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Before the Senate Banking Committee

"State of the Housing Market: Removing Barriers to Economic Recovery"

February 9, 2012

The six-year-old housing crash continues to threaten the U.S. economic recovery. Home sales and housing construction remain weak, while house prices are still falling in many parts of the country. Millions of homeowners have lost their homes, and millions more are likely to follow them, given the unprecedented number of foreclosures.[i]

It is hard to be enthusiastic about the U.S. economy's prospects as long as house prices are declining. A house is typically a family's most important asset. Many small-business owners also use their homes as collateral for business loans, and local governments rely on property tax revenues, which are tied to housing values, to fund schools and other important public services.

Most worrisome is the risk that housing will fall back into the vicious cycle that occurred at the depths of the last recession. As prices fell, homeowners found they owed more than their homes could sell for; this led to more defaults, more distress sales, and still-lower prices. That cycle was broken only through unprecedented monetary and fiscal policy support.

The gloom in the housing and mortgage markets notwithstanding, there are reasons to be optimistic that housing's long slide will end soon. While a mountain of distressed property remains to be sold, investor demand appears strong. Prices have fallen enough to allow investors to profitably rent these homes until the market recovers. Rental vacancy rates have fallen meaningfully over the past two years, suggesting that new construction is slow enough to let builders work down the still-considerable number of vacant homes.

Nonetheless, risks remain uncomfortably high. Policymakers should thus consider taking additional modest steps to support housing temporarily. These should include facilitating more mortgage refinancing, supporting increased mortgage loan modifications, and aggressively pursuing efforts to convert distressed properties to rental use before they are sold and further depress prices. These steps are consistent with the Obama administration's recent housing initiative and various policy steps proposed by the Federal Reserve in a recent white paper. Many of the proposals come at no cost to taxpayers; others have costs that are already accounted for in the budget.

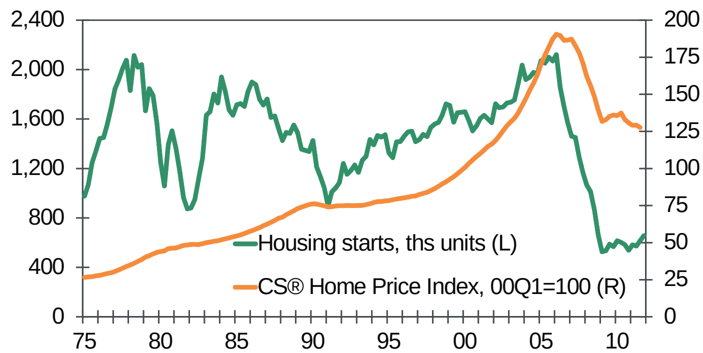
While many of these policy steps will not be politically popular, the outcome may be much worse if policymakers stand by while a weak housing market continues to undermine the economy.

Six lean years

The housing crash is six years old and counting. Sales of existing homes—a gauge of demand—languish near an annual rate of 4.5 million, of which about a third are foreclosures and short sales. Sales of new homes are even bleaker, running at a record low rate close to 300,000 units per year. In a well-functioning housing market, about a million more new and existing homes would change hands per year, and fewer than a tenth would be distress sales.[ii]

Housing construction—the marker for supply—is also depressed. Single- and multifamily housing starts run close to 650,000 units annualized, and manufactured home placements barely reach 50,000 per year (see Chart 1). This is nearly the weakest pace for residential construction since World War II. A well-functioning housing market would produce closer to 1.75 million units annually.[iii]

Chart 1: An Epic Housing Crash



Sources: Fiserv, BEA, Moody's Analytics

Nationwide, house prices remain fragile. The Fiserv Case-Shiller national house price index has dropped by a third since peaking in the first quarter of 2006, and prices are still falling in many parts of the country as a result of the pressure created by the large number of distressed property sales. In a well-functioning market, prices should rise around 3% per year.[iv]

Economic fallout

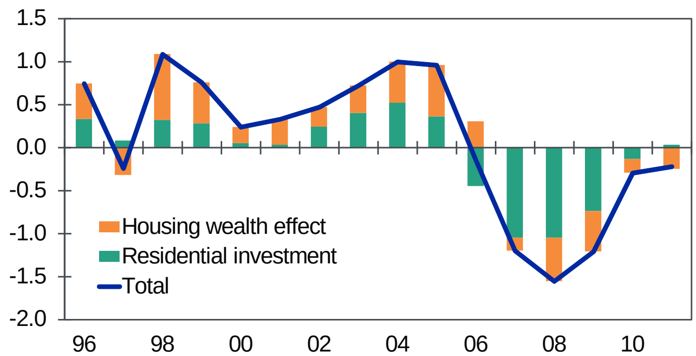
Although housing is no longer the drag it was during the worst of the Great Recession, it remains a significant weight on economic growth. This is particularly disappointing since housing is often a major source of growth early in an economic recovery (see Chart 2).

Falling house prices and the resulting hit to household wealth remain serious problems. Some $7.4 trillion in homeowners' equity was lost in the housing crash, with close to $500 billion of that occurring in 2011. Given the impact on consumer spending from lost housing wealth, this shaved about 0.2 percentage point from real GDP growth last year.[v]

The loss was particularly hard on middle-income households, who benefited less from rising stock prices than did their higher-income neighbors.

Chart 2: Housing Weighs on the Economy

Contribution to real GDP growth, %



Source: Moody's Analytics

Shaky house prices also make it difficult for small-business owners to use their homes as collateral. Bank lending to small businesses picked up over the past year, but it is hard to see how credit will flow freely until house prices rise again. Since small businesses are a key part of job creation, this is a significant impediment to a stronger job market.

