WESTWOOD CAPITAL, LLC

OPINION

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The Housing and Debt Crises: Intractable Problems and How they can be Resolved

Highlights

- A failure to fully understand and appreciate the causes and likely magnitude of twin housing and debt crises may result in inadequate solutions, economic stagnation and a diminishing of the traditional resiliency of American markets.

- The easy money policies of the first half of the current decade resulted in the unprecedented doubling of mortgage and consumer debt, which grew by nearly $7 trillion in only six years.

- Other than relative to the speculative fever of the past several years, housing prices grew to unjustafiable and unsustainable levels that disconnected from the three real determinants of value, consumer affordability, responsible and sustainable mortgage lending practices, and the alternative cost of rental housing.

- Conservatively running the numbers on the impact of crises has led Westwood to conclude that trends increasingly point to at least $1 trillion of likely non-recoverable mortgage losses (to say nothing of the loss of 100% of the home equity invested in connection with such homes).

- The solutions that have been suggested in political and business circles in recent weeks reflect a less than full appreciation of the genesis of the crash in the overvaluation of residential real estate and a massive over-leveraging and dis-saving by the American consumer. Even less is understood about what can be done to move directly and swiftly to address the problem.

- In this piece, Westwood presents a bespoke solution to the housing and debt crises, adhering to five principles which: a) cause the parties that took unwise risks also take responsibility for their acts (i.e. no bailout, no exacerbation of moral hazard); b) rely as little as possible on the government/taxpayer; c) strive to keep people in their homes; d) save lenders and borrowers the enormous cost of adversarial foreclosure; e) provide sufficient time for American families, who are unable to afford continuing as homeowners, to work their way out of their mountain of debt and to rebuild material savings.

Overview

The source, magnitude and impact of the twin housing and debt crises that are plaguing the economic outlook for the US, if not the world, are only now beginning to be fully understood.

Solutions have been bandied about political and business circles in recent weeks that reflect significant misunderstandings about the genesis of the crash in the residential housing and debt markets, and what would provide for effective recovery within the shortest period of time. As with the commercial real estate and banking crises of the early 1990's, a premium must be placed on swiftly understanding what is transpiring, implementation of solutions that protect the economy and taxpayers, and resolution of the market dislocations in as short as possible a time frame – especially when the alternative, continued business as usual, would almost certain to result in Japanese-style stagnation and the eventual diminishing of our traditionally resilient American economy.

Origins in Unprecedented Debt Creation

The problem that has overcome the economy has its most recent roots in the creation of nearly $7 trillion of new residential real estate and consumer debt during the first 6 years of this decade. Much of that debt was created in the period of 2004 through 2006 during which savings rates in this country turned decisively negative. Simply put, this level of debt creation was unprecedented – more than doubling the amount of homeowner and consumer (credit card and auto loan debt, for the most part) debt that existing at the end of 1999. The extension of this mountain of debt was enabled by a prolonged period during which the Federal Reserve Bank maintained its target Fed Funds rate at or below the rate of inflation – thus essentially providing a subsidy to borrowers (banks that borrowed from the Fed, and the institutions and individuals to which the Fed Funds were re-lent) and a massive incentive to borrow. The Fed's policy went well beyond offsetting the shock to the economy that followed the crash of the technology stock bubble in 2000 and the horrific impact of 9/11/2001, but engineered a new, and quite dangerous, asset inflation bubble in residential real estate, as well as in the value of businesses and commercial real estate assets acquired with billions of dollars of leveraged acquisition loans.

`That the ready availability of trillions of cheaply priced, loosely originated loans pushed residential real estate prices to unjustifiable levels is now generally appreciated. The magnitude of the problem, its ultimate impact on our economy and society, and what can actually be done by government and the private sector to put this behind us as swiftly as possible, have been thus far drowned out by a combination of blind optimists and well meaning politicians who have suggested solutions that have proven to be either non-starters or wholly inadequate to the unprecedented state of affairs. The present situation demands a through understanding of what has transpired, the threats posed to our economy and financial security, and a path to resolution of the problem that can (i) be employed with great dispatch, (ii) does not amount to a government bailout of either homeowners or lenders, and (iii) does not burden the general commonwealth of this country (the ordinary citizen and taxpayer) with the financial responsibility for the crisis.

