How Mortgage Debt is Holding Back the Recovery

June 28th

Mike Konczal

mkonczal@rooseveltinstitute.org

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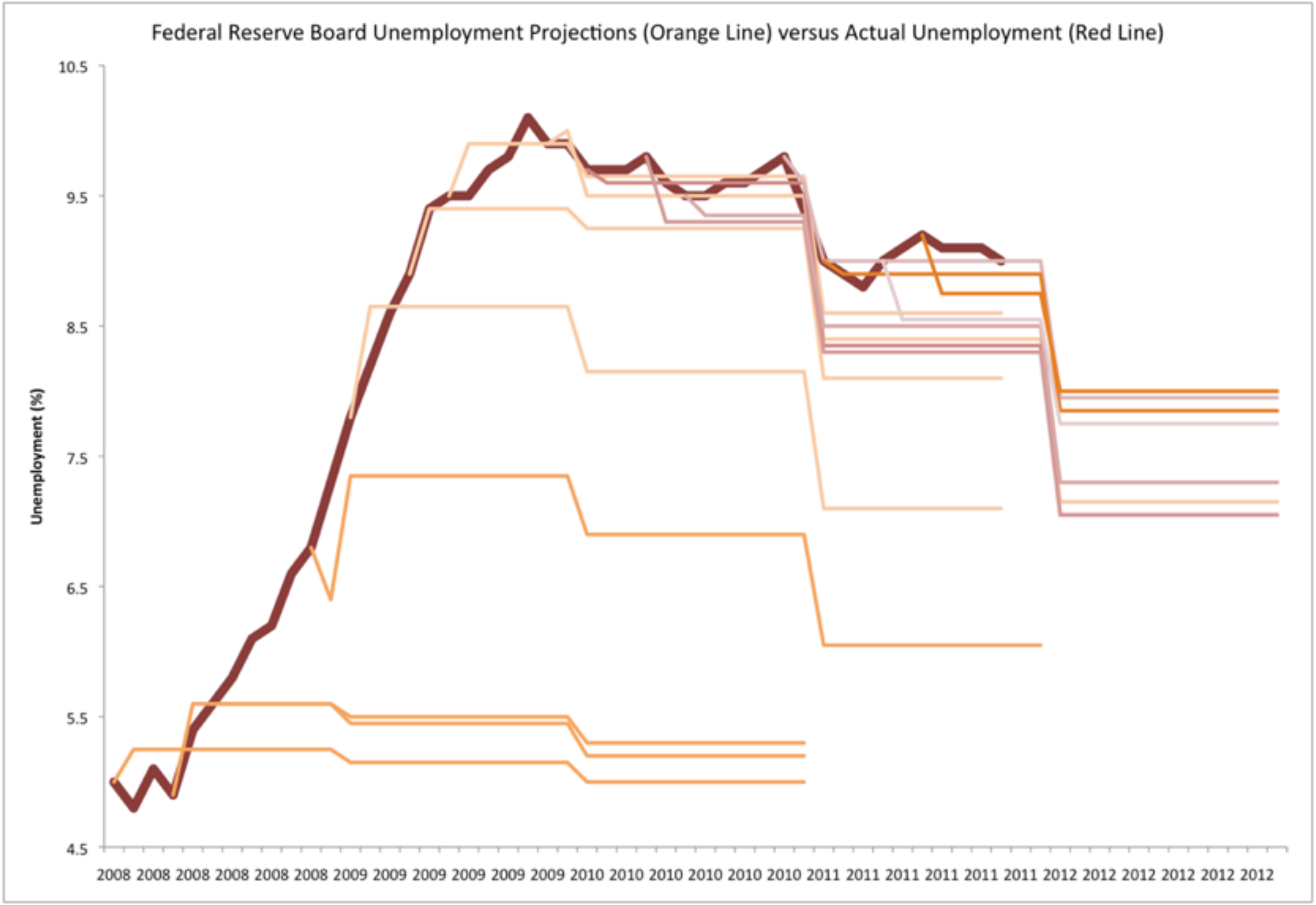
The Recovery is Going Slower Than Anticipated, With Unemployment High....



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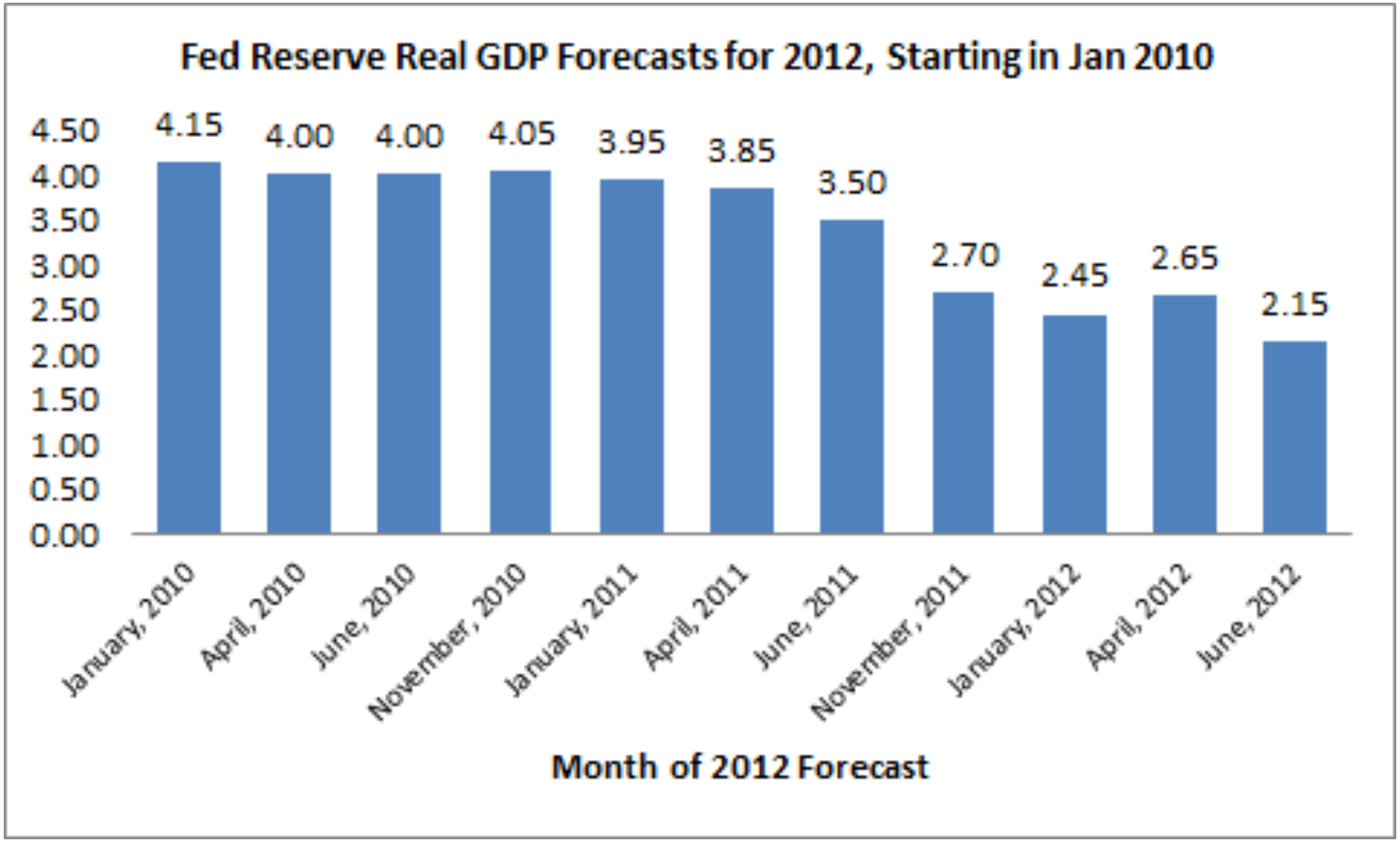
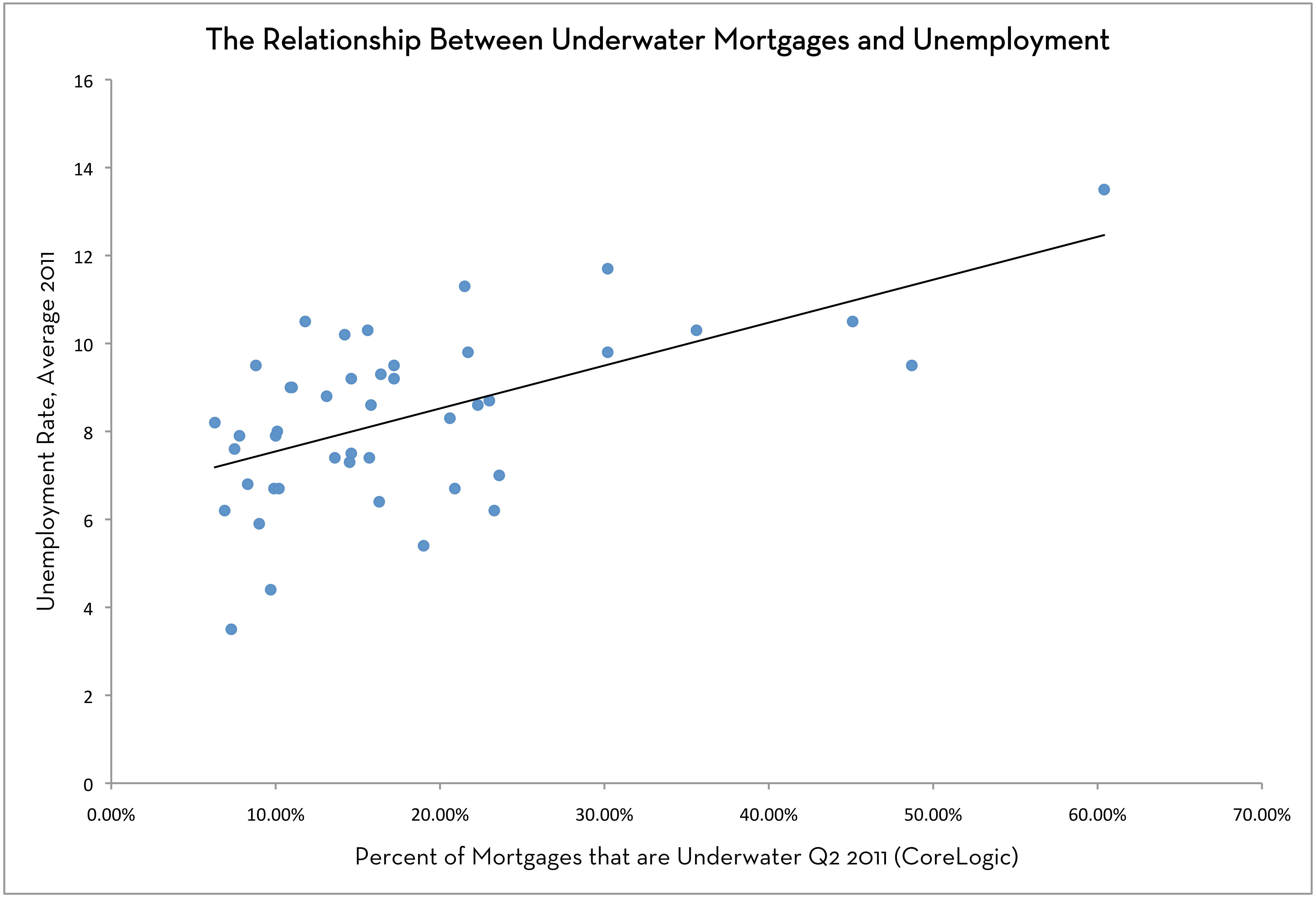
....and Growth Slowing.



