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**Real Estate, Interest Rates, and the
Mortgage Market Meltdown**

Summary

- Mortgage rates are an important factor in explaining house prices and homeownership rates
- House prices have already corrected to levels at or below their long-term trend
- High spreads between Treasury securities and mortgage rates are further pushing down house prices
- Government must act to reduce mortgage spreads to “normal levels” stabilize house prices and spur homeownership

**What could possibly have caused
real asset prices to boom around
the world (at the same time)?**

Low interest rates

Evidence from user costs

- Variation in the after-tax cost of owning a home can explain an appreciable amount of variation in price-rent ratio
- Excess variation remains, but it is mostly due to US national factors
 - Lending markets
 - Irrational exuberance

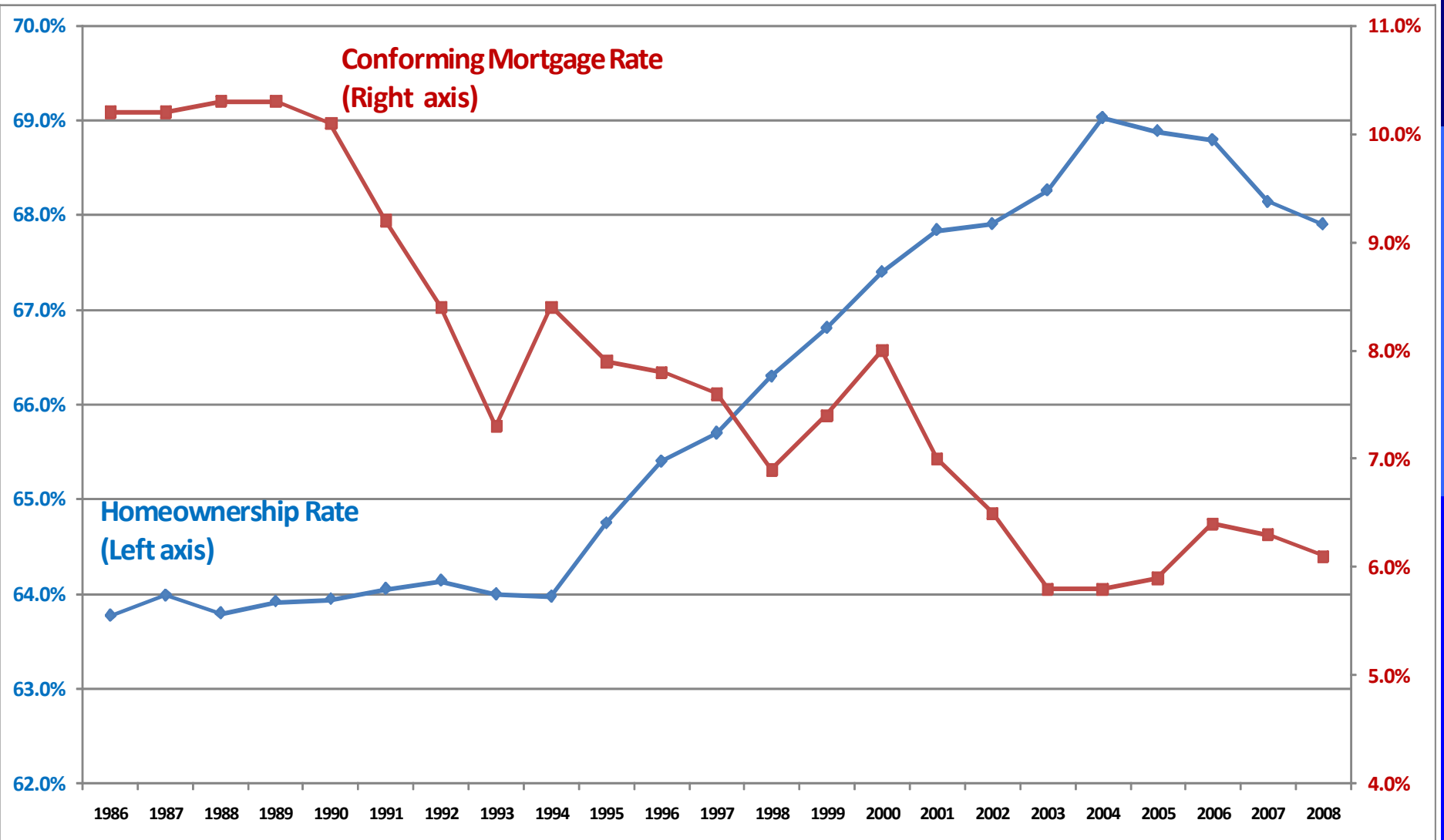
User Cost Regressions With Case and Shiller and OFHEO Price Indexes

