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Rebalancing the Housing Market

Remarks by

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Good afternoon. I'd like to join my colleagues in welcoming you to the Federal Reserve Board. This policy forum, "The Housing Market Going Forward: Lessons Learned from the Recent Crisis," has been designed to connect lessons learned from the recent past with policy alternatives that may affect the market for years to come. Determining the key lessons and getting this connection right are important, and as you have already heard, perhaps not as easy as it might sound. I would like to offer some suggestions that I think could help. Before I begin, though, I should clarify that the ideas I will be discussing do not necessarily reflect the opinions of my colleagues on the Federal Reserve Board and that these suggestions should not be construed as policy of the Board or the Federal Open Market Committee.

There are many interpretations of the key factors that led to the current state of affairs, and there are a similar number of visions of what the future should look like. But, while it is important to learn from and avoid the mistakes of the recent past, we should not forget what did work for many years in the housing and housing finance markets. So, in crafting appropriate policy responses, an important starting point is to carefully analyze what we're solving for. Certainly we want a solution based on private capital, but the role of government in housing and mortgage markets will need to be defined before private markets will fully reengage. Any policy solution will have to be evaluated in the context of its effect on both owner-occupied and rental housing markets. And as the policy conversations progress, it will also be important to maintain a focus on the demand side of the market--which is to say, all of us, as consumers of housing. Finally, a national housing policy must also serve the needs of the segments of our society that have been historically underserved--low-income and low-wealth families, including disproportionate numbers of minorities and households headed by females.

These longer-term questions are critical. But before we get to the longer-term solutions, we need to deal with the unprecedented number of loans in or still entering the foreclosure pipeline, the disposition of properties acquired through foreclosure, and the effect of a high percentage of distressed sales on home prices. Regardless of how we got here, we, as a nation, currently have a housing market that is so severely out of balance that it is hampering our economic recovery.

To many, the story of the recent financial crisis and its aftereffects for the housing market is one mainly attributed to subprime lending. Although problems were concentrated initially in subprime mortgages, today about two-thirds of underwater mortgages and loans in foreclosure are actually prime or Federal Housing Administration (FHA) mortgages. This fact suggests that solutions aimed at righting the wrongs of previous reckless lending in the subprime market are not sufficient to tackle the scale of current problems.

Clearly, the market is not functioning as it should. Despite near-record-low interest rates, credit conditions remain tight for many consumers and investors interested in buying or refinancing residential real estate. Moreover, the lack of sufficient numbers of buyers and sellers may limit price discovery, which heightens uncertainty about the "right" price for a given piece of real estate and further limits activity. In addition, the large number of foreclosures and a protracted foreclosure process have led to an unprecedented level of bank-owned homes, a level that is likely to persist for some time.

So how do we move forward in these difficult circumstances?

The economy normally has some self-correcting mechanisms. Typically, a drop in prices--whether the price of an apple or the price of a house--stimulates demand and brings new buyers into the market. In the case of houses, price declines often occur in the context of a broad-based weakness in the overall economy. In response to macroeconomic weakness, the Federal Reserve generally can lower the target federal funds rate, which would be expected to lower mortgage rates. The combination of lower prices and lower mortgage rates makes home purchase more affordable and helps revive the housing market. Indeed, most recent recoveries have been led by housing. But for a variety of reasons, these mechanisms are not working fully in today's economy. When crafting solutions, it is helpful to first identify areas where removing some obstacles might enable these self-correcting mechanisms to operate more productively.

Refinancing Existing Mortgages at Lower Rates

One way to reduce the flow of foreclosed homes is to ease the payment strain on borrowers, which can be accomplished by modifying loans that are past due or by refinancing performing loans at lower rates. The Federal Reserve has already acted to lower longer-term interest rates, including mortgage rates, through the purchase of longer-term Treasury securities, agency debt, and agency mortgage-backed securities. In addition to enabling more buyers to purchase homes, low mortgage rates act to reduce the debt service cost of existing household debt. However, while refinancing activity has picked up in response to the lower rates, the pickup has been subdued compared with past low-rate environments. That is, even though mortgage rates on many outstanding loans are well above current market rates, many borrowers have not been able to take advantage of the lower rates because they have little or no equity in their homes or face other obstacles.

To facilitate refinancing for borrowers who are current on their mortgages but whose equity has eroded as home prices have fallen, the Administration's Home Affordable Refinance Program, or HARP, provides streamlined refinancing for low- or no-equity mortgages if the borrowers meet certain qualifications and if their existing mortgages are already guaranteed by Fannie Mae or Freddie Mac. So far, more than 800,000 borrowers have refinanced their mortgages through HARP.