Source: Jared Bernstein, CBPP, On the Economy Blog.

This Seems to be Important. But Why?



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This Seems to be Important. But Why?

Three Stories:

1. Structural Unemployment.

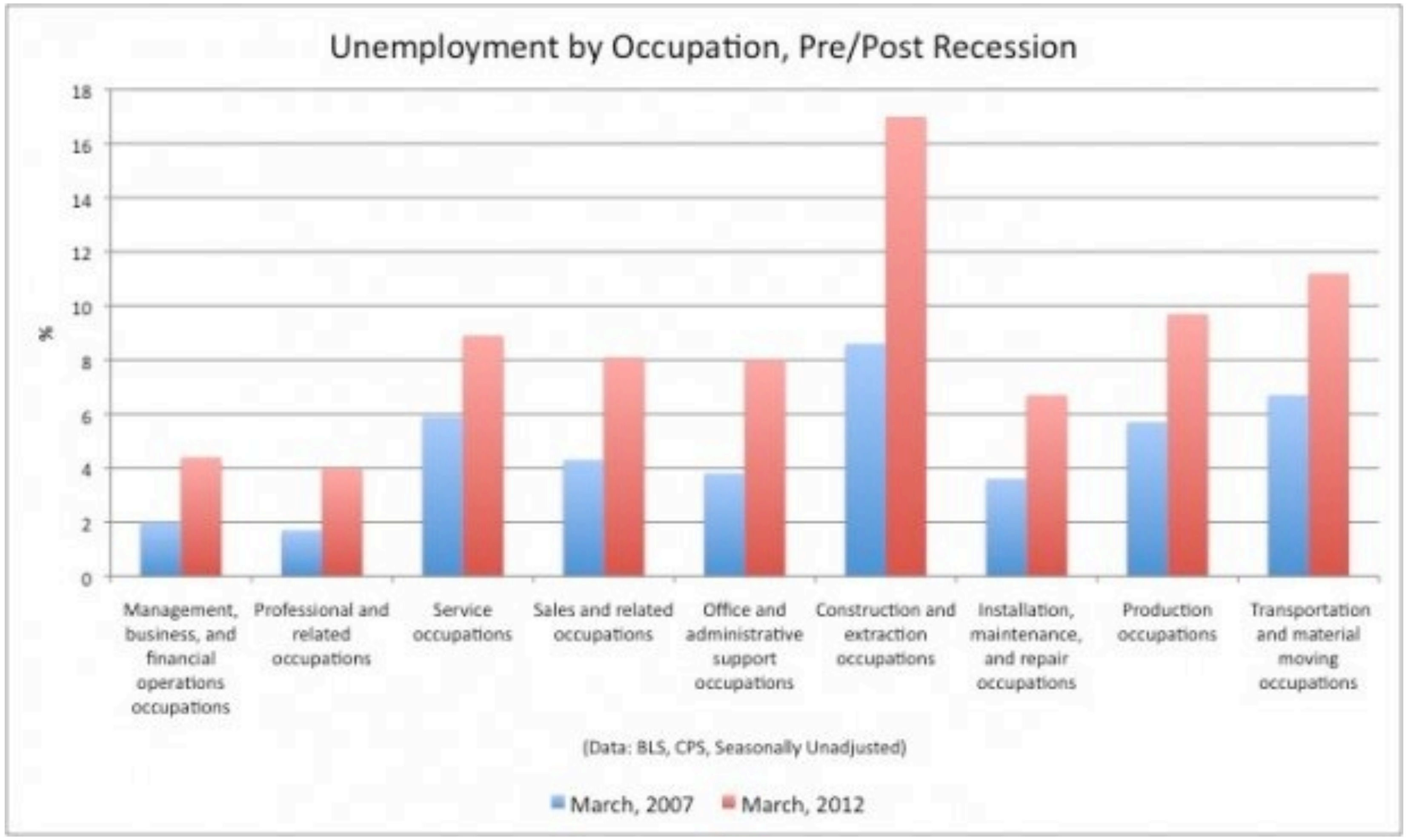
2. Wealth Effect.

3. Balance-Sheet Recession.

This Seems to be Important. But Why?

1. Structural Unemployment.

Unemployment is higher everywhere, across industries, occupations, education, location and age.



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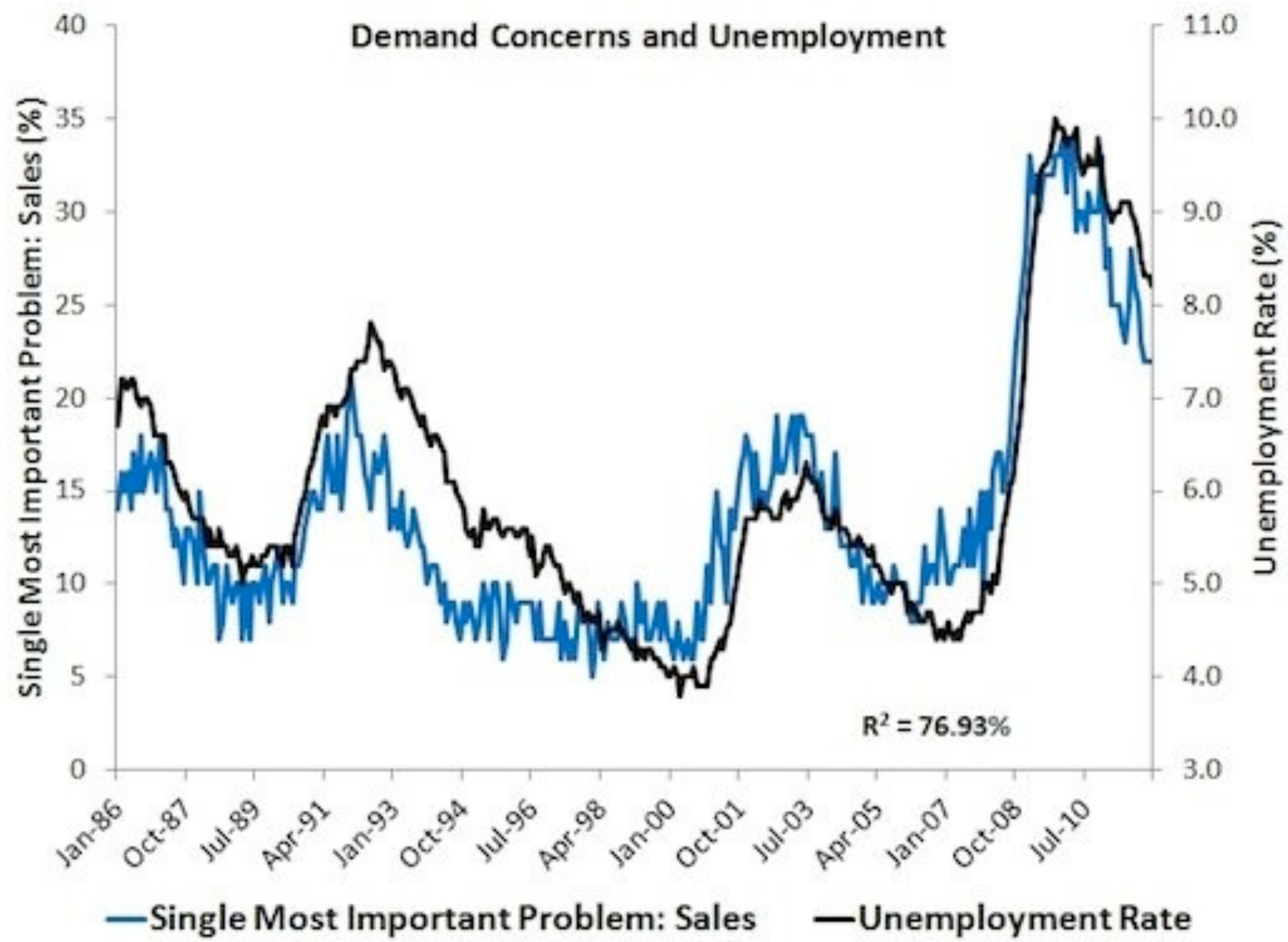
1. Structural Unemployment.

