Some thoughts on housing and the economy

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Exploring Impediments to a Real Estate Recovery
Federal Reserve Bank of Atlanta
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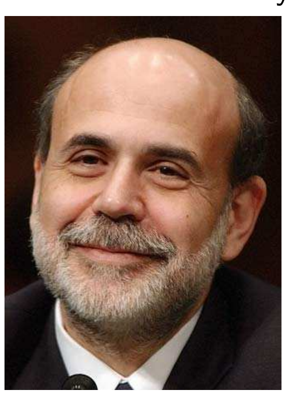
Disclaimer

- I am speaking today as a researcher and as a concerned citizen
- not as a representative of:
  - The Boston Fed
  - or the Federal Reserve System



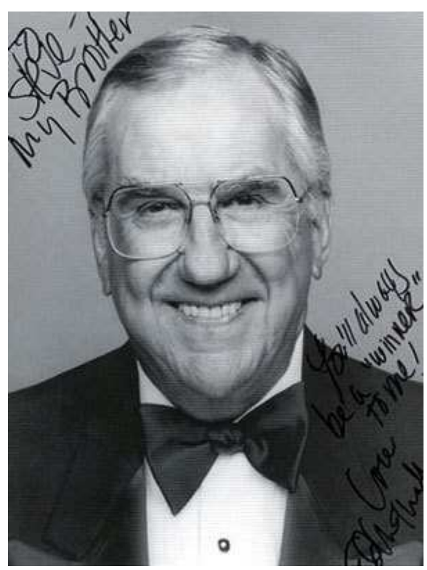
- When I say “we”, I don’t mean Ben and me.

What causes foreclosure?

- If the house is worth less than the balance on the mortgage, you have "negative equity"
- Negative equity is necessary for default to make sense
  - If house is worth more than outstanding balance on mortgage
  - Sell!
  - In fact, servicers will usually force you to sell.
- But most people with negative equity don't default
  - In 1991 in MA, we estimate that about 100,000 people had negative equity
  - Over the next three years, only about 7 percent lost their homes
- Irrational?
  - No!
- Double Trigger
  - Negative equity makes it impossible to sell or refinance
  - Most people default when they have a "life event".

What do these two men have in common?

Eric Rosengren



Ed McMahon

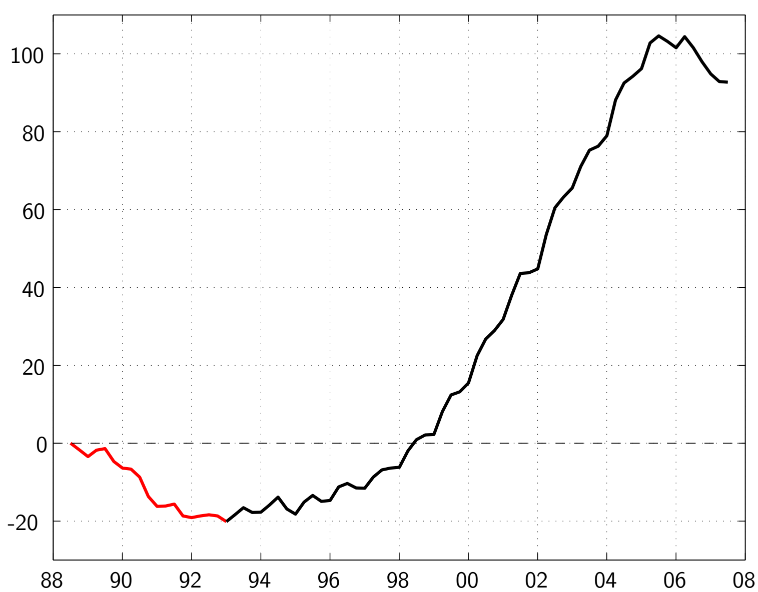
Ed and Eric

	Eric Rosengren	Ed McMahon
Booming voice	✓	✓
Memorable laugh	✓	✓
Silver hair	✓	✓
Negative Equity	in 1993	in 2008
Foreclosure	No	Yes

- Why the different outcome?
  - Different stochastic discount factor
  - Ed values consumption today relative to future more than Eric

Outlook

- Cumulative appreciation for Massachusetts homeowner who bought in Q3, 1988.



