



“Housing and the Economy: Perspectives and Possibilities”

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It is a pleasure to be with you this evening. We all know that housing and mortgage lending have played central roles in the dramatic economic and financial developments of the last year and a half. As a central banker, I welcome opportunities to meet with and hear from you in the industry, and to share my views on housing markets, the economy, and policy options with you.¹ So I thank you for inviting me to join you this evening.

The Economic Outlook

By way of introduction, I would like to make a few observations on the economic situation. With the holidays concluded, it is clear that sales fell short of expectations for many retailers. Despite significant discounting it seems that consumers, worried about the economy and their own economic situation, curtailed their spending. Indeed, it appears that the economy contracted quite significantly in the final quarter of 2008, and may continue contracting over the first half of 2009. We are seeing businesses retrenching and unemployment rising, and many of our international trading partners expect equally grim results.

As a result, this recession looks to be longer and more severe than was originally forecast. Still, there are indications that the second half of the year will show improvement.

Consider several developments. Energy prices have fallen dramatically, making it much less expensive to drive cars or heat homes, freeing up much-needed cash flow for many consumers. Fiscal-stimulus packages being discussed in Washington could provide an economic boost. And monetary policy is also contributing. With the federal funds rate at historic lows, in a range only slightly above zero, and various lending facilities helping to lower the elevated spreads on many interest rates, the result is that many short-term interest rates are now significantly below the levels seen at the end of the third quarter. Also, recent actions by the Federal Reserve to reduce mortgage rates are having an impact, with mortgage rates already falling about 100 basis points from the end of the third quarter. While all of these developments will take a little time to fully impact the economy, they should be sowing the seeds for a recovery later in 2009.

Observations on the Housing Market

Now I would like to turn to the focus of my remarks, the housing market. By way of context, residential investment² has been declining since the first quarter of 2006 (see **Figure 1**, which plots the quarterly percent change), and this decline in residential investment is already of notable length and depth relative to previous housing downturns.³

It goes without saying that it is important to the broader economy that the housing market stabilizes. Normally, housing markets decline because mortgage interest rates have risen and the higher cost of obtaining a mortgage weighs down residential investment. During more normal times, the Federal Reserve can address this by reducing the federal funds rate, a step that usually helps to lower mortgage rates – and the housing market improves.

But this housing downturn is different. Increasingly, the housing market is impacted more by the *availability* of credit than the *cost* of credit.

Borrowers who have poor credit histories or little equity in their homes are having difficulty finding mortgages – even higher-rate mortgages. Borrowers looking for home equity loans or seeking to refinance are finding that falling housing prices have reduced their ability to borrow against the value of their home. Borrowers that stretched to purchase or refinance their home are finding it difficult to stay current on mortgage payments if a family member is laid off or assigned reduced hours, or if other problems strike the household.

Given all these factors, it is important to recognize that no *one* solution is likely to fix our housing market challenges. And let me be clear, I am not for a moment suggesting the return of lax underwriting standards. Rather, I am suggesting that with a variety of well-designed approaches, tailored to current problems, the housing market can and should stabilize – by which

I mean easing the difficulties with the cost and availability of mortgage credit that we are seeing, which in turn would support housing markets more generally.

I plan tonight to first discuss some recent trends in the housing market. I will then touch on actions that could influence the *cost* of financing for housing. I will then discuss some actions that could influence the *availability* of financing for housing – especially for troubled borrowers – before offering a few concluding remarks.

I. Recent Trends in Housing

As **Figure 2** illustrates, single-family housing starts have declined precipitously from their peak in January 2006. The extent of the decline is so striking, in part, because of the large increases in housing starts that occurred over this decade. But housing starts are at their lowest level in the past 50 years – and many private forecasters suggest they have not yet bottomed out.

Of course, the decline in housing starts is playing a necessary role in reducing the excess inventory of new homes for sale. As shown in **Figure 3**, there has been a substantial decline in that inventory – although at 374,000 units for sale as of November, new homes for sale still remain above the historical average.

Sales have declined for new homes of all price ranges. For the most expensive homes, “jumbo” mortgage rates remain very elevated relative to conventional mortgages. At the other end of the spectrum, purchasers of the least expensive homes are having great difficulty securing financing if they have little down payment equity, or low credit scores.

A critical aspect of the current situation has been the disruption of the securitization⁴ process, where mortgages are sold to be part of a security backed by many (pooled) mortgages,

and re-sold onto the secondary market to investors. For expensive homes that are financed with jumbo mortgages, the disruptions in securitization have caused rates on jumbo mortgages to rise even while the federal funds rate has dropped sharply. Prior to the financial-market disruptions that began in August 2007, jumbo mortgage rates had moved closely with conventional mortgage rates, with an approximately 25 basis-point premium over conventional mortgages (see **Figure 4**). However, the spread became quite large as securitizing jumbo mortgages became increasingly difficult. Many jumbo mortgages were provided by portfolio lenders who began to demand a premium over what they had required when the loans could be more easily securitized.

The current government-sponsored enterprise (GSE) cut-off for jumbo mortgages is \$417,000 nationally, although the limit is \$625,500 in some areas with particularly high costs of housing⁵ and is somewhere between \$417,000 and \$625,000 in certain cities and counties. In places with a relatively high cost of housing, the large premium for jumbo mortgages is a deterrent to home purchases. Raising the maximum amount on conforming mortgages would likely go some way towards reducing this spread, by making it easier for the industry to securitize home loans and thus for borrowers to purchase homes in regions where housing costs are high.

Of course, securitization is also disrupted for subprime⁶ and Alt-A loans. The result has been that borrowers with limited down-payments, low credit scores, or other issues are finding it increasingly difficult to obtain mortgage financing – even at rates well above conventional prime mortgages.

With the securitization market not seeming ready to recover in the near term, one thinks of the traditional way that low- and moderate-income borrowers qualified for mortgages prior to

the expansion of the subprime market – through Federal Housing Administration (FHA) lending programs. They alleviate some of the risk of lending to borrowers who can only afford a small down payment and therefore might have difficulty obtaining a conventional mortgage product.

However, many would say that FHA lending has a reputation for bureaucracy and unwieldiness. By many accounts, FHA has been working to address this, and there have been significant modifications made to traditional FHA lending programs. At the Boston Fed we have developed a brief guide with questions and answers that may be helpful to institutions considering becoming an FHA lender – either a correspondent or a full mortgagee.⁷ The resource is available on our website.⁸

FHA mortgage lending expanded quite significantly in the latter half of 2008. Still, many banks remain unwilling to participate. Making these programs more accessible to borrowers and banks would help ensure that low- and moderate-income borrowers can obtain financing, which should help stabilize the market for lower-priced homes.

II. Policies that Influence the Cost of Financing for Housing

As we consider steps that could assist the recovery of housing markets, I would now like to share some perspectives on the potential for policies to influence the cost of financing for housing. Over the past 18 months, the Federal Reserve aggressively lowered the federal funds rate, as financial problems worsened and the economic outlook deteriorated. But despite aggressive easing, many interest rates in the marketplace remained high, or rose – thus, the “spreads” between overnight fed funds and many rates in the marketplace widened considerably.