One question, however, is why more borrowers have not benefited from this program. We estimate that 4 million borrowers appear to meet the basic eligibility for HARP refinancing.[1] Of course, some of these borrowers may be ineligible for reasons that we cannot observe, and others may be uninterested in refinancing. However, given the potential savings to households, the relatively low take-up on this program warrants another look at the frictions that may be impeding these refinancing transactions.

Responses to our inquiries regarding impediments to HARP refinancing have revealed four possible frictions:

1. **Loan-level pricing adjustments (LLPAs).** LLPAs are upfront fees that are added to the refinancing costs of loans that are judged to have higher risk characteristics, such as high loan-to-value ratios. The fees can increase the cost of refinancing by thousands of dollars and thus discourage borrowers

[1] This estimate is for borrowers who have mortgages guaranteed by Fannie Mae or Freddie Mac that were originated no earlier than 2003 and no later than May 31, 2009. The mortgages carry an interest rate on the first lien that is more than 75 basis points higher than the current level of mortgage rates and have loan-to-value ratios on the first-lien mortgage that are between 80 and 125 percent. The borrowers are current on their loans and have missed either no payments in the past year if guaranteed by Freddie or a maximum of one payment in the past year if guaranteed by Fannie.

from participating in the HARP program. Risk-based pricing is a standard risk-management tool for lenders in evaluating new risk. However, when the lender or guarantor already owns the credit risk, refinancing a low- or no-equity loan can actually reduce risk because it reduces payments and thus makes default less likely.

2. **Limited lender competition for HARP refinance loans due to lender concerns about taking on "putback" risk from previous underwriting.** Putback risk is the possibility that the loan originator will have to repurchase the loan from the government-sponsored enterprises (GSEs) because the underwriting violated GSE guidelines. Although the streamlined HARP guidelines do not require lenders to verify all aspects of a borrower's application, lenders who process the HARP refinancings have putback risk both from the refinance and from the original underwriting, even if the refinancing lender did not underwrite the original loan. This risk may make lenders reluctant to refinance loans originated by other lenders and so limits participation in the program. Perhaps competition among potential lenders could be increased if a minimum number of timely payments could be used as a proxy for sound original underwriting to relieve the liability of the refinancing lender for the mistakes of previous lenders.
3. **Junior lienholders.** In some cases, holders of junior liens are refusing to allow their loans to remain subordinate to a proposed new refinance loan, thus holding up the HARP process.

4. **Mortgage insurers.** Similarly, some mortgage insurers will not agree to reunderwrite their policies despite presumably diminished default risk after the refinancing.

The common theme in all of these frictions is that, in each case, the parties to the transaction are applying standard risk-management tools that would normally apply to low- or no-equity loans--but they are applying them to risk they already own. The economics of the situation suggests that if the first mortgage becomes more affordable, the existing risk exposure of all credit risk holders actually decreases. Moreover, to the extent that more widespread refinancing reduces the overall volume of distressed mortgages, it likely reduces pressures on house prices which would, in turn, lead to lower losses on sales of foreclosed properties across all mortgage portfolios. And finally, removal of barriers to refinancing would boost the impetus to recovery provided by lower long-term interest rates. Thus, finding different approaches to the policies that are hindering refinancing would likely provide some support to the economic recovery while improving the circumstances of homeowners and reducing the overall level of credit risk borne by the various holders of the risk.

Converting Real Estate Owned to Rental

Let me turn now to the effect on the housing market of properties acquired by creditors through foreclosure, commonly called real estate owned, or REO. An estimated 1 million or more properties will likely pass through REO inventory in 2011, with another million or so per year expected in both 2012 and 2013.

REO properties are weighing heavily on the market for owner-occupied houses in at least three ways. First, REO properties increase the total inventory of properties for sale. While the numbers are difficult to measure precisely, we estimate that in the second quarter of 2011, roughly 500,000 to 600,000 of the 2 million vacant homes for sale in the United States were REO properties. This extra supply is particularly problematic because demand is quite low. High unemployment and tight credit standards are currently precluding many families from buying homes, and other potential buyers may be staying out of the market due to uncertainty about their incomes. Even ignoring the potential inventory represented by the large backlog of distressed loans that have not yet been foreclosed upon, the current inventory of existing homes for sale represents approximately nine months of sales compared with a norm of five to six months, suggesting additional pressure on house prices as the market struggles to clear the excess inventory. Second, the downward pressure on prices is compounded by the high proportion of sales considered to be distressed sales. Currently, around 40 percent of sales transactions are considered to be distressed sales--that is, short sales or sales of REO properties. And third, high vacancy rates and the low level of maintenance that often characterize foreclosed properties make a neighborhood a less desirable place to live and thus depress the value of surrounding homes.[2]

