March 11, 2010

"If you owe your bank a hundred pounds, you have a problem, but if you owe a million, it has." -- John Maynard Keynes.

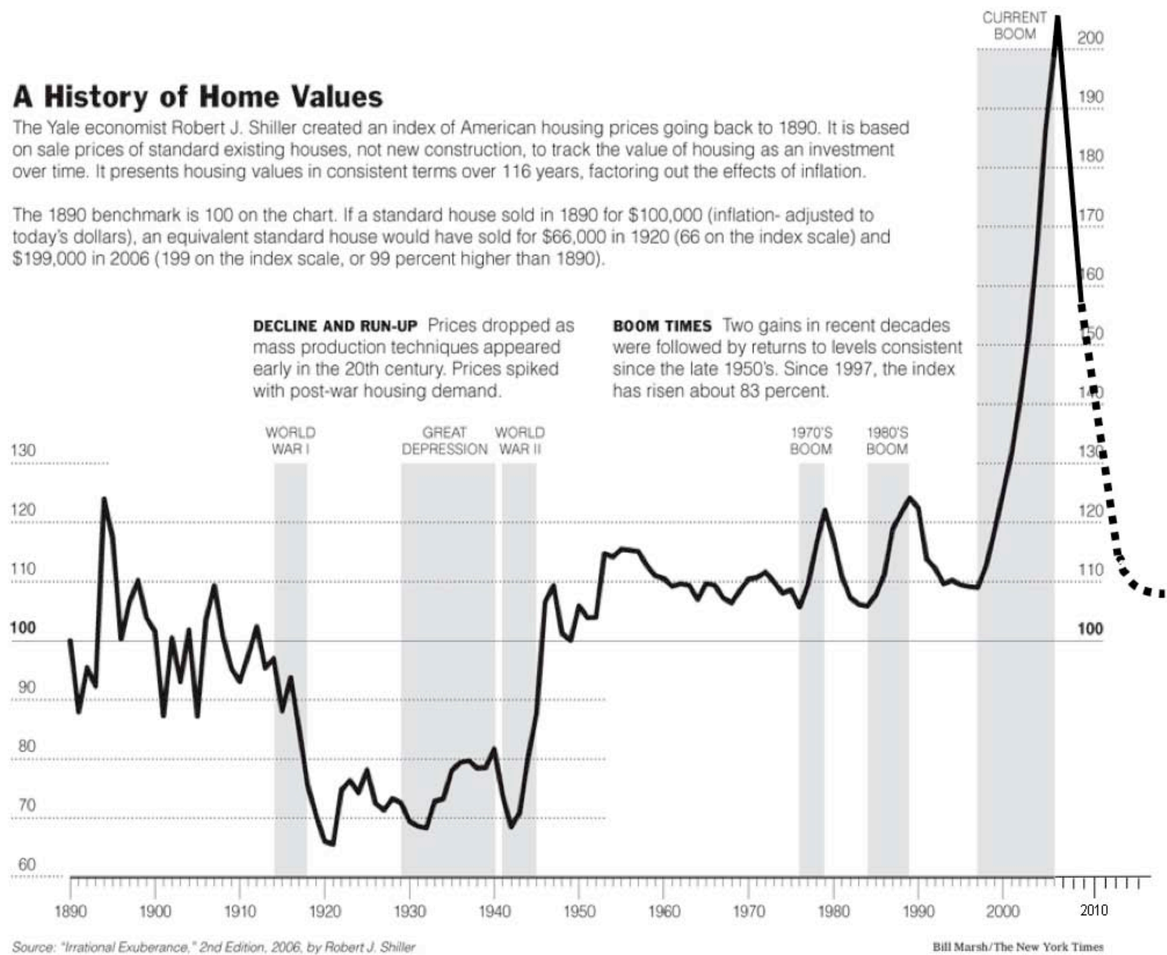
"If you owe your bank a billion pounds, everybody has a problem." --*The Economist.*

THE LEGACY OF LEVERAGE

The recent episode of global economic and financial instability was triggered by a housing boom in the United States (as well as other nations, including the United Kingdom and Spain) that went horribly bust. The housing boom was built on weak lending standards, a surge in household sector debt, and a proliferation of housing-related securities sliced and diced into unrecognizable forms.

Each of these factors has left households and banks struggling under a staggering amount of debt, dimming prospects for robust economic growth in both the U.S. and the rest of the world. The United States is now three years into a sharp and unprecedented home price deflation, which has left households with balance sheets in which the value of what has often been the household's biggest asset – the home – is less than the value of the household's liabilities. Given the unprecedented falls in housing prices that have taken place, assessing how far the U.S. mortgage and real estate markets have come in correcting prior excesses sheds light on the challenges the economy will face.

