

By Ronald Temple

## How to *Underpin* Tottering House Prices

The figures for U.S. housing do not look good, with the average homeowner sitting on a huge loan-to-value ratio while property prices continue to fall. But it is not a lost cause. Lazard Asset Management's co-director of research outlines his view that two effective and speedy measures could help lead a way out of the crisis.

The U.S. economy appears to have escaped the chaotic free-fall of just a few months ago. We can thank recent monetary and fiscal decisions for that. But it is too early to say that the economy is stabilizing. Currently, housing is the single biggest risk to recovery.

Efforts to date to shore up the market, while having some effect, have been inadequate to stop the bleeding. It now appears, based on our analysis, that the average U.S. household with a mortgage had only 8% equity in their home as of the end of March — or an average loan-to-value ratio of 92%.

Meanwhile, our proprietary house price forecast, developed in collaboration with Dr. Emma Rasiel at Duke University, predicts an average national decline of 46% from the end of 2008 (see box on the Lazard/Duke house price forecast).

The good news is that this is an improvement on the estimate of 54% generated six months ago. Factoring in the realized declines already observed in the first quarter of this year along with our estimate of the impact of lower mortgage borrowing rates, we would reduce the downside further to a range of 17% to 23%.

That still bodes ill, however, implying that over 30 million mortgage borrowers may end up owing more than their homes are worth within two years. The implications of such a situation for foreclosures, consumer spending, unemployment, and a host of other problems are dire and real. But, in my opinion, housing is not a lost cause. An effective solution, though, must be easy to implement, as time is of the essence in this matter. Its ultimate goal should be to increase demand for houses or to reduce supply, or both, to avoid a situation in which home prices overshoot to the downside. And it should be broadly applicable to the entire universe of homebuyers, rather than to a narrow, targeted group of borrowers as is the case with most of the policies already announced and implemented.

Before laying out a plan to achieve this, I'll review what has and has not worked so far.

### What has worked

The decision by the Federal Reserve and the Treasury Department to purchase government-sponsored enterprise (GSE, or agency) mortgage-backed securities (MBS), announced in late 2008, has worked well. Mortgage rates declined after the announcement by as much as 220 basis points before rebounding recently. For every 10 basis points the mortgage rate declines, the payment on a 30-year



*Avoiding more of these is possible — but Washington should act fast*

Associated Press

fixed-rate mortgage declines approximately 1%. Hence, the 220 basis-point decline in mortgage rates is equivalent to a 22% decrease in the monthly payment for a typical borrower at the lows.

This is very important in two ways: first, it increases demand for housing by lowering the monthly payment on mortgage debt; second, by enabling existing homeowners to refinance their mortgages to lower monthly payments, it leaves more cash flow available to deleverage, sustain consumer spending, or both.

Unfortunately, while mortgage borrowing rates have declined across the board, the rates for non-agency MBS have been less impacted and remain stubbornly high.

Two big tax benefits for home purchases have also had some positive impact. The first, included in February's federal fiscal stimulus package, allows first-time homebuyers with income of less than \$150,000 to claim a tax credit of up to \$8,000 for a home purchase. The second program, implemented in California, grants any buyer of a previously unoccupied home a tax credit equal to the lesser of \$10,000 or 5% of the home purchase price. Both programs appear to have increased home purchases among the targeted audience.

However, I believe the federal program is too narrowly defined and limited in size to impact large segments of the home market and the California program actually creates an incentive to build new homes when there is already a glut of properties available on the market.

### What has not worked

Mortgage modification plans have been both praised and vilified. The reality is that they have helped some borrowers, but not enough to reduce materially the number of homes entering foreclosure. The biggest problem is that processing each loan is a lengthy process, as borrowers often will not even return phone calls from the servicer seeking to reduce their payments.

Moreover, in spite of extensive effort, cost and time expended, many modifications are not justifiable as the borrower simply cannot afford even reduced payments. The fact that so many borrowers whose loans are modified redefault quite quickly thereafter merely adds insult to injury by reinserting the homes into the fore-

closure process at a later date. I believe modifications should not be halted, but they should be applied sparingly. There are negative consequences of such activity, including heightened moral hazard and ultimately higher mortgage borrowing costs, as investors learn that their cash flows can easily be reduced in spite of contractual agreements.

Plans that address one borrower at a time simply take too long to reach the over four million mortgage borrowers who are already delinquent and the over 14 million more borrowers who

now have negative equity and are at an elevated risk of slipping into delinquency. The appeal of designing policies with strict tests of eligibility is that they would appear to narrow the range of beneficiaries to those who truly need assistance. The reality is

that they represent an undisguised manipulation of markets at the micro level that ultimately is likely to raise the cost of mortgage finance. They are also divisive from a partisan perspective at precisely the time when we need bipartisan solutions to the financial catastrophe facing the 75 million U.S. homeowners.

