEs but would rather not be.

2. Lately about a third of their assets are debt funded. Most of this has come from repurchasing their MBS and selling bonds; some has come from buying other asset-backed securities.

3. Servicing refers to managing the cash flows from mortgages, in this case as agents for FF.

4. This is quite complicated in practice; the guarantee to deposits can be used indirectly to guarantee other liabilities, as we have seen recently with bank "bailouts," which like the FF bailout have bailed out all sorts of security holders. Differences in regulatory structure have been particularly important in determining capital requirements.

5. Sometimes the structures have default insurance (the infamous Credit Default Swaps).

6. It is not easy to summarize the portfolios of the two GSEs in a brief way. Both companies have web sites with "investor relations" tabs, including power point presentations of their positions and links to publicly available data such as data provided to the SEC. Many of the loan categories shown are overlapping.

7. Sub-prime loans have generally been defined by lender (traditional sub-prime lenders) and more recently by whether they are in a pool classified as sub-prime. Credit score by itself does not make a loan sub-prime.

8. The problem with sorting this out is that the Alt-A loans, which have had the worst defaults, have also been in the worst places and suffered the worst price declines, so they would have had high default levels in any event.

9. See http://www.imf.org/external/pubs/ft/gfsr/2009/01/pdf/summary.pdf. Note though that write-downs almost certainly overstate likely losses for all investors, including FF.

10. A subtle, but nontrivial, benefit of guarantees is that they diminish excessive investment in information about security quality. See Woodward and Hall (2009).

11. For instance, banks can issue "covered bonds," which are almost the same as securitization, and they can raise short term funds in the deposit market and hedge the risk, which is the same as the GSE portfolio. FF can be allowed to originate loans like banks. More simply, they can require significant recourse from sellers, in the form of reserves set aside until loans have proven themselves, to protect against moral hazard.

12. Special attention does need to be paid to the fact that mortgages have the prepayment option. This can be handled by funding with callable debt, so that the debt can be called when the mortgages are prepaid, or with more complicated hedging instruments.

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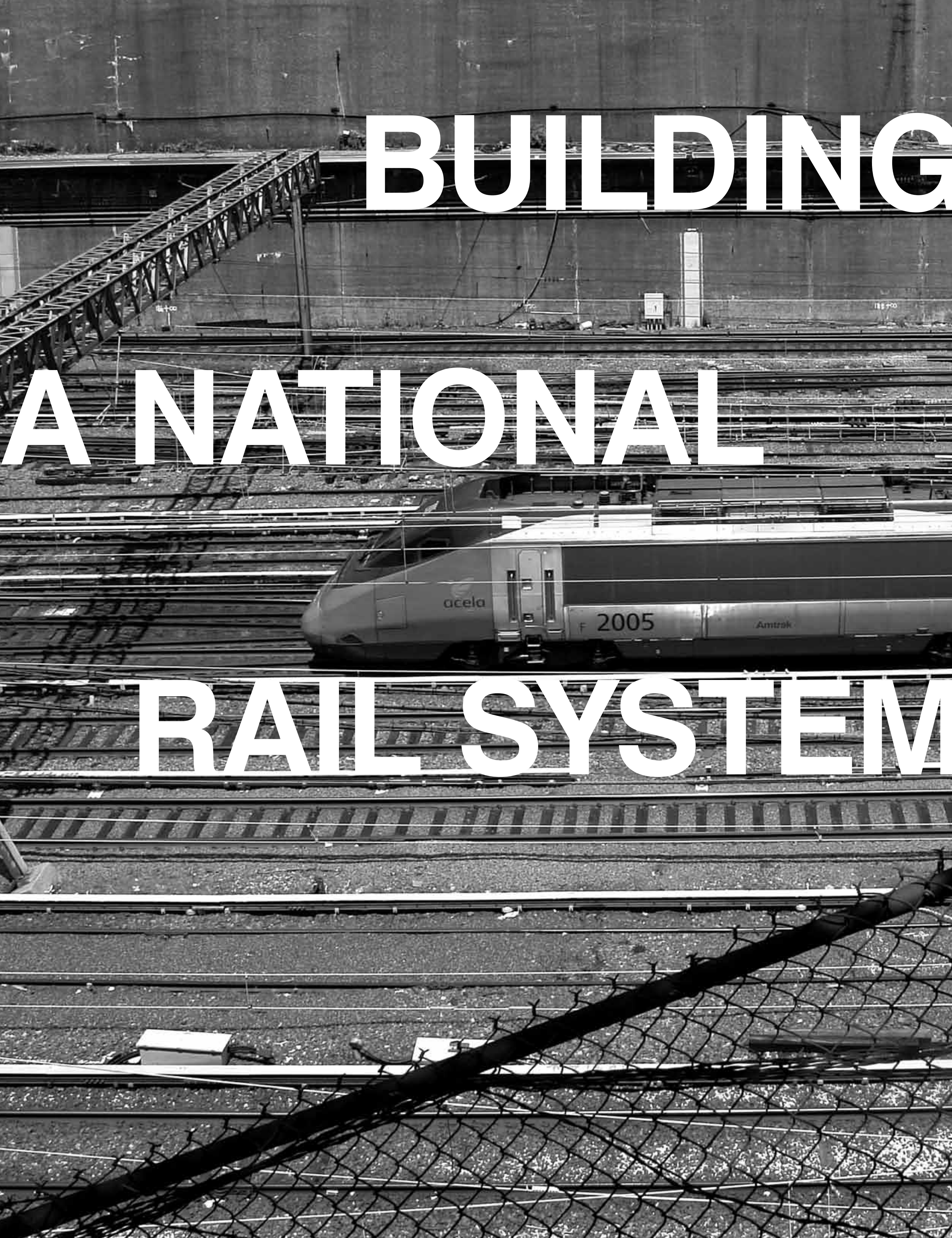

BUILDING A NATIONAL RAIL SYSTEM

JOHN V.N. PHILIP

THE NEW PUBLIC INVESTMENT IN RAIL TRANSPORTATION

Congressional support for rail, in particular for Amtrak and for urban transit, has steadily grown in recent decades. But the economic downturn, and the election of Barack Obama and a decidedly pro-rail Vice President, Joseph Biden, have opened a new era of public investment in rail transportation. Railroads, neglected for decades in favor of highways and air, could recapture market share. But the obvious question is how best to spend the money.

