Testimony

of

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My name is Stuart Gabriel and I am Arden Realty Chair and Professor of Finance at the UCLA Anderson School of Management. It is my pleasure to address the Committee on recent trends in Southern California housing markets. Further, as requested, I will provide brief discussion of effects of government regulation of housing markets. Finally, I will also speak to potential adverse residential property value effects of proximity to high-voltage transmission lines.

To begin, the boom and bust of house prices defined the opening decade of the 21st century. As widely reported, US national house prices recorded a decline of roughly 30 percent over the 2006 - 2010 period, about on par with the peak-to-trough contraction during the Great Depression. Implosion in house prices figured importantly in the 2007 meltdown in mortgage and capital markets and the downturn in the global economy. As is widely appreciated, the fall-off in house prices and related economic decline were especially severe in California.

In contrast to historical precedent, our research indicates that the recent boom-bust cycle in US housing markets was driven by unusually high levels of speculative activity.[1] Further, speculative motivations and related investment risk were especially pronounced in Southern California. In particular, high levels of exposure to housing market risk were evidenced inland areas, notably including San Bernardino and Riverside Counties.

Our research also has sought to characterize the magnitude, spatial incidence, and timing of US metropolitan house price fluctuations over the broader boom-bust cycle. That work provides evidence of aberrant and excessive swings in house prices among Southern

[1] See Karl Case, John Cotter, and Stuart Gabriel "Housing Risk and Return: Evidence from a Housing Asset-Pricing Model", Journal of Portfolio Management, Vol. 35, No. 5: pp. 89-109, 2011)

California metropolitan areas, relative to other localities in the United States. Further, we documented high levels of correlation in house price movements among Southern California metropolitan areas during the 2006-2007 upswing in valuations.[2] In market contrast, as the bubble burst, house price declines among coastal California cities were relatively less severe than the sheer implosion in prices evidenced in the inland areas.

The above analysis also showed that metropolitan house price fluctuations became much more sensitive of national economic fundamentals over the course of the recent boom-bust cycle. In other words, house prices across the country were increasing responsive of changes in monetary policy, household incomes, and other national factors. However, in California, that pattern changed as boom turned to bust and as performance of coastal markets diverged from that of the interior of the state. Indeed, in inland California areas (including the Central Valley, Inland Empire, and the like), house prices fell back markedly, consistent with the national economic recession and the overall weak housing market fundamentals. However, along the coast of California, house prices evidenced substantially less downward adjustment, despite weak national fundamentals, as localized factors came into play. Along the California coast, factors supporting house prices included lack of overbuilding and long-standing supply constraint, desirable natural amenities, and shorter commutes to sub-regional employment centers. As was broadly reported, Central Valley and Inland Empire cities collectively comprised the epicentre of the 2000s boom-bust cycle in California housing markets. Those areas were characterized by high levels of subprime lending to households maintaining little equity in the

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[2] See John Cotter, Stuart Gabriel, and Richard Roll, "Integration and Contagion in US House Prices", Working Paper 2011-12, UCLA Ziman Center for Real Estate, 2011.

home, substantial overbuilding in the context of elastic land and housing supply, less desirable natural amenities, and longer commutes. In many cases, interior MSAs have limited local employment base (or local economies were disproportionately driven by residential construction) and function as outer-ring bedroom communities for employment centers located closer to the coast.

Recent data suggests that the housing markets of both interior and coastal areas have found their footing (albeit at substantially damped prices and very low levels of residential construction) and are poised for modest and gradual recovery. This assessment is based on review of the range of housing market indicators, including sales, prices, inventory levels, construction trends, and the like. For the State of California as a whole, sales of existing homes moved up from about 280,000 units in late 2007 to about 500,000 units in late 2011. The recent sales pace is about on par with 2006 levels. Similarly, inventories of existing homes for sale statewide have trended down to about 5 months supply at the current sales pace, close to levels traditionally associated with long-run equilibrium in the market. While sales have recovered to a significant degree, prices remain depressed. The median price of an existing home is currently about $300,000 for the state as a whole, well below the $560,000 recorded in 2006. However, while house prices drifted a bit lower in 2011, they are expected to move up modestly in 2012 in the context of stabilization and recovery of the statewide market.

Turning to the Inland Empire, note that the median price of an existing home has been roughly flat since late 2009 at about $170,000. At the same time, the first three quarters of 2011 witnessed substantially heightened sales activity. During this period, prices continued to drift down in Los Angeles County to roughly $300,000 on average. Similar to the Inland Empire, Los Angeles has witnessed some rebound in existing home sales during the first three quarters of 2011.

