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Public Policy Responses to the Housing and Foreclosure Crisis
Housing crisis has caused much pain in the economy, unfortunately with more to follow.

Housing problems are destroying our financial system and hammering consumers!
Vacant housing at an all-time high!

Current as of Quarter 3, 2008
Source: US Census
US Residential Vacancy
Foreclosures have skyrocketed!
Months Inventory of Housing Units Available for Sale

Current as of December 2008
Source: National Association of Realtors
Expected Months on the Market
House prices in most markets have fallen at or below their real value prior to the boom in most markets.
House Prices in Cyclical Markets

Source: OFHEO, Case-Shiller Index and BLS
OFHEO Index Current as of Quarter 3 2008
Case-Shiller Index Current as of November 2008
Real Home Price Index
House Prices in Steady Markets

Source: OFHEO, Case-Shiller Index and BLS
OFHEO Index Current as of Quarter 3 2008
Case-Shiller Index Current as of November 2008
Real Home Price Index
House Prices in “Bubble” Markets

Source: OFHEO, Case-Shiller Index and BLS
OFHEO Index Current as of Quarter 3 2008
Case-Shiller Index Current as of November 2008
Real Home Price Index
• September, 2008

• The Government takes conservatorship of GSEs...

• And mortgage rates go up!
Spread between conforming mortgage rate and 10-year Treasury

Source: Freddie Mac, St. Louis Federal Reserve
30-Year Fixed-Rate Mortgage Rate - 10-Year Treasury Constant Maturity Spread
Today…

• 30-year fixed-rate mortgage is 5.2% (lowest rate since 1930s)

• Nonetheless, mortgage rates should be even lower
• 10-year US Treasury bond is 2.8%

• So FRM rates should be 80 basis points lower-about 4.4%; even with strong Fed support
• Think of the fiscal stimulus from those rates…
So what should policy makers do?

• “Hubbard-Mayer” proposal
• Fix the mortgage market: lower mortgage spreads to their 20-year average of 1.6 percent prior to the crisis (mortgage rate of 4.4% today)
• Create modern HOLC to share losses on negative equity (similar to “Hope for Homeowners” but less punitive for lenders)
  – Lenders write-off one-half the loss
  – Taxpayers pay half the loss, get some future appreciation on the house
  – Borrower gives up future appreciation for the loss write-down
How do we do this?

- GSEs now issue bonds in broker credit markets (1.3% above Treasuries despite government guarantee), so their yields are too high
- US Treasury would issue government securities to fund new mortgage-backed securities
  - No new credit risk
    - Taxpayers already on the hook for 30 million GSE mortgages
    - GSEs making ¾ of all new loans today with associated credit risk
  - Small prepayment risk--lowest rates in 60 years
Cost of the mortgage rate proposal

- Lower mortgage rates do not cost the government as it would return mortgage market to normal functioning
- Government already has the credit risk
- Increased government balance sheet use is offset by tangible assets (newly underwritten mortgages with borrowers who have verified income)
- Treasury should match duration of newly-issued government securities with the mortgages it refinances
Why do this?

- No private mortgage market: Govt is originating more than 90% of mortgages, so it is setting rates
- Hold up house prices by 10-17 percent nationally relative to where they would fall if the mortgage market remains broken
  - 20% house price decline led to $600 billion in losses for banks, what if prices fall another 20-25%?
  - Taxpayers on the hook for nearly $6 trillion in guarantees due to Fannie, Freddie, Ginnie, AIG, and NY Fed…
Why do this?

• *Save the banking system*
  – Up to $2 trillion of prepayments on existing mortgages on bank balance sheets at par, flooding system with liquidity
  – Separate good assets from bad assets
  – Prevent potentially huge future losses from housing

• *4 million houses on the market: must be eased*
Macroeconomic stimulus

• Reduce mortgage payments by $200 billion per year
  – 40 million homeowners can refinance existing mortgages
  – Average saving of $425/month
• Additional wealth effect of $60 billion thru reduced house price declines of $1.8 trillion (with a marginal propensity to consume from housing wealth of 3.5%)
Other benefits

- Help make houses affordable for first-time buyers
- Dramatic program to improve confidence in the housing market
- Remove millions of mortgages from troubled and conflicted servicers
- Refinance borrowers into 30-year, fixed-rate mortgages
- Benefits many homeowners, not just the most over-levered borrowers
Homeownership rate appear strongly linked to mortgage rate.