Government plans show considerable sophistication, applying an incremental approach that updates a system of regional rail corridors, for the most part on existing routes, allowing eventual operation at speeds between 110 and 150 mph. The only high speed (over 150 mph) project with initial funding is the proposed California line, supported with last year's state bond issue. Nevertheless, current initiatives omit several key steps that could improve service nationwide, relatively quickly, and build public support for a system inevitably requiring permanent subsidy. Such projects include electrification of the entire passenger network, provision of light rail services on secondary lines, intense inter-modal coordination with bus lines, and greater attention to the aesthetic environment of rail travel.

RECENT LEGISLATION SIGNIFICANTLY ALTERS SPENDING IN RAIL'S FAVOR

To appreciate the magnitude of the railway funding now proposed, it is useful to first examine the pattern of recent decades. Prior to the passage of the Passenger Rail Investment and Improvement Act in October 2008 (the "PRIIA"), and the Obama Administration's transportation provisions in the American Recovery and Reinvestment Act of 2009 (the "ARRA"), federal investment in passenger rail was a relatively constant 3% of the total federal outlay for intercity transportation (since the 1970s). A review of the passenger railroad spending of the PRIIA and the combined transportation outlays of the ARRA, including rail, shows that the federal government now plans to devote almost 20% of its 2009 total intercity transportation spending (not including urban transit) to the improvement of rail services.

Amtrak funding, until now the only federal funding for intercity rail transportation, has peaked at just over $1 billion annually in some recent years. For 2009 federal highway spending will reach over $40 billion (state and local spending on highways effectively doubles this amount), and will represent some 75% of the total federal intercity transportation outlay. Pursuant to the ARRA, air now replaces rail as the least subsidized mode, with roughly the remaining 5%, representing $1.3 billion for spending on airports and other support (apart from the ARRA, there is also the ongoing funding for the Federal Aviation Administration and its critical air traffic control function of about $2.5 billion annually).

The PRIIA initially envisioned $13 billion for rail spending, including the development of intercity rail corridors, and provided approximately $1.3 billion per year for five years for Amtrak. The subsequent ARRA, pursuant to provisions of the PRIIA, authorized $8 billion for the development of new intercity corridors, $7 billion for transit, including rail, and $750 million for transit systems on fixed 'guideways' (everything from aerial tramways, buses operating on exclusive rights of way, and high occupancy vehicle ("HOV") lanes). The bills themselves followed the FY 2008 Appropriations Act, which allocated $30 million to states in matching grants for intercity rail. In addition significant further resources are provided by the Amtrak annual budget, now some $1.3 billion, $10 billion annually to urban mass transit, and the subsidy programs of 13 individual states—California in November 2008 passed an almost $10 billion bond issue for high speed rail.[1] Other government spending, with passenger transportation applications, such as freight railroad improvements, the enhancement of transportation related structures, and renewable energy research also promise to advance a national network.

Collateral funding sources also benefit passenger rail. Although freight lines have generally not been heavily subsidized by the federal government, ARRA discretionary funds could be used to benefit freight railroads. Most Amtrak services, excepting the Boston-Washington corridor owned outright by Amtrak, share rights-of-way on private freight lines. Accordingly, freight railroad improvements can benefit passenger rail operations as well. The Transportation Enhancement Program, pursuant to the Intermodal Surface

Transportation Act of 1991(“ISTEA”),[2] and related provisions of the ARRA, set aside significant funds for a broad range of initiatives “to strengthen the cultural, aesthetic, and environmental aspects of the Nation’s inter-modal transportation system,” including the renovation of historic train stations, landscaping and scenic beautification (specifically the removal of outdoor advertising), and bicycle paths and walking trails.[3] And recent government funding of ongoing research in renewable energy could have broad application across many transportation modes.[4]

The various appropriations reflect a more truly national perspective on overall transportation policy. At the same time, this spending schema, while vastly more favorable to rail, still upholds highway funding as the keystone of contemporary passenger transportation. Planning a sound overall system still means understanding the car’s preeminent place, while structuring rail and air components[5] to meet efficiency, environmental and aesthetic goals.[6]

GOVERNMENT PLANNING FOR A NATIONAL RAIL CORRIDOR NETWORK

In March 2009, following passage of the PRIIA, the U.S. Government Accountability Office produced a comprehensive study (the “GAO Study”). One month later, shortly after passage of the ARRA, the Secretary of Transportation published a strategic plan: “Vision for High-Speed Rail in America.” (the “High Speed Rail Report”). The GAO Study and the High Speed Rail Report outline current government planning in this area.

Unquestionably, America needs a vastly enhanced railroad network, including high speed rail, defined as trains operating at over 150 mph, on dedicated rights of way, between population centers up to 600 miles apart. Study and observation of 50 years of high speed train service abroad have generally proven its importance in linking high-density population centers. Japan initiated the ‘Shinkansen’ line between Tokyo and Osaka, in 1964, operating regularly at a maximum speed of approximately 150 mph.[7] France began operating its “Train a Grande Vitesse” (“TGV”) at roughly the same speed in 1981. Both lines now operate considerably faster. While the systems’ development and operational costs are huge and entail constant subsidy, they meet major social goals: ensuring safe and efficient transportation choice (including the decrease of highway and airport congestion), boosting economic competitiveness, increasing energy efficiency, encouraging denser ‘smart growth,’ and benefiting environmental quality. However, regional intercity lines, even at lesser speeds, meet most of the same objectives. Transportation policy, now taking shape, correctly proceeds from these assumptions.

Maintaining this policy, especially with the construction costs for high speed lines, will require ongoing public support and funding sources that are independent of recurring legislative authorizations. In France high speed rail projects have taken 14-16 years to complete. The GAO Study candidly points out that any rail system, in particular a high speed one, will need substantial additional investment, much greater than the recent appropriations, for upgrading and construction as well as operation. While even conventional rail passenger systems need permanent subsidy (the experience of Amtrak proving the point), high speed lines, with their heightened maintenance requirements, require more public funding the faster they operate. Japanese, French and Spanish examples, cited in the GAO Study, show that few if any high speed lines have covered construction costs, and continual subsidies are assumed.