In marked contrast to the usual order, housing is now a lagging rather than leading sector. The path of housing is now highly dependent on the timeframe and magnitude of the larger macroeconomic recovery. As is broadly appreciated, California was especially hard hit in the context of the global economic downturn and continues to suffer from low job creation, substantially elevated unemployment, and ongoing and significant cuts to public budgets at state and local levels. Inland areas remain threatened, as much of their boom economy was built on housing construction, an activity not likely to return en masse in the near-term. Inland areas are further threatened by the substantial hikes in the cost of gasoline and related commuting costs, coupled with ever-growing popularity of urban living, which threaten their traditional role as more-affordable bedroom communities. While the Federal Reserve has sought to reduce the cost of mortgage credit in efforts to stabilize and support the market, ongoing tightening of mortgage underwriting and credit conditions by major lenders has served to frustrate some of the Fed's intended stimulative effect. Pricing of residential mortgages is similarly adversely affected by lack of private residential secondary market liquidity. In sum, the forecast for Southern California housing markets is slow and gradual recovery, with little likelihood of surprises on the upside. For reasons discussed above, coastal, multifamily markets are expected to perform better than inland single-family markets in the short-term.

Beyond the status of Southern California housing, the Subcommittee also sought input on residential property value impacts (intended or unintended) of state and federal government regulation. In general, this is a broad and complex topic, as a myriad of government regulations impact property values, including those associated with banking regulation, mortgage lending, securities issuance and regulation, appraisal, brokerage, truth-in-lending, consumer protection, land use, and the like. Further, in recent years, property values have been markedly affected by demise of the residential secondary mortgage market and related insolvency and re-regulation under government conservatorship of the housing GSEs (Fannie Mae and Freddie Mac). Separating out the precise property value effects of these and other federal regulations is a difficult task.

That being said, a few examples may be worth noting. The pre-housing crisis regulator of the GSEs, known as OFHEO (Office of Federal Housing Enterprise Oversight), permitted the GSEs to meet their federally-mandated affordable housing loan purchase goals via purchase of subprime mortgage-backed securities. The GSEs accordingly undertook substantial purchases of senior subprime MBS tranches. The GSE purchases served to support the prices of such securities, in turn resulting in some downward pressure on subprime MBS yields and related subprime mortgage interest rates. As such, this feature of OFHEO regulation of the GSEs ultimately allowed more households to qualify for subprime mortgages. This in turn likely served to put some upward pressure on house values and contributed as well to the exacerbated boom-bust house price cycle in areas where subprime lending was prevalent (such as inland areas of Southern California). This regulatory effect was likely unintended (and unrecognized), as OFHEO simply sought mechanisms to assist the GSEs in adhering to their affordable housing loan purchase goals.

In a similar vein, lack of proper federal regulator oversight of derivative mortgage-backed securities, notably including subprime mortgage-backed collateralized debt obligations (CDOs), may have contributed to the excessive swings in house prices. For example, in our recent research, we show that rapid capitalization and then abrupt implosion of the subprime-backed CDO market resulted in related swings in pricing of subprime mortgage-backed securities.[3] During the boom period, we link the surge in CDO issuance to higher subprime MBS issuance volumes and lower subprime mortgage interest rates, whereas the opposite is observed in the context of the housing bust. Here again we observe potential unrecognized and unintended effects of lax government regulation, whereby re-securitization of poorly rated subprime mortgage-backed securities into CDOs served to exacerbate subprime mortgage interest rate and house price swings.

In another example, an easing of regulatory oversight of mortgage lending likely resulted in qualification for home purchase by buyers that were ultimately unable to sustain their ownership in the home, in turn contributing to the epic bursting of the house price and homeownership boom. Arguably, the myriad of federal incentives associated with homeownership, importantly including mortgage interest and property tax write-off, GSE regulation, and the like, contributed to the boom-bust cycle.

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[3] See Deng, Gabriel and Sanders, "CDO Market Implosion and the Pricing of Subprime Mortgage-Backed Securities", Journal of Housing Economics, Vol 20, Issue 2, pp. 68-80, 2011).

To close here, summary statements about the effects of state and federal regulation on house prices are difficult. The regulations are diverse, ever-evolving, imposed across industries, and at different levels of government. The intended (not to mention unintended or unrecognized) effects of regulation are not well documented. While some effects are salubrious, others are deleterious. Having said that, it is vital that we undertake related analyses, so as to better understand how government might intervene to reduce the likelihood of future damaging swings in housing asset values.

I now briefly turn to residential property value effects of proximity to high-voltage transmission lines. Note that adverse property value impacts may derive from perceived deleterious health effects of such proximity, regardless of whether such harmful effects are evidenced in epidemiological studies. To the extent the power lines in question are deemed safe on the basis of laboratory or field studies, every effort should be made to disseminate those results. Even in that case, however, there may be perceived adverse visual, sound or other impacts of such power lines that will be viewed as negatives by potential buyers. While transmission of electric power is a clear national priority, efforts should be made to mitigate health hazards and related adverse neighborhood house price effects pertaining thereto.

I thank the Committee for the opportunity to testify and am available for any questions.