

Breaking

THE HOUSING CRISIS CYCLE

Since 2006, the U.S. housing markets have struggled, and Americans have been losing their homes at extraordinary rates. New foreclosures in Ohio alone during the past three years total 170,000—almost as many housing units as in the entire city of Cleveland. The institutions, market forces, and nonprofit community groups that normally come to the rescue of distressed homeowners and their neighborhoods have been overwhelmed with the growing scope of the problem.

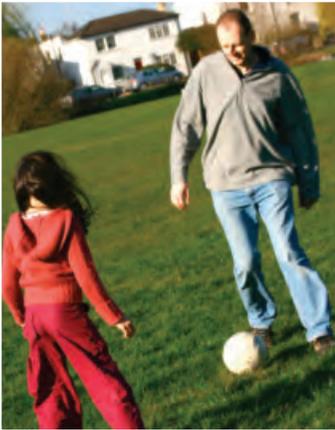
No longer is the housing crisis limited to the borrowers or lenders who simply made poor choices—the uncertainty is affecting nearly everyone. From families who have been uprooted from their homes to fiscally sound homeowners who have nonetheless witnessed their property values plunge, the housing market collapse has eroded what for many of us was a hard-won sense of financial security. Indeed, according to statistics compiled in the Federal Reserve Flow of Funds Accounts, the net worth of American households fell by \$4.2 trillion between the end of 2006 and the end of 2008 as a result of changing fortunes in the residential real estate market.



THE FOCUS IN 2009 AND BEYOND MUST BE ON REPAIR AND RECOVERY.



How do we restore vitality to our housing markets and, by extension, to our communities? In this essay, we depict the housing crisis as the product of a destructive cycle that feeds on itself—from delinquencies to foreclosures to capital losses and back to more delinquencies. Thinking about the housing crisis in the form of a simple, self-feeding circle can help identify the most effective policy responses to weaken specific links in the cycle. In our view, the housing market became engulfed in crisis because several distinct elements of the marketplace failed in ways that made the decline worse. To restore stability to the housing market, we see the need for a set of coordinated policies that attack the problem at multiple points on the cycle.



Our analysis of the housing crisis leads us to three main conclusions. First, the magnitude of the crisis calls for the creation of new government initiatives to help steady the housing market and the provision of public funds to assist some distressed homeowners. Second, to deal with the fundamental problems in the marketplace, we need to craft solutions that are likely to be sustainable over the long term. Finally, national policymakers and regional civic leaders must be aggressive in working collaboratively because no two housing markets are exactly alike, even as we use an all-encompassing framework to describe the housing crisis cycle. For example, in the Fourth Federal Reserve District, which comprises Ohio and parts of Pennsylvania, Kentucky, and West Virginia, policies will need to be tailored to the weak-market conditions that prevail here.



The essay begins with a concise overview of the housing boom and bust. We briefly sketch out recent developments in the mortgage lending market and then describe the geographic diversity of housing dynamics in the country. Next we explain why the housing market's usual balancing forces failed in this cycle, with devastating consequences. We conclude by discussing some of the potential responses to the current situation and our view of the steps being taken to date. Of course, political and logistical realities mean it will take some time and patience to break the housing crisis cycle.

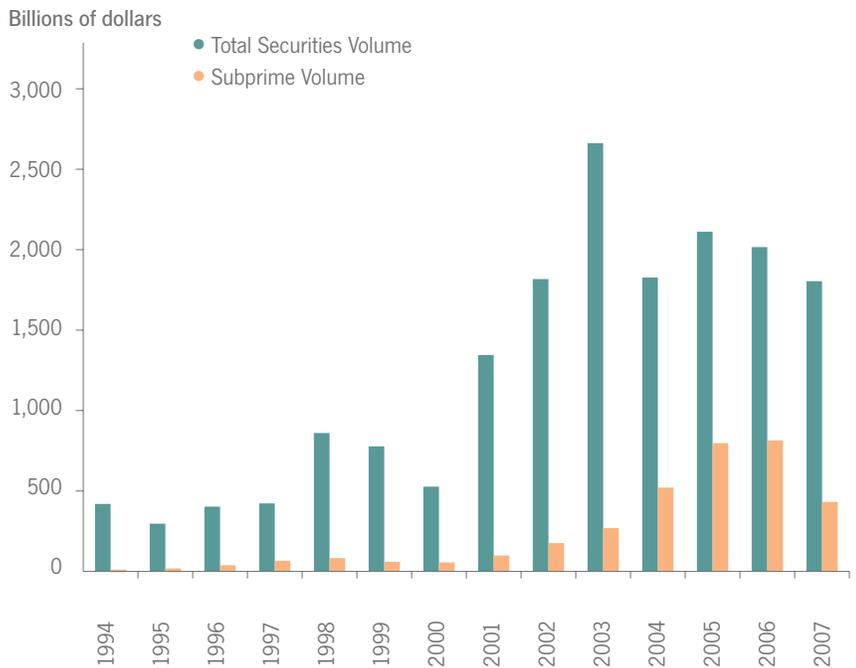
The Problem in Snapshot

To fully understand the housing crisis, we must first understand the national lending boom that preceded it. Between 1990 and 2006, mortgage originations more than tripled in value in the United States. Huge gains were seen everywhere from California to Ohio to New York. It was an out-and-out lending boom, largely attributable to two developments—a long-term, low-interest-rate environment, and financial innovation.

For a period in the early 1980s—leading up to the time known as the “great disinflation”—the real 30-year mortgage rate topped 9 percent. But the low and stable interest rate environment over the past two decades helped bring lower mortgage rates as well. By 2005, the real industry benchmark rate had fallen to less than 2.5 percent. This low rate, in turn, stimulated demand for housing by making mortgage payments more affordable. At the same time, real estate was seen as a safe and financially rewarding investment.

