Will helping homeowners help the economy?

# OPEN HOU$E

BY JESSIE ROMERO

Since September 2008, there have been approximately 3.4 million completed foreclosures in the United States, and between 1.4 million and 1.9 million more properties are currently in the foreclosure process. Many foreclosed homes are still sitting vacant: About 1 million more vacant homes are for sale than in the average market of the past two decades. New home construction — usually a source of economic growth after a recession — has been at historic lows for the past four years.

"It's an economic, financial, and human tragedy that we have let the foreclosure problem fester as long as we have," says Alan Blinder, an economist at Princeton University and former vice chair of the Federal Reserve Board of Governors.

Opinions differ, however, as to why the problem has continued to fester. On one hand, it's possible that policy interventions have not gone far enough, and that additional support for underwater and distressed homeowners is essential to the recovery of the housing market, and by extension, the economy. On the other hand, continued government intervention has thus far failed to spur a recovery in housing, and instead might have served only to delay the inevitable bottom of the market. Given the costs and risks of new or expanded programs that attempt to prevent foreclosure, is the best course of action to let the market determine house prices, and allow the strengthening economy to stabilize the housing market?

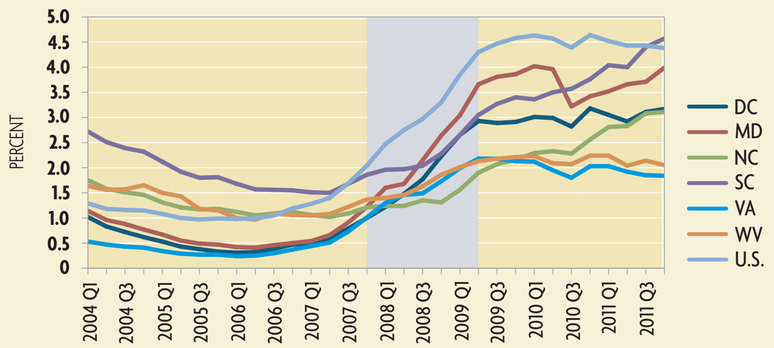
## Free Falling

Six years after the housing bubble popped, the market still looks grim. Nationwide, house prices have declined about 33 percent from the 2006 peak. Prices were flat in the fourth quarter of 2011 and were down 3 percent from their level one year earlier, according to the Federal Housing Finance Agency (FHFA). In the Fifth District, prices declined 2.4 percent during 2011.

The drop in house prices contributed to the wave of foreclosures. Overall, the Fifth District has fared slightly better than the nation as a whole, with about 3.1 percent of homes in foreclosure, compared to 4.4 percent nationwide, according to data from the Mortgage Bankers Association (see chart). In addition to the homes already on the market, there is a looming "shadow inventory" of homes that are more than 90 days delinquent, and thus likely to enter foreclosure, or that have already been foreclosed but are not yet listed for sale. Another 12 million homeowners are currently "underwater" on their mortgages — they owe more than their homes are estimated to be worth — and are thus a potential source of additional foreclosures.

Problems in the housing market are felt throughout the economy. Households have lost more than $7 trillion in wealth. While estimates vary, research suggests that consumers spend between $3 and $5 less for every $100 lost in housing wealth. Consumer spending is about 70 percent of

**Foreclosure Inventory, U.S. Total and Fifth District**




NOTES: Foreclosure inventory is the percent of mortgages in the foreclosure process at the end of the quarter. Shaded area denotes recession.
SOURCE: Mortgage Bankers Association, Haver Analytics

GDP, and in previous post-war recessions, it has actually risen slightly, since households try to smooth their consumption. During the 2007-09 recession, spending actually fell almost 2 percent, contributing to the large decline in GDP. The loss of home equity also dampens the effect of monetary policy on the economy, since underwater homeowners aren't able to refinance and take advantage of low interest rates.

In 2005, residential investment made up 6 percent of GDP; today it is only 2.5 percent. The decline is manifest in the construction industry, where the unemployment rate is about 17 percent, and in sectors that depend on demand from the housing market, such as cement and wood products manufacturing.

Some economists believe the housing market also affects the labor market through "housing lock": If homeowners with negative equity are unable to sell their homes, they will not be able to move to areas with better employment prospects. Underwater homeowners are 30 percent less likely to move, according to research by Fernando Ferreira and Joseph Gyourko of the University of Pennsylvania and Joseph Tracy of the New York Fed. But there is debate about how large the housing effect actually is. Research by Sam Schulhofer-Wohl of the Minneapolis Fed suggests that underwater homeowners are actually more likely to move; rather than selling, they simply walk away from the homes. Underwater homeowners also have the option of renting out their homes and then moving.

