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Housing, Mortgage Markets, and Foreclosures

Remarks by

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The U.S. financial system has been in turmoil during the past 16 months. Credit conditions have tightened and asset values have declined, contributing substantially, in turn, to the weakening of economic activity. As the participants in this conference are keenly aware, I am sure, housing and housing finance played a central role in precipitating the current crisis. As the crisis has persisted, however, the relationships between housing and other parts of the economy have become more complex. Declining house prices, delinquencies and foreclosures, and strains in mortgage markets are now symptoms as well as causes of our general financial and economic difficulties. These interlinkages imply that policies aimed at improving broad financial and economic conditions and policies focused specifically on housing may be mutually reinforcing. Indeed, the most effective approach very likely will involve a full range of coordinated measures aimed at different aspects of the problem.

I will begin this morning with some comments on developments in the housing sector and on the interactions among house prices, mortgage markets, foreclosures, and the broader economy. I will then discuss both some steps taken to date and some additional measures that might be taken to support housing and the economy by reducing the number of avoidable foreclosures. As we as a nation continue to fashion our policy responses in coming weeks and months, we must draw on the best thinking available. I expect that the papers presented at this conference will add significantly to our understanding of these important issues.

Developments in Housing and Housing Finance

As you know, the current housing crisis is the culmination of a large boom and bust in house prices and residential construction that began earlier in this decade. Home sales and single-family housing starts held unusually steady through the 2001 recession and then rose dramatically over the subsequent four years. National indexes of home prices accelerated significantly over that period, with prices in some metropolitan areas more than doubling over the first half of the decade.[1] One unfortunate consequence of the rapid increases in house prices was that providers of mortgage credit came to view their loans as well-secured by the rising values of their collateral and thus paid less attention to borrowers' ability to repay.[2]

However, no real or financial asset can provide an above-normal market return indefinitely, and houses are no exception. When home-price appreciation began to slow in many areas, the consequences of weak underwriting, such as little or no documentation and low required down payments, became apparent. Delinquency rates for subprime mortgages--especially those with adjustable interest rates--began to climb steeply around the middle of 2006. When house prices were rising, higher-risk borrowers who were struggling to make their payments could refinance into more-affordable mortgages. But refinancing became increasingly difficult as many of these households found that they had accumulated little, if any, housing equity. Moreover, lenders tightened standards on higher-risk mortgages as secondary markets for those loans ceased to function.

Higher-risk mortgages are not the only part of the mortgage market to have experienced stress. For example, while some lenders continue to originate so-called jumbo prime mortgages and hold them on their own balance sheets, these loans have

[1] Estimates for specific metropolitan areas are based on Case-Shiller Home Price Indexes.
[2] See Kristopher Gerardi, Andreas Lehnert, Shane Sherlund, and Paul Willen (forthcoming), "Making Sense of the Subprime Crisis," Brookings Papers on Economic Activity (Washington: Brookings Institution Press). Also see Chris Mayer, Karen Pence, and Shane Sherlund (2008), "The Rise in Mortgage Defaults," Finance and Economics Discussion Series 2008-59 (Washington: Board of Governors of the Federal Reserve System, November).

generally been available only on more restrictive terms and at much higher spreads relative to prime conforming mortgage rates than before the crisis. Mortgage rates in the prime conforming market--although down somewhat from their peaks--remain high relative to yields on longer-term Treasury securities, and lending terms have tightened for this segment as well.

As house prices have declined, many borrowers now find themselves "under water" on their mortgages--perhaps as many as 15 to 20 percent by some estimates. In addition, as the economy has slowed and unemployment has risen, more households are finding it difficult to make their mortgage payments. About 4-1/2 percent of all first-lien mortgages are now more than 90 days past due or in foreclosure, and one in ten near-prime mortgages in alt-A pools and more than one in five subprime mortgages are seriously delinquent.[3] Lenders appear to be on track to initiate 2-1/4 million foreclosures in 2008, up from an average annual pace of less than 1 million during the pre-crisis period.[4]

Predictably, home sales and construction have plummeted. Sales of new homes and starts of single-family houses are now running at about one-third of their peak levels in the middle part of this decade. Sales of existing homes, including foreclosure sales, are now about two-thirds of their earlier peak. Notwithstanding the sharp adjustment in construction, inventories of unsold new homes, though down in absolute terms, are close to their record high when measured relative to monthly sales, suggesting that residential construction is likely to remain soft in the near term.

