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Time to Accelerate the Housing Recovery

Reed Saxon/Associated Press

In June, hundreds of mortgage holders seeking to have their loans modified met with Bank of America advisers at a foreclosure prevention event in Los Angeles.

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It’s housing, stupid. More precisely, it’s housing finance.

As the Obama administration seeks ways to revive the economy, not to mention win an election, it is becoming clear that the biggest mistake officials made when they took office nearly three years ago was to underestimate the continuing damage to the economy from the mortgage crisis.

“There is widespread agreement among economists that housing debt is at the heart of the slow recovery,” said Kenneth Rogoff, the Harvard economist, “and that finding a way to bring it down faster would accelerate the recovery.”

The administration has sought to encourage mortgage modifications by making it easier for homeowners who owe more than their homes are worth to nonetheless refinance their mortgages. But the success of that effort seems to have been limited, and calls are growing for more action.

Interestingly, it is Federal Reserve officials, who normally seek to avoid commenting on specific government policies outside the range of monetary policies, who have been sounding the alarm with increasing regularity. They have made clear that they fear monetary policy will not be enough to get the economy moving, and that they need help from Congress and the White House.

"We at the Federal Reserve are moving vigorously to promote a stronger economic recovery," said Janet Yellin, the Fed's vice chairman, in a speech in San Francisco this week. "However, monetary policy is not a panacea, and it is essential for other policy makers to also do their part. In particular, there is a strong case for additional measures to address the dysfunctional housing market."

William C. Dudley, the president of the Federal Reserve Bank of New York, laid out a housing agenda when he spoke at West Point last month. He said action was needed to make it easier for more people to qualify for mortgage loans, and also broached an idea for something that so far has gotten little political support but probably will be necessary: reducing the amount that many borrowers owe while letting them keep their homes.

He suggested that borrowers who were under water on their loans — that is, they owe more than their houses were worth — but were still making their payments should be able "to earn accelerated principal reduction over time."

Any such plan risks infuriating homeowners who were responsible and did not borrow more than they could afford to pay. One way to improve the perceived fairness of a plan to allow principal reductions would be to tie such reductions to a structure that would give the lenders a share in any recovery in property values when the homes were eventually sold.

To many Republicans, the answer is simply to let the markets sort it out. That prescription seems to be based more on ideology than on any actual analysis of how the housing market is functioning, and it seems to infuriate Fed officials.

"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," said Elizabeth A. Duke, a Fed governor, in a speech in September.

Mr. Dudley, the New York Fed president, also denounced the way the market was functioning. "In contrast to the efficient mechanisms in place in the commercial property market to work out troubled debt," he said in his speech at West Point, "the infrastructure of the residential mortgage market is wholly inadequate to deal with a systemic shock to the housing market. Left alone, this flawed structure will destroy much more value in housing than is necessary."

First impressions can be misleading, and nowhere is that more true than in understanding the housing mess. The first symptoms of trouble came in the subprime market, and it was the problems of that market that were first put under a microscope. We found loans that had been made to unqualified borrowers on terms that were, in some cases, outrageous. We found fraud. We found that credit had become far too easy to get.

And we found private-label mortgage securitizations that were stuffed with horrid loans that never should have been made, rubber-stamped by rating agencies, guaranteed by insurance companies and purchased by institutional investors without anyone in the chain doing any real due diligence. We found securitizations that were managed so haphazardly that papers proving who owns mortgages had disappeared.

All that was true, but focusing on such outrages can obscure what needs to be done. By now we should understand that the problems went far beyond the subprime market. There are many prime loans, made to responsible borrowers with good credit, that are in deep trouble. Property values did not collapse only in the neighborhoods where dubious loans were being made.

The bulk of those troubled prime loans now are owned by the United States government — or, to be more specific, by its wards, Fannie Mae and Freddie Mac. That is highly regrettable in some ways, but it gave the Obama administration an opportunity to take steps to change things without Congressional action.

It did that this fall when it changed the rules for the mortgage modification program, starting Thursday, to allow homeowners who were under water on their mortgage obligations to nonetheless refinance their loans — and thus get the benefit of the lower interest rates that the Fed's monetary policy has produced.

That makes sense because Fannie and Freddie already have the credit risk on the underwater loans. Allowing the borrower to refinance — and thus owe lower monthly payments — reduces the risk of the loan, at least by a little.

Fannie and Freddie financed many of the loans by selling mortgage-backed securities to investors who collect the interest until the loans are repaid, and then get the principal back. If there were large numbers of refinancings, the owners of those securities would be the losers.

In normal times, old securities with relatively high interest rates would have virtually disappeared as owners refinanced, paid off the old mortgages and took out loans at lower rates. But these are not normal times, and speculators now are profiting from the woes of homeowners who cannot refinance but have not defaulted. Because Fannie and Freddie guarantee the loans, buyers of those securities are sure to recover the amounts lent.

Prices of high-coupon mortgage securities rose to unprecedented heights earlier this year as investors concluded that those who had not refinanced by then would never be able to do so, and that owners of the securities would be able to collect above-market interest rates for a long time. Those prices have declined, but not by very much, since the administration announced its refinancing plan.

Christopher J. Mayer, a professor at Columbia Business School who had been pushing to allow refinancings by underwater owners, says more is needed. He would like to see rule changes that would encourage competition for issuing such mortgages, rather than leaving it up to the bank that issued the original mortgage and that is still collecting fees from servicing it.

There are other things the government should be trying to do. Mr. Dudley says ways should be found to reduce foreclosures by providing "bridge financing for borrowers with proven ability to service their debts who lose their jobs and may take longer than normal to find new jobs in today's weak labor market."

Mr. Dudley and other Fed officials have pushed for efforts to reduce the supply of homes for sale by turning some foreclosed properties into rental properties. The administration has asked for proposals on how that could be done, but has not announced any decisions.

Given the current imbalance in supply and demand for homes, and relatively strong rental markets, such an idea seems obvious. But there seems to be no precedent. While there are of course large apartment complexes that are managed and rented by a single company, there is no business model that has been used to allow one manager to own and rent out a large number of homes. It would be particularly hard to do if the homes were spread over a large area.

But there are neighborhoods where Fannie and Freddie own large numbers of foreclosed homes. It is at least conceivable they could package them and sell them in bulk to a company that could manage them efficiently.

It was, in part, unquestioning belief in the wisdom of markets that led the Fed, under Alan Greenspan, to refuse to take action that could have at least retarded the growth of the housing bubble. It would be unfortunate if such beliefs kept the government from heeding the pleas now coming from the Fed.

“Over the medium term,” said Ben Bernanke, Mr. Greenspan’s successor as Fed chairman, in his August address to the annual Jackson Hole conference of central bankers, “housing activity will stabilize and begin to grow again, if for no other reason than that ongoing population growth and household formation will ultimately demand it.

“Good, proactive housing policies,” he added, “could help speed that process.”