6

The Foreclosure Fiasco

The call with Bob Steele wasn't going well. He was curt and growing increasingly annoyed as I laid out a plan to stem the accelerating housing crash. It was summer 2008, and it was clear that housing was the core of the economy's problem, although it wasn't yet clear that the problem was catastrophic.

Moody's executives had arranged the call. They knew the Under Secretary for Domestic Finance in the Bush Treasury Department from his years working at Goldman Sachs. Two years earlier, Moody's had purchased Economy.com, the firm I had cofounded in 1990, and I had gained some credibility within the credit rating agency by arguing that housing was a bubble and that Moody's highly profitable mortgage securitization business was severely threatened. The executives hoped that a more aggressive government response to housing's crisis might salvage the securitization market and some part of their business.

My proposal was unorthodox, and it quickly became apparent that it was too far outside the box for the Under Secretary.[1] I argued that to stem the housing collapse, the government needed a program of principal reduction for mortgages. With house prices in free fall, millions of homeowners were being pushed underwater—their homes were worth less than the debt they owed. Homeowners in this precarious situation were more likely to stop paying on their mortgages and foreclosures would soar. Only a plan to reduce the debts of these stressed homeowners would stop this nightmare quickly. To discourage homeowners from defaulting simply to cut their mortgage

debt—a form of what economists call moral hazard—I proposed that eligible homeowners share any future house price appreciation with their mortgage lenders.[2]

Bob Steele wasn't having any of it. He didn't seem to think housing's problem was that big, and certainly not big enough to demand that taxpayers help reduce homeowners' mortgage debts. Not only was this likely to be costly and laden with moral hazard, he argued, but it also wasn't fair to those homeowners who struggled successfully to pay their mortgages, and thus wouldn't receive a reduction. Urban legend has it that the Tea Party was borne out of the anger that greeted even the chance that government would go in this direction.[3] I agreed that it would be costly and that some would benefit more than others, but I argued that without policies along these lines, taxpayers would pay much more, and that everyone would be measurably worse off.

I suppose it wasn't realistic to think the Bush administration would deviate radically from its incremental approach to the housing problem. The administration had done a few positive things, such as working with the mortgage industry to establish Hope Now— a consortium of mortgage-related companies working to establish standards and facilitate mortgage loan modifications. The White House also supported efforts to temporarily eliminate the tax liability on mortgage debt forgiven in a short sale—a sale for less than the amount owed on a mortgage. Such taxes had been a significant impediment to resolving underwater mortgages and putting properties back on the market. So that Fannie Mae, Freddie Mac, and the Federal Housing Administration would increase lending as private lenders pulled back, President Bush included higher conforming loan limits—caps on the size of mortgage loans these lenders could make—as part of his fiscal stimulus plan. But compared with these policy steps, my proposal appeared quite radical. The call with Steele ended abruptly, but the debate over how to end the foreclosure crisis raged on.

Aside from the fiscal stimulus, no issue was more important than housing for President Obama's new economic team. The Great Recession wouldn't end unless the housing market stabilized. A key early decision for the incoming Obama team was whether to support an effort to allow homeowners to have their mortgages reduced in bankruptcy. Historically, bankruptcy judges had significant discretion in restructuring a troubled borrower's debts but could not touch first mortgages. This was to encourage lenders to offer lower mortgage rates and easier terms to prospective borrowers. Now a change was being proposed that would retroactively affect mortgages made during the housing bubble. Proponents argued that because these loans had been poorly made in the first place, it was permissible for the government to change the rules after the fact.[4]

Candidate Obama endorsed the idea, but President Obama demurred. It could serve as a big stick to get lenders to work with borrowers, but for the government to change the terms of a mortgage—a private contract between a lender and a borrower—felt like an assault on the rule of law. If government could alter the rules after the fact, lenders in the future would demand compensation for the risk of such changes occurring again. This would mean higher lending rates, tougher terms, and less credit for future borrowers. The administration decided to use carrots instead to address the foreclosure crisis.

It seemed clear that avoiding foreclosure was in everyone's interest. Foreclosure is extraordinarily costly. Homeowners likely to lose their homes have little incentive to keep them up and may take out their frustration by removing plumbing fixtures, copper wires, or anything else of value. The legal and maintenance costs are enormous, and vacant properties quickly fall apart, as vandals and varmints damage structures. The broader economic costs are also significant; homes in foreclosure sell at big price discounts, driving market prices down for everyone and pushing more homeowners underwater, which leads to more defaults and further house price declines. Logic strongly suggests that everyone—lenders, homeowners,

and taxpayers—should share the cost helping homeowners avoid foreclosure.

The administration's attempt to implement this logic was the Making Home Affordable Program, announced by President Obama in February 2009, and in effect by that summer.[5] The plan offered a plethora of clever incentives to get mortgage lenders to modify loans and reduce monthly payments for struggling homeowners. It also encouraged Fannie Mae and Freddie Mac to make use of the lower mortgage rates engineered by the Federal Reserve to refinance homeowners who had little or no equity. Such borrowers hadn't been able to refinance at reasonable rates. The program's goals were ambitious—two to three million mortgage loan modifications and four to five million refinancings.