[3] Estimates of delinquencies are based on data from the Mortgage Bankers Association and from First American LoanPerformance.
[4] Foreclosure starts are based on data from the Mortgage Bankers Association, adjusted to reflect the limited coverage of their sample. Historically, about half of foreclosure starts resulted in the borrower losing the home, but recent rates appear higher.

As I mentioned earlier, the problems in housing and mortgage markets have become inextricably intertwined with broader financial and economic developments. For example, mortgage-related losses have eroded the capital of many financial institutions, leading them to become more reluctant to make not only mortgage loans, but other types of loans to consumers and businesses as well. Likewise, some homeowners have responded to declining home values by cutting back their spending, and residential construction remains subdued. Thus, weakness in the housing market has proved a serious drag on overall economic activity. A slowing economy has in turn reduced the demand for houses, implying a further weakening of conditions in the mortgage and housing markets.

Reducing Preventable Foreclosures

Because developments in the housing sector have become so interlinked with the evolution of the financial markets and the economy as a whole, both macro and micro policies have a role in addressing the strains in housing. At the macro level, the Federal Reserve has taken a number of steps, beginning with the easing of monetary policy. To the extent that more accommodative monetary policies make credit conditions easier and incomes higher than they otherwise would have been, they support the housing market.

The Federal Reserve has also implemented a series of actions aimed at restoring the normal functioning of financial markets and restarting the flow of credit, including providing liquidity to a range of financial institutions, working with the Treasury and the Federal Deposit Insurance Corporation (FDIC) to help stabilize the banking system, and providing backstop liquidity to the commercial paper market. The Federal Reserve supported the actions by the Federal Housing Finance Agency (FHFA) and the Treasury to put the housing-related government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, into conservatorship, thereby stabilizing a critical source of mortgage credit. The Federal Reserve has also recently announced that it will purchase up to $100 billion of the debt issued by Fannie Mae, Freddie Mac, and the Federal Home Loan Banks and up to $500 billion in mortgage-backed securities issued by the GSEs.

Although broad-based macroeconomic policies help to create an economic and financial environment in which a housing recovery can occur, policies aimed more narrowly at the housing market are important, too. In the remainder of my remarks, I will focus on policy options for reducing preventable foreclosures.

Foreclosures impose large costs on families who face the loss of their homes and reduced future access to credit. But the public policy case for reducing preventable foreclosures does not rely solely on the desire to help people who are in trouble. Foreclosures create substantial social costs. Communities suffer when foreclosures are clustered, adding further to the downward pressure on property values. Lower property values in turn translate to lower tax revenues for local governments, and increases in the number of vacant homes can foster vandalism and crime.[5] At the national level, the declines in house prices that result from the addition of foreclosed properties to the

[5] For evidence that concentrations of foreclosures lead to lower house prices throughout the neighborhood, 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, and Yao Vincent (2008), "The Contagion Effect of Foreclosed Properties," Social Science Research Network working paper 1160354 (July), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1160354.

supply of homes for sale create broader economic and financial stress, as I have already noted.[6]

On the surface, private economic incentives to avoid foreclosure would appear to be strong for the lender as well as the borrower. Foreclosure dissipates much of the value of the property: Indeed, recent losses on defaulted subprime mortgages have averaged around 50 to 60 percent of the loan balance.[7] Besides the general decline in property values and foregone payments, fees related to foreclosure, such as court costs, maintenance expenses, and others, can amount to 10 to 15 percent of the loan balance; furthermore, the discount in value due to foreclosure status can be an additional 5 to 15 percent.[8]

