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How Goldman Sachs Helped Paulson and Company Short Housing in Smart Growth States

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It has been widely known in investment circles for several years that the hedge fund Paulson and Company earned huge profits by turning bearish on the U.S. housing finance market in 2006, when much of the investment and finance community believed that housing sales and home prices would continue to boom. Paulson was correct in its research, which found that certain U.S. housing markets were awfully wobbly and headed for a bust, and in early 2007 it bet against their mortgages as other investors gobbled them up. Paulson is estimated to have earned $1 billion in profits with these investments.

What gets lost in the discussion, however, is the role that "smart growth" and restrictive land use regulations played in the creation and eventual bust of the housing bubble. Moreover, the Administration's current policies not only encourage the same kind of behavior but may lead to additional bubbles in the future.

Profiting from Destructive Land Use Regulations. The U.S. Securities and Exchange Commission (SEC) has asserted that Goldman Sachs created financial instruments to accommodate Paulson's negative bets and that these instruments were improperly marketed to investors who held a more optimistic view of the housing market. While it is beyond the scope of this paper to explore the legality of the transactions that characterized this process, it is important to note for purposes of improving U.S. housing policy that Paulson insisted that the mortgages backing the collateralized debt obligations it was betting against be in states that happened to follow *smart growth* principles—i.e. states that had the most restrictive land use regulations in the nation for purposes of discouraging suburban growth.

Specifically, and as noted in *The Wall Street Journal*, "According to the SEC complaint, [Paulson and Company head John] Paulson especially wanted to find risky subprime adjustable rate mortgages that had been given to borrowers in California, Arizona, Florida, and Nevada—states with big spikes in home prices that he reckoned would crash."[1]

Not surprisingly, one key reason for escalating home prices in these four states was their tight regulation of land use, which created artificial shortages of developable land at a time when sales were soaring and credit plentiful.[2] In fact, all of the Paulson target states have been rated as having some of the most restrictive land use regulations in the nation by independent analysts as diverse as Princeton economist Paul Krugman, Wendell Cox of Demographia, and analysts at the Brookings Institution.[3]

As a consequence, house prices in those states soared. In all of these places home prices increased much faster than household incomes, and by the mid-

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2000s these states had some of the least affordable housing in comparison to their residents' incomes.

Measures of Affordability. Traditionally, housing is said to be affordable if the median house price in a community is no more than three times the median income of a household in that community. This measure of affordability is referred to as the median multiple, and a median multiple of three or less is affordable. As the median multiple increases above three, it becomes increasingly unaffordable.

By 2007, just as the housing market was beginning to turn down, many California areas—notably Los Angeles, San Francisco, and San Diego—suffered under median multiples as high as 10 or more. In 2006, the median multiple hit 5.1 in Phoenix and 6.1 in Las Vegas. It reached 7.1 in Miami in 2007.

By way of contrast, in areas with much less onerous land use regulation, housing remained affordable, reaching only 2.3 in Indianapolis and 2.8 in Atlanta in 2007. Housing also remained affordable in Texas, whose land regulation system Brookings labels as the "Wild, Wild West": The median multiple in Dallas was 2.5 and 2.9 in Houston. In each of these affordable areas, the median sales price of a house never exceeded $200,000, in contrast to the $804,000 recorded in San Francisco in 2007.[4]

Consequences of the Smart Growth Collapse. Two years after the housing collapse, the consequences of the crisis were at their most extreme in the states with the toughest land use rules. According to RealtyTrac, by 2008 nine of the 10 areas with the highest foreclosure rates were in California, Nevada, Arizona, and Florida, while 18 of the top 20 were in urban areas that Brookings includes in its most restrictive category, including California, Nevada, Arizona, and Florida.[5]

By early 2010, foreclosure and delinquency rates compiled and reported by Lender Processing Services revealed that mortgages in Florida, Nevada, and Arizona were the worst three performers in the country and that California was the fifth worst.[6] Nearly a quarter of the residential mortgages in Florida and Nevada were "non-current" as of early 2010.