Employers find a lack of sales their biggest problem.



Source: David Becksworth, Texas State University

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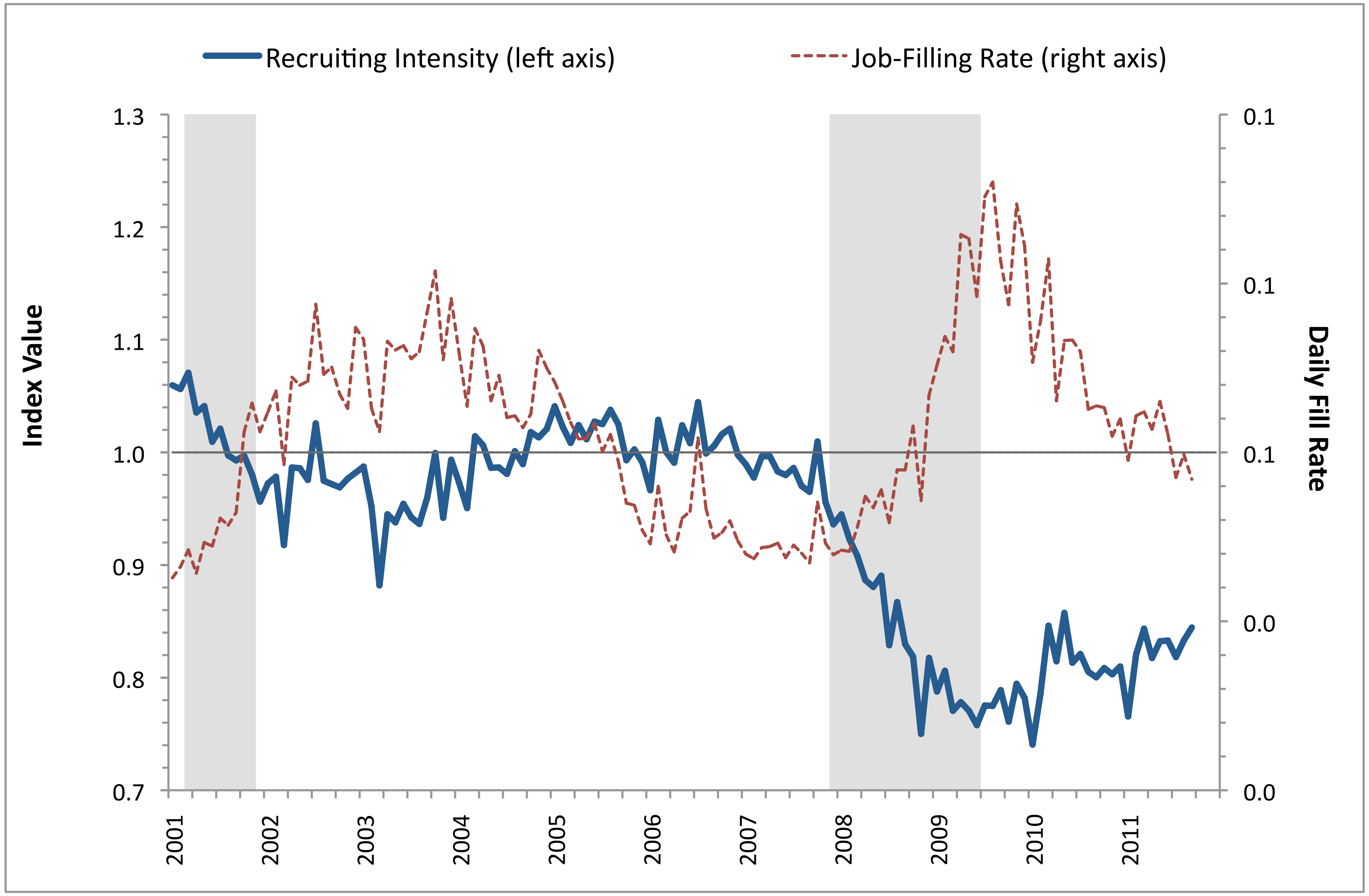
1. Structural Unemployment.

Employers aren't trying very hard to fill vacancies.



Source: Steven J. Davis & R. Jason Faberman & John C. Haltiwanger, 2012, "Recruiting Intensity during and after the Great Recession: National and Industry Evidence,"

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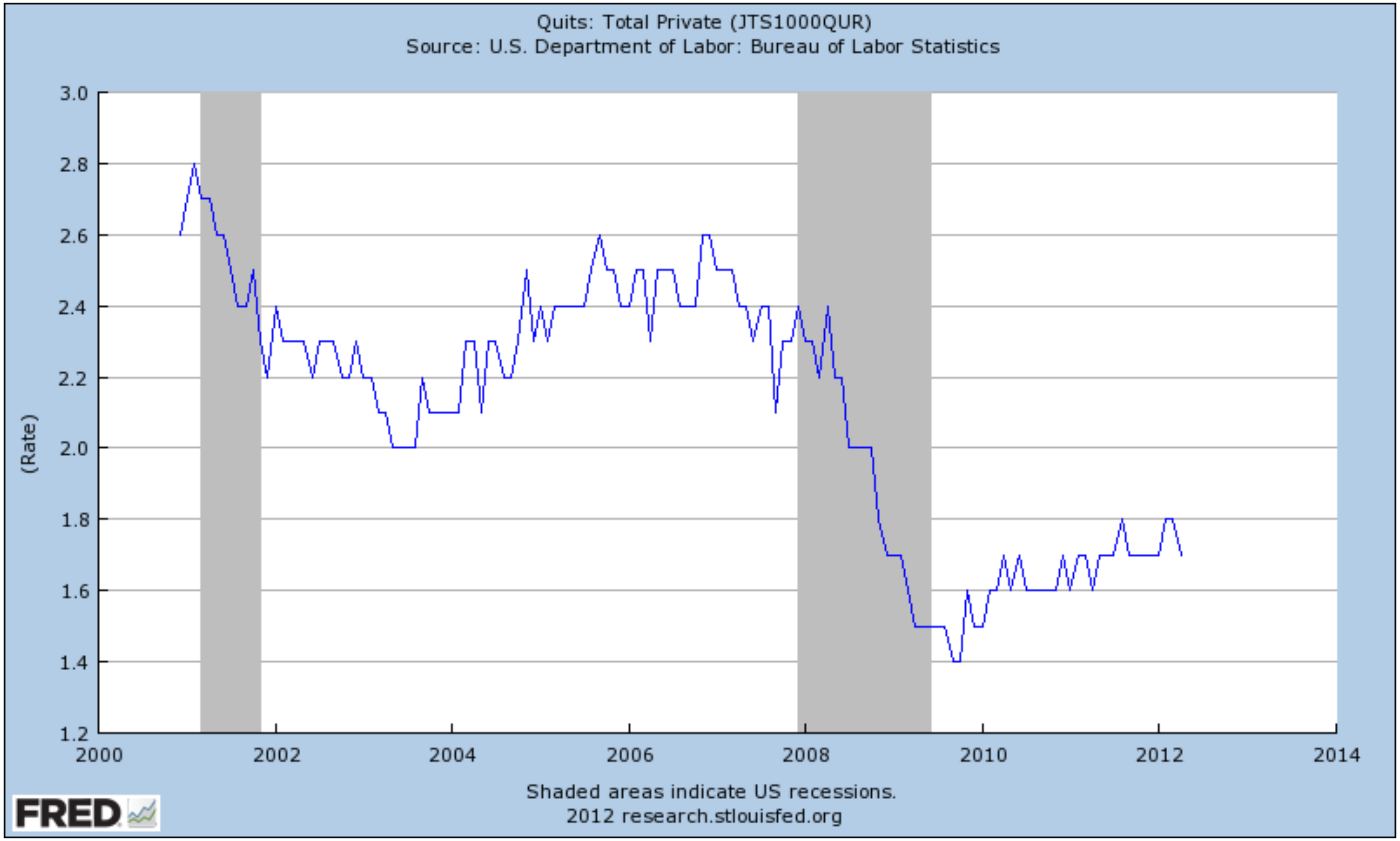
1. Structural Unemployment.