These elevated spreads reflected investors' pessimism about the economic outlook and lack of liquidity in many financial markets. The lack of liquidity raised investors' concerns about their ability to resell financial assets other than Treasury securities without very steep discounts. This has been particularly evident for assets with longer maturities, lower credit quality, or structured financing. The sharply discounted sale prices on some mortgage-backed securities implied a very bleak outlook for default experience.

While the federal funds rate declined substantially over the past 18 months, the rates that many borrowers paid to finance assets rose, or declined by much less than would have been expected given the decline in the federal funds rate. This unusually large widening of interest-rate spreads implies that the transmission mechanism for monetary policy has been impacted. If the goal of monetary policy is to avoid severe economic problems and maintain liquid markets, the evident disruption to the transmission mechanism implies that more than just a lower base rate is needed.

So, over the past year the Federal Reserve System designed a variety of liquidity facilities, aimed in large part at reducing the interest rate spreads on short-term, high-quality assets. In particular, the interbank loan market (as reflected in the London Interbank Offered Rate or LIBOR) and the market for short-term commercial paper saw extremely high spreads, as **Figures 5 and 6** show. Because the central bank established a variety of liquidity facilities designed to address these markets, the spreads have declined substantially. Further evidence of reduced stress in short-term markets comes from the Federal Reserve's Term Auction Facility (TAF), where the auctions have recently been under-subscribed and stop-out rates have been equal to the Overnight Index Swap (OIS) rate.

As investors become more confident that they can sell assets if needed, the premium on liquidity falls, and interest spreads decline. By supporting short-term credit markets, the Federal Reserve is signaling its determination to take appropriate actions to prevent “seize-ups” in financial markets, reducing the risk premium. In short, we have seen improvements of late in the functioning of many short-term credit markets, and I expect this improvement will continue.

Improvements in short-term credit markets do have indirect effects on the housing market. Some mortgages, particularly sub-prime loans, were tied to the six-month LIBOR rate. As short-term rates have fallen, those who either refinance or whose adjustable rate mortgages adjust are suffering smaller payment shocks.

However, many interest rates remained relatively unresponsive to the decline in the federal funds rate. **Figure 7** shows that during 2007 and the first half of 2008, mortgage rates remained around 6 percent and the rates on “Baa” rated corporate bonds actually rose. As conditions in the short-term credit markets have started to improve, and as the base federal funds rate is trading between 0 and 25 basis points, it seems that improving housing finance is likely to take concerted fiscal and monetary policy actions.

On the *fiscal* side, it is possible that Fannie Mae and Freddie Mac could play a more significant role in restoring liquidity and providing a secondary market for mortgages that reflect the lower cost of funds in many credit markets. Further exploration of the GSEs’ options for pricing and programs may result in additional support to the mortgage market.

On the *monetary* policy side, the Federal Reserve announced on November 25 that it would be buying up to \$100 billion in GSE direct obligations, and up to \$500 billion in mortgage-backed securities.⁹ A subsequent announcement on December 30 provided more

details.¹⁰ Since the announcement of the program, designed to reduce the recently widening rate spreads on GSE debt and on GSE-guaranteed mortgages, mortgage rates have declined (see **Figure 8**). Some mortgages in Boston are now available for under 5 percent.

Lower mortgage rates help alleviate the current problems in several ways. *First*, potential home buyers have the possibility of buying their homes with the lowest rates in the past 30 years. Because interest rates may only be lower temporarily, they provide an incentive for buyers to purchase now rather than wait in the hope that home prices fall more. In terms of cash flow, locking in a lower rate now may be more important than potentially buying the home at a somewhat lower price, later. Obviously, getting buyers “off the sidelines” and back into the market is critical for a housing market recovery. *Second*, the lower rates provide the opportunity to refinance. This can improve cash flow, freeing up household resources to fix up the home or consume other items. *Third*, lower rates have the advantage of benefiting credit-worthy borrowers as well as more troubled homebuyers.

Low mortgage rates primarily benefit home buyers with significant equity for a down payment and good credit scores, and borrowers that seek to refinance and still have significant equity in their house as well as good credit scores. However, if prices stabilize, home owners and holders of mortgage instruments will benefit. Since stabilizing the housing market is critical, expanded use of policies that address the cost of housing finance may give further impetus for new home buyers and existing mortgage holders to take advantage of what are very low rates by historical standards.

III. Troubled Homebuyers and the Availability of Financing for Housing

Now a few comments on the *availability* of home finance. Clearly, there are many borrowers that are unlikely to fully benefit from the aforementioned lower mortgage rates, because they have negative home equity or poor credit scores. It can be helpful to think of these troubled borrowers in segments. There are those who are stressed but still making their payments, despite impaired credit scores or home equity; those who are temporarily unable to make payments (for example because of reduced hours, a spell of unemployment, or health issues); and those whose inability to make the payments is not temporary, but permanent. Different approaches are probably necessary for borrowers in these different circumstances.

For borrowers who continue to make payments but are under stress and unable to ease their payment burden through refinance (perhaps because they cannot provide a significant down payment), one possibility is to improve access to FHA loans. During the subprime boom, many lenders stopped providing FHA loans.¹¹ Improving access to FHA programs, and providing greater incentive for bankers to provide FHA loans, could help many borrowers gain access to the market at relatively favorable rates. Since many banks have been raising their minimum credit score to qualify for mortgages, the FHA may be able to provide loans for borrowers whose credit history is not up to current thresholds, yet have the capacity to make payments.

During a recession like the current one it becomes increasingly common for borrowers to experience temporary setbacks. A family member might lose a job, have hours reduced, or no longer get overtime. These can all present significant difficulties, and these problems can be compounded if a family member encounters significant health issues. For such individuals, steps such as deferring payments or reducing interest rates can prevent foreclosure. By providing a

temporary or permanent reduction in payments, the lender can avoid foreclosure and bridge the borrower through a difficult period. Of course, with a job loss and loss of income the required payment reduction, while temporary, can be quite significant, on the order of 50 percent. For this type of borrower, small modifications are unlikely to prevent foreclosures.

The United Kingdom has announced a program that focuses on borrowers facing temporary challenges – allowing lenders to reduce interest payments, with the deferred payments added to the principal and paid when the borrower’s circumstances improve.¹² The British government guarantees the lender against a percentage of the deferred interest payments. In a similar vein, a proposal developed by several Federal Reserve economists, and available on our website,¹³ suggests that the U.S. government could pay a significant portion of monthly payments for borrowers who are facing *severe but temporary* financial setbacks. There are two variants to the proposal. One way in which such a plan might work is for the government to offer these borrowers temporary *loans* that must be paid back once the borrower returns to financial health. Another version of this plan calls for the government to offer *grants*, not loans, to borrowers who have adverse life events, such as job loss.

Importantly, both versions include aspects that will minimize the number of people who would sign up for government help when they do not really need it.¹⁴ While any extension of direct government assistance to borrowers has potential “moral hazard” problems, the mere potential for such problems should not automatically derail proposals that are likely to keep temporarily troubled borrowers in their homes.

