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The Housing and Financial Markets: Congressional Action Could Disrupt Market Correction

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Housing and financial markets are in distress, and Congress is ready once again to ride to the rescue. Needed long-term reforms of the housing GSEs[1] and the Federal Housing Administration may be swept up in the process, but Congress is mainly looking to help troubled homeowners now. There is precious little good Congress can do in the near term, and much harm. To maximize the first and minimize the second, Members should keep three simple issues in mind.

Issue 1: The Problem. The central economic problem the nation faces today is that markets are passing through dual asset bubbles—one in housing and a related one in financial markets—and there's no alternative to a full correction. In many areas of the country, housing prices rose too fast for too long and are now coming back to Earth. Thousands of borrowers have mortgages they cannot afford, and based on those mortgages, the financial markets have constructed complex assets that are declining rapidly in value.

The root causes of these bubbles are that mortgages were underwritten for borrowers who often were not credit worthy, often on terms even creditworthy borrowers could not afford for long, and for properties that were often overvalued. Many elements led to these circumstances, and many people in and out of government made mistakes. As a result, many investors and many current and former homeowners are going to suffer serious losses.

Recovering from asset bubbles is painful and rarely smooth, but there is no safe or prudent way to short-circuit the process by which assets find their new, lower, and proper values based on economic fundamentals. Congressional attempts to slow or soften the process would only serve to prolong and ultimately accentuate the pain. The sooner these asset prices find their proper levels, the sooner families, investors, and businesses can get on with restoring their finances and resuming normal business activity. Anyone offering an elixir to prevent or short-circuit this correction is selling snake oil.

Issue 2: The Solution. With housing values falling significantly in some cities and states, the values of related financial assets falling in tandem, and great uncertainty operating in many markets, the private sector is under tremendous strain. Yet, once again, market forces—individuals and firms in pursuit of their own best interests—are proving up to the task.

The economic healing process underway is, foremost, one of price discovery. Housing and credit markets are discovering the new, proper price levels for their troubled assets. Neighborhoods that saw unrealistic home price appreciation are learning how far prices must fall. Homeowners who paid too much or borrowed unwisely are learning whether they will be able to stay in their homes. Investors

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who bought securities related to these assets are learning how much in losses they must suffer.

Markets are also working to make sure that past mistakes are not repeated. Financial markets have learned the price of inadequate disclosure and transparency, risk management and assessment. Participants understand that losses happen in a profit-and-loss economy. But they also work hard to avoid unnecessary losses, and that means learning from past mistakes. They have a powerful incentive to learn today's lessons in full: According to one recent study, these mistakes will cost U.S. financial institutions about $460 billion, while financial institutions globally will suffer about $1.2 trillion in losses.[2]

Faced with such losses, shareholders are demanding more information from the firms they own. Corporate boards have woken from their slumber and are exercising their oversight responsibilities more vigorously. Institutions are demanding more information from the counterparties to their transactions. Private credit rating agencies are demanding more information from those who sell securities, while investors are demanding that credit rating agencies be more thorough in attaching credit ratings to the securities.

The sole role of government in this process is to ensure that markets are functioning, that full and accurate information is available, and that contracts are honored. While the private market, unfettered by foolish policy and red tape, is capable of seeing this process through, a light touch by government can help to accelerate the process. An excellent example of such a light touch is the Hope Now program, orchestrated in October 2007 by the Departments of Treasury and Housing and Urban Development to help credit-worthy homeowners keep their homes.

Hopes Realized with Hope Now. When homeowners fall behind on their mortgages, lenders are often able and willing to work with them to restructure the terms. Lenders are willing to renegotiate because the foreclosure process is expensive and because lenders are generally ill-equipped to take possession of and resell a property. In short, it's often cheaper for the lender to keep the homeowner in the home.

The incentives for lenders to be flexible are even greater when housing values are falling. The homeowner has even less incentive to try to keep up payments if the face value of the note exceeds the new, lower value of the property. If the lender receives the property following a foreclosure, the lender is still faced with the loss from a property worth less than the note and is then faced with the prospect of finding a new owner under unfavorable market conditions. Hope Now was launched to amplify ongoing private efforts to rework existing at-risk mortgages.

Hope Now is a voluntary alliance of scores of servicers, investors, counselors, and other mortgage market participants ranging from Catholic Charities to the Bank of America. Many troubled homeowners fail to contact their mortgage companies until they've missed a number of payments and are possibly already in foreclosure proceedings. Participants in the alliance seek to reach out aggressively to potentially at-risk, credit-worthy homeowners to help them rework their mortgages. With the help of the Hope Now alliance, the mortgage industry is helping more than 160,000 families a month to keep their homes either by modifying their loans or by developing more realistic repayment plans.[3] Since the summer of 2007, the industry overall has reworked over one million mortgages to help homeowners stay in their homes.