The GAO Study estimates cost per mile for the proposed upgrading of rail lines at $4-11 million. Estimates for high speed rail construction are much higher and generally range from $20-60 million per mile. High speed construction is estimated to cost almost $34 billion from Los Angeles to San Francisco, almost $13 billion from Los Angeles to Las Vegas, and, using a more advanced ‘maglev’ (magnetic levitation) technology,[8] some $5.5 billion from Baltimore to Washington (costs for maglev reach about $130 million per mile). While private industry partnerships, bond measures and loan programs may offer some future operational support, the immediate years require sustained and increased public expenditure.

Summarizing decades of review and consensus by transportation experts and policy makers, the GAO Study supports the eventual implementation of high speed systems, but now focuses on a process of upgrading, or incremental improvements, in five intercity corridors already operating at speeds greater than 79 mph. These are Washington to Boston, Los Angeles to San Diego, New York to Albany, Harrisburg to Philadelphia, and Chicago to Detroit. The GAO Study also identifies 11 others still in the environmental review process, and another 33 in earlier planning. The total, complementing Amtrak’s existing long distance services, would create a comprehensive national network.

A recent ride over one of these corridors, from Philadelphia to Harrisburg, shows the impressive gains already made by an incremental approach, funded by federal and state money, some $145 million since the late 1990s. Electric expresses, operating roughly every two hours between restored terminals, reach top speeds of 110 mph on rehabilitated roadbed, traveling through handsome suburbs and Amish countryside increasingly cleared of unused track and derelict structures. Up to four stops are made in the Philadelphia environs, providing multiple connections with local transit services. The line showcases many reasonable and exemplary improvements which point the way to planning with immediate national impact.[9]

ELECTRIFICATION: A COMPELLING PRIORITY THAT SHOULD BE PART OF CURRENT PLANNING

While the current corridor plans are practical and achievable, some key improvements appear to have been so far overlooked. First and foremost of these is electrification of virtually the entire network (as is already the case with Philadelphia to Harrisburg described above) with an overhead ‘catenary’ system (current delivered to locomotives from wires suspended over tracks).[10] This entails high costs, principally in the construction of poles, wire and substations, but as the expense of diesel fuel increases, the operating efficiencies tilt toward electrification.[11] Such a system can also deliver tremendous reliability in scheduling, a key component of customer satisfaction, along with safety.

Outside of North America, virtually all rail systems in the developed world, conventional and high speed, operate under electric traction. Developing electrically powered corridors could also catalyze the electrification of major suburban lines in urban centers. While Philadelphia and New York[12] already operate with such systems, only one other city, Chicago, has even a partial catenary network currently in place. And there are significant economies of scale in using a uniform technology, with components easily obtainable from domestic and foreign suppliers. The environmental benefits of relatively clean energy would be long term.[13]

The only major caveat is scenic beauty. Even the best engineered catenary system produces visual clutter. Routes of exceptional scenic appeal—for example the New York-Albany corridor, much of the existing West Coast route, the various lines through the Rockies, to name a few—should continue to operate diesel-electric locomotives.

QUICK EXPANSION OF THE NETWORK TO SECONDARY LINES

A second key policy objective should be expanding the reach of the system to bring rail service, or rail service connections, to many more Americans. A primary way could be by using relatively inexpensive and environmentally unobtrusive self-powered (diesel) ‘light rail vehicles.’ These would run at average maximum speeds up to 50-60 mph, at subsidized fares, on a wide array of secondary routes. This equipment can be operated singly or in multiple units according to demand, and it adapts to shared rights of way.

Some 32 American cities now have such networks and others are planned. An excellent prototype, the New Jersey Transit “River Line,” shows how such systems can also operate in an ‘interurban’ (the 19th century word for such ‘trolley’ services) context.[14] Running between inter-modal terminals with bus and other rail connections at Trenton and Philadelphia, the line serves 18 other communities at attractive rebuilt stations, operating most days twice an hour, running the historic and scenic route of one of America’s first railroads. Even at these frequencies the vehicles efficiently share street space in several towns with automobile and truck traffic, as well as with the freight trains of private railroads. The cars themselves feature expansive picture windows. The one way fare is $1.35.[15] Construction of such systems can vary from $15 million to the much higher $100 million per mile in congested urban areas, especially where tunneling is required. But service on existing lines, particularly through rural areas, could reasonably be expected to cost in the lower range.

Ease of access for the River Line is provided by the two inter-modal terminals, noted above. Essentially, every rail station, excepting perhaps overcrowded major urban stations,[16] should be reconfigured as inter-modal with connecting long distance

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bus lines and local transit contained within one complex. Boston's renovated South Station (with its new bus station) and the recently opened St. Louis inter-modal station are excellent examples. There should be more aggressive efforts to cross-market rail and bus services, particularly outside urban areas. Rail service reservation systems, such as Amtrak's, should sell tickets for bus connections. Amtrak currently sells tickets for its own "Amtrak Thruway" bus lines. But expanded through-ticketing with major operators such as Greyhound could reach a much greater customer base.

THE AESTHETIC IMPERATIVE

Finally, in this nascent phase of a renewed national commitment to rail, there should be a stated commitment to aesthetics, further enhancing the initiatives of the ISTEA legislation noted above. There is no better time to adopt and enforce aesthetic criteria for a national rail system than at the beginning of the bidding process for specific projects. Such standards should be viewed as an evolving but permanent feature of future legislation for design and planning of stations, and for trains[17] and rights of way.[18] Stations, particularly in smaller towns, should be thought of as serving a community center function, as was the case in the 19th century, when mail and express deliveries by train were central to local communities. Stations could house not only retail establishments, such as restaurants and banks, but also public facilities such as local government offices and regional museums.[19] Designs should be the subject of frequent competitions and intramural evaluations. Regional differences should be accommodated and encouraged in exteriors, even if basic configurations are standardized for economy.[20] Maintenance should include routine clean up of debris along rights of way.

