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RSC Policy Brief:
Understanding the Current Housing Market

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In light of the increasing concerns over the state of housing in America, the RSC has prepared the following policy brief analyzing the current housing market and legislative responses.

Executive Summary:

- The current housing situation is relatively localized. 44.7% of all foreclosures are located in a handful of states. However, despite clear dips in these and other states, houses are still worth more now than they were four years ago. The Case-Shiller U.S. National Home Price Index was 169.2 in the first quarter of 2005, and it was 170.6 for the fourth quarter of 2007.

- In the fourth quarter of 2007, 91.7% of borrowers were paying on time, 6.3% of borrowers were late in making a mortgage payment (but not in foreclosure), and only 2.0% of borrowers were in foreclosure.

- While many lenders have proven to be unscrupulous, so have borrowers. There was a 44% increase in mortgage loan fraud filings in 2006, stemming from borrowers materially misrepresenting their income, assets, or debt, forging documents, or simply lying about whether the property would be occupied as a primary residence, when in fact it is to be purchased for investment purposes. In addition, the Boston Federal Reserve concluded that the main reason for foreclosures in the subprime market has been the decline in the value of their homes, supporting the conclusion that these homeowners never intended to pay their mortgages at the higher reset interest rate. They bet that their home would continue to appreciate, allowing them to refinance before the expiration of the lower "teaser" rate.

- House Financial Services Committee Chairman Barney Frank (D-MA) has proposed transferring to the taxpayer the actual risk that borrowers and lenders took during the mortgage boom up to a total of $300 billion.

- Many conservatives may have strong concerns with such a government bailout that asks taxpayers who are currently struggling to pay their own mortgage (or renting) to then pay the mortgage of their neighbor. Instead, the RSC is championing the Economic Growth Act (H.R. 5109) to provide broad, growth-oriented incentives for economic activity across all sectors and industries. H.R. 5109 would 1) allow all businesses to immediately expense—or fully deduct on their tax returns—the costs of assets (including buildings) they purchase for their business in the year that they buy such assets ("Section 179" expensing); 2) immediately cut the top corporate income tax rate from 35% to 25%, aligning it with the average rate in the European Union; 3) index for inflation the cost basis used when calculating the capital gains tax on assets acquired before the end of 2008; and 4) allow corporations to benefit from the 15% capital gains rate.

Background: Throughout much of the past decade, housing prices rose rapidly. With interest rates low and fast profits available from accelerating home prices, more and more people bought homes (rather than rent) or moved into larger properties. Lenders and borrowers worried little about the ability of the borrower to make future mortgage payments—especially after a mortgage reset as part of an adjustable rate mortgage—because either: 1) the mortgage would likely be refinanced before the reset, and the borrower would profit from the price appreciation; or 2) if a borrower could not make the mortgage payments, home price appreciation made it presumably certain that the lender could be made whole during foreclosure. Perceived risk dropped dramatically; actual risk remained hidden.

One reaction to this perceived decline in risk for both lenders and borrowers was the proliferation of no- or low-documentation mortgages, for which borrowers supplied no or little information about their financial situations. Additionally, lenders became more willing to extend subprime mortgages—some with no or minimal downpayments—to borrowers with impaired credit histories, and borrowers were happy to benefit from such lower standards. These trends were accelerated by "fair housing" advocates who pushed governments at various levels to require lenders to make more loans using less responsible standards with the goal of increasing home ownership in depressed neighborhoods.

These higher-risk mortgages were typically repackaged into mortgage-backed securities (MBS), which were purchased by investors attracted to the high rates of return and the perceived safety of these securities (because home prices were increasing steadily and robustly). The securitization of subprime mortgages freed-up additional capital for banks to fund even more higher-risk mortgages. As interest rates remained low, credit available for home-buying was relatively inexpensive and easily available, and as a result, according to the National Association of Realtors, the national median home price rose from $110,500 in 1995 to $190,000 ten years later.

Beginning in 2006, housing prices in some areas of the country either flattened or recessed, preventing some borrowers from refinancing. As a result, mortgage defaults and home foreclosures increased significantly. The Mortgage Bankers Association reports that 550,000 subprime loans went into foreclosure in 2007. Default is when a borrower has failed to meet any of the terms of a mortgage contract, including timely or accurate payment, whereas foreclosure is when the lender files to seize the house purchased with the loan because the borrower is in default and no negotiated settlement is reached. It is very much in the interest of the lender and the borrower to avoid foreclosure, since it is expensive, time-consuming, and—for the borrower—damaging to future creditworthiness. The Congressional Research Service cites one study that puts the total cost to a lender of foreclosure, including lost interest, legal fees, and the cost of disposing of the house, at $58,759—and the whole process takes an average of 18 months. Thus, foreclosing is hardly an easy exit from questionable financial decisions.