Labor market isn't working out for those with jobs.



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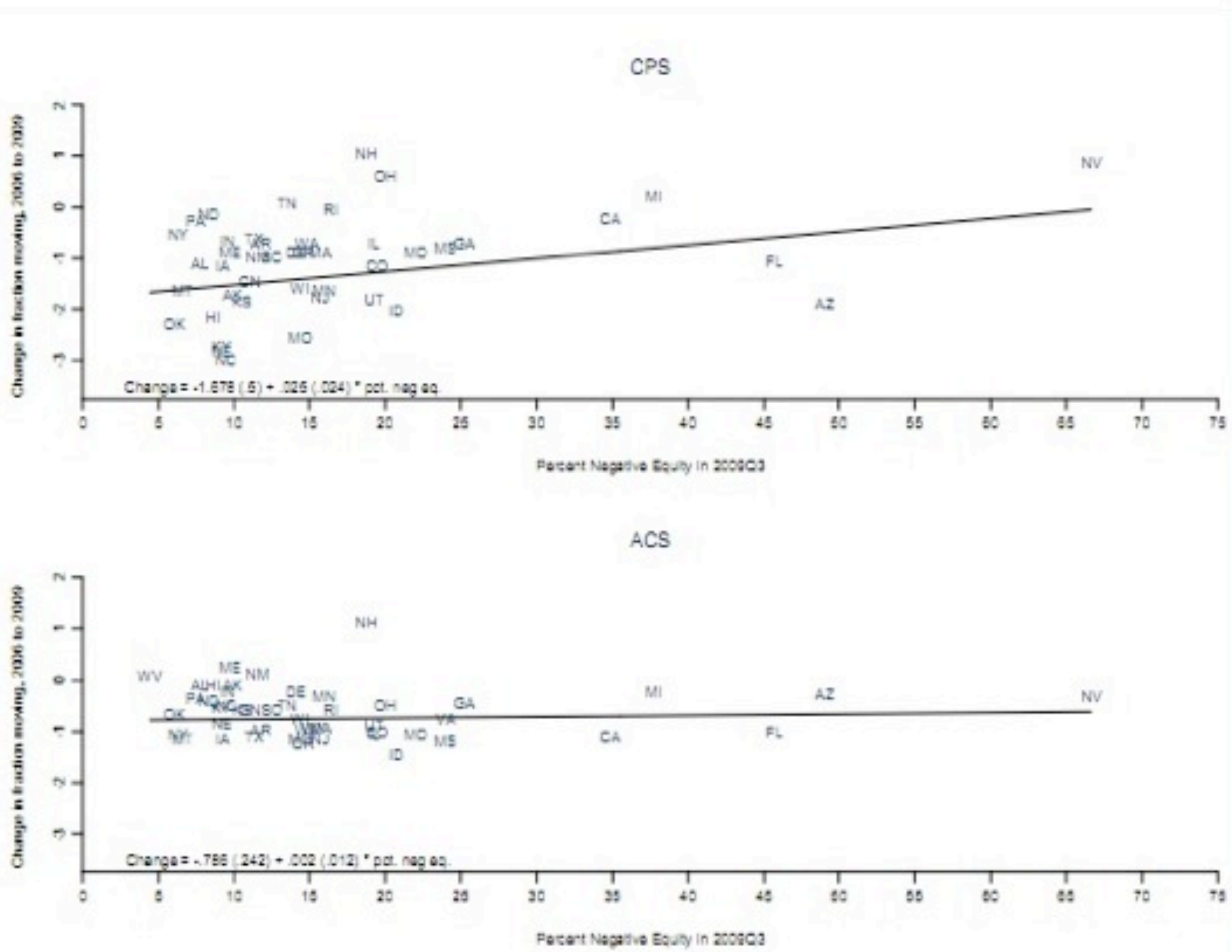
1. Structural Unemployment.

People can move ok, even in underwater states.

Figure 3
Negative Equity and Changes in Migration 2006-2009



Source:Internal Migration in the US: Updated Facts and Recent Trends (Molloy, Smith, Wozniak)

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2. Wealth Effect.

- At the level of the entire economy?

- The elasticities, or the quantified measure of the wealth effect, would have to be "on the order of 0.3 to 0.5 for non-durable goods and 0.5 to 0.7 for durable goods. Previous research suggests an elasticity of consumption with respect to housing wealth of 0.05 to 0.10."

- households with less financial savings and assets had a much larger decrease in consumption, controlling for household prices. Debt is important.

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3. Balance-Sheet Recession.

Requires three elements in an otherwise healthy economy.

1. Significant inequality, and differences between creditors and debtors.

2. Shock to the asset value of the debtors, triggering de-leveraging to restore balance-sheet health.

3. Creditors are not able to make up loss of consumption as a result of balance-sheet driven de-leveraging. Most common story is zero lower bounds on conventional monetary policy.

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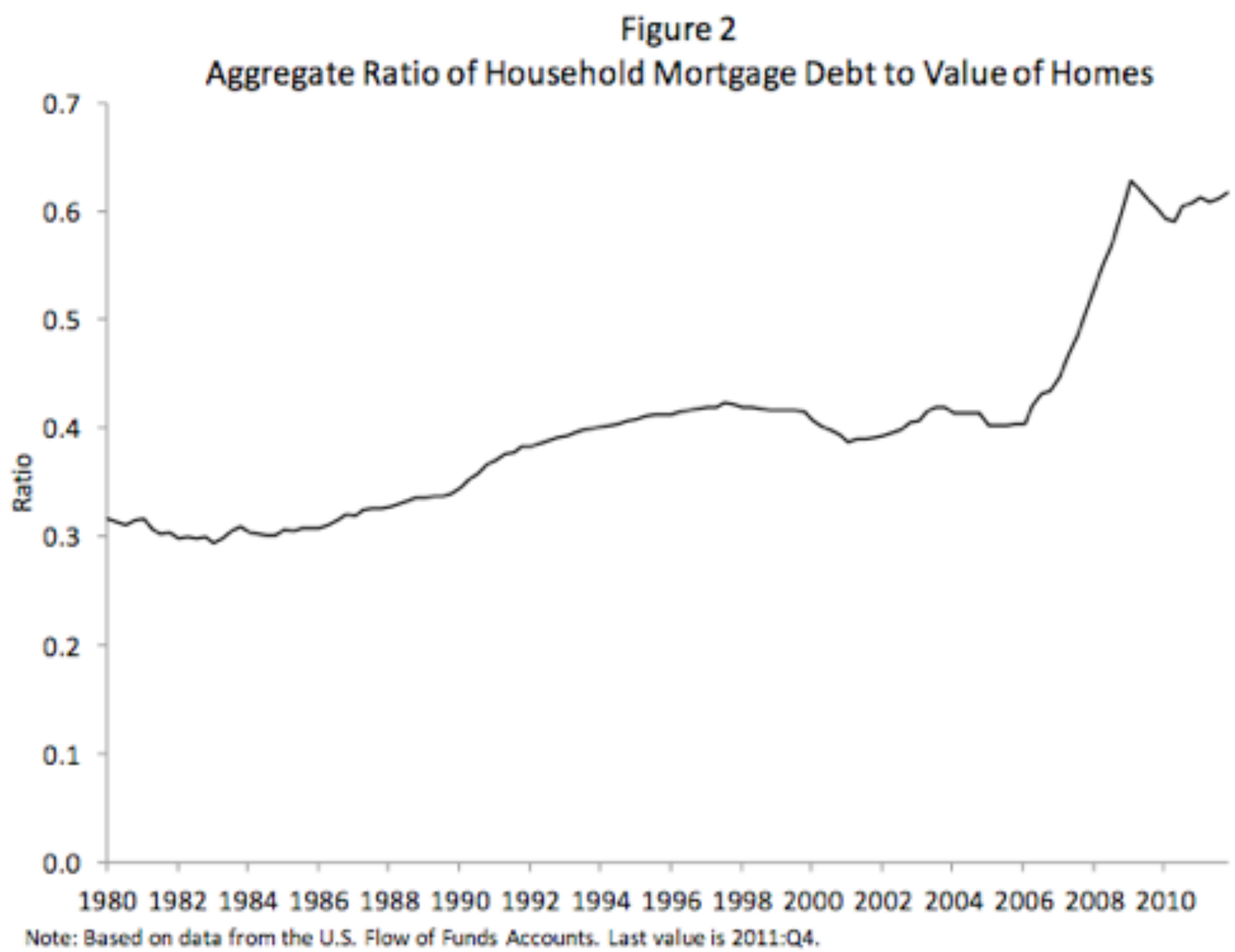
3. Balance-Sheet Recession.