To date, mortgage cram-down proposals have not been legislated successfully, as concerns over the integrity of contract law,

moral hazard and the inherent decrease in predictability of mortgage-related cash flows have derailed supporters. This failure may be a good thing as such proposals would raise serious questions about the rule of law and the property rights of investors who funded the mortgages while having very little positive impact on the number of homes being

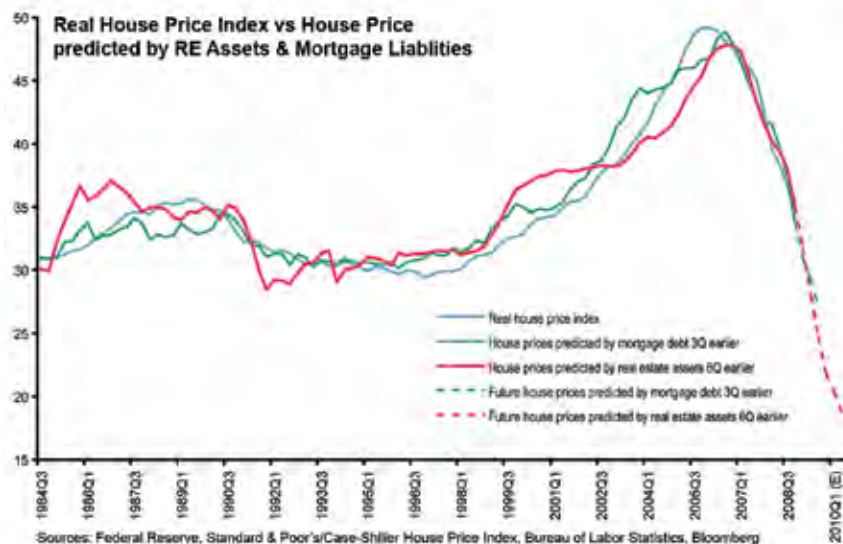
foreclosed. As with modifications, I believe the single most important flaw related to cram-down is that it requires judicial intervention on a borrower-by-borrower basis.

### Tax break for all

What should be done instead? I propose the Obama Administration adopt two measures, both of which expand on policies already in place.

First, extend the tax credit to all buyers of existing, previously occupied homes, without income restrictions. I would like to see a

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## Back to the Future

Our analysis of U.S. house prices adopts an approach not typically used elsewhere. Rather than analyzing house prices relative to rental rates or other affordability metrics — all of which have strong attractions — we examined the consumer balance sheet and changes in the composition of borrowing and the assets such liabilities finance.

What we found is intuitive, but at the same time foreboding. Using data from the Federal Reserve, we discovered that between 1952 and 2006 there was effectively a positive feedback loop between three inflation-adjusted variables: changes in the value of all U.S. residential real estate assets; changes in the amount of home mortgage debt outstanding; and the level of house prices.

Of course, these ought to vary without

any feedback loop, all else being equal: even if home prices stayed the same in real terms, for example, one would expect the total value of residential real estate to increase due to population growth and the resulting household formation, assuming a certain portion purchase a home. It is also logical to assume that this would include some element of financing, meaning home mortgage borrowing would increase as well.

But the model we developed connected these three variables and highlighted the feedback loop quite clearly. We learned that changes in residential real estate assets had strong predictive power, with a three-quarter lag, for the changes in home mortgage debt. We identified a range of reasons for why the relationship might have existed. Quantitatively, the relationship produced a very high R-squared and t-stat.

The relationship between the changes in home mortgage debt and the level of house prices was even stronger from a quantitative perspective with a coincidentally similar three-quarter lag.

What we found was that we had a very effective model that could predict the level of real house prices six quarters forward with the knowledge of changes in the value of residential real estate assets.

The interesting part of these relationships began, however, in the late 1990s. For two decades from the mid-1970s, the level of real house prices was basically range-bound. In the late 1990s this situation changed. As changes in tax policies, decreases in interest rates and easing of terms and conditions for home mortgages coalesced, the increases in residential real estate assets became larger and larger. As financiers saw the increases, they were more willing to provide incremental lever-

tax credit of the lesser of either 5% of the home purchase price or \$20,850 — which is 5% of \$417,000, the upper limit for an agency-conforming mortgage prior to the increase enacted in 2008.

By creating incremental demand, this would significantly reduce the downside in home prices caused by the large number of foreclosed homes being put on the market. Moreover, given the maximum size of the credit, it would provide a boost, albeit smaller, for purchasers of homes that are more expensive than the historical agency conforming loan limit without subsidizing purchases for the wealthiest buyers who are not in need of assistance.

To succeed, this plan should have a short defined life. I would suggest it extends only through the end of 2010, a period of time during which estimates of incremental foreclosures in the United States range to over three million. This enormous incremental number of homes coming into the supply chain in a distressed position necessitates the boost to demand from such a tax credit.

The key point is that we need to pull forward demand for houses to match the bubble of excess supply from foreclosures. This will clearly reduce demand in the years after the tax credit. But the good news is that new housing starts have already declined precipitously, indicating supply and demand may well be balanced without extra government incentives after 2010.

