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## **A FREER MARKETS APPROACH TO FIXING THE HOUSING MARKET**

**CLARK L. MAXAM  
UNIVERSITY OF IDAHO**

**MARYCAROL B. MAXAM  
TRAILCREST CAPITAL ADVISORS**

### **ABSTRACT**

The unprecedented level of government intervention in recent financial markets has mainly ignored the root cause of the financial institution balance sheet problem: housing prices. Rather than apply taxpayer dollars to the symptoms (*i.e.* buying securities), policies directed at reducing inefficiencies and poor incentives in the housing market will help fix the system from the bottom up and motivate the substantial capital waiting in the wings to buy distressed housing assets. This paper proposes eliminating some of these frictions and inducing positive optionality in the housing market to better incentivize fresh housing investment at a much lower cost than many of the alternative plans included in the \$700+ billion congressional and administrative plans thus far.

### **PROPOSAL**

Although the Treasury's recent moves to purchase financial assets and inject capital into the banking system are designed to ease market fears, they do little to address the primary cause of financial institution balance sheet problems: housing markets. Housing markets are the very foundation beneath all of the headline culprits such as collateralized debt obligations, credit default swaps and asset-backed security valuation. Shoring up the value of financial assets based on housing is akin to treating the symptoms and ignoring the disease. Dissatisfaction with the Treasury is focused on concerns that risk is being transferred from private markets to the taxpayer with no mechanism in place to address the root causes of housing prices and defaults. Housing markets are frozen by fear of further price declines. This fear has sidelined both individual and institutional capital that is anxiously waiting to take advantage of depressed prices. We need a solution that reassures buyers in the wings that does not put the burden fully on the U.S. taxpayer and costs substantially less than \$700 billion.

There are about 3.8 million existing homes for sale (National Association of Realtors 2009). A substantial number of these homes are either already in foreclosure or in danger of foreclosure. Imagine being able to negotiate the purchase price of a home with the knowledge that 30% of any potential fall in price is shared by a partner, but 100% of the gain is yours. The federal government could immediately become this partner by making all capital losses 100% deductible on home purchases from this point forward. This price protection could be initially offered for a six-month period with extensions as needed. Home buyers could purchase with the knowledge that the U.S. government is sharing the risk with them. To further sweeten the pot, we could extend

the current capital gains exemption to all types of home buyers, not just owner occupied purchasers. Assuming a 30% tax rate, if all 3.8 million existing homes were to sell at the current median price and then subsequently sell at a further 25% decline, the cost to the Treasury would be \$47.1 billion – far less than the price tag on many of the TARP programs and other plans being considered. If the market stabilizes or even rises, the cost would be zero.

Unlike direct purchase of financial assets by the U.S. Government, this proposal motivates private capital and allows the risk to be borne mostly by market participants. Increased sales levels and stabilizing prices would immediately result in rebounding mortgage backed securities prices as existing mortgages prepay providing both cash and balance sheet repair. Mark to market prices on mortgage backed securities would rise and the capital crunch throughout the credit system would ameliorate. Increasing sales and stabilizing prices would lower the incentive to walk away from upside down mortgages and also assist the bank REO (real estate owned) market. Delinquent existing homeowners might find a buyer for their property and avoid default also repairing bank balance sheets and capital positions. Improved balance sheet positions would obviate the need for Federal capital injections into the banking system and allow banks to quickly pay back any emergency capital obtained thus far.

This proposal helps eliminate the element of fear that has frozen real estate and real estate securities markets through risk sharing and risk transfer that is borne mostly by the market. Risk is transferred from existing homeowners to new capital able to make this decision with full market knowledge and choice. Further, this risk transfer is fully transparent, open to all market participants and does not involve high levels of implicit leverage unlike the Public Private Investment Fund (PPIF) recently proposed by the Treasury which allows for 6:1 leverage by private investors using public money. This proposal would likely ameliorate (although not fully eliminate) the possibility of risk shifting by investors relative to other proposals such as the PPIF since any leverage employed would be provided by the private sector. Moreover, current market conditions would naturally regulate the credit process and leverage employed by buyers of real estate. The proposal could go into effect immediately and have immediate effects on market behavior. Most importantly, if housing markets do stabilize, the cost to the Treasury could be much, much lower and the need to purchase \$700 billion in distressed assets could be lowered or eliminated.

#### **REFERENCE**

National Association of Realtors, Retrieved February 2009:  
<<http://www.realtor.org/research/research/ehsdata> , February, 2009>.