Economic Recovery – Treat the Disease, Not the Symptom

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By now it has become all too apparent that the patchwork of monetary, fiscal and regulatory band aids administered in pursuit of revitalizing the economy are likely to be ineffective in achieving that objective and restoring domestic and international confidence. The term "patchwork" is intended to be pejorative, in that the steps that have been taken do not necessarily work in tandem, and to some extent are counterproductive.

For the typical working or middle class household, the debate regarding if, when and the severity of any recession carries little meaning and is often cast aside as an intellectual exercise for the wealthy. Reliance on the technical definition of a recession (two consecutive quarters of negative growth) grossly understates the severity of the current economic downturn, in that it relies on national averages and does not fairly gauge the economic well being of the average American household. It's a recession if you are reading about it. It's a depression if you are living under the twin evils of reduced household income and double digit inflation for the core basket of household necessities (food, gas, healthcare, utilities, college tuition, etc…).

The stated objective of the monetary and fiscal actions that have been taken so far is to provide stimulus to consumer spending – a primary driver of economic growth. Just as flawed blueprints ultimately cause delay and added expense to the construction of a new building, a misguided objective in treating the ills impacting the economy will similarly add delay and expense, while still proving ineffective in the end.

In the current economic downturn, the actual and projected decline in consumer spending is merely a symptom of the much greater disease – the collapse of the U.S housing and related capital markets. Absent this crisis and the spillover to other asset classes, declines in consumer spending would not be on the front

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burner. Uncoordinated and offsetting dosages of tax rebates, interest rate cuts and unsettling regulatory proposals are being administered on pure speculation that discretionary resources will be created and immediately elevate consumer spending levels. It is not surprising the market response is less than enthusiastic, as evidenced by widening spreads, continuing illiquidity, and increasing inflationary pressures.

There are no easy or perfect remedies. However, a fair assessment of the factors that continue to plague the housing sector and the dim prospects of a quick economic recovery suggest a cohesive prescription can be fashioned. This plan can support the improved promise of curing the patient without squandering taxpayer dollars and unnecessarily prolonging a painful process that is unavoidable given the proverbial hole we are already in. The basic tenets of this prescription are fourfold:

- Focus on liquidity, not interest rates
- Support the demographics that comprised **core** housing demand **prior** to the real estate bubble
- Utilize HUD and the existing distribution system for housing finance to disburse needed remedial resources, as they will prove to be far more cost effective than the alternatives
- Allow the unavoidable and inevitable pain to run its course as quickly as possible.

With these guiding principles in mind, consider the following:

I. The Impact of Interest Rate Cuts

The actions of the Federal Reserve in cutting short term rates have done little to provide relief to deteriorating economic conditions. To the contrary, the 300 basis points of rate cuts over the last six months have been counterproductive in addressing the disease infecting the economy.

The proof in the pudding is that the rate for fixed rate mortgages is higher today than at the beginning of the year, and slightly higher than one year ago. Thus, the Fed's actions have not assisted in increasing the purchasing power of potential homebuyers or reducing the carrying costs of existing homeowners through mortgage refinancing. One exception is any cost savings realized by homeowners with extended home equity lines of credit.

Any perception that significant rate cuts could mitigate future defaults relating to adjustable rate non-prime loans and negative amortization ARMs (often referred to as option ARMs) is clearly misguided. For the most part, rate adjustments

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relating to the toxic sub-prime and Alt A mortgages dominating the headlines are tied to the London Interbank Offered Rate (LIBOR), an index that the Fed has little direct influence over. Option ARMS are tied to the moving 12 month average of the 1 year treasury, a lagging index that considerably dilutes the near term benefits of rate cuts. Here again, the Fed's actions are virtually impotent in addressing a key concern weighing heavily on the prospects of an expedient economic recovery.

On the other hand, the Fed's actions relative to rate cuts have spawned inflationary pressures evident in the considerable increases in oil prices, food and other commodities. Has there been a fundamental shift in our dependence on foreign investment in our debt instruments (which includes the considerable financing needs of Fannie Mae and Freddie Mac)? Of course not.

With the Federal Reserve telegraphing a willingness to accommodate sizeable future rate cuts while most other central banks have stated intentions to stand pat or increase rates, the risk of continuing devaluation of the dollar against other currencies is considerable. It's no wonder foreign investors require a premium to cover the anticipated slide in the currency to maintain the level of demand for dollar denominated debt. The same holds true for goods purchased with dollars, driving up the cost of imports, most significantly, oil.

Finally, a considerable demographic component of the consumer spending equation is retirees and seniors dependent on fixed incomes. While least accountable for the excesses of the recent past, the spending power of these consumers are being hit hard in terms of higher costs for their necessities, and lower rates on their savings.
In short, any potential benefits of pronounced cuts in short term rates have been largely diluted or eliminated by offsetting reductions in consumer spending power.

II. Restoring Core Housing Demand

The proliferation of aggressive non-prime mortgage products inflated housing demand in recent years - fueling the current crisis. At the peak of the bubble, non-prime or exotic mortgage products made up as much as 40% of total purchase money financings.

Non-prime mortgages have been around for many years prior to the peak of the real estate bubble. While comprising a significantly smaller population of total purchase money financings (10%-15% from the late 1980s through the 1990s), the availability of the historically less aggressive non-prime mortgage products supported a similar percentage of core housing demand and served to bridge the socioeconomic diversity that has been the hallmark of our nation's

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homeownership objectives. Healing the housing market requires resurrection of the more modest non-prime industry that predated the housing bubble, as the absence of this component is artificially depressing demand and contributing to falling values.