Of course, variants of these proposals are currently being used by mortgage servicers. At an event at Gillette Stadium last August, the Federal Reserve Bank of Boston in conjunction with

the Kraft family, the New England Patriots Charitable Foundation, the HOPE NOW Alliance, and NeighborWorks America brought troubled borrowers together with mortgage servicers to help address preventable foreclosures. The results, based on follow-up contacts with a subset of the 2,200-plus borrowers that attended the event, are shown in **Figure 9**. A little more than one-third of borrowers, about 35 percent, received some type of modification or workout offer from servicers. The most prevalent type was a loan modification that reduced monthly payments, which was received by 27 percent of borrowers. These were achieved by reductions in interest rates or by plans that lowered payments on a temporary basis. Only in very rare cases was the outstanding balance of the mortgage reduced.

Allow me to make an important parenthetical note. As mortgage rates decline, the ability of servicers to provide these interest rate concessions to borrowers should increase.

Large foreclosure-prevention events like this are one way to bring troubled borrowers together with servicers, since borrowers often complain they have difficulty reaching servicers and servicers complain that many borrowers do not open mail or return calls. Indeed, we at the Boston Fed will soon be announcing another such foreclosure-prevention workshop, to be held in Connecticut. While such events can play an important role, I think we would all agree that more systematic approaches or programs are desirable to reach a larger number of troubled borrowers.

The third pool of troubled borrowers involves those that realistically are not going to be able to make their mortgage payments. In such cases, it may well be impossible for lenders and borrowers to work out a plan. But that does not mean that nothing can be done to make the best of a difficult situation, for the borrower as well as their neighbors and the housing market in their area. One possibility is to provide borrowers who have little or no housing equity and are unable

to make mortgage payments with assistance to move to a rental property. Some may eventually have the capacity to purchase a home that is affordable to them, while for others, renting may be the appropriate long-term solution. But there is an important role for stabilization in high-foreclosure communities and a need to put foreclosed properties back to productive use, whether for rental or homeownership. An alternative would involve the government making a significant financial commitment that makes the mortgage affordable on terms acceptable to the lender – but the cost of such a program would likely be very high.¹⁵

Conclusion

The housing market has played a significant role in current economic problems. But with appropriate steps, the housing market could stabilize this year. The recent reductions in mortgage rates, in part due to monetary policy actions, have enabled more borrowers than would otherwise have done so to purchase or refinance homes. Expansion of this effort, and encouraging greater GSE participation, should encourage borrowers that have equity and reasonable credit scores to purchase or refinance homes.

For more troubled borrowers, programs will need to be designed to address the specific nature of their problem. For some borrowers, greater use of FHA programs may be appropriate; while for others, interest rate concessions that are now more affordable for lenders may serve as a bridge for the temporarily impaired.

Let me conclude by making a point that should not be overlooked. Although it is a discussion for another day, we need to remember that once the market has stabilized, much work needs to be done to structure mortgage securitization in a way that that reduces the likelihood of

future episodes of significant upheaval in mortgage finance. And more generally, financial regulatory reform will also be a key policy topic this year.

Thank you and I wish you the very best in the year ahead.

NOTES:

¹ Of course, the views I express today are my own, not necessarily those of my colleagues on the Federal Reserve's Board of Governors or the Federal Open Market Committee (the FOMC).

² Residential investment is the housing component of Gross Domestic Product (GDP). GDP is essentially the value of goods and services put in place during a time period. "The main indicator of the quantity of new housing supplied to the economy is the residential fixed investment series from the national income and product accounts. Residential investment is made up of new construction put in place, expenditures on maintenance and home improvement, equipment purchased for use in residential structures (e.g., washers and dryers purchased by landlords and rented out to tenants), and brokerage commissions." (Source: "Residential Investment over the Real Estate Cycle" by John Krainer, in the Federal Reserve Bank of San Francisco's Economic Letter #2006-15; June 30, 2006).

³ I offered a more extensive historical perspective on housing downturns in a January 2008 speech available at <http://www.bos.frb.org/news/speeches/rosengren/2008/011108.htm>.

⁴ As I have pointed out in prior talks, mortgages that used to be held at local banks came to be originated by mortgage companies that reach out to borrowers through brokers, and then sell the mortgage to be part of a security backed by many mortgages. Mortgages were pooled and securitized, then split and re-sold onto the secondary market to investors. Servicing companies act as intermediaries between the borrowers – the person making the monthly mortgage payment, and the ultimate investor. The securities are governed by complex pooling and servicing agreements that vary in terms of what they allow.

⁵ The economic stimulus bill passed earlier in 2008 raised the loan limits to nearly \$729,750 in certain high-cost areas. However, in 2009, this limit for high-cost areas fell to \$625,500. The \$625,500 number is 150% of the traditional limit for GSE securitization (\$417,000), which remains unchanged from 2008.

⁶ In essence "subprime" loans refer to mortgages that have a higher risk of default than prime loans, often because of the borrowers' credit history. Certain lenders may specialize in subprime loans, which carry higher interest rates reflecting the higher risk. Banks, especially smaller community banks, generally do not make subprime loans, although a few large banking organizations are active through mortgage banking subsidiaries. According to interagency guidance issued, in 2001, "The term 'subprime' refers to the credit characteristics of individual borrowers. Subprime borrowers typically have weakened credit histories [and] may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria... Subprime loans are loans to borrowers displaying one or more of these

characteristics at the time of origination or purchase. Such loans have a higher risk of default than loans to prime borrowers.”

⁷ An FHA mortgagee can originate, underwrite, fund, service, and/or own FHA-insured loans. An FHA loan correspondent can only originate loans that are underwritten by their sponsoring mortgagee.

⁸ The guide – *Frequently Asked Questions on FHA Lending: Business Considerations Regarding the Decision to Become an FHA Lender* – is available on the Boston Fed's website at <http://www.bos.frb.org/bankinfo>.

⁹ The November 25 announcement is available at:
<http://www.federalreserve.gov/newsevents/press/monetary/20081125b.htm>

¹⁰ The December 30 announcement is available at:
<http://www.federalreserve.gov/newsevents/press/monetary/20081230b.htm>

¹¹ In a speech in December 2007 I discussed FHA lending trends in more detail. The speech is available at http://www.bos.frb.org/news/speeches/rosengren/2007/120307.htm#_ednref9

¹² A description of the program (“The Homeowner Mortgage Support Scheme”) is available at http://www.hm-treasury.gov.uk/press_135_08.htm

¹³ The proposal, developed by Federal Reserve economists Chris Foote, Jeff Fuhrer, and Paul Willen (Federal Reserve Bank of Boston) and Eileen Mauskopf (Federal Reserve Board), will be available on the Boston Fed's website at <http://www.bos.frb.org/economic/index.htm>.