## Help for Housing

Policymakers have tried to address both the demand and supply sides of the housing market. On the demand side, the First Time Homebuyer tax credit, first enacted in mid-2008 and expanded twice in 2009, offered first-time homebuyers a tax credit of up to $8,000 and repeat homebuyers a credit of up to $6,500 for homes under contract before May 1, 2010. Home sales rose 10 percent during the life of the $29 billion program and the decline in house prices slowed, but the effects were short-lived. The credit appears to have gone largely to people who were planning to buy homes anyway, and it merely changed the timing of their purchase. Sales fell below their previous level in the months after the credit expired, and prices reverted to their downward trend, falling 5.6 percent between May 2010 and February 2012, according to the FHFA.

Historically low interest rates also have failed to boost demand, which perhaps shouldn't be surprising given the state of the economy, says economist Paul Willen of the Boston Fed. "There's a reason people are reluctant to get into housing. In 2005 people were over eager about housing — if they're under eager now, that's understandable."

On the supply side, the goal has been to reduce the number of foreclosures by helping borrowers get mortgage modifications or refinance at a lower interest rate. A modification changes the terms of an existing loan, for example by lowering the interest rate or writing down the principal amount; refinancing replaces the old loan with a new loan. In theory, mortgage modifications are a win both for homeowners, who get to keep their home, and for lenders, who recover more than they would in a foreclosure. "The deadweight loss caused by a foreclosure is massive," says Blinder. "If the home can be saved, there is a gain to be shared between the mortgagor and the mortgagee."

The fact that more modifications have not occurred is often attributed to the packaging of loans into mortgage-backed securities. The incentives of mortgage servicers and the investors who own the loans are not always aligned; for example, because it is time-consuming to offer modifications, servicers might have an incentive to move quickly to foreclosure even when a modification would benefit both homeowner and investor. On the other hand, investors tend to oppose refinancing, since refinancing means that mortgage bonds are prepaid, and bondholders must then reinvest their money in lower-yielding investments.

Two government programs, the Home Affordable Modification Program (HAMP) and the Home Affordable Refinance Program (HARP), were implemented in 2009 to reduce these frictions by paying incentives to lenders who agree to offer mortgage modifications, and by refinancing the loans of underwater borrowers whose loans are owned or guaranteed by Fannie Mae and Freddie Mac (government-sponsored enterprises, or GSEs). Both programs have failed to live up to expectations; about 970,000 modifications have been offered through HAMP as of February 2012, compared to initial projections of between 3 million and 4 million, and only about 1 million loans have been refinanced through December 2011, compared to projections of 4 million to 5 million.

Reasons for the low uptake include application processing problems, limited eligibility, and the reluctance of lenders and the GSEs to offer modifications and refinancing options. (Lenders have completed more than 4 million modifications outside HAMP; the terms of proprietary modifications tend to be less generous to borrowers, which might make lenders more willing to offer them.) Both programs were recently expanded to attempt to address these problems, for example by making deeply underwater homeowners eligible for HARP, eliminating GSE surcharges on certain refinance offers, and tripling the incentives paid to investors via HAMP. The Treasury Department also will start paying incentives to the GSEs for principal reductions, although the GSEs' regulator, the FHFA, currently refuses to offer them to borrowers. In April, the FHFA's director indicated that he would consider revising this position. (No decision had been announced at press time.)

Many economists and policymakers believe that the extensions of HARP and HAMP don't go far enough. One option, proposed separately by a Federal Reserve Board of Governors white paper and the Obama administration, among others, is to require Fannie Mae and Freddie Mac to refinance non-GSE loans for underwater borrowers, potentially helping millions of additional borrowers take advantage of low interest rates. While this proposal would greatly increase the size and the risk of the GSEs' balance sheets, the Board of Governors concluded that the potential benefits — stabilizing house prices, reducing foreclosures, and boosting consumer spending — could likely outweigh the costs.

Another proposal is large-scale principal reduction; for example, Congress could legislate that the GSEs offer write-downs or have the government pay for them across the board. Martin Feldstein, an economist at Harvard University and chair of the Council of Economic Advisers under President Reagan, proposed having the government pay to reduce the principal for every homeowner whose loan-to-value ratio was over 110 percent. He estimated that the cost to help 11 million borrowers would be $350 billion, writing in a *New York Times* op-ed, "As costly as it will be to permanently write down mortgages, it will be even costlier to do nothing and run the risk of another recession."