We did get a shock to household assets.



Source: Karen Dynan, Brookings, 2012, "Is A Household Debt Overhang Holding Back Consumption?"

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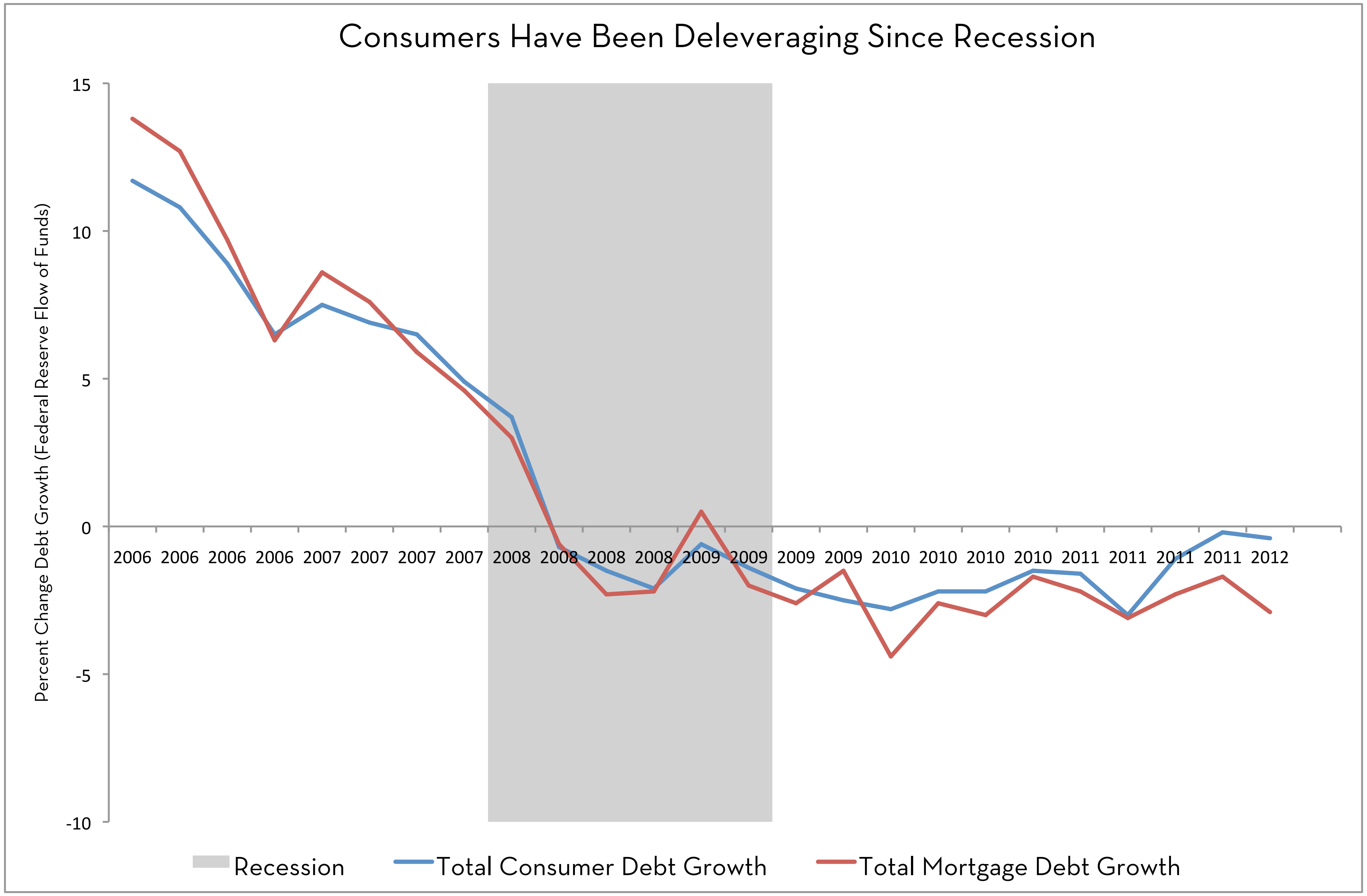
3. Balance-Sheet Recession.

And consumers did start de-leveraging at the same time.



Source: Karen Dynan, Brookings, 2012, "Is A Household Debt Overhang Holding Back Consumption?"

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This Seems to be Important. But Why?

3. Balance-Sheet Recession.

Title	Household Balance Sheets, Consumption, and the Economic Slump	What Explains High Unemployment? The Aggregate Demand Channel	Is A Household Debt Overhang Holding Back Consumption?	Dealing with Household Debt
Author	Atif Mian, University of California, Berkeley Kamalesh Rao, Mastercard Advisors Amir Sufi, University of Chicago Booth School of	Atif Mian, University of California, Berkeley Amir Sufi, University of Chicago Booth School of Business and NBER	Karen Dynan, Brookings Institution	IMF
Date	November, 2011	November, 2011	May, 2012	April, 2012
Data Sets	Equifax for county-level debt/defaults, Mastercard Advisors, for consumer consumption data	Equifax for county-level debt/defaults, Census and ACS for jobs by industry and wages	United States, Household Survey data (PSID), 2005-2011	24 OECD economics and Taiwan Province of China from 1980 to 2011
Conclusion	Moving from low to high leverage results in "18 to 28% drop in durable consumption and a 10 to 19% drop in non-durable consumption."	Reduced aggregate demand due to high leverage can account for 4 million of the 6.2 million jobs lost between 3/07 and 3/09	"Highly leveraged homeowners had larger declines in spending."	Housing busts with "larger household debt tend to be followed by more severe and longer-lasting declines in household consumption."
Notes	This study confirms a relationship between the balance-sheet effects and a drop in consumption.	This study confirms a relationship between the balance-sheet effects and a drop in employment and wages	"U.S. households, on the whole, have made very limited progress in reducing leverage over the past few years."	This study confirms a balance-sheet effect internationally following housing busts, shows sluggish growth not driven by financial crisis.

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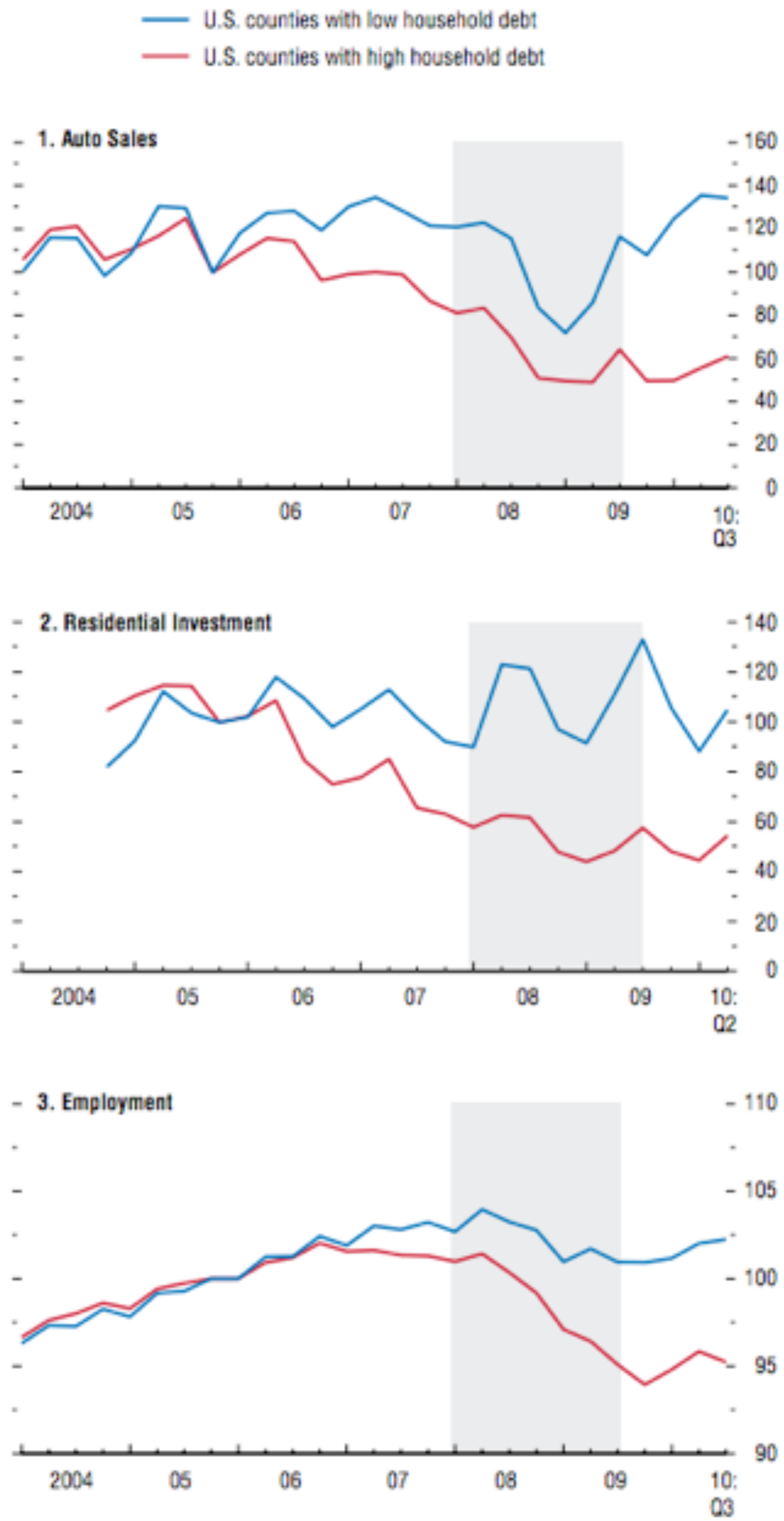
Paper: Household Balance Sheets, Consumption, and the Economic Slump



