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Rebuilding the Crumbling Foundation of the U.S. Economy: Update

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Much has been accomplished since we published our first house price forecast in January. The good news is that monetary and fiscal policy decisions in the United States appear to have transformed a chaotic economic freefall into what can be characterized as economic normalization. The bad news is that very little progress has been made in stabilizing the housing market. Based on our analysis, as of the end of March, the average American household with a mortgage had only 8% equity in their home. This implies that the loan-to-value ratio is, on average, at 92%. Our updated house price forecast, developed in collaboration with Duke University,¹ predicts a decline of 46% from the end of 2008, a lower decline than predicted in our January forecast. While this is still a large number, we believe the realized declines already observed in the first quarter of this year, along with our estimate of the impact of lower mortgage borrowing rates, will reduce the downside to a range of 17% to 23%, as shown in the table below. This forecast implies that we could see a situation in which over 30 million mortgage borrowers end up owing more than their homes are worth within a matter of two years. The implications of such a situation for foreclosures, consumer spending, unemployment, and a host of other problems are dire and real.

Duke/Lazard Forecast¹	-46%*
Observed YTD**	-7%
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Subtotal	-39%
Offset from interest rate reductions¹	+16% to +22%
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Remaining potential decline	-17% to -23%

* From the end of 2008

** As of March 31, 2008. Source: Standard & Poor's/Case-Shiller Home Price Indices

But, in our opinion, housing is not a lost cause. Numerous policies have been announced and implemented. Based on my analysis of the success and failure of various policies, it has become clear that an effective solution to the house price crisis must be broadly applicable to the entire universe of home buyers, rather than a narrow, targeted group of borrowers; and easy to implement quickly, as time is essential in this situation. The ultimate goal of any policy should be to increase demand for houses and/or to reduce the supply thereof to avoid a situation in which home prices overshoot to the downside. I believe that the two solutions that fit these criteria are:

1. To significantly expand the federal tax credit for home purchases through the end of 2010
2. To broaden the purchase of mortgage-backed securities (MBS) to include AAA-rated non-agency MBS

Looking at the policies implemented to date, we have witnessed both success and failure.

WHAT HAS WORKED?

1. **Interest rate reductions.** The U.S. Federal Reserve (the Fed) and the Treasury Department announced plans to purchase government-sponsored enterprise (GSE or Agency) MBS in late 2008. In the case of the Fed, these plans were later increased in size to as much as \$1.25 trillion, while the Treasury announcement did not include any specified limit on purchases. Since the initial announcements, mortgage rates have declined by between 160

and 220 basis points. For every 10 basis points the mortgage rate declines, the payment on a 30-year fixed rate mortgage declines 1%. Hence, this 160 to 220 basis points decline in mortgage rates is equivalent to a 16% to 22% decrease in the monthly payment for a typical borrower.

This reduction in borrowing rates is very important in two ways: First, it increases demand for housing by lowering the monthly payment on mortgage debt; second, by enabling existing homeowners to refinance their mortgages to lower monthly payments, it leaves more cash flow available to deleverage and/or sustain spending.

Unfortunately, while mortgage borrowing rates have declined across the board, the rates for non-agency MBS have been less impacted and remain stubbornly high. Non-agency MBS are particularly relevant to higher priced homes, many of which are located in states such as California and New York.

2. **Tax benefits for home purchases.** We have seen two major tax incentive programs. The first was included in the federal fiscal stimulus package that was signed into law in late February. In this package, first-time homebuyers with income of less than \$150,000 were able to claim a tax credit of up to \$8,000 for a home purchase. The second program, implemented in California, grants any buyer of a previously unoccupied home a tax credit equal to the lesser of \$10,000 or 5% of the home purchase price. Both programs appear to have increased home purchases amongst the targeted audience. However, we believe the federal program is too narrowly defined and limited in size to impact large segments of the home market, and the California program actually creates an incentive to build new homes when there is already a glut of homes available on the market.
3. **Broad (i.e., not narrowly targeted) measures.** I think it is clear that the underlying principle being pursued with the two tax incentive programs discussed above can have a powerful impact on housing supply and demand dynamics. I believe that the lesson for policy makers should be that carefully engineering social objectives, or determining who is allowed to enjoy moral hazard, on an individualized basis is self-defeating on multiple levels. First, ad hoc approaches may limit the effectiveness of the policies themselves, as they limit the number of people who can leverage them. Second, by introducing randomness to the determination of which borrowers can or cannot access programs, the policies could create more uncertainty around the cash flows that investors can expect from financing home purchases. To the extent uncertainty increases, the cost of funding increases in the market, offsetting the benefits the programs are designed to achieve now and in the long term. Third, the more detailed the plans are, the more difficult it may be to implement them from an administrative as well as user-education perspective.

WHAT HAS NOT WORKED?

