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Hearing on

"New Ideas to Address the Glut of Foreclosed Properties"

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Introduction

Thank you Chairman Menendez, Ranking Member DeMint, and Members of the Subcommittee, for the invitation to speak today. I am the chief economist of Zillow, the leading real estate information marketplace, where I closely follow and report on the state of the housing market.

I'd like to preface my statements by noting the perspective with which Zillow approaches analysis of the housing market. We launched our website in 2006 with the goal of creating more transparency of real estate information for consumers. As a media-supported business, we have no vested interest in the outcome of this debate, other than the hope that whatever is decided will best address the needs of consumers (by which I mean sellers, buyers and homeowners with no intent of moving).

Today I'll make three points about the housing market and about how to address foreclosures.

First, don't underestimate the market's ability to fix itself. This is, in fact, already happening. We may not like the timetable, but economic recovery can't always happen overnight.

Second, many policies addressing foreclosures are simply addressing symptoms, not fundamental drivers of a healthy housing market. Yes, declining values have led to foreclosures, which have created an excess supply of housing. But eliminating this excess supply can't easily be achieved via policy. But policy can help the demand side, chiefly when targeted at decreasing unemployment.

Third, in trying to speed up the recovery of the housing market, the first priority of the government should be to do no harm. The federal homebuyer tax credits of 2009 and 2010, while they stimulated sales in the short term, did not materially change the trajectory of the housing market in the long term. In fact, it is arguable that they delayed the ultimate market bottom. We should be sure not to make similar mistakes in the future which are incredibly costly to taxpayers but net very few positive long-term results.

How the housing market is fixing itself

Regarding my first point about the ability of the housing market to fix itself, there are several reasons I believe this is already happening. It is true that there is a large pool of previously foreclosed properties owned by banks, and by entities like Fannie Mae and Freddie Mac. Estimates suggest that there are more than a half million real-estate owned properties held by lenders and government-sponsored enterprises, about 2.2 million more homes in the foreclosure process, and still another 1.9 million homes with mortgages that are delinquent more than ninety days. These homes are flooding the marketplace with abundant, cheap inventory which pushes prices down near-term and will keep a firm lid of price appreciation in the long-term even after the bottom in home values has been reached.

But, while we often focus on the dismal state of the purchase side of the housing market, the other side of this same coin is a booming rental market. With the foreclosure epidemic converting many homeowners into renters, rental supply is reportedly as tight now as it was prior to the recession, and effective rents are estimated to rise 4 percent this year. The homeownership rate crested in 2004 at 69.2%, fueled by easy lending, low rates, and a positive feedback loop of appreciation and irrational expectations. During the housing recession, this rate has fallen to 65.9% currently, still not even in line with the longer term historical average of 64%.

Investors smell a distinct opportunity in this situation: The chance to buy an asset cheaply and rent it out dearly. In fact, close to one-third of the purchases of existing homes this year have gone to all-cash buyers, the bulk of whom are real estate investors.

The private market is stepping in briskly to buy up distressed homes and convert them to rentals (or, in some cases, fix them up and sell them on to other buyers). Additionally, thanks in part to these investors, the inventory of foreclosed homes owned by Fannie Mae, Freddie Mac and the FHA declined at the end of the first quarter. This market-clearing is sometimes hard to watch. It's a slow process of healing, but one that plays out when natural dynamics are not disrupted.

Addressing the continuing problem of foreclosures

Regarding the second point I outlined, the two fundamental factors that will affect housing over the next several years are negative equity and unemployment. Negative equity—estimated by Zillow as 26.8% of single-family homes with mortgages—contributes to foreclosures and also suppresses housing demand. Unemployment affects household formation and consumer confidence. Unfortunately, negative equity is a difficult problem to influence via policy and it will only recede slowly over time.

But employment is more easily addressable by policy action. Make no mistake, the quickest and best way to improve the housing market is to grow jobs faster. Just last week, we were reminded where so much housing demand has gone during the recession when the Census Bureau reported that almost 22 million households are currently doubled up. Grow jobs and these households can start to uncompress and occupy additional housing units. A jobs plan is a housing plan.

