STOPPING THE FREEFALL: STABILIZING MINNESOTA’S HOUSING MARKET

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# Table of Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Key Findings &amp; Recommendations</td>
<td>1</td>
</tr>
<tr>
<td>Introduction</td>
<td>3</td>
</tr>
<tr>
<td>The Collapsing Home Market</td>
<td>6</td>
</tr>
<tr>
<td>Social Costs of Falling Home Values, Foreclosures</td>
<td>10</td>
</tr>
<tr>
<td>The Mortgage Crisis Can Spread to Farms &amp; Business</td>
<td>12</td>
</tr>
<tr>
<td>Bailouts at Top Don’t Reach the Ground</td>
<td>13</td>
</tr>
<tr>
<td>Minnesota Can Stop the Bleeding</td>
<td>15</td>
</tr>
<tr>
<td>Economic Reasoning</td>
<td>17</td>
</tr>
<tr>
<td>Sources</td>
<td>21</td>
</tr>
</tbody>
</table>
Key Findings & Recommendations

Credit markets have dried up. Federal recovery dollars are not reaching homeowners and potential homebuyers on the ground. Consumers and lenders are afraid to invest in homeownership when the market’s bottom is still a blur.

This is the base level of the current financial crisis facing both the United States and Minnesota economies. It ripples outward, waves sweeping over Minnesota’s financial and industrial economic sectors, even threatening agriculture—Minnesota’s strongest sector for the past two years.

At the same time, prominent economists and finance analysts believe that the underlying problem is the housing market itself even though the collapse has spread far beyond foreclosures, bankruptcies and mortgage lending.

But a new program, if implemented, could turn things around here in Minnesota, and eventually, in the rest of the country.

Stopping the Crash, Stabilizing Prices

The Minnesota Home Values Guarantee Program will stop the housing market free fall and stabilize prices.

This “front porch” approach to the housing and finance crisis will get credit markets flowing again for housing, household expenditures, and business retention and expansion.

It will serve as an insurance policy for new homebuyers worried about whether their new home will lose value or appreciate. It will quickly stabilize the state’s housing market and, as a result, the state’s shaky economy.

How the Minnesota Home Values Guarantee Program Works

This program will begin as a homeowner’s equity insurance program for new buyers. It will ensure that a new buyer’s down payment is protected after five years, regardless of future housing market conditions. This means that people interested in buying a home can once again feel safe investing in a property. The Minnesota Home Values Guarantee Program promises buyers that they can get those down payments back even if the market continues to decline.

But since this program jump starts home purchasing again, it’s much more likely to stabilize prices and return the housing market to a normal rate of appreciation. This will create a floor under home values to protect down payments and home equity. In turn, that will allow lenders and borrowers to restructure existing but troubled loans knowing that equity in the property is protected.

The plan is similar to the earlier Land Values Guarantee Program developed by the Farm Credit Bank of St. Paul, but it will work in reverse: home values will be stabilized first making it easier for lenders to restructure troubled loans once property values start to rebound.

A pilot program using Ramsey County as an urban example and several counties in Greater Minnesota as rural examples will provide sufficient critical mass and differing demographics to demonstrate effectiveness and iron out complications before implementing a statewide or national values guarantee program.
Minnesota needs a state program to put a “floor,” under home values to stop prices from falling farther, under the downward trend in home values. Federal efforts to make funds available for lenders and borrowers to rework troubled mortgages are not likely to succeed if home property values continue to fall. What could work, however, is a **Minnesota Home Values Guarantee Pilot Program** similar to what the Farm Credit Bank of St. Paul developed in 1987 to end erosion of farmland values in the Midwest.

We propose the following two-phase program to stabilize home values and encourage restructuring delinquent and stressed mortgages:

- **Phase I** – *Stabilize home values.* Anyone qualifying for a conventional mortgage for a home in good condition in one of the pilot program counties, and for investment as a primary residence, would be eligible for a five-year guarantee of the home’s value. This means a homebuyer’s down payment would be protected for five years regardless of the home’s value at the end of that time period. (See section on **Minnesota Can Stop the Bleeding**.) The home ownership market operates city and countywide, in some parts of the state, and within specific neighborhoods in larger cities. Both Ramsey County and counties in Greater Minnesota have diverse neighborhoods and micro-markets. As a result, the pilot program would not be restricted to depressed, targeted areas where the housing market has failed.