Strapped local governments are also struggling with the impact of falling house prices on property tax revenues. Despite rising millage rates in many parts of the country, tax revenue is growing at nearly its slowest pace on record. Given the lag between market price changes and tax assessments, revenues are likely to slow even more in the coming year. Local governments will thus have little choice but to continue cutting budgets and laying off workers. Local government payrolls are off by more than 500,000 from their peak and shrinking by about 10,000 jobs per month.

Other effects of falling house prices are serious but harder to quantify, such as a reduction in labor mobility—an important way for the economy to adjust to shocks—and the erosion of retirement savings for low- and middle-income homeowners.

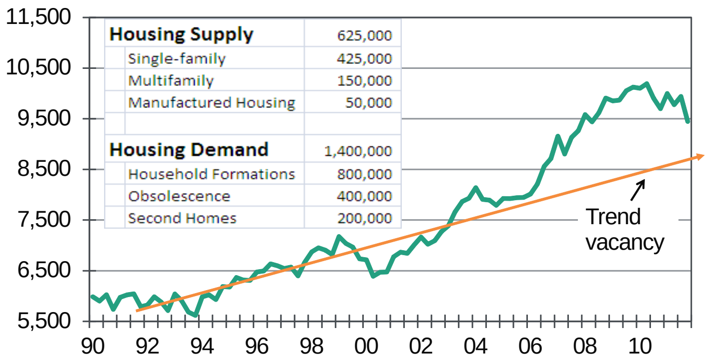
While the worst of the crash appears to be over, housing continues to grapple with big problems, including a glut of vacant homes and a mountain of properties in or approaching foreclosure. With so many home loans deeply under water, risks remain uncomfortably high that the vicious cycle of foreclosures and price declines that ravaged the economy during the Great Recession will be reignited. Aside from the European sovereign debt crisis, there is arguably no more serious threat to the current economic recovery than the troubled housing market.

Excess inventory

The rampant overbuilding that occurred during the bubble years remains a significant impediment to a housing rebound. While builders have slashed construction and have made progress working down inventory, the market still struggles with excess vacant homes; we estimate just over 900,000 are either for sale, for rent, or being held off the market (see Chart 3). This is the difference between the 9.4 million vacant homes measured by the Census Bureau's Housing Vacancy Survey and the number of vacancies—around 8.5 million—that would be consistent with a well-functioning housing market. At current levels of supply and demand for new houses, it would take until mid-2013 to work off this excess inventory.

Chart 3: Glut of Vacant Homes

Vacant homes for sale, for rent and held off market, ths



Sources: Census, Moody's Analytics

There is some evidence that the situation may not be quite as bad as these numbers suggest. It is unclear how well many vacant properties are being maintained, especially in heavily overbuilt markets such as Florida and California's Central Valley. Such houses may be unusable without significant renovation. Moreover, the excess-inventory problem is regionally concentrated. Atlanta, Florida, Nevada, Arizona, and the Central Valley are awash in vacancies; elsewhere the inventory problem is much less pronounced and will thus be resolved sooner.[vi]

Demand and supply will not improve simultaneously, moreover. It is likely that demand for vacant homes will pick up more quickly than will new construction. The principal component of demand is household formation, which has been depressed recently because of the weak job market. With fewer job opportunities, young people have been staying in school; labor force participation has plunged among those between 16 and 29 years old. While the data here are sketchy, it appears that at its low point, household formation slowed to an annualized pace close to 300,000 in early 2010. It has picked up over the past year to closer to 750,000 per year; this has fueled a surge in rental absorption but is still well below the 1.25 million households expected to be formed each year in a well-functioning economy.

As the job market comes back to life and young people return go to work, household formation should accelerate. Many young people have stayed in their parents' homes longer than in normal times, suppressing household formation; this should be reversed in the next year or two. Formations in 2013 and 2014 could be well over the 1.25 million expected in a typical year.

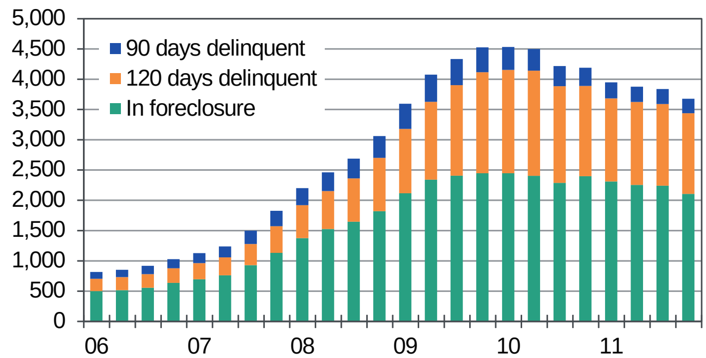
Still, it will take a number of years for housing construction to really get going. Even as demand revives and the inventory of vacant homes is worked down, it will take time for builders to obtain construction and land development loans from banks, many of which are still processing the poor loans they made during the bubble. It also will take time for builders to ramp up new-home construction, a process that includes acquiring land, obtaining permits, and getting equipment on site. Multifamily construction will come back first—it already is reviving thanks to stronger absorption, falling vacancy rates, improving rents, and more ample credit—but even under the best of circumstances, single-family home construction will not be back to full strength until the middle of the decade.

Foreclosure crisis

A more serious threat is the huge number of first mortgage loans stuck in foreclosure or more than 90 days delinquent and thus headed for eventual foreclosure. At the end of 2011, 3.6 million loans (out of 49.9 million loans outstanding) were in this predicament (see Chart 4). Most will end up in foreclosure, short sale or distress sale over the next 12 to 24 months, pushing house prices lower.

