

Elizabeth A Duke: Stabilizing the housing market – next steps

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The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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In the summer of 2007, the U.S. and global economies entered a period of unprecedented financial turmoil, which has since led to a significant slump in macroeconomic activity. Problems in both the housing sector and the housing finance sector played a central role in precipitating the crisis, and ongoing weakness in housing activity, along with persistent strains in mortgage markets, continue to inhibit a broader recovery. In particular, we have entered a cycle where high levels of default on mortgage debt have led to a reduction in the availability of mortgage debt as well as a tightening of terms for it. This situation has led to lower levels of home sales and prices paid for homes, which, in turn, contributes to yet more defaults by borrowers. As financial risk managers, I am sure you are aware of the important steps that have already been taken to try to break this cycle, but that you also recognize the need to do more. My remarks today will focus on the next steps – efforts to increase demand for homes, efforts aimed at further reducing preventable foreclosures, and efforts aimed at limiting the costs imposed on households and communities by foreclosures that cannot be avoided. Both the government and the private sector have important roles in these efforts. These suggestions and recommendations are my opinion alone and do not reflect the views of other members of the Federal Reserve Board or any other government entity.

The current weakness in housing markets

Housing activity remains extraordinarily weak. Sales of new and existing homes have been running at a pace that is 60 percent of that seen at the peak in 2005. Single-family housing starts are now less than one-quarter of their peak level. With the cutbacks in construction, inventories of unsold new homes have declined, but the months' supply – that is, inventories relative to sales – is still very high by historical standards. The inventory of existing homes for sale is also quite elevated – and it would be even higher if not for would-be sellers that have withheld or withdrawn their homes from the market amid poor selling conditions.

We have also seen sharp drops in home prices. When home prices were at their peak three years ago, most analysts agreed that housing valuations looked to be substantially higher than warranted by fundamentals. However, home prices at the national level are now 17 percent off their peak, with some states, such as California and Florida, seeing declines on the order of 40 percent.¹ These declines may have reversed much, or perhaps all, of the earlier overvaluation.

Notwithstanding this correction, all indications are that the softness in housing activity is likely to persist for some time. In normal times, population growth and the attendant formation of new households tend to support housing demand. Indeed, by some estimates, the current stock of housing is not high relative to the number of housing units that would be predicted by long-run trends in household formation. However, the actual number of households has fallen well short of trend household formation. Macroeconomic conditions no doubt explain part of the shortfall in household formation, as, for example, younger people facing weak job

¹ Figures based on data from LoanPerformance, a division of First American CoreLogic.

prospects defer striking out on their own. More generally, the soft economy has diminished demand for housing among already-established households. High rates of job loss and weak income growth are directly reducing what some individuals can spend on housing, and the prospect of losing a job or suffering an income loss is damping the housing demand of others.

The cost and availability of mortgage credit is also bearing critically on housing demand. With private-label securitization markets almost completely closed, most purchases are financed with some form of government-supported credit. Purchasers with strong credit histories and sufficient down payments can obtain a "conforming" mortgage, one that can be sold to the housing government-sponsored enterprises (GSEs). Loans insured through the Federal Housing Administration (FHA) are also available to eligible borrowers, who have historically been first-time homebuyers, borrowers without significant down payments, and higher-risk borrowers. In addition, veterans with eligibility can obtain virtually 100 percent financing through VA loans.

However, households without access to government-supported programs are having much more difficulty obtaining a mortgage than in the past. One obstacle is that the private mortgage securitization markets that previously supported most non-GSE mortgage lending are now shut down. Subprime and near-prime mortgages – which traditionally were funded almost exclusively through securitization – are essentially unavailable, leaving those higher-risk households that do not qualify for FHA programs without access to mortgage credit. Prime jumbo mortgages are still available for those seeking to finance a more expensive home, but lenders are being more selective, and spreads to conforming rates remain very high. In addition, the availability of products that complement conforming loans is impaired. For example, second liens are more difficult and more expensive to obtain, which has deterred some households from making purchases that previously would have been financed by combining a conforming loan with a second lien that would cover some additional amount. Access to private mortgage insurance is more restricted, which holds back some households that lack a sufficient down payment but otherwise qualify for a conforming mortgage.

