

What Congress Should—and Shouldn't—Do about the Housing Crisis

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As Congress returns next week from its summer recess, it will find itself under enormous pressure to do something about the nation's worsening housing market situation. In the present atmosphere of financial market crisis, the real challenge for Congress will be to resist being rushed into ill-thought out and hasty action as it was with the Sarbanes-Oxley Act following the Enron and World Com crisis. Rather, one must hope that, Congress, chastened by its earlier mistakes, will carefully weigh both the equity and the efficiency considerations of its various options before acting this time around.

Over the summer, the nation's housing situation has gone from bad to worse. Home prices are now falling at the national level for the first time since the Great Depression. Worse still, there is every prospect that home prices will fall at a faster pace in the rest of the year as more adjustable rate mortgages reset and as mortgage lending standards are tightened. Goldman Sachs is now estimating that US home prices could still be overvalued by anywhere between 15 and 30 percent, which holds out the prospect of declining home prices for a protracted period of time.

At the same time that home prices have started to fall, home foreclosures have risen by around 90 percent over the past year. As many as 2 million households are now widely estimated to be at risk of losing their homes this year. Further adding to the housing market gloom is the virtual seizing up of credit markets as mounting sub-prime mortgage losses undermine confidence in the US financial system.

In tackling the many issues raised by this crisis, Congress should find it easier to build consensus on the longer-run measures that are needed to prevent a future recurrence of today's housing market crisis than they are in addressing the immediate fallout of the crisis. After all, most would agree that the federal regulatory framework needs to be extended to cover the almost 50 percent of mortgage originators who are not subject to federal regulation and who were the main source of abusive mortgage lending practices. Similarly, few would oppose a thorough overhaul of the way in which the rating agencies operate with a view to better aligning those agencies' incentives to issue more accurate ratings of the mortgage backed securities that they rate.

The very much more contentious issues for Congress will arise in deciding what to do in the here and now to provide relief from the fallout of the housing bust. For in effect this will be a politically charged discussion of how to distribute the losses from the housing bust. How might those losses be distributed between the sub-prime mortgage borrowers, the ultimate holders of the mortgage bond, and the taxpayer? It is precisely in dealing with these difficult issues that Congress can do real mischief not simply as to the future functioning of the US housing market but also as to the state of the country's public finances.

Among the more basic issues that Congress needs to address is the question as to who might be deserving of federal housing market relief. Surely it is not the regular home owner who might be now experiencing home price declines after many years of exceptionally rapid home price

increases. And surely it is not all sub-prime mortgage borrowers. For while a strong case can be made for providing relief to those sub-prime mortgage borrowers who were the victims of predatory lending practices, the same cannot be said of those many sub-prime borrowers who knowingly took the risk that interest rates would remain low and that home prices would keep on rising.

An equally important issue worthy of careful Congressional consideration is how to minimize the so-called "moral hazard" problem whereby incentives might inadvertently be given that reward past bad behavior and that might encourage future repetition of that behavior. In providing any relief to sub-prime mortgage-borrowers, great care will need to be exercised not to effectively bail-out mortgage lenders from the consequences of the poor decisions that they might have made in assessing the inherent risks in their reckless lending.

In applying these criteria, one must hope that Congress will rule out extreme proposals for action like that being advocated by Bill Gross, a prominent bond fund manager. He would like to see the establishment of a Reconstruction Mortgage Corporation on a Rooseveltian scale that would engage in the massive purchase of mortgage loans to spare all homeowners from the consequences of otherwise declining home prices. Leaving aside the inordinately large budgetary cost that such a proposal would entail, Congress should reject such a proposal on the grounds that it would provide indiscriminate relief to all homeowners and it would effectively be a bailout of mortgage lenders with taxpayer money. For similar reasons, Congress should resist the proposals being vociferously advanced in some quarters to raise the overall ceiling on mortgages that Fannie Mae and Freddie Mac might purchase.

Instead, Congress would do well to consider more modest and better targeted proposals like that being advocated by Dean Baker of the Center for Economic and Policy Research. He is arguing for a change in the rules on foreclosure to allow sub-prime mortgage homeowners to remain in their homes indefinitely as renters, provided that they pay the fair market rent on those homes. The attraction of Mr. Dean's proposal is that it would provide relief to those homeowners most in need. And it would do so without having to resort to taxpayers' money and without compounding "moral hazard" problems.

The home market issues facing Congress are not easy and not amenable to quick fixes. The least for which one can hope is that Congress does not once again aggravate an already difficult problem by ill-advised and politically motivated legislative initiatives.

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