Even such things as station and route names should be considered. Railroads are inherently geographical. Names such as "River Line," as noted above, large city station names such as "North" and "South," names such as "30th Street" evoking the specifically American tradition of numbered streets and roads, all augment this aspect. With considered exceptions, railroad services should hew to such prototypes instead of renaming after recent political personages, even the deservedly renowned.[21] Railroads—as they have been historically—should be avatars not only of comfort, but of taste. There is no reason that transportation for a mass market cannot be as aesthetically distinguished as that for luxury. Only imagination and consistent support are needed to make the imaginings real.

A PIVOTAL MOMENT

America is at a crossroads with national rail policy. The Federal government has decisively intervened. Regional rail projects have much stronger support as they make improvements. Planning for upgraded rail services, and eventual high speed service, is vigorously underway. As improvements occur, public support will continue to increase. And sustained support will be crucial for building and maintaining the system over time. Many ideas for affecting the outcome will be put forward and debate will inevitably ensue. But decades of rail advocacy have borne fruit; a legislative foundation has been laid. The next years promise significant progress.

NOTES

1. The $9.95 billion "Safe, Reliable High Speed Passenger Train Bond Act," see: http://www.cahighspeedrail.ca.gov.

2. The original Act was followed by the "TEA-21" of 1998, and "SAFETEA-LU of 2005.

3. National Transportation Enhancement Clearing House, http://www.enhancements.org; the aesthetic inspiration provided by this mandate is profound. "Getting on the subject of beautification is like picking up a tangled skein of wool...all the threads are interwoven—recreation and pollution and mental health, and the crime rate, and rapid transit, and highway beautification, and the war on poverty, and parks—national, state and local. It is hard to hitch the conversation into one straight line, because everything leads to something else." Lady Bird Johnson, instrumental in promoting the "Highway Beautification Act" of 1965, writing in her diary on January 27th of that year. PBS "Portrait of a First Lady," http://www.pbs.org/ladybird.

4. The ARRA gives $42 billion to the Energy Department for renewable energy projects. A development such as a viable electric car—or rail locomotive—powered by renewable energy, could impact transportation as astonishingly as the invention of the internal combustion engine or steam engine. "Deed vs. Promises: A Scorecard," The *Wall Street Journal* April 29, 2009, p. R4.

5. It is foreseeable that inland waterways, at least for purposes of tourism, could become a factor in the passenger network, albeit relatively small. Inland waterways currently carry approximately one-sixth of the nation's intercity cargo, on 12,000 route miles. Federal support for their ongoing construction and maintenance has averaged about $700 million in this decade (excluding spending on ports for overseas traffic), see "Harbors and Inland Waterways: An Overview of Federal Financing," (January 12, 2004), available at: http://wikileaks.org/leak/crs/RL32192.txt.

6. After World War II the railroad industry did not universally recognize the formidable competitive advantage of the automobile. Even as the mass of Americans bought cars, many rail lines continued to believe in the passenger business. The nation's second biggest carrier, the New York Central, placed a record-breaking order for 720 'streamlined' cars in the mid-1940s. As of 1948 the Central was carrying some 67 million passengers a year (Amtrak carried only 8.7 million in 2008, its record year.). Ten years later it had only about 37 million. The company's ads showed families on vacation, all formally dressed, enjoying scenery from the picture windows, eating in the elegance of dining cars, sleeping overnight in small and efficient 'roomettes' and 'bedrooms.' The ads missed the point. Postwar Americans wanted to jump in the car when they wanted, drive where they pleased, eat without ceremony, and dress informally—ever more so as the years passed. They wanted the freedom of the road. "New York Central's Great Steel Fleet 1948-1967" by Geoffrey H. Doughty (TLC Publishing, Inc. 1995), pp. 11, 19 and 26; "Amtrak Rider Joe Biden Pledges `First-Class' Railroad" Bloomberg.com, Nov. 8, 2008.

7. Japan started building the first high speed line in 1941, but halted work in the midst of World War II. The Japanese government restarted the project in 1959. "Shinkansen About More Than Speed" *The Japan Times* December 9, 2008.

8. A system using magnets for propulsion, still in development with very limited operating examples worldwide.

9. The route has impressive antecedents, being the heavily engineered "Mainline" of America's leading railroad, the Pennsylvania, before deferred maintenance of the 1960s and '70s caused decline. It was electrified in the 1930s as a Works Progress Administration project.

10. In the 1930s the US had more route miles of electrified railroad than any other country, some 20% of the world's total. "Railroad Electrification Proposals," ClassicTrainsMag.com.

11. "Time to Revisit Electrification," *Railway Age* (September 2008).

12. New York presents some special problems in this regard as a majority of the services, while electrified, are 'third rail,' as opposed to catenary operations. Conversion will be expensive. But again, the economies of operation in merging with a nationwide system would eventually justify initial costs.

13. Even major freight railroads are considering electrification, in one case using wind generated power and paying for the costs of the energy with the lease of railroad right of way. Considering this, and also the fact that some of the same routes are plied by Amtrak, the cost sharing possibilities are multiple. "Time to Revisit Electrification" *Railway Age* (September 2008).

14. The extent of these services in 19th century America was enormous, for the most part linking cities, large and small, to the towns, villages and hamlets strung along their lines and delivering clean (electric) transportation to thousands of communities, many of them bypassed by rail lines. In 1923 interurbans carried some 44 million passengers per day. As one example, in Depression year 1935, the Lehigh Valley Transit Co. operated every hour between Philadelphia and Allentown, Pennsylvania, a distance of just over 60 miles, each trip taking about two hours, making twenty one intermediate stops, many coordinated with connections to other trolley and bus lines, the passengers traveling in "an interurban car of quality and elegance supreme." The line operated (overnight) freight trains as well. Timetable, Lehigh Valley Transit Co., "Liberty Bell Route," March 5, 1935; "The Life and Times of the Pacific Electric" (Orange Empire Railway Museum 1983).

15. See: http://www.riverline.com/fareinfo_options.php.

16. An argument often raised against such a proposal in urban centers is the generally higher population of homeless that traditionally congregate in bus terminals. But realistic and humane solutions, including the provisioning of soup kitchens and other aid facilities near the terminals (as is the case at Port Authority in New York City), can alleviate the issue.