Chart 4: A Mountain of Distressed Property

First mortgage loans, ths

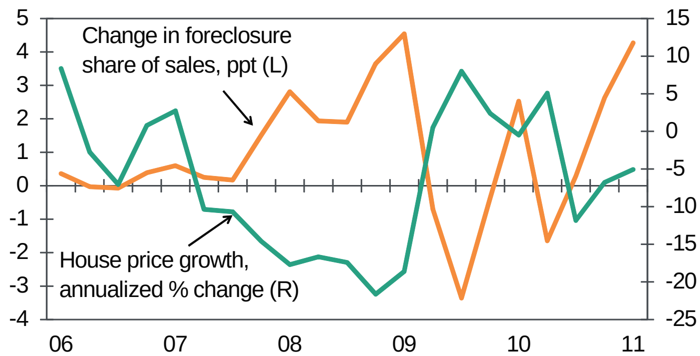


Sources: Equifax, Moody's Analytics

The key to house prices in the current environment is the change in the share of home sales that involve distressed properties. Prices fall when the share rises, stabilize when the distressed share peaks, and rise when the share declines (see Chart 5). It is important to note that house prices will rise if the share of distress sales declines, even if the share remains elevated, as it will for a number of years given the large number of troubled properties.

Chart 5: Higher Distress Share…Lower House Prices

NSA



Sources: Fiserv, Zillow, Moody's Analytics

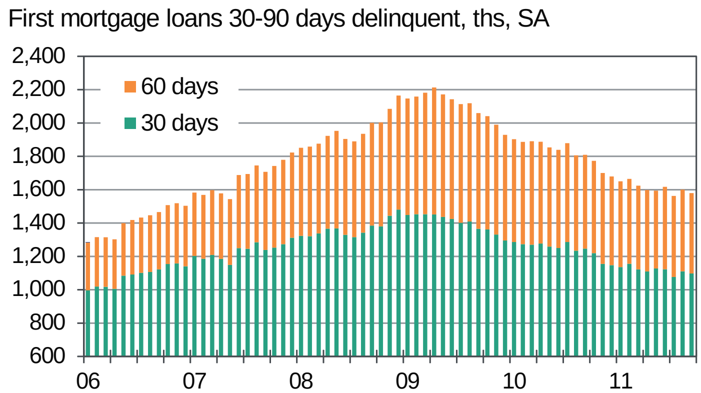
The share of distress sales is likely to rise and house prices to fall further after the nation's largest mortgage servicers and state attorneys general resolve legal issues arising from the robo-signing scandal and other foreclosure process issues. These issues have significantly slowed the pace of foreclosures and distress sales over the past year or so. Little progress has thus been made in reducing the number of troubled loans. Once the pending lawsuit is settled, which should be soon, the foreclosure process is likely to gear up again, resulting in more distress sales and more house price declines.

House prices are expected to fall only modestly, no more than 5% from current levels. Sturdy investor demand for distressed properties will limit the declines, particularly in the hardest-hit markets. Prices have already fallen so sharply in Atlanta, much of Florida, Nevada, and Arizona that investors can purchase distressed properties and profitably rent them out. Many of these markets actually appear undervalued when current prices are compared with household incomes and effective rents. Unlike the house flippers who sought quick profits during the bubble, today's distressed-property investors seem willing to hold on. They include both individuals and institutions with investment horizons of more than a few years.

Prices for nondistressed homes are also holding up better than they did earlier in the foreclosure crisis, according to CoreLogic and FNC. Many distressed properties may be in less desirable areas and no longer in direct competition with nondistressed properties. This suggests that damage to homeowners' wealth will be less severe, with less economic fallout.

The flow of mortgage loans entering foreclosure should also begin to slow soon, since fewer troubled loans are in early stages of delinquency. The number of first mortgage loans between 30 and 90 days delinquent is falling quickly (see Chart 6). This reflects a better job market and improvements in underwriting standards since the recession. Mortgage loans originated during the past three years are of excellent quality.

Chart 6: Early-Stage Mortgage Delinquency Is Falling Fast



Sources: Equifax, Moody's Analytics

Vicious cycle

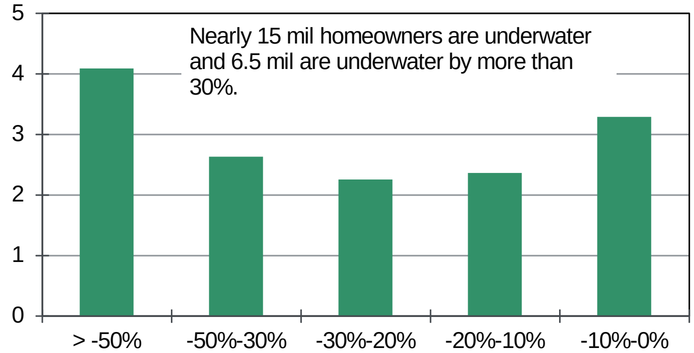
Notwithstanding our optimism that future house price declines will be modest, risks are too high that they will be more severe than anticipated. With so many underwater homeowners, it would not take much to reignite the vicious cycle that roiled the housing market and economy during the Great Recession: Falling prices pushed more homeowners under water, prompting more mortgage defaults and more distress sales and thus more price declines.

With an estimated 14.6 million homeowners under water, half by more than 30%, this is a real possibility (see Chart 7).[vii] Adding to the concern, the average underwater homeowner's debt exceeds the market value of her home by nearly $50,000. It would not take much to induce many in this situation to mail their keys back to lenders; a leaky roof or broken air conditioner might be sufficient, particularly if rental housing is available nearby for less than the cost of the mortgage. Studies based on credit file data suggest the share of strategic defaults—involving homeowners who are current on other debt obligations—has risen and now accounts for approximately one-fourth of all defaults.