Also at work was a revolution in consumer finance, thanks to technological and statistical innovations in the 1990s. Credit was extended to a broader pool of applicants. Among the new mortgage offerings were interest-only loans and small- or zero-down-payment loans. This activity was largely fueled by securitization—the process by which different parties originate, package, guarantee, and service loans. Investment banks pooled mortgages and sold them as mortgage-backed securities. In principle, securitization should help financial institutions share their risk with other institutions around the globe and hold more diversified portfolios. As long as borrowers do not default at the same time, risks can be reduced and everyone benefits (*see figure 1*).

Figure 1. Mortgage Securitization 1994–2007



Source: Mortgage Market Statistical Annual, 2008.

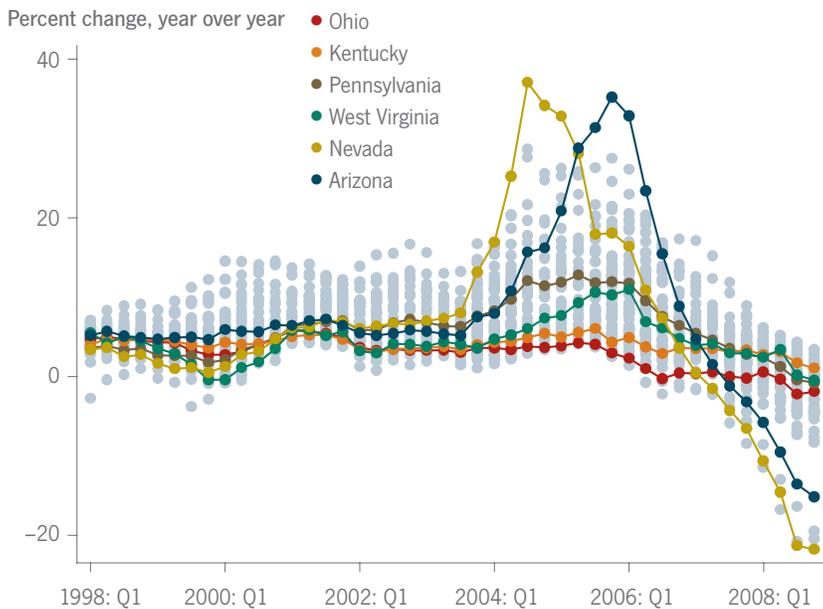
What Is a Subprime Loan?

Definitions vary for what constitutes a “subprime” loan. In this essay, we use it to refer to loans that are expected to perform more poorly than prime loans.

In general, subprime borrowers have blemished credit histories and pose greater repayment risks. A typical subprime mortgage is offered at rates more than 2 or 3 percentage points higher than a conventional 30-year loan.

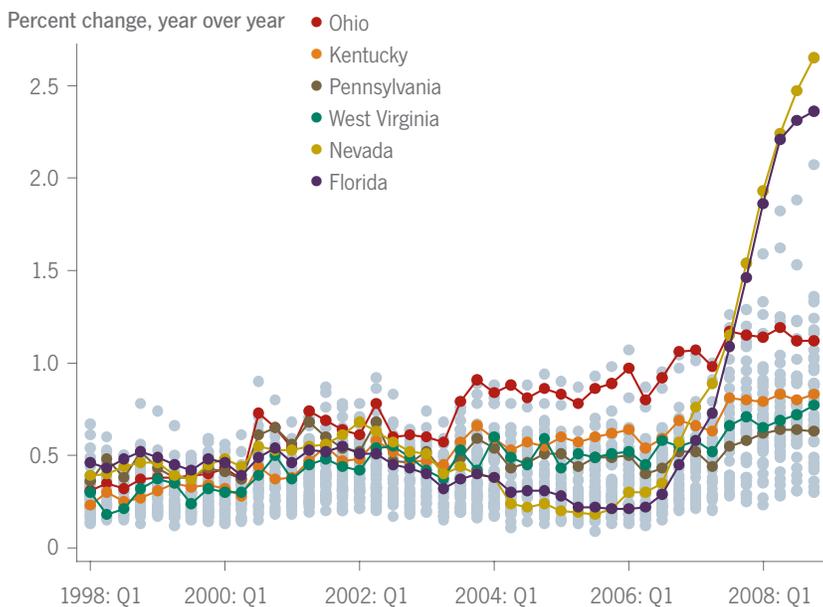
A loan may also fall into the subprime category if it is originated by a lender that specializes in such loans or if it is available only in subprime-type contract terms, such as a 2/28 hybrid mortgage, in which the fixed rate resets after two years to an index rate. Within the nonprime category are so-called Alt-A loans, a credit risk somewhere between prime and subprime.

Figure 2. U.S. Home Price Appreciation



Note: Each dot represents one of the 50 states.
Source: Federal Home Financing Agency.

Figure 3. U.S. Foreclosure Start Rates



Note: Each dot represents one of the 50 states.
Source: Mortgage Bankers Association.

Investors, lenders, brokers, and borrowers all reaped some benefits from securitization, at least in the short run. Securitization of mortgage loans had the most profound impact on subprime borrowers, as increases in securitization coincided with increases in subprime mortgage lending. Such loans carried the possibility of higher returns to investors and were often arranged by largely unregulated mortgage brokers. In a time of rising home prices, concerns about repayments were secondary because most people expected that even the riskiest subprime mortgages contained an implicit escape clause: that the value of the underlying asset—the house—would remain strong. As more and more mortgages were originated, underwriting standards began to slip.¹ The initial deterioration in loan quality was masked by rising house prices.² Even the riskiest loans did not result in losses, since the underlying properties were still worth more than the loans themselves.

