The Housing Market Going Forward: Lessons Learned from the Recent Crisis
Governor Elizabeth Duke, Member, Federal Reserve Board of Governors
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(Applause.)

GOVERNOR ELIZABETH A. DUKE: There is nothing better than being introduced by someone over whom you have oversight. (Chuckles.)

Good afternoon. I'd like to join my colleagues in welcoming you to the Federal Reserve Board, where multiple viewpoints and lively discussions are a way of life. This policy forum, The Housing Market, Going Forward: Lessons Learned From the Recent Crisis, has been designed to connect lessons from the recent past with policy alternatives that may affect the market for years to come.

Determining the key issues and getting this connection right are important, but as you have already heard, perhaps not as easy as it might sound. I'd like to offer some suggestions that I think could help.

Before I begin though, I should clarify the ideas that I'll be discussing do not necessarily reflect the opinions of my colleagues on the Federal Reserve Board, and that these suggestions should not be construed as policy of the Board or the Federal Open Market Committee.

As we saw in the last panel discussion, there are many interpretations of the key factors that led to the current state of affairs, and there are a number of similar visions about what the, there are a number of visions about what the future should look like.

But while it's important to learn from and avoid the mistakes of the recent past we should not forget what did work for many years in the housing and housing finance markets.

So in crafting appropriate policy responses, an important starting point is to carefully analyze what we are solving for. Certainly we want a solution based on private capital. But the role of government in housing and mortgage markets will need to be defined, before private markets will fully reengage.

Any policy solution will have to be evaluated in the context of its effect on both owner occupied and rental housing markets.

And as the policy conversations progress, it will also be important to maintain a focus on the demand side of the market, which is to say all of us, as consumers of housing.

Finally, a national housing policy must also serve the needs of segments of our society that have been historically underserved, low income and low wealth families, including disproportionate numbers of minorities and households headed by females. Longer term questions are critical. But before we get to longer-term solutions, we need to deal with the unprecedented number of loans in or still entering the foreclosure pipeline, the disposition of properties acquired through foreclosure, and the effect of a high percentage of distressed sales on house prices.

Regardless of how we got here, we as a nation currently have a housing market that is so severely out of balance that it's hampering our economic recovery.

To many the story of the recent financial crisis and its aftereffects for the housing markets is one mainly attributed to subprime lending. Although problems were concentrated initially in subprime mortgages, today about two-thirds of underwater mortgages and loans in foreclosure are actually prime or FHA mortgages.

This fact suggests that solutions aimed at righting the wrongs of previous reckless lending in the subprime market are not sufficient to tackle the scale of the current problems. Clearly, the market is not functioning as it should. Despite near record low interest rates, credit conditions remain tight for many consumers and investors interested in buying or refinancing residential real estate.

Moreover, the lack of sufficient numbers of buyers and sellers may limit price discovery, which heightens uncertainty about the right price for a given piece of real estate, and further limits activity.

In addition, the large number of foreclosures and a protracted foreclosure process have led to an unprecedented level of bank-owned homes, a level that is likely to persist for some time.

So how do we move forward in these difficult circumstances?

The economy normally has some self-correcting mechanisms. Typically a drop in price, whether the price of an apple or the price of a house, stimulates demand and brings new buyers into the market.

In the case of houses, price declines often occur in the context of broad-based weakness in the overall economy. In response to macroeconomic weakness, the Federal Reserve generally can lower the target federal funds rate, which would be expected to lower mortgage rates.

The combination of lower prices and lower mortgage rates makes home purchases more affordable and helps revive the housing market.

Indeed, most recent recoveries have been led by housing. But for a variety of reasons, these mechanisms are not working fully in today's economy. When crafting solutions, it's helpful to identify areas where removing some obstacles might enable these self-correcting mechanisms to operate more productively.

One way to reduce the flow of foreclosed homes is to ease the payment strain on borrowers, which can be accomplished by modifying loans that are past due, or by refinancing performing loans at lower rates.