There have been numerous proposals to more directly stem the tide of foreclosures, many of which we have already tried, but which have unfortunately yielded more limited results than we hoped. I greet with great optimism each new idea about how to help prevent more foreclosures because the aggregate numbers defining this crisis mask such terrible suffering for millions of individual homeowners who experience foreclosure.

But the reality is that most proposals to fix this issue become problematic or infeasible because targeting only the people who truly need and can benefit from help is exceedingly difficult. With respect to foreclosure risk, there are essentially three categories of homeowners: 1) those who don't need our help; 2) those who need more help than we can possibly give them because they are facing a fundamental change in their household financial situation; and 3) those for whom modest assistance like principal reduction, reduction in mortgage rate, or unemployment forbearance can make a difference in outcomes.

Helping this third group, which is the smallest, without spilling over into the much larger first and second groups, where our money is wasted because they don't need it or because it won't fundamentally help them, is extremely challenging. And ineffective targeting of any policy balloons the cost and creates substantial unintended consequences, usually involving moral hazard in which people will avail themselves of the remedy even when they do not truly need it. I believe that the need to thread the eye of the needle so closely here is why we've seen such lower than expected outcomes for programs like the Home Affordable Modification and Refinance Programs.

Assuring government policy does no harm

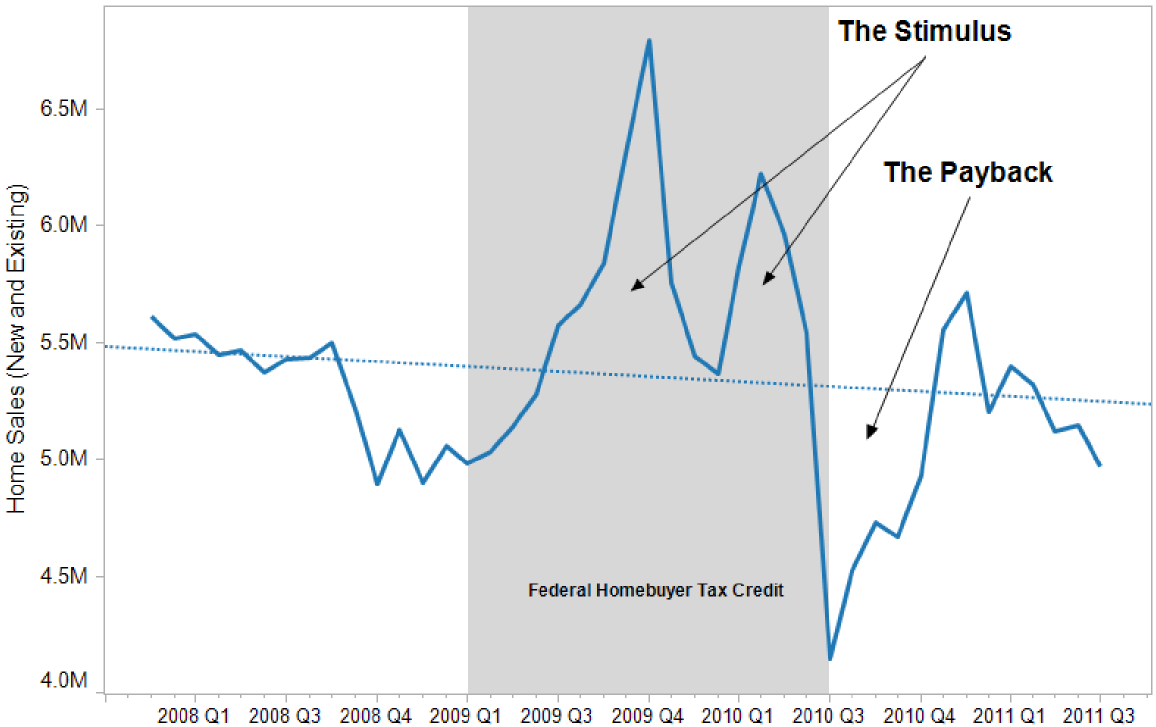
Finally, let me return to my third point about government policy doing no harm. One idea being explored is that of Fannie and Freddie getting into the rental market in some fashion. I've already discussed how private investors are soaking up distressed inventory and transforming many of these homes into rentals. The government should be very careful about trying to interfere with this natural process. Investors have been and currently are betting that more foreclosures will create more renters, and they are moving to serve that market. Any plan that may upset this balance – such as Fannie and Freddie getting into the rental market and creating competition – will have a chilling effect on private investment in the one segment of the housing market that is performing well. Yes, Fannie and Freddie becoming landlords could decrease the number of foreclosed homes coming into the market, but at the expense of further decreasing demand because investors will no longer buy properties for conversion and buyers may choose to rent instead of buy.