- **Phase II** – *Restructure delinquent mortgages.* Once home values start to stabilize, the **Home Values Guarantee Pilot Program** will accelerate restructuring of delinquent mortgages. In some cases a *shared-appreciation* mortgage could help both borrower and lender. (See section cited above.)

**The Housing Meltdown – Key Findings**

- The typical Twin Cities single-family home lost about $80,000 in equity in the past two years. The Minneapolis Area Association of Realtors traced the fall of median home sale prices from a peak of $236,850 in June 2006 to a low of $167,000 in December 2008. The trend continues in 2009, with the median home sale price falling to $155,000 in January.

- Home values vary greatly across local markets. Despite these micro-markets, all 87 Minnesota counties show problems with foreclosures, bankruptcies involving mortgages, sheriff’s sales of homes and pre-foreclosure actions.

- More problems are on the way. In October, the St. Paul Pioneer Press (Snowbeck) found 52,000 Minnesota mortgages were deemed to be in negative equity status, and 71,616 more mortgages were within five percent of negative equity—equity most likely lost in the final quarter of last year. What’s more Serres (Star Tribune) reported in January that 50 state banks are now on a regulators’ “watch” list.

- An estimated 22 federal programs have now committed more than $7.7 trillion to halt the financial meltdown and restore lenders and credit markets (Bloomberg News, Nov. 24, 2008). Little of this has trickled down to help borrowers and lenders restructure troubled mortgages.

- According to HousingLink, in 2008 Minnesota saw a 33 percent increase in foreclosures over 2007.
Introduction

“This could be the worst economy in 25 years. It could be the worst since World War II.” - Minnesota State Economist Tom Stinson (StarTribune.com, Dec. 4).

Stinson made reference to the severe recession of 1981-1982. It lasted much longer for the state’s resource-related economy, and the period 1982-1987 is generally remembered as “The Farm Financial Crisis.” Therein lies hope for a way out of our current financial mess. A system for restoring farmland values was invented by agricultural bankers in St. Paul and the Bank’s loan restructuring program was subsequently adopted nationwide within the year. That success points to proven ways that Minnesotans can again respond to the current equity crisis.

For these reasons, the authors of this report spent the past few months looking back to extraordinary measures taken to stop the collapse of farmland values more than two decades ago, and looked ahead at ways those earlier tools might now be used to do the same for Minnesota home values.

Been There, Done That

The former Farm Credit Bank of St. Paul, now known as AgriBank, represents the largest turnaround from insolvency in the history of American financial institutions. It lost $1 billion in 1985 and 1986 and had one million acres of Midwest farmland on its books from foreclosures and voluntary conveyance as farmers went into bankruptcy or simply abandoned their farms. What’s worse, there were another 1 million acres of land about to fall back on the bank’s books in 1987, and the bank was losing $1 million a day from continuing operations.

Traditional banking practices were not working. Larry Buegler, president of Norwest Bank St. Paul at the time, was hired by the cooperative Farm Credit Bank to take on an extraordinary rescue challenge at the farm bank. The rescue efforts worked, although in hindsight the effort was in reverse order. First, the bank tried to restructure farm loans to get farmers paying something again toward interest and principal and thus generated income for the bank. Later, it sprang with its Land Values Guarantee Program that assured potential purchasers that their equity would not be lost from declining land values during the next five years. The assurance came from the bank’s pledge to take back the land and return the insured equity after five years if land values continued to fall.

The program instantly put a floor under Midwest land values. The bank was back on the road to recovery, and AgriBank is today the largest bank between Chicago and San Francisco with more than $50 billion in farm loan assets. More significant, the bank’s extraordinary guarantee program instantly created a floor price for land that shored up all farmers’ loans and mortgages, starting what statisticians call a reversion to mean (see
section on Economic Reasoning). Unknown thousands of farms were saved, including a large portion of the 22,000 farm families then struggling with Farm Credit bank debt. This land guarantee program stretched to other lenders and strengthened commercial banks’ loan portfolios as well, helping bring an end to the string of more than 350 bank failures that resulted from the Farm Financial Crisis.