A key factor inhibiting recovery is that the adverse conditions in the housing and mortgage markets have been, and continue to be, mutually reinforcing. As I am sure you are painfully aware, delinquencies on mortgages have risen sharply in recent years. By way of background, the problems began in the nonprime mortgage market. As house prices boomed in the middle part of this decade, mortgage originators relaxed underwriting standards and extended mortgages with low or no down payments to households with weak credit histories or that did not fully document their income. Many of these loans had low initial interest rates that reset to market rates after a couple of years, which resulted in a significant increase in the monthly payment. Had house prices continued to rise, many borrowers would have been able to refinance to avoid higher payments and perhaps to extract accumulated home equity to use for future payments. However, the downturn in house prices meant that many borrowers did not have sufficient equity to refinance. Payment problems began to rise, which, in turn, led lenders to tighten standards and made it even more difficult for borrowers to obtain new loans, which put even more upward pressure on delinquencies. Eventually, investors became unwilling to fund high-risk mortgages at any price.

While the high delinquency levels and subsequent pullback of credit for subprime loans was certainly foreseeable, what was less obvious was the degree to which problems in the subprime market would spread to the market for prime loans. Loans in the prime loan market are going delinquent for all the traditional reasons: economic conditions and life events, such as job loss, medical problems, and divorce. In a rising or even stable price environment, these delinquencies would often be cured through refinance or sale of the property, which would result in low levels of actual foreclosure. However, loss of equity and tighter standards on all types of mortgages mean that even prime loans are more difficult to refinance, and weak housing demand has made it difficult to sell.

According to the latest data, 25 percent of subprime loans and 13 percent of near-prime loans are now seriously delinquent – that is, more than 90 days past due or in foreclosure. The serious delinquency rate for prime mortgages, at between 3 percent and 4 percent, is much lower than for nonprime loans, but it has almost doubled over the past year. Foreclosures have also risen sharply. The available data suggest that lenders initiated 2-1/4 million foreclosures last year, more than double the number seen in 2006.² While the percentage of mortgages entering foreclosure is likely to increase further, the decline in the number of subprime loans means that this percentage will be applied to a smaller base of loans, which will tend to damp the overall number of foreclosures. In the past, about one-half of foreclosures initiated were cured through a repayment plan or some other arrangement, but the remaining one-half resulted in the loss of a home. The share resulting in home loss could well be higher now given the large numbers of distressed households and the bleak underlying economic conditions. So, even if the number of foreclosures initiated begin to drop, we are still likely to see higher levels of property taken into real estate owned (REO) as foreclosures initiated earlier are completed and the share of those foreclosures resulting in the loss of a home increases.

Addressing the problems in housing and mortgage markets

Several considerations underscore the need for policymakers to take further actions to address the problems in housing and mortgage markets. To begin, the weakness in the housing sector remains a significant drag on the macroeconomy and is reinforcing the strains in the financial system. Moreover, the wave of foreclosures has the potential to exacerbate the problems going forward. In past housing cycles, house prices have tended to fall below the level warranted by fundamentals, presumably as weak market conditions led sellers to make aggressive price cuts. The potential for an overcorrection of house prices in this cycle seems particularly acute, given the potential for foreclosures to create a glut of properties for sale. And, of course, further large declines in house prices would accentuate the broader problems in the macroeconomy and financial system through the channels that I just discussed.

In addition, foreclosures cause significant distress among the families that lose their homes. Whether the foreclosure is the result of inadequate underwriting by the mortgage lender, irresponsibility on the part of homeowner, or uncontrollable life events such as job loss, the result is the same: Displaced families with depleted resources and impaired credit have difficulty finding a new place to live. They may have to move significant distances, which may affect their ability to retain their jobs and disrupt other aspects of their lives as well as the lives of their family members.

The effects of foreclosures extend beyond these immediate families. One in five foreclosures appears to be affecting renter-occupied units. The families in these units may also be displaced, even if they are paying their rent on time and abiding by the terms of their lease agreement. In areas where foreclosures are concentrated, communities will suffer. Clusters of vacant properties can foster vandalism and crime, and studies have shown that they lead to lower house prices throughout the neighborhood.³ Municipal governments may have to

² Estimates of subprime and near-prime delinquency rates are for loans in securitized pools, based on data from LoanPerformance, a division of First American CoreLogic. Estimates of prime delinquency rates are based on data from McDash. Estimates of foreclosures initiated based on data from the Mortgage Bankers' Association.