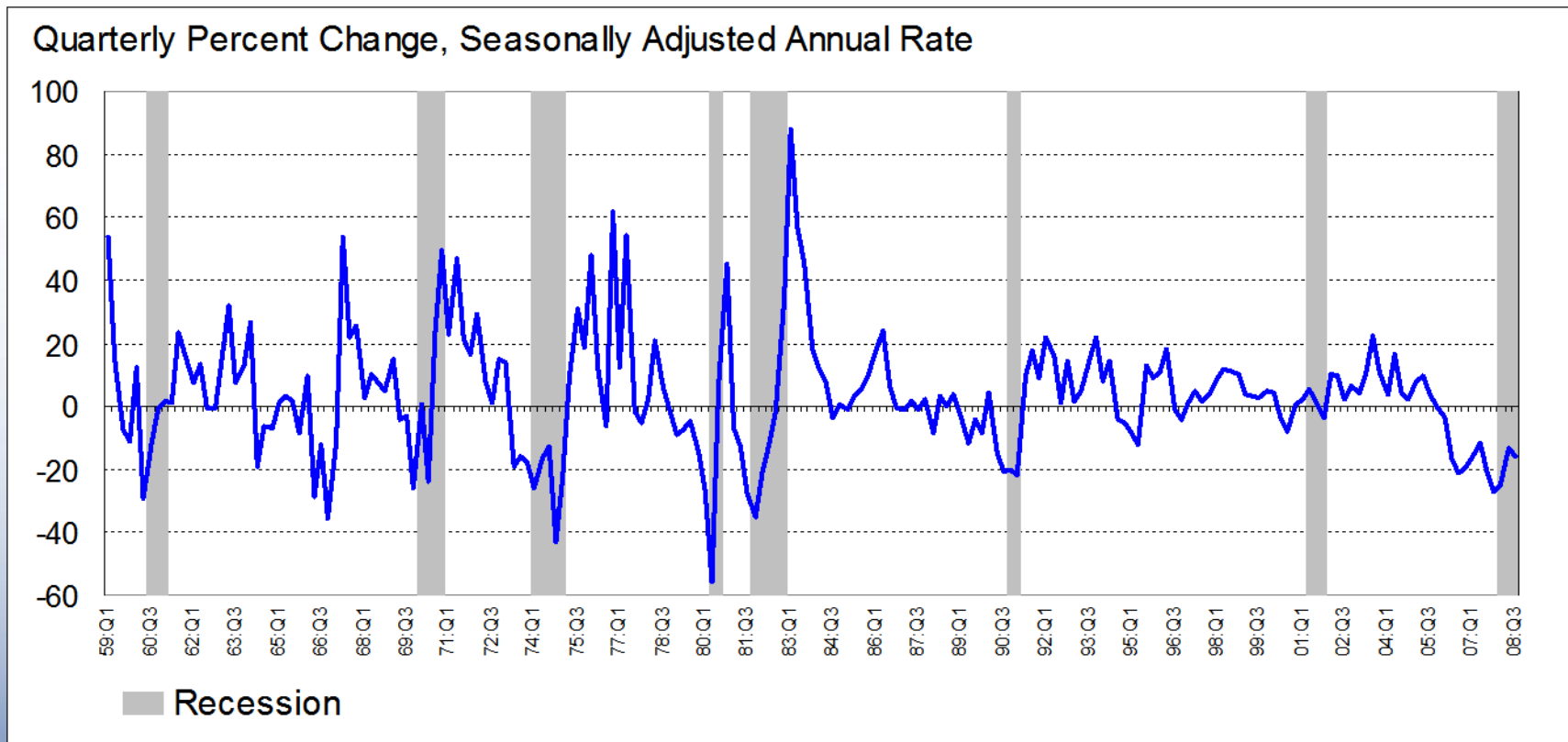
¹⁴ In the first version of the plan, which extends government loans, the interest rate on these loans would be set high enough so that only people who really need help will want to sign up for them. In the second version, which extends grants, participation would be predicated on an adverse life event such as job loss. Given the difficult state of the labor market, relatively few people are likely to quit their jobs or refuse to take new ones in order to save some fraction of their monthly mortgage payment.

¹⁵ So any such program would need very carefully framed public policy objectives, careful and appropriate screening of potential applicants, and well-designed program terms.