Then problems surfaced in the subprime market. The rate of serious delinquency (payments at least two months past due) for securitized subprime mortgages at least 12 months old more than tripled between 2003 and 2007—to the point that almost one in every five subprime loans at least a year old was not performing. Although subprime loans account for only 12 percent of the home mortgage loan market, fully half of all U.S. foreclosure starts at the end of March 2008 involved subprime loans, according to the Mortgage Bankers Association.

In the Fourth Federal Reserve District, the timing of the boom and bust played out somewhat differently than in most parts of the country. Fourth District states participated fully in the *lending* boom, but they were largely bystanders to the *housing* boom (see figure 2). From 1998 through 2008, home prices were relatively flat in Ohio, Kentucky, Pennsylvania, and West Virginia compared with national trends. But in Ohio, elevated rates of foreclosure starts were evident as early as 2000, well before the national housing bust began (see figure 3).

1. Mayer, Pence, and Sherlund (2008).
2. Demyanyk and Van Hemert (2008).

What sets Ohio apart from the national housing market? In general, differences in regional home prices are a function of population change, land availability, the regulatory environment, and overall economic conditions. The way mortgage markets were regulated may have played an important role in the Fourth District's experience, and it is quite clear that population change and economic conditions were important.³ Unemployment was a problem in many parts of Ohio well before the current recession, and the ongoing flight of manufacturing jobs led to an accompanying population flight. Cuyahoga County, which encompasses Cleveland, has lost almost 7 percent of its population—nearly 100,000 people—since 2000, the steepest decline in the state and among the steepest in the nation.

The same counties that endured significant unemployment and population loss also suffered some of the highest foreclosure rates. Moreover, in these struggling counties, high percentages of borrowers held subprime mortgage loans.⁴ Some of the highest foreclosure rates are seen in Northeast Ohio, around the cities of Cleveland and Youngstown. In Cuyahoga County, for example, almost 3 percent of prime mortgages and nearly 14 percent of subprime mortgages were in foreclosure at the end of 2008, according to figures provided by LPS Applied Analytics.⁵

By comparison, the national foreclosure rate for prime mortgage loans was 1 percent at the end of December, and 8.8 percent for subprime loans (see figures 4, 5, and 6).

One might think that the effects of the mortgage crisis are being inflicted exclusively on the subprime borrowers and lenders who entered into flawed contracts in the first place. Not so. Researchers have found that foreclosures can have serious spillover effects—decreasing the values of neighboring houses, incurring costs to governments,⁶ and leading to increased crime.⁷ Troubled housing markets put prices under downward pressure, which can lead to more foreclosures and even abandoned properties.

Figure 4. Five Highest Subprime Foreclosure Rates in Large* Fourth District Counties

County	Percent
Mahoning (Youngstown)	14.8
Summit (Akron)	14.2
Cuyahoga (Cleveland)	13.7
Stark (Canton)	12.4
Montgomery (Dayton)	12.3

*Populations greater than 250,000.

Source: LPS Applied Analytics; as of December 2008.

Figure 5. Prime Foreclosure Rates in the Fourth District

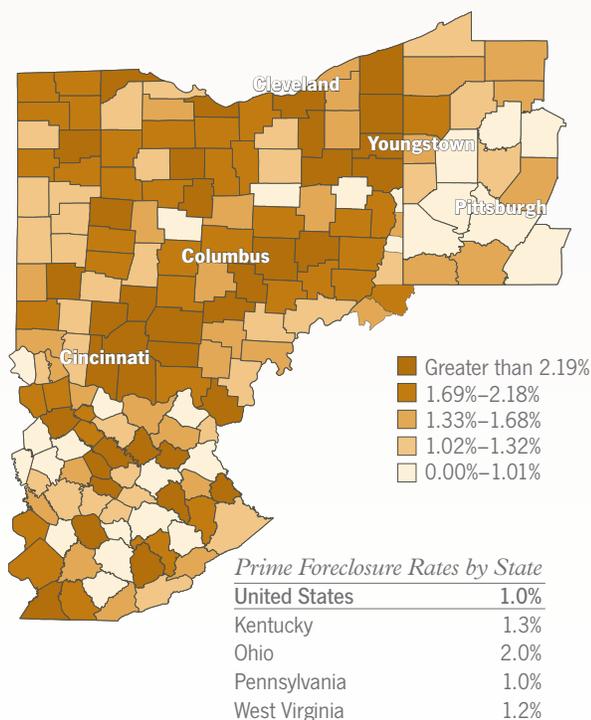
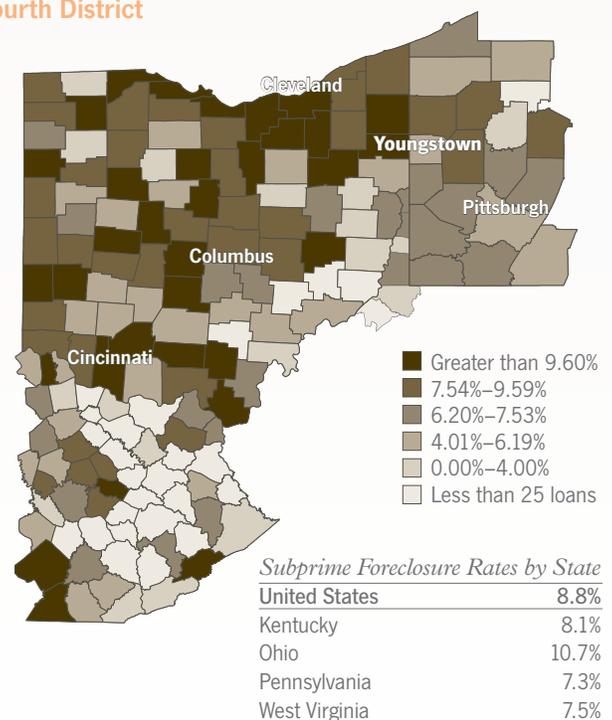


Figure 6. Subprime Foreclosure Rates in the Fourth District



Note for figures 5 and 6: The distribution is broken down into quantiles, with each class containing an equal number of data points.