Why it's so difficult to modify loans

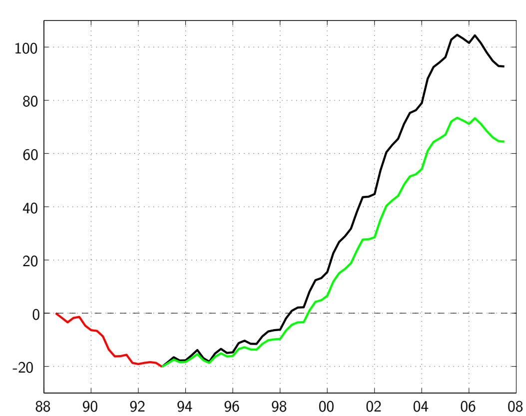
- Suppose we have two borrowers: Ed and Eric
- Ed and Eric both need payment reduction
- Both WILL DEFAULT without assistance
  - Eric needs a 10% reduction.
  - Ed needs a 50% reduction
  - Foreclosure costs 60%.
- **Problem: I can't tell Ed and Eric apart.**

Policy	Loss on Eric	Loss on Ed	Mean Loss	# of Foreclosures
Do Nothing	60%	60%	60%	2
Cut 10%	10%	60%	35%	1
Cut 50%	50%	50%	50%	0

- Both borrowers will default if you do nothing – no strategic default.
- Yet it is *still* profitable to foreclose.

Shared Appreciation

- There is a place for shared appreciation,
- But it has serious practical problems – maintenance, measuring the price.
- But there's a deeper problem.



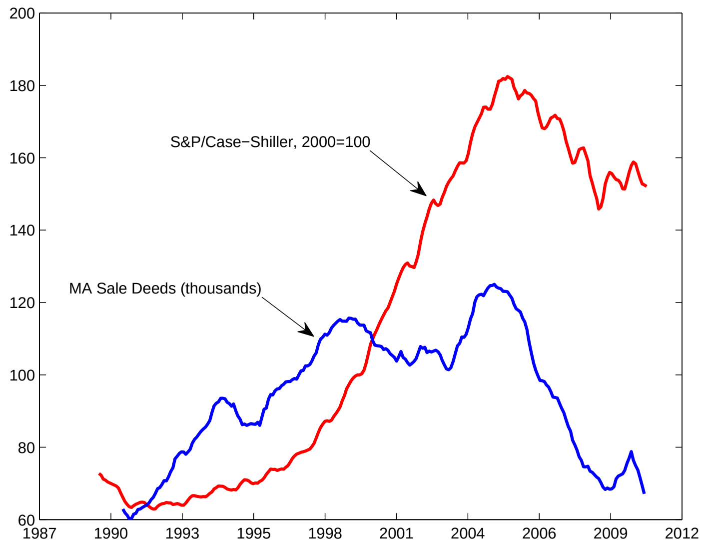
Forecasting house prices

- Beware of house price forecasts.

Foreclosure Overhang

- Many have worried that foreclosures drive down prices.
  - Add supply to market
  - Law of supply and demand and all that.
- But the data suggests that
  - Insufficient demand is what driving down prices and causing foreclosures.
  - Foreclosures aren't driving prices down.
- Why?
- Supply and demand! Falling prices can reflect
  - Falling demand
  - Increasing supply
- The problem is low demand
  - In a "normal" year, MA buyers absorb 40K more properties than are selling right now.