The Federal Reserve has already acted to lower longer term interest rates, including mortgage rates, through the purchase of longer term treasury securities, agency debt, and agency mortgage-backed securities.

In addition to enabling more buyers to purchase homes, low mortgage rates act to reduce the debt service cost of existing household debt. However, while refinancing activity has picked up in response to the lower rates, the pickup has been subdued compared with past low rate environments.

That is, even though mortgage rates on many outstanding loans are above current market rates, many borrowers have not been able to take advantage of the lower rates, because they have little or no equity in their homes, or other obstacles.

To facilitate refinancing for borrowers who are current on their mortgages, but whose equity has eroded as home prices have fallen, the administration's Home Affordable Refinance Program, or HARP, provide streamlined refinancing to low or no equity mortgages if the borrower meets certain qualifications, and if their existing mortgages are already guaranteed by Fannie Mae or Freddie Mac.

So far, more than 800,000 borrowers have refinanced their mortgages through HARP.

One question, however, is why more borrowers have not benefited from this program. We estimate that 4 million borrowers appear to meet the basic eligibility for HARP refinancing. Of course, some of these borrowers may be ineligible for reasons that we cannot observe, and others may be uninterested in refinancing.

However, given the potential savings to households, the relatively low take-up on the program warrants another look at the frictions that may be impeding these refinancing transactions.

Responses to our inquiries regarding impediments to HARP refinancing revealed four possible frictions. Number one, loan level pricing adjustments, LLPAs. LLPAs are up-front fees that are added to the refinancing cost of loans that are judged to have higher risk characteristics, such as higher loan-to-value ratios.

The fees can increase the cost of refinancing by thousands of dollars, and thus discourages borrowers from participating in the HARP program. Risk-based pricing is a standard risk management tool for lenders in evaluating new risk.

However, when the lender or guarantor already owns the credit risk refinancing, a low or no equity loan can actually reduce risk because it reduces payments and makes default less likely.

Number two, limited lender competition for HARP refinance loans due to lender concerns about taking on put-back risk from previous underwriting.

Put-back risk is the possibility that the loan originator will have to repurchase the loan from the GSEs because the underwriting violated GSE guidelines.

Although the streamlined HARP guidelines do not require lenders to verify all aspects of a borrower's application, lenders who process HARP refinancing have put-back risk both from the refinance and from the original underwriting, even if the refinancing lender did not underwrite the original loan.

The risk may make lenders reluctant to refinance loans that were originated by other lenders, and so limit participation in the program.

Perhaps competition among potential lenders could be increased if a minimum number of timely payments could be used as a proxy for sound original underwriting to relieve the liability of the refinancing lender for the mistakes of previous lenders.

Number three, junior lienholders. In some cases, holders of junior liens are refusing to allow their loans to remain subordinate to a proposed new refinanced loan, thus holding up the HARP process.

And number four, mortgage insurers; similarly, some mortgage insurers will not agree to reunderwrite their policies despite diminished default risk after refinancing.

The common theme in each friction, is that in each case the parties to the transaction are applying standard risk management tools that would normally apply to low or no equity loans, but they are applying them to risks they already own.

The economics of the situation suggest that if the first mortgage becomes more affordable, the existing risk exposure of all credit riskholders actually decreases. Moreover, to the extent more widespread refinancing reduces the volume of distressed mortgages, it likely reduces pressures on house prices, which would in turn lead to lower losses on the sale of foreclosed properties across all mortgage portfolios.

And finally removal of barriers to refinancing would boost the impetus to recovery provided by lower long term rates. So thus finding different approaches to policies that are hindering refinancing would likely provide some support to the economic recovery, while improving the circumstances of homeowners, and reducing the overall level of credit risk borne by the various holders of the risk.

Let me turn now to the effects on the housing market of properties acquired by creditors through foreclosure, commonly called real estate owned or REO. An estimated one million or more properties will likely pass through REO inventory in 2011, with another million or so per year expected in both 2012 and 2013.