17. To view the interiors of the "Mercury," conceived in 1936, terminated in 1959, is to see a clarion example of what a daylight 'corridor' train can be. The service ran initially between Detroit and Cleveland, later Detroit and Chicago, and Cleveland and Cincinnati. Coaches featured two-abreast seating, with mid-car seats set across from each other creating lounge and conversational areas, first class 'parlor' cars with one-and-one seating across, each seat swiveling from window to aisle as desired, low tables and table lamps scattered throughout, separate dining cars, colors of tan, brown and rust. Henry Dreyfuss, one of the twentieth century's preeminent designers, conceived and executed the scheme. "The Art of the Streamliner" by Bob Johnston, Joe Welsh with Mike Schafer (Metro Books 2001).

18. As one key example of a potential design problem, high speed lines abroad are increasingly depressed in trenches, perhaps for noise abatement and safety, perhaps to ease the visual scar of the line itself in the landscape. But the consequence is protracted periods when viewing the passing scenery itself—one of the joys of train travel—is barely possible, not ultimately a desirable result.

19. A new station in Saco, Maine has a station tower clock and brick façade, resembling the nearby mills, is powered by a 100-foot windmill turbine, and heated and cooled using a geothermal well along with solar and radiant heat. The local Chamber of Commerce meets in the building. Empire State Passengers Association, Newsletter (May/June 2009).

20. Adopting the phrasing of preeminent architectural critic Ada Louise Huxtable, writing recently to praise a building constructed pursuant to the guidelines of New York City's "Design and Construction Excellence Initiative," initiated by Mayor Bloomberg in 2004, such structures should be "beautiful, economical and tough." The *Wall Street Journal* May 13, 2009, p. D7.

21. There have been few better names chosen for a transportation entity than the euphonic "Idlewild," for New York's largest international airport, named after a golf course it displaced, recast as today's "JFK."

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MANHATTAN'S OFFICE LEASING MARKET: A PANEL DISCUSSION

The following is an abbreviated and edited transcript of a panel discussion on May 8, 2009 at the Ruben Company's Madison Avenue offices.

SICULAR: I'm the editor of The Stamford Review, and this is a panel on the office leasing market hosted by the Ruben Companies. Our participants are Brian Higgins of Jones Lang La Salle; Clyde Reetz of CB Richard Ellis; Peter Berti of Cushman & Wakefield; Robert Silver of Newmark Knight Frank; and Bill Elder of the Ruben Companies. Chuck Goldberg of The Pentucket Company is moderating.

GOLDBERG: Gentlemen, thank you. Let's go around the table. I'd like to know what kind of office space is available today that might have been a rarity one or two years ago.

REETZ: Large blocks of office space. When the market was tighter, there were few large blocks; now we see a much greater number available. The market was driven by those big deals. Anything over a hundred to two hundred, up to 250,000 square feet. Landlords went into other neighborhoods to look for or develop large blocks of space.

BERTI: A tremendous amount of sublease space. The vacancy rates two to two and a half years ago were approaching five percent, a very landlord oriented market. Sublease space was probably about one percent, twenty percent of that. Over the past twelve months, the amount of sublease space has risen. It is now 3.6 percent—a tremendous amount of supply. And there are blocks of sublease space that we call shadow space, not listed but that could be made available.[1]

HIGGINS: There's a much simpler answer: everything is available now. Nothing was available two years ago. You now have a handful, maybe half a dozen buildings, that can generate rents over one hundred dollars. Two years ago there could have been a hundred buildings at that level. Right now that $150 space is $60-dollar space.

SICULAR: What characterizes space, in this market, that rents for over $100 a square foot?

HIGGINS: It's views, height, ownership and reputation. 375 Park Avenue; 9 West 57th Street.

GOLDBERG: The Seagram Building, the Solow Building.

HIGGINS: The GM Building. But there were buildings down around Bryant Park, at 42nd Street and 6th Avenue and renovated buildings in the garment center that were commanding $100.

SILVER: In the 25 years that I'm doing this, I've never seen anything go this fast and this deep in such a short period of time. And Brian's [Higgins] right. You know, buildings that were trading in the $125, $140 range are now $60.

ELDER: We all had concerns in the summer of '07 which did not materially impact the market until September or October of 2008. Since then, the precipitous fall-off has been staggering.

Clockwise, left to right:
The Solow Building (9 W 57th Street), The Bank of America Building (One Bryant Park), The Seagram Building (375 Park Avenue), The GM Building (767 5th Avenue)

The problem is the debt is at the twelve hundred per square foot level, and the pricing for a purchase today is at the four to five hundred dollar level, **so when the loan comes due, you won't be able to refinance it.**

SILVER: One of the things that we see today, that we weren't seeing, is furnished space. Few tenants looking at space want to spend additional capital for a build-out. And it's important to point out that a tremendous number of these large blocks are recently built and fully furnished, and the furniture's new and good.

REETZ: The concession packages have also gone up as the base rental rates have dropped. The landlords have to compete. So they're building better quality and a higher end. Sublessors that are trying to dump large blocks of space are offering cash. Some will even add significantly to a work letter from a landlord.

GOLDBERG: Now let's turn out attention briefly to non-disturbance clauses. Let's continue with you, Clyde [Reetz].

REETZ: You've always had them. If a tenant made a commitment for a 10 or 15-year period, and if the landlord lost the building, they did not want to be thrown out or renegotiate their lease. Now if you're a tenant looking at sublease, you have the benefit of a reduced price and built-out space. But you also have the concern that the over-tenant may not be there for the entire length of that term.

So you look to the landlord for a non-disturb. And, in order to make that deal, there are cases where that will happen. If you've seen the price drop from $130 a square foot to $70 a square foot, you don't want to sublet space at $70 a square foot only to have someone default and then be responsible for $130 a square foot.

GOLDBERG: And now the question that every customer and client asks: "When will this market stabilize?"

SILVER: It is our belief that rents will begin to stabilize some time late second quarter or early third quarter and then just be flat for a period of time. I don't see anything coming back any time soon. The question is when does the bottom hit? In disposing of space, I think the landlords have become patient, despite the fact that many are pushing their agents very, very hard to lease their buildings.