Decisions to default depend critically on expectations about future house prices. If homeowners think prices will rise, they are more likely to hold on; if they believe more price declines are coming, they are more likely to give up. This can quickly become a vicious cycle, as occurred during the depths of the recession.

Chart 7: Millions of Homeowners Sink Underwater

Homeowners' equity distribution, mil of homeowners, 2011Q3



Sources: Equifax, Moody's Analytics

Only a massive policy effort broke that vicious cycle. The federal government put Fannie Mae and Freddie Mac into conservatorship and the FHA aggressively expanded its lending. Today the federal government originates more than 90% of all new mortgages. In addition, conforming loan limits were increased and three rounds of housing tax credits were enacted as part of the federal fiscal stimulus. The Federal Reserve purchased $1.25 trillion in mortgage securities to bring mortgage rates down as part of its quantitative easing initiative. The government also took part in the mortgage-loan modification effort via the Home Affordable Mortgage Program and encouraged mortgage refinancing via the Home Affordable Refinancing Program.

Although various elements of this policy response may warrant criticism, it is important to remember that the effort was devised and implemented quickly, under extreme circumstances. Moreover, in its totality, the policy response worked; the housing market stabilized beginning in 2009. Yet if housing were to begin another dark cycle, the policy response would not be nearly as aggressive. There is little political appetite for another big-government intervention in the economy, particularly given Washington's precarious fiscal situation.

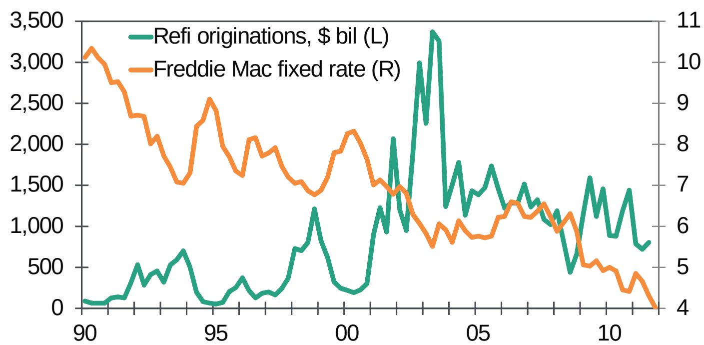
With housing and the economy still facing significant threats, and with policymakers unlikely to respond aggressively in another crisis, it is sensible to consider a number of modest additional steps now to make sure housing does not backtrack. These should include facilitating more mortgage refinancing, supporting increased mortgage loan modifications, and aggressively pursuing efforts to convert more distressed properties to rental use before they are sold and further depress house prices.[viii]

More mortgage refinancing

Policymakers should move to substantially increase the amount of mortgage refinancing.[ix] This is a particularly propitious time for homeowners to refinance, as mortgage rates have fallen to record lows. The 30-year fixed mortgage rate for prime borrowers is well below 4%, and likely to remain very low for some time given the Federal Reserve's stated resolve to keep interest rates low for the next several years. Monetary authorities are also keeping open the possibility of more quantitative easing that would likely include purchasing more mortgage-backed securities.

Given record low borrowing costs, refinancing has been disappointingly slow. In 2003, when fixed mortgage rates were between 5.5% and 6%, home loans were being refinanced at an annualized rate above $4 trillion. The current level of activity is about one-fourth of that (see Chart 8). The 2003 boom was fueled by the large number of mortgages that had been originated when rates were much higher, making a sub-6% rate very attractive. Yet even today, some two-thirds of all outstanding mortgages carry coupons above 5%. Millions more U.S. homeowners should be refinancing, significantly cutting their monthly payments. This would be a boost both for individual household finances and for the ailing economic recovery.

Chart 8: Rates Plunge, Refis Putter



Sources: MBA, Freddie Mac, Moody's Analytics

The Obama administration has worked since the introduction of HARP in mid-2009 to encourage homeowners with little or negative equity, and whose loans are insured or owned by Fannie Mae and Freddie Mac, to refinance. Originally, the administration said HARP would allow between 4 million and 5 million homeowners to reduce their interest rates to market levels. But so far, only about 1 million homeowners have refinanced using HARP, and fewer than 100,000 underwater homeowners have refinanced.

The disappointing results prompted the administration to unveil a number of important changes to the HARP program late last year. These included relaxed eligibility requirements, allowing borrowers with loan-to-value ratios (LTV) of above 80% to participate, streamlining the appraisal and underwriting process, getting most mortgage insurers to drop their recession rights, and requiring Fannie and Freddie to relax their reps and warranties. It has taken a few months for mortgage servicers and insurers to implement the new HARP rules, but the benefits of the new rules should become evident in coming months.[x] Servicers appear to be particularly enthusiastic about the possibility of reducing their put-back risk.[xi]

As recently as early February, the administration proposed even more aggressive steps to support refinancing, affecting all mortgage loans including those insured by Fannie, Freddie, the FHA, and nongovernment lenders.[xii] If implemented quickly, this proposal should boost refinancing, speeding the recovery in housing and beyond.