The mortgage market's issues were much too complex for the administration's goals to be realized, at least quickly. The Making Home Affordable Program helped, but there were numerous problems. Many of the troubled mortgage loans had been used to back mortgage securities, whose owners—investors from all over the globe—had different incentives. Some weren't enthusiastic about loan modifications; they preferred to push the loans through foreclosure quickly. The big banks servicing the loans were also unsure that modification and refinancing made economic sense for them. The process was further slowed by lawsuits and countersuits over the cost of the defaults and foreclosures. It took months, and then years, for the various parties to understand the program. The administration made numerous changes, and by 2012 it was working better, but even then the program seemed unlikely to achieve its stated goals.

Some aspects of the policy response to the housing crash worked surprisingly well. Most notable was the role played by the Federal Housing Administration. The FHA, which had been all but dormant during the housing bubble, sprung back to life during the bust, accounting for about one-third of all mortgage loans at the height of the credit crunch. During this period, when banks were making

few loans of any kind, mortgage borrowers could still obtain credit because of the FHA. This was precisely what the agency's New Deal-era designers had had in mind when they set it up in the 1930s. Without a steady flow of credit from the FHA, the housing market would have completely shut down, taking the economy with it. The agency's extraordinary efforts took a toll on its finances, but the FHA seemed likely to navigate this without having to turn to taxpayers for help.[6]

Three successive temporary tax credits for homebuyers were much criticized at the time, but proved surprisingly effective. Each break lasted only a few months, giving buyers compelling reasons to act rather than wait for prices to fall further. The tax savings were enough to more than compensate buyers for any additional expected price declines. Home sales gyrated as the credits were extended, withdrawn, then extended again, but the free fall in sales and prices stopped. Government policy succeeded in breaking a vicious deflationary psychology that had gripped the housing market.

The government's effort to shore up housing was well timed. By mid-2009, house prices had already fallen by about a third nationwide. In the hardest hit markets, such as Las Vegas, Miami, and the Central Valley of California, prices were down more than 60%. Combined with low and falling mortgage rates, this made single-family housing affordable again—as affordable as homes had ever had been, at least by some measures.[7] It also was no longer clear that renting was a better bargain than owning for many households. Critics argued that government housing policy was keeping prices artificially high, but these concerns were misplaced. Although prices wouldn't rise on a consistent basis for several more years, the price declines and housing crash were largely over. Policy had prevented housing from falling to levels that would have rekindled financial panic and renewed the Great Recession.

Criticism that policymakers were inappropriately slowing down the foreclosure process also seemed misplaced, at least through much of the crisis. As the robo-signing scandal that broke in late 2010 had

made clear, it was important to ensure homeowners were treated fairly in foreclosures.[8] The slower process also prevented too many distressed properties hitting the market at once, which would have caused prices to spiral lower. The policy's critics had a better case after the mortgage companies had agreed to change foreclosure procedures and house prices had stabilized. Millions of troubled loans remained to be resolved before housing could truly find its footing. This required the court system to work through its backlog of cases and for state and municipal governments to reevaluate the complex mediation efforts many had put in place. By mid-2012 it was time to move on.

How the response to the housing crash would ultimately be judged also depended on how gracefully the government unwound its involvement in the housing and mortgage markets. As the Obama administration prepared to face the voters again, Fannie Mae and Freddie Mac remained firmly in government control, and the FHA remained an outsized part of the mortgage market. Private lenders were still hobbled, and the mortgage securitization market was still broken. There was widespread agreement that this wasn't desirable or sustainable, but there was no clear vision of what mortgage finance would look like in the future.

There was also no consensus about whether government should continue to subsidize homeownership as it had long done. The mortgage interest tax deduction, favorable capital gains treatment, access to credit created by the FHA, and lower mortgage rates afforded by Fannie Mae and Freddie Mac all cost taxpayers a bundle. It was difficult to see how this largesse could continue at a time when policymakers were scouring the federal budget for savings. And although it had long been conventional wisdom that homeownership was good for both households and their communities, the millions of foreclosed homes showed clearly that not everyone could afford to own.

Housing Boom and Bust

No industry reaches deeper into the economy than housing, and the boom and bust of the 2000s took the economy for a wild and scary ride. The Great Recession could not end until housing hit bottom, and the recovery could not take hold until housing was on the rise again. Policymakers rightly focused on addressing the foreclosure crisis.

Selling and building homes is big business, and in many U.S. towns during the boom it seemed like the only business. When the housing market was at its most crazed in the mid-2000s, nearly 8.5 million homes, or about one-tenth of the entire housing stock, were turning over annually (see Figure 6.1).[9] House flippers, who bought and sold homes quickly using little if any of their own money, had overrun places like Florida, Nevada, Arizona, and California. Real-estate speculation was rampant in many markets, and prices soared.

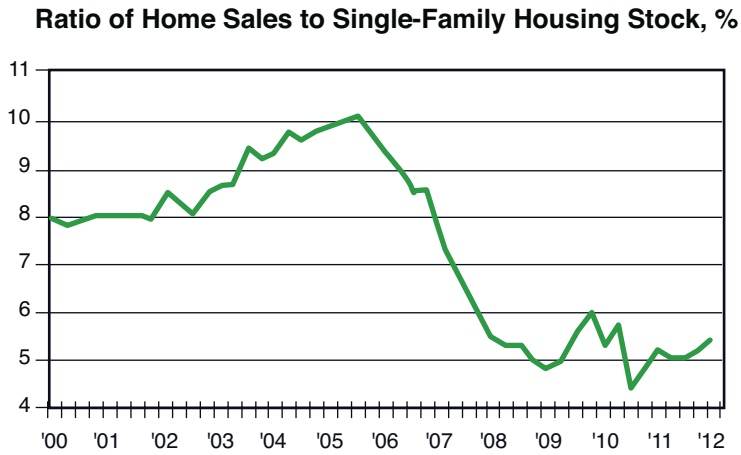

Figure 6.1 House flipping surges during the bubble.