Source for figures 5 and 6: LPS Applied Analytics; as of December 2008.

3. Richter (2008).

4. Cooley (2008).

5. The LPS Applied Analytics database is the industry's largest, including information from seven of the 10 major servicers. It encompasses federal and local foreclosure filing information.

6. Agpar and Duda (2005).

7. Immergluck and Smith (2006).



Foreclosures are expensive for lenders too. The cost of a typical foreclosure to a lender is up to 25 percent of the loan balance.

The Housing Crisis Cycle

In normal housing markets, people enter and exit the ranks of homeownership constantly, with minimal negative consequences beyond the parties immediately involved. Backstops exist at every step of the process to help borrowers and to deal with vacated properties:

- Lenders and community groups provide borrower counseling, financial education, and foreclosure prevention programs, helping to slow the pace of defaults (see “Foreclosure Prevention in Action,” p. 12).
- Governments and private-sector lenders offer purchase-assistance programs for first-time homeowners, helping to keep prices stable by creating demand to match the supply.
- Homebuilders slow the growth of the housing stock by easing up on new developments.
- Lenders refinance or modify loans for some of the relatively few borrowers faced with extreme mortgage distress.
- If all else fails, government-operated land banks step in to acquire abandoned properties. Cleveland’s pioneering land bank was one of the first to deal with tax-delinquent properties in this way. We will explain the function of land banks in further detail later in this essay.

In a 1998 study of home values in Cleveland, researchers found that a 1 percent increase in tax delinquencies was associated with a \$788 decline in average sale prices within a two-block area.⁸ A recent study on the Columbus metro area revealed that foreclosures and abandonment have ripple effects in their neighborhoods, negatively affecting the sale prices of neighboring houses.⁹

The magnitude of the foreclosure spillover effect seems to depend in part on the health of the local housing market. In bust times, foreclosures have twice the effect on nearby prices as they do during boom times.¹⁰ The effect is not as strong in regions where labor markets have been robust or where housing supply has not kept up with demand.¹¹

Taken together, these studies strongly indicate that foreclosures inflict a significant toll on their communities. The implied social costs may justify government interventions to bolster demand for housing and limit foreclosures. But will this be enough to stabilize the housing market? Are we tackling independent problems or are they all pieces of a bigger puzzle? To answer these questions, we describe how the housing crisis has taken the form of a self-feeding cycle. We then use this cycle as a framework for assessing potential policy responses.

In weak markets, these backstops were already stretched to their limits before the housing crisis hit. Since the crisis began, many regions have been unable to beat back the wave of properties heading quickly from delinquency to abandonment. A natural recovery has become more difficult, especially given the unlikely prospect of increased demand for housing in areas with declining populations.

In fact, the shock has been so large and widespread that our national housing market is currently trapped in a cycle of deterioration. As we see it, the cycle contains six main components, each one leading to the next. In the real world, these components may interact with each other in ways that are much more complex than what our illustration suggests (see figure 7). But even this simple description of the housing crisis provides a framework for understanding how the crisis builds on itself.

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8. Simons, Quercia, and Maric (1998).

9. Mikelbank (2008).

10. Lin, Rosenblatt, and Yao (2009).

11. Been, Greene, and Schuetz (2007).

Foreclosure Prevention in Action

For years, organizations in the Fourth District and nationwide have provided assistance to homeowners in danger of foreclosure. The housing crisis has recently pushed many of these organizations to a breaking point.

At Neighborhood Housing Services (NHS) of Greater Cleveland, Executive Director Lou Tisler recalls that 75 percent of his clients four years ago sought pre-homeownership counseling. Today, 75 percent require foreclosure prevention assistance.



NHS is headquartered in Cleveland's Slavic Village, where foreclosures are affecting as many as one in four homes. "We're at the epicenter of where it all started," Tisler says. As before, many of the agency's applicants have recently suffered job loss or other shocks to their incomes. Today, only about one out of every three applicants is accepted for mortgage assistance funds. But of those who are accepted, only 1 percent default on their loans.

One of the longest-running foreclosure prevention efforts is administered by the Pennsylvania Housing Finance Agency (PHFA). The Homeowners' Emergency Mortgage Assistance Program, or HEMAP, launched in 1983 and has helped keep 42,000 families in their homes. Funded by \$234 million in government appropriations, the program has lent \$430 million over the years to borrowers who have experienced job loss, medical bills, and other shocks to their incomes. It pays partial or full mortgage payments for up to 24 months or \$60,000 in assistance, whichever comes first. The idea is that the assistance will provide homeowners time to get back on their feet with employment or health.

Applications have surged from about 8,000 in 2004 to more than 12,000 in 2008. "The crisis is putting a strain on our program, which means we can approve fewer applications," says Brian Hudson, PHFA executive director. "It's going to be a very challenging year."