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The plan would be expensive. Assuming there are four million existing home transactions with an average price of \$300,000 in 2010, the cost could be as much as \$60 billion. That said, given that the benefit would be capped at the \$417,000 level, some portion of many homes would be above the limit where there would be no incremental subsidy. This limit could lead to a material reduction in the total subsidy

amount, but it seems safe to assume that the total would not be less than \$40 to \$50 billion over a 12-month period.

Though large, it is actually not far out of line with the funds proposed by the

Obama Administration to support a range of homeowner stabilization plans. By redirecting this money to where it's immediately needed, I believe the Administration should see a much better result. Moreover, this tax incentive is much more likely to be embraced across the aisle, as it would allow consumers to make decisions based on their own economic calculus rather than that of an elected official designing detailed plans.

### Buy more bonds

Second, the current MBS purchase plans should be expanded to include non-agency mortgage bonds: the existing purchase programs conducted by the Fed and the Treasury have been pivotal to reducing the downside in house prices. Even if they have had

age. Real house prices began reaching new highs just as equity and unsecured credit markets were reeling from the technology, media and telecommunications bust and fears of downgrades.

Financing housing-related borrowers was also initially seen as a good vehicle for earning yield and obtaining a long-duration instrument when the U.S. Treasury had stopped issuing 30-year bonds. And as the refinancing bubble of 2003 heightened reinvestment risk for agency mortgage bondholders, the markets facilitated a way to pull forward demand from future years by allowing smaller downpayments, often from homebuyers who in the past would have had to save longer to accumulate the 20% requirement, and created demand that never should have existed from people who were simply not credit-worthy for a credit card or car, much less a house.

What became clear is that once the relationship between the three variables described above broke free from historical, locally driven fundamental constraints, there was room for a sizable overshoot on the upside.

Ultimately, the overshoot was enormous. Now that the bubble has been pricked, our model indicates that we are likely to overshoot any metric of fair value from the context of affordability or comparability by some degree, even after reducing the downside indicated by our model to take into account lower borrowing rates.

That's understandable. Having now learned that housing is not a sure-fire way to always make money, buyers are cautious and lenders are much more conservative. The market needs to disgorge demand for houses that should never have been needed. And legitimate buyers who

were prematurely allowed to purchase a property have to revert to renting until they can obtain the necessary capital to reenter the property market as purchasers. Left to its own devices, the market would probably not simply return to an historical normal level of home ownership of around 63-65%, but instead drop to what could be a materially lower level, perhaps even below 60%.

This can and should be avoided as it is likely to be followed some years down the road by another overshoot to the upside as people realize we became too conservative. The proposals offered in the attached article are designed precisely to avoid that.

*The Duke/Lazard study, entitled [The Crumbling Foundations of U.S. House Prices](http://www.lazardnet.com/lam/us/literature_research.shtml), can be found at [http://www.lazardnet.com/lam/us/literature\\_research.shtml](http://www.lazardnet.com/lam/us/literature_research.shtml).*

a secondary effect on mortgages that cannot be purchased or guaranteed by the GSEs, rates on these loans remain stubbornly high and liquidity is minimal. To protect the Fed's balance sheet, I would suggest purchasing only the triple-A-rated tranches of non-agency MBS.

These securities are less likely to see capital losses now than perhaps at any time in the last two decades: loan-to-value levels are lower across the mortgage lending industry and as the capital structure is more supportive than in the past of the integrity of the triple-A-rated securities.

Last, but not least, given the lack of Fed intervention to date, the non-agency market has been much less liquid than the agency market. The Fed would not have to intervene to nearly the same degree to have a significant impact on these borrowing rates.

The benefit of this plan is that it better addresses the needs of many of the states that have high-cost housing, especially California, but also newly emerging problem areas such as the New York/New Jersey/Connecticut region and areas in the Mid-Atlantic and Southeastern United States. Combined with the tax credit, these actions, and the resulting decreases in borrowing rates, could reduce the cost of purchasing such homes by as much as 10%.

Both policies I propose could be enacted within a short time frame, with an immediate benefit to millions of Americans who

own a home or want to purchase one. Some say we should wait to see the results of plans already announced. But home prices are declining at a pace of 2% to 3% a month based on the S&P Case-Shiller's Home Price Index. If we wait six months to realize that the one-borrower-at-a-time approach does not work, the average American with a mortgage may well have no equity left.

At that point, designing a new plan will be futile to some degree, as the implementation timeline and details around eligibility will mean a mid-2010 solution at best. If the problem is addressed through these tools, I believe the

future decline in home prices could be cut in half, greatly reducing the secondary and tertiary ramifications of remaining house-price weakness.▼

*The views expressed are those of the author and do not necessarily reflect the views of Lazard Asset Management. Information and opinions presented have been obtained or derived from sources believed to be reliable. All opinions expressed herein are as of May 2009 and are subject to change.*

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