**Into the Unknown**

The macroeconomic effects of housing intervention are unclear, however. Economists at the Congressional Budget Office (CBO) and the Massachusetts Institute of Technology recently studied the effects of a hypothetical refinancing program for both GSE and Federal Housing Authority (FHA) borrowers. Their paper projected that the program would not have a large effect on the economy as a whole: About 2.9 million homeowners would refinance, leading to 110,000 fewer foreclosures, a relatively small amount compared to the size of the housing market. The authors also projected that each homeowner would save about $2,600 in the first year, for a total savings of $7.4 billion, a small stimulus relative to the size of the economy. Other estimates are much higher, however. Economists at Columbia Business School and the Absalon Project, a mortgage finance consulting firm, projected that expanding refinancing for just GSE loans could reach 14 million borrowers and save $36 billion. If the program were extended to include FHA and Veterans Administration loans, it could reach 30 million borrowers and save up to $70 billion.

The challenge is predicting how many borrowers will participate. "It has always been a puzzle in mortgage finance why so few people take advantage of refinancing," says Willen of the Boston Fed. "They refinance much less than standard analysis would suggest they would." The participation rate might be especially low at present, even if new programs make it easier to qualify, since borrowers don't have the option to take cash out of the refinancing, according to Willen.

The impact of large-scale refinancing could also be muted by the fact that the money saved by households is money lost to investors who own mortgage-backed securities, as the CBO working paper noted. Losses to investors potentially limit the stimulative effect of refinancing.

There is also considerable debate about the $25 billion settlement reached in February between the nation's five largest mortgage servicers and 49 state attorneys general. The settlement sets aside $3 billion for refinancing and $17 billion for modifications for distressed homeowners, including about $10 billion for principal reductions. Compared to 12 million underwater homeowners and $700 billion of negative equity, the settlement is quite small. The settlement looks larger, however, when compared to 3.9 million seriously delinquent loans, and could reduce the number of such loans by about 10 percent, according to calculations by Bill McBride of the economics blog Calculated Risk. The attorneys general believe that the impact will be amplified if other lenders see that the principal reductions required by the settlement are a cost-effective option, and thus become more willing to offer reductions in the future.

A major concern about principal reductions and other modifications is moral hazard — the possibility that borrowers would purposely default on their mortgages in order to qualify for assistance, or that future borrowers would be more likely to take out unaffordable mortgages since they'll expect to receive assistance in the future. Another problem is one of information asymmetry: It's difficult for lenders to distinguish which borrowers actually need help, or which borrowers are likely to default even after a modification. "It's a big problem from the lender's perspective, because they don't have full information about the borrowers," explains Urvi Neelakantan, an economist at the Richmond Fed currently studying mortgage modification programs. "They want to help the people who will succeed with assistance, not those who will succeed without assistance, or who will receive assistance and then fail." About 43 percent of HAMP modifications to date were canceled before the trial period ended, often because the borrower re-defaulted. Of those who went on to receive permanent modifications, nearly one-quarter were more than 90 days delinquent within 18 months, according to the Treasury Department.

Research suggests that such informational frictions are a greater impediment to mortgage modifications than securitization. Christopher Foote and Willen of the Boston Fed, Kristopher Gerardi of the Atlanta Fed, and Lorenz Goette of the University of Lausanne (Switzerland) found that there was no significant difference in the likelihood of modification between securitized and nonsecuritized loans. The reason, according to the authors, is that while lenders lose money in a foreclosure, they also lose money when they modify mortgages for borrowers who would have repaid anyway, or when assisted borrowers go on to default. "While investors might be foreclosing when it would be *socially* efficient to modify, there is little evidence to suggest they are acting against *their own* interests when they do so," the authors wrote.

The authors' research also suggests that the premise of mortgage modification programs might be faulty. The rationale for modifications is that many homeowners took out "unaffordable" mortgages; if the monthly payment can be lowered, then the homeowner is less likely to default. But

Foote and his coauthors found that the debt-to-income ratio of the mortgage, the typical measure of unaffordability, is a poor predictor of the likelihood of default. Instead, falling house prices, expectations about future prices, and especially the unemployment rate are all better predictors of default. When unemployment is high and income is volatile, a mortgage that is modified to become affordable today might not remain affordable tomorrow.