With greater risks of default and foreclosure and declining home prices (the collateral that secures these mortgages), investors' skepticism increased about the worthiness of mortgage backed securities. As a result, the market for mortgage-backed securities has dried up, with other investors reluctant to purchase these securities because of the increased risk of loss and the increased uncertainty of home values, and a potential government bailout government. And as the demand for these securities has diminished, lenders have stopped making new loans, choosing to instead shore up their reserves, causing a so-called "credit crunch."

The Democrat Bailout: House Financial Services Committee Chairman Barney Frank (D-MA) has proposed transferring to the taxpayer the actual risk that borrowers and lenders took during the mortgage boom. For mortgages originated between the start of 2005 and mid-2007, a lender and borrower would be able to agree on a federal refinancing plan in which lenders would have to write down their loan to no more than 85% of the current appraised value of the property and borrowers would get low, fixed monthly payments and reductions in their principals to 90% of current market value—all backed by the Federal Housing Administration (FHA), up to a total of $300 billion (or $400 billion under Senate Banking Committee Chairman Dodd's plan). To get into the program, a person would have to have debt-to-income ratio over 40. Some observers, including Rep. Frank, are also concerned that otherwise reliable borrowers may "purposely default" to be eligible for federally-backed assistance; thus participating borrowers would have to "certify" that they are not gaming the taxpayer. Further, borrowers could not be denied FHA mortgage insurance because of low credit scores, thereby replanting the seeds for a future surge in foreclosures—but this time at direct cost to the taxpayer.

Over the last three years, according to the Mortgage Bankers Association, the average default rate for borrowers on FHA loans was 12.64%, while the average foreclosure rate on FHA loans was 2.27%. Doing the simple math shows that adding $300 billion in new FHA loans under the Frank proposal would yield $37.92 billion in default risk for the taxpayer and $6.81 billion in foreclosure risk for the taxpayer. However, these figures assume no degradation in FHA risk standards, whereas the "flexible underwriting criteria" standard in the Frank bill would require FHA to ignore borrower credit scores and previous defaults in assessing risk.

A Localized Housing Problem: In assessing the current housing situation, it is important to note that 44.7% of all foreclosures are located in seven states: Arizona, California, Colorado, Florida, Indiana, Minnesota, and Nevada. However, despite clear dips in these and other states, houses are still worth more now than they were four years ago. The Case-Shiller U.S. National Home Price Index was 169.2 in the first quarter of 2005, and it was 170.6 for the fourth quarter of 2007.

Furthermore, in these areas where home prices have gone down, many consumers of housing are likely to benefit. Price *increases* are bad for some people and good for others. Price *decreases* are bad for some people and good for others. When the government intervenes and decides when prices are too high and when they are too low—based on political and media-driven considerations, rather than economic calculation—the government merely distorts the market artificially, hampers the market's natural corrective tendencies, extends the timeframe in which such corrections occur, and spreads the damage to a wider population than would otherwise be affected. In addition, such intervention threatens those future homeowners who smartly chose not to buy in the last few years, believing that such price appreciation was unsustainable, and who now may have a realistic prospect of an affordable home. Why should the federal government alter the market to keep them renting?

The Foreclosure Pool Is Concentrated: It is also important to note how few borrowers are in real trouble and how many homeowners and renters are making due, often by adjusting their behavior to pay their bills. 25 million households own their home without an existing mortgage, 35 million households rent, and 42 million households are adhering to the terms of their existing mortgages. According to the Mortgage Bankers Association, in the fourth quarter of 2007, 91.7% of borrowers were paying on time, 6.3% of borrowers were late in making a mortgage payment (but not in foreclosure), and only 2.0% of borrowers were in foreclosure. An estimated 1.35 million homes went into the foreclosure process last year (up from 705,000 in 2005), and 1.44 million more are predicted for 2008. While these are not insignificant numbers, should the 91.7% be expected to shoulder the burden of the 6.3% (or the 2.0%), especially when many of these homeowners made a conscious decision to bet on the continued appreciation their home values and/or committed mortgage fraud?

As one RSC Member recently stated: “When you’re struggling to pay your own mortgage, you shouldn’t have to pay your neighbor’s.” Many constituents agree. One recently wrote:

> I am opposed to any attempt by government to bail out private citizens who have defaulted on their mortgage. I am not a rich man. I live in a modest 3 bedroom home. My driveway is dirt, and my tractor is worth more than either mine or my wife's automobile. But I have always been careful to not borrow more than I knew I could repay. I have seen others make foolish decisions on home purchases and the associated debt while I did not.