Sources: Bureau of Census, National Association of Realtors, Moody's Analytics

Rapidly rising house prices emboldened buyers to ramp up borrowing, and lenders to offer them cheap and easy credit. Low- and no-down payment mortgages became the norm; cash-out refinancing, in which homeowners borrowed more than the current mortgage

balance, was all the rage. Hundreds of billions of dollars were pulled out of home equity in this period. Some of it went to pay for sensible things such as tuition or business start-ups, but more of it went for questionable things such as new cars, vacations, or dinners out. The total amount of mortgage debt rose even faster than house prices. In the decade before the bubble burst, national house prices doubled and outstanding mortgage debt tripled.

The private mortgage securities market was responsible for much of this. In the mid-1990s, before the lending boom, there were only a couple hundred thousand subprime, alt-A, and option-ARM loans outstanding. By the mid-2000s, there were more than 8 million of these loans, accounting for an enormous one-fifth of all mortgage debt outstanding (see Figure 6.2).

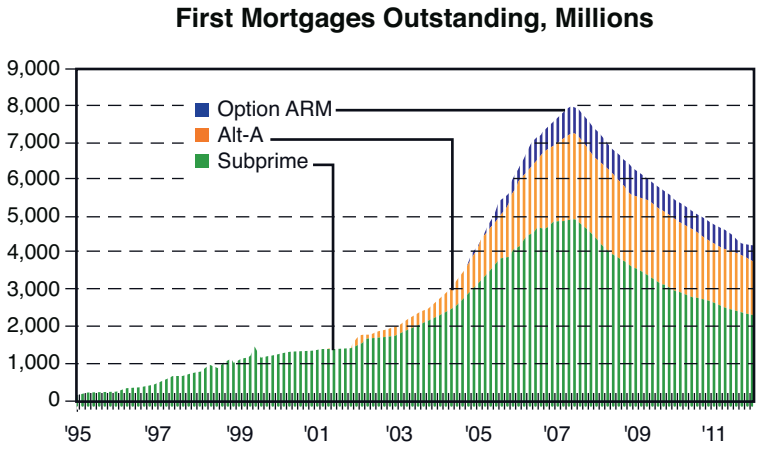

Figure 6.2 Private mortgage securities market soars.

Source: Moody's Analytics

Homebuilders suspected they were selling many of their new homes to flippers, but they couldn't resist. Builders built like there was no tomorrow, adding a couple of million homes each year during the boom—more than could be absorbed by new households, used as second homes, or to replace obsolete structures.[10] By the mid-2000s

when the bubble was fully inflated, housing was vastly unaffordable, overvalued, and overbuilt.

The housing boom was dizzying, and the bust was harrowing. When the flippers figured out they were flipping mostly to each other, the game was up. Speculators began defaulting on their mortgages, shocking the financial institutions that had lent to them. Flippers went from making timely loan payments straight through delinquency and into foreclosure. They had made bum investments, and by returning the keys to lenders, they were washing their hands of the problem.

Lenders and investors in residential mortgages suffered massive losses, undermining their solvency and driving the global financial system to its knees. Between 2006 when the housing bust began and 2011, financial institutions realized more than $900 billion in losses on mortgage lending (see Table 6.1). Not surprisingly, nearly half were on loans funded by the private mortgage securities market. The old banking adage proved true: "If it's growing like a weed, it probably is one." Only a government bailout saved the financial system and forestalled a more severe credit crunch. Yet losses continued to mount, and it would take years of legal wrangling to sort out who would bear the costs.

Table 6.1 Residential Mortgage Loan Realized Losses (Billions $)

	2006	2007	2008	2009	2010	2011	2006-2011	Share of Losses
Total	17.3	45.4	181.8	305	198.8	167.4	915.7	100
Government Backed	7.4	13.9	55	113.8	57.9	53.1	301.2	32.9
Fannie Mae & Freddie Mac	1.1	8.1	47.3	103.4	43.8	38.2	241.9	26.4
Fannie Mae	0.8	5	29.8	73.5	26.6	27.5	163.3	17.8
Freddie Mac	0.3	3.1	17.5	29.8	17.2	10.7	78.6	8.6
Federal Housing Administration	6.3	5.9	7.6	10.5	14.1	14.9	59.3	6.5
Privately Backed	9.9	31.5	126.8	191.1	140.9	114.3	614.5	67.1
Depository Institutions	2.7	7.3	35	54.9	48.2	35.3	183.4	20
Private Label Mortgage Securities	7.2	24.2	91.8	136.2	92.7	79	431.1	47.1
Subprime	5.6	15.4	55.9	71.5	38.9	34.7	222.1	24.3
Alt-A	0.2	0.9	10.8	27.5	23.8	20.3	83.4	9.1
Option ARMs	0	0.2	5.1	17.8	17.4	14.5	55	6
HELOC	0.2	1.5	5.1	5.1	3.4	2.1	17.4	1.9
Jumbo	0	0	0.3	1.9	3.1	3.7	9.1	1

Note: Total of private label mortgage securities includes securities not in components shown in the table.
Sources: Fannie Mae, Freddie Mac, HUD, FDIC, Federal Reserve Board, Moody's Analytics

The housing bust wiped out the net worth of millions of homeowners, for whom a house was the most important asset. Well over $7 trillion in homeowners' equity, half of all existing equity at the peak, was lost in the housing crash. Middle-income households were hit especially hard; unlike their wealthier neighbors they didn't have stocks or other investments to cushion the blow. With their balance sheets in tatters, these families had no choice but to curtail spending.[11]

Shaky house prices also made it difficult for small-business owners to use their homes for seed money or loan collateral. When I started my company in the early 1990s, I used my home as collateral to get a loan to pay the company's first employee. I would not have been able to do that if my home's value had not held up. The housing crash caused bank lending to dry up to small businesses, and because small businesses are a key part of job creation, this was a significant impediment to a better job market.