As measured by the S&P/Case-Shiller price index composite for 10 metro areas, U.S. national home prices have plummeted 32% from their June 2006 peak (see below). The value of residential real estate holdings is estimated by the Federal Reserve to have fallen by $3.4 trillion over the same time period. Falling home prices have devastated household balance sheets and bank balance sheets as well.



According to the latest Mortgage Bankers Association Delinquency Survey data, 4.5 million homes were delinquent or in foreclosure in the fourth quarter of 2009. Enterprise Community Partners, a non-profit that provides capital and expertise for affordable housing development, estimates that each foreclosure depresses the property value of surrounding homes by $6,000. Foreclosed and abandoned properties invite a vicious cycle of blight. The Enterprise report explains that "[a]s homes are foreclosed upon, neighboring home values decline, leading to additional foreclosures." As the Boston Fed noted in 2008, "Lower house values in turn also reduce the net worth of the homeowners and their communities, often limiting their economic mobility and prospects."

In addition to the properties already in foreclosure, housing industry analysts have warned of a large "shadow inventory" of properties due to foreclosure moratoriums, loan modification programs, or the failure of lenders to take ownership of

foreclosed properties or offer them for sale. Standard and Poor's recently estimated that at least 1.75 million properties will need to be foreclosed upon in the next few years.[i] The surge in housing supply when these properties are dumped on the market will further depress house prices and further aggravate the negative equity problem. Regulators have also warned about increasing foreclosures. Late last year, Janet Yellen, President of the San Francisco Federal Reserve Bank, cautioned that the coming months could bring more foreclosures as government programs to prop up the housing market wind down.[ii]

WALKING AWAY

For some U.S. homeowners, being "underwater" in their mortgages — that is, owing more than the house is currently valued — looms large. For example, a homeowner with an 80% loan-to-value ratio on his property in 2006, at the peak of the housing boom, is now facing closer to a 117% loan-to-value ratio, assuming he has experienced the average decline in home prices cited above.

The negative equity that some U.S. homeowners are discovering in their properties has emboldened some to resort to "jingle mail" — where homeowners intentionally default on their mortgages and mail the keys to their houses back to their lenders. Lender Processing Services analyzed 30 million mortgages and found that while only 12% of these mortgages were underwater, these mortgages accounted for nearly half of all the foreclosure activity.

The Administration's efforts to address "underwater" mortgages and stem the foreclosure tide have failed. The **Home Affordable Refinance Program** (**HARP**), for example, has raised the loan-to-value ratio of applicants who can qualify for a Federally subsidized loan refinancing to 125%. Still, even with these favorable bubble-era terms, the volume of refinancing through HARP remains very disappointing.

The **Home Affordable Modification Program** (**HAMP**), which attempts to help homowners by reducing interest payments, has also failed to grapple with the problem of underwater mortgages. A working paper from the Federal Reserve Board made exactly this point:

> *In addition, the program may not be very effective when the value of the mortgage greatly exceeds the value of the home. Some borrowers who believe that there is little prospect for house prices to recover enough to put the mortgage "above water" within some reasonable period of time will not participate in the program and instead walk away from their mortgages. Worse yet, other borrowers may shift beliefs only after entering the program; these borrowers are likely to default after many of the costs associated with the modification have already been borne.*[iii]

In other words, a homeowner offered a HAMP trial modification plan where the monthly payments are reduced can still walk away after making a few cheap payments. In one instance, a HAMP modification plan entailed monthly payments of $1170, when comparable houses were renting for close to $1,500 a month. That's a bargain for the (underwater) homeowner. But it is not so great for the people and institutions assuming the cost of the modifications.

INEVITABLE FORECLOSURES

Despite the Administration's foreclosure prevention initiative, many foreclosures cannot be prevented. In response to this reality, Congress created the **Neighborhood Stabilization Program** (**NSP**) to address the problems posed by foreclosed and abandoned properties.

Of the numerous approaches to resolving the foreclosure crisis, the NSP has consistently been one of the most controversial. The nearly $6 billion dollar program allows states and localities to purchase foreclosed and abandoned properties for sale to low- and moderate-income owner-occupants and for rental development. The program also allows states and localities to provide home purchase financing mechanisms for low- and moderate-income homeowners and to demolish abandoned properties. HERA provided an initial $3.92 billion in funding and distributed money according to a formula grant which prioritized allocations to states and localities based on the number of foreclosures. An additional $1.93 billion was authorized by the American Recovery and Reinvestment Act of 2009 (ARRA) for a competitive grant program to states, localities, and non-profits.