Dependent Variable: Log of House Price Index

(t-statistics in parentheses)

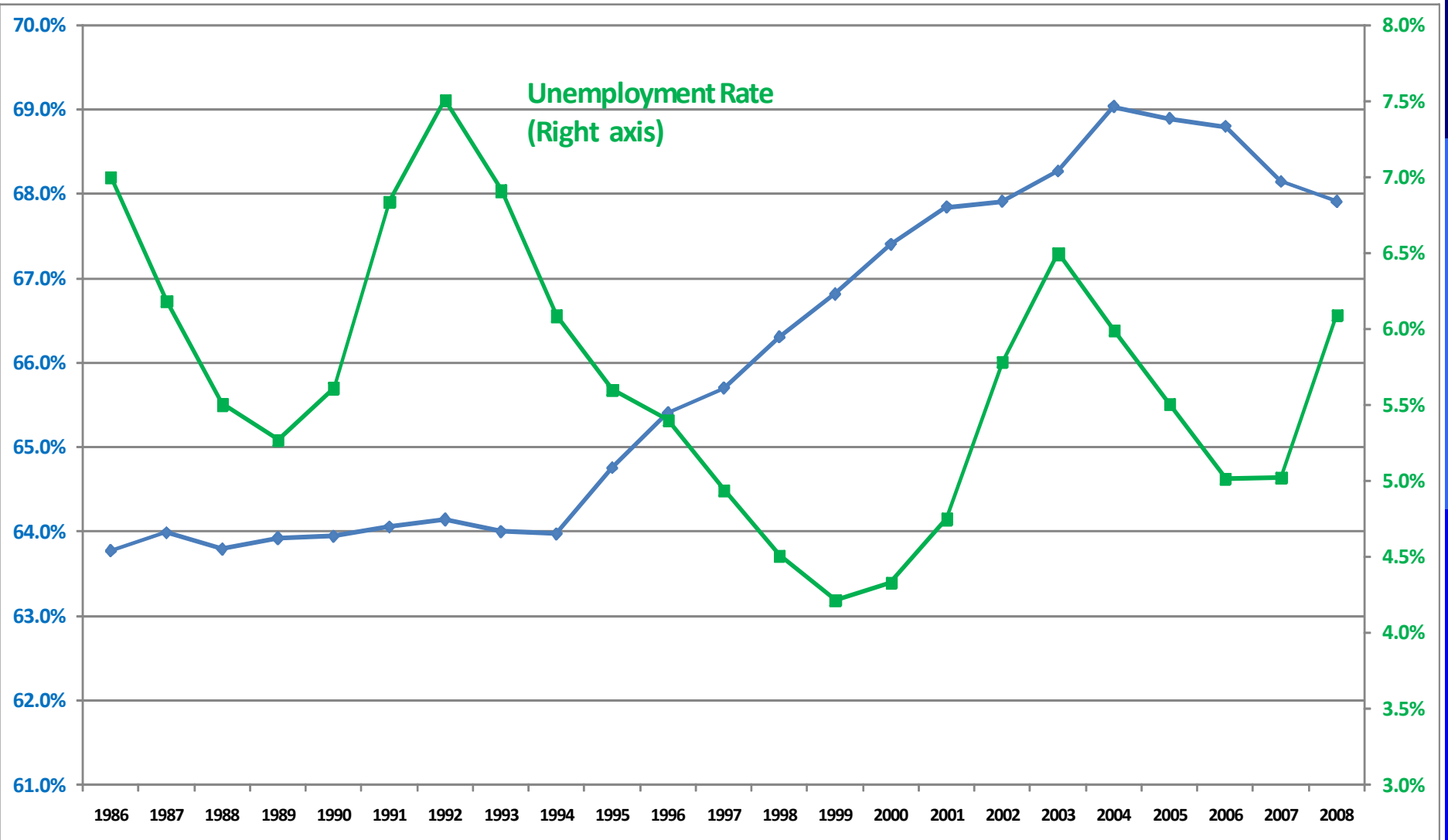
	OFHEO Price Index		Case and Shiller/S&P Price Index	
	(1)	(2)	(3)	(4)
Log of User Cost	-0.85 <i>(-12.71)</i>	-0.62 <i>(-2.53)</i>	-0.73 <i>(-10.80)</i>	-0.75 <i>(-3.09)</i>
Log of Rent	1.34 <i>(15.91)</i>	0.81 <i>(10.74)</i>	1.42 <i>(16.73)</i>	0.93 <i>(12.44)</i>
Year Fixed Effects	No	Yes	No	Yes

Homeownership rate appear strongly linked to mortgage rate



(Sources: US Census Bureau and Freddie Mac)