Figure 1

Real Residential Investment

1959:Q1 - 2008:Q3

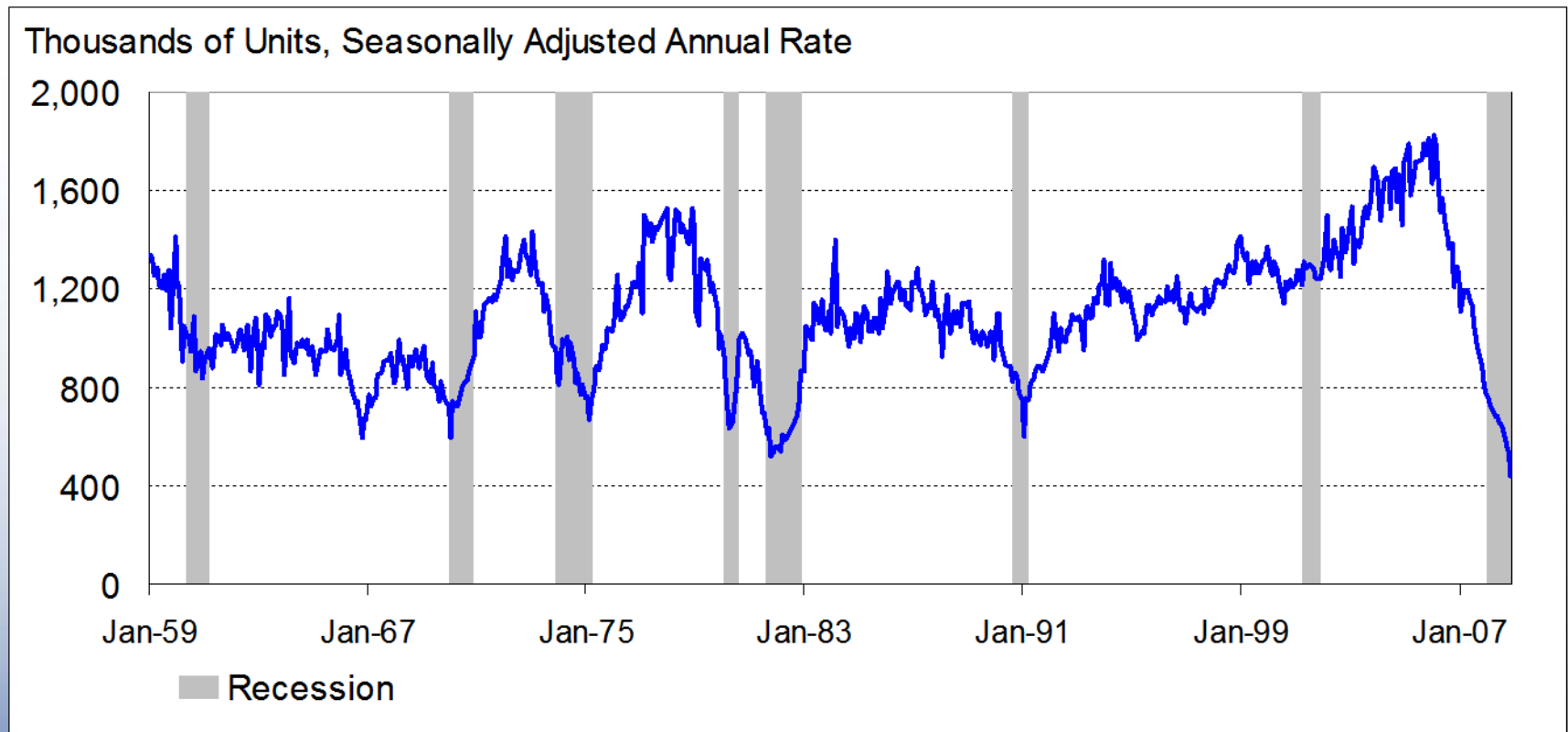


Source: BEA / Haver Analytics

Figure 2

Single-Family Housing Starts

January 1959 - November 2008

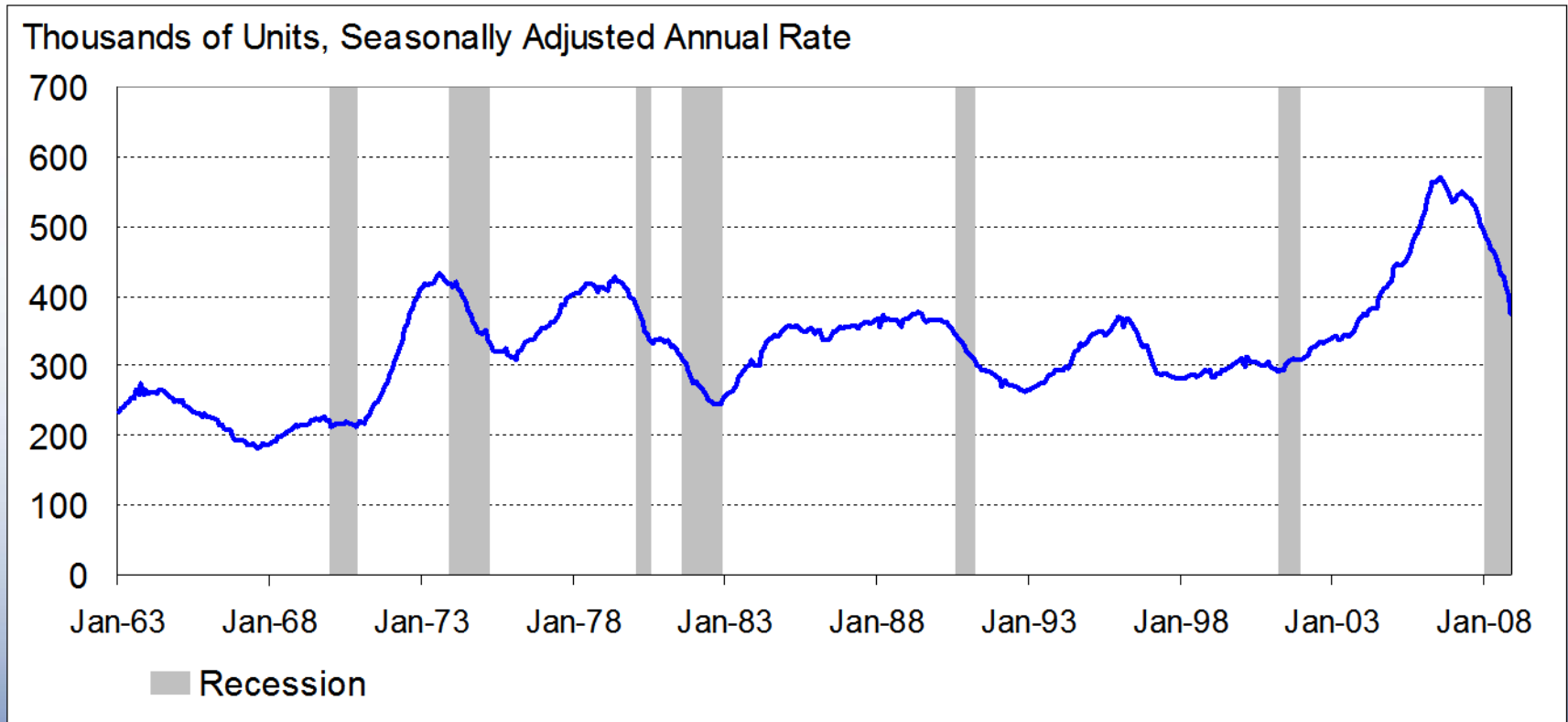


Source: Census Bureau / Haver Analytics

Figure 3

New Single-Family Homes for Sale

January 1963 - November 2008