Figure 7: Cycle of Deterioration

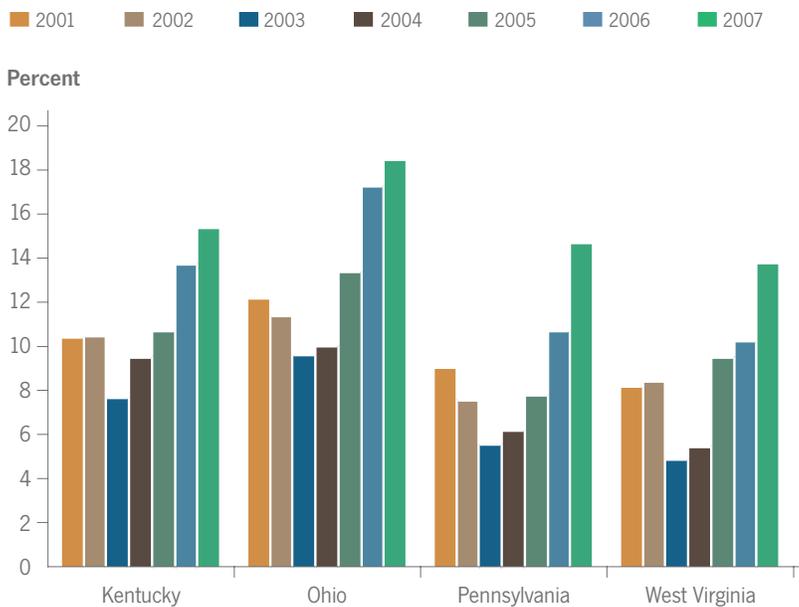


1. Lending and Housing Market Disruptions

Our economy is trying to find its footing after an extended period of credit misallocation. In boom markets, home prices were bid up to record levels. In weak markets, free-flowing credit buttressed prices that otherwise would have fallen given underlying economic conditions. When lending and housing markets are disrupted, everyone tries to discover what homes and mortgages are really worth. The uncertainty makes mortgage lenders and investors more cautious, so that many prospective homebuyers can no longer get the financing they need. Others put off purchases until they can see some sign of stability. Existing homeowners who can no longer keep up with payments—perhaps because of job loss—may wish to sell their homes but cannot find buyers. Homeowners forced to move in search of new work may keep their properties on the market for a long time, waiting for the market to recover.

In this way, disruptions to the lending and housing markets spin in two directions: to defaults and delinquencies, leading to foreclosure, or to an oversupply of housing.

Figure 8: Seriously Delinquent Subprime Loans in the Fourth District^a



a. By origination year, at the age of 12 months (60-plus day delinquent loans, including foreclosures and real-estate-owned [REO] properties).

Source: Loan Performance.

2. Delinquencies and Defaults

The recent rash of delinquencies and defaults was years in the making. Increasingly relaxed underwriting practices led to a nosedive in mortgage loan performance by 2004. In Ohio, for example, 10 percent of all subprime mortgages that year were seriously delinquent (more than two months late) within 12 months of origination. By 2007, this delinquency rate approached 19 percent (see figure 8).

In the past, borrowers and investors could have counted on painless refinancings and brisk housing markets to save troubled mortgages from foreclosure. In this crisis, those options are no longer available.

3. Foreclosures

When the emergency exits of the housing market are blocked, foreclosure is the last remaining option. By the end of 2008, a record-setting 3.3 percent of U.S. mortgage loans were in foreclosure, according to the Mortgage Bankers Association. For the year, an estimated 2.2 million foreclosures were expected nationwide. Within certain neighborhoods, foreclosures became even more rampant and concentrated.

Even though foreclosure starts seem to have peaked recently, these numbers may underestimate the underlying problem. Financial institutions and investors, overwhelmed by foreclosure proceedings, are declaring a moratorium on additional foreclosure filings. This situation creates a misleading signal about the actual magnitude of loan delinquencies and borrowers' stress.

4. Oversupply of Housing

After foreclosure (or in some cases, direct disruptions to the lending and housing markets), the next step on the housing crisis cycle is an oversupply of houses on the market. In some regions, the oversupply problem may prove to be temporary. Vacant housing in healthier markets will eventually be absorbed by growing populations as the economy rebounds. Economists refer to this type of problem as "cyclical"—it can fix itself over time even though the process may be slow and painful.

In weaker markets, long-abandoned properties have little hope of finding new buyers because houses for sale do not meet the needs and preferences of potential buyers. The homes may reflect the tastes of many decades ago, or may simply be too numerous given current and expected population levels. This is the type of problem economists call "structural"—it lies in the structure of the market itself, and some policy action will be necessary to put the market on a more sustainable path.

A different type of problem currently exists in all markets, whether they are growing or declining—the uncertainty about the path of future home prices. Economists refer to this as a "frictional" problem. Lenders are worried and buyers are timid, creating a friction that seizes up the process of moving homes from sellers to buyers. Frictional problems may heal on their own when prices reach a bottom, or some policy assistance may be needed to speed up the adjustments.

5. Home Price Depreciation

When the oversupply of houses collides with a market of buyers who have diminished expectations about the future and reduced access to credit, the result is falling home prices.

In some markets, depreciation motivated borrowers who had bought homes as investments to unload them en masse, which led to further depreciation. In other markets, like



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Cuyahoga County, depreciation revealed a market built on shaky subprime mortgages. Now, foreclosures of homes purchased with these subprime mortgages are spreading across neighborhoods, further dragging down prices.

At worst, foreclosed homes become abandoned homes, and blight ensues, promoting further abandonment. In a single city block with even just a handful of abandoned homes—the sort of blocks that are all too easy to find in parts of the Fourth District—neighboring homeowners are faced with strong economic incentives to walk away from their own increasingly worthless houses.

6. Capital Losses

Saddled with foreclosed homes and depreciating mortgage-backed securities on their balance sheets, lenders take steep losses. According to Bloomberg, banks and brokerages worldwide have sustained more than \$935 billion in credit losses so far in the crisis. The resulting hits to capital, together with the difficulty of raising new equity funds, have cut the bloodline of credit creation.

Capital is a cushion that financial institutions maintain to absorb unexpected losses. As the cushion thins, financial institutions reduce their lending and risk exposures so that whatever is left of their capital will be enough to cover potential losses.

This decline in lending creates another disruption to the mortgage and housing markets. And so we return to the beginning of the housing crisis cycle—further delinquencies, foreclosures, oversupply of housing, home price declines, and additional capital losses. It then becomes a destructive, self-reinforcing cycle.