Homeownership rate appear weakly linked to unemployment rate

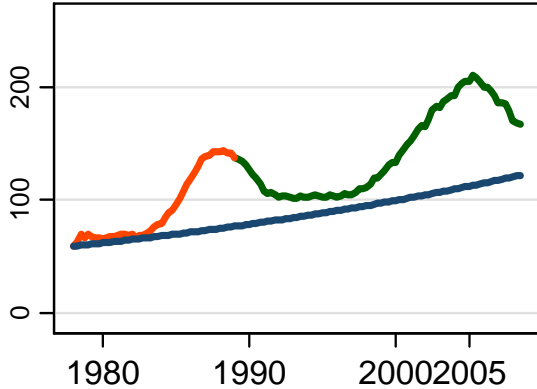


(sources: US Census Bureau and Freddie Mac)

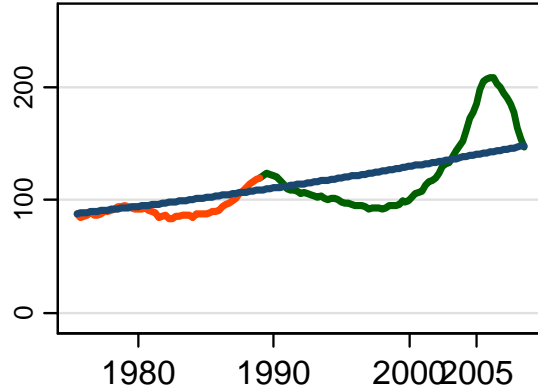
House prices in most markets have fallen close to their real value prior to the boom

