Rebalancing the US Housing Market: Two Proposals

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The US housing market continues to suffer from a serious imbalance[1], threatening the economic recovery. Record foreclosures are at the heart of this imbalance and so far, progress in stemming them has been too slow. In our view, a successful solution has to focus jointly on *both* the owner and renter segments of the housing market. Between 1998 and 2008 almost 5 million renter households became owners as Wall Street provided excessive credit that was both misplaced and mispriced. It was misplaced because many of these households had credit risk that previously made ownership problematic. It was mispriced because underwriting became most generous and lax – at the very peak of the market. The end result is that about half of these households have already defaulted on their homes, and there are prospects for this to continue for several years more.

Two types of mortgage default have occurred - which not surprisingly match the misplacement and mispricing of credit. Many of the defaults to date have followed from job losses – particularly among those historically most at risk for this but to who credit was extended nevertheless. With luck and a growing economy, this source of default should ebb. But looking out there looms the specter of "strategic defaults" wherein homeowners with secure income and the ability to make payments "walk" from seriously underwater loans[2]. They do so as they finally realize they may never regain their lost equity because they were granted credit so far in excess of their home's long run value. Recent estimates put under water mortgages at between 12% and 22% of all mortgages, although the majority of seriously underwater loans are concentrated in just four states[3].

In another sign of housing imbalance, foreclosures are contributing to a large inventory of units for sale at exactly the same time that there is a scarcity of first time borrowers to take them out of the inventory[4]. With sales durations fluctuating between 8 and 11 months (the long term average is 5.8) a well known economic relationship has had prices falling for much of the last 3 years and unable to recover. At the same time, rental vacancy rates have begun to drop sharply over the last year and rents are now rising significantly [Figure 1]. This is totally expected, just as the reverse tenure flows earlier caused prices to rise and rents to languish. What can be done?

In fact, a little ingenuity suggests two strategies would speed the market's healing and help its return to balance. The first is to recognize that poorly underwritten loans resulted from a *jointly* misguided decision between lender and borrower and that the solution requires a *joint* partition of the losses. With proper loan restructuring, a looming quantity of "strategic defaults" can be averted.

The second is to recognize that very high home ownership rates are unsustainable without unrealistic assistance, and that possibly several million more recent owners are likely to become renters. The question then becomes how to make that transition as easy as possible. With a gentle nudge vacant units for sale can become rental units for those foreclosed upon – avoiding another specter – that of a rental unit shortage with looming rent inflation.

To help prevent "strategic default", existing mortgages could be restructured into two parts: a). a standard new mortgage against the current (reduced) value of the home, and then b). a claim against some fraction of any capital gains (above that reduced value) when the home is eventually sold. The two parts could even be packaged separately and securitized or traded in separate markets. When a household sells their home they would pay off both claims - receiving their share of whatever gains accrued. Mostly likely the lender's claim on future gains would be capped – for example at a value equal to the difference between the original mortgage balance and that created in part a).

For illustration, consider the dilemma of an owner whose original house and loan were established at $100,000, but whose house is currently worth only $60,000. The loan is thus 40% underwater. When restructured, the loan would be divided into a $60,000 traditional mortgage and a claim of, for example, 50% of the future appreciation – capped at $40,000. The borrower's payments would fall by 40% but later when they moved and the property sold for, say $90,000, they would surrender $15,000 of the sales proceeds. The lender could recover all its money if farther into the future the property sold for $140,000, while the owner's gain in this case would be reduced from $80,000 to $40,000.

This restructuring is a clear "win win". For borrowers, the new loan's payments would be more in line with what current buyers (of similar homes) are experiencing. Owners also would maintain a stake in the value of their property which aligns maintenance incentives. By surrendering future capital gains, the perception of "letting some borrowers off scot free" would be ameliorated. On the lenders side we know there is considerable resistance to restructuring mortgages – since restructured loans sometimes re-default while loans left alone often "self cure"[5]. But these result mostly from income-based defaults. The proposal here, with the contingent claim, allows lenders to add an additional (fully liquid) asset on their books relative to a conventional modification. The negotiated split and value of this contingent claim of course could vary by market.

While this first proposal should help to stem foreclosures, many have already occurred and some further foreclosures cannot be avoided. With reasonable likelihood the nations home ownership rate will continue to fall – nearer to recent averages from its historic high of 69%. This could well generate as many as 5 million new renters – with virtually no rental units currently under construction. For the last several quarters, apartment rents have begun to move upward – in some markets quite vigorously [Figure 2].

While private market construction will eventually respond to rising rents and recover, there is a ready source of potential rental supply in the large inventory of for-sale units Encouraging the transfer of units from for-sale to for-rent serves two purposes: to help firm up housing prices and to help avert a looming rental shortage.

We propose that some form of accelerated depreciation or investment tax credit be created when investors purchase vacant units for sale (single-family homes or multi-family condominiums) and place them into the rental stock. The incentive would require that the units have been vacant for some period and, once converted, remained in the rental stock for a long time to prevent "tax flipping". The Administration tried a temporary tax credit program once, but it was designed to encourage first-time buyers – and with a short life span merely encouraged intertemporal purchase substitution. This program would be directed at investor-buyers, and effectively shift the long-term rental supply via conversions from the existing stock.