GOLDBERG: In the early 1970s, it was this bad. You couldn't give space away. The World Trade Center had just come on the market. The Trade Center cut deals at six dollars and fifty cents a square foot. The most you could get for non-World Trade Center space was five fifty. So the entire island of Manhattan tipped towards the Trade Center. Harry Helmsley handed back the keys to a couple of buildings on lower Broadway and said to his mortgagees "be my guest", and we may be seeing more of that today.

BERTI: Roughly one third of the New York market is occupied by the financial services industry. As Clyde [Reetz] said, there are financial institutions that have shadow, formerly occupied, space. Assuming that some of the major financial institutions pick up steam next year, they are not going lease space until they fill the space that they have. That's why you have this tremendous lag. If vacancy rates in New York go to fifteen percent—let's just look at Midtown—two hundred and fifty, by some statistics three hundred million square feet of space, at a fifteen percent vacancy rate, and you're looking at forty million feet of surplus space. Absorption might be a million, or two million, in some cases you hear three million feet per quarter, but that's a rarity.

SICULAR: Fifteen years worth of absorption?

BERTI: It will never get to that point because a reasonable vacancy rate would be about half that, between seven and nine percent.[2]

SILVER: It's important to understand the difference between availability rate and vacancy rate. The vacancy rate is space that is literally vacant and empty whereas available space, the number that Peter is describing, includes space that is currently occupied, coming available and currently on the market. And it's almost a fifty percent differential.

GOLDBERG: Gentlemen, what are the percentage drops of asking rentals in class A, B and C, and is one more dramatic than the other?

HIGGINS: The important differential is between average asking rents and where deals are getting done. That differential is anywhere from a third to a half. We have not seen rents like this in twelve to fifteen years.

ELDER: That's not taking into account inflation. That's why we're a lot closer to the bottom then ever before, and that's based on a number of factors. There are going to be absolutely no new buildings. You can't finance them. Nobody's got the guts to do it, although this is probably the perfect time to do it. We all saw that Boston Properties has finally pulled the plug on the 55th Street project. So there is a lack of great Class A space coming online, clearly something to be considered. Also there are little glimmers of hope; Citi took back some of the space it was going to sublease at 450 Lexington; they're going to need that space to do the integration of the Morgan Stanley, Smith Barney merger.

HIGGINS: Bill [Elder], as the only landlord in the room, we have not seen the foreclosures that have been predicted; is there another shoe to drop?

ELDER: Mainly it's time. Many buildings were financed with floating-rate and short-term debt that is coming to maturity over the next two years. It's probably somewhere between four and six hundred billion dollars. The Macklowe Portfolio is in terrible distress. Worldwide Plaza and Fifteen Forty Broadway are the two latest victims. The John Hancock Tower up in Boston was a victim. The lenders will have to make a decision. We may not see the kind of foreclosure activity that we're all anticipating because people don't want to take on the problem.
Back in the old days, I think we'd all agree that halfway decent buildings were trading at about twelve hundred dollars a foot. While there are no comps to really justify what the market is today, the general sentiment is probably somewhere between four to five hundred a foot.

REETZ: CBRE investors bought 1540 Broadway for less...

ELDER: For about $360, I think. So, think about the economic ruin of buying a building at twelve hundred and then having to sell at three-to-five hundred. The conversation that will take place over the next two years is whether the institutions really want to foreclose or whether they want to try to work it out, wipe out some equity or restructure.

REETZ: For some buildings, the interest rates now are low enough that they can carry the building. The problem is the debt on it is at the twelve hundred per square foot level and the pricing for a purchase today is at the four to five hundred dollar level, so when the loan comes due, you won't be able to refinance it.

SICULAR: Could you talk a bit about what makes a good building and a good landlord?

ELDER: It starts at the front door. How you manage your property's curbside appeal. How you handle the relationship with your tenant/partners. How you have financed your buildings. Have you done it with low leverage, so you're not going to lose the building over some short period of time? I think the New York families have a different viewpoint on running real estate then the private equity guys. The REITs actually do a pretty good job of managing their buildings and managing their relationships with their tenants. They're not short-term guys. So it's very qualitative.

BERTI: Quality of landlord? Yes, there are names, the Rudin family, the Rubens, but tenants in existing property are one of the best references for a quality landlord. I think what separates the New York families is their ability to make decisions quickly. When you deal with an institution, and they have to go before a committee, or there are guidelines that have to be met, the extended time kills deals. People that will be successful in this

...the game's changed. Everybody's represented now. Everybody's becoming a sophisticated user of real estate.

market will respond quickly, seize opportunities, renew tenants quickly and take a pro-active stance.

GOLDBERG: Let's talk about the major components of a deal—new building installation, cash contribution, electricity, escalation provisions—how might that have changed over the years? Why don't we just go around the horn here? Peter, we'll start with you.

BERTI: There are several components to a deal. The basic ones essentially are a rent abatement and a contribution to work. There was a magical $40 contribution number, which had been around and not moved, for almost 15, 18 years, even though construction costs went from $40 a foot to in excess of $100 a foot for a quality installation.

Right now tenants are unwilling to go out of pocket to build out space. They don't want to be bothered with it beyond having a plan. Landlords are willing to do that, so it's costing them more, on the order of $70 a foot. Previously, the rent abatement was essentially construction time. A landlord would give you six months of rent abatement or nine months or eight or twelve months. For a large tenant, it can take twelve months to build space. What people are asking for and getting right now is actual rent abatement after they're in the space.

GOLDBERG: Peter, how much of that, beyond construction time, is being given on a 5 year deal and a 10 year deal?

BERTI: I would say on a 5 year lease, you are probably looking at anywhere from 4 to 5 months. If you have Mr. Higgins negotiating for you, you might get double that. I would say on a 10 year lease, you're getting 12 months; although it may be spread out over the term of the lease.

SILVER: I think that these numbers are almost hypothetical because there really is no market right now. There's so little lease volume, so few deals getting made, the majority of the deals are renewal deals. There are very few deals over say 10,000 feet getting finished, very few.

GOLDBERG: Gentlemen, what are current escalation provisions, how do they differ from what we enjoyed a couple of years ago?