House prices relative to 50-year trend

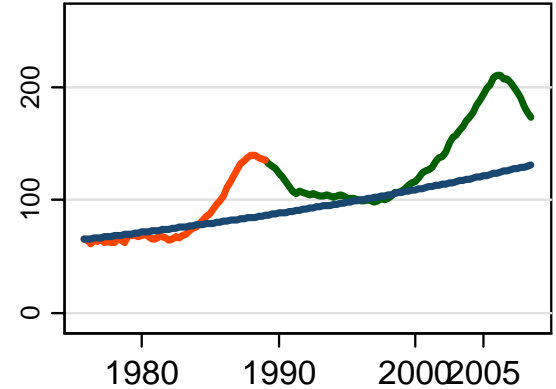
BOSTON



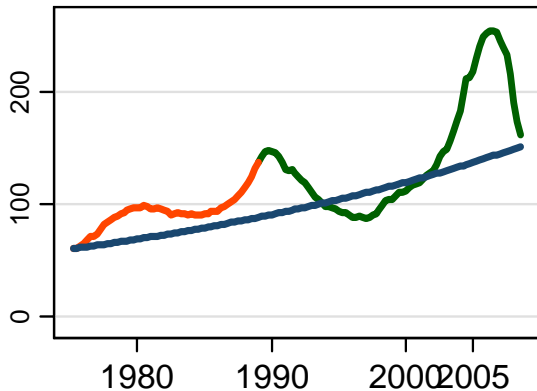
DC



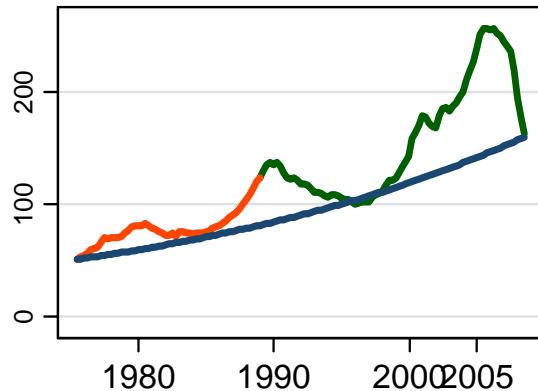
NEW YORK



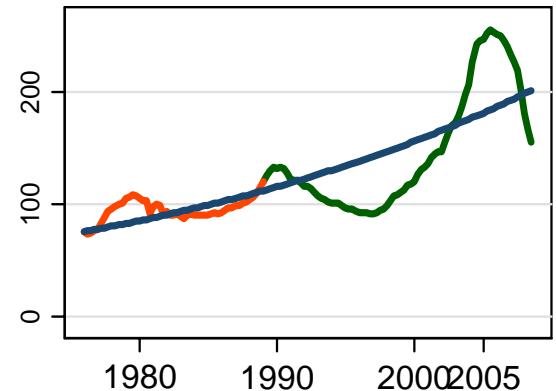
LOS ANGELES



SAN FRANCISCO

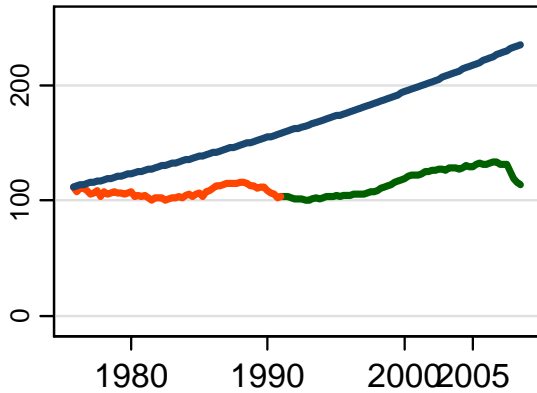


SAN DIEGO

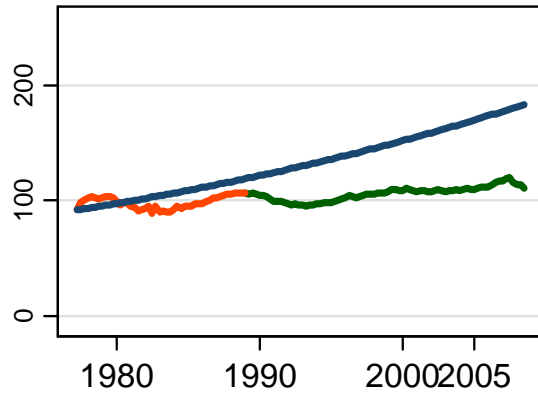