The US housing market continues to represent a ticking time bomb not just for lender balance sheets but for the whole economy. A continual flow of displaced households is holding back consumption and depressed prices are discouraging the traditional recovery-based construction boom. Housing market balance needs to be restored for successful economic growth to resume and continue. It is time for both the Financial Industry and the Administration to be more proactive in ensuring the long-term health of the housing market

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[1] In a balanced housing market, the homeownership rate is stable, prices and rents move together and construction equals household formation. None of these has been present for the last 5 years.

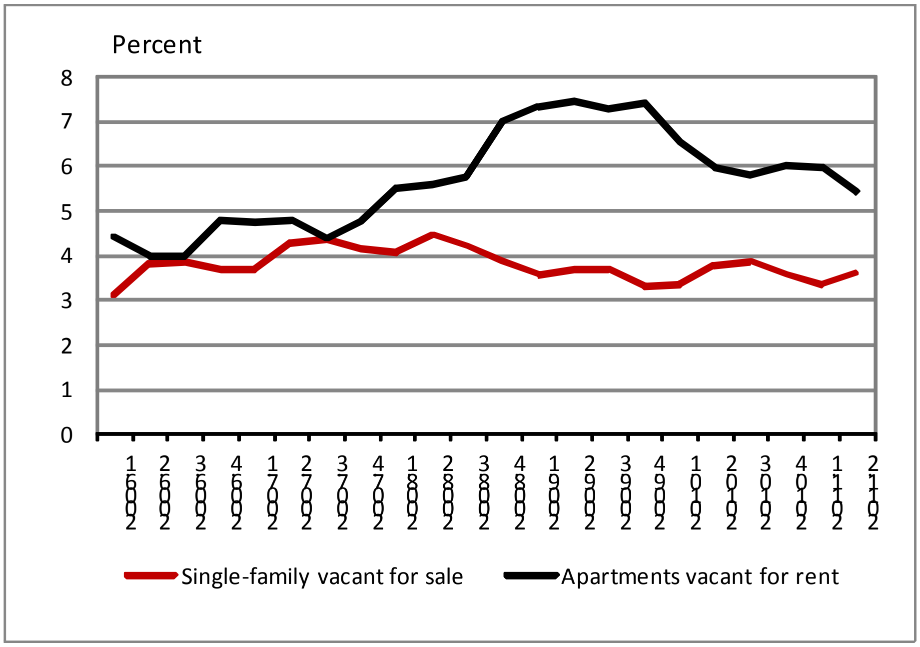
[2] Some see great borrower resistance to strategically defaulting [Butta, Dokko, Shan, "The Depth of Negative Equity and Default Decisions", Federal Reserve, FEDS #2010-35, May, 2010]. Others argue this moral resistance quickly fades once friends and neighbor's begin defaulting ["Moral and Social Constraints to Strategic Default on Mortgages", Guiso, Sapienza, Zingales, NBER # 15145, July 2009]

[3] CoreLogic.com Press Release of August 26, 2010; 2010 AHS reported LTV; California, Arizona, Florida, Nevada.

[4] Since a generation of 1st time buyers was prematurely drawn into the owner market between 1998 and 2006, and down payments have now increased, it will be several years before the next generation saves enough to make the ownership transition.

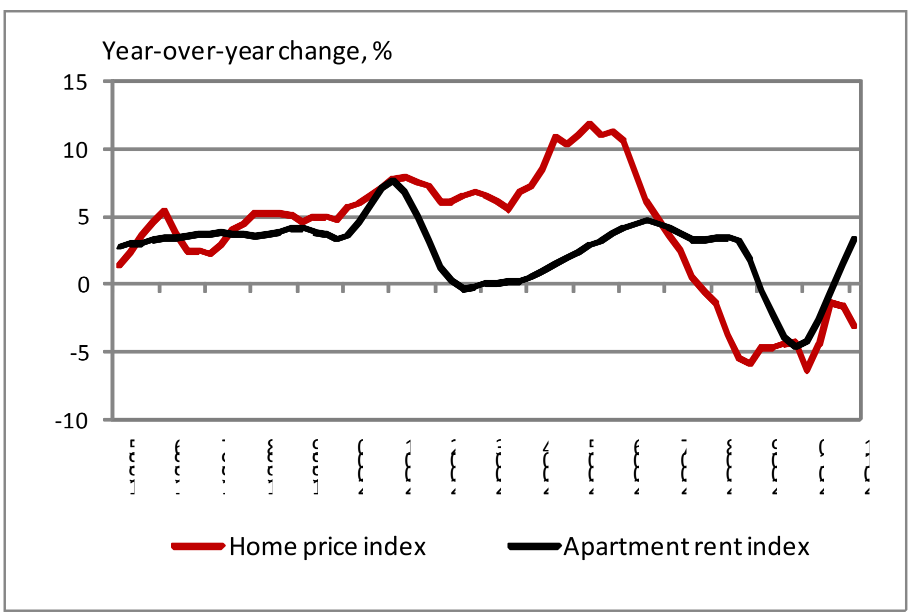
[5] Manuel Adelino, Kristopher Gerardi, "Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization," FRB Boston Public Policy Discussion Paper Series, no. 09-4 (2009)

Figure 1: Vacant for Sale, Vacant for Rent



Sources: National Association of Realtors, MPF Research, CBRE Econometric Advisors

Figure 2: Home Price Growth versus Rent Growth



Sources: FHFA, MPF Research, CBRE Econometric Advisors.