SILVER: During the, the unrealistic days of '06, '07, '08, landlords looked for percentage increases, even on midtown rents, which was historically the case only in B and C buildings, in midtown south, Chelsea, Soho, Noho.

GOLDBERG: And those compounded percentages were?

SILVER: They were between 2.5 and 3 percent. In midtown, the idea was that you wanted to get your rent, but your operating was supposed to be a direct pass-through. The landlord's philosophy was "I only want my rent, I'm not looking to make money on the operating". That changed. We saw landlords asking $65–$70–$75, wanting 2.5-3 percent on that, which is like a $2 number per year compounded. What you're going to see is a movement, especially in midtown, back to more realistic escalations. I think you're going to get back to more direct operating. In midtown south, it will remain percentage increases but those percentage increases will come down to maybe 2.5 or 2.25 percent.

GOLDBERG: We should say that direct operating means a proportionate share of....

SILVER: Actual operating expenses of the property.

GOLDBERG: Over and above a certain base.

SILVER: In other words, the reimbursement rises with the cost of running the building, but the base rent is fixed for the term of the lease.

GOLDBERG: Correct. And it's dollar for dollar. It's transparent. It's audited.

SILVER: And things were just so crazy in 2007 that landlords were really profiting from the escalation as well. That's not going to continue.

ELDER: It's true. It's going to be a direct pass through, or just to cover whatever costs of the landlord that are increasing. Tenants have gotten pretty sophisticated on what's an operating expense and what's not. There are audited financial statements from the accounting firms that you have to use to prove you're operating expenses. I don't see a lot more to the downside to rents. But I think you will see increases in the concession packages. I think you'll see landlords willing to spend for tenant improvements, give more free rent, maybe some broker incentives.

SICULAR: There's a psychological component to the face rent not dropping too low, and they play around with how they handle these concessions?

GOLDBERG: Good point. It's my understanding that about 85 percent of all transactions in the first quarter of this year were 10,000 sq. ft. or less. Let's comment upon small businesses being the foundation of a recovery of New York City commerce.

ELDER: I think the actual statistic is that 75 percent of the tenants in New York City are in 10,000 feet and under. However, the flip slide is that large tenant users, those who occupy 100,000 feet or greater, are about 50 percent of the market. Most activity is from the smaller tenant, and in past markets they were sometimes a little less sophisticated, sometimes not represented. I think the game's changed. Everybody's represented now. Everybody's becoming a sophisticated user of real estate. The great news is that a lot of these smaller guys aren't financial firms, or if they are, they are relatively healthy because they spun out of a bank, or they're a boutique investment bank or a money management firm or whatever that is actually profitable. So thank God for the smaller tenants, because there you will see the activity for the next few quarters, while the large banks figure out what's going to happen.

HIGGINS: We lag other markets because we have a bigger percentage of the big users here. When employment starts picking up, you'll know you've not only reached bottom, you've bounced off it. Those guys will hire people; then they'll be out in the marketplace saying I need a place to put them.

BERTI: Politically, we have what is perceived as a very pro-business mayor. I think you can get into a situation where someone can portray businesses, and real estate, as greedy people and just hacks away at them. Let's tax them, and the end result of that is what happened in the seventies; people and companies can vote with their feet by leaving town. So politically, I think that is something that is going to very much effect the outcome.

SILVER: I'm seeing now that people feel that the world is not ending, and they are starting to make more moves, and they feel a little bit more positive about things going forward. Whether it's the stimulus, or timing, I don't know. My feeling is that transaction volume will increase tremendously. Unfortunately for landlords, I think there is still going to be a decline in pricing for a time, and then you're just going to see flatness for a period of two to three years.

ELDER: I think that's right. This is not an overnight kind of recovery. You're going to look back in 4 or 5 years from now and say it was a great time to make a deal. It's still early, but this is a great time, probably over the next 24 months, to buy real estate. I think that great fortunes will be made in this market.

PANELISTS
Top, left to right: Brian Higgins, Jones Lang La Salle; Clyde Reetz, CB Richard Ellis; Peter Berti, Cushman & Wakefield
Bottom, left to right: Robert Silver, Newmark Knight Frank; Bill Elder, Ruben Companies, Chuck Goldberg (moderator), Pentucket Company

NOTES

1. Put more simply, total Manhattan inventory is approximately 392 million square feet. The 5.1% overall vacancy rate for Manhattan office space, as of 12/31/2007, was approximately 20 million square feet. Roughly 1%, or 4 million square feet, was sublease space. As of 5/31/2009 the overall vacancy rate had moved up to 10.5%, with the sublease component increasing to 3.6% or 14 million square feet. Most forecasts project an overall vacancy rise to the 15% level, or 59 million square feet, by early 2010. Follow-up analysis provided by Peter Berti based on Cushman & Wakefield data.

2. The vacancy rate may rise to 15% by early 2010, or to approximately 59 million square feet. Experts consider the equilibrium rate, meaning a relatively stable market, to be in the 7-8% range. This would translate into about 29,000,000 square feet vacant and available. When the NYC economic engine gets going again, perhaps in 2010, thirty million square feet would need to be absorbed to lower the 59 million square foot projected vacancy to the 29 million square foot equilibrium. Absorption goes up and down and is anything but constant. However, an absorption rate of two million square feet per quarter, or eight million square feet per year, would require 3.75 years of growth. This follow-up analysis provided by Peter Berti based on Cushman & Wakefield data.

EATING AT JUBILEE:

NO-NONSENSE FRENCH DISHES PREPARED FROM QUALITY INGREDIENTS

JASPER JONES

IT IS TEMPTING to describe Jubilee (347 East 54th Street) as a neighborhood restaurant, but the term neighborhood in New York has been a controversial one for years. One thing that distinguished the East 50s during the generation after World War II were its great French restaurants: Café Chauveron, La Côte Basque, Lafayette, Lutèce, and many others, including the grand daddy of them all, Le Pavillon on East 57th Street. These restaurants served classic French cuisine, in chic, fashionable surroundings. Now the only survivor of this halcyon period is La Grenouille on 52nd Street. These restaurants were always for people who didn't worry about the bill, but there were other restaurants in the area with impeccable French credentials and modest tabs, like La Toque Blanche on 50th Street and Le Moal on Third Avenue.