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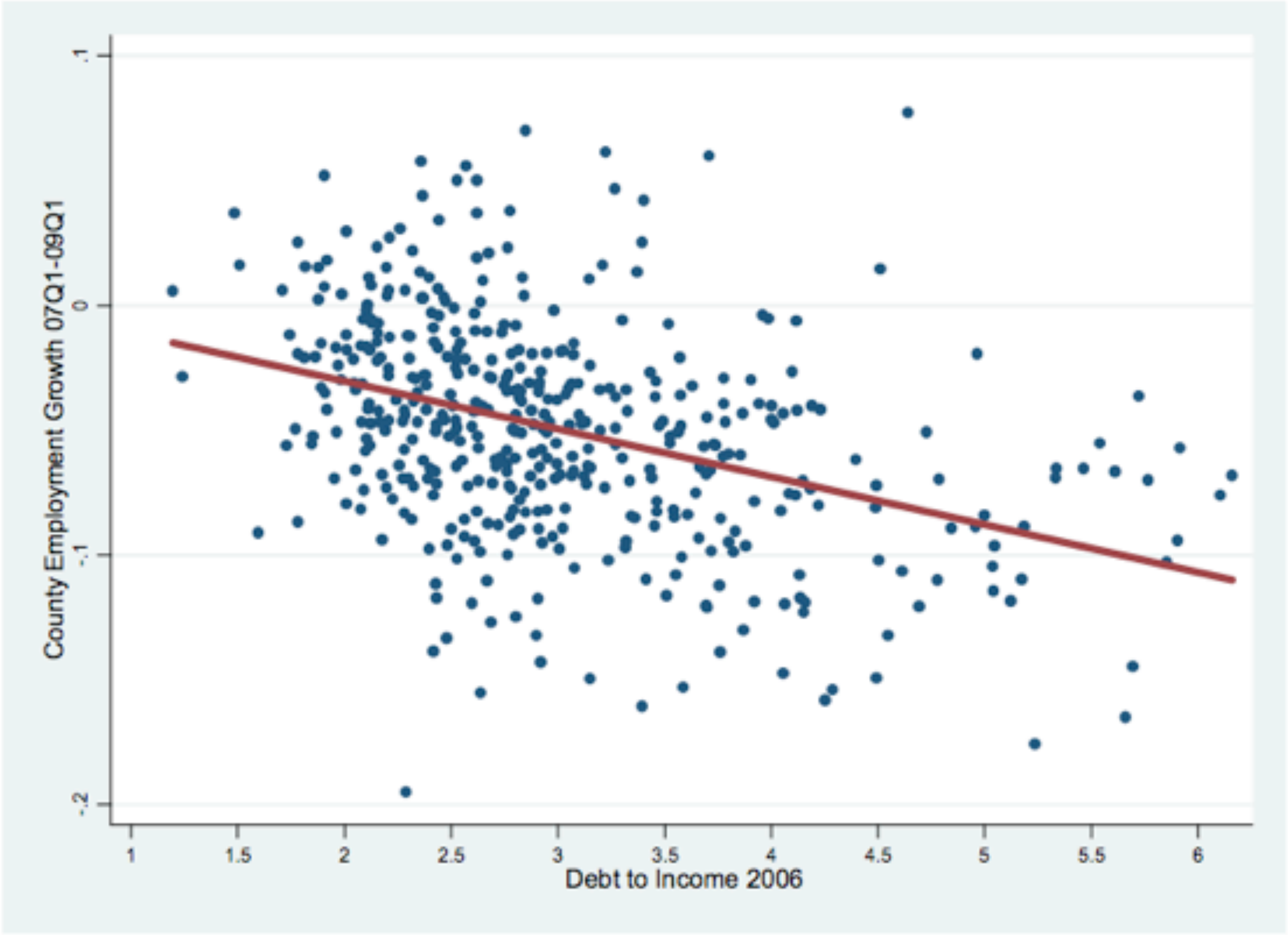
Paper: What Explains High Unemployment? The Aggregate Demand Channel

Figure 2
Aggregate Demand and Employment across Counties: All Industries

This figure presents a scatter-plot of county level employment growth from 2007Q1 to 2009Q1 against the debt to income ratio of the county as of 2006. All industries are included. The sample includes only counties with more than 50,000 households.



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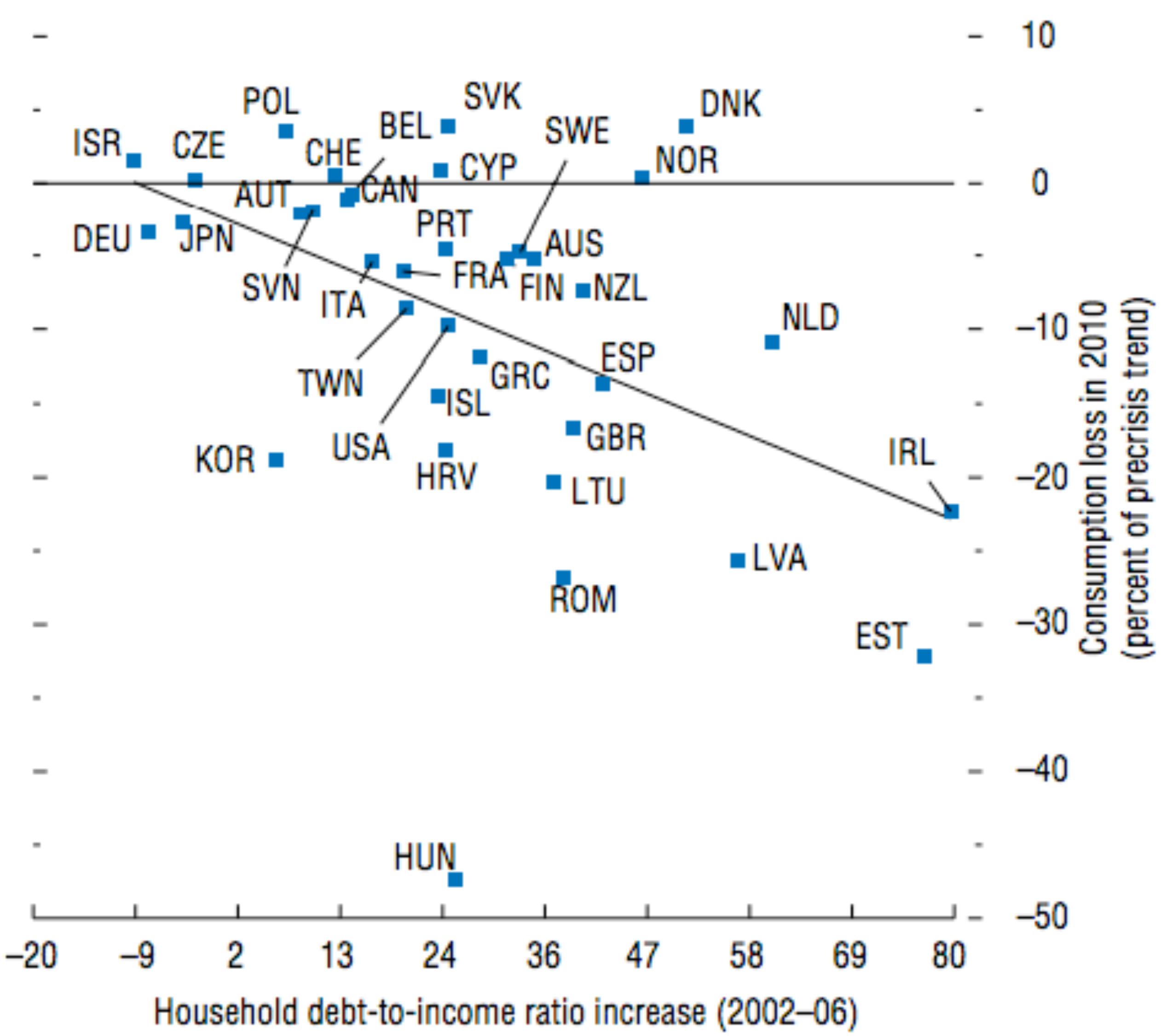
Paper: IMF.