REO properties are weighing heavily on the market for owner occupied houses in at least three ways. First, REO properties increase the total inventory of properties for sale. While the numbers are difficult to measure precisely, we estimate that in the second quarter of 2011, roughly 500,000 to 600,000 of the two million vacant homes for sale in the United States were REO properties.

The extra supply is particularly problematic because demand is quite low. High unemployment and tight credit standards are currently precluding many families from buying homes, and other potential buyers may be staying out of the market due to uncertainty about their incomes.

Even ignoring the potential inventory represented by the large backlog of distressed loans that have not yet been foreclosed upon, the current inventory of existing homes for sale represents approximately nine months of sales compared with a norm of five to six months, suggesting additional pressure on house prices as a market struggles to clear the excess inventory.

Second, the downward pressure on prices is compounded by the high proportion of sales considered to be distressed sales.

Currently around 40 percent of all sales transactions are considered to be distressed sales; that is, short sales or sales of REO properties. And third, high vacancy rates and the low level of maintenance that often characterizes foreclosed properties make a neighborhood a less desirable place to live, and thus depress the value of surrounding homes.

In contrast to the market for owner occupied houses, the market for rental housing has been strengthening of late. For example, apartment rates have turned up in the past year and vacancy rates on multifamily rental properties dropped noticeably. The relative strength of the rental market reflects increased demand, as families who are unable or unwilling to purchase homes because of tight mortgage conditions or income uncertainty are renting properties instead. Rental demand has been supported by families who lost their homes to foreclosures. The majority of these families move to rental housing, most commonly single family rentals. Unfortunately, these conditions supporting rental demand may persist for some time.

The weak demand in the owner occupied housing market and the relatively high demand in the rental housing market suggest that transitioning some REO properties to rental housing might benefit both markets. Such conversions might also be in the best interest of lienholders and guarantors if recoveries from renting out properties exceed those from outright sales.

Over time, as financing conditions ease, and the number of REO properties for sale declines, the share of properties sold to owner occupants and sold to investors for rental will adjust commensurately. Small investors are already converting some foreclosed properties to rental units on a limited scale.

Larger scale conversion, however, has been hindered by at least two factors. First, managing single family rental homes is expensive, unless the properties are concentrated within a geographic area, and investors can be certain of acquiring a critical mass of properties.

Second, regulatory guidance and standard servicing practices have typically encouraged GSEs, FHA, servicers and financial institutions to actively market REO properties for sale, and to consider rentals only as a short-term income generator while the properties are being marketed.

In August, the Federal Housing Finance Agency working with the Treasury Department and the Department of Housing and Urban Development issued a request for information seeking ideas for the disposition of REO owned by Fannie Mae, Freddie Mac and the FHA, including ideas for turning these properties into rental housing.

Together, the GSEs and FHA hold half of the outstanding REO inventory, and so may be able to aggregate enough properties to facilitate a cost effective rental program in many markets.

In thinking through how a rental program might be structured, I want to highlight three possible design considerations. First, as I noted earlier, achieving a cost effective program may require attaining a critical mass of properties, perhaps a couple hundred or more within a limited geographic area; in this respect the comparative advantage of government is in solving the aggregation problem.

Combined portfolios, GSE and FHA, are large enough to achieve the necessary scale in a number of markets. However, the structuring of such a program might require the flexibility for a pooling entity to acquire properties from more than one seller or to contract for the acquisition of a minimum number of properties over time.

With such flexibility, the scale potential of the GSE FHA portfolios could be supplemented with properties from servicer or financial institution portfolios.

Second, it's important to ensure that such rental conversions are executed in a responsible manner, and in the best interest of renters and local communities.

Replacing the blight of a foreclosed home with a blight of a run-down rental property would provide little assistance to affected neighborhoods.

Examining how best to ensure that landlords keep their properties well-maintained will be crucial.

Third, in many markets house prices have fallen to such an extent that better recoveries may result from renting properties rather than selling them.

However, in other markets, converting REO properties to rentals may not be in the narrow best interests of financial institutions or mortgage investors, but may be in the best interests of local communities.