Strapped local governments also struggled with the impact of falling house prices on property tax revenues. Despite rising millage rates in many parts of the country, property tax revenues declined for the first time on record. Local governments thus had little choice but to cut budgets and lay off teachers, firefighters, and police, ultimately cutting more than half a million jobs. And considering the lag between house price changes and tax assessments, local government revenues and jobs weren't likely to bounce back quickly.

The most worrisome development was the vicious cycle that took hold in housing by fall 2007. Falling house prices pushed more and more homeowners underwater, producing more defaults, foreclosures, and short sales—and because these distress sales involved large discounts, still lower prices. There were fewer than 2 million underwater homeowners in 2005, most with only slightly negative equity. By late 2007, 6.5 million owed more than their homes were worth on the market, and by early 2009 at the peak, 16 million were in this uncomfortable position. For more than half of those households, mortgage debt exceeded the home's value by more than 30% (see Figure 6.3).

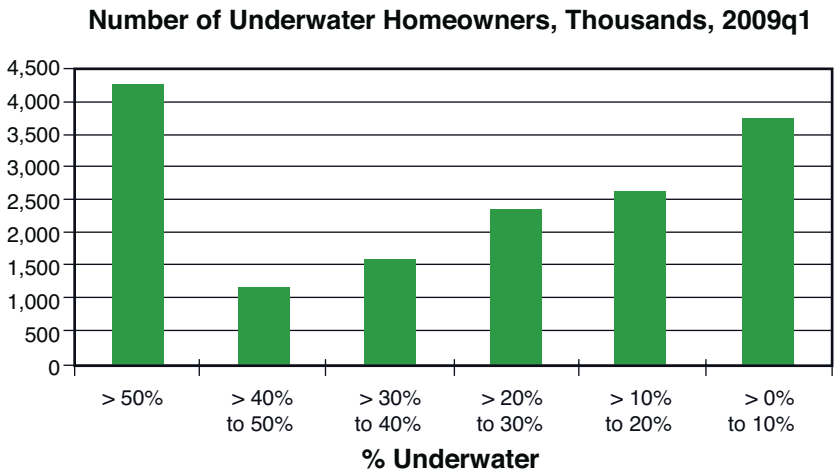

Figure 6.3 Millions were pushed deeply underwater.

Sources: Equifax, Moody's Analytics

Threatening to send this vicious cycle into hyper-drive were surging defaults by subprime borrowers, whose mortgage payments were rising suddenly. Most subprime mortgages were of the type known as "2-28" loans, with payments fixed for 2 years, and adjusted after that based on 6-month Libor rates. Subprime loans made during the height of the housing bubble were first reset in 2007 and 2008. At that point the Federal Reserve had yet to push interest rates very low, so the average subprime borrower's monthly mortgage payment jumped from $1,200 to an unmanageable $1,550.[12]

Dazed and Confused

Pressure mounted on the Bush administration to act, but the White House had little appetite for an aggressive response. Officials tended to believe that private lenders and homebuilders had gotten themselves into trouble and should figure a way out of it. There was also wide confusion about what government could do to help.

The administration's first response was to have the FHA refinance subprime homeowners whose mortgage payments were being reset at much higher levels. To qualify for what was dubbed an FHA Secure loan, homeowners had to stay current on their payments prior to the payment reset, make at least a 2.5% down payment, and have sufficient income and a stable job. The program fell flat because those who needed it most also faced job insecurity and had trouble coming up with even small down payments.

FHA Secure was followed by Hope Now, a voluntary consortium of the nation's largest mortgage companies, Fannie Mae, Freddie Mac, and the FHA.[13] The group was charged with finding ways to head off the tsunami of foreclosures threatening to wash out the housing market.[14] No one had ever anticipated that many millions of mortgage loans might go bad at once, and the system wasn't up to the task. Companies that serviced mortgage loans were profitable when most borrowers paid on time, but they lost money when forced to work through problems with borrowers who weren't paying at all. This was a labor-intensive and costly process, and the servicers weren't being compensated for it.

Further complicating matters was mortgage loan securitization, which combined the most troubled subprime loans into pools. Servicers collected payments on the loans in the pools and forwarded them to investors. Little thought had been given to the scenario that was now unfolding, in which lots of borrowers stopped paying all at once. Servicers had little guidance from investors, and investors couldn't agree how to proceed.

"Tranche warfare" broke out among investors. Tranches were layers of mortgages, arranged in the securities so that some would suffer first and others later if borrowers began to default. Investors who owned the riskiest layers now began to feud with those who owned the safer parts. The first group wanted servicers to cut the borrowers a break and modify their loans; for these investors, a lower monthly payment was better than nothing. But investors in the safer tranches

favored letting the weakest borrowers default. These investors weren't immediately at risk, and modifying loans would add to the costs and raise the odds of more problems later. The mortgage servicers froze, afraid of the legal crossfire.