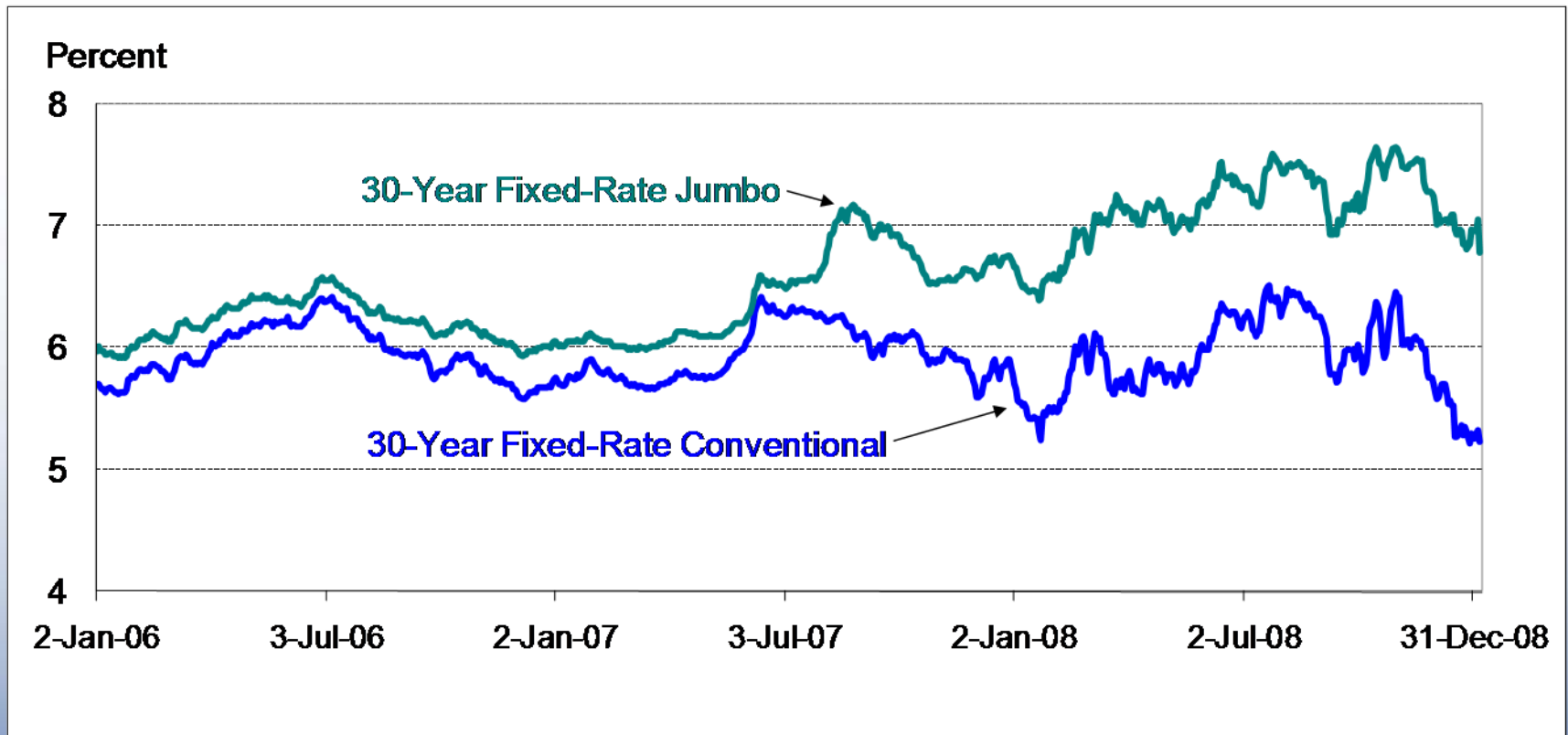


Source: Census Bureau / Haver Analytics

Figure 4

National Average Mortgage Rates

January 2, 2006 - January 6, 2009

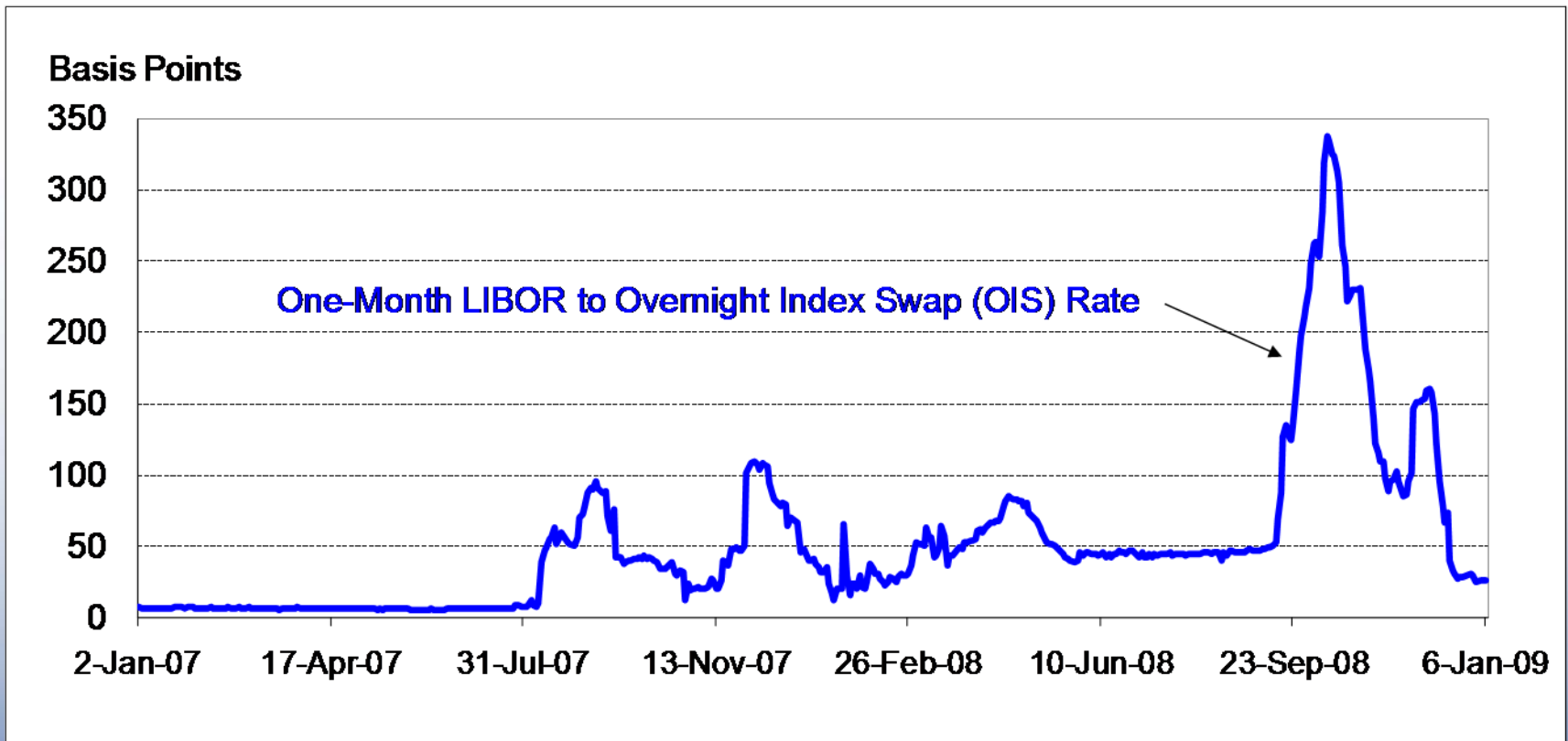


Source: Bloomberg

Figure 5

Short Term Interest Rate Spread

January 2, 2007 - January 6, 2009

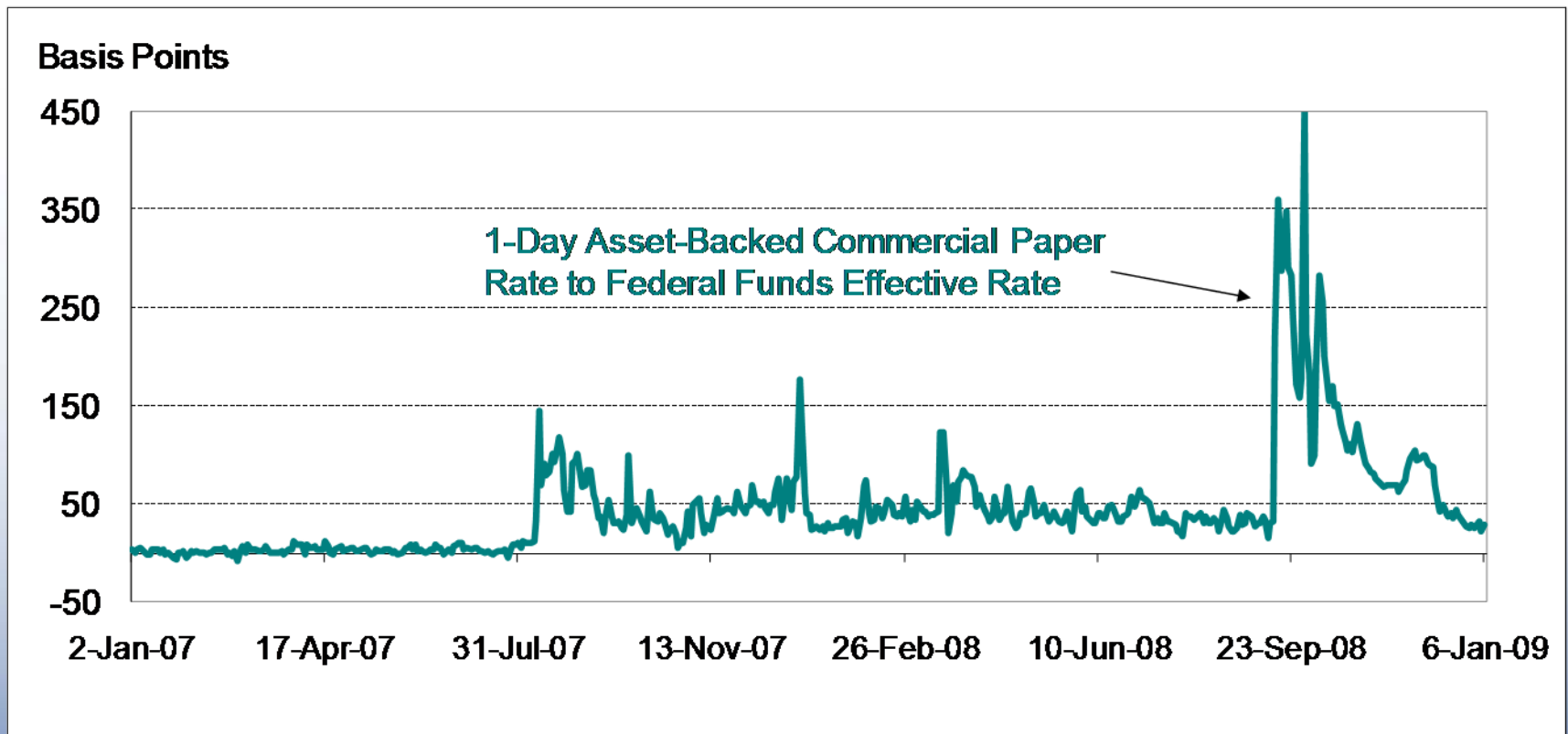