More recently, former U.S. Sen. Rudy Boschwitz, R-Minn., wrote about that experience as well (“Failure to Act Will Cost Much More in Dollars and Pain.” Center of the American Experiment. Sept. 30, 2008). Within a year of the St. Paul bank’s land guarantee program, Boschwitz teamed with Senate and House Agriculture Committee members in Congress to make the St. Paul plan federal Farm Credit System policy.

“It might work ... Nothing else could work.”

Looking back, the St. Paul bank’s land values program was met with great skepticism by the bank’s board of directors after listening to the federal Farm Credit System regulators. The skepticism continued when agricultural and applied economists were brought in to study the proposed plan. Michael Boehlje, formerly with the University of Minnesota and now at Purdue University, recalls that the team of economists assembled to study the plan started with great doubts. They quickly turned to thinking “it might work” as they looked at the bank’s huge land portfolio. As the economists dug deeper, he said in a recent interview, “We pretty much concluded that nothing else could work.”

Boehlje brought together several leading farm finance economists that included the late Bruce Bullock from the University of Missouri, University of Illinois economist David Lins, Farm Credit System research economist David Reinder, and an applied economist colleague from the University of Minnesota, Glenn Pederson.

Boehlje said an analogy of the mortgage market as the card that toppled the house of cards is valid. “The financial crisis is far greater than the mortgage mess,” he said.

At the same time, a state that guaranteed property values for five years out, thus keeping housing market values above mortgages values, would get the housing market flowing again, make mortgage lending less risky for buyers and lenders, and stabilize property values.
It worked.

Jim Ruen, president of Edge Communications at Lanesboro, has kept graphic evidence of the successes from when he served as communications officer for the St. Paul bank. Putting a floor under land values with the guarantee program brought buyers back into the land market. The guarantee program initially offered three money-back guarantees priced at three different interest rates to reflect the time period of the guarantee. Most parcels of land, however, were sold with no guarantee at the lowest interest rate available, he said.

Moving land values upward then made the loan restructuring efforts also successful. The loan restructuring graphics below quantify those extraordinary efforts that kept Upper Midwest (Minnesota, Wisconsin, North Dakota and Michigan) farm families on the land.

Reasons why a similar home values program could work again can be found in the Economic Reasoning section at the end of this report.
The urgency for state action is borne out by the downward slope of median home prices in the Twin Cities metropolitan area. Since July, the median price in the metro area slipped from $208,000 to $200,000 in August, to $189,900 in September, and to $180,000 in October. The trend line was firmly established. The median price in the 13-county area dipped to $175,000 in November and closed Year 2008 at $167,000 in December. It fell to $150,000 in February to start the new year.

All 87 Minnesota counties report foreclosure activity, lenders report mortgages in danger of failing, and the national economic woes are extending out to communities with manufacturing and rural job losses that endanger even more home mortgages and home values.

Minneapolis-based HousingLink warned in a Feb. 26 report on Minnesota foreclosure activity that current economic conditions make forecasting 2009 foreclosures impossible, noting that 2008 saw a 33 percent increase over 2007. A chart showing the numbers of foreclosures for all 87 Minnesota counties is reproduced from the HousingLink report on the following page.

The data show all counties affected by the housing crisis.

Let’s look at three areas suggested for a Minnesota home values pilot program:

**Rural Metropolitan Counties**

A logical pilot program would include counties that have both rural and urban features, a variety of demographic features, diversified industries and micro-housing markets exposed to national and state economic forces.

While there may be reasons to substitute some counties for the following, we believe the following list of counties, and their principal cities, would make a valid pilot program: Blue Earth County (Mankato), Nobles County (Worthington), Otter Tail County (Fergus Falls) and St. Louis County (Duluth).

