BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

January 4, 2012

The Honorable Spencer Bachus
Chairman
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

The Honorable Barney Frank
Ranking Member
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman and Ranking Member:

Restoring the health of the housing market is a necessary part of a broader strategy for economic recovery. There has been much discussion about the pathway forward, and the Federal Reserve has received questions and requests for our input and assistance. We have been looking at these issues and in the interest of continuing a dialogue, my staff has written a white paper, entitled "The U.S. Housing Market: Current Conditions and Policy Considerations." In this report, we do not attempt to address every problem faced by the housing market; rather, it is our intention to provide a framework for thinking about certain issues and tradeoffs that policymakers might consider.

I have enclosed a copy of the white paper for your review. I and my staff would be happy to discuss these ideas more fully. I hope that you will not hesitate to contact me if we can be of assistance.

Sincerely,

Enclosure

January 4, 2012

The U.S. Housing Market: Current Conditions and Policy Considerations

The ongoing problems in the U.S. housing market continue to impede the economic recovery. House prices have fallen an average of about 33 percent from their 2006 peak, resulting in about $7 trillion in household wealth losses and an associated ratcheting down of aggregate consumption. At the same time, an unprecedented number of households have lost, or are on the verge of losing, their homes. The extraordinary problems plaguing the housing market reflect in part the effect of weak demand due to high unemployment and heightened uncertainty. But the problems also reflect three key forces originating from within the housing market itself: a persistent excess supply of vacant homes on the market, many of which stem from foreclosures; a marked and potentially long-term downshift in the supply of mortgage credit; and the costs that an often unwieldy and inefficient foreclosure process imposes on homeowners, lenders, and communities.

Looking forward, continued weakness in the housing market poses a significant barrier to a more vigorous economic recovery. Of course, some of the weakness is related to poor labor market conditions, which will take time to be resolved. At the same time, there is scope for policymakers to take action along three dimensions that could ease some of the pressures afflicting the housing market. In particular, policies could be considered that would help moderate the inflow of properties into the large inventory of unsold homes, remove some of the obstacles preventing creditworthy borrowers from accessing mortgage credit, and limit the number of homeowners who find themselves pushed into an inefficient and overburdened foreclosure pipeline. Some steps already being taken or proposed in these areas will be discussed below.

Taking these issues in turn, the large inventory of foreclosed or surrendered properties is contributing to excess supply in the for-sale market, placing downward pressure on house prices and exacerbating the loss in aggregate housing wealth. At the same time, rental markets are strengthening in some areas of the country, reflecting in part a decline in the homeownership rate. Reducing some of the barriers to converting foreclosed properties to rental units will help redeploy the existing stock of houses in a more efficient way. Such conversions might also increase lenders' eventual recoveries on foreclosed and surrendered properties.

Obstacles limiting access to mortgage credit even among creditworthy borrowers contribute to weakness in housing demand, and barriers to refinancing blunt the transmission of monetary policy to the household sector. Further attention to easing some of these obstacles could contribute to the gradual recovery in housing markets and thus help speed the overall economic recovery.

Finally, foreclosures inflict economic damage beyond the personal suffering and dislocation that accompany them.[1] In particular, foreclosures can be a costly and inefficient way to resolve the inability of households to meet their mortgage payment obligations because they can result in "deadweight losses," or costs that do not benefit anyone, including the neglect and deterioration of properties that often sit vacant for months (or even years) and the associated negative effects on neighborhoods.[2] These deadweight losses compound the losses that households and creditors already bear and can result in further downward pressure on house prices. Some of these foreclosures can be avoided if lenders pursue appropriate loan modifications aggressively and if servicers are provided greater incentives to pursue alternatives to foreclosure. And in cases where modifications cannot create a credible and sustainable resolution to a delinquent mortgage, more-expedient exits from homeownership, such as deeds-in-lieu of foreclosure or short sales, can help reduce transaction costs and minimize negative effects on communities.

