The Washington Post

With home prices headed down, three ideas to soften the fall

By Mark Zandi, Published: November 10

U .S. home prices are set to fall further. There is nothing policymakers can do to forestall this, but there are things they can do to mitigate the severity of the decline. With Europe in disarray, the supercommittee struggling to reduce the federal deficit and a payroll tax increase looming next year, help for the housing industry could make the difference between a continued economic recovery and a double-dip recession.

House prices are currently being driven by distressed home sales — foreclosure and short sales. About a third of home sales nationwide involve distressed properties, an astounding figure. In the busted housing markets of Arizona, California, Florida and Nevada, the share is well over half. Distressed properties are often vacant and in disrepair, and thus sold at significant discounts. As the share of distressed sales grows, home prices fall.

House prices have been more stable in recent months, largely because legal and regulatory issues have slowed foreclosures and thus limited the number of distressed sales. A major impediment has been the state attorney generals' lawsuit against the mortgage companies over the robo-signing fiasco and other foreclosure process problems. Once this suit is settled, the foreclosure machine will gear up again, distressed sales will increase, and house prices will resume their descent. Prices have already fallen by a third since the housing crash began six years ago.

Falling home prices pose a serious threat to the economic recovery. A home is still the biggest asset that most Americans own. Small-business owners use their homes as collateral for loans to finance investment and hiring. Local governments rely on property tax revenue, which is tied to real estate values, to fund schools and pay police officers and firefighters. As home prices fall, moreover, more homeowners find that they owe more than their properties are worth, setting the stage for more foreclosures and more price declines. This vicious cycle, which raged during the Great Recession, could easily resume.

Given the current political and fiscal realities, there is no silver policy bullet that will avoid all this, but policymakers can take several smaller steps that will make a meaningful difference.

Allow for higher conforming loan limits for another year. The conforming limit determines the maximum loan that Fannie Mae, Freddie Mac and the Federal Housing Administration are permitted to insure. When private mortgage lending collapsed during the recession, these limits were increased temporarily to allow the federal agencies to step into the breach.

The higher limits expired in October. It's too early to gauge the fallout, but there is some evidence that the change has hurt. Despite lower mortgage rates, applications for home purchase loans have weakened since the summer, and the monthly flow of pending home sales — contracts signed but not yet closed — fell significantly in September. Higher loan limits help housing in the Northeast, in Florida and on the West Coast. Allowing the conforming loan limits to decline is necessary, eventually, to ease the government out of its role as the nation's mortgage lender, but now is not the time, while the housing market and the economy are still in trouble.

Extend new rules for mortgage refinancing to all Fannie and Freddie borrowers. The administration recently revamped its program to encourage refinancing, extending it to Fannie or Freddie borrowers who have little or no equity in their homes. Though these homeowners are current on their payments, they have been unable to refinance for a range of reasons, so they have been unable to take advantage of near-record-low mortgage rates to reduce their monthly bills. Lower payments would help keep these homeowners from defaulting and thus adding to the pile of distressed-property sales. It would also free up cash for these stressed homeowners to spend elsewhere.

To promote more refinancing, Fannie and Freddie could apply the new rules to all the loans they insure, including those to homeowners who have adequate equity. This would give more than 14 million homeowners an opportunity to significantly reduce their mortgage payments. Since they would be making smaller payments, the investors that own these mortgages would receive less — but the biggest investors include the Federal Reserve, overseas investors, and Fannie and Freddie themselves.

Allow investors in foreclosure and short sales next year to expense their investments for tax purposes up front. This move would help absorb the coming sales of distressed properties. This is the same benefit that businesses receive this year if they invest in equipment and software. Investor demand for distressed property has been healthy, as rents rise to levels that can cover investors' costs while they wait for properties to appreciate. Giving investors a small tax break should further juice up demand, supporting prices for distressed homes and the market in general.

These proposed policy steps would cost taxpayers little, if anything. Fannie and Freddie, now owned by taxpayers, would be compensated for any additional risk they take by guarantee fees on the additional loans they would end up insuring. While the Treasury would give up some money next year if investors could expense their purchases of distressed homes, most of that would come back as investors' tax bills increase in subsequent years. This should make it easier for policymakers to pass legislation needed to increase the loan limits and provide investors a tax break.

Our economy isn't going to recover until the housing market finds its footing. The foreclosure crisis means that this won't happen anytime soon, and in fact there is a serious risk that housing problems will intensify in the coming months. Unfortunately, there is no policy home run that will address the problems, at least not quickly. But the policy singles proposed here should advance the game, as long as lawmakers act soon.

Mark Zandi is chief economist of Moody's Analytics, a subsidiary of Moody's Corp. He is the author of "Financial Shock," an exposé of the financial crisis. His column will appear quarterly.

http://www.washingtonpost.com/realestate/with-home-prices-headed-down-three-ideas-to-soften-the-fall/2011/11/07/gIQAGzUZ8M_story.html