House prices relative to 50-year trend

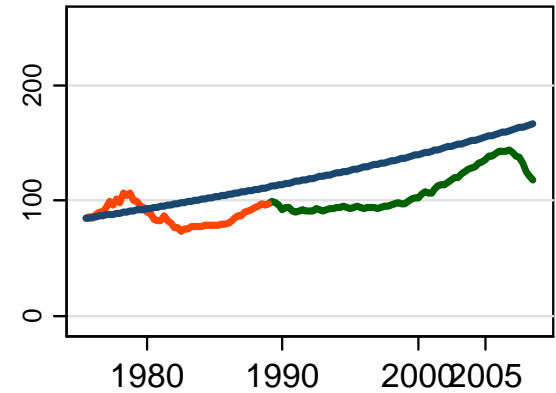
ATLANTA



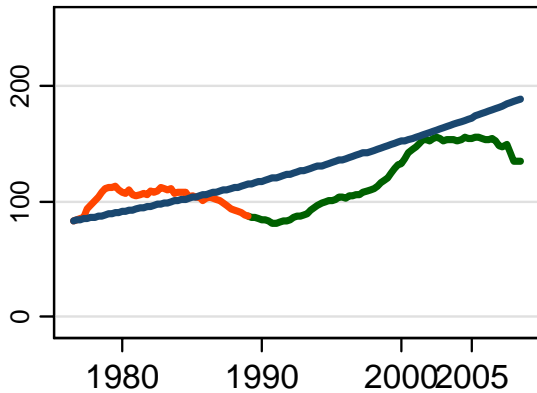
CHARLOTTE



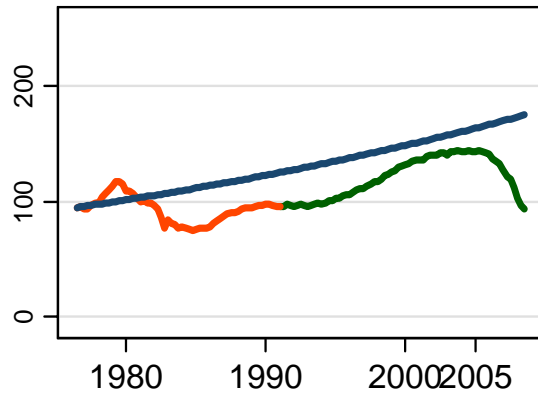
CHICAGO



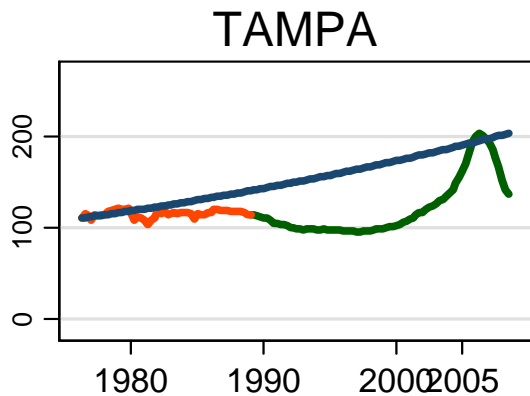
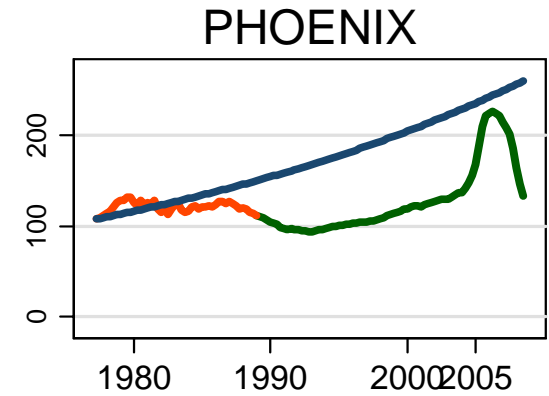
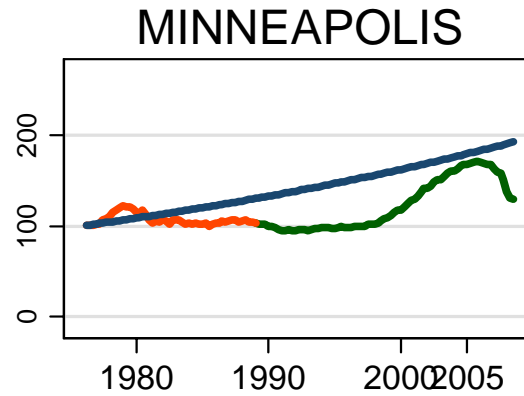
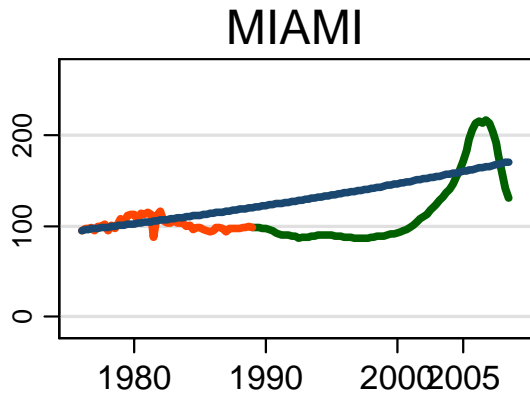
DENVER



