

## **Viewpoint: Countercyclical Loan-to-Value Limits Can Help Prevent the Next Bubble**

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By Alex J. Pollock

Financial and economic cycles are inevitable. But do they have to overshoot into bubbles and crises? Once there has been a bubble, the crisis cannot be avoided, so the essential project is to work on preventing the bubble.

To address this at the most fundamental level, we should be working on countercyclical behavior to moderate the upside overexpansion. Specifically for mortgage finance, we should create countercyclical loan-to-value limits. Of course, this is the same thing as countercyclical down-payment requirements.

Such LTV limits should be transparent, easy to apply and relatively free from political interference.

A bubble involves an insidious self-reinforcing feedback loop between asset prices and increasing debt and leverage. The 21st century housing bubble presents a perfect example of this perverse interaction.

As house prices rise in a housing bubble, more debt and more leverage always seem better. Both borrowers and lenders see their profits and the return on their leveraged equity get bigger. Lots of people are making money as the bubble expands.

As long as house prices keep rising, delinquencies, defaults and losses on mortgage loans are all low. This experience makes lenders and investors more confident, just as borrowers become more optimistic. Risk appears contained. Politicians are happy and push increasing homeownership and credit "access."

At the mortgage-loan level, leverage is measured by the LTV ratio: how big a mortgage are you willing to grant relative to the current market price of the house? But what does the current price really mean if prices have been rapidly inflating on a tide of credit expansion? Lenders should view very skeptically the current price of greatly appreciated houses.

As house prices inflate further and further above their trend line in a bubble, the risk of their subsequent fall becomes greater and greater. So although the risk of the loans is felt to be decreasing, in fact it is greatly increasing. In this context, consider what should happen to LTVs and down payments.

What typically does happen in a bubble is that with increasing optimism and apparent profits on all sides, LTVs rise and down payments fall, reflecting the illusory success. "Innovative" no-down-payment and low-down-payment mortgages are promoted. This helps inflate the price and credit bubble still further. Rising leverage and inflating house prices are in their insidious and ultimately fatal feedback loop.

What should happen is the opposite: rational, countercyclical management of LTVs would reduce LTV ratios, not increase them, as the price of houses escalates. Correspondingly, down payments should be increased, not reduced.

In short, lenders should be trying to make a long-term loan against the underlying, sustainable value of the house, not merely its current price.

Once you think about it, using countercyclical LTVs is an obviously logical strategy. One provocative idea on a specific way to define them has been proposed by Rep. Bill Foster (a member of the House Financial Services Committee, who also holds a PhD in physics from Harvard). He suggests applying a "Skepticism Factor" to current house prices in a boom, using the moving average of real house prices, and then to derive a lower allowable LTV. It might work like this:

1. The relevant regional house price index is adjusted to current dollar equivalents, and for the half a percentage point long-term trend increase in real house prices. This creates an adjusted house price index.
2. The Skepticism Factor is the ratio of the moving average of this adjusted price index to the current price index.
3. Multiply the normal LTV requirement by the Skepticism Factor. This determines the countercyclical LTV (and of course, required down payment).

For example, suppose regional house prices have boomed at a 10% per year annual rate in nominal terms with 2.5% general inflation. Adding to this the long-term trend real increase in house prices of half a percentage point per year makes 3%, so we are experiencing a 7% per year real, overtrend rate of house price increase. The nominal house price index was 100 three years ago and is 133 today, having increased 10% per year. A price of 100 three years ago that had increased at the trend 3% per year would have become 109, so stated in current dollars, prices have increased from 109 to 133. Suppose your maximum normal LTV is 90%. The Foster proposal would then make the following calculations:

- The average of the adjusted price index from three years ago to now is 121.
- The Skepticism Factor is therefore  $121/133 = .91$ .
- The countercyclical allowable LTV is  $.91 \times 90\% = 82\%$ , so the required down payment is 18%, instead of the normal 90% LTV and 10% down payment.

If you apply this formula pro forma to house prices at the top of the housing bubble, it results in very low allowable LTVs and unrealistically high down payments. However, in practice, the LTVs would have been decreasing as the countercyclical requirements worked along the way, which would have absorbed speculative capital and moderated the bubble.

You would never get to the house price peak we experienced — and this is exactly the point. Moreover, the market's knowledge of countercyclical discipline would itself have further discouraged the inrush of speculative loans, house purchases and house construction.

Rep. Foster suggests that countercyclical LTVs can be thought of as an automatic housing finance stabilizer, as a financial case of a feedback controller or a governor on an engine. This is a useful analogy.

I do not insist on this particular method or any specific formula for countercyclical LTVs. But the general logic seems to me unassailable, and in some appropriate form, they should definitely be implemented.

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