Source: Financial Times, Bloomberg / Haver Analytics

Figure 6

Short Term Interest Rate Spread

January 2, 2007 - January 6, 2009

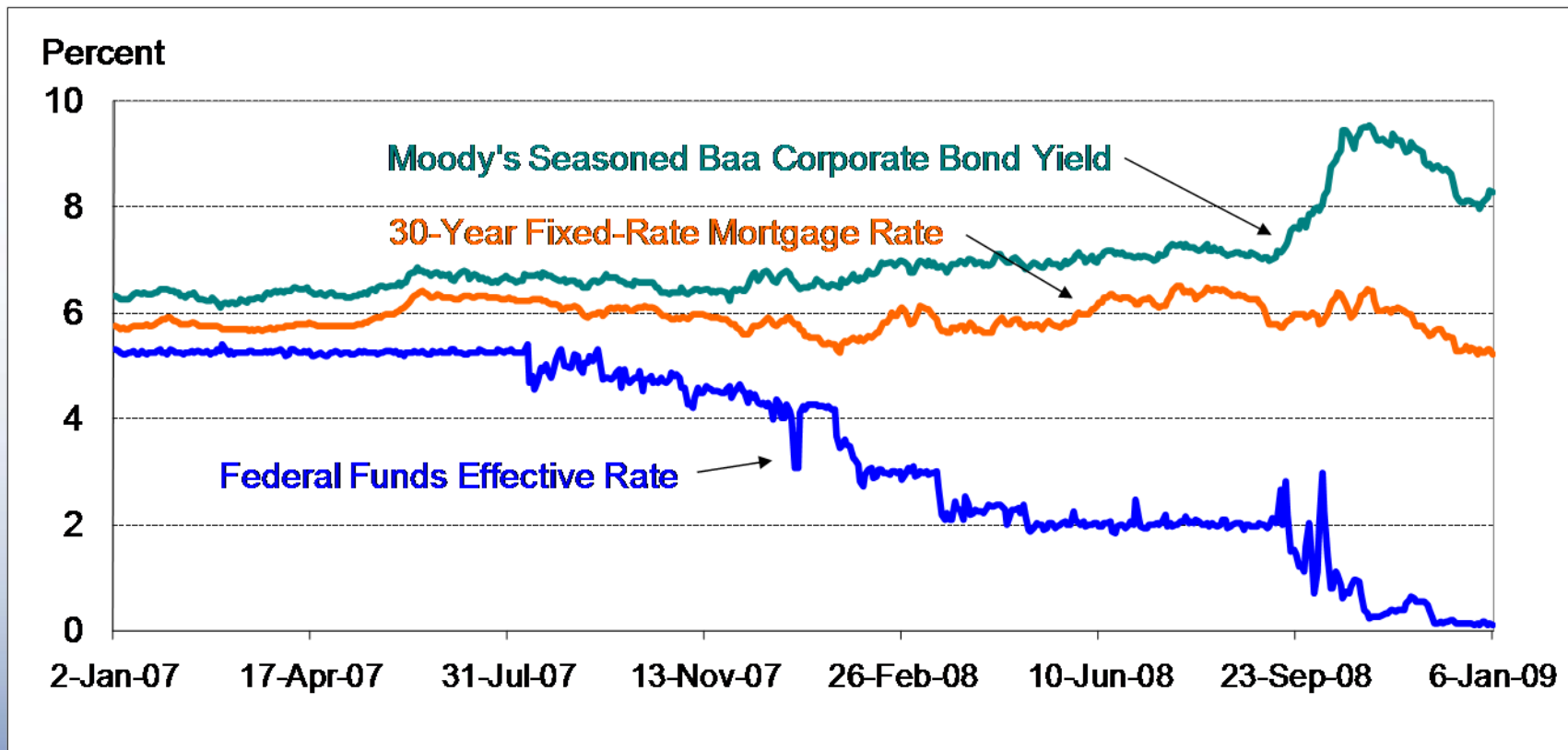


Source: Federal Reserve Board / Haver Analytics

Figure 7

Corporate Bond Yields, Mortgage Rates, and the Federal Funds Effective Rate

January 2, 2007 - January 6, 2009

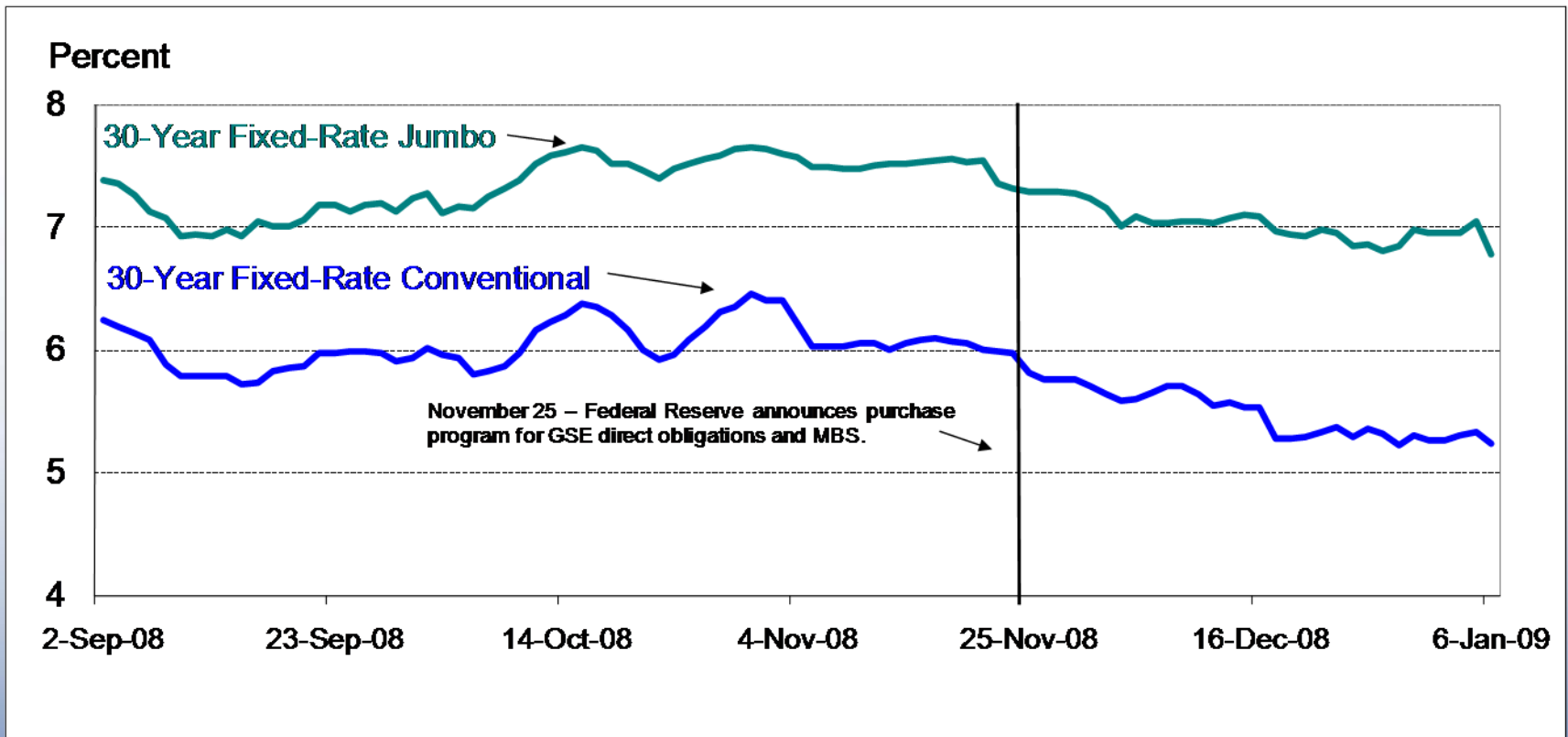