DETROIT

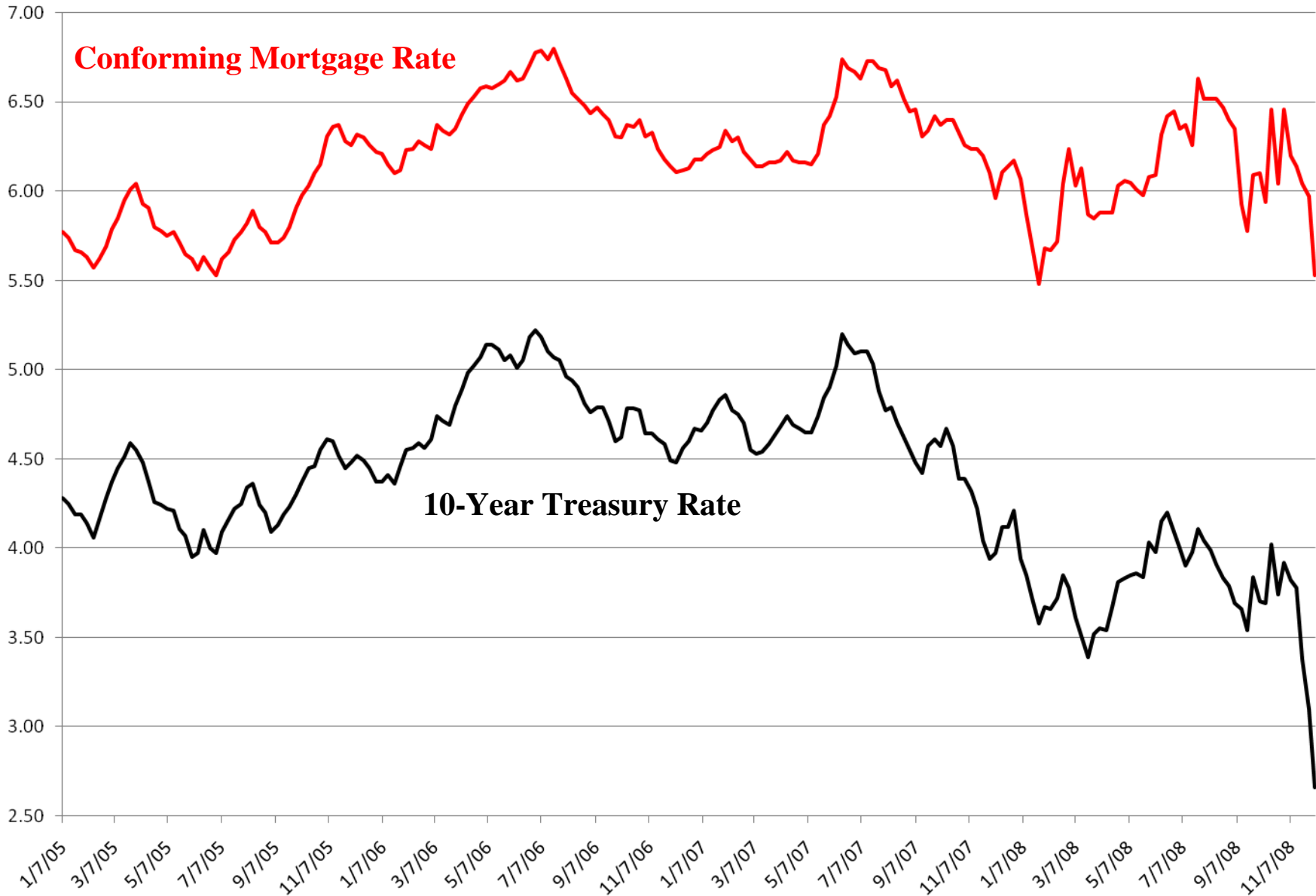


House prices relative to 50-year trend

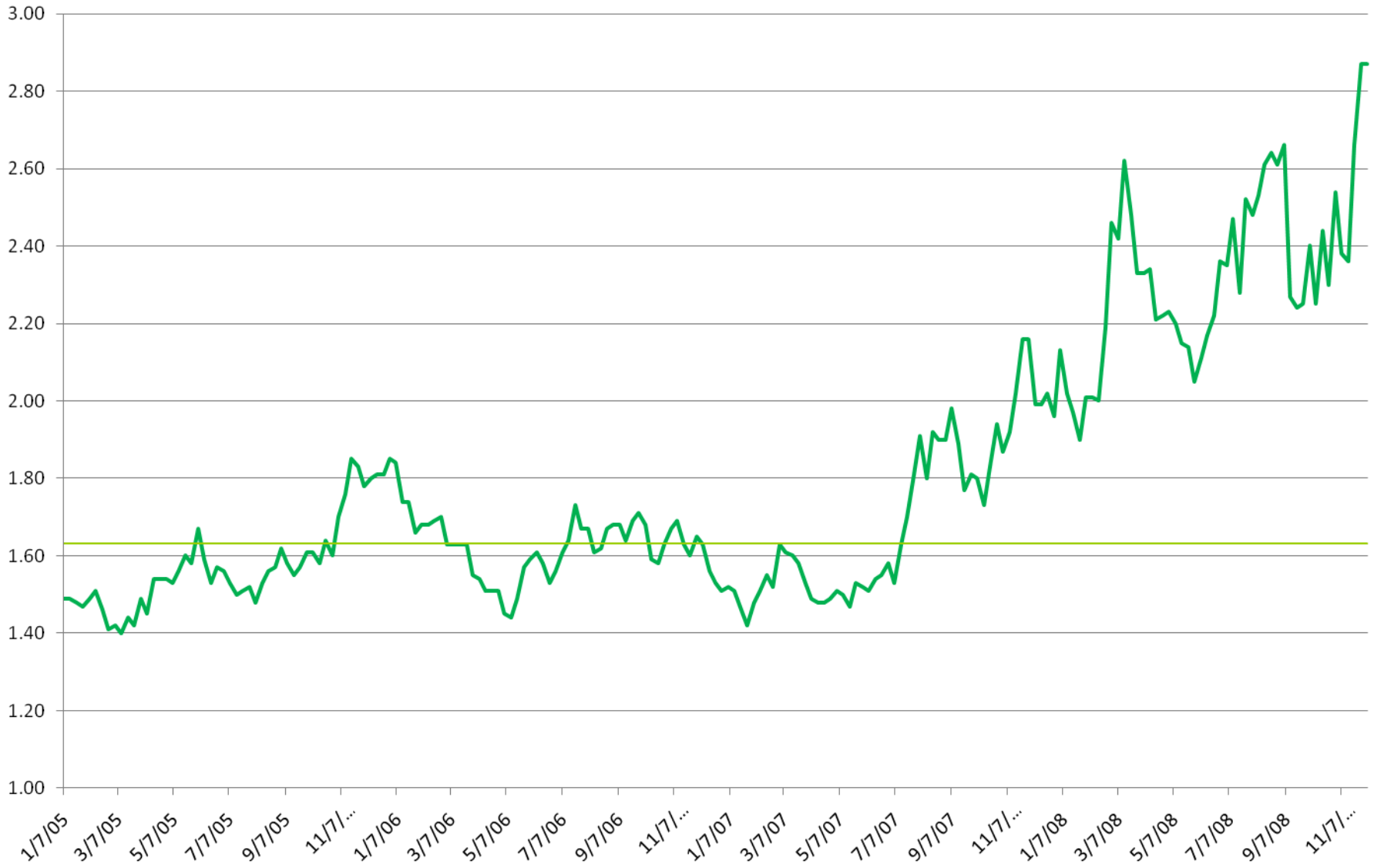


- Fast Forward to September, 2008
- The Government takes conservatorship of GSEs...
- And mortgage rates go up!

