

OP-ED ON MORTGAGE RATES AND HOUSE PRICES

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Recent news articles suggest that the Treasury Department is considering a plan to offer a 4.5 percent mortgage for homebuyers for a period of time. This bold idea, akin to our proposal on this page on October 2, would help arrest the decline in house prices and absorb excess inventory of housing— without substantial costs to taxpayers.

Essentially, such a proposal combines an important economic link between mortgage rates and housing demand with the government control of nearly 90 percent of the mortgage market through the Federal Housing Administration and the “conservatorship” of Fannie Mae and Freddie Mac. Acting on this realization will offer a potent tonic to the downward spiral led by falling house prices and the associated credit market deterioration.

Four questions are raised by such a program. First, is a plan to raise housing demand sensible given the current level of house prices? Second, won't a 4.5 percent mortgage rate require a large subsidy from taxpayers? Third, by how much would the Treasury's plan raise housing demand? Fourth, why not allow mortgage refinancing at the same 4.5 percent rate?

House Prices Are Not Obviously “Too High”

Declining house prices are a key macroeconomic problem, driving up foreclosures, reducing household wealth and consumption, as well as bankrupting our financial institutions.

While fundamental factors clearly played a role in driving down house prices that were at excessive levels two years ago, we have argued in a recent paper that house prices have fallen at or below fundamental levels. Indeed, in most markets, house prices have already overshot the value of housing consistent with the average level of affordability in the past 20 years.

Nonetheless, absent policy action, house prices are likely to continue falling. A key factor, of course, is the meltdown in mortgage markets that has substantially increased the spread between mortgage rates and long-term interest rates.

Until recently, the Treasury's conservatorship of Fannie Mae and Freddie Mac had been associated with *higher* mortgage rates in a period of lower Treasury yields. Even with recent Federal Reserve purchases of GSE bonds, the difference between the 10-year Treasury bond and the 30-year conforming mortgage rate is still at about 2.8 percent, compared to a historical average of 1.6 percent. The weakening employment outlook adds to the likelihood of substantial additional house price declines.

We see little risk of inflating another housing bubble. Indexing the mortgage rate to U.S. Treasury yield provides exactly the mechanism to allow the economy to naturally correct.

While the economy is contracting, low interest rates would spur housing activity—exactly as needed in an economic crisis. When economic activity improves, the U.S. Treasury yield and mortgage rates would rise. Improved economic conditions would help offset the negative effect of rising mortgage rates on house prices. This would provide for a “soft landing” for house prices relative to the forecast that house prices would fall another 12 to 18 percent or more in the next 18 months.

A 4.5 Percent Rate Is Not “Too Low”

The 10-year U.S. Treasury yield closed at 2.6 percent on December 12, 2008. Hence a 4.5 percent mortgage rate is 1.9 percent above the Treasury yield, close to the 1.6 percent spread that would prevail in a normally functioning mortgage market. At that mortgage rate, the GSEs (taxpayers) are even likely to earn a profit.

Some critics of our plan have argued that lenders should earn more than the average of 1.6 percent to compensate for the fact that housing is a much riskier investment today than in the past. Nonetheless, we believe that the 1.6 percent spread is still appropriate. A mortgage can be thought of as a risk-free bond plus two options: the default (put) option plus a prepayment (call) option. Historically, the default option costs about 0.25 percent and the remaining spread of the mortgage rate over the Treasury yield represented the prepayment option and underwriting costs. With falling house prices, the default option could cost 0.75 or more for a newly underwritten and fully documented loan. Nonetheless, the government could still earn a profit. That is because a mortgage rate of 4.5 percent would be the lowest mortgage rate in more than 30 years, rendering little value to the prepayment option. If anything, prepayments would likely take place at a time of higher rates and thus be profitable to the government. In addition, low mortgage rates would substantially reduce the risk of further house price declines.

Guaranteeing rates for a fixed period of time (for example, for the year 2009) would run the risk that the yield on the 10-year Treasury bond might rise next year even while rates are fixed at 4.5 percent, leading to an effective government subsidy. This risk is real and must be considered. The government could mitigate the risk by pre-funding lending capacity. Alternatively, the government could commit to originating mortgages at rates that are always 1.6 percent above the 10-year Treasury yield. Such a rule would guarantee that borrowers get low rates but protect lenders and taxpayers in the event that yields on U.S. Treasury bonds rise. However, it loses the simplicity and headline-grabbing nature of the “once-in-a-lifetime” opportunity to purchase a home at a historically low rate.

