Government Needs to Get Radical to Fix Housing

By Barbara A. Rehm, American Banker, FEB 29, 2012

Spend some time with Bill Emmons of the Federal Reserve Bank of St. Louis and you'll question our government's stick-a-finger-in-the-dike-and-hope-for-the-best approach to the housing crisis.

When Emmons, an economist at the St. Louis Fed since 1995, talks about the size of the housing sector's problems it is clear that the administration's programs to encourage loan modifications and refinancings are drops in the proverbial bucket.

We all knew that, of course. No one, except perhaps those employed by the government, views either the original or revamped versions of the administration's housing reforms as much more than good intentions.

But we could all be forgiven for believing that if the economy simply continues its tentative recovery we'll just grow our way out of this mess.

Emmons will quickly disabuse you of that.

"All this stuff about refinancing people down 50 basis points is peanuts. It's absolutely peanuts," he says. "We have to fundamentally recapitalize housing. … There is not enough equity to support the debt. You have to get rid of this debt."

Just how big is the housing problem?

To figure that out, Emmons found the average loan-to-value ratio for mortgages from 1970 to 2005. It was 58.4%. In words, that means borrowers had nearly 42 cents in equity for every dollar of their home's value.

Fast forward to today. That LTV ratio is 93.3%. Again, in words, that means the average borrower has less than 7 cents in equity for every dollar of his home's value.

By Emmons' calculation, for the U.S. to return to the precrisis LTV average, today's total mortgage debt would have to be reduced by $3.7 trillion.

Emmons is careful to note that his views are his own and he is not representing the St. Louis Fed or the Federal Reserve System. Still, St. Louis Fed President and CEO James Bullard cited Emmons' work in a Feb. 24 speech at the University of Chicago.

"One could think of this number as the size of the bailout that would be certain to 'heal' the housing sector," Bullard said.

Just how much money is $3.7 trillion? It's 24% of the nation's 2011 GDP. It's more than twice the total equity held by the banking system, which was $1.57 trillion at yearend. Emmons says we'd need to give $75,000 to each of the 49.4 million people with mortgage debt.

"We just have so many homeowners who are so far underwater it is hopeless," Emmons says. "There is no practical way that people can grow out of this."

So what are our options? There are three and they run the spectrum from unrealistic to ineffective to unimaginable.

On the unrealistic end is a recovery in home values. Emmons estimates home prices would need to spike by 60% to fill the $3.7 trillion gap. Of course, it is much more likely that home prices will soften further, which of course would flip more borrowers upside down on their mortgages. (Experts estimate up to 15 million people today owe more than their homes are worth.) Borrowers aren't refinancing to take advantage of low interest rates because they don't have enough equity in their homes. They are stuck, and until the market rebounds more people will default, more foreclosures will occur and that will drive prices lower. It's a vicious circle that only bold policymaking can end.

The ineffective middle ground is where the Obama administration is firmly planted — various targeted programs designed to help the right borrowers and avoid dealing a death blow to the banking system.

It's understandable policy and politics. No one wants to bail out reckless borrowers or lenders and everyone is worried about moral hazard.

But tinkering around the edges isn't working. We've been at this three-plus years with little to show for it. As of December, the first big assistance effort, the Home Affordable Modification Program, had saved 930,000 borrowers $10.5 billion.

All the policies added together — from Hamp to Harp to REO-to-rental pilot programs and the $25 billion servicing settlement — merely scratch the surface. And that's largely because the government is so worried about helping anyone — borrower or lender — who doesn't "deserve" it.

We can't run the country from that perspective. If we do, we're dooming ourselves to decades spent in an economic twilight zone.

Some experts think such initiatives are merely prolonging the pain.

"These temporary programs aggravate the problem," says James R. Barth, a policymaker turned academic and a co-author of the newly released "Fixing the Housing Market: Financial Innovations for the Future."

"These programs put everything on hold," Barth says. "Lenders are not sure what's going to happen to them next and borrowers think maybe they will benefit if they don't make payments and they wait longer because the government may assist them or require the holders of the mortgages to assist them."

That brings us to option No. 3: massive writedowns. I labeled it "unimaginable" because the size of the problem is so huge and the political odds so long. But somehow, some way the government is going to have to figure out how to relieve borrowers and lenders of crushing debt and mounting legal liabilities and entice investors into the real estate market.

Policymakers have known this since the crisis hit. Back in 2008 when the feds persuaded Congress to cough up $700 billion to address the meltdown, the original goal was to use the money get lousy mortgage assets off the books of private-sector lenders. That's why it was called the Troubled Asset Relief Program.

But the Treasury Department quickly realized it would be simpler to invest the money directly into banks. That bought us some time, but it didn't resolve the problem. The mortgage market is still buried under a mountain of debt, and until we start doing some serious digging the economy won't recover.

Pushing the day of reckoning off only makes the problem worse, and more expensive.

Look no further than the S&L crisis of the 1980s for evidence. When it became clear the industry and its insurance fund were broke, Congress put up a little money. A couple years later, it kicked in a little more. After several more years of dithering, Congress in 1989 created the Resolution Trust Corp.

Like any organization, the RTC made some mistakes, but it did succeed. It cleared the market, mainly by selling assets for whatever price it could get. The agency also put itself out of business in record time and didn't end up costing as much as critics feared.

Still, the final cost — $150 billion to close more than 1,000 financial institutions and liquidate $500 million in assets — would have been less if policymakers had faced the facts earlier.

We need a long-term plan for fixing the housing market that pulls private capital in to replace the outsize role the government has assumed. Some investors will get rich. Some borrowers will lose their homes. Some lenders will get bailed out. Some plaintiffs won't get their day in court. Some state foreclosure laws will be trampled. Homeownership rates will fall.

But uncertainty will fade. Confidence will return, and with it investment. The economy will grow. Employment will swell. Hope will replace fear. The pie will be larger.

We will all benefit.