³ See, for example, William C. Apgar, Mark Duda, and Rochelle Nawrocki Gorey (2005), "The Municipal Cost of Foreclosures: A Chicago Case Study," Housing Finance Policy Research Paper 2005-1 (Minneapolis, Minn.: Homeownership Preservation Foundation, February), www.995hope.org/content/pdf/Apgar_Duda_Study_Full_Version.pdf; and John P. Harding, Eric Rosenblatt,

spend more on maintaining properties and preventing crime, such as vandalism and arson, just when resources are stretched thin, in part because of the lower tax revenue associated with lower house prices. Such spending may well crowd out the provision of other types of public services.

Fiscal and monetary stimulus directed at improving employment conditions and federal support for housing finance will ultimately strengthen the housing market. However, we also need measures that directly address the foreclosure problem. In designing such measures, we must consider the different types of borrowers. First, there are distressed borrowers who can avoid foreclosure through an appropriate modification of their loan. Second, there are some borrowers who, due to resources or circumstance, will be unable or unwilling to sustain their mortgage payments even with reasonable loan adjustments from the lender or support from government programs. In such cases, foreclosures will happen, and we need to limit both the direct costs to the borrower and the broader social costs. Of course, there is a third group of borrowers – those who are still successfully meeting their mortgage obligations. One might be tempted to view these households as a lesser concern, but we must be mindful that they will be more likely to shift into one of the distressed groups if we do not reduce both the number of foreclosures and the cost of the foreclosures that do occur.

Reducing preventable foreclosures

To help distressed households for which foreclosure can be prevented, servicers must implement effective and sustainable modifications. Key private and public steps toward preventing unnecessary foreclosures have already been taken. For example, the industry-led Hope Now Alliance – a coalition of mortgage servicers, lenders, housing counselors, and investors – has produced loss mitigation guidelines for servicers. In addition, Hope Now members have agreed to adopt a streamlined modification program for certain loans that they service for the GSEs. Among government efforts, the FHASecure program provided long-term fixed-rate mortgages to borrowers facing a rise in payments due to an interest rate reset. The more recent FHA "HOPE for Homeowners" (H4H) program, on whose oversight board I sit, allows lenders to refinance a delinquent borrower into an FHA-insured fixed-rate mortgage if the lender writes down the mortgage balance to create some home equity for the borrower and pays an up-front insurance premium. In exchange for being put "above water" on the mortgage, the borrower is required to share any equity created through the refinancing and any subsequent appreciation of the home with the government.

Although the pace of loan modification has picked up over the past year, more needs to be done. Indeed, many cases still seem to be appearing in which foreclosure is occurring even though both the borrower and lender would benefit from avoiding that outcome. There are several potential ways that the Congress and policymakers could help expand the number of at-risk borrowers who can obtain assistance and reduce the incidence of preventable foreclosures. For example, the impact of the H4H program has so far been limited because of the terms and conditions for program loans mandated by the authorizing legislation and because of the general reluctance of servicers and lenders to write down the principal of delinquent mortgages. The Congress is currently considering several modifications to the H4H program that have the potential to make the program more attractive to both servicers and homeowners. These modifications include eliminating the upfront mortgage premium that must be paid by the owner of the current mortgage and the requirement that borrowers share with the government a portion of any future appreciation in the property. Among other options that the Congress or the government might consider is reducing the interest rate that H4H borrowers pay, either through a direct subsidy or through Treasury purchases of the

and Vincent W. Yao (2008), "The Contagion Effect of Foreclosed Properties," Social Science Research Network working paper 1160354 (New York: SSRN, July).

relatively illiquid Ginnie Mae securities to which the borrowers' interest rate is tied. The government might also consider purchasing delinquent or at-risk mortgages in bulk and then refinancing them into the H4H or other FHA programs.