However, despite the substantial costs imposed by foreclosure, anecdotal evidence suggests that some foreclosures are continuing to occur even in cases in which the narrow economic interests of the lender would appear to be better served through modification of the mortgage. This apparent market failure owes in part to the widespread practice of securitizing mortgages, which typically results in their being put into the hands of third-party servicers rather than those of a single owner or lender. The rules under which servicers operate do not always provide them with clear guidance or the appropriate incentives to undertake economically sensible modifications.[9] The

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[6] To be sure, policy should not attempt to keep house prices from falling sufficiently to stabilize the demand for housing. But preventing avoidable foreclosures does not block necessary adjustments. Indeed, failing to prevent such foreclosures may heighten the risk that house prices will move lower than they would otherwise need to go.

[7] See J.P. Morgan (2008), “SOS--Summary of Subprime, Alt-A, Prime Jumbo,” Global Structured Finance Research (November 2); and Credit Suisse (2008), “Deep Dive into Subprime Mortgage Severity,” Fixed Income Research Report (June 19).

[8] See “Deep Dive,” note 8.

[9] Servicers of mortgages in securitized pools must abide by the pooling and servicing agreements, which state what modifications may be prohibited but provide limited guidance about what types of modifications investors would consider to be appropriate. See Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie

problem is exacerbated because some modifications may benefit some tranches of the securities more than others, raising the risk of investor lawsuits. More generally, the sheer volume of delinquent loans has overwhelmed the capacity of many servicers, including portfolio lenders, to undertake effective modifications.

During more normal times, mortgage delinquencies typically were triggered by life events, such as unemployment, illness, or divorce, and servicers became accustomed to addressing these problems on a case-by-case basis. Although taking account of the specific circumstances of each case remains important, the scale of the current problem calls for greater standardization and efficiency. Loan modification programs with clearly defined protocols can both help reduce modification costs and protect servicers from the charge that they have acted arbitrarily. The federal banking regulators have urged lenders and servicers to work with borrowers to avoid preventable foreclosures. The regulators recently reiterated that position in a joint statement that encouraged banks to make the necessary investments in staff and capacity to meet the escalating workload and to adopt systematic, proactive, and streamlined modification protocols to put borrowers in sustainable mortgages.[10]

A number of initiatives have attempted to address the problem of unnecessary foreclosures. Working in collaboration with the Treasury Department, the Hope Now Alliance, a coalition of mortgage servicers, lenders, housing counselors, and investors--led by Faith Schwartz, a member of the Fed's Consumer Advisory Council--has produced

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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).

[10] See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision (2008), "Interagency Statement on Meeting the Needs of Creditworthy Borrowers," joint press release, November 12, www.federalreserve.gov/newsevents/press/bcreg/20081112a.htm.

a set of guidelines that participating servicers have agreed to use as they work to prevent foreclosures. In addition, servicers in the Alliance agreed to delay foreclosure proceedings if an alternative approach might allow the homeowners to stay in their home. Recently, in conjunction with the FHFA, the coalition announced that its members will adopt a streamlined modification program for certain loans that they service for the GSEs. This program will closely follow the one that the FDIC has introduced for modifying the loans in the portfolio that it took over from IndyMac.[11]

The Federal Reserve has also been actively supporting efforts to prevent unnecessary foreclosures. Through the System's Homeownership and Mortgage Initiative, we have conducted studies on housing and foreclosures, provided community leaders with detailed analyses to help them better target their borrower outreach and counseling efforts, and convened forums like this one to facilitate the exchange of ideas and the development of policy options. Taking advantage of the Federal Reserve's nationwide presence, the twelve Reserve Banks have sponsored or co-sponsored more than 100 events related to foreclosures around the country since last summer, bringing together more than 10,000 lenders, counselors, community development specialists, and policymakers. A particular focus of the Fed's efforts has been the mitigation of the costs to communities of high rates of foreclosure. For example, we have partnered with NeighborWorks America on a neighborhood stabilization project and helped them develop responses to community needs as well as train local leaders.