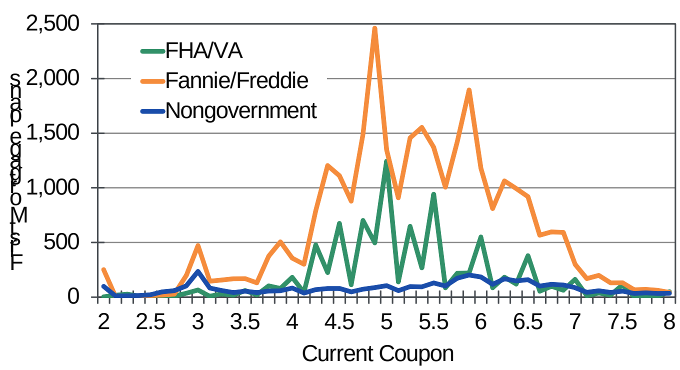
For Fannie and Freddie loans, the Obama administration proposes that the new HARP rules apply to all loans, not just those with LTVs over 80% as is now the case. For FHA/VA loans, the administration is proposing that the FHA drop refinanced loans from the "Compare Ratio" process by which the performance of lenders is assessed (analogous to Fannie and Freddie's reps and warranties). For nongovernment loans, the administration is proposing that the FHA refinance the mortgage. The administration is also proposing that taxpayers pay closing costs when homeowners agree to loans of 20 years or less, with monthly payments equal to those on their current loan. This would allow homeowners to build equity more quickly.

The administration's proposal substantially increases the pool of homeowners eligible to refinance and helps remove impediments to more refinancing. Significantly reducing the put-back risk faced by lenders on refinanced loans will encourage lenders to aggressively compete for refinancing business. Lowering borrowers' closing costs increases the incentive for them to participate as well.

Fully implemented, the administration's proposals would increase the number of homeowners eligible to refinance to nearly 28 million, covering more than half of all loans outstanding.[xiii] The plan would affect all mortgage loans on owner-occupied single-family homes for which the current mortgage rate is above 5%, and that have been current over the past six months. To qualify, borrowers would have to be no more than one month past due in the prior 12 months, be within the conforming loan limits, and have a credit score of more than 580 (see Chart 9). There would be no restriction on when the loans were originated, unlike the current HARP, which is limited to loans originated before mid-2009.

Chart 9: Mortgage Loans Eligible for Refinancing

First mortgage loans, ths



Sources: McDash, LPS

For all this, many homeowners would still not refinance. Yet under reasonable assumptions—including mortgage rates remaining near their current 4%—we estimate that the administration's proposal would result in 6.8 million more refinancings by the end of 2013.[xiv] That number includes 3 million Fannie/Freddie borrowers, 2.5 million FHA/VA borrowers, and 1.3 million nongovernment borrowers.

There should be no cost to taxpayers for the additional Fannie, Freddie, and FHA/VA refinancings. As the FHA refinances loans of nongovernment borrowers it will take on added credit risk, the cost of which would be borne by the financial industry under the administration's plan. Since the industry will likely oppose this, jeopardizing the overall effort, Congress could instead use some of the remaining $20 billion in TARP money set aside to pay for policies targeted at addressing the housing crisis.

For the administration's efforts to be effective, the FHFA—Fannie and Freddie's regulator—will need to support the plan, and the FHA refinance plan for nongovernment borrowers will require legislation. The FHFA has been reluctant to engage in such efforts, ostensibly because it fears they will require more taxpayer support for the agencies.[xv] This argument seems increasingly specious. While the agencies would lose some interest income on their $1.2 trillion in mortgage securities and whole mortgage loans, under reasonable assumptions the cost would be offset by lower default rates on loans that are refinanced. Borrowers are more likely to stay current if their monthly payments drop by $100 or $200. Indeed, under reasonable assumptions, Fannie and Freddie would break even if the probability of default on the loans and securities they own and insure falls by about 25 basis points.[xvi]

The benefit to borrowers is meaningful. Assuming the average homeowner can refinance into a 4% fixed-rate loan, the gross saving from lower mortgage payments would come close to $18 billion a year (6.8 million borrowers x $140,000 average mortgage balance x 1.8% average rate reduction). This would provide a quick cash boost for mostly middle-income homeowners. Some would be used to repay other debt, but the bulk would likely be spent on home improvements or other needs. Assuming about three-fourths of the extra cash is spent during the year, real GDP will see a small but meaningful boost, adding 0.1 percentage point to growth this year.[xvii] The fragile U.S. recovery can clearly use all the help it can get.

More refinancing would also further the Federal Reserve's short-term goals. Monetary policymakers are considering a new round of quantitative easing—a process in which the Fed purchases long-term securities in an effort to bring down interest rates, including fixed mortgage rates. Indeed, the recent decline in mortgage rates is due in part to expectations that the Fed will resume quantitative easing. If it does, arguably the most significant benefit would involve increasing the pace of home-loan refinancing. Anything fiscal policymakers can do to support the Fed's efforts would be a plus.

While homeowners would clearly benefit from more refinancing and taxpayers would be largely unaffected, global investors in agency mortgage-backed securities would be hurt financially. As more loans are refinanced, higher-yielding MBS would be retired and replaced with lower-yielding MBS. To be precise, if a more effective HARP resulted in 6.8 million more refinancings, private investors would receive approximately $11 billion less in annual interest income.[xviii]

MBS investments are held by a wide array of institutions. Through its credit easing efforts last year, the Fed quickly became the largest owner of agency MBS, amassing $1.25 trillion or about a fourth of the total outstanding. The nation's central bank can easily absorb the lost interest income from increased prepayments, but this may put pressure on the Fed to be more aggressive in its quantitative easing efforts to forestall a counterproductive rise in mortgage rates. The interest rate spread between MBS and Treasury yields will increase regardless, but MBS yields need not rise if the Fed buys a sufficient amount of Treasury bonds.

While other private MBS investors will not be happy to get their money back when interest rates are low, they were aware of this prepayment risk when they purchased their securities. Indeed, investors are likely surprised that their securities have not been retired already, as they would have been in a more normally functioning mortgage market. The updated HARP can thus be seen as a way to correct a serious market failure. It is also important to note that MBS investors have been significant beneficiaries of the monetary and fiscal policy response to the financial panic and Great Recession. The Fed's massive purchases of agency MBS during a previous round of quantitative easing was a windfall. Myriad federal housing and foreclosure policies aiming to stem foreclosures have also significantly benefited investors through reduced prepayments.

