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The Housing and Mortgage Market Problem: A Set of Policy Options

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Executive Summary

The housing and mortgage market problems are at the core of the economic issues facing the American economy. Solutions to these problems must be key parts of any economic stimulus package. Housing has led the economy out of each of the recessions since World War II and can do so again with the right set of public policy initiatives.

The housing and mortgage markets face three interconnected problems:
- rising foreclosure and delinquency rates on poorly structured mortgages given to high credit risk borrowers;
- continuing house price declines in the 20% range nationally and 25-50% in formerly "hot" markets;
- a collapse in new housing starts, a sharp decline in existing home sales, and a large inventory of unsold homes.

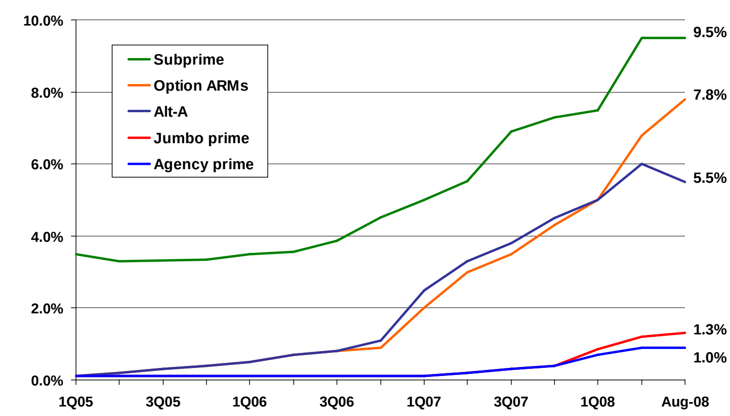
To address these problems, our economic stimulus policy must focus on the housing consumer.

The following three policy initiatives will moderate the current crisis. First, we need a comprehensive, standardized, and massive loan modification plan to assist those owner-occupiers whose loans are delinquent or are already in foreclosure. Reducing the potential losses from the 5-8 million households who face foreclosure in the next several years is critical to stabilizing the housing and mortgage market. Second, we need to restore the flow of mortgage credit on reasonable terms to the mass housing market so the households who are prepared to buy a house can qualify for a loan. We have moved from having the easiest mortgage credit environment in the 2004-2007 period to having the tightest mortgage credit environment in decades. Third, we need to stimulate the demand for houses to absorb the excess inventory of houses to stabilize prices. With the right demand stimulus, home sales will resume and new home construction and job creation in the huge housing and real estate industry will begin again.

Analysis and Explanation

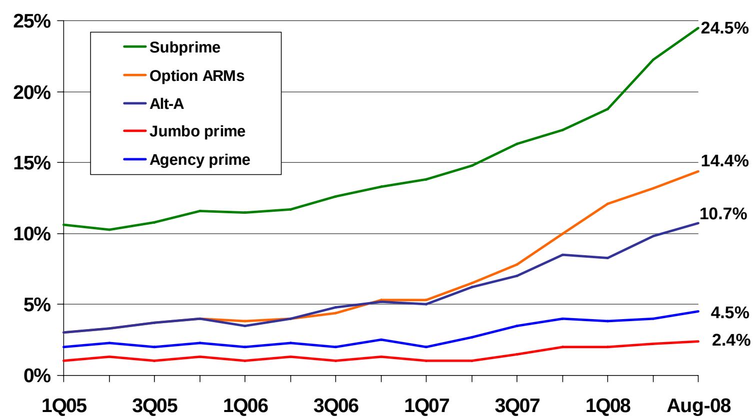
Most of the foreclosures we have seen in 2008 were the result of the proliferation of risky mortgages that were offered to high credit risk borrowers. The underwriting was so lax in residential real estate that "anyone who could fog a mirror" could get a 100% home loan. Three types of aggressive loans are the core of the problem. **Figures 1 and 2** show the high and rapidly rising foreclosure and delinquency rates on sub-prime, option-ARM, and Alt-A mortgages.

Figure 1: Foreclosures Started by Loan Type



Note: Mortgages originated btw Jan 2004 and Aug 2008, excluding HELs. Subprime & Alt-A loans are non-agency, non-gov. loans.
Source: Mortgage Bankers Association, LPS Applied Analytics, WSJ

Figure 2: Loans Delinquent Over 30 Days



Note: Mortgages originated btw Jan 2004 and Aug 2008, excluding HELs. Subprime & Alt-A loans are non-agency, non-gov. loans.
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Over $2.8 trillion of these mortgages were originated from 2004-2007, representing over 40% of the mortgage originations during this period. Many of these loans required little or no down payment, lacked full income verification (liar loans), or were negative amortization loans. A substantial number of these loans also had potentially large payment-resets built into the structure of the loan. Anecdotal evidence suggests that many of the delinquencies and foreclosures seen in the past year were caused by payment shock rather than the usual suspects of job losses, medical and family issues. However, rising unemployment rates and falling house prices are now compounding the problem, not only for the risky mortgage pool but also for the prime mortgage market. Delinquency rates are beginning to rise substantially for prime ARM and jumbo mortgages. It is estimated that without a substantial loan modification program, nearly half of the risky mortgages will go into foreclosure at a loss of nearly $1 trillion to the financial system. If the downward spiral in the housing market is not stopped, another $1-$2 trillion in losses in the prime mortgage might occur.

A partial solution to the mortgage market problem is a comprehensive, standardized, and massive loan modification plan. There is no "silver bullet" or "one size fits all" solution to the problem. There have been a number of voluntary programs put in place in the past year by banks, mortgage servicers, FNMA, FHLMC, and FHA.   A number of states have also initiated various loan modification plans. We commend all these efforts and they are having some impact on the market. However, early results from these efforts have been disappointing in terms of numbers of households helped and in terms of re-default of the loans modified. A different and much more ambitious plan is clearly necessary to assist the 5-8 million households facing foreclosure over the next three years.