Beyond these efforts, two government programs to facilitate loan modifications have been authorized, both through the Federal Housing Administration (FHA). The

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[11]In addition, Hope Now has been an important source of data on loss-mitigation activity. The loan-level data that they plan to provide in the future will be useful for analyzing the relative effectiveness of alternative strategies for loan modifications.

FHASecure program has provided long-term fixed-rate mortgages to borrowers facing a rise in payments due to an interest rate reset. Another, more recent program, dubbed Hope for Homeowners (H4H), allows lenders to refinance a delinquent borrower into a new, 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 subsequent appreciation of the home with the government.

Although the basic structure of the H4H program is appealing, some lenders have expressed concerns about its complexity and cost, including the requirement in many cases to undertake substantial principal write-downs. As a result, participation has thus far been low. In response to these concerns, the board of the H4H program--on which Governor Duke represents the Federal Reserve--recently approved a number of changes, using the authority granted to it under the Emergency Economic Stabilization Act (EESA). These changes would reduce the necessary write-down on some loans, address the complications caused by subordinate liens by permitting up-front payments to those lien holders, allow lenders to extend mortgage terms from 30 to 40 years to increase affordability, and eliminate the trial modification period to expedite loan closings. It is still too early to know what the ultimate demand for H4H loans under this set of rules will be, but as I will discuss further momentarily, a case can be made for further adjusting the terms of the program to make it more attractive to both lenders and borrowers.

Despite good-faith efforts by both the private and public sectors, the foreclosure rate remains too high, with adverse consequences for both those directly involved and for the broader economy. More needs to be done. In the remainder of my remarks I will discuss, without ranking, a few promising options for reducing avoidable foreclosures. These proposals are not mutually exclusive and could be used in combination. Each would require some commitment of public funds.

To be effective, loan modifications should aim to put borrowers into mortgages that they can afford over the longer term. During more normal times, many homeowners could be helped with a temporary repayment plan--for example, a deferral of interest payments for a period. But under the current circumstances, with house prices declining and credit tight, permanent loan modifications will often be needed to create sustainable mortgages and keep people in their homes. Most current proposals to reduce foreclosures incorporate this view and thus emphasize permanent modifications.

A more difficult design question turns on the extent to which the probability of default or redefault depends on the borrower's equity position in the home, as well as on the affordability of the monthly payment. Although not conclusive, the available evidence suggests that the homeowner's equity position is, along with affordability, an important determinant of default rates, for owner-occupiers as well as investors. If that evidence is correct, then principal write-downs may need to be part of the toolkit that servicers use to achieve sustainable mortgage modifications.[12]

[12] Studies tend to find that equity positions matter most for default rates when they interact with other contributing factors; for example, numerous studies have found that borrowers are more likely to default when house prices have fallen *and* incomes decline. At the household level, such "double triggers" may induce defaults because of cash flow constraints or because continuing to make payments on a mortgage whose balance significantly exceeds the value of the house is more difficult to justify when the family budget is strained. See Shane Sherlund (forthcoming), "The Past, Present, and Future of Subprime Mortgages," Finance and Economics Discussion Series (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), www.bos.frb.org/economic/ppdp/2008/ppdp0803.pdf; and Haughwout, Andrew, Richard Peach, and Joseph Tracy (forthcoming), "Juvenile Delinquent Mortgages: Bad Credit or Bad Economy?" *Journal of Urban Economics*.

If one accepts the view that principal write-downs may be needed in cases of badly underwater mortgages, then strengthening the H4H program is a promising strategy, as I have noted. Beyond the steps already taken by the H4H board, the Congress might consider making the terms of H4H loans more attractive by reducing the up-front insurance premium paid by the lender, currently set in law at 3 percent of the principal value, as well as the annual premium paid by the borrower, currently set at 1-1/2 percent. The Congress might also grant the FHA the flexibility to tailor these premiums to individual risk characteristics rather than forcing the FHA to charge the same premium to all borrowers.