The argument for wide-scale principal reduction is based on concerns about the large number of underwater borrowers. It might not be an efficient approach, though. While falling house prices are one factor in the default decision, "most people with negative equity will not default on their mortgages," Willen says. In a related paper, Willen, Foote,

## For Rent

Prices are falling for single-family homes; there are about 2.4 million on the market, and one-quarter of them are foreclosures. At the same time, rents are rising across the country, and the vacancy rate in multifamily housing has dropped nearly two percentage points since the 2009 peak (see chart). Large-scale conversion of foreclosed homes (called real-estate owned, or REO homes) into rental properties is one option for addressing this apparent mismatch between the supply of homes available for purchase and consumers' demand for homeownership.

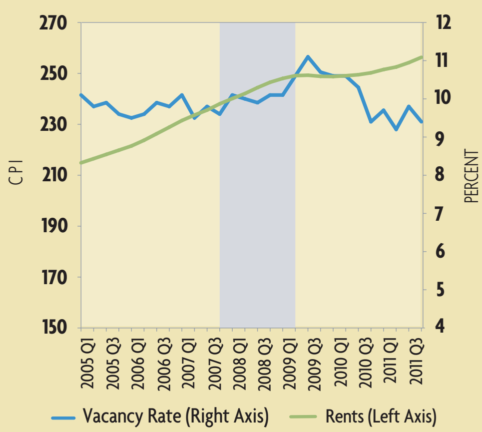
Until now, the Federal Housing Finance Authority (FHFA), which regulates Fannie Mae and Freddie Mac, has been reluctant to allow bulk sales of homes to investors. Fannie and Freddie, together with the Federal Housing Administration, own about half of all REO property on the market. Bulk sales typically require taking a steeper discount on the sale price than selling to an owner-occupant. Selling a portfolio of homes also requires the REO holder to absorb carrying costs such as property taxes and maintenance while it assembles enough properties to make the sale attractive. An additional obstacle has been the lack of financing available to investors. Currently, mortgage products exist for one-to-four family homes and for large multifamily properties, but not for portfolios of single-family homes. Some economists and policymakers have called for government-subsidized financing as a way to encourage investors to enter the rental market.

With millions more foreclosed homes projected to enter the market in the next two years, the FHFA's interest in REO-to-rental programs is growing. In August 2011, the FHFA issued a call for proposals on designing a rental program. It received more than 4,000 responses. In February, the agency announced the first pilot auction of 2,500 homes for qualified investors and began accepting applications at the end of the month. There is also speculation that government financing will be available in some form. Several large broker-dealers and private-equity firms are planning to bid, according to *The Wall Street Journal*. The auction is intended to be the first step in a national REO-to-rental program, although no further details have been announced.

The other half of REO properties are owned by banks and other investors. Some banks, including Charlotte-based Bank of America, are exploring selling homes for rental or acting as landlords themselves. Current supervisory policy requires banks to dispose of REO property as quickly as possible, but the Federal Reserve is considering issuing guidance that would give banks leeway to hold REO properties on their books for longer, and thus open the door to a rental program.

While the goal of a rental program would be to reduce the number of homes on the market and thus keep prices higher, a large number of rental properties in a neighborhood might actually lower property values if renters are perceived as less stable occupants or as less likely to maintain their homes than owner-occupants. An increase in the supply of rental housing could also lead to lower rents, reducing households' incentives to purchase a home.

**Rental Market Conditions, 2005-2011**




NOTES: Rents are based on the Consumer Price Index (CPI) for shelter. Shaded area denotes recession.
SOURCES: Vacancies, U.S. Census Bureau, Haver Analytics; rents, Bureau of Labor Statistics, Haver Analytics

But perhaps the greatest hurdle to a successful rental program — and a factor potentially holding back many institutional investors — is the logistical challenge of managing a large number of single-family homes. "Single-family homes are way too idiosyncratic to have the economies of scale that would work for a large organization," says Paul Willen, an economist at the Boston Fed.

Despite these concerns, many economists and policymakers believe that an REO-to-rental program is the best option for addressing the current and future supply of vacant homes on the market. "There are at least some investors who think they can make a profit out of it," says Alan Blinder, an economist at Princeton University and former vice chair of the Federal Reserve. "If they lose money trying, that's capitalism."