Policymakers may be nervous that overseas investors, who constitute a sizable and growing source of capital for the U.S. Treasury, will be annoyed by faster prepayments. Policymakers may also worry about implications for the financial health of the nation's depository institutions and pension funds, who also are big investors in agency MBS. While not unreasonable, these seem marginal concerns given the magnitude of the losses that will be widely distributed among investors.

Another potentially unwelcome side effect of boosting refinancing activity today could be less labor mobility in the future. Borrowers who lock in record low mortgage rates today will be less willing to move when rates start to climb. Given that homeowners tend to be more skilled than renters, this impediment to labor mobility could aggravate the U.S. economy's current skills mismatch. However, it is difficult to know the scale of this consideration; it seems small against the sizable near-term benefits of a refinancing program. It is also worth noting that homeowners who switch from adjustable-rate to fixed-rate mortgages will be protected when interest rates ultimately rise.

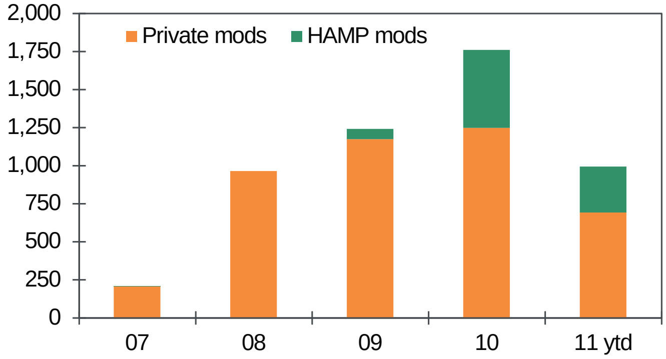
Principal reduction modifications

A more dramatic and costly policy step, but one with the best odds of ending the housing crash more quickly and definitively, would be to encourage more mortgage modifications, particularly those involving substantial principal write-downs. Principal reduction has economic positives and negatives, but is a positive on net if it is well-designed. The main concerns are moral hazard and fairness. To deal with these, modifications must be well-targeted, with clearly articulated eligibility requirements. A long vesting period and some type of clawback provision for future capital gains to guard against potential fraud would also be helpful.

HAMP was reworked in late 2010 to promote principal reduction modifications, but the change has accomplished little so far. To date, there have been fewer than 1 million permanent HAMP modifications, and very few of these have involved principal reduction. When HAMP was unveiled in mid-2009, President Obama was hoping for between 2 million and 3 million HAMP modifications.[xix] (see Chart 10)

Chart 10: Modification Efforts Flag

Permanent modifications, ths, annualized



Sources: Hope Now, Moody's Analytics

Responding to this shortfall, the Obama administration proposes more changes to HAMP to increase eligibility and extend the program through 2013. More importantly, the new program will significantly increase incentives for mortgage servicers who modify mortgages by reducing principal. For every dollar that a servicer writes down a loan, the Treasury will pay the servicer up to 63 cents. The president proposes paying for this out of the remaining $20 billion in TARP money slated for housing.

This expansion of HAMP could be particularly effective given the impending settlement between state attorneys generals and mortgage servicers over robo-signing and other foreclosure process issues. This deal is reported to include a monetary settlement of up to $25 billion, a significant share of which will be allocated to modifications, including principal reduction, of loans on the servicers' balance sheets.

For scale, suppose a total of $20 billion is allocated to principal reduction modifications, including those done via the new HAMP and the mortgage settlement. If the average amount of principal reduction per homeowner is $30,000, more than 650,000 homeowners would benefit. This is approximately equal to the number who currently satisfy the following eligibility requirements:

- Homes are owner-occupied.
- Homes were bought before December 31, 2008.
- The homeowner took no cash out in past refinancings.
- First mortgages are below conforming loan limits.
- Loan principal is reduced by no more than $40,000.

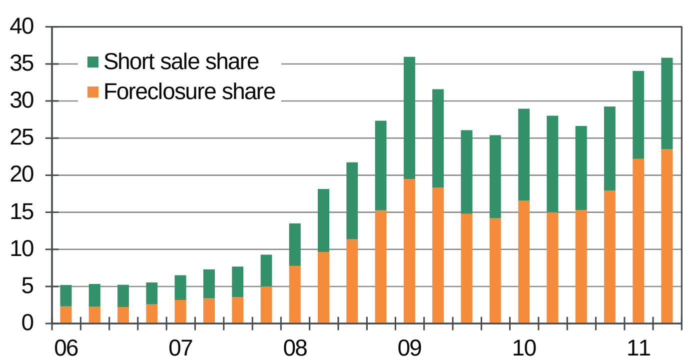
Moreover, the modification would have to result in the following conditions:

- The loan could be no more than 10% above the home's market value (to limit the probability of redefault).
- The "front-end" debt-to-income ratio (counting only housing costs) could not exceed 31%, and the "back-end" DTI ratio (counting all obligations) could not exceed 50%.

Assuming a redefault rate of 25%, this would result in almost 500,000 sustainable modifications.[xx] Along with those that would take place in any event, this is about the number needed to forestall anticipated house price declines. Without such a plan, the share of distress sales is expected to rise from more than a third to just under 40% by late 2012 (see Chart 11). House prices will decline as the share of distress sales rises. But if a modification program is implemented soon, the share of distress sales will level off and house prices will stabilize.