Another constituent wrote:

> Eight years ago, my wife and I bought our first home. Three months later, she was pregnant. She had a very rough pregnancy and had to quit working. My wife is college educated and I am not, so she was the main bread winner of the household. When her income quit coming in, I had to take on multiple jobs in order to keep a roof over our heads and food on our table….To supplement this income, I started a lawn care service, got a vending machine route and sold steak for a meat company….I took on extra hours at my job and started working additional odd jobs. Needless to say, I worked constantly and only came home to sleep….To this day I still don't know how we made it, but we did. We had a couple of late payments on our mortgage but were never in danger of losing our home. Today I own a Real Estate Company that specializes in selling foreclosed homes for banks. I see these people that have given up and just decided to let their homes go back to the bank like it's no big deal….My point is that ANYBODY can take on an extra job to make ends meet.

Predatory Borrowers and Property Speculators: While many lenders have proven to be unscrupulous, according to the Financial Crimes Enforcement Network (FinCEN), so have borrowers. There was a 44% increase in mortgage loan fraud filings in 2006. Most of these stem from borrowers materially misrepresenting their income, assets, or debt, forging documents, or simply lying about whether the property would be occupied as a primary residence when in fact it was to be purchased for investment purposes. As cited in an article by Steven Malanga, BasePoint Analytics notes that 70% of mortgages that quickly default result from some sort of misrepresentation on the part of the borrower, broker, or appraiser (or some combination thereof).

In addition, a new study from the Boston Federal Reserve, which examined 1.5 million homeownerships over nearly twenty years, concluded that the main reason for foreclosures in the subprime market has been neither unmanageable debt thrust upon unknowing borrowers nor financial setbacks of such borrowers, but rather the decline in the value of their homes. Some borrowers made the decision that their home is worth less than they owe on it, and without having much (or any) of a downpayment to lose, chose to walk away from the loan and leave the bank with the property. This study supports the conclusion that these homeowners never intended to pay their mortgages at the higher reset interest rate. Instead, they bet that their home would continue to appreciate, allowing them to refinance before the expiration of the lower “teaser” rate. Taxpayers ought not have to absorb the financial blow for speculators.

The Need for Capital and Certainty: To be clear, the market is already responding. Recognizing that foreclosure is typically an unprofitable last resort, most of the lending community has joined together as part of the Hope Now Alliance to modify over one million mortgages to lower monthly payments to keep families in their homes.

Similarly, some private sector entities are hearing the call of the market. For example, Goldman Sachs Group and private equity firm Equifin Capital Partners are seeking to make money from the collapse of the subprime mortgage market while helping borrowers hold onto their homes. By purchasing loans for as little as 50 cents on the dollar and then collecting the payments and handling the paperwork, these investors can cut costs enough to offer easier terms and still make a profit, says one hedge fund manager engaged in this activity. Once borrowers have re-established themselves, the loans can be resold in the secondary market at a 15-20 percent gain.

Other investors are remaining on the sidelines, waiting to see how Washington will respond. Lawmakers can best help the marketplace normalize by sending a clear message of certainty that there will not be a mortgage bailout enacted and that the government will not engage in risk management with the private sector. Taxpayers at large should not be asked to absorb any of the risk; the risk should be distributed by the private sector. In addition, it is impossible to help some honest borrowers without validating the questionable activities of some dishonest borrowers and lenders who failed to require proper documentation, establish adequate risk controls, and reassess their operating procedures when trouble began to emerge.

Many conservatives are championing a broader proposal aimed at growing the overall economy and unlocking untapped reserves of capital. The **RSC's Economic Growth Act** (H.R. 5109/ S. 2592), introduced in the House by Rep. Scott Garrett (R-NJ) and in the Senate by Sen. Jim DeMint (R-SC), would: 1) allow all businesses to immediately expense—or fully deduct on their tax returns—the costs of assets (including buildings) they purchase for their business in the year that they buy such assets ("Section 179" expensing); 2) immediately cut the top corporate income tax rate from 35% to 25%, aligning it with the average rate in the European Union; 3) index for inflation the cost basis used when calculating the capital gains tax on assets acquired before the end of 2008; and 4) allow corporations to benefit from the 15% capital gains rate. The RSC proposal is designed to provide broad, growth-oriented, permanent incentives for economic activity across all sectors and industries, with immediate application and sustained, long-term implications.

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