(source: US Census Bureau and Freddie Mac)
Homeownership rate appear weakly linked to unemployment rate (sources: US Census Bureau and Freddie Mac)
What about foreclosures?

- Many mortgage modifications fail (and too few modifications take place)
- Portfolio lenders foreclose about 1/3 less frequently on their own delinquent mortgages than third-party servicers (Piskorski et al. 2009)
- Many barriers to mortgage modification for third-party servicers:
  - Explicit legal restrictions
  - Bad incentives (paid to foreclose)
  - Litigation risk
  - Loss leader (servicers close to bankruptcy)
Part 1: Pay Incentive Fees to Servicers ($9 billion)

- Applies to privately securitized mortgages (15% of mortgages; 50% of foreclosure starts)
- Pay servicers an amount equal to 10% of monthly mortgage payments on all mortgages (capped at $60/month per loan)
- One-time fee equal to 12 times previous month’s Incentive Fee if the mortgage prepays (including short sale and refinancing)
- 3-year life
- Loans below conforming loan limit at origination
Part 2: Create a legal “Safe Harbor” for servicers to maximize returns to investors as a group

- Affirmative defense, not immunity!
- Clarify servicers duty to maximize returns to all investors (positive NPV modifications only)
- Eliminate explicit contractual restrictions against modification (exist in almost 1/2 of securitizations)
- Compensate investors whose interests are harmed
- Reporting requirement for all eligible mortgages (investors can monitor modifications and performance)
Mayer, Morrison, & Piskorski (2009)

- **Part 3: Small payment for 2nd liens to get out of the way**
  - 2nd liens
  - Applied to all 2nd liens in which the first mortgage is modified ($1.65 billion)
How would our plan work?

• Servicer currently receives $250-$500/year per loan
  – Mortgage modifications cost $750-$1,000
  – Not enough to break even given risk of failures

• Our plan gives more money and better incentives
  – Receive $2,160 if a loan survives for 3 years
  – Do not want to over-modify—legal liability if they modify all loans
  – Overly aggressive modifications reduce the servicer’s Incentive Fee
Why would our plan work?

• Explicit legal protection (including cost shifting for unsuccessful litigation under safe harbor)
• Align servicers interests with investors
• Pay for success, not just for modification
• Recognize that not all mortgages should be modified
• Reporting to investors helps monitor conflicts of interest and performance
Costs/Benefits of our proposal

• Must address foreclosures
  – Negative externality on other homeowners and financial system
  – Inefficient and socially costly to kick borrowers out of their homes when alternatives are possible

• Reduce up to 1 million foreclosures at a cost of $10.7 billion

• Much less expensive than other plans: TARP Reform bill proposes minimum of $40 billion up to $100 billion to reduce foreclosures
Other policies are much worse

- Bankruptcy “cramdowns” are not the answer
  - Moral hazard: 4 million delinquent loans, 51 million loans that are current
  - More costly mortgages in the future
  - Extend credit crisis with millions of foreclosures
  - Servicers would be paid to push borrowers into bankruptcy instead of modifying loans
- FDIC/Sheila Bair proposal
  - Costly mortgage guarantees ($70 billion or more)
  - Pay servicers to modify loans, but no incentive for successful modifications
Other policies are much worse

• Blind Trustees
  – Requires large government bureaucracy (long time to do this)
  – Trustees lack incentive to spend time or effort to modify loans (agent, not principal)
  – Not clear how mortgages referred to trustees
  – Hard to distinguish from bankruptcy reform (centrally determine how to do modifications)
Conclusions

• House prices are sensitive to interest rates
• Malfunctioning credit markets are hammering US house prices, even in markets with little exposure to subprime lending
• Government intervention can immediately ensure more normal functioning mortgage and housing markets, saving millions from foreclosure
• Foreclosure prevention through re-working servicer incentives and legal agreements
• Covered bond-like structure may provide a new model for residential and commercial mortgages