Chart 11: Distressed Share of Sales Are High and Rising

Share of home sales

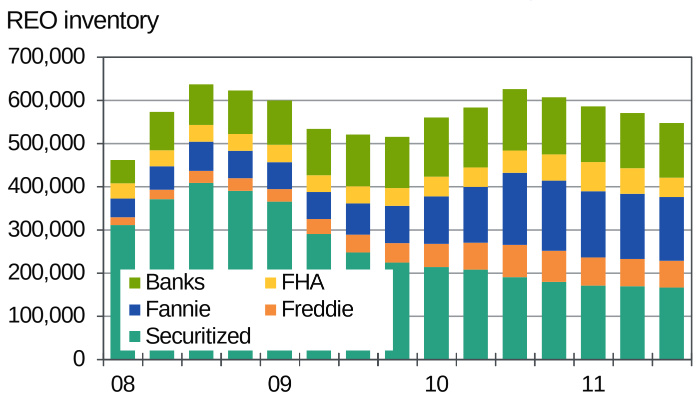


Sources: Zillow, Realtors, Moody's Analytics

REO to rental

Policymakers are also rightly focused on converting more distressed property to rentals. Reducing the number of distressed properties that go up for sale will reduce the share of such sales and thus support house prices. The number of properties classified by banks as “other real estate owned” or REO—the last stage of the foreclosure process before a distress sale—has declined over the past year, but only because the robo-signing scandals have slowed foreclosures (see Chart 12). Once a settlement is reached between the state AGs and mortgage servicers, foreclosures and thus REO properties and the distressed share of home sales will pick up again. Converting more REO property rentals will mitigate this increase and thus slow further house price declines.

Chart 12: REO Inventory Remains High



Sources: Fannie, Freddie, FHA, FDIC, Moody’s Analytics

A key to doing this is getting private investors and property managers involved. Investors show healthy interest in buying distressed property for rental, fueled by the fall in house prices alongside a sharp increase in rents. Given strong rental absorption and very weak construction of rental space, rents are rising at a sturdy mid-single-digit pace and are at levels that can cover investors’ costs while they wait for properties to appreciate. Most investors are not flippers looking for quick profits—given the state of the housing market this would not be a winning strategy—but have investment horizons of three to seven years. Such investors would likely be willing to rent properties purchased from Fannie, Freddie and the FHA for at least several years, selling them after house prices begin to rise again.

It is important to note that many investors are local, living in the neighborhoods where they are buying. Many have also bought with cash, given the dearth of mortgage financing. Institutional investors are also participating, but at least so far have been cautious and selective in their purchases.

The Obama administration recognizes that converting REO properties to rentals is a potentially productive way to help the housing market. Last summer they asked various housing market participants how to design an REO-to-rental program. As part of the president’s recent housing initiative, the FHFA announced it would pre-qualify investors to bid on Fannie and Freddie REO-to-rental transactions. Hopefully more initiatives will soon come to fruition.

It is also important for the FHFA to fully embrace this process. Fannie and Freddie have historically not engaged in bulk foreclosure sales to investors or entered into agreements with property managers. To successfully engage in these kinds of activities will require the blessing of the FHFA and significant investment. Even then, Fannie’s and Freddie’s lack of experience in this area is among the most significant impediments to success.

One way to significantly increase investor interest in purchasing REO properties is to allow buyers to expense their investments for tax purposes up front. This is the same benefit received last year by businesses for investments in equipment and software. Giving investors a small tax break should boost demand, supporting prices for distressed homes and the housing market in general. It would cost taxpayers little, since the tax liabilities of investors will be greater once they have exhausted their depreciation benefits.

Conclusions

The housing crash and foreclosure crisis are not over. Home sales and housing construction are stable but depressed, and house prices remain weak. With millions of foreclosures and short sales set to hit the housing market over the next two years, house prices are set to fall further.

While house prices are declining, the recovery will have difficulty gaining traction. For most Americans, the home is still the most important asset, and consumers will be reluctant to spend while their wealth erodes. Many small-business owners use their homes as collateral to grow, and local governments rely on property taxes tied to house prices.

There are some reasons to be optimistic that the crash is winding down. House prices have fallen far enough that single-family housing is affordable and increasingly attractive compared with renting. Investors are putting up cash to purchase distressed properties. Overbuilding remains a problem, but a decreasing one given a record-low pace of new construction and increased household formation.

But this optimism will be easily overwhelmed if house price declines reignite a vicious cycle, putting more homeowners under water, accelerating foreclosures and distress sales and driving prices even lower. Only an unprecedented monetary and fiscal policy response short-circuited that cycle during the recession.

Given the balance of risks, policymakers should thus consider providing additional temporary help to the housing and mortgage markets. Reinvigorating mortgage refinancing would provide a substantial boost with no meaningful cost to taxpayers. More refinancing will mean fewer borrower defaults and more money in the pockets of homeowners, supporting the recovery through a quick and sizable cash infusion.

Facilitating more well-targeted principal reduction loan modifications would be a much larger and costlier step but would bring the housing downturn to a quicker and more definite end. The number of modifications and the amount of principal reduction necessary to stabilize house prices can be reasonably financed with funds from the impending settlement between state attorneys general and mortgage servicers, and the president’s proposals to expand HAMP.

Moving more property out of the foreclosure pipeline before it goes to a distress sale would also be a big plus, reducing the pressure on housing values. Given the sharp decline in house prices and the recent increase in effective rents, the returns to private investors participating in such efforts are increasingly attractive.

Each of these policy steps has their problems, but they are worth carefully considering given that the housing downturn remains among the most serious threats to the still-fragile economic recovery.