Housing Prices Disconnected from Related Metrics Supporting Value

By way of additional background, at the end of the housing bubble from 2000 to 2006, home prices had risen nationwide by 74% while median incomes across the nation had risen by only 15% during the same period. Rental income from the portion of the housing market that is not owner-occupied, grew only slightly more than the rate of inflation. The resulting divergence in ownership vs. occupancy costs of residential real estate created a situation in which, for the first time in modern American history, it became more expensive – on an after-tax basis – for someone to carry the costs of owning a home, as compared with the cost of renting one.

The inflation in existing home prices, and the resulting building boom in new homes, was debt-driven to a very large extent. The easiest way of appreciating the bubble is to take the case of an individual with $100,000 to put down on the purchase of a home in 1999. In the same year, with residential mortgage rates at 6% for adjustable rate mortgages, a mortgage loan could be had for 80% of the purchase price of a home and consequently the $100,000 down payment allowed for the purchase of a $500,000 home (80% of $500,000 = $400,000 in mortgage). Interest only, the monthly payment on a home acquired in such a manner would have been approximately $2,000 per month. By 2006, however, the metrics had changed substantially. The same $100,000 could be combined with offers from free-wheeling lenders for a home mortgage featuring an adjustable teaser interest rate of 3% and loan amounts of 90% of purchase price and more. Thus, the same $100,000 down payment and the same $2,000 per month carrying cost could support the payment of $1,000,000 for the very house for which one would have been able to pay $500,000 six years before. Simple math, but the unfortunate conclusions drawn from such financial engineering of higher home prices diverged massively from the true value of residential shelter.

Home prices are now in the process of reverting to levels supportable by reference to three principal data points, consumer affordability, responsible and sustainable mortgage lending practices, and the alternative cost of rental housing. Calculating the magnitude of the likely decline in home values, and thus the level of non-recoverable losses by mortgage lenders, is where the rubber meets the road in this crisis. As to the degree of inflation in home prices over real sustainable value, it is useful to note that quite a number of financial professionals, seeing mortgage loan balances ballooning to $11 trillion by the end of 2006, took comfort in the fact that home values had ostensibly ballooned to roughly $20 trillion at the same time. At first glance, that would indicate that – on average – about 55% of the value of all homes was owed to lenders, not a particularly uncomfortable percentage. Looking more closely at these numbers, however, yields a reliable indication of likely losses materializing from the debacle.

How to Reliably Compute the Damage

US Census data estimates that 30% of all homes have no mortgage debt on them at all. In reality, therefore, the $11 trillion of mortgage debt outstanding were secured by homes worth only about $14 trillion when the market peaked in 2006. This would indicate that the average loan-to-value ratio was actually in excess of 78%. Recent estimates of the level of retrenchment in housing values by Wall Street analysts and economists, in order to bring housing back into line with the data points referenced above, range from 15% to 40%, depending on regional market. A 25% nationwide and sustained decline from the peak is not unlikely. Such a reduction would set the value of all homes in the US at around $15 trillion and the value of all homes with mortgages at about $10.5 trillion – $500 million below the amounts of the mortgages outstanding against such collateral. The story doesn't end there. Because mortgage debt is not spread evenly over all mortgaged homes, some homes are mortgaged for well below the average loan-to-value ratio. Homes belonging to our older or retired citizens, for example, generally have far lower (or no) debt outstanding against them. The unfortunate corollary is that after such a reduction in value, between a third and one-half of all homes with mortgages would be mortgaged for amounts well in excess of their value. As a result, the numbers and trends increasingly point to at least $1 trillion of likely non-recoverable mortgage losses (to say nothing of the loss of 100% of the home equity invested in connection with such homes).