One thing that characterized these restaurants at dinner was a cosmopolitan clientele—rich and not so rich—who traveled a lot and knew French food. The East 50s has always had many residents who also have homes in other places, both in this country and abroad. The reason is not the nearby United Nations, which is a different community, but the many expensive apartment buildings and the unbeatable location within walking distance of Midtown Manhattan. Think Sutton Place, Beekman Place, Turtle Bay, and the desirable residential blocks between the avenues. Recent development has not changed the demographic.

The dinner crowd at Jubilee is a reminder of the cosmopolitan quality of the neighborhood. Although it's hardly a grand restaurant, it attracts a crowd who knows a good thing when they find it. On a recent evening there, I was trying to remember the name of the town just north of Paris where I'd had a memorable Chinese meal. I remembered that the town also had a huge, famous (or notorious) pet cemetery. I asked the patronne of the restaurant, who was standing nearby, and when she hesitated, two nearby diners said, "Asnières." One of them added, with mock solemnity, "It's the final resting place of Rin Tin Tin."

People return to Jubilee for no-nonsense French dishes prepared from quality ingredients. It serves a French cuisine that used to be called provincial, that is, regional and less complicated than classic cuisine. The kitchen is remarkably consistent. The menu doesn't change often, but if you enjoyed a dish here once, you're likely to find that it's just as good the second time. A good example is the soupe de poissons ($9.00), a heady traditional fish broth enriched with cream and served with the traditional garnish of coarsely grated gruyere cheese and rouille (a rich garlic mayonnaise). Jubilee doesn't always serve the expected croutons any more, but you can use the crusty country white bread that they do serve. Their version of this classic omits the tomatoes you'd expect in the south of France in favor of a north Atlantic version with a creamier broth. (It's like the difference between the Italian-inspired Manhattan and the New England clam chowders, but Jubilee's fish soup is in a different class from the latter.) The seasoning is suitably restrained with hints of herbs and a suggestion of saffron. It has the fresh taste of the sea, and it's very, very good.

Other appetizers include the snails, billed as cassoulette des escargots. You can order either a half-dozen ($10.00) or a dozen ($15.00). They are the traditional snails with garlic and parsley, served in metal cassoulettes that are hot as fire. Enjoy the scent of the garlic a while before you take a bite. The green salads, either

the simple one with organic field greens, dressed with a mild vinaigrette ($8.50), or the fancier one with goat cheese, beets, and basil ($10.00), are generous and fresh. The tuna tartare with ginger and sesame seaweed salad ($14.00) seems a bit exotic among the more traditional dishes, but it's very tasty.

My favorite entree is the striped bass ($24.00) described on the menu as "a la plancha," that is, broiled or baked on a metal plate. Fortunately it's served on a regular dinner plate with artichoke hearts and zucchini. The bass is seared on the outside to perfection, and the inside is moist and flavorful. I sometimes go the Jubilee resolved to order a different entrée and then have this one. It's one of the best fish dishes in town. In fact all of the fish and seafood entrees at Jubilee are fresh and well-prepared. For the summer menu, Jubilee removes the broiled salmon served on a bed of lentils ($22.00) and, for the same price, substitutes cold poached salmon with tabouli and asparagus in basil lemon sauce. (For me this is an improvement, since I tend to associate lentils with andouille or some other sausage.) Sometimes there'll be a seasonal seafood specialty, like soft-shelled crabs, available for "market price." If price is a concern and you like mussels, you can order a big bucket of them served with either French fries or salad for $20. The steamed mussels come in three versions: traditional marinière, curry-flavored, or the general favorite, poulette—in chicken broth with cream, mushrooms, chives

My favorite entree is the striped bass...I sometimes go to Jubilee resolved to order a different entree and then have this one. **It's one of the best fish dishes in town.**

and white truffle oil. This preparation raises the humble mussel to something rather extraordinary.

Like many other restaurants in Manhattan, Jubilee now offers a prix fixe meal ($30.00) at lunch or dinner which includes appetizer, main course, and dessert. Unless there's something on the prix fixe that you really want, it's probably better to order an entrée and either an appetizer or dessert from the a la carte selections. But I guess this is always the case.

The meat dishes are also consistently fine. The steak frites in green pepper sauce ($28.50) is reliable and cooked to order. The rack of lamb ($30.00) is the most expensive entrée. It's really good, though, and the gratin of potatoes that accompany it is terrific. I think almost everyone is tired of chicken, but Jubilee's roasted organic chicken breast with garlic mashed potatoes ($23.50) may revive your interest. The steak tartare is served with both French fries and salad, and at $24.00 is one of the bargains on the menu. It's highly seasoned (but not spicy), so if you like your raw chopped beef au naturel, this one's not for you. The cassoulet ($23), beans with duck leg confit (duck cooked and preserved in duck fat), bacon and garlic sausage is off the menu for the summer. But to keep your cardiologist in business, you can make do with the confit alone served with asparagus, roasted potatoes, bacon, and truffle sauce ($25.00).

Desserts include the inevitable chocolate cake, warm apple tarte with vanilla ice cream, and great profiteroles with chocolate sauce (These are becoming hard to find, even in France). There's also an elegant gratin of raspberries. Prices range from $7.00 for ice cream or sorbets to $9.00 for the more interesting desserts.

The wine list is a bit pricey, but you can have a very good Muscadet for $29 to go with the seafood dishes. As for the red wines, a top Brouilly (Chateau des Tours) will run $41, but a very acceptable Cote de Rhone is $32. Bottles get more expensive when you venture into the Burgundies.

If you go to Jubilee regularly, you see the same people often, obviously happy to be there, nodding to familiar faces around the dining room and ordering their favorite dishes. One thing Jubilee doesn't have is plenty of space between tables, and most of the seating is at banquette tables. This means that you'll be dining in pretty tight quarters. Fortunately, the people at neighboring tables are very considerate, as one would expect. Jubilee is not exclusive in any way, but it's necessary to call early and get a reservation. If you show up without one, you may get a table, but the chances are you'll wait for quite a while.

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