For these markets, it may be useful to consider the possible role of new incentives, and if so, what form these incentives might take.

While existing statutes and regulations do not prohibit financial institutions from renting REO properties, supervisors in current sales is the primary disposition tool.

In light of the relative weakness of the owner occupied market, and the strength of the rental market, along with the potential for the GSE FHA program to solve the problem of insufficient scale in some markets, conditions are unusual enough that it might also make economic sense to clarify existing expectations, to recognize that in some cases converting a portion of residential REO to rental may be a reasonable option for financial institutions.

Depending upon the conditions and their individual markets, I believe that having such an option could allow for better outcomes for institutions; that is, a superior net present value, compared with traditional disposition approaches, and could at the same time contribute to market healing.

However, to be effective in promoting better outcomes, such an approach would require supervisors to clarify current supervisory guidance, or address how existing standards might apply to the valuation of real estate converted to rental, the time limits applicable to such holdings, and other aspects of managing those properties.

Financial institutions with large portfolios might be able to achieve scale in some markets on their own, or possibly leverage the scale of a GSE FHA program. If such a program were created, smaller institutions should also have the flexibility to act in accordance with conditions in their local markets.

In addition to consideration of conversion strategies with significant scale, there are steps that all REO holders can take today to ensure that they are not contributing further to the problems. They can and should make sure they are adequately monitoring any third-party vendors with which they contract to maintain, market, or sell REO properties.

Certainly the recent interagency review of servicers revealed the severe consequences that can result from failing to monitor third-party vendors.

Before converting REO properties to rental, REO holders could also consider first look types of programs, to enable owner occupants, public entities and nonprofits windows of time to bid on available properties.

A number of institutions have already used such programs with successful results. And REO holders who sell large numbers of properties to investors should consider processes such as those used by the GSEs to screen and monitor bulk investors to reasonably assess their probable actions regarding maintenance and disposition after acquiring the properties.

So far I've talked solely about REO to rental as a solution for REO properties, but that is not going to work everywhere. In particular, some properties are too damaged or otherwise too low value to be sold as owner occupied units or profitably converted to rental properties. In fact, we estimate that about 5 percent of the properties in the REO inventory of FHA and GSEs are appraised at less than $20,000, and in some markets the share is significantly higher.

In many of these cases, the cost to repair or demolish existing structures exceeds their market value, and a different type of approach might be needed. In recent years local governments and community-based organizations have struggled to counter the effects of foreclosure on neighborhoods. One tool for controlling the temporary condition and ultimate disposition of REO properties is use of a unique entity known as a land bank.

Land banks are typically public or nonprofit entities created to manage properties not dealt with adequately through the private market. The life span of these entities may be time limited with sunset provisions. The notion of a land bank rather than a land trust is that properties are brought in and moved out of a land bank's portfolio rather than permanently preserved.

Using this kind of mechanism, a community can gain control of low-value properties that may otherwise sit vacant and cause problems for surrounding neighborhoods. Options available for disposing of the properties include physical rehabilitation, some period of rental, sale to new owner occupants or responsible investors, or in some cases demolition.

Because it likely will take several years for the overhang vacant properties to be sold, such a strategy would help some communities deal with a short-term crisis and then ultimately allow for the disposition of properties in a manner suitable to local market conditions over the longer term.

While few land banks currently have the resources to operate at significant scale, the land bank model is one that has shown success, and that could help many communities stabilize troubled properties if used more extensively.

However, although such an approach holds promise, the current infrastructure for land banks is limited. First, not all states have passed legislation that is needed to permit land banks. Second, this is difficult work, and existing land banks have limited capacity to handle high numbers of properties at a time. More funding and technical assistance would be needed to scale efforts up to an adequate level.

Of course, new funds are hard to come by in the current fiscal environment. But this approach appears to be an instance where relatively modest investments have the potential to yield significant benefits, such as reduced cost, reduced crime stemming from vacant properties, lower municipal costs, to limit property deterioration, or to provide services to neighborhoods that are largely vacant, higher property tax revenues derived from property values not being unduly depressed, and other benefits that may be realized.