1. **Mortgage modification plans.** These plans have been praised and vilified. The reality is that they have helped some borrowers, but not enough to reduce materially the number of homes entering foreclosure. The most significant problem is that the amount of processing time for each loan is lengthy, as borrowers often will not even return phone calls from the loan servicing agent seeking to reduce their payments. Moreover, in spite of extensive effort, cost, and time expended, many modifications are not justifiable, as the borrower simply cannot make even reduced payments. The fact that so many borrowers whose loans are modified re-default quite quickly thereafter merely adds insult to injury by reinserting the homes into the foreclosure process at a later date. We believe modifications should not be halted, but they should be applied sparingly. There are negative consequences of such activity, including heightened moral hazard and ultimately higher mortgage borrowing costs, as investors learn that their cash flows can easily be reduced in spite of contractual agreements.
2. **Cram-down proposals.** To date, mortgage cram-down proposals have not been legislated successfully, as concerns over the integrity of contract law, moral hazard, and the inherent decrease in predictability of mortgage-related cash flows have derailed supporters. This failure may be a good thing, as such proposals would raise serious questions about the rule of law and the property rights of investors who funded the mortgages while having very little positive impact on the number of homes being foreclosed. As with modifications, we believe the single most important flaw related to cram down is that it requires judicial intervention on a borrower-by-borrower basis.

3. **Plans that address one borrower at a time.** These plans simply take too long to reach the over four million mortgage borrowers who are already delinquent and the over 12 million more borrowers who now have negative equity and are at an elevated risk of slipping into delinquency.² The appeal of designing policies with strict tests of eligibility is that they would appear to narrow the range of beneficiaries to those who “truly need assistance.” The reality is that they represent an undisguised manipulation of markets at the micro level that ultimately is likely to raise the cost of mortgage finance, while they are also divisive from a partisan perspective at precisely the time when we need bipartisan solutions to the financial catastrophe facing the 75 million U.S. homeowners.

WHAT DO I PROPOSE?

1. The tax credit should be for all buyers of existing, previously occupied homes without income restrictions. I would like to see a tax credit of the lesser of 5% of the home purchase price or \$20,850 ($=\$417,000 * 5\%$). This tax credit would significantly reduce the downside in home prices, due to the large number of foreclosed homes being put on the market, by creating incremental demand. Moreover, given the maximum size of the credit, it would provide a boost, albeit smaller for purchasers of homes that are more expensive than the historical GSE conforming loan limit (\$417,000), without subsidizing purchases of “mansions” for the wealthiest buyers who are not in need of assistance.

To succeed, this plan should have a short defined life that extends only through the end of 2010. Over this period of time, estimates of incremental foreclosures in the United States range to over three million. This enormous incremental number of homes coming into the supply chain in a distressed position necessitates the boost to demand from such a tax credit.

The plan would be expensive. Assuming there are four million existing home transactions with an average price of \$300,000 in 2010, the cost could be as much as \$60 billion. That said, given that the benefit would be capped at the \$417,000 level, some portion of many homes would be above the limit where there would be no incremental subsidy. This limit could lead to a material reduction in the total subsidy amount, but it seems safe to assume that the total would not be less than \$40 to \$50 billion of cost to the Federal Government over a 12-month period.

Though this cost is large, it is actually not far out of line with the amount of funds proposed by the Obama Administration to support a range of homeowner stabilization plans. By redirecting this money to the immediate need, I believe the Administration is likely to see a much better result. Moreover, I think this tax incentive is much more likely to be embraced across the aisle, as it would allow consumers to make decisions based on their own economic calculus rather than that of an elected official designing detailed plans.

2. The current MBS purchase plans should be expanded to include non-agency MBS: The existing purchase programs conducted by the Fed and the Treasury have been pivotal to reducing the downside in house prices. Even if they have had a secondary effect on mortgages that cannot be purchased or guaranteed by the GSEs, rates on these loans remain stubbornly high. To protect the Fed’s balance sheet, I would suggest purchasing only the AAA-rated tranches of such non-agency MBS. These securities are less likely to see capital losses now than perhaps at any time in the last two decades, as loan-to-value levels are lower across the mortgage lending industry, and as the capital structure is more supportive than in the past of the integrity of the AAA-rated securities. Last, but not least, given the lack of Fed intervention to date, the non-agency market has been much less liquid than the Agency market. The Fed would not have to intervene to nearly the same degree to have a significant impact on these borrowing rates.

The benefit of this plan is that it better addresses the needs of many of the states that have high cost housing. These states include most obviously California, but also newly emerging problem areas such as the New York/New Jersey/Connecticut region and areas in the Mid-Atlantic and Southeastern United States. Combined with the tax credit referenced above, these actions, and the resulting decreases in borrowing rates, could reduce the cost of purchasing such homes by as much as 10% through a combination of lower monthly payments and tax credits.

In conclusion, while we see reasons to believe the United States has moved into a phase of economic normalization, it is too early to say that the economy is stabilizing. Currently, housing is the single biggest risk to economic recovery, and the efforts to date, in my opinion, have been inadequate to stop the bleeding. Both policies I propose in this document to stem the decline in home prices could be enacted within a short time frame, with an immediate benefit to millions of Americans who own a home or want to purchase one. Some say we should wait to see the results of already announced plans. The problem with this approach is that home prices are declining at a pace of 2% to 3% per month based on the S&P Case-Shiller's Home Price Index. If we wait six months to realize that the one borrower at a time approaches do not work, the average American with a mortgage will likely have no equity left. At that point, designing a new plan will be futile to some degree, as the implementation timeline and details around eligibility will mean a mid-2010 solution at best. If the problem is addressed through these tools, we believe the future decline in home prices could be cut in half, greatly reducing the secondary and tertiary ramifications of remaining house-price weakness.

NOTES:

1 Refer to "The Crumbling Foundation of U.S. House Prices – May 2005 Update" Investment Research paper published by Lazard Asset Management, in collaboration with Duke University, on 22 May 2009.

2 Source: Inside Mortgage Finance and Lazard Asset Management.

Published on 22 May 2009.

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