

The Housing Problem and the Economic Crisis: Evaluating Policy Prescriptions Subprime Crisis Research Consortium White Paper

**Ashok Deo Bardhan
Robert Edelstein
Cynthia A. Kroll**

Executive Summary

The so called subprime crisis is likely to be a major historic milestone for the U.S. and the world economy. The speculative bubble in the housing market began to burst in the United States in 2006, and has been followed by ruptures in virtually every asset market in almost every country in the world (with rare exceptions, such as the U.S. Treasury market). The forces unleashed by the subprime crisis in the United States will probably take many years to dissipate, threatening additional interactive collateral damage in asset markets as well as to the financial system. There are those who believe that the subprime crisis has set in motion fundamental socio-economic changes that will profoundly affect consumer behavior, influence economic outcomes and societal tastes and preferences.

While the housing market and the attendant mortgage sector in the United States is the focus of our analysis, the solutions that we evaluate must be understood in the broader context of the global financial crisis and the entire financial value-chain. It is necessary to “stabilize” the U.S. housing market and the mortgage sector in order to restore economic growth and confidence at home and abroad. However, policies to stabilize the housing market are unlikely to succeed fully unless many of the other asset markets and financial institutions are stabilized simultaneously

Our analysis addresses three intertwined issues:

- What is the genesis of the subprime crisis?
- How effective will existing and proposed housing-mortgage policies be for fixing the subprime crisis?
- What needs to be done, both in terms of research and policy, for a better understanding of the crisis and for the development of policy solutions?

Root Causes of the Subprime Crisis

The confluence of Macroeconomic, social and financial factors caused the housing bubble in the US. Macroeconomic conditions provided several crucial elements. The US consumer debt fueled the trade deficit, which was financed substantially with savings by US trading partners. These global imbalances and capital inflows combined with official Fed interest rate policy (in response to the dot com bust and the recession of 2002) generated cheap debt. There was cheap mortgage money for homebuyers at one end, and a willing pool of global investors in securitized mortgages, at the other.

New borrowers emerged to meet the expanding supply of mortgage money. Homeownership rates rose among younger and lower income households. The financial sector frenetically expanded products to meet the demand from homeowners and satisfy

yield starved investors. Through financial alchemy, investment firms created derivatives with higher ratings than what the underlying securities would support. The fee structure rewarded lenders, mortgage brokers, and securitizers for originations rather than financial product viability, thereby creating incentives for increased transactions. Regulatory laxness passively permitted diluted underwriting standards and predatory lending practices, supporting the growth of subprime and Alt-A mortgages, which were then securitized and sold to investors around the world.

Subsequently, with lower growth in demand for homes, prices began to stabilize or dip slightly and the boom in home construction collapsed. Simultaneously, the many subprime mortgages with interest reset provisions started to come due. Combined with lower sales activity and prices, a self-sustaining loop was created, causing marginal borrowers to default, further worsening the housing market. As home prices sank and mortgage default rates rose, the value of mortgage securities began to decline and the derivatives market started unraveling. The failure of major U.S. financial institutions, heavily invested in dodgy assets, and the repeated need for tens and then hundreds of billions of dollars in government provided funds to keep them afloat, led to a much broader financial crisis not only within the US but globally.

Regional Variations

While this broad process worked its way through the housing market throughout the US, there was considerable geographic variation. For example, median 2007 home values ranged from \$88,000 in Mississippi to \$536,000 in California. At present, states with the largest home value losses are California, Nevada, Florida, Arizona and Michigan. The top five states for subprime shares in total mortgage outstanding (end 2005) were Nevada, Florida, Tennessee, Texas and Arizona, and the top five states with highest share of foreclosures (end of 2007) were Michigan, Ohio, Florida, Nevada and Indiana.

A statistical analysis confirms that the highest share of subprime mortgages were issued in states with populations with younger median age, higher average price growth rates in the recent past (2000-2005), and weaker state-level financial regulatory structures (proxied by per capita expenditures on financial administration and supervision). Higher subprime shares in the recent past were the single most important determinant of higher foreclosure rates. These statewide variations suggest that policy programs will need to take account of regional variations, and that states with strong preexisting regulatory and institutional frameworks may be better positioned to partner workout programs.

Initial Responses at the Federal Level

The avalanche of foreclosures at the local level has drawn responses from both state and federal legislative bodies. At the state level, much of the initial response has been to institute protections for those facing foreclosure and to limit the ability of financial institutions to repeat the mistakes that led to this crisis. The collapse of critical, publicly traded financial institutions and the failure of government sponsored enterprises have drawn responses at the executive and legislative levels of the federal government. At the same time, Congress, as well as regulatory bodies such as the FDIC, have begun

crafting measures to deal not only with the large scale collapse of the credit system, but with the local and individual issues directly related to mortgage default and foreclosure.

The mortgage default and foreclosure problem manifests in several different ways, each of which contributes to the larger crisis: 1) Individual borrowers face payment distress, either because they were not able to afford the initial loan, because rate adjustment decreases their ability to pay, or because of change in income status (such as job loss) has impacted their ability to pay. 2) In weak market areas, the incentive to continue mortgage payments may be eroded by declining values leading to negative equity and “under water” loans. 3) Price decline may accelerate in neighborhoods with numerous foreclosures, because of slower sales where prices are expected to decline further and the impacts of neighborhood quality where foreclosed vacant units pockmark the area. 4) Resolving mortgage issues in problem homes and problem neighborhoods becomes more difficult if the home is underwater, if the loan has been securitized, or if there is more than one lien on the property.

Policy responses to date have nibbled at these issues, but leave large chunks unresolved. Several different programs deal directly with one or more segments of the existing borrower population, with some variation in the types of modifications available.