Intertwined in these issues is the unresolved role of the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, in both the near term and long term.[3] The GSEs hold or guarantee significant shares of delinquent mortgages and foreclosed properties. Because of their outsized market presence, the GSEs' actions affect not only their own portfolios, but also the housing market overall. However, since September 2008, the GSEs have operated in conservatorship under the direction of the Federal Housing Finance Agency (FHFA), with specific mandates to minimize losses for taxpayers and to support a stable and liquid mortgage market. In many of the policy areas discussed in this paper--such as loan modifications, mortgage refinancing, and the disposition of foreclosed properties--there is bound to be some tension between minimizing the GSEs' near-term losses and risk exposure and taking actions that might promote a faster recovery in the housing market. Nonetheless, some actions that cause greater losses to be sustained by the GSEs in the near term might be in the interest of taxpayers to pursue if those actions result in a quicker and more vigorous economic recovery.

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[1] This paper does not address the important issues surrounding whether lenders and servicers have appropriately carried out their roles in foreclosures. In April 2011, the Federal Reserve, along with the other federal banking agencies, announced formal enforcement actions requiring many large banking organizations to address a pattern of misconduct and negligence related to deficient practices in residential mortgage loan servicing and foreclosure processing. These deficiencies represented significant and pervasive compliance failures and unsafe and unsound practices at these institutions. For further information, see Board of Governors of the Federal Reserve System (2011), "Federal Reserve Issues Enforcement Actions Related to Deficient Practices in Residential Mortgage Loan Servicing and Foreclosure Processing," press release, April 13, www.federalreserve.gov/newsevents/press/enforcement/20110413a.htm, and Board of Governors of the Federal Reserve System (2011), "Federal Reserve Board Announces a Formal Enforcement Action against the Goldman Sachs Group, Inc., and Goldman Sachs Bank USA," press release, September 1, www.federalreserve.gov/newsevents/press/enforcement/20110901b.htm.

[2] See, for example, John Y. Campbell, Stefano S. Giglio, and Parag P. Pathak (2011), "Forced Sales and House Prices," *American Economic Review*, vol. 101 (August), pp. 2108–31, www.aeaweb.org/atypon.php?return_to=/doi/pdfplus/10.1257/aer.101.5.2108; and Dan Immergluck and Geoff G. Smith (2006), "The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values," *Housing Policy Debate*, vol. 17 (1), pp. 57–80 (Washington: Fannie Mae Foundation), http://content.knowledgeplex.org/kp2/cache/documents/1860/186040.pdf.

[3] This paper does not discuss alternatives for longer-term restructuring of the housing finance market, including the future form or role of the GSEs.

In this report, we provide a framework for thinking about directions policymakers might take to help the housing market. Our goal is not to provide a detailed blueprint, but rather to outline issues and tradeoffs that policymakers might consider. We caution, however, that although policy action in these areas could facilitate the recovery of the housing market, economic losses will remain, and these losses must ultimately be allocated among homeowners, lenders, guarantors, investors, and taxpayers.

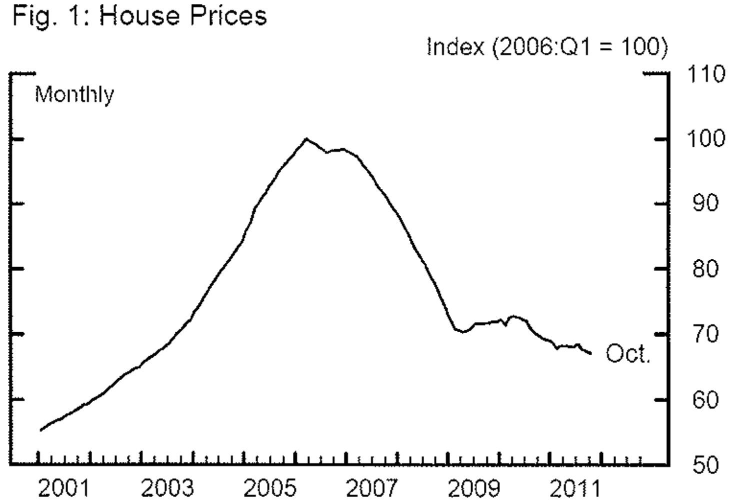
We begin with some background regarding housing market conditions. We then discuss proposals aimed at foreclosed properties that are owned by financial institutions such as the GSEs or banks. After that, we examine proposals aimed at homeowners at risk of default or foreclosure. Finally, we discuss ideas for improving mortgage servicing practices.