Potential Responses

Suppose we find a way to cure delinquencies and, thus, new foreclosures. But if the housing inventory overhang is not corrected, the uncertainty about home prices will persist. Lenders will continue to be saddled with foreclosed properties, potential buyers will continue to sit on the sidelines, and new delinquencies will arise as troubled homeowners cannot exit the housing market. We are back in the full cycle.

Alternatively, suppose we raze all excess housing supply and prices are ready to recover. But unless we recapitalize our financial system, new loans will not be forthcoming. Without loans, new buyers cannot enter the housing market and sellers cannot exit. We are back to the cycle with increasing delinquencies, foreclosures, and vacant properties.

Unless we attack the cycle at multiple points, there is a chance that our efforts will fall short. We also know that some efforts will be more effective or necessary in some regions of the country than others. Moreover, the wider effects of the housing crisis compel us to undertake public interventions aimed at stabilizing the housing market and our neighborhoods (see “*Federal Reserve Actions*”).

In this section, we review proposals that address specific points in the cycle and then consider whether they together constitute a full-scale attack on the crisis.

1. Loan Modifications

Foreclosures are expensive. The cost of a typical foreclosure to a lender is up to 25 percent of the loan balance.¹² In times of falling prices, loan modifications look increasingly attractive to lenders, servicers, and investors—not to mention defaulting borrowers. In our cycle, loan modifications specifically target the links between market disruptions, defaults, and foreclosures.

A loan modification is a permanent change in the terms of a mortgage loan. Typically, the new terms—which may include an extension of the maturity of the loan, forgiveness or delay in the collection of missed payments, lowering of interest rates, or the elimination of prepayment penalties—make the mortgage more affordable for the borrower.

However, securitization has made the loan modification process more difficult and expensive than it was in earlier decades. Loan servicers, for example, are contractually required to allow a modification only if it is in the best interest of investors. Defining “investors’ best interest” is hardly straightforward. Some pooling contracts allow for modifications only in the event of default and forbid proactive modifications of high-risk loans. Others may allow, for example, only up to 5 percent of the loans in a pool to undergo modifications each year.

Federal Reserve Actions

The Federal Reserve System has already undertaken a number of efforts to address the foreclosure crisis. First, we have asked mortgage lenders and servicers to consider loan workouts in appropriate situations. Also, in partnership with the national nonprofit NeighborWorks® America, we are developing programs to ease the problem of foreclosures and vacant properties.

In July 2008, the Federal Reserve acted to address unfair and deceptive mortgage lending with approval of a final rule under the Home Ownership and Equity Protection Act. More recently, we have sought public comment on revisions to the Truth in Lending Act. Consumer protection is important, but it is not possible to ensure complete safety. The Federal Reserve’s job is to ensure as much information and transparency as possible while restoring an appropriate appetite for risk.

To get credit markets functioning again, we have taken actions ranging from lowering the federal funds target rate to developing a set of policy tools to support borrowers and investors in key markets. In March 2009, the Federal Reserve announced plans to purchase up to \$1.25 trillion of mortgage-backed securities from government-sponsored enterprises by the end of the year. This program in particular is intended to improve the flow of credit to homebuyers and to allow existing homeowners to refinance at lower rates.

12. Mason (2007).

To understand why such severe restrictions were put in place, consider the state of the housing market during the boom. Any troubled borrower could try to refinance his mortgage and lower his payments. Borrowers who did not qualify for refinancing were most likely to be such poor risks that most would not be helped by a modification; a foreclosure would be the most efficient outcome. However, if servicers had unlimited power to modify mortgages, they would have an incentive to modify every loan and avoid foreclosure to maximize their compensation for loans serviced. To limit this type of behavior, investors imposed heavy restrictions on the number of modifications and, in most cases, provided no compensation to the servicer for the extra costs of modifying a loan. With the expectation of relatively few foreclosures and healthy housing markets, these contracts were designed to favor foreclosures over modifications.

It is a different world today, but the old contracts are still in force. Servicers and most investors would probably prefer removing those restrictions and restoring some cash flow from these loans to being stuck with unwanted properties. However, some investors would likely be disadvantaged by loan modifications. With millions of mortgages and thousands of investors involved, obtaining an agreement to modify the rules would be practically impossible.

This type of coordination problem creates an opportunity for constructive policy action. First, servicers need to receive compensation for loan modifications because investors will not reimburse them for some of the costs. Second, when loans are modified, some investors will be forced to take losses. Currently, the threat of investor litigation to prevent such losses tends to freeze any modification effort in its tracks, or makes modifications too superficial to help the borrower. Indeed, re-default rates are high among modified loans: 46 percent of U.S. borrowers whose mortgages were modified during the second quarter of 2008 were delinquent after eight months.¹³ Thus, a temporary shielding of servicers from investor lawsuits may be necessary to get modifications done right and on a large scale. Third, removing restrictions on servicers brings us back to the original problem of too many modifications at investors' expense. Policy-makers must put a mechanism in place that rewards successful modifications. One such program announced by the Treasury would pay \$1,000 per year for three years to servicers for each modified mortgage that remains current in that period. While we cannot conclude that this policy is the only way or the best way to incentivize servicers, it is likely to be helpful.



Allowing some people to continue living in their homes as renters would help neighborhoods by keeping homes occupied and avoiding vacancy and abandonment.



Land banks are government entities that can acquire distressed properties, clear title defects, and convert the properties to alternative uses.

13. Office of the Comptroller of the Currency and Office of Thrift Supervision (2009).

A Unique Partnership

Hiring a team of expert, certified inspectors to check code compliance one property at a time is expensive. So last year, the Cleveland Neighborhood Development Coalition, the nonprofit umbrella group for the city's community development corporations (CDCs), partnered with the city's Department of Building and Housing to create a new code enforcement program.