In addition, consideration might be given to reducing the interest rate that borrowers would pay under the H4H program. At present, this rate is expected to be quite high, roughly 8 percent, in part because it is tied to the demand for the relatively illiquid securities issued by Ginnie Mae to fund the program. To bring down this rate, the Treasury could exercise its authority to purchase these securities, with the Congress providing the appropriate increase in the debt ceiling to accommodate those purchases. Alternatively, the Congress could decide to subsidize the rate.

A second proposal, put forward by the FDIC, focuses on improving the affordability of monthly payments. Under the FDIC plan, servicers would restructure delinquent mortgages using a streamlined process, modeled on the IndyMac protocol, and would aim to reduce monthly payments to 31 percent of the borrower's income. As an inducement to lenders and servicers to undertake these modifications, the government would offer to share in any losses sustained in the event of redefaults on the modified mortgages and would also pay $1,000 to the servicer for each modification completed.[13] The strengths of this plan include the standardization of the restructuring process and the fact that the restructured loans remain with the servicer, with the government being involved only when a redefault occurs.

As noted, the FDIC plan would induce lenders and servicers to modify loans by offering a form of insurance against downside house price risk. A third approach would have the government share the cost when the servicer reduces the borrower's monthly payment. For example, a servicer could initiate a modification and bear the costs of reducing the mortgage payment to 38 percent of income, after which the government could bear a portion of the incremental cost of reducing the mortgage payments beyond 38 percent, say to 31 percent, of income. This approach would increase the incentive of servicers to be aggressive in reducing monthly payments, which would improve the prospects for sustainability. Relative to the FDIC proposal, this plan would pose a greater operational burden on the government, which would be required to make payments to servicers for all modified loans, not just for loans that redefault. However, this approach could leverage existing modification frameworks, such as the FDIC/IndyMac and Hope Now streamlined protocols, and in this respect would build on, rather than crowd out, private-sector initiatives.

[13] The original plan would have had the government share half of any loss incurred by the lender, regardless of how far underwater the loan might have already been by the time of modification. The latest version of the plan modifies this provision by offering lower loss-sharing rates for loans that have loan-to-value (LTV) ratios above 100 percent at the time of the modification. Under the modified plan, the loss-sharing rate declines from 50 percent on a loan with an LTV of 100 percent at the time of modification to 20 percent on a loan with a LTV of 150 percent. Loans with LTVs of more than 150 percent at the time of modification do not qualify for loss-sharing. An alternative way to address this concern would be to base the amount of the government insurance payment on the loss in value relative to the appraised value of the property at the time of the loan modification.

Yet another promising proposal for foreclosure prevention would have the government purchase delinquent or at-risk mortgages in bulk and then refinance them into the H4H or another FHA program. This approach could take advantage of the depressed market values of such mortgages, and buying in bulk might help avoid adverse selection problems. In addition, scale efficiencies could be achieved by contracting with specialty firms (perhaps including the GSEs) capable of re-underwriting large volumes of loans to make them eligible for H4H or another program. The Treasury has already considered how to undertake bulk purchases as part of its work under EESA, and the Federal Reserve has submitted to the Congress an analysis of bulk purchases per a legislative requirement in the H4H bill. Even so, this program could take some time to get up and running, and the re-underwriting required for H4H loans would likely take more time and incur greater operational costs than other plans. But such an approach could result in many homeowners being refinanced into sustainable mortgages.

Conclusion

The housing market remains central to the economic and financial challenges that we face. Because housing and mortgage markets are tightly interlinked with the rest of the economy, actions to strengthen financial markets and the broader economy are important ways to address housing issues. By the same token, steps that stabilize the housing market will help stabilize the economy as well.

In this regard, reducing the number of preventable foreclosures would not only help families stay in their homes, it would confer much wider benefits. Significant efforts have been taken in this direction, but more can be done. Today I have briefly discussed a few promising options, which are not necessarily mutually exclusive. As we as a country consider ways to address our financial and economic challenges, policy initiatives to reduce the number of preventable foreclosures should be high on the agenda.