Also mucking up the modification process were second liens. About half of those homeowners whose first mortgages were in trouble also owed money on home equity loans or other second mortgages.[15] The owners of those second mortgages had to agree to any modification or refinancing of a first mortgage before it could take place. This isn't that complicated in theory, but the mortgage industry's poor recordkeeping often made it painfully difficult to determine who held a borrower's second lien. Even when they could be identified, some second-lien owners would withhold consent unless they were paid. This infuriated first-mortgage owners, who felt they were being shaken down, and drove many loans into foreclosure.

Hope Now succeeded in bringing the players together, and it also opened lines of communication between stretched homeowners and mortgage servicers. But the program couldn't overcome the economic and legal barriers to modification. Lenders were also putting most troubled homeowners into repayment plans, which provided little relief; the plans simply let delinquent homeowners resume paying their mortgages with no change in terms. Borrowers still had to make up missed payments and pay associated penalties. Monthly payments actually rose under many repayment plans. Hope Now couldn't keep enough distressed homeowners out of foreclosure.[16]

Bold and Foolhardy

The foreclosure crisis metastasized in 2008. It no longer was just about a few million subprime borrowers who had overreached with the help of overly aggressive lenders. The crisis now involved nearly all U.S. homeowners with mortgages—some 55 million households—and

two of the nation's blue-chip companies, Fannie Mae and Freddie Mac, whose stock and debt were owned by hundreds of millions of investors across the globe.

Fannie and Freddie, also called ~~the~~ government-sponsored enterprises or GSEs, are mammoth financial institutions vital to the nation's housing market. In 2008, they either owned or insured some $5 trillion in residential mortgage debt; not quite half of all the mortgage debt outstanding. For context, this was approximately equal to the amount of U.S. Treasury debt then held by the public. Moreover, the collapse in private mortgage lending had made the GSEs much more important; aside from the FHA, no one else was making mortgage loans.

Cracks in the GSEs' financial façade had become obvious by spring 2008. Mortgage defaults were up everywhere—not just in California and Florida, where Fannie and Freddie had historically made fewer loans, but also in places such as Minneapolis and Dallas, where the GSEs were the principal sources of mortgage credit. Although GSE loans performed better than others, they were still losing money, and the losses were washing away the institutions' capital cushions. Those cushions were thin, relative to Fannie's and Freddie's size. Commercial banks at the time generally held assets equal to 10 times their capital; for investment banks the limit was 30 times. Fannie's and Freddie's assets were closer to 70 times their capital.[17] As the situation deteriorated, this lack of a cushion spooked investors, and they sold the GSEs' stocks and bonds. The run became self-fulfilling, as other potential investors were scared away and other institutions grew afraid to do business with Fannie and Freddie.

Confidence continued to erode during the summer, compelling Bush Treasury Secretary Henry Paulson to ask Congress for what he called a "bazooka" to deal with it. In late July, Congress granted the government authority to add capital to the GSEs and to take them over if necessary.[18] To dispel concerns that the GSEs might have trouble raising cash, they were given access to the Fed's discount window

and a larger credit line to the Treasury. In testimony to Congress, Secretary Paulson said

> If you've got a squirt gun in your pocket, you may have to take it out. If you've got a bazooka and people know you've got it, you may not have to take it out.

Yet the bazooka did come out, and only a few weeks later. The GSEs' new regulator, the Federal Housing Finance Administration, put them into conservatorship on September 6, 2008. Shareholders in Fannie Mae and Freddie Mac were wiped out as the U.S. government took full ownership. Bondholders were made whole, and with the full faith and credit of the Treasury backstopping Fannie and Freddie, bond investors no longer had any concern about getting their money back. The GSEs' borrowing cost thus declined. The government was now the nation's mortgage lender; thus mortgage credit would continue to flow regardless of bottom-line profits.

It was an incredibly bold move, and many would argue a brave one, but it wasn't clear that it was necessary. The consequences, moreover, would last years or even decades. The government could have guaranteed the GSEs' borrowings, much as the FDIC did with bank debt in the middle of the financial panic just a few weeks later. Any liquidity concerns would have been quickly dispelled. The government could have taken an equity position in the GSEs without wiping out shareholders, just as the TARP funds were used to recapitalize the nation's big banks. The GSEs needed capital, not an unlimited pipeline to the Treasury. Instead of extending a helping hand, the government put the GSEs in a death hug.

This exacerbated the financial panic, setting off a cascade of bank failures in the days after the takeover. Stock- and bondholders in financial institutions no longer knew where the government stood. If owning a stake in the two biggest financial institutions on the planet wasn't safe, what was? Certainly not Lehman Brothers, which collapsed a week later.

The government takeover of Fannie and Freddie also severely complicated the reconstruction of the mortgage finance system. Few thought the federal government should forever remain the nation's dominant mortgage lender, but reprivatizing Fannie and Freddie would be extraordinarily difficult. In whatever form they were reincarnated, their relationship with the government would be different than it had been before the financial panic. Their focus on providing mortgage credit to disadvantaged groups with lower homeownership rates might diminish, for one thing, making it politically hard for Congress to set the firms free.

Quelling the Chaos

When the Obama economic team took over in early 2009, the nation's housing and mortgage markets were in chaos. House prices were spiraling lower, pushing millions of homeowners underwater. Unemployment was rising rapidly, and foreclosures surged. Housing and the broader economy were inextricably intertwined, and unless the free fall in housing was stemmed, the Great Recession would only intensify.