Now, city code enforcement staff work in tandem with about 20 participating CDCs. The city diverts routine complaints to the CDCs for screening. In neighborhoods, CDCs have developed a "good cop" reputation that helps ensure that properties are maintained. Meanwhile, city inspectors are free to handle and follow up on more serious cases.

"It works really well," says Cleveland Councilman Jay Westbrook. "I think of it in public health terms. The mortgage crisis is an epidemic, and code enforcement is your frontline defense. It's your country doctors—your general practitioners on the frontlines—who are detecting the disease and triaging the treatments."

2. Converting Owners to Renters

While loan modifications may succeed at severing the link between market disruptions and delinquencies and foreclosures, in many weak markets of the Fourth District, we are still left with a large inventory of vacant housing units.

In growing communities, one way to deal with the inventory problem is to convert existing vacant units into rental properties. In calmer times, private investors would purchase vacant units and make the changes themselves given the opportunity for profit. However, these are not calm times, and the inventory is massive. The first investor to attempt such conversions will test the survivability of a neighborhood—but followers will come only if the first succeeds. Therefore, policymakers may find it necessary to subsidize the first movers.

An alternative policy would be to allow some people to continue living in their homes as renters. Some former homeowners may have the option of buying back the property in the future. For example, Fannie Mae and Freddie Mac recently announced that renters of foreclosed properties and some owners will be allowed to remain in their houses as renters on month-to-month leases. This policy would help neighborhoods by keeping homes occupied and avoiding vacancy and abandonment. To be clear, some rent-to-own programs are little more than investment scams that do little good in neighborhoods. By contrast, well-established community development corporations have a history of reliably managing such programs and might be useful resources in future efforts on this front.



As an approach to preventing vacancy and abandonment, code enforcement—compelling property owners to maintain their properties—may be among the most effective.

3. The Land Bank Approach

Dealing with the oversupply problem in weak-market areas may require further government involvement such as land banks. Given that the housing stock is larger than the population in some Fourth District counties, for example, there is no profit in conversion to rental use. Therefore, some vacant and abandoned properties must be repaired and sold (or rented) if there is still value left in the neighborhood; others may need to be demolished.

The costs of dealing with vacant and abandoned properties fall mainly to local governments, which are often unable to break the cycle of foreclosure to abandonment to blight. They are thwarted by heavy costs, the lack of a timely legal mechanism to acquire properties, liability concerns, and no overarching strategy to address the problem at a regional level. Land banks provide that mechanism.

At their simplest, land banks are government entities that can acquire distressed properties, clear title defects, and convert the properties to alternative uses. All of these tools require legislation to award government entities with appropriate powers.

Ohio's recently adopted land bank legislation, which applies to Cuyahoga County over two years, aims to give such entities the powers they need to address vacant and abandoned housing on a regional basis.¹⁴ These powers include streamlining the property acquisition process via tax foreclosure; securing funding sources without creating new taxes; and providing the ability to organize as corporations that are legally distinct from local governments. Among other benefits, the new Ohio rules help land banks act as repositories for data, allowing for region-by-region evaluation of the vacant and abandoned housing problem. In addition, the time it takes for Ohio land banks to acquire vacant properties should shorten, which in turn should speed the properties' return to real property tax rolls if possible.

The land bank system has its own pitfalls, however. In the rush to help people in need, it is easy to lose sight of which neighborhoods are viable and which are not. A land bank that renovates homes in an otherwise blighted area is unlikely to promote wider revitalization. The home may very quickly be abandoned anew, if foreclosures and abandoned properties are growing much faster than the land bank can fix and use them. Therefore, a transparent and accountable triage process is necessary to identify the neighborhoods that can benefit from a land bank's involvement. If the new Ohio land bank legislation can be measured as effective in Cuyahoga County, a statewide and permanent rollout should be considered.

4. Code Enforcement

As an approach to preventing vacancy and abandonment, code enforcement—compelling property owners to maintain their properties—may be among the most effective. The “broken window” theory tells us that damaged properties can lead to further deterioration on their streets, ultimately spurring a spiral of disinvestment. Code enforcement can weaken the link between housing oversupply and home price depreciation.

The devil, of course, is in the details. Often, the data sources that local governments use to track the condition, ownership, and legal status of distressed or abandoned properties are fragmented and inaccurate.¹⁵ Local governments spend large amounts of time and money to locate and serve notices of code violations, search warrants, demolition notices, nuisance abatement assessments, or legal actions. In addition, there can be delays in the recording of deeds on properties, or assignments and transfers of liens.

Securitization of mortgages has made tracking lien holders an expensive challenge. Considering the vast numbers of abandoned houses and lots where the liens have less value than the cost of the legal process to clear them, this record-keeping chaos imposes a steep cost on taxpayers. Beyond new funding, code enforcement efforts might benefit from more creative approaches (see “*A Unique Partnership*,” p. 17).

5. Recapitalization

As all of these efforts carry on, financial institutions absorb significant damage. With capital levels low, new funds are harder to come by, as institutions appear to be at greater risk than before. Financial institutions that cannot raise new capital cannot resume lending, so offsetting losses with new reserves is an important step in breaking the cycle. Thus, government programs aimed at stabilizing financial institutions and strengthening their capacity to lend should not be regarded as a strategy that is independent from stabilizing housing markets. Improving borrowers' access to housing credit on favorable terms requires that financial institutions have the capacity and confidence to lend. Of course, if banks and other financial institutions are to be recapitalized with taxpayer money, the infusions should be provided through programs that are both transparent and adequately sized to the problem. These programs should also provide an upside to taxpayers if and when profitability returns.

The details of how to recapitalize the banking system are complex—and well beyond the scope of this essay. Economists at the Federal Reserve Bank of Cleveland continue to study recapitalization strategies. We encourage further investigation of this necessary step in halting the housing crisis cycle.