These are my thoughts on things that could be done in the near term to help housing markets stabilize and rebalance. An immediate priority is rebalancing supply and demand in a market overwhelmed by financially stressed homeowners, tight credit conditions and an unusually high number of foreclosed homes.

It's an important part of rebuilding our market for housing and housing finance, but it's only a part.

In addition, we must think carefully about longer term policy and market changes that may affect Americans' housing options for years and even decades to come. This is important work, and I appreciate your participation in the forum today. Thank you.

(Applause.)

And it looks like we do have time for a couple of questions and can stay on schedule. Please raise your hand to get a microphone.

>> Thank you for that. It was excellent. Two questions. One, a data point. The two million houses that you talked about, I think you said were REO for sale, meaning on the market. I'm wondering if you have an estimate of the shadow inventory that is not yet on the market, but already defaulted.

Then the second question is 600,000 seems much higher. You have given so many really great ideas about how to deal with this REO, and yet we've been dealing with this crisis now going on for four years and we're still having foreclosures stack up. I'm just wondering from your perspective, where do you see the housing market going, assuming none of these great ideas that have been being put forward over the last several years actually get instituted in a scale. What is your sort of outlook for where we're going?

>> ELIZABETH A. DUKE: To your first question, I'm not going to try to cite a statistic off the top of my head that hasn't been checked. But I will say that the two million I refer to were

vacant homes for sale, not REO for sale. The REO out of that is 5 or 600,000.

To your second question, we thought a lot about this. I think there's been an awful lot of attention paid to loan modifications, and frankly, less attention paid to what happens to the loans that for whatever reason can't be modified, won't be modified, and ultimately will go through the foreclosure process.

I think we are getting to the point where we are addressing that part of it. It is critically important to getting back to whatever the market is going to be going forward.

There is nothing in here that is, if we just did this one thing, that would clear all of that inventory. But I think it's going to take a number of small things all of which will help and complement each other in a strategic sense, and so that you get a little movement from one and a little movement from the other, and they work together to get a little movement from something else.

I think that is the way we are going to have to approach it. I've tried not to be very prescriptive as to how the programs would work, but talk about some of the frictions, looked for things that were not necessarily incentives to get someone to do something, but places where the market itself just didn't seem to be working the way you would expect it to.

>> Governor Duke, nice to see you again. I was pleased to hear you mention the disparate impact that the crisis has had on lower wealth people, people of color and female headed households. And I wondered which of your policy solutions that you discussed or other solutions would most help those populations.

>> ELIZABETH A. DUKE: I don't think there's anything in this group of policy solutions. I think there may be some other things that are specifically directed in that area, although I do think paying attention to both the needs of renters and owner occupants is going to be

particularly important, because there seems to be a growing demand for not just rental properties that are multifamily properties, but also rental properties that are single family properties in the same neighborhoods where foreclosures are taking place.

And so in that sense, I think to the extent that those families are being disproportionately foreclosed upon, this would provide housing options again in the same neighborhoods.

>> Thank you, Governor. Jared C. Burke with MF Global. You talked about this refinancing program. One of the counter-arguments we have heard is that if there is a mass refinancing, that that could cause MBS investors to either flee the market going forward, or to demand a higher risk premium that could raise housing finance cost across the board.

How do you weigh that potential risk against the potential benefits that you were discussing?

>> ELIZABETH A. DUKE: I guess what I would say to that is that when I used to buy mortgage-backed securities, I always knew they were subject to refinancing if rates fell below a certain level.

And I think that's been the case. I think prior to the last couple of weeks, when there has been a lot of discussion about refinancing, there had gotten to be within the market a pricing of these frictions into those mortgage-backed securities; in other words, assumption the frictions would continue and therefore refinancings would not occur at the rate that might have been expected.

I don't view changing that dynamic as being harmful to the markets. One more? Or maybe not. Thank you very much.

(Applause.)