Our recent experience with the federal homebuyer tax credits should tell us something about the limits of policy in shifting long-term market dynamics. Yes, we were successful in stimulating more housing demand during the period of the tax credits. Unfortunately, this demand was largely stolen from future months, resulting in a decline in sales after the tax credit expiration which was commensurate with the increase during the credits. We should be cautious about similar proposals that, like the tax credits, would stimulate the market only in the short-term, when what we really need is long-term recovery.

In summary, forces in the housing market are at play that will lead to long-term stabilization. But it's a delicate balance that should be well-understood before the government steps in to help it along.

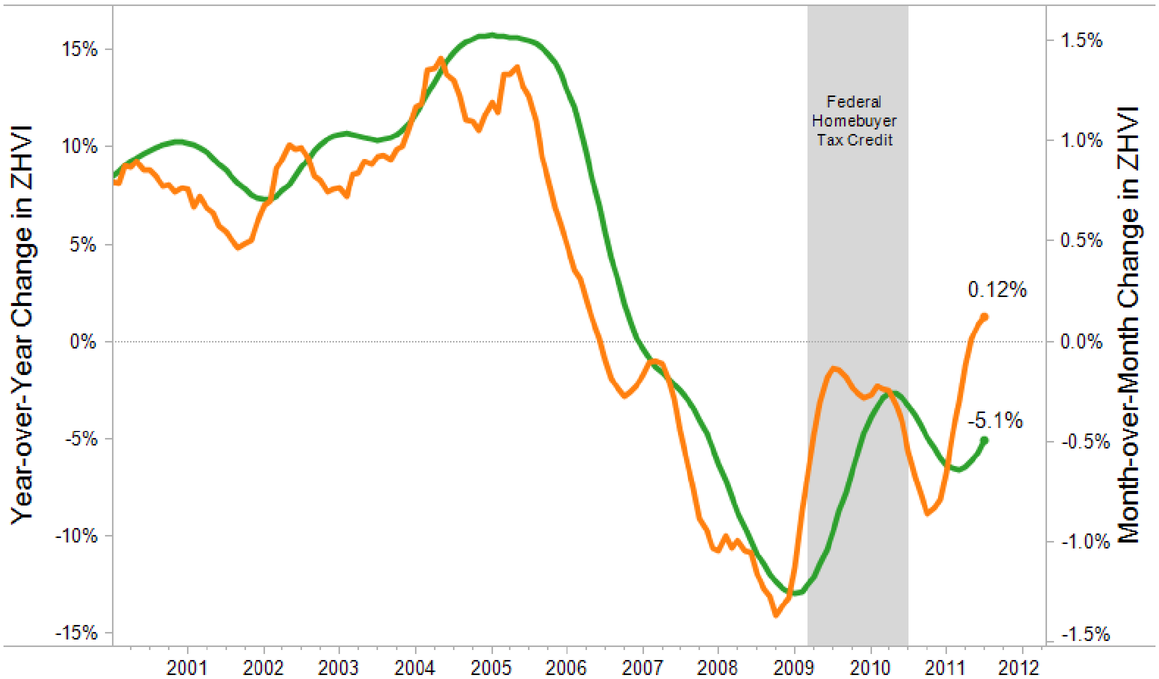
Thank you again for the opportunity to address you today and I look forward to answering any questions that you might have.

Figure 1: The Limits of Policy?
Federal Homebuyer Tax Credits Initially Stimulated Sales But Were Largely Offset Once Credits Expired



Note: New and existng home sales, seasonally adjusted annualized rate
Source: Census Bureau and National Association of Realtors

Figure 2: Some Signs of Improvement in Home Value Trends
Tax-Credit Fueled Surge Was Not Sustainable. More Declines to Come But Trends Now are Organic and Hopefully Sustainable.



Source: Zillow

Month-over-month change in Zillow Home Value Index (ZHVI)
Year-over-year change in Zillow Home Value Index (ZHVI)