In addition, government funds might be used to offer some general inducement for servicers to modify loans at risk of default. For example, the Federal Deposit Insurance Corporation (FDIC) has proposed that, for loans modified in accordance with a streamlined process adapted from the protocol that the FDIC has used for IndyMac loans, the government would agree to absorb some of the losses on the modified loans that redefault. Another approach would have the government share with the servicer the cost of a reduction in the borrower's monthly payment. Alternatively, the government might make payments directly to homeowners who – because of temporary job loss or a similar event – need help meeting their mortgage obligations.⁴ Because institutional and legal obstacles may be holding back modifications by servicers, these plans could be effective ways to deliver assistance to some distressed homeowners.⁵

While speed and volume in modifications are important, in my view, it is equally essential that the new obligations be sustainable in the long run. By "sustainable" I mean that the payment should be fixed for the life of the loan, it should be affordable, and it should be based upon verified income. In changing the terms of the mortgage, servicers may start with changing the interest rate or adjusting the maturity to make the payments more affordable, but they also need to consider whether writing down loan principal amounts make sense. Doing the latter may be more effective at reducing the probability of redefault.⁶ These design principles for modifications are all included in the Homeownership Preservation Policy recently adopted by the Federal Reserve Board.⁷ The Federal Reserve will apply this policy to the residential mortgage assets held by the special purpose vehicles established by the Federal Reserve to facilitate the acquisition of Bear Stearns by JPMorgan Chase and to assist the American International Group, Inc.

Although it is encouraging that so many policymakers are focused on the issue of loan modifications and making thoughtful proposals, I think it is equally important that the government decide how it wishes to move forward, and then do so. As long as uncertainty exists as to the scope and terms of the additional steps that likely will be offered, borrowers, lenders, and servicers will continue to hold out in hope of securing a better deal. In this case, the cost of delay could easily outweigh the differences in outcome between the proposals. For these reasons, I am pleased that the Administration is moving ahead on this front.

⁴ See, for example, Chris Foote, Jeff Fuhrer, Eileen Mauskopf, and Paul Willen (2009), "A Proposal to Help Distressed Homeowners: A Government Payment-Sharing Plan," Federal Reserve Bank of Boston (January 15).

⁵ For a discussion of these obstacles, see Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang, and Eileen Mauskopf (2008), "The Incentives of Mortgage Servicers: Myths and Realities," Finance and Economics Discussion Series 2008-46 (Washington: Board of Governors of the Federal Reserve System, November).

⁶ The available evidence, though not conclusive, suggests that the homeowner's equity position is, along with affordability, an important determinant of default rates, for owner-occupiers as well as investors. See Shane Sherlund (2008), "The Past, Present, and Future of Subprime Mortgages," Finance and Economics Discussion Series 2008-63 (Washington: Board of Governors of the Federal Reserve System); Kristopher Gerardi, Christopher L. Foote, and Paul S. Willen (2008), "Negative Equity and Foreclosure: Theory and Evidence," Public Policy Discussion Papers 08-3 (Boston: Federal Reserve Bank of Boston, June); and Andrew Haughwout, Richard Peach, and Joseph Tracy (forthcoming), "Juvenile Delinquent Mortgages: Bad Credit or Bad Economy?" *Journal of Urban Economics*.

⁷ See Board of Governors of the Federal Reserve System (2009), "Board Announces Policy to Help Avoid Preventable Foreclosures on Certain Residential Mortgage Assets Held, Owned, or Controlled by a Federal Reserve Bank," press release, January 30; and Board of Governors (2009), "Homeownership Preservation Policy for Residential Mortgage Assets," Board policy, January 30.

Reducing costs when foreclosures cannot be prevented

Without in any way minimizing the need for continued emphasis on foreclosure prevention, I don't believe we can fully formulate appropriate policy responses to the crisis unless we acknowledge and address the large numbers of foreclosures that are not avoidable. We are likely only beginning to see the serious costs of the foreclosures that have already been initiated, both because of the often-substantial amount of time required to complete a foreclosure and because the costs likely compound as the number of foreclosures grows larger. Moreover, even under optimistic assumptions for the number of loan modifications and other forms of private and public assistance that may be realized, the pace at which foreclosures are initiated is likely to remain extremely elevated for some time. Just as public focus, experimentation, and policy debate have informed best practices with regard to loan modifications, we must also begin the work of developing responsible foreclosure and real estate inventory management protocols. Minimizing the amount of time that properties remain vacant and maximizing the price at which they are sold will serve the interests of both lenders and the communities. At this moment, lenders and communities alike are woefully under-resourced and unprepared for the volume of real estate that will need to be processed.