Knowing this, policymakers threw everything they had at the housing crash. The Federal Reserve began buying mortgage securities backed by Fannie and Freddie in January and kept buying them for more than a year. The Fed became the largest investor in GSE securities, with some $1.25 trillion on its balance sheet. Mortgage rates moved steadily lower, reaching record lows. A few legislators complained that the Fed had wandered into Congress' domain of fiscal policy, but although this was a reasonable concern, the lower borrowing costs were instrumental in keeping housing from unraveling completely.

To ensure that the credit crunch didn't cripple the housing market, Congress extended higher conforming loan limits for Fannie, Freddie, and FHA loans as part of the Obama administration's stimulus legislation, the American Recovery and Reinvestment Act of 2009.[19] Mortgage credit remained tight, but below certain limits, homebuyers with jobs and solid credit scores continued to find loans. Indeed, government-backed mortgages were about the only loans being made during the panic and credit crunch.

Congress also lobbed several rounds of tax credits at housing. The first, included as part of the Bush stimulus, was small; only lower-income, first-time homebuyers qualified. Although they received some cash up front to make down payments, they had to repay with higher taxes in the future.[20] The Recovery Act included a much larger tax credit for first-time buyers that was theirs to keep. Home sales surged as that second credit neared expiration in fall 2009. A last, larger homebuyers' tax credit went into effect a few months later, and sales popped again, although not as much as the previous time.

The tax credits didn't spark additional home sales so much as pull sales forward from the future; sales weakened sharply as soon as the credits expired. The credits also were expensive, costing the Treasury tens of billions of dollars, and much of the benefit went to homebuyers who would have purchased homes anyway. But the credits were instrumental in breaking a deflationary, self-reinforcing cycle that had taken hold in the market. Prospective buyers were sitting on the sidelines, waiting for prices to stop falling before acting—and their reluctance caused prices to drop still more. The tax benefit gave buyers a reason to stop waiting, and the free fall in house prices abated (see Figure 6.4).[21]

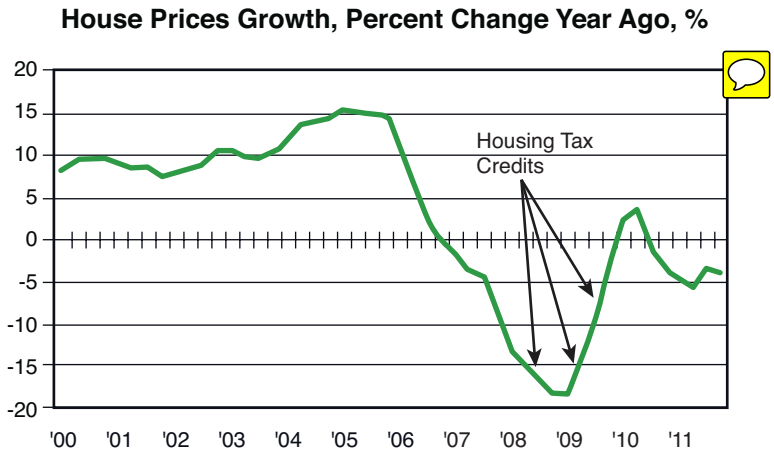

Figure 6.4 Housing tax credits dispel deflation psychology.

Source: Fiserv Case Shiller

Emptying the Pipeline

Reducing the number of homes in the foreclosure pipeline was another key to stabilizing housing. By early 2009, the pipeline included more than 3.5 million homes and was growing rapidly (see Figure 6.5).[22] These included loans somewhere in the foreclosure process and those more than 3 months past due. In normal times, approximately half a million loans fall into these categories at any one time. The increase put significant pressure on all U.S. house prices because they foreshadowed a huge rise in the number of distressed properties that would eventually be put back on the market at large discounts.[23] House prices wouldn't rise again until the foreclosure pipeline shrank.

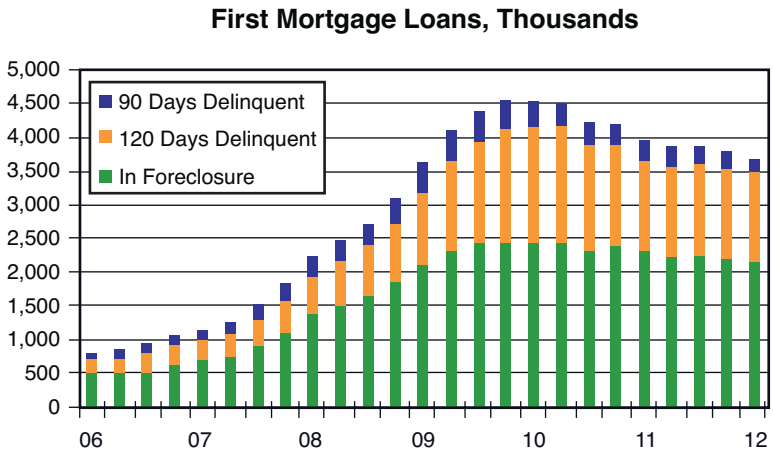

Figure 6.5 The foreclosure pipeline swells.