In contrast to the market for owner-occupied houses, the market for rental housing has been strengthening of late. For example, apartment rents have turned up in the past year, and vacancy rates on multifamily rental properties have dropped noticeably. The relative strength of the rental market reflects increased demand as families who are unable or unwilling to purchase homes because of tight mortgage conditions or income

[2] See, for instance, John P. Harding, Eric Rosenblatt, and Vincent W. Yao (2009), "The Contagion Effect of Foreclosed Properties," *Journal of Urban Economics*, vol. 66 (November), pp. 164-78; and John Y. Campbell, Stefano Giglio, and Parag Pathak (2011), "Forced Sales and House Prices," *American Economic Review*, vol. 101 (August), pp. 2108-31.

uncertainty are renting properties instead. Rental demand has also been supported by families who have lost their homes to foreclosure. The majority of these families move to rental housing, most commonly to single-family rentals.[3] Unfortunately, these conditions supporting rental demand may persist for some time.

The weak demand in the owner-occupied housing market and the relatively high demand in the rental housing market suggest that transitioning some REO properties to rental housing might benefit both markets. Such conversions might also be in the best interests of lienholders and guarantors if recoveries from renting out properties exceed those from outright sales. Over time, as financing conditions ease and the number of REO properties to be sold declines, the share of properties sold to owner-occupants and sold to investors for rental will adjust commensurately.

Small investors are already converting some foreclosed properties to rental units on a limited scale. Larger-scale conversion, however, has been hindered by at least two factors. First, managing single-family rental homes is expensive unless the properties are concentrated within a geographic area and investors can be certain of acquiring a critical mass of properties. Second, regulatory guidance and standard servicing practices have typically encouraged GSEs, FHA, servicers, and financial institutions to actively market REO properties for sale and to consider rentals only as a short-term income generator while the properties are being marketed.

In August, the Federal Housing Finance Agency (FHFA), working with the Treasury Department and the Department of Housing and Urban Development, issued a request for information seeking ideas for the disposition of REO owned by Fannie Mae,

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[3] See Raven Molloy and Hui Shan (2011), "The Post-Foreclosure Experience of U.S. Households," Finance and Economics Discussion Series 2011-32 (Washington: Board of Governors of the Federal Reserve System, May), www.federalreserve.gov/Pubs/FEDS/2011/201132.

Freddie Mac, and the FHA, including ideas for turning these properties into rental housing. Together, the GSEs and the FHA hold about half of the outstanding REO inventory and so may be able to aggregate enough properties to facilitate a cost-effective rental program in many markets.

In thinking through how a rental program might be structured, I want to highlight three possible design considerations. First, as I noted earlier, achieving a cost-effective program may require obtaining a critical mass of properties--perhaps a couple hundred or more--within a limited geographic area. In this respect, the comparative advantage of government is in solving the aggregation problem. The combined portfolios of the GSEs and the FHA are large enough to achieve the necessary scale in a number of markets. However, the structuring of such a program might require the flexibility for a pooling entity to acquire properties from more than one seller or to contract for the acquisition of a minimum number of properties over time. With such flexibility, the scale potential of the GSE-FHA portfolios could be supplemented with properties from servicer or financial institution portfolios.

Second, it is important to ensure that such rental conversions are executed in a responsible manner and in the best interests of renters and local communities. Replacing the blight of a foreclosed home with the blight of a rundown rental property would provide little assistance to the affected neighborhoods. Examining how best to ensure that landlords keep their properties well maintained will be crucial.

Third, in many markets, house prices have fallen to such an extent that better recoveries may result from renting properties rather than selling them. However, in other markets, converting REO properties to rentals may not be in the narrow best interest of financial institutions or mortgage investors but may be in the best interest of local communities. For these markets, it may be useful to consider the possible role of new incentives and, if so, what form those incentives might take.

While existing statutes and regulations do not prohibit financial institutions from renting REO properties, supervisors encourage sales as the primary disposition tool. In light of the relative weakness of the owner-occupied market and strength of the rental market along with the potential for a GSE-FHA program to solve the problem of insufficient scale in some markets, conditions are unusual enough that it might also make economic sense to clarify existing expectations to recognize that in some cases converting a portion of residential REO to rental may be a reasonable option for financial institutions. Depending upon the conditions in their individual markets, I believe having such an option could allow for better outcomes for institutions--that is, a superior net present value compared with traditional disposition approaches--and could at the same time contribute to market healing. However, to be effective in promoting better outcomes, such an approach would require supervisors to clarify current supervisory guidance to address how existing standards might apply to the valuation of real estate converted to rental, the time limits applicable to such holdings, and other aspects of managing those properties. Financial institutions with large portfolios might be able to achieve scale in some markets on their own or possibly leverage the scale of a GSE-FHA program if such a program was created; smaller institutions should also have the flexibility to act in accordance with the conditions in their local markets.