A 4.5 Percent Rate will Raise Housing Demand Significantly

Understanding the effect of a 4.5 percent mortgage rate on housing demand requires an analysis of the impact of both mortgage rates and economic activity on homeownership. A simple forecast can be obtained by applying the 2003-2004 homeownership rates to 2007 households. We use the 2003-2004 home ownership rates because those were the years of the

lowest previous mortgage rates (the average mortgage rate was 5.8 percent). An increase in the homeownership rate from 67.9 (3rd quarter, 2008) to 68.6 (the average rate from 2003-2004) would increase homeownership by 0.7 percent, or about 800,000 new homeowners (using 110 million households in 2007). Alternatively, if we do the same calculation, but instead take into account the relative age distribution of the population, we get a much higher increase in the homeownership rate of 1.5 percent, or as many as 1.6 million new households. These estimates suggest there is appreciable pent-up demand that could be stimulated with much lower mortgage rates.

To check this estimate, we also use simple statistical analysis to examine the impact of lower mortgage rates and higher unemployment rates on homeownership. The results show that lower mortgage rates are strongly correlated with higher homeownership rates, but that higher unemployment rates are only weakly correlated with lower homeownership rates. We estimate that the homeownership rate would rise from 67.9 to 70.1 percent in 2009 with a mortgage rate of 4.5 percent and an unemployment rate of 8.5 percent. This increase of 2.2 percent in the homeownership rate would result in an additional 2.4 million additional owner-occupied homes.

While such an estimate is high, there are many reasons to believe that the increase in the homeownership rate under this plan would be substantial.

A reduction in mortgage rates from 6 to 4.5 percent represents an appreciable drop in mortgage payments. With a hypothetical \$180,000 mortgage, monthly payments would fall from \$1,079 to \$912, a decrease of about 16 percent. Of course, the amount of interest payments would drop by a full 25 percent. For a new homebuyer, such low payments combined with today's much lower house prices would represent a historic opportunity to purchase a home.

There are also a record number of vacant houses in the United States. According to the U.S. Census Bureau, there are about 2.2 million vacant for-sale homes and another 4 million vacant rental properties. In addition, about 800,000 new units were started in October (an annual rate) and over 1 million units were completed (also an annual rate). Of course, these data ignore further increases in vacant units due to foreclosures that might be started or completed in 2009. While foreclosures of owner-occupied units might decrease homeownership rates, many foreclosures are of investor-owned properties. So there is more than enough vacant housing to support an appreciable growth in demand for owner-occupied housing.

Finally, lower mortgage rates would provide a substantial floor on house price declines. Estimates in our recent paper suggest that real house prices increase by about 75 percent of the decline in after-tax mortgage payments. So a decline in mortgage payments of 16 percent would result in approximately a 12 percent floor on the decline in house prices. Current futures markets suggest that house prices will decline by 12-18 percent in the next 18 months. So such a low rate might well lead to flat or even slightly higher house prices in 2009. The impact of putting a floor on house price declines is likely to be substantial in terms of improved consumer

confidence and an increased willingness of homebuyers to come back into the market. Increases in house prices relative to where they would have gone with higher mortgage rates would also provide a housing wealth effect on consumption of as much as \$76 to \$113 billion dollars each year.

Allowing Refinancing at a 4.5 Percent Rate Remains the Best Option

A proposal to provide a 4.5 percent for homebuyers for a period of time is a welcome and important step toward arresting falling house prices. Yet, we believe these low rates should be applied to all newly originated mortgages, both purchase money loans and refinancing. Even without any provisions to allow borrowers with negative equity to refinance (as we included in our earlier proposal), we calculate that as many as 34 million households would be able to refinance their mortgages at an average monthly savings of \$428, or a total reduction in mortgage payments of \$174 billion. This is a permanent reduction in payments and is thus likely to spur appreciable increases in consumption. For example, as Detroit might hope, the monthly savings could be used to cover the payments on a new car.

Finally, trillions of dollars of refinancings would retire a large number of the existing mortgage-backed securities. Not only would a large-scale refinancing wave reduce uncertainty about the value of existing mortgage-backed securities, it would flood the market with additional liquidity that the private sector could deploy to other uses such as auto loans, credit cards, commercial mortgages, and general business lending. And it would substantially reduce the more than \$2 trillion dollars that the Federal Reserve has as collateral for short-term loans.

Looking Ahead

The recent discussion of a process to lower mortgage rates offers a bold step in addressing the mortgage market meltdown and falling house prices. This is important: the decline in house prices remains the elephant in the room in the discussion of the financial crisis and weakening economic activity.

The Treasury's plan dominates proposals focused only on stopping foreclosures or reforming the bankruptcy code to keep people in their homes. An emphasis on stopping foreclosures, while meritorious, may not limit the dangerous decline in house prices as much as proponents claim. It could work the other way. Stripping down mortgage balances in bankruptcy would likely raise future mortgage interest rates and lower the availability of mortgages, *reducing* house prices.

While a mortgage rate move is intended to be a temporary intervention in the present exigency, it plants a seed for future thought. Mightn't a return to simple 30-year fixed-rate mortgages with a low rate be the right foundation for mortgage finance, a foundation for a 'home, sweet home'?

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