Accordingly, in focusing on resolution of the housing and debt crises and the impact thereof on the US economy, there are two principal issues to consider:

(i) The magnitude of the non-recoverable mortgage losses discussed above deriving from homeowners who are either "underwater" or who default because of inability to make payments, and adversely impacting the financial viability of a wide swath of our banking and lending institutions; and

(ii) The degree to which the housing and debt bubbles fueled consumer spending during the 2000 through 2006 period (with the debt binge and asset inflation having been confused with an increase in real wealth) and inflated corporate earnings and GDP, in a manner that can no longer be maintained.

A large amount of attention is, of course, also being paid to write-downs of downgraded or hard-to-sell/impossible-to-mark securities by the financial institutions that are stuck with them. As enormous as such write downs are they are not the primary concern. Many such institutions may even recover a small portion of the value they have written off on some credit default swaps, senior tranches of CDO-squared securities and securities for which markets have temporarily evaporated, when markets stabilize. The real issue is the permanently lost value of homes, and the negative wealth and ancillary effects thereof.

Many Attempted Solutions to the Crisis have been Misguided or Ineffective

The solutions that have been suggested in political and business circles in recent weeks reflect a less than full appreciation of the genesis of the crash in the overvaluation of residential real estate and a massive over-leveraging and dis-saving by the American consumer. Even less is understood about what can be done to move directly and swiftly to address the problem. The Fed's ongoing cutting of the Fed Funds target interest rate has been the keystone of its reaction to the situation. Intended to pump liquidity (through new lending) into the economy, reduce pressure on borrowers with adjustable rate loans, and deflate the currency so as to produce more jobs in the export economy, the rate cuts sound very desirable on paper. But nothing could be more poorly designed for the unprecedented magnitude of the crisis

The Fed can only do so much – or more bluntly, it can do so little. Lenders can't lend in this environment, for fear of not getting repaid. Borrowers lack the unencumbered collateral needed to obtain new loans. In February, the increase in risk premiums charged for loans began to offset the decrease in LIBOR and treasury rates. The debasing of our currency has produced sky high prices for commodities and increased the price of the relatively cheap imports on which we survive in our de-industrialized nation.

Earlier in the crises, several proposals for repackaging of troubled securities (such as the failed MLEC) into larger pools of still troubled securities, failed because of dependence on the "greater fool theory" and a corresponding dearth of fools to purchase the securities generated by such pools. The Bush Administration's jawboning lenders to voluntarily grant concessions to borrowers or institute moratoria on foreclosures have amounted to little more than delayed payment arrangements, because of the multiple economic interests involved in pooled mortgage securities and a rightful unwillingness on the part of lenders to give borrowers a "free ride."

Proposals to have Fannie Mae and Freddie Mac step in to purchase troubled mortgages and replace them with what are implicitly government-guaranteed loans have, appropriately, found no favor among either the shareholders of such institutions or many sectors of government.

The Fed's move on March 11th to provide liquidity to the banking sector by using its inventory of Treasury securities, while important, is like taking a cold tablet to enable getting through one's day. It treats the symptoms very well but not the infection. The symptom of market illiquidity for even high-grade debt securities resulted in regulated institutions taking markdowns that may prove to be excessive and threaten such institutions with illiquidity crises of their own (insufficient capital to support their balance sheets). The Fed's action may relieve some of the pressure, but it also does not treat the underlying cause of the symptoms - the unknown magnitude of residential mortgage loan losses that will be essentially non-recoverable and will need to be compromised or written off.

Congressional proposals to get the government directly into the business of buying troubled loans to stave off foreclosures have been, wisely, strongly resisted by the administration. Indeed, at what price is the government or its affiliates to buy the distressed loans from the private sector? If the price paid is greater than the eventual value of the loans or the underlying property, taxpayers would be footing a bailout.

