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

<table>
<thead>
<tr>
<th>Eric Rosengren</th>
<th>Ed McMahon</th>
</tr>
</thead>
<tbody>
<tr>
<td>Booming voice</td>
<td>✓</td>
</tr>
<tr>
<td>Memorable laugh</td>
<td>✓</td>
</tr>
<tr>
<td>Silver hair</td>
<td>✓</td>
</tr>
<tr>
<td>Negative Equity</td>
<td>in 1993</td>
</tr>
<tr>
<td>Foreclosure</td>
<td>No</td>
</tr>
</tbody>
</table>

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

Outlook

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.**

<table>
<thead>
<tr>
<th>Policy</th>
<th>Loss on</th>
<th>Mean Loss</th>
<th># of Foreclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Eric</td>
<td>Ed</td>
<td></td>
</tr>
<tr>
<td>Do Nothing</td>
<td>60%</td>
<td>60%</td>
<td>60%</td>
</tr>
<tr>
<td>Cut 10%</td>
<td>10%</td>
<td>60%</td>
<td>35%</td>
</tr>
<tr>
<td>Cut 50%</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
</tr>
</tbody>
</table>

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

There is a place for shared appreciation,

But it has serious practical problems – maintenance, measuring the price.

But there’s a deeper problem.
Beware of house price forecasts.

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.
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!
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.”

![Graph showing cumulative incidence of foreclosure and cure over time](image-url)
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.