— Jessie Romero

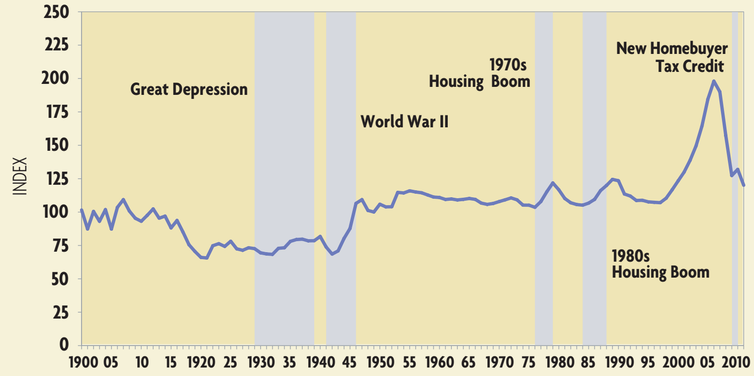
and Gerardi found that negative equity is a necessary — but not sufficient — condition for default. Instead, their work describes a "double trigger" theory: Negative equity must be combined with some adverse shock, such as a job loss or serious illness, before default occurs. Their results suggest that a better focus for policymakers might be helping homeowners cope with job loss or other shocks — and that an improvement in economic conditions might be the best cure for the housing market.

### Does Housing Come First?

Is assistance for borrowers a prerequisite for economic recovery? Some economists and policymakers argue that the policies enacted to date have only delayed the bottom of the market. Although home prices have declined about a third relative to their 2006 peak, they are still above their long-run average (see chart), and allowing prices to fall to the level where supply matches demand might finally restore stability to the housing market. It's possible that withdrawing government support for housing would leave millions of homeowners even further underwater, or that another drop in prices could permanently spook a large number of potential buyers. But in the long run, "there may be no pain-free path to the eventual righting of the market," wrote Danielle DiMartino Booth and David Luttrell in a Dallas Fed *Economic Letter*. "Allowing the market to clear may be the path of least distress."

While many commentators are concerned about the "oversupply" of housing, there might in fact be enough buyers — they just aren't willing to buy at current prices. Relative to population growth, the number of single-family homes built in the United States during the past decade is lower than during the 1990s. And currently, there are about 2 million fewer new households than would be expected given population growth — eventually, the people who are living with their parents to save money are going to want to move into their own homes. Given the very low rates of new construction during the past four years, pent-up demand for housing might be building. "The population is growing, the economy is growing, and eventually we need a place to put all those people. At some point the value of housing has to go up just because of population," Willen says.

**House Prices, 1900-2011**




NOTES: The 1970s and 1980s booms were largely regional. Between 1975 and 1980, real house prices in California rose 60 percent, affecting national home price indices. Price increases in the 1980s occurred in the Northeast and California. Data are annual through 1953, and quarterly thereafter. Prices are indexed to 1890=100.
SOURCES: The *New York Times*; Shiller, Robert. *Irrational Exuberance*. Princeton, N.J.: Princeton University Press, 2005.

Those who believe that a recovery in the housing sector is a prerequisite for economic recovery more broadly point out that housing has led the way after previous recessions. Typically, housing contributes about a half percentage point to overall GDP growth in the two years following a recession; throughout much of the current recovery, housing's contribution has actually been negative. Previous recessions weren't precipitated by a boom and bust in housing like that which occurred in the 2000s, however, so it might not be surprising that the current recovery is different.

Since the end of 2011, there have been indications that the economy is gaining strength: The unemployment rate has declined from 9 percent to 8.1 percent since September, and consumer spending is on the rise. There are also signs that the housing market might begin to improve in 2012. New housing starts picked up at the end of 2011 and beginning of 2012, and some forecasters predict that prices will finally hit bottom in 2012. In March, the Pending Home Sales Index published by the National Association of Realtors increased 4.1 percent, and is 13 percent above its level one year ago. If these trends continue, a recovery in the housing sector could be the natural consequence of economic growth more broadly. **RF**

### Readings


Blinder, Alan. "How to Clean Up the Housing Mess." *The Wall Street Journal*, Oct. 20, 2011.

Foote, Christopher L., Kristopher S. Gerardi, and Paul S. Willen. "Negative Equity and Foreclosure: Theory and Evidence." Federal Reserve Bank of Boston Public Policy Discussion Paper No. 08-3, June 5, 2008.

Foote, Christopher L., Kristopher S. Gerardi, Lorenz Goette, and Paul S. Willen. "Reducing Foreclosures." Federal Reserve Bank of Boston Public Policy Discussion Paper No. 09-2, April 8, 2009.

"The U.S. Housing Market: Current Conditions and Policy Considerations." Federal Reserve Board of Governors White Paper, January 4, 2012.

Weinberg, John A. "No Quick Fix for the Housing Market." *Region Focus*, Fourth Quarter 2011, p. 56.