Figure 3.2. The Great Recession: Consumption Loss versus Precrisis Rise in Household Debt
(Percent)

The Great Recession was particularly severe in economies that experienced a larger run-up in household debt prior to the crisis.



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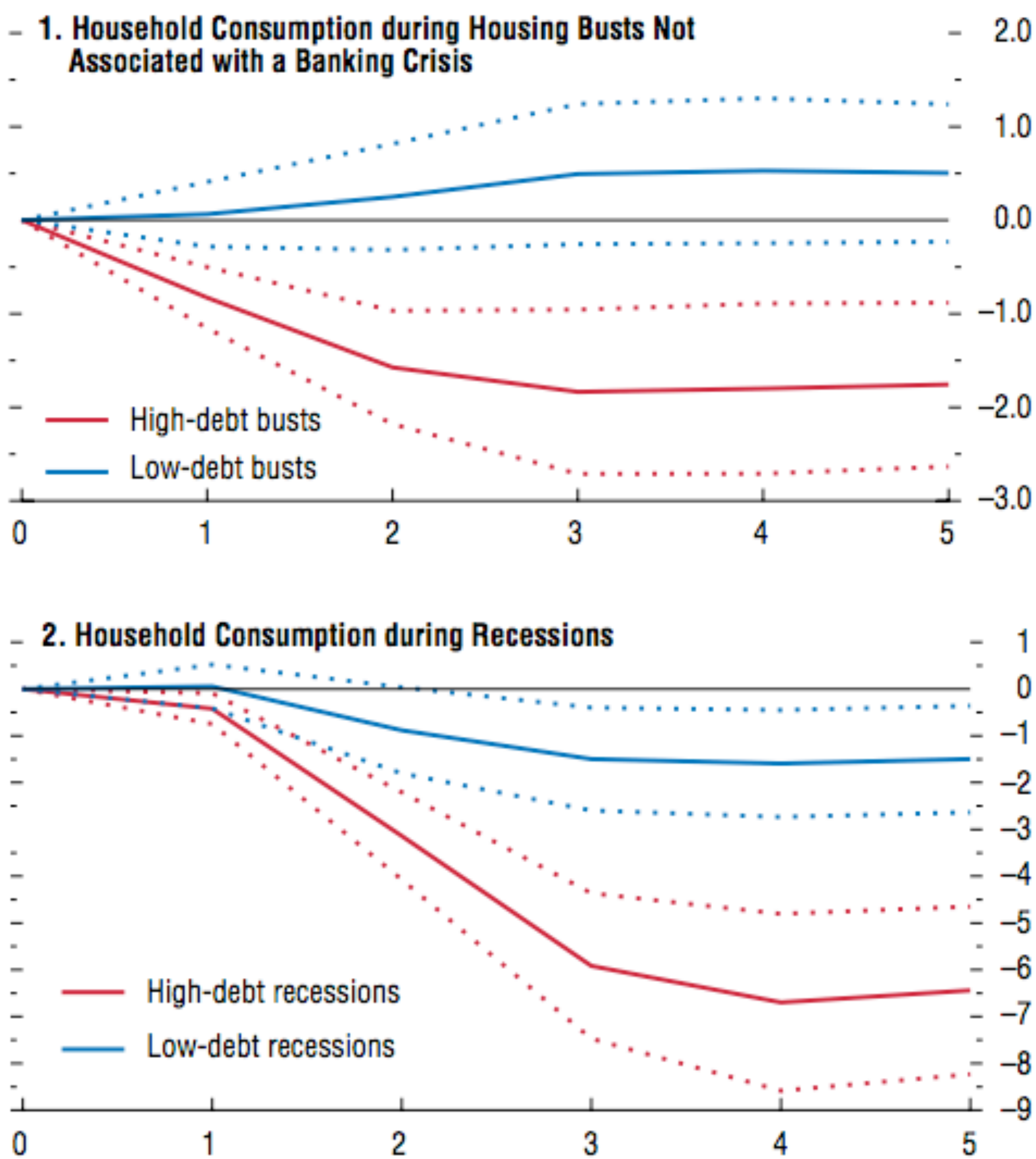
Paper: IMF, which finds this internationally, with our without financial crises.



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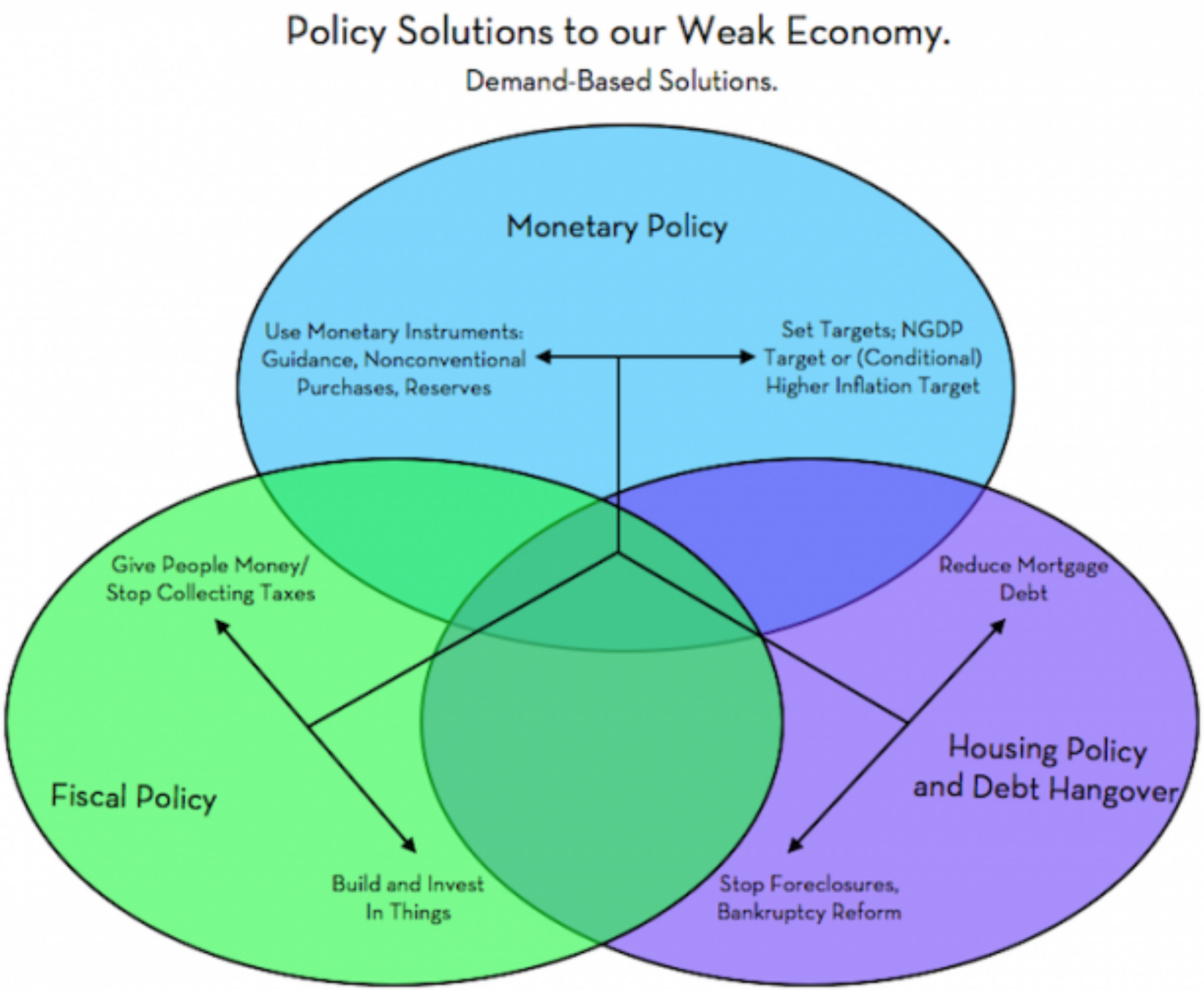
What Can Be Done About This?



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What Can Be Done About This?

Mortgage servicing model has serious conflicts of interest.

"[S]ervicers do not have a meaningful stake in the loan's performance; their compensation is not keyed to the return to investors. Second, the servicing industry's combination of two distinct business lines – transaction processing and default management — encourage servicers to underinvest in default management capabilities, leaving them with limited ability to mitigate losses. Servicers' monetary indifference to the performance of a loan only exacerbates this situation...

Servicers' incentives in managing individual loans do not track investors' interests. This creates **three interrelated problems. First**, servicers are incentivized to pad the costs of handling defaulted loans at the expense of investors and borrowers. **Second**, servicers are not incentivized to maximize the net present value of a loan, but are instead incentivized to drag out defaults until the point that the cost of advances exceeds the servicer's default income. In other words, servicers are incentivized to keep defaulted homeowners in a fee sweatbox rather than moving to immediately foreclose on the loan. **Third**, servicers are incentivized to favor modifications that reduce interest rates rather than reduce principal, even if that raises the likelihood of redefault."