Source: Federal Reserve Board, Bloomberg /Haver Analytics

Figure 8

National Average Mortgage Rates

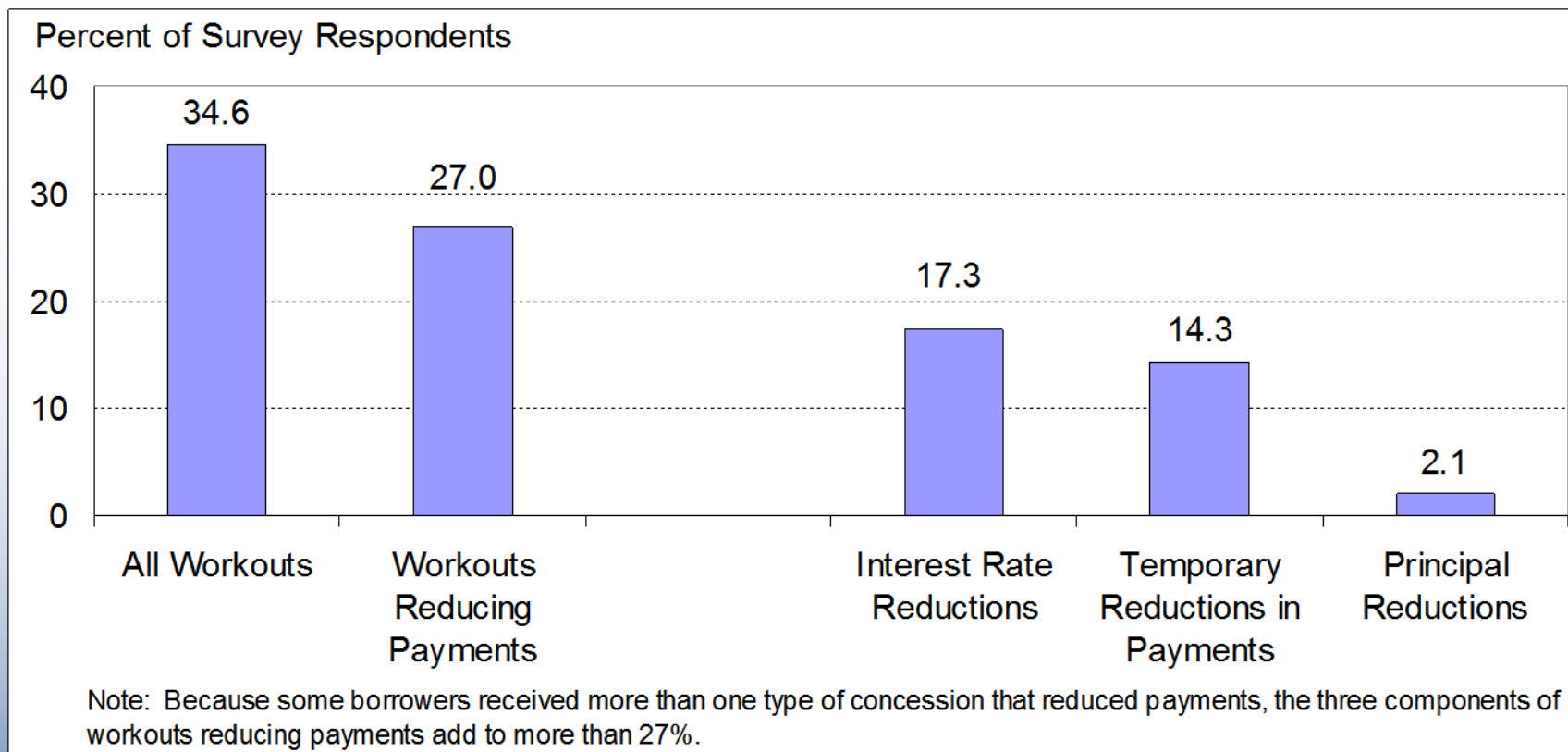
September 2, 2008 - January 6, 2009



Source: Bloomberg

Figure 9

Borrowers Receiving Loan Workouts at (or after) Gillette Stadium Event



Source: FRB Boston Survey of Borrowers Attending Gillette Stadium Event