The Federal Reserve's Role. The Federal Reserve is playing a similar role in assuring orderly financial markets. Markets sometimes "seize up" as asset

1. The federal housing government-sponsored entities (GSEs) are Fannie Mae and the Freddie Mac, established in 1936 and 1970, respectively, to support housing in America primarily by creating more stability in housing markets, more affordability of homes, and more liquid secondary markets for mortgage-backed securities. For a discussion of the needed reforms, see Ronald D. Utt, Ph.D., "Time to Reform Fannie Mae and Freddie Mac," Heritage Foundation *Backgrounder* No. 1861, June 20, 2005, at *www.heritage.org/Research/GovernmentReform/bg1861.cfm.*
2. Estimates are from an analysis by Goldman Sachs economist Andrew Tilton, released March 26, 2008, as reported in Reuters and other news agencies.
3. See Hope Now, a *www.fsround.org/hope_now/pdfs/Summarypdf-AdobeAcrobatStandard.pdf.*

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prices seek their new, lower levels. Resistance to surprisingly lower sales prices meets buyer uncertainty about fair prices, and, suddenly, no transaction is possible.

In recent months, a number of financial markets have seized up temporarily, beginning last summer with the commercial paper market. During these periods of extreme stress, the Federal Reserve has properly stepped in by providing liquidity directly to those markets in trouble, accepting as temporary collateral the excess amounts of assets for sale and thus restoring orderly markets.

The Fed has taken even more aggressive steps to assure orderly financial markets in husbanding the acquisition of the failed investment firm Bear Stearns by another investment firm, J. P. Morgan. In the transaction, Bear Stearns shareholders were practically wiped out, but Bear's various employee, business, and client relationships were largely maintained.[4] The Fed's action also provided markets with a needed dose of confidence by demonstrating its willingness and ability to take bold steps to assure that markets remained open and operated properly so that private participants could exchange as they see fit.

Issue Three: Federal Government's Heavy-Handed HELP NOT WANTED. The private sector is working effectively to sort through the problems in both the housing and financial markets by acknowledging its mistakes, admitting its losses, and working to keep troubled but credit-worthy borrowers in their homes. Yet Congress seems determined to "do something." Before it acts, Congress ought to consider a few simple questions:

1. *Is the real intent to prop up values and bail out homeowners or investors?*

   If so, then Congress should understand that their good intentions will come to naught and may do great harm by creating even more uncertainty. For example, Senator Isakson's (R–GA) proposal for a $15,000 refundable tax credit proposal would do nothing to help current homeowners stay in their homes.[5]

2. *If the intention is to improve the working of the markets, can the legislation be implemented soon enough to matter?*

   Representative Barney Frank (D–MA) and Senator Chris Dodd (D–CT) have proposed legislation effectively injecting the Federal Housing Administration (FHA) into the already operating Hope Now alliance. However, there is little chance that this would have any direct effect on homeowners until late in the fall of 2008 and less chance that it would add to what Hope Now is already accomplishing.[6]

3. *Would the effects of the legislation disrupt the normalizing market processes already underway in the housing sector, thus prolonging the period of recovery?*

   The Frank–Dodd bill and similar approaches threaten to disrupt and slow the private sector's efforts to help troubled borrowers, because either borrowers or lenders may believe they could get taxpayer-subsidized terms under the new FHA-based arrangements when they do become available.

4. *Would the effects of the legislation disrupt the normalizing market processes already underway in the financial sector, thus prolonging its period of recovery?*

   Financial markets are working diligently to correct the mistakes that have led to enormous losses. The circumstances are difficult, even with the current known legal and regulatory frameworks. Congressional threats to impose intrusive new regulations on financial markets represent yet another new and ill-defined source of uncer-

4. In facilitating the transaction, the Federal Reserve also originally pledged $30 billion in guarantees for specific Bear Stearns assets of uncertain quality. However the transaction concludes, this part of the Federal Reserve's involvement raises a number of important policy questions.
5. For additional information on the Isakson tax credit proposal, see David C. John, *The Isakson Tax Credit: Another Approach that Won't Fix the Mortgage Mess*, Heritage Foundation *WebMemo* No. 1873, March 31, 2008.
6. For a discussion of the Frank–Dodd legislation, see David C. John, "Frank–Dodd Approach Won't Fix the Mortgage Mess," Heritage Foundation *WebMemo* No. 1864, March 24, 2008, at *http://www.heritage.org/Research/Economy/wm1865.cfm.*

tainty. The result would likely be a quick halt to many of these private corrective actions.

5. ***Would the legislation make sense in the absence of current troubled conditions in the housing sector or financial markets?***

   If the legislation is ineffective in the near term, then at least it should be good long-term policy. Of particular concern is the inclination to expand the roles of the housing GSEs and the FHA and to create new ad hoc tax provisions relating to housing. A greater role for these agencies would not have prevented the current troubles, would not do so in the future, and would expose taxpayers to greater future costs.

Conclusion. Many American homeowners are facing financial hardships resulting from onerous mortgages and falling home values. Many investors are facing financial losses as the risky instruments they bought in happier times decline in value. These processes must work through to conclusion for the economy to regain a sound footing, and the private sector is working effectively toward this end.

Congressional action cannot change this reality, except by prolonging and exacerbating the situation. Congress should focus its energies on policies to strengthen the economy coming out of the current slowdown.

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