Current Federal Policies Will Deepen the Problem. One of the more common complaints about President Barack Obama's many mortgage relief programs is that they tend to reward bad behavior as well as stupid decisions on the part of borrowers who voluntarily took on debt burdens they knew they could never carry—and in some cases committed fraud.

1. Carrick Mollenkamp, Mark Whitehouse, and Anton Troianovsky, "The Busted Homes Behind a Big Bet," *The Wall Street Journal*, April 22, 2010, at *http://online.wsj.com/article/SB10001424052748704133804575198120387721724.html?mod=WSJ_hpp_MIDDLENexttoWhatsNewsSecond* (May 4, 2010).
2. Abusive land use practices in Arizona and Nevada are exacerbated by land shortages caused by extensive government ownership of land and limited sales of such land from government portfolios.
3. Rolf Pendell, Robert Puentes, and Jonathan Martin, "From Traditional to Reformed: A Review of the Land Use Regulations in the Nation's 50 Largest Metropolitan Areas," Brookings Institution, August 2006, at *http://www.brookings.edu/~/media/Files/rc/reports/2006/08metropolitanpolicy_pendall/20060802_Pendall.pdf* (May 3, 2010); Paul Krugman, "Georgia on My Mind," *The New York Times*, April 11, 2010, at *http://www.nytimes.com/2010/04/12/opinion/12krugman.html?emc=eta1* (May 3, 2010); Wendell Cox, "How Smart Growth Exacerbated the International Financial Crisis," Heritage Foundation *WebMemo* No. 1906, April 29, 2008, at *http://www.heritage.org/Research/Reports/2008/04/How-Smart-Growth-Exacerbated-the-International-Financial-Crisis.*
4. All numbers are calculated from Demographia International Housing Affordability reports for 2006 and 2007. See Demographia, "4th Annual Demographia International Housing Affordability Survey: 2008," at *http://www.demographia.com/dhi2008.pdf* (May 4, 2010). Demographia is an international public policy firm based in St. Louis, Missouri, that specializes in demographics, urban policy, and transportation.
5. Press release, "Foreclosure Activity Increases 81 Percent in 2008," RealtyTrac, January 15, 2009, at *http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=5681&accnt=64847* (May 3, 2010).
6. Lender Processing Services, "LPS Mortgage Monitor: March 2010 Mortgage Performance Observations," February 2010, at *http://www.lpsvcs.com/NewsRoom/IndustryData/Documents/03-2010%20Mortgage%20Monitor/Pres_MM_Feb10Data.pdf* (May 3, 2010).

In February 2010 the President further expanded the focus on failure by announcing a $1.5 billion program available to only five states, four of which had imposed abusive land use regulations that caused much of the problem in the first place: California, Nevada, Arizona, and Florida. Of course, no mention was made of the role these regulations played in the problem, and no reform was required as a condition of receiving the federal subsidy.[7]

Other pending legislation and policies—notably the draft of the transportation reauthorization bill and the many statements by Transportation Secretary Ray LaHood on the need for greater housing and population densities—will make things worse by pursuing counterproductive policies endorsed by the President's environmental supporters. As recent Heritage Foundation reports have revealed, both the legislation and the proposed policies have as one of their chief purposes the encouragement of the type of land use regulations that led to the house price inflation in the four states whose mortgages Paulson targeted for opportunity based on potential failure.[8]

Americans Deserve Better. These policies may open up even more profit opportunities for discerning investors in high tax brackets, but the American people will not be better off as a result. They deserve a government committed to the restoration of affordable housing, stable homeownership, and a functioning mortgage finance market.

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7. Michael D. Shear and Renae Merle, "Obama's $1.5 Billion Financing Plan Would Help Struggling Homeowners in 5 States," *The Washington Post*, February 20, 2010, A14.
8. Ronald D. Utt, "No Tax Increase for Federal Transportation Programs," Heritage Foundation *WebMemo* No. 2870, April 19, 2010, at *http://www.heritage.org/Research/Reports/2010/04/No-Tax-Increase-for-Federal-Transportation-Programs*.