Given the total absence of liquidity for private label mortgage securities, resurrecting a downsized non-prime financing industry is a tall order and is perhaps the area most in need of fiscal and regulatory support. The following steps will prime the private label mortgage securities market until liquidity returns:

- Provide a tax exemption for interest relating to newly issued (and presumably more transparent) non-prime residential securities that meet defined parameters; and
- Impose a moratorium on the mark to market rules for these securities.

Tax incentives are necessary to elevate the after tax yields for investors while maintaining the nominal non-prime rate of the underlying mortgage within a reasonable range to support affordability.

Imposing a moratorium on mark to market for defined securities would mitigate the catch 22 that fixed income fund managers find themselves in under the current climate. On the one hand, fixed income funds are in the cat bird seat and can virtually demand more conservative underwriting standards, improved due diligence and a pricing premium in a market that presents considerable challenges in generating returns for investors. On the other hand, the funds are immediately punished by an impairment charge due to the absence of liquidity benchmarks, even though there has been no adverse change to fundamental cash flows.

The above actions are without cost to taxpayers. With the current absence of new issuance activity, there simply are no related taxable revenues.

III. HUD and The Housing Finance Distribution System

There has been much debate on the propriety of a taxpayer bailout for homeowners. Proposals have been tossed around that include subsidized mortgages for distressed homeowners, expanding the power of state agencies to issue tax exempt bonds, and expanding the product menu purchased by Fannie Mae, Freddie Mac and HUD to support refinances of outstanding non-prime mortgages.

A surgical approach to assist the population of borrowers deserving of assistance will be far less costly and more immediately effective than other proposed

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alternatives. A HUD insured mortgage product that would allow for an immediate subsidy in the form of a principal reduction, with the opportunity for taxpayers to recoup that subsidy over time through shared appreciation at the time of sale can be funded at an estimated cost of no more than $30 billion (before recoupment) – far less than the $150 billion of rebates that are likely to have considerably less impact in driving economic recovery.

HUD and the existing national housing finance system should be the tool for distribution of any remedial assistance. Fannie Mae and Freddie Mac are mired in too many regulatory, capital and political issues to be effective at this time.

The FHA was created in 1934 to address distressed conditions in the national housing market. In recent years, the relevance of HUD and the FHA program has been seriously questioned. With the private sector severely compromised, now is the time to demonstrate the relevance that is consistent with the FHA's core mission.

Additionally, it was the efficiency of the existing distribution system that allowed for the proliferation of the products that triggered the housing crisis. This same system can and should distribute remedial measures through a mature partnership between HUD, lenders and servicers. All that is needed is a defined product, the right economic incentives and proper guidance, and the private sector can and will respond in a timely and cost effective manner. By the time local agencies and state sponsored tax exempt bonds actually hit the market, the crisis would be more severe and the cycle unnecessarily prolonged.

Also, HUD needs to provide clarification of its credit standards to its approved base of lenders. Now is not the time to impose credit criteria that are more restrictive than the FHA regulations permit. There is ample documentary evidence that HUD approved mortgagees have become so wrapped up in the bias towards universally tighter credit standards that they have begun to impose minimum credit scores and other criteria that are not mandated by the FHA. The imposition of tighter standards than required by a government insured program provides additional stress to the market in the form of less liquidity.

IV. Hasten the Painful Road to Recovery

Measures that effectively treat the root cause will improve the chances of shortening this painful cycle. Likewise, actions that create a considerable risk of extending the cure period are counterproductive and should be avoided.

With this in mind, all regulatory proposals posing the risk of delaying or otherwise adding complexities to markets already burdened by uncertainty should be abandoned. Resources should also be dedicated to remedial steps that will foster

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acceleration in the recycling of distressed housing inventory, including the shared appreciation program described above. In contrast to the “gift” of principal balance forgiveness proposed under the Frank-Dodd proposal, a shared appreciation arrangement provides for later reimbursement of some or all of the subsidy. By including a quid pro quo component there is less of the stigma of a “homeowner bailout” and a degree of fairness to homeowners who demonstrated fiscal responsibility by taking on only so much mortgage as they could afford.

Legislation empowering the courts with greater discretion in bankruptcy proceedings cannot possibly be an approach to getting this economic cycle behinds us. Since when have the courts ever been considered the most expedient and cheapest way to resolve adversity?

Greater discretion promotes factual inquiries and allows attorneys to devise creative strategies that inevitably add expense and delay. Additionally, the added uncertainty as to creditors’ rights relating to mortgages does not support the principle of promoting liquidity for the related capital markets.

Other regulatory proposals that need to be quickly abandoned are assignee liability, moratoriums on foreclosure and interest rate freezes—all of which undermine recovery of the capital markets without providing any real path to expedient resolution. Administer the medicine, bear the pain and let’s move on to better times as soon as possible.

V. Conclusion

While critical of the remedial approach to date, this assessment is not intended to imply the absence of laudable intent on the part of our leaders. Rather, it is the inherent limitations posed by economic and intellectual standing and politics that often stands in the way of a cohesive plan. Central bankers tend to operate in the world of academic theory. Political leaders survive on their talent for identifying and supporting populist solutions that may unintentionally prove costly and miss the mark in truly addressing the issues. Simply put, a practical and cohesive plan calls for greater inclusion of market participants that are closer to where the rubber meets the road on Wall Street, Main Street and in Washington.

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