Housing Market Conditions

House Prices and Implications for Household Wealth

House prices for the nation as a whole (figure 1) declined sharply from 2007 to 2009 and remain about 33 percent below their early 2006 peak, according to data from CoreLogic. For the United States as a whole, declines on this scale are unprecedented since the Great Depression. In the aggregate, more than $7 trillion in home equity (the difference between aggregate home values and mortgage debt owed by homeowners)--more than half of the aggregate home equity that existed in early 2006--has been lost. Further, the ratio of home equity to disposable personal income has declined to 55 percent (figure 2), far below levels seen since this data series began in 1950.[4]

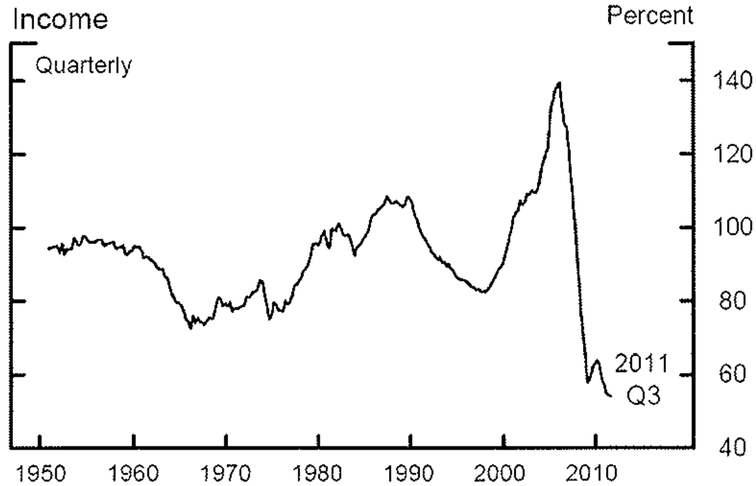
Fig. 1: House Prices



Source: CoreLogic.

[4] Data are from the Federal Reserve Board's Flow of Funds Accounts.

Fig. 2: Ratio of Home Equity to Disposable Personal Income



Source: Flow of Funds Accounts of the United States.

This substantial blow to household wealth has significantly weakened household spending and consumer confidence. Middle-income households, as a group, have been particularly hard hit because home equity is a larger share of their wealth in the aggregate than it is for low-income households (who are less likely to be homeowners) or upper-income households (who own other forms of wealth such as financial assets and businesses). According to data from the Federal Reserve's Survey of Consumer Finances, the decline in average home equity for middle-income homeowners from 2007 through 2009 was about 66 percent of the average income in 2007 for these homeowners. In contrast, the decline in average home equity for the highest-income homeowners was only about 36 percent of average income for these homeowners.[5]

For many homeowners, the steep drop in house prices was more than enough to push their mortgages underwater--that is, to reduce the values of their homes below their mortgage balances (a situation also referred to as negative equity). This situation is widespread among borrowers who purchased homes in the years leading up to the house price peak, as well as those who extracted equity through cash-out refinancing. Currently, about 12 million homeowners are underwater on their mortgages (figure 3)--more than one out of five homes with a mortgage.[6] In states experiencing the largest overall house price declines--such as Nevada, Arizona, and Florida--roughly half of all mortgage borrowers are underwater on their loans.

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[5] Middle-income households are defined as those in the 40th through 60th percentiles of the household income distribution. High-income households are defined as those with income exceeding the 90th percentile of the household income distribution. In 2007, the 40th percentile was around $40,000; the 60th percentile was around $65,000; and the 90th percentile was around $150,000.

[6] This calculation does not account fully for second liens. The share of underwater borrowers would likely be a bit higher if we had complete coverage of these liens. These estimates are derived from CoreLogic and LPS Applied Analytics data.