- HOPE NOW began in late 2007 and was entirely voluntary, with the government role limited to bringing together housing assistance organizations and lenders in the process of reworking loans for distressed borrowers. The program addresses only delinquent loans for single family owner occupants who are not in bankruptcy, and whose loan to value ratio is too high to allow standard refinancing. The primary adjustment offered is to decrease payments to 38 percent of household income, by lowering interest rates, increasing loan duration, or principal forbearance.
- Hope for Homeowners, established by Congressional measure in mid-2008, is also a voluntary agreement between borrower and lender. Borrower owner-occupants may be in default but must have a history of at least 6 payments, may not own a second home, and must have payments greater than 31 percent of income. Both principal and interest rate may be adjusted into a fixed rate loan of no more than 96.5 percent loan to value. Any decrease in principal is offset by shared equity appreciation in the future.
- FDIC has a program for adjusting interest rates and forbearance of principal on at-risk loans in the portfolios of institutions in receivership that has been a proving ground for some of the current government strategies.

Alternative Proposals

Large segments of loans are not addressed by these programs and a number of academics and finance experts have offered advice on how to reach larger groups of borrowers, tackle the negative equity disincentives, or provide further home buying stimulus.

- Caplin, Cunningham, Engler and Pollack suggest a 2-loan solution, one interest bearing with a standard LTV, and a second shared appreciation mortgage with no interest, but a payoff on sale or at the end of the mortgage term

- Martin Feldstein recommends a supplemental government low cost loan for up to 20 percent of the mortgage, with rates based on the cost of funds.
- The Qualified Impaired Mortgage program gives the lender the deed and releases the borrower from the loan. The home occupant may enter a 5 year recovery lease with the option to repurchase the home at its current fair market price at the end of the lease (Alpert).
- Zingales recommends standardized renegotiation at the zip code level, based on changes in the home price index. The mortgage face value would be reduced by the average price decline of the local index, wherever prices had decreased more than 20 percent. On sale, the mortgage holder would receive half of the difference between mortgage value and sale price.
- Hubbard/Mayer call for lowering the mortgage spread between 30 year fixed and 10 year Treasury to its 20-year average of 1.6 percent. They also call for the creation of a modern HOLC, which would share losses on negative equity with lenders, but would also share in future appreciation with homeowners.
- Geanakoplos and Koniak recommend transferring the reworking function from the paralyzed master servicers to government appointed community-based “blind” trustees to work out problem mortgages.
- Blinder, Roubini and others suggest establishing a HOLC-type entity to buy and rework problem loans, while providing counseling to at-risk borrowers and determining when foreclosure is necessary.
- Fix-Housing-First (FHF) recommends stimulating home-buying by an expanded version of this program, applicable to all homebuyers, with “credits” of up to 3.5 percent of the conforming loan limit (possibly as high as \$22,000). They suggest tying requiring repayment only if the home is sold in the first three years. The program would include a subsidized interest rate for a thirty-year fixed rate loan.

The Obama Plan

The program instituted in February 2009 by the Obama administration incorporates a number of existing and recommended approaches, but still falls short of a comprehensive all-inclusive residential rescue program. The major components of the current program are:

- Refinancing for borrowers in good standing—This program helps borrowers with loans held by the GSEs to refinance if reduced equity makes them ineligible for refinancing without assistance.
- Reworked loans for borrowers at-risk of foreclosure—Uses a Treasury-backed plan to reduce monthly payments. Lenders and the program share the costs of reducing payments to equal or less than 31 percent of income. Incentives are offered to servicers to rework loans (in increments over time, to encourage workable loans), to borrowers to stay current, and to lenders through insurance on further declines in home value.

- Increased investment in GSEs to increase confidence in mortgage backed securities, expand availability of loans
- Other types of assistance, from allowing bankruptcy judges to modify mortgages, to renter and neighborhood stabilization assistance.

Several important factors are not addressed in the current version of the Obama plan. First, troubled borrowers still require case-by-case workouts, a time consuming process. If the plan is indeed intended to stem foreclosures, then some type of foreclosure “breathing room” may be necessary for the workout process to succeed. Second, a very large number of the subprime mortgages have been securitized, often into several different products. Legislative action is needed to provide servicers the flexibility and incentives to rework these loans. Third, many of the problems of loans that are deeply under water have not been resolved by the stability initiative. Fourth, many homeowners carry multiple mortgages; there may need to be a more explicit role and responsibility for holders of second mortgages to allow the plan to work smoothly. Fifth, a monitoring system of home prices by region would be useful to determine if the restriction of action to conforming loans is capturing most of the problem.

A Check List for Moving Forward

A quick solution to the mortgage/home price/foreclosure problems will likely engender stabilizing forces for other critical sectors of the economy. Applying our benchmark criteria of i) future mitigation of moral hazard, ii) bang for the buck, iii) fairness and distributive aspects, and iv) judicious mix of short-term and long term solutions, we evaluate all the major, existing housing and mortgage proposals. Going forward, several factors will be important for fostering stability in the housing and residential finance markets;

1. A sustainable, viable plan is likely to require elements of a standardized approach (e.g. for interest rate reduction), as well as triage for case-by-case analysis for loan modifications.
2. Losses and gains may have to be shared among three parties: lenders, borrowers and Government.
3. Legal reform may be necessary in order that refinancing will delink servicers from security investors.
4. Targeting home-buying assistance to areas with high foreclosure rates would bring the support directly to the areas most in need of stabilization.
5. There is little data on “jingle mail” share of foreclosures and on investor-landlords. A method for addressing these homes, perhaps tied to rental assistance, could keep the homes occupied and off the market.
6. An overhaul, restructuring and redistribution of federal and state regulatory responsibilities might combine the best institutional features of both.