

# All of the Above: What to Do About Housing—Now



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In the immediate aftermath of the financial crisis in 2008, housing was at the top of policymakers' priorities. Congress saw a flurry of proposals to deal with the mounting wave of defaults and foreclosures, and the collapse of Fannie and Freddie led first to intensive federal intervention and then to one round of full-fledged debate on what the future of these agencies should be.

Today, with housing in at least as bad a shape as it was in 2008, housing is now the forgotten debate. The conversation over Fannie and Freddie has stalled, if not died altogether; the government's efforts to stem foreclosures have been largely unsuccessful; and with a handful of bold exceptions, few policymakers are putting forward ideas to restore homeowner equity, cope with burgeoning inventory and spark new demand in the market.

But with the economy continuing to sputter, housing is a problem that policymakers can't afford to ignore any longer.

While some may debate the chicken-and-egg issue of whether housing can lead the recovery or whether a recovery can stabilize housing, there's no dispute that the health of the housing market and the broader economy are inextricably intertwined. Housing and its related industries account for roughly 19 percent of the American economy.<sup>1</sup> Since the housing crash, housing—especially construction—has shed 2.9 million jobs<sup>2</sup> since the start of the recession. Not coincidentally, the states with the highest unemployment rates—California, Nevada, Rhode Island, Michigan<sup>3</sup>—are among the states that have been hit hardest by the housing crisis. Moreover, Americans have lost \$7 trillion in equity,<sup>4</sup> which is dampening consumer confidence as well as forcing many families to rethink their future plans and expectations of financial security.

Even conservative economists such as Martin Feldstein are beginning to call for urgent action on housing. As Feldstein opined recently, "the fall in

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house prices is not just a decline in wealth but a decline that depresses consumer spending, making the economy weaker and the loss of jobs much greater.”<sup>5</sup>

The question now is not whether to act on housing, but how.

## **All-of-the-Above: A Five-Step Framework for Restoring Housing**

What follows is a five-step framework for taking action on housing, including a menu of specific policy options that are all worth discussion, even if some of them aren't immediately practicable or need refinement. Many of these recommendations are the fruit of a bipartisan conference<sup>6</sup> sponsored recently by PPI and the Washington-based think tank e21—proof that even in a hyper-partisan environment, bipartisan consensus is possible.

Moreover, the approach we recommend here is “all of the above.” As much as policymakers yearn for a silver bullet, there isn't one. Housing is not only complex, the causes of its current malaise arise from multiple and varied sources. One solution cannot address it all. But the good news is that Congress need not act on a sweeping scale in order to make progress on housing. A package of variously-sized measures, both big and small, could in the aggregate be enough to provide the boost the market currently needs. What follows are some of the potential measures that would have the greatest short-term impact on solving the crisis.

### **Step 1. Do no harm**

For better or for worse, the federal government currently enjoys a much bigger footprint in the housing market today than it has historically. Government-sponsored (and now government-owned) mortgage giants Fannie Mae and Freddie Mac (the “GSE's”) account for nearly 100 percent of the mortgages being bought and “securitized” today. Moreover, the Federal Housing Administration's loan guarantee program accounts for 20 percent of mortgages issued,<sup>7</sup> including the majority of the mortgages made to borrowers with less-than-perfect credit scores under 720.

Government's outsized presence in the housing finance market means that policy decisions now have outsized impact. As practically the monopoly player in issuing, securitizing and guaranteeing mortgages, the federal government's every move now has the potential to create shock waves throughout the market. In particular, policymakers should be wary of proposals that threaten to dampen demand, especially among first-time buyers. First-time buyers typically comprise 40 percent of the market, accounting for about 2 million sales per year, and are the ones we'll need to count on to soak up excess housing inventory in the future.

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Thus, the first step that government can take is not to act on certain proposals that risk weakening the market still further.

- **Don't mandate a 20 percent down payment for homebuyers.**

One of the most damaging things federal regulators are currently thinking of doing is to effectively require all homebuyers to put 20 percent down on a home loan. As part of the implementation of the Dodd-Frank reform legislation, regulators must define what counts as a “qualified residential mortgage” (“QRM”) that is eligible for securitization. Many fear this definition will mandate a 20 percent down payment.

While the intent is to prevent risky zero-down loans and other bad assets from once again tainting the mortgage pool, the government's efforts could turn “skin in the game” into more like a pound of flesh. A 20 percent down payment requirement is exceptionally onerous for first-time and moderate-income buyers, many of whom will be forced to defer their dreams of homeownership. For example, buying a house at today's median price of \$171,900<sup>8</sup> would require \$34,380 down—a heavy burden.