A comprehensive plan to stem the coming tsunami of foreclosures could involve the following steps. First, we have to declare a NATIONAL HOUSING EMERGENCY and declare a 6 month MORATORIUM on foreclosures for all owner-occupied houses (excludes the investor/speculator), so that a new comprehensive federal plan can be put in place and personnel trained to implement the plan. Second, we have to enable all borrowers who are in the foreclosure process or are 90 days delinquent on their present loan to refinance into a new 4.5% fixed rate mortgage funded by FNMA, FHLMC, or FHA. This will help many more borrowers meet the payment shock issue.

Unfortunately, these steps can solve only a portion of the foreclosure problem. Many households still will not be able to afford to make even these modest payments. Such homeowners can be offered an extended mortgage term (40 years), or a graduated payment fixed-rate mortgage with a lower starting payment that rises a modest 5% a year until the mortgage is fully amortized. Even with this help, however, a substantial minority of households will have too little income to afford the cost of homeownership and will still face foreclosure. Homeowners in this category should be offered the opportunity to give up their ownership interest and to rent their house with the option to repurchase in two or some other period of years, with 10% of their rent payment set aside to build up an adequate down-payment. This would enable them to stay in their homes.

Another problem is that many households have seen their house value drop substantially below the amount owed on their mortgage (the under water mortgage issue). In these cases, the mortgage amount might be reduced and the mortgage recast with a shared appreciation second mortgage added to the refinancing so that the bank or government will share on a 50/50 basis any house price appreciation above the recast mortgage amount. This last feature will address the "moral hazard" issue and make it less attractive for households to voluntarily go delinquent to qualify for this plan, while incentivizing lenders to provide this refinancing option.

There are several issues that need to be addressed to get this plan implemented. We need to provide "safe harbor" legislation to protect mortgage servicers from lawsuits by private mortgage securities holders if they modify the loans in conjunction with the plans outlined above. Also, we need to provide financial support to help servicers modify loans. We need to provide careful and extensive mortgage counseling for those participating in the loan modification program. Despite all these issues, it is vital that we stem the tide of the foreclosures if we are to stabilize housing prices.

While addressing the foreclosure problem is a vital step in promoting a recovery in the housing market, we also need to stimulate consumer demand for housing. Demographic and income growth, even during a recession, will lead to demand for owner- occupied housing. Low mortgage rates (4.5%) enhance that demand. At present, however, mortgage credit conditions are so tight that a typical buyer has to put down a 20% down-payment to enter the home purchase market. This eliminates over 40% of the normal home buyers. In order to get recovery in the mass housing market we need to have widespread availability of 5-10% down-payment loans for households with modest means. The Private Mortgage Insurance industry has been the main source of insurance on low down-payment loans that have been purchased or guaranteed by FNMA and FHLMC. The PMI industry capital is being depleted as they pay claims on the loans that are being foreclosed upon. While the companies may have enough capital to pay prior claims, they need an injection of new capital if they are to perform their normal role of insuring new low down-payment loans for FNMA and FHLMC purchase or guarantee. If each of the 5 big companies issued $1 billion of convertible (into 49% common stock ownership) preferred stock to the Treasury, they could insure $250 billion of new low down-payment loans. This, along with the increased activity of the FHA mortgage insurance program would go a long way towards facilitating the return of demand to the mass housing market.

While the restructuring problem mortgage loans and the return of reasonably priced mortgage debt are necessary to stabilization of the housing market, it may be necessary to administer an additional "electric shock" to the system to jump start consumer confidence enough to revive the housing market. A 10% tax credit (up to a maximum of $22,500) for a purchase of a newly built house or a foreclosed house for owner occupancy, or the purchase of ANY house by a first-time home buyer in 2009 could create a surge in confidence and demand. If combined with a fixed rate 3% mortgage, such a stimulus plan could ignite a wildfire of demand in the housing market. This could quickly clean up the inventory of foreclosed houses, reduce the overall inventory of unsold homes, and stabilize house prices across the nation. Such a tax credit and mortgage buy-down plan successfully stimulated a recovery in the housing market in the 1974-1975 recession.

Conclusion

To sum up, the key elements of our housing stimulus package are: 1) a 180 day moratorium on foreclosures while a comprehensive, standardized, and massive mortgage restructuring plan is put a place; 2) a restoration of mortgage credit for the mass housing market by increased the availability of low down payment mortgages; and 3) a home purchase tax credit, combined with a low interest fixed mortgage to ignite consumer housing demand in 2009.

To assure that these complicated programs are implemented quickly and in the right way, A HOUSING AND MORTGAGE ADVISORY COUNCIL should be established with key government and industry officials appointed as members. It would probably be useful to appoint a single government point person (a housing and mortgage czar) to make sure all these ideas are implemented as soon as feasibly possible.

A housing stimulus program that contains all or most of these elements will provide many benefits to our nation. In addition to enabling millions of Americans to avoid having to lose their homes and jump-starting new home construction, this package of proposals will prevent further meltdown of our financial markets.

The vast majority of risky mortgages made over the past five years have been packaged into mortgage-backed securities and repackaged into collateralized debt securities (CDOs). These securities contain provisions that make it difficult to modify the underlying loans. By declaring a National Housing Emergency, establishing a 6 month Moratorium on foreclosures for all owner-occupied houses, creating the Housing and Mortgage Advisory Council, and, most importantly, establishing programs that will enable homeowners to stay out of foreclosure, a structure will be established for government leaders, top mortgage servicers, securities owners, and community groups to meet to negotiate creative, win/win legal solutions to the housing and bubble mortgage foreclosure mess that is responsible for so much of the credit crisis.