It is important to remember that this is not the commercial real estate crises of the early 90's when weakly capitalized banks and S&L's were faced with a tidal wave of commercial mortgage loan and overseas loan defaults and began to fail. The federal government (i.e. all taxpayers) was guaranteeing the deposits of the failing institutions and moved swiftly to seize or carve out the bad banks and liquidated their assets through the government affiliated Resolution Trust Corporation. While the hits to bank capital under the present crises will be substantial, and some may fail, so much of the risk is held outside of the depository banking system (about $7 trillion of the $11 trillion of residential mortgage exposure) that another solution needs to be found.

Westwood Proposes a Targeted Solution aimed at Swift Resolution

To us, the solution must adhere to five clearly articulated principles which: a) cause the parties that took unwise risks also take responsibility for their acts (i.e. no bailout, no exacerbation of moral hazard); b) rely as little as possible on the government/taxpayer; c) strive to keep people in their homes; d) save lenders and borrowers the enormous cost of adversarial foreclosure; e) provide sufficient time for American families, who are unable to afford continuing as homeowners, to work their way out of their mountain of debt and to rebuild material savings.

There are presently fewer potential buyers of homes than there are homes available for sale, so the best thing to do in the case of many "underwater" homes and their occupants is to offer market-rate leases in exchange for the surrender of deeds, in lieu of foreclosure and sale. A workable solution would envision banks, other lending institutions and securitized mortgage holders obtaining, and ultimately selling, title to homes in question (homeowner equity having been wiped out anyway) and homeowners being offered a special, government promulgated, 5-year "Recovery Leases" to enable them to get their lives back in order.

This Recovery Lease-based plan would involve less cost to the government/taxpayer than the huge cost of write-offs and other expenditures associated with the massive wave of foreclosures that is the alternative. It would dramatically reduce the social and economic impact of growing

dislocation in the housing market. Moreover, this proposal would not expose the government to valuation issues arising from being a buyer of last resort for defaulted mortgages. While the plan would involve only private market transactions (hopefully outside of the contested foreclosure process), government would enact the following to encourage the participants to move in this direction:

- Grant tax deductibility to all or a portion of rents paid on Recovery Leases, to lessen the burden on the former homeowners (just as they were previously deducting mortgage interest) – leveling the playing field between owning and renting for existing owners of homes secured by troubled mortgages.

- Establish mandated benchmarks and guidelines for rents that can be charged under Recovery Leases, based on prevailing rents in the local sub-markets in which the homes are located (during the housing bubble, market rents fell well below the carrying cost of ownership in most markets).

- Enable financial institutions and subsequent investors in the homes to rapidly depreciate the value of the homes they have taken over, reducing depreciation periods from 28 years to 18 years.

- Remove passive activity loss limitations in the case of homes subject to Recovery Leases – thus providing enhanced tax incentives to individual investors interested in buying Recovery Leased real estate.

- Mandate a right of first offer to the former homeowner/Recovery Leaseholder, pursuant to which the occupant would be offered a 90 day right to buy the house at the price at fair market value just prior to the expiration of the 5-year Recovery Lease term, if the occupant is able to do so.

In the event the now-renting occupants stop paying their rent, they would be subject to eviction as in the case of any lease. Most importantly, this should all be viewed as an emergency measure and should have a defined sunset – applying only to Recovery Lease arrangements made for the next 18 to 24 months or so, thereby forcing maximum resolution into the shortest period of time. Finally, lenders should be encouraged to monetize (sell) the homes, subject to the Recovery Leases, as soon as possible to get the assets off their balance sheets and permit professional investors to replace the repossessed real estate with cash, on the balance sheets of lenders, in order to improve regulatory capital.

Conclusion

In the early 1990's, aggressive and creative actions by capital markets participants, regulatory agencies, the Fed and Congress, enabled the United States to move decisively towards recovery within a few short years – while Japan's inaction in response to its exploded bubble left it wallowing in recession for some 13 years. Today's circumstances are different, and likely more severe, than those of the early 90's – and the imperative to take off the blinders and act constructively and quickly is all the more critical.

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