Mortgage and Treasury Rates



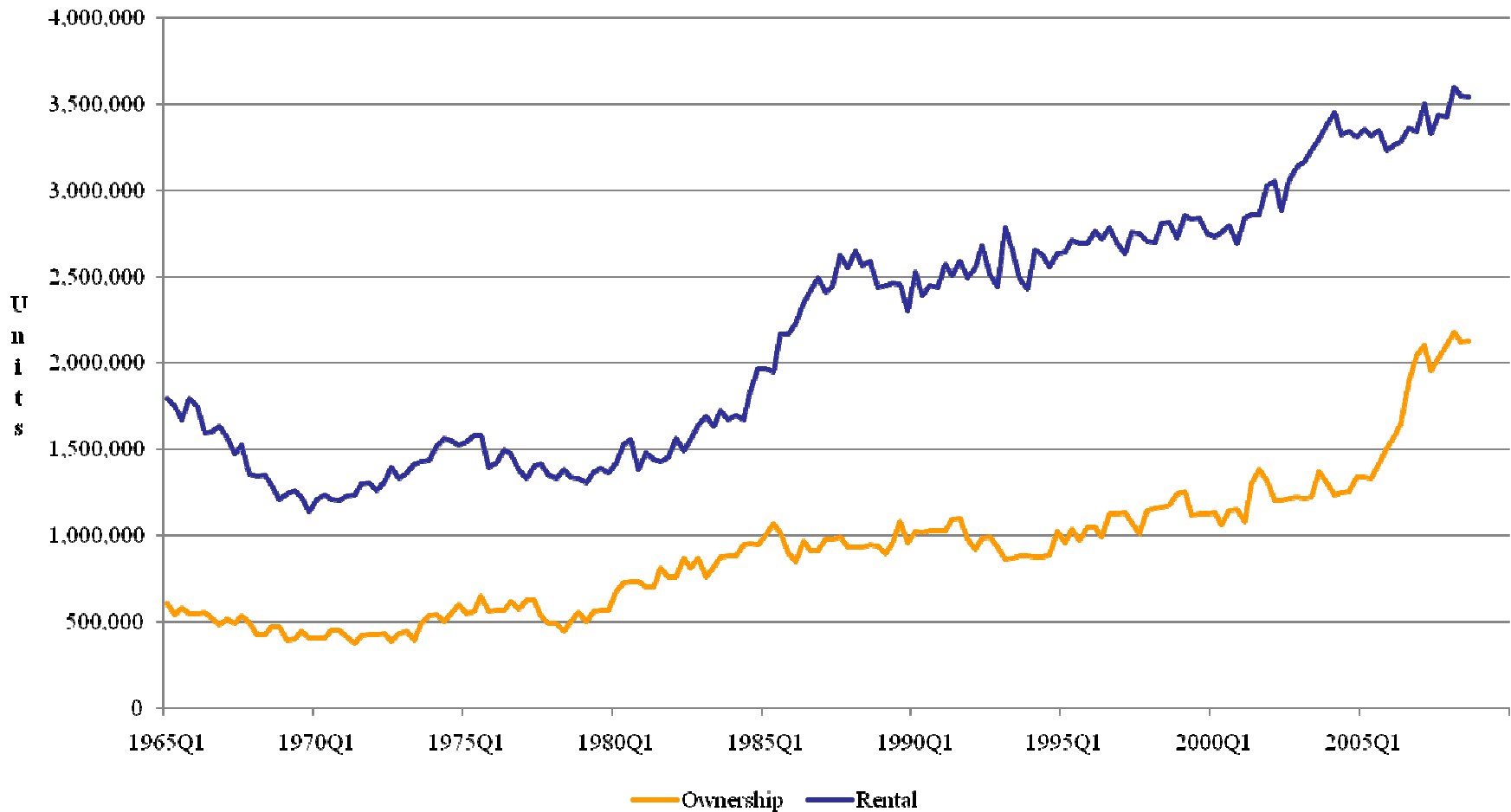
Spread between conforming mortgage rate and 10-year Treasury



Mortgage Market Meltdown and House Prices: Imputed Rent-to-Rent Ratio

Imputed-Rent to Rent Ratio			
	Historical	2008 Q3	Difference
Spread	1.60	2.45	
ATLANTA	0.93	1.07	16%
BOSTON	0.92	1.06	15%
CHARLOTTE	0.91	1.06	16%
CHICAGO	0.99	1.11	13%
CLEVELAND	0.87	0.97	12%
DC	0.89	1.02	14%
DENVER	0.94	1.10	16%
DETROIT	0.78	0.88	12%
LOS ANGELES	0.86	1.02	19%
MIAMI	0.95	1.07	13%
MINNEAPOLIS	0.97	1.10	14%
NEW YORK	0.85	0.96	13%
PHOENIX	0.89	1.05	18%
SAN DIEGO	0.79	0.95	21%
SAN FRANCISCO	0.76	0.95	25%
TAMPA	0.95	1.08	13%

Vacant housing at an all-time high!