- **Restore higher loan limits for federal mortgage programs.**

As we argued in a previous PPI memo, *Another Kick in the Teeth: Loan Limits and the Housing Market*,<sup>9</sup> the government's current presence in the housing market is crucial. Without the support of such important federal efforts as the Federal Housing Administration's (FHA) guarantee program, the market would arguably be in far worse shape.

On October 1, the size of the loans that could be supported by the FHA and the GSEs dropped in hundreds of counties across the country when legislation intended to broaden access to these programs arbitrarily expired. Potential buyers in as many as 669 counties now have less access to FHA lending than they did before, which means potentially higher costs and fewer available loans, especially for the first-time and minority buyers who are the FHA's core market. Policymakers should restore broader access to FHA lending by restoring the loan limits that were in effect in September.

### **Step 2. Throw a lifeline to underwater borrowers**

One of the most damaging aspects of the current crisis is the loss of home equity. With some lucky exceptions, practically every homeowner in the country has seen the value of his or her home decline or, at best, stay flat. As many as 28 percent of homeowners with a mortgage—11 million borrowers—are now “underwater,”<sup>10</sup> meaning that they owe more on their mortgages than their homes are worth. Moreover, many of these borrowers are also victims of the stagnant economy and can no longer even afford the payments on their underwater loans.

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“Negative equity” is a lead weight on both the housing market and the broader economy. It means borrowers can’t refinance into lower-rate mortgages with smaller monthly payments and less likelihood of default. It may encourage “strategic defaults,” which also only adds to the death spiral of falling prices. Underwater borrowers are the leading edge of the current onslaught of delinquencies and foreclosures.

In addition, negative equity is a problem even for those at no risk of losing their homes. This vast loss of middle-class wealth means less equity for homeowners to draw on to send a child to college, start a small business or engage in other endeavors that could lead to future growth. It means “job lock” for those who might want or need to relocate for a better job but who can’t sell their houses, as well as the inability of families to “trade up.” And it means generalized lack of confidence and anxiety in the future value of the single biggest asset that most middle-class families own.

Unfortunately, the debt owed by underwater borrowers can’t simply be wiped away without causing even greater damage to either the federal budget or to the economy. But we can begin to chip away at the problem.

- **Encourage lenders to write down loans in exchange for a share of future appreciation.**

As Richard Smith, President and CEO of Realty Corporation, puts it, underwater borrowers in trouble on their loans face no good options now for resolving their plight: (1) they can keep paying their mortgage and hope home values improve (which could take awhile); (2) they could default and hope for a modification; (3) they could mail the keys back to the lender (a.k.a. “jingle mail”) in a “deed in lieu of foreclosure” arrangement; (4) they could sell at a loss in a short sale; or (5) they could default and wait for foreclosure. The result, Smith says, is that “families are displaced, credit scores are destroyed, lenders and [mortgage-backed securities] investors suffer significant losses, average home prices continue to decline and neighborhoods are blighted.”

Smith and others advocate what he calls a “debt for equity” approach: “the lender would retire the existing loan, write a new loan based on the current appraised value and then take an ownership position in the property.” When the owner sells the home at a later date (presumably for a higher price than the amount of the new loan), the lender would take a share of the appreciation in price. Under this approach, homeowners keep their homes and lower their monthly payments while lenders take a smaller hit than they would have with a default and foreclosure.

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Variations of this proposal have already been tried with success on a smaller scale in the private sector by servicers such as Ocwen, and Sen. Robert Menendez (D-NJ) is currently drafting legislation to create a two-year pilot program within the Federal Housing Finance Agency for the modification of GSE-held loans in this way. This legislation would “test” the concept on a smaller scale. While the mechanics of “shared appreciation” require further refinement, this concept could be a highly promising way of rescuing underwater borrowers and the market.

- **Refinance GSE portfolio loans to lower market rates.**

One of the most talked about recent proposals is the so-called “grand refi,” which would strip away many of the current barriers that have kept millions from refinancing at today’s historically low interest rates. Under each of the several variations of this plan, borrowers who don’t currently have enough equity in their home to qualify for a refinancing would still be able to do so. For example, under the leading proposals sponsored by Sens. Barbara Boxer (D-Cal.) and Johnny Isakson (R-Ga.) and Rep. Dennis Cardoza (D-CA), homeowners whose mortgages are currently owned by one of the GSEs would be eligible for refinancing into a lower-rate loan, even if the owner has no equity. Because the GSEs own these loans already, refinancing would create no additional risk of default. If anything, it would lower the risk of default by lowering the payments for borrowers, while at the same time putting more money into the pockets of borrowers to spend on other things that could stimulate the economy.