Sources: Equifax, Moody's Analytics

The Making Home Affordable Program was the Obama administration's attempt to work the pipeline down. It was a potpourri of initiatives that offered incentives and set standards and guidelines for mortgage servicers, lenders, and investors to modify first and second home loans, refinance mortgages, and facilitate short sales and deeds-in-lieu.[24] Given the extraordinary complexity of getting the various interest groups to work together, the programs had to evolve continually.

HAMP was the flagship effort.[25] Like Hope Now, HAMP was voluntary, but once a mortgage company agreed to participate, it was required to follow HAMP rules.[26] Most critically, each troubled loan considered for a modification had to be run through a calculator to determine its net present value after modification. That value was compared with the price it would likely fetch in a distress sale. If the modification had a higher NPV than the foreclosure, the loan was modified, most often, by having the interest rate reduced or the term extended to reduce the homeowners' monthly payment. The goal was to get the payment down to 31% of the homeowner's income; a ratio thought to be affordable. To tip the scales of the NPV calculation in

favor of modification, HAMP provided mortgage servicers and owners a cash incentive if they modified.

With so many moving parts, it wasn't surprising that HAMP got off to a messy start. Troubled homeowners were quickly put into HAMP modifications without the necessary information on employment, debt, or loan-to-value ratios being collected to determine whether the process would actually help them avoid foreclosure. HAMP modifications required a 3-month trial, in which the homeowner had to remain current on the new loan before it was made permanent. Many failed to make it.

HAMP kicked into higher gear over the next couple of years, but never lived up to expectations. President Obama was hoping for between 2 million and 3 million HAMP modifications when he unveiled the program in summer 2009, but as his first term wound down, closer to 1 million homeowners had been helped.[27] Efforts to promote principal reductions through HAMP also failed. The President went so far as to triple the monetary incentives to Fannie Mae and Freddie Mac for principal reduction mods, but the GSEs' regulator, the FHFA, was reluctant to go down this path.[28] The FHFA's objections to principal reduction were the same ones that Under Treasury Secretary Bob Steele had expressed on the phone to me 4 years earlier.

HARP, the mortgage refinancing plan, also had trouble getting off the ground.[29] The program's working assumption was that refinancing as many homeowners as possible into mortgages with lower interest rates would help them and aid the economy as well. Lower monthly payments would ease financial pressure on households, enabling many to stay current on their loans and stay out of the foreclosure pipeline. With mortgage rates at record lows, this seemed like a slam-dunk idea.

The problem was that millions of underwater or nearly underwater homeowners couldn't refinance. The mortgage rates they were offered were so far above the going rate for borrowers with equity

that it didn't make economic sense to refinance. Fannie Mae and Freddie Mac were adding interest-rate surcharges, arguing that underwater borrowers were at greater risk of defaulting. Other lenders were charging more to compensate for put-back risk, the chance that if they made a loan and sold it, it would come back to them after a default. Lenders were especially sensitive to this, worrying that they would be forced to buy back loans found to have been originated improperly.[30] Hundreds of billions of dollars in loans made during the housing boom were being put back; lenders weren't going to make the same mistake by refinancing underwater borrowers.

After a couple of years of lackluster HARP refinancing amid low mortgage rates, a number of key changes were made. Most important, Fannie and Freddie agreed to lower their interest-rate surcharges when refinancing their own loans and to ease off on putting back refinanced loans to lenders. Because Fannie and Freddie would suffer anyway if the loans they owned defaulted, it made sense for them to refinance homeowners regardless of how much equity they had. And because the loans had been originated at least a couple of years earlier, the agencies already had a good idea how well the loan was originated.[31] With fixed mortgage rates falling below 4% in early 2012, HARP refinancing picked up, but remained below expectations. HARP was supposed to produce 3 million to 4 million refinancings, but unless there were more changes, and unless rates remained extraordinarily low a lot longer, this seemed unlikely.

HAMP, HARP, and the rest of the Making Home Affordable Program didn't live up to its goals. The programs were nevertheless instrumental in ensuring that the foreclosure pipeline didn't burst. This was all the more impressive given the blizzard of scandals and lawsuits that engulfed nearly all parts of the housing and mortgage markets, slowing the foreclosure process to a crawl. Most important, as the end of President Obama's first term approached, the foreclosure crisis was fading and no longer a mortal threat to the broader economy.

Endnotes

1. The idea that principal reduction was necessary was ultimately adopted by a range of economists including Harvard Professor Martin Feldstein (http://www.nytimes.com/2011/10/13/opinion/how-to-stop-the-drop-in-home-values.html), Harvard Professor Kenneth Rogoff (http://www.theatlantic.com/business/archive/2011/10/wisdom-on-housing-from-rogoff-and-blinder/247066/), and even Federal Reserve Chairman Ben Bernanke (http://www.federalreserve.gov/newsevents/speech/bernanke20080304a.htm).

2. My proposal for shared-appreciation mortgages is described in the "Home Appreciation Mortgage Plan," May 2008. http://www.economy.com/mark-zandi/documents/Home-Appreciation-Mortgage-Plan.pdf I made a similar proposal in the "Homeownership Vesting Plan," December 2008. http://www.economy.com/mark-zandi/documents/Homeownership_Vesting_Plan.pdf

3. In a February 19, 2009 broadcast on CNBC, Editor Rick Santelli ranted about the Obama administration's plan, announced the day before, to help stressed homeowners modify and refinance their loans. Santelli denounced the plan as "promoting bad behavior" by "subsidizing losers' mortgages" and raised the possibility of putting together a "Chicago Tea Party in July".