Sales and house prices in MA, 1990-2011



Economists suck at forecasting house prices

- Most house price variation over time is unforecastable.
  - Economists
  - Practitioners.
- Consensus did not anticipate:
  - Boom in the late 90s-00s
  - Bust in 2006-2010.
- In 2006, some argued that low interest rates explained why house prices were so high.
  - Interest rates are much, much *lower* now.
- From *WSJ*: "The laws of supply and demand suggest housing prices [in Phoenix] should be rising, or at least stop falling.
- If simple "supply and demand" models were useful, we wouldn't be in this mess.
- Good news: Economists are predicting falling house prices.
  - So it's time to buy!

The slide you've all been waiting for...

- The end.

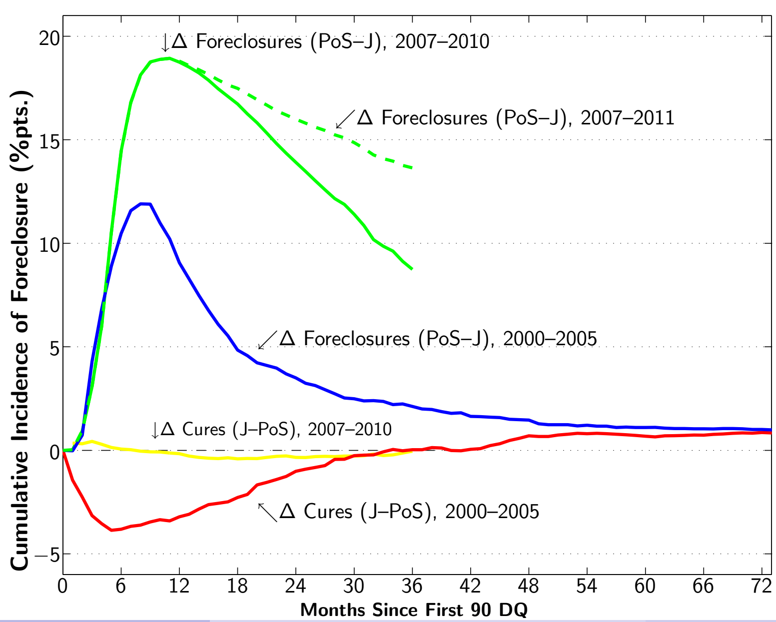
Legal Issues

- Recently, lots of issues raised about sloppy foreclosure procedures:
  - Title transfer: Servicer not authorized to carry out foreclosure.
  - Robosigning: Servicer employee not authorized to sign affidavits.
  - Poor controls.
- These are serious issues
- Interagency Review (OTS, OCC, FDIC, Federal Reserve)
- The reviews found:
  - "critical weaknesses in servicers' foreclosure governance processes..." (p. 5)
  - "foreclosure document preparation processes..." (p. 5)
  - "oversight and monitoring of third-party vendors, including foreclosure attorneys." (p. 5)

- But it's not clear that any of this really hurts borrowers. Review found that:
  - "...borrowers subject to foreclosure in the reviewed files were seriously delinquent on their loans." (p. 6)
  - "...servicers possessed original notes and mortgages and, therefore, had sufficient documentation available to demonstrate authority to foreclose." (p. 6)
  - "servicers generally attempted to contact distressed borrowers prior to initiating the foreclosure process to pursue loss-mitigation alternatives, including loan modifications."(p. 6)
  - "... some – but not widespread – errors between actual fees charged and what the servicers internal records indicated, with servicers undercharging fees as frequently as overcharging them."(p. 9)
- If anything, sloppy procedures result in delays that allow borrowers to stay in homes longer!
- In fact, BofA paying billions to investors for foreclosing *too slowly*.

Borrower protection only delays the inevitable

- In power-of-sale states, lender forecloses without court.
- In judicial states, borrower guaranteed a "day in court."



Right-to-cure law similarly ineffective

- Mass. Right to cure law gives borrowers 90 days to work with lender.
- Compared borrowers eligible for the law with ineligible borrowers.