### **Step 3. Soak up supply by sparking new demand**

Thanks to a deepening spiral of falling home prices, high foreclosure rates and overbuilding during the boom, the housing market is close to paralysis: there’s both too much to sell and no one is buying.

The glut of foreclosed properties has led to a variety of proposals for soaking up supply by converting them into rentals or putting them toward other purposes (for example, Detroit Mayor Dave Bing has created a community-policing program to house police officers in foreclosed homes). But the best way to reduce inventory might be to unleash pent-up demand, especially among first time buyers.

- **Create a permanent homebuyer tax credit for moderate-income homebuyers.**

Sen. Jeff Merkley (D-Ore.) has proposed a permanent homebuyer tax credit to help low- to moderate-income families who can’t take advantage of the mortgage interest deduction. Sen. Merkley proposes a \$5,000 first time homebuyer tax credit that would need to be matched dollar-by-dollar by the homeowner. Sen. Merkley notes two primary benefits: in the short term, it

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would help the market absorb distressed inventory. In the longer term, it would create a strong pathway to homeownership for working families and encourage savings.

- **Create “HomeK” set-aside accounts to encourage savings for down payment and retirement.**

Under this proposal by PPI, people would have the option to segregate up to 50 percent of their employee contributions into an existing retirement account (401(k), IRA, SEP) for a housing-specific “sub-account.” Employer matching contributions would not be eligible for this set-aside, and the lifetime limit per individual would be \$50,000 in pre-tax contributions. Money in a person’s HomeK set-aside could be withdrawn without penalty and at steeply discounted tax rate to be applied toward a down payment on a first home. This proposal would not only put younger Americans on the path to homeownership, it would create an incentive to open a retirement account by providing a shorter-term financial goal. Currently, just 13 percent of Americans aged 20 to 30 who have access to a 401k, own a 401(k) account.<sup>11</sup>

- **Encourage investor purchases of foreclosed property.**

Currently, the government is sitting on millions of foreclosed homes—a liability for taxpayers as well as a blight on the communities where these homes are located. One way to reduce this inventory and help restore communities is to enable bulk purchases by investors willing to turn around these properties into affordable rental housing. One proposed approach, for example, would be to open the Section 203(k) FHA loan program to investors.

- **Create “homeownership vouchers” for lower-income Americans.**

In another report for PPI, American University Professor Robert Lerman proposes “homeownership vouchers,” patterned after Section 8 vouchers, that would be targeted to lower-income first-time buyers. Lerman proposes converting the current Low-Income Housing Tax Credit into 1 million homeownership vouchers, which he argues would help reduce excess inventory, stabilize prices in particularly hard-hit areas and reduce the waiting list for federal housing assistance.<sup>12</sup>

#### **Step 4. Fix Fannie and Freddie sooner rather than later**

Thanks to the heroic—but politically unpopular—federal intervention in the immediate aftermath of the financial crisis, Fannie Mae and Freddie Mac are the federal government’s ultimate “toxic assets.” Understandably, politicians would like to avoid the subject of GSE reform: it’s complicated, it’s

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potentially expensive, it's divisive, and any practical solution would force policymakers—at significant political risk—to acknowledge that the government must maintain a major presence in housing.

Nevertheless, policymakers need to bite the bullet sooner rather than later. The reason: uncertainty. Government cannot maintain its near-monopoly on housing finance forever, yet private capital is wary of investing in a market whose rules could change in 18 months or with the next election. If government ever wants to reduce its footprint in the market, it must establish a clear path for how it's going to do so. Even if solutions aren't immediately in the offing, policymakers must at least agree to a process that will lead to near-term certainty and help build confidence in the market.

- **Establish a GSE reform super-committee.**

Like deficit reduction, the fate of the GSEs can only be resolved with a bipartisan process that is as depoliticized as possible. A bipartisan panel of lawmakers should be given a six-month timetable to draw up a proposal that would be subject to an up-or-down vote by Congress.