These counties contain both rural and urban demographic and economic characteristics, and all share exposure...
to the housing crisis in varying degrees. For example Duluth and St. Louis County have seen foreclosures more than double since 2005, before the start of the housing and mortgage collapse, from 219 foreclosures to 476 last year; foreclosures in Blue Earth County, around generally prosperous Mankato, have nearly tripled in that time from 57 to 153; and foreclosures around St. Cloud in Stearns County have followed suit, from 136 to 375. St. Cloud, of course, also includes parts of Benton and Sherburne counties and probably accounts for the huge jump, from 36 to 176 foreclosures, in the much smaller and mostly rural Benton County.

Agriculture and its economy have been somewhat sheltered from the current recession among Minnesota’s major economic sectors, but the two most agrarian-based counties in the group of rural metropolitan counties are also showing foreclosure stress. The comparably small Nobles County, around Worthington, had foreclosure activity jump from 18 in 2007 to 24 last year, and Otter Tail County, around Fergus Falls, had foreclosures nearly double during the four years in the study from 59 in 2005 to 101 in 2008.

Southwest Minnesota

Another choice for the pilot program could be the nine counties in Southwest Minnesota that are members of the Southwest Regional Development Commission, based at Slayton. They include Lincoln, Lyon, Redwood, Pipestone, Murray, Cottonwood, Rock, Nobles and Jackson counties.

Marcy Barritt, Murray County Assessor at Slayton, said there is no systematic monitoring of home real estate values in the southwestern Minnesota region or by counties comparable to monthly measurements in the metropolitan Twin Cities area. Rather, she said, realtors know individual markets for communities and they aren’t always countywide.

In general terms, however, Barritt said most

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<th>Year</th>
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</tr>
<tr>
<td>2006</td>
<td>4,774</td>
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<td>2007</td>
<td>7,039</td>
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Credit: HousinatLink
areas of southwestern Minnesota have been comparatively stable. One reason is obvious. “We never had the housing ‘bubble’ that you had up there,” she said, referring to the metro area’s steady build up in home prices for most of the past decade.

Following the Murray County Assessor’s suggestion, a quick survey of southwestern Minnesota real estate people did find different community quirks but mounting pressures that do resemble metro area problems. The descriptions would apply to the earlier list of rural and metro counties as well.

Don Wachal, real estate agent with Bull Market Realty, said his area around Jackson had a slowdown in the fourth quarter last year although January home sales were a little ahead of normal. He noted that the number of homes bought and sold each month is not like around large cities.

What was troubling, he said, was that sellers were having difficulty getting asking prices for their property and some were taking large losses “to just get out.” Still more homeowners are “trapped” in mortgages, he added. The equity is gone and their mortgages are already “under water,” meaning that they owe more for their homes than the current market value of the property. “I don’t know how this is going to work out,” Wachal said. “There are different lending programs out here, but it is the same human dimension—the hardship—you have in the metro area.”

Realtors around Worthington said lower priced homes have stayed fairly stable, but homes priced at $150,000 and above are taking hits. It is too early to say how much those home values have fallen, but homes in the $60,000s and $70,000s keep increasing by about 3 percent per year.

Gavin Winter, a real estate broker with the Winter Group at Pipestone, sees a similar market in his area. Sales of homes were actually up in 2008 from the year earlier, but most sales were in more modest price ranges.

Pipestone has lost a boat manufacturing company to the recession, he said. So far, it hasn’t lead to an increase in homes on the market with people moving out to seek employment elsewhere. Given the health of the economy, however, it is difficult to predict the 2009 market.

Both Pipestone and Luverne are close enough to Sioux Falls to allow commuting to jobs, notes Luverne Mayor Andy Steensma. At least 30 percent of workers in his area commute to jobs in the Sioux Falls metro area, although Sioux Falls now also has job losses. Closer to home, a wind energy equipment factory has picked up employees that lost jobs at the Pipestone boat works, he said. “It’s not like losing the Ford plant in St. Paul,” he said.

At the same time, the psychology of the housing market does discourage higher priced homes from selling in his area as well, Steensma said. “There’s money around, but the people with money are usually the first to hold back when the economy isn’t good,” he said. “I think we’re seeing that again