Critics of the program from across the ideological spectrum have highlighted the effectiveness of NSP's approach to addressing the foreclosure crisis. In spite of a nearly

$6 billion price tag, the actual impact that NSP can have on communities is severely limited. NSP funding to states and localities impacted by the foreclosure crisis amounts to little more than a drop in the bucket. The Congressional Research Service estimated that the $5.9 billion of NSP funding would only be able to purchase approximately 30,000 homes using a national median home price of $200,000:

> *According to data from the Mortgage Bankers Association (MBA), an estimated 1.35 million homes were in foreclosure in the third quarter of 2008. Using a national median home price of $200,000, the $5.9 billion in funding for both NSP 1 and 2 activities would buy a total of approximately 30,000 homes in foreclosure, or about 2% of the 1.35 million foreclosed homes. Even if the homes were purchased at half their value, NSP funds would help to purchase only about 4% of all homes in foreclosure. Some observers may question the efficacy of NSP funding in light of the great need for assistance. In addition to the purchase price, recipients of grant funds are responsible for rehabilitating homes, which may further diminish the level of NSP funding available for acquisition activities.*[iv]

A March 2009 paper released by Enterprise Community Partners listed the limitations of the NSP approach. Chief among them was the problem of scale:

> *Even with the additional resources provided to the NSP in the recent economic recovery bill, the amount of funding to deal with foreclosures is not sufficient to the scale of the problem as the economy worsens. In order to address this difficulty, a number of national nonprofits have created the National Community Stabilization Trust (NCST), which is working to consolidate resources to maximize impact and thus help localities and states make best use of their NSP money.*[v]

The limitations of the NSP program and various foreclosure mitigation efforts call into question the most effective means to deal with the foreclosure crisis. Some have argued that the best approach would be to allow the market to take its losses and allow demand for homes to increase naturally as prices decline.

DEALING WITH LEGACY EFFECTS

Mortgages that required low or no down-payments undoubtedly extended the housing boom and increased the homeownership rate in the United States, but as home prices have tumbled down to earth, these products have come back to haunt the mortgage market. Research produced by First American Financial on changes in

underwriting standards between 1998–2006 found the following shifts in the share of new originations:

- Adjustable-rate mortgages rose from 0.7% to 69.5%
- Negative amortization rose from 0% to 42.2%
- Interest-only loans rose from 0.1 % to 35.6%.

Each of these changes to lending patterns increased the vulnerability of homeowners to home price deflation — something previously believed to be impossible on a nationwide level. Option adjustable-rate mortgages and Alt-A loans have interest rate reset schedules that are ramping up now and due to peak in the middle of 2010. In other words, homeowners have yet to be completely exposed to these vulnerabilities. In addition, it is not just borrowers who are exposed — lenders also will need to brace for loan losses. At the peak of the housing boom, commercial bank holdings of mortgages reached 32% of bank financial assets. The prior peak exposure was closer to 25% back in 1990.

The legacy of the housing bubble weighs heavily on households that find the market value of their homes is now less than the mortgage debt they are carrying. This assault on household balance sheets is typical of what Richard Koo, chief economist of the Nomura Research Institute, describes as a balance sheet recession, in which a steep drop in asset prices causes businesses and households to curtail spending and reduce risk by deleveraging. In a balance sheet recession, conventional monetary policy responses have little effect:

> *In these cases, after an asset pricing shock, after a bubble bursts, the private sector's balance sheets are underwater. When that happens, the first priority of people in the private sector becomes to minimize debts instead of to maximize profits. And if there are enough underwater balance sheets around, even if you bring interest rates down to zero, still nothing happens.*[vi]

Unfortunately, there are no easy solutions to the problem of underwater mortgages. Conceptually, there are three ways out of such an impasse:

1. Mortgage principal can be paid down or written down;

2. Private incomes can be buttressed with fiscal stimulus to improve the ability of households to continue servicing existing mortgages; or

3. Housing market appreciation can be encouraged to reverse the negative net worth position facing many households.

Though policymakers are frantically attempting to make progress on all three fronts, there is good reason to expect the trajectory of U.S. consumer spending in any economic recovery will prove shallower than usual, given that 20–30% of homeowners are currently estimated to be underwater with their mortgages. Slow consumer spending is, again, the consequence of the balance sheet recession; the consumer will not spend if he is underwater.

FURTHER READING

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END NOTES

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