### **Step 5. Articulate a new national housing policy**

For at least the last 30 years, federal housing policy has largely been driven by a single number—the homeownership rate—and the “success” of federal policy has been largely determined by whether that rate has increased and by how much. What we are witnessing today is, in part, the consequences of pushing homeownership to a level beyond where it could responsibly go.

The driving goal of federal homeownership policy in the last several decades was to promote middle-class homeownership. We have largely succeeded. Homeownership is the hallmark of middle-class success, and a home is still the single-largest asset that most Americans own.

But we have yet to come to a national consensus on what the next animating vision for federal housing policy should be. Is there an “optimal” level of homeownership in America? What is the proper role of rental housing? What is the purpose of federal housing policy? Is it simply to ensure that all Americans have adequate shelter; is it to ensure that all Americans have access to affordable shelter; or is it to ensure that all Americans who want to own have adequate access to opportunities for becoming responsible homeowners? Given housing's role in the broader economy, how can federal housing policy help mitigate “systemic risk” in the financial system? What is the role of federal housing policy in building communities that support other federal goals such as greater energy independence?

- **Appoint a housing policy commission to recommend a new federal housing policy.**

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Rethinking federal housing policy cannot be done solely within the confines of HUD. Policymakers should create a broad-ranging panel of policymakers from both the legislative and executive branch, industry, advocates and citizens to articulate a new vision for the role of housing and homeownership in America. Moreover, the panel’s mission should be broader than HUD’s traditional focus on lower-income Americans—it should focus on housing policy for all Americans, including the middle-class.

- **Create a “housing market health index.”**

Policymakers should devise a variety of new metrics to supplement the homeownership rate as a means of gauging the “success” of federal policy. In addition to some of the measures currently employed by HUD to measure the level of housing affordability for lower-income Americans, policymakers should develop new measures that take a systemic view of the impact of federal policy on the housing market, such as the stability of the housing finance system, the affordability of mortgages for middle-class Americans, the ability of federal housing programs to act counter-cyclically to soften shocks to the market, and even the extent to which federal housing programs boost or hinder economic development.

## **Conclusion: The Politics of Housing**

Thanks to the multiple “bailouts” of financial institutions and the GSEs in the immediate wake of the financial crisis, many lawmakers might fear that any proposal to intervene still further in the housing market would draw the dreaded “bailout” label and ignite Tea Party ire.

But the more disastrous political course might be to do nothing. So long as home values continue to decline, more homeowners slip under water and more Americans feel less and less secure about their financial future, continuing gridlock and inaction can only add to Americans’ anger toward Congress. Moreover, the link between housing, jobs and the broader economy is too crystal clear to ignore. Just recently, the home-improvement chain Lowe’s announced the closure of 20 stores and the layoff of nearly 2000 employees, a move that analysts have largely blamed on the continuing collapse of housing.

The longer we do nothing, the longer our economy will stay stalled, and the bad news will only continue.

The time to act is now.

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## Endnotes

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<sup>3</sup> United States, U.S. Department of labor, Bureau of Labor Statistics, “Local Area Unemployment Statistics,” Accessed October 18, 2011. Available at:

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<sup>4</sup> Carrie Bay, “Foreclosure Woes to Plague Industry for at Least Five Years: Survey”, *DSnews.com*, October 3, 2011, Accessed October 6, 2011. Available at:

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<sup>5</sup> Martin S. Feldstein, “How to Stop the Drop In Home Values,” Op-ed, *The New York Times*, October 12, 2011, Accessed October 18, 2011. Available at:

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<sup>6</sup> See the archived webcast, “New Solutions for America’s Housing Crisis,” Oct. 4, 2011, Progressive Policy Institute, at

<http://progressivepolicy.org/webcast-new-solutions-for-americas-housing-crisis> and at <http://c-spanvideo.org/videoLibrary/event.php?id=197745&timeline>

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<sup>8</sup> “Median sales Price of Existing Single family Homes for Metropolitan Areas,” National Association of Realtors, 2011, Accessed October 5, 2011. Available at:

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<sup>9</sup> Available at <http://progressivepolicy.org/policy-brief-another-kick-in-the-teeth-loan-limits-and-the-housing-market>

<sup>10</sup> John Gittelsohn, “U.S. Underwater Borrowers Increase to 28 Percent, Zillow Says”, *Bloomberg*, May 9, 2011, Accessed October 13, 2011. Available at: <http://www.bloomberg.com/news/2011-05-09/u-s-underwater-homeowners-increase-to-28-percent-zillow-says.html>

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