[i] We estimate that nearly 6.5 million homeowners have lost homes through foreclosure, short sale, or deeds in lieu since the housing crash began in 2006. An additional 6 million homeowners are expected to lose homes before foreclosures return to levels consistent with a well-functioning housing market, expected in 2015.

[ii] A well-functioning housing market is defined as one consistent with an economy operating at full employment and growing at its potential rate.

[iii] The pace of new construction is supported by the annual formation of 1.25 million households, the obsolescence of 300,000 housing units, and the purchase of 200,000 vacation homes.

[iv] House prices should increase at a pace between the annual rate of growth in household income (4%) and overall annual price inflation (2%). House prices are ultimately determined by replacement costs, which equal the cost of land plus the cost of construction. The cost of land is determined by its opportunity cost, or GDP per developable acre. The growth in GDP per acre is equal to the growth in household income (assuming that the profit share of GDP remains constant). Construction costs will grow at the rate of overall inflation in the long run, although material and labor costs can fluctuate substantially in the short run. Since the share of land costs in overall house prices varies considerably from place to place (very high in San Francisco, for example, much lower in Des Moines) growth in house prices will vary considerably among regions. For the past quarter century or so (the recent boom and bust aside), house prices have grown at a rate closer to household income. As financial and other incentives for homeownership increased, households spent as much on housing as their incomes would allow. These incentives have likely peaked and may well decline; therefore households will devote less of their income to housing, and prices are likely to increase at rates closer to inflation.

[v] There is a long literature with regard to the wealth effect. For a description of my estimates and how they are incorporated into the Moody's Analytics model of the U.S. economy, see "The Wealth Effect," Mustafa Akcay. Regional Financial Review, November 26, 2008.

[vi] The Housing Vacancy Survey may also overstate the problem. Recent data from the 2010 census suggest there are fewer rental vacancies than the survey implies. The Census Bureau's Housing Vacancy Survey is based on a sample that, given the 2010 census data, appears to be biased.

[vii] CoreLogic estimates there are closer to 11 million underwater homeowners. The Moody's Analytics data are based on actual mortgage debt outstanding from Equifax credit files, while CoreLogic's estimate is based on debt outstanding at origination. The Moody's estimate of negative equity is nearly the same as CoreLogic's in California, much lower in Florida, and higher most everywhere else. CoreLogic may have some difficulty measuring debt outstanding in rural or exurban areas where homeowners generally have little equity even in good times (since house prices there do not rise much) and go into small negative-equity positions in difficult times. The Moody's estimate is much higher in Texas, for example. CoreLogic data are also unavailable for a half-dozen states.

[viii] The Federal Reserve's recent white paper on housing advocates similar steps. See "The U.S. Housing Market: Current Conditions and Policy Considerations," January 4, 2012. http://federalreserve.gov/publications/other-reports/files/housing-white-paper-20120104.pdf

[ix] Calls for policymakers to enable mortgage refinancing have steadily increased since late 2010. See "Restringing HARP: The Case For More Refinancing Now," Mark Zandi and Cris DeRitis. Moody's Analytics Special Report, October 7, 2010. http://www.economy.com/mark-zandi/documents/HARP_100710.pdf

[x] See "Improved HARP Will Expand Refinancing and Boost Recovery," Mark Zandi and Cris DeRitis. Moody's Analytics Special Report, October 31, 2011. http://www.economy.com/mark-zandi/documents/2011-10-26-Zandi-Improved-HARP-Will-Expand-Refinancing-Boost-Recovery.pdf

[xi] Put-back risk is the chance that Fannie and Freddie will require the servicer to take back a loan that was improperly originated. There is also a risk that mortgage insurers will rescind insurance on a poorly underwritten loan. The cost to servicers of having loans put back has been considerable.

[xii] A fact sheet describing the president's housing plan can be found at http://www.whitehouse.gov/the-press-office/2012/02/01/fact-sheet-president-obama-s-plan-help-responsible-homeowners-and-heal-h.

[xiii] This is based on an analysis conducted by LPS using the McDash servicing database and the LPS-AA HPI.

[xiv] This is a very conservative estimate of the number of homeowners who will refinance, excluding all eligible Fannie/Freddie/FHA/VA borrowers with LTVs of less than 100% and nongovernment borrowers

with LTVs of less than 80%. The working assumption is that these borrowers have already had the opportunity to refinance and are thus unlikely to use the new programs.

[xv] Taxpayers have already put more than $150 billion into Fannie Mae and Freddie Mac since they were put into conservatorship in September 2008.

[xvi] The break-even change in the default rate equals the lost interest income divided by the product of the mortgage debt owned and insured and the loss from default, which is assumed to be 50% of the mortgage balance.

[xvii] This assumes the proposed changes to HARP are implemented by early next year. The assumed spendout rate is consistent with that of the 2001 tax rebate and the refinancing wave early in the last decade. See Johnson, et. al. "Household Expenditure and the Income Tax Rebates of 2001," American Economic Review, vol. 96, no 5. pp. 1589-1610. The spendout would likely be greater given that homeowners will view lower mortgage payments as a more permanent increase in real incomes.

[xviii] This excludes the interest income that would be lost by Fannie, Freddie, and the Federal Reserve.

[xix] There have been nearly 5 million total modifications, including those done under HAMP, by the FHA and in the private sector since the modification effort began in earnest in 2007. HAMP has arguably facilitated more private modifications by requiring private servicers to invest in their own modification efforts. Hope Now provides the most comprehensive accounting of the modification effort. See: http://www.hopenow.com/industry-data/2012-01-13-HOPENOW%20Data%20Report-(November)%20DraftV3.pdf

[xx] The redefault rate could be even lower given that this is comparable to the redefault rate on HAMP modifications.