Given the likely number of properties that will enter foreclosure and the time and resources involved in the foreclosure process, financial institutions can help minimize the cost by developing clear policies and procedures for approval of short sales and deeds-in-lieu-of-foreclosure. For homeowners who cannot, or no longer wish to, stay in their homes, such strategies would release them from their obligation and avoid foreclosure. Some institutions offer a so-called fresh start or cash-for-keys program, in which they provide a payment to consumers in exchange for voluntarily surrendering the deed to the home. Such arrangements reduce the cost of foreclosure and effectively provide the borrower with funds that can help offset some of the expenses associated with relocation. Other lenders are offering borrowers the option to remain in the house as renters rather than owners. Options such as these could be offered in conjunction with loan modification programs as further inducement for borrowers to engage in loan resolution discussions.

If renters occupy the property, servicers of REO properties should extend existing lease arrangements, when possible, and while tenants are abiding by the terms of their lease. Some REO owners, including Fannie Mae and Freddie Mac, are already taking steps to minimize the disruption and displacement to renters living in foreclosed-upon properties.

Vacant properties are especially problematic for communities. Ideally, lenders would identify early in the process whether or not property securing delinquent loans is occupied and, if occupied, by whom. Lenders might be provided the incentive to do so if foreclosure laws permitted lenders who agree to secure and maintain the property to accelerate foreclosure in cases where the property has been vacated. If a property is likely to sit vacant for long periods of time and create problems for the surrounding area, servicers might consider sale of REO properties to, or partnerships with, responsible third parties, including local governments and nonprofit groups. And financial institutions should look for ways to partner with community groups and governments to support strategies to stabilize communities affected by foreclosure. Last summer, the Congress set aside \$3.92 billion through the Housing and Economic Recovery Act of 2008 to assist state and local governments with REO purchases and related efforts. It is likely that such efforts will require significantly more funding. In addition, regulators should consider whether to review regulations regarding real estate held for extended periods of time on bank balance sheets to be sure that they do not preclude creative solutions to the foreclosure problem.

The last credit cycle primarily involved loans secured with commercial property. The properties liquidated by banks and the Resolution Trust Corporation weighed on commercial property values for years. This time we are talking about homes, and we are talking about neighborhoods. Whether mortgage assets are taken off banks' balance sheets, ring fenced, or left alone, the REO problem remains the same. Regardless of which entities actually own

the loan assets – be they financial institutions, investors, or government entities – the servicers who represent them are going to have to deal with large real estate inventories. Wholesale dumping of those inventories that leads to sharply lower prices and recovery rates will not serve the interests of the public or the investors. But strategies to avoid dumping and to maximize the ultimate value of the properties could be beyond the normal liquidity and expertise resources of servicers. To avoid such an outcome, owners of the assets will need to adequately fund servicers or separately engage property managers. For example, they may need funding to repair and improve properties, which will lead to higher returns than sale of those same properties in "as is" condition. They may need to offer seller financing. Bulk sale or land banking strategies may offer the best likely outcome. In the most recent credit cycle, much of the commercial inventory was sold through auction, and many of the buyers realized a substantial profit. Using today's technology, Internet auctions could increase the pool of potential buyers as well as price transparency.

Conclusion

In summary, broadly targeted policy is a central ingredient to restoring the health of the U.S. economy and global financial system. However, as I have discussed today, there is also a pressing need for more policy measures that specifically address the problems in the housing sector. We need considerable public support for housing finance until private credit and securitization markets are restarted. We need to strengthen and augment our efforts to reduce preventable foreclosures. In addition, we need to turn far greater attention to limiting the costs of foreclosures that do occur. Such efforts are not only in the interest of the affected families and their communities but also in the interest of the financial institutions involved and the broader economy. Because much of the costs do not occur immediately after a foreclosure has been initiated and can grow with time, we must be forward-looking and affirmatively engage in efforts to mitigate the consequences now.