Current as of Quarter 3, 2008

Source: US Census

US Residential Vacancy

So what should policy makers do?

- Original “Hubbard-Mayer” proposal
- Fix the mortgage market: lower mortgage spreads to their 20-year average of 1.6 percent (mortgage rate of about 5.25%)
- Create modern HOLC to share losses on negative equity (similar to “Hope for Homeowners” but less punitive for lenders)
 - Lenders write-off one-half the loss
 - Taxpayers pay half the loss, get some future appreciation on the house
 - Borrower gives up future appreciation for the loss write-down

Cost of the proposal

- Lower mortgage rates do not cost the government as it would return mortgage market to normal functioning
- Increased government balance sheet use is offset by tangible assets (newly underwritten mortgages with borrowers who have verified income)
- HOLC provision costs \$121 billion, but taxpayers receive future equity to offset this expense

Why do this?

- *Do something now!* (not wait for courts or legislation)
- *No private mortgage market:* Govt is originating more than 90% of mortgages, so it is setting rates
- *Hold up house prices by 10-17 percent nationally* relative to where they would fall if the mortgage market remains broken
 - 20% house price decline led to \$600 billion in losses for banks, what prices fall another 15%?
 - Taxpayers on the hook for nearly \$6 trillion in guarantees due to Fannie, Freddie, Ginnie, AIG, and NY Fed...

Macroeconomic stimulus

- Total stimulus of \$118 billion *per year*
- 20 million homeowners can refinance existing mortgages, saving an average of \$350/month
 - \$39 billion lower interest payments *per year*
 - \$16 billion lower payments on lower loan balances from HOLC
 - Lower amortization of \$42 billion
- Additional wealth effect of \$63 billion thru reduced house price declines of \$1.8 trillion (with a marginal propensity to consume from housing wealth of 3.5%)

Other benefits

- Help make houses affordable for first-time buyers
- Dramatic program to improve confidence in the housing market
- Remove millions of mortgages from troubled and conflicted servicers
- Refinance borrowers into 30-year, fixed-rate mortgages
- Benefits many homeowners, not just the most over-levered borrowers

“Leaked” US Treasury Proposal

- Mortgage rate of 4.5% for purchase money mortgages only through end of 2009
- Primary vehicle: Fannie and Freddie (minimum 10% down)
- Additional program through FHA for lower down payment mortgages
- Questions:
 - How to ensure retail rate stays at 4.5%
 - Mechanism is still unclear; likely involve Fed facility

Why is this a good plan?

- **Once in a lifetime opportunity to purchase a house at a time of already very low prices!**
- Appreciably improve homeownership and reduce housing inventory
 - About 4.6 million houses on the market
 - 2.1 million vacant houses
- Add up to 2.2 million additional homeowners (see regression below)
- Change consumer perceptions of additional price declines

What is needed next?

- Extend plan to refinancings
 - Easily done without extensive legislation
 - Could be 20 million or more refinancings with bulk of homeowners saving \$400/month or more (this is the equivalent of a new car!)
 - No cost to government with low US Treasury rates

What about foreclosures?

- Bankruptcy reform is not the answer
 - Servicers receive no additional fees to do costly workouts (Gan and Mayer, 2007)
 - Servicers have strong incentive to foreclose instead of workout loans (higher fees for foreclosure and senior to all other obligations)
 - But servicers have exactly the same incentive to go to bankruptcy instead of working out loans (higher fees for bankruptcy)
 - 3 million delinquent loans, 52 million loans that are current
 - Risk of higher rates and lower LTVs in the future

What about foreclosures?

- Our tentative proposal (Mayer, Morrison, Piskorski)
 - Create a fund to pay servicers for successfully working out loans (funded by industry)
 - Most workouts fail, so fee is only paid if borrower is current for at least 6-12 months
 - Set minimum percent of income for workout payments (some loans should not be worked-out)
 - Loan forbearance instead of principal write-down

Conclusions

- Real estate prices are sensitive to interest rates
- Malfunctioning credit markets are hammering US house prices, even in markets with little exposure to subprime lending
- Government intervention can immediately ensure more normal functioning mortgage and housing markets, saving millions from foreclosure
- Foreclosure prevention through re-working servicer incentives
- Covered bond-like structure may provide a new model for residential and commercial mortgages