Source: Adam Levitin, Tara Twomey, "Mortgage Servicing."

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What Can Be Done About This?

Effect of Components of Servicer Compensation on Likelihood and Speed of Foreclosure

	Favors Foreclosure?	Likely Effect on Speed of Foreclosure?
Structural Factors		
PSAs	Neutral	Speeds Up
Repurchase Agreements	Neutral	Slows Down
REMIC rules	Neutral	Neutral
FAS 140	Slightly Favors Foreclosure	Neutral
TDR Rules	Slightly Favors Foreclosure	Neutral
Credit rating agency	Slightly Favors Foreclosure	Speeds Up
Bond insurers	Slightly Favors Foreclosure	Speeds Up
Servicer Compensation		
Fees	Strongly Favors Foreclosure	Slows Down
Float Interest Income	Slightly Favors Foreclosure	Neutral
Monthly Servicing Fee	Strongly Favors Modification (but not principal reductions)	Slows Down
Residual Interests	Slightly Favors Modification (but not interest reductions)	Slows Down
Servicer Assets		
Mortgage Servicing Rights	Neutral	Slows Down
Servicer Expenses		
Advances	Strongly Favors Foreclosures	Speeds Up
Fee Advances to Third Parties	Slightly Favors Foreclosure	Speeds Up
Staff Costs	Strongly Favors Foreclosures	Speeds Up

Source: Diane E. Thompson, NCLC. "Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior?"

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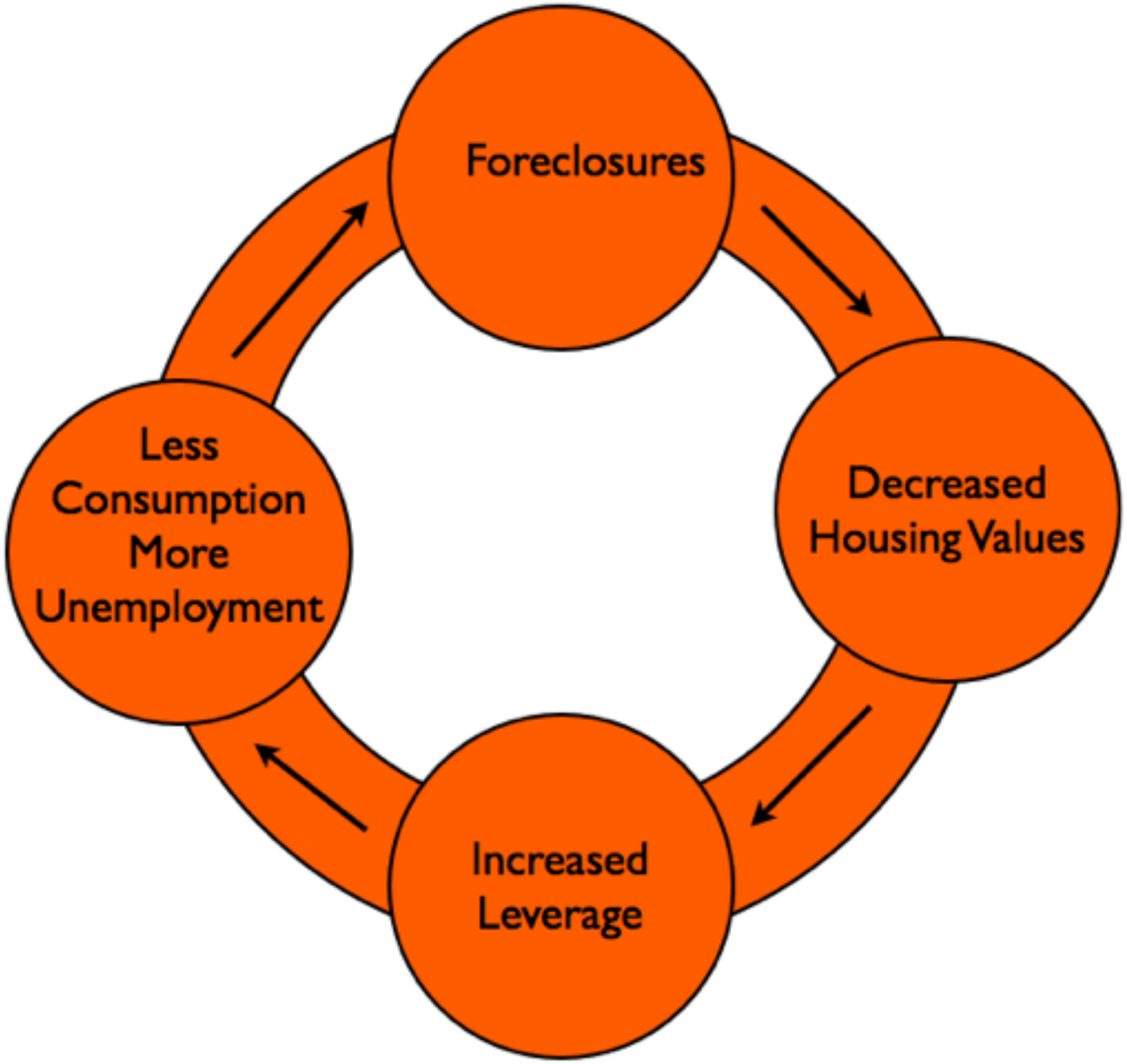
What Can Be Done About This?

If the problem is debt, would more foreclosures help?



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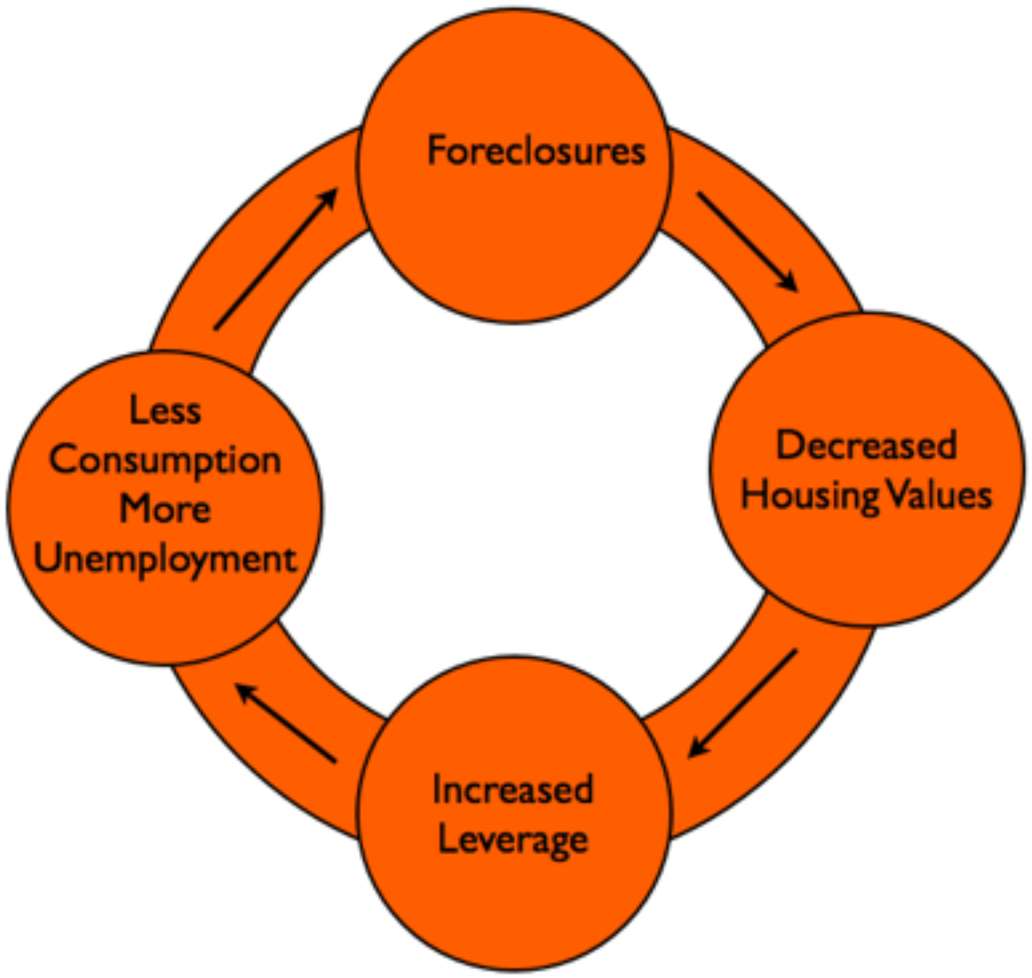

Mian, Sufi, and Trebbi, "Foreclosures, House Prices, and the Real Economy," finds estimates that "suggest that foreclosures were responsible for 15% to 30% of the decline in residential investment from 2007 to 2009 and 20% to 40% of the decline in auto sales over the same period."

Any questions?

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