Responsible REO Management

In addition to the consideration of conversion strategies at significant scale, there are steps that all REO holders can take today to ensure that they are not contributing further to the problems. They can and should make sure that they are adequately monitoring any third-party vendors with which they contract to maintain, market, or sell REO properties. Certainly, the recent interagency review of servicers revealed the severe consequences that can result from failing to monitor third-party vendors. Before converting REO properties to rental, REO holders could also consider “first look” types of programs to enable owner-occupants, public entities, and nonprofits windows of time to bid on available properties. A number of institutions have used such programs with successful results. And REO holders who sell large numbers of properties to investors should consider processes, such as those used by the GSEs, to screen and monitor bulk investors to reasonably assess their probable actions regarding maintenance and disposition after acquiring the properties.

Low-Value Properties

So far I’ve talked solely about REO-to-rental as a solution for REO properties. But that’s not going to work everywhere. In particular, some properties are too damaged, or otherwise too low-value, to be sold as owner-occupied units or profitably converted to rental properties. In fact, we estimate that about 5 percent of properties in the REO inventory of the FHA and the GSEs are appraised at less than $20,000, and in some markets the share is significantly higher. In many of these cases, the cost to repair or demolish existing structures exceeds their fair market value, and a different type of solution may be needed.

In recent years, local governments and community-based organizations have struggled to counter the effects of foreclosures on neighborhoods. One tool for controlling the temporary condition and ultimate disposition of REO properties is the use of a unique kind of entity known as a land bank.[4] Land banks are typically public or nonprofit entities created to manage properties not dealt with adequately through the private market. The lifespan of these entities may be time-limited with sunset provisions. The notion of a land *bank*, as opposed to a land *trust*, is that properties are brought in and moved out of a land bank's portfolio rather than permanently preserved. Using this kind of mechanism, a community can gain control of low-value properties that may otherwise sit vacant and cause problems for the surrounding neighborhood. Options available for disposing of the properties include physical rehabilitation, some period of rental, sale to new owner-occupants or responsible investors, or, in some cases, demolition. Because it likely will take several years for the overhang of vacant homes to be sold, such a strategy would help some communities deal with the short-term crisis and then ultimately allow for the disposition of properties in a manner suitable to local market conditions in the longer term.

While few land banks currently have the resources to operate at significant scale, the land bank model is one that has shown some success and could help many communities stabilize troubled properties if used more extensively. However, although such an approach holds promise, the current infrastructure for land banks is limited.

[4] For more information, see Thomas J. Fitzpatrick IV (2010), "How Modern Land Banking Can Be Used to Solve REO Acquisition Problems," in *REO and Vacant Properties: Strategies for Neighborhood Stabilization*, proceedings of the conference REO and Vacant Properties: Strategies for Neighborhood Stabilization cosponsored by the Federal Reserve Banks of Boston and Cleveland and the Federal Reserve Board, pp. 145-50, www.federalreserve.gov/events/conferences/2010/reovpsns/downloads/reo_20100901.pdf.

First, not all states have passed legislation that is needed to permit land banks. Second, this is difficult work, and existing land banks have limited capacity to handle high numbers of properties at a time. More funding and technical assistance would be needed to scale these efforts up to an adequate level. Of course, new funds are hard to come by in the current fiscal environment, but this appears to be an instance where relatively modest investments have the potential to yield significant benefits, such as reduced crime stemming from vacant properties, lower municipal costs to limit property deterioration or provide services to neighborhoods that are largely vacant, higher property tax revenue derived from property values not being unduly depressed, and other benefits that may be realized.

Conclusion

These are my thoughts on some of the things that can be done in the near term to help the housing market stabilize and rebalance. An immediate priority is balancing supply and demand in a market overwhelmed by financially stressed homeowners, tight credit conditions, and an unusually high number of foreclosed homes. It is an important part of rebuilding our market for housing and housing finance, but it is only a part. In addition, we must think carefully about longer-term policy and market changes that may affect Americans' housing options for years and even decades to come. This is important work, and I appreciate your participation in the forum today.

Thank you.