How to End the Housing Mess

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In most US cities, housing prices are falling again. They were down in 18 out of 20 metropolitan areas in December, according to the Case-Shiller index released Tuesday. The Boston metro area did "better'' than most — down only 0.8 percent over the previous year.

That's bad news for the economic recovery, the financial system, and the American middle class. There are solutions that could restore a normal housing market — but political gridlock and the influence of the financial industry is keeping them off Congress's agenda.

Today, about one home in three carries a mortgage worth more than the underlying property, and some 7 million homeowners are at risk of foreclosure. The banking system is reeling under the weight of non-performing loans and depressed mortgage-backed securities.

To complicate the mess, during the bubble phase when lenders were on steroids, many banks neglected to do the paperwork properly. When a note (the promise to pay) or lien (the right to take the house if the loan defaults) is sold to a third party, the transfer must be fully documented.

But adrenalized banks got careless with paperwork as they sold off the loans. Today it's not clear who, if anyone, has the right to foreclose. More and more foreclosures are tied up in court, and the average duration of a foreclosure case is now close to two years.

Meanwhile, the Obama administration's main remedy, the 2009 Home Affordable Mortgage Program, is far too feeble. It has nudged the banks to give modest loan modifications to fewer than 700,000 homeowners — one-tenth of those at risk — and half of these are expected to go back into default. The program is voluntary for the banks, which often prefer to disguise their balance-sheet losses rather than offer homeowners enough relief to keep their homes.

All of this adds up to a horrible downward spiral. But it's not as if we are without solutions. For starters, we could use a true refinancing program that reduces principal and interest owed, so that homeowners who took out mortgages in good faith could afford to keep their homes.

The banks would take a financial hit, but they will take one anyway. It's better to get it over with, and stabilize housing prices.

Adam Levitin of the Georgetown Law School has proposed to amend the bankruptcy code to allow a distressed homeowner to go before a judge and have the mortgage reduced to current value of the house. Howell Jackson of Harvard Law School wants government to use its power of eminent domain to turn securitized loans back into whole mortgages. The reduced market value of the security would translate into a subsidy for the new mortgage.

Either approach would enable millions of distressed homeowners to keep their homes, and thus arrest the decline in real estate values.

The Recovery Act of February 2009 includes funding to help municipalities and community organizations acquire and repair vacant houses. This arrests neighborhood blight and increases the supply of affordable homes. But that money is running out, and no new funds are likely, given the austerity mood of both parties.

Congress is being shortsighted. The choice is aggressive action — or a slow bleed that will sap the economy's strength for a generation. While both parties fixate on deficits, the deeper sources of the economic crisis are offstage, demanding attention.