14. Fitzpatrick (2009).

15. Lind (2008).

Youngstown's Reinvention

Over the past three years, the city of Youngstown has demolished more than 1,500 structures, most of them homes. None of that old housing stock has been replaced.

To Youngstown Mayor Jay Williams, this is progress. The "Youngstown 2010" plan he has championed for nearly a decade aims to re-size the city to better fit its population. Youngstown was designed to hold as many as 250,000 people within its 35 square miles; at its peak, 175,000 lived there. Today it has 80,000 residents.

"Getting smaller doesn't have to be a bad thing," Williams says. "It doesn't necessarily mean inferior."

Youngstown was once the nation's steel mill hub, teeming with industry. The slow-motion decline began in the 1970s. Amid mounting evidence that there would be no economic comeback, Williams began pushing the notion that a readjustment of expectations and plans for the future was in order.

At its core, Youngstown 2010 is a land-use plan. The ground underneath many of the demolished properties is held in the city land bank. Formerly residential neighborhoods are being rezoned for recreation or "green" industry. In some cases, back taxes are forgiven on abandoned lots so that neighboring landowners can take over upkeep. New residential construction is managed with a greater degree of oversight, particularly residential housing financed with low-income housing tax credits.

Other guiding principles of the Youngstown 2010 plan include preserving historical structures, clearing access to the Mahoning River, and improving neighborhood safety. Funding has come primarily through Housing and Urban Development block grants.

The reviews to date have been largely positive. City managers from around the country have visited Youngstown to replicate its model. Williams admits that it remains challenging to allocate increasingly scarce resources given the city's shrinking tax base. But as the plan becomes technically obsolete with the impending arrival of 2010, Williams is looking forward to development of Youngstown 2020. As he sees it, the old plan will simply be updated and roll over into the new plan.

"It's a journey," Williams says, "not a destination."



Several communities are following Youngstown's lead in rethinking their neighborhoods. In this rendering, the Cleveland Urban Design Collaborative imagines existing housing integrated with new waterways and green space created from formerly vacant housing.

The Way Forward

The breadth and depth of the housing market decline call for a massive, multifaceted response—one that takes into account the different needs of different communities with a constant eye on the long term. A set of coordinated policies that attacks multiple points in the housing crisis cycle can help to balance the supply of housing with the demand for homeownership. A multipronged approach is also useful because it recognizes that some programs—even well-designed ones with all the right incentives—may take longer than others to bring relief.

What works in Cleveland may not be necessary or useful in Cincinnati, or even Chicago. This reality underlines the desirability for flexible approaches to the problem, region by region, neighborhood by neighborhood. Our intent has been to provide a framework for evaluating policy options more generally.

The Administration's Homeowner Affordability and Stability Plan, as proposed in February 2009, takes aim at many of the links we identify in the cycle. The plan addresses at-risk homeowners who are already behind on their mortgage payments or who are struggling to keep their loans current. This program is voluntary, but it provides incentives to loan servicers to modify loans, and incentives to borrowers to stay current on their modified loans. Another feature of the plan directs the housing agencies Fannie Mae and Freddie Mac to refinance conforming loans they hold or securitize for certain eligible borrowers.¹⁶

Policymakers are also considering whether to enact legislation to allow judges to modify loan terms and balances due on mortgage loans for principal residences as part of a bankruptcy proceeding, and whether to extend a "safe harbor" to loan servicers who modify loans "in good faith on behalf of investors" even though the modifications are outside the scope of their existing discretion. Although these actions effectively upset prior contractual agreements between borrowers and lenders, they might be necessary in a time of crisis. However, this type of legislation may affect the willingness of lenders and investors to provide housing credit long after the current crisis has ended. We urge that the long-term health of the housing markets be kept in mind, so that changes made to address today's crisis are consistent with the future availability of private mortgage credit on reasonable terms and conditions.

The textbook rules of economics still apply during this crisis. We want to avoid policies that produce "deadweight loss"—providing incentives like tax breaks or loan workouts for people to do things they would have done anyway. We want to stay out of the way of resource reallocation.

Why build more housing when the market is sending strong signals that demand lies elsewhere? Indeed, the sharp pullback in subprime lending and the return of sound underwriting practices we are witnessing today are necessary and expected steps in the recovery process.

Even under the best of circumstances, a housing recovery will not be immediate, so short-term policy actions will take time to work their way through the system. Also, recovery in the housing markets does not necessarily mean that our neighborhoods will go back to the way they were in their most vibrant heyday. Some neighborhoods will undergo an unwinding, not a revival. This is especially true for regions with declining populations (see "*Youngstown's Reinvention*," p. 19). People may leave, but the housing stock remains. To clear the market, house prices must fall. Consequently, shrinking cities tend to have inexpensive housing disproportionately occupied by poor people.¹⁷



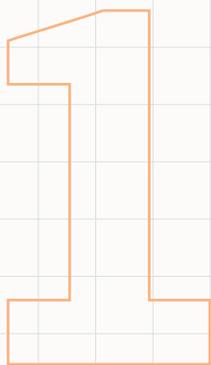
It is far too easy to say that recoveries happen because they always do. We can and should help our communities in their time of need.

16. Loans on single-unit properties as high as \$729,750 will qualify.

17. Glaeser and Gyourko (2005).

Shrinking cities wishing to ensure their viability must be assertive about removing blighted housing from the market, using land banks, and enforcing building codes. Cities that cannot expect to grow out of their excessive housing stock might also benefit from new ways of working together with business leaders, community organizations, and community development lenders on land-use strategy. Coming to grips with new views of the future is perhaps the greatest challenge.

It is far too easy to say that recoveries happen because they always do. We can and should help our communities in their time of need. A first step is breaking the housing crisis cycle. Then the recovery can really begin.



A first step is breaking the housing crisis cycle.

THEN THE RECOVERY CAN REALLY BEGIN.

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