4. I was one of those proponents. My views are detailed in testimony before the House Judiciary Subcommittee on Commercial and Administrative Law, January 29, 2008. http://judiciary.house.gov/hearings/printers/110th/40455.PDF

5. The Obama administration's loan modification and refinancing plan is described in detail at http://www.treasury.gov/initiatives/financial-stability/programs/housing-programs/mha/Pages/default.aspx

6. The FHA suffered large losses on its mortgage loans, as did every financial institution exposed to the housing and mortgage markets. The FHA's capital was substantially depleted and even as the housing crash came to an end in 2012, it was unclear whether the FHA would need help from taxpayers to remain solvent.

7. The National Association of Realtors' housing affordability index, which gauges the ability of median-income households to purchase median-priced homes at prevailing mortgage rates, rose to a record high in 2012.

8. The robo-signing scandal involved the revelation that many mortgage servicers were not completing the necessary legal paperwork in states where foreclosures went through the courts. State attorneys general banded together to sue the big mortgage service companies. They settled the case in February 2012.

9. This included both new and existing homes. In a well-functioning U.S. housing market, there should be closer to 6 million home sales annually.

10. This includes single family homes, multifamily homes, and manufactured housing. A well-functioning U.S. housing market would see closer to 1.75 million homes built each year to meet demand from new households, to serve as replacement structures, and to provide second homes.

11. This is known as the wealth effect. A decline in household wealth reduces consumer spending as less wealthy households save more, spend less, and curtail borrowing.

12. Adding to the concern at that time were the large payment resets due to hit option ARMs. Most of these mortgages featured 5 years of fixed payments and rates pegged to Libor after that. Option ARMs issued at the peak of the housing bubble in 2005 and 2006 were thus due to reset for the first time in 2010 and 2011. Yet this never became a crisis because of the Federal Reserve's zero-interest rate policy and various loan mitigation efforts.

13. Various agencies also initiated their own loan modification efforts. The FDIC worked with homeowners who had borrowed from institutions later placed in federal receivership. Fannie Mae and Freddie Mac had their own programs, as did mortgage lenders and servicers such as Bank of America, Citigroup, and JPMorgan Chase. But although laudable, these efforts did not reach the most troubled homeowners.

14. Hope Now was formally established in October 2007. At its inception the consortium included lenders representing 60% of outstanding mortgages, counseling services, trade organizations, and a group representing investors in mortgage-backed securities http://www.hopenow.com/

15. During the housing boom, home equity lines of credit (HELOC) were a popular way for homeowners to raise cash, and a way for homebuyers to avoid more costly mortgage insurance. In so-called "piggy-back seconds," a homebuyer would take out a first mortgage with an 80% loan-to-value ratio, and thus not require insurance; then also take out a HELOC to cover the rest of the home's purchase price.

16. Hope Now ultimately played a constructive role in the foreclosure mitigation effort. Modifications involving interest rate reductions and term extensions increasingly became the norm.

17. The GSEs' regulator, the Office of Federal Housing Enterprise Oversight, permitted such high leverage on the theory that Fannie's and Freddie's assets were traditionally low-risk, fixed-rate mortgage loans to prime borrowers. Those loans they owned or insured that had down payments of less than 20% also were backstopped by private mortgage insurance. Even these loans were in trouble, but for Fannie and Freddie, the bigger problem was in their below-prime, alt-A loans. Meanwhile, the firms that wrote private mortgage insurance contracts were struggling even more than Fannie and Freddie, creating doubts about their ability to meet their own obligations.

18. The Housing and Economic Recovery Act of 2008 was passed on July 30, 2008. http://www.gpo.gov/fdsys/pkg/PLAW-110publ289/pdf/PLAW-110publ289.pdf

19. The loan limits for single-family residences were increased to the lesser of $729,750 or 125% of the median home value within a given metropolitan statistical area.

20. The Bush housing tax credit was much like a zero-interest rate loan to first-time homebuyers to help with a down payment.

21. The third tax credit made it clear that repeating this tactic would be counterproductive. Homebuyers were becoming conditioned to wait for the next tax break to buy. Realtors and others in the housing industry thus did not ask for a fourth temporary tax break.

22. This was also called the shadow inventory.

23. At the height of the distress sales, homes sold in foreclosure for nearly 25% less than comparable homes sold conventionally.

24. The incentives in the Making Home Affordable Program were funded by money appropriated as part of the Troubled Assed Repurchase Program.

25. HAMP—the Home Affordable Modification Plan—was fashioned off a proposal made by then FDIC Chairwoman Sheila Bair. The FDIC had engaged in similar modifications for mortgage loans of banks that it had taken over during the financial panic.

26. Mortgage company participation in HAMP and HARP was high. This made economic sense for the companies, but there was also substantial pressure to participate from regulators and policymakers.

27. This likely understates HAMP's benefit; it helped streamline the modification process and facilitated more than four million additional modifications done by lenders outside of the HAMP process.

28. In early 2012, the Obama administration proposed tripling monetary incentives to Fannie and Freddie under HAMP for principal reductions. For every dollar Fannie and Freddie took off a home mortgage, taxpayers would pay up to 63 cents, using money from the $700 billion TARP fund originally appropriated to help struggling financial institutions.

29. HARP is the Housing Affordable Refinancing Plan.

30. Fannie, Freddie, and private mortgage insurers were aggressive in putting back loans to lenders if they violated standards, also known as representations and warranties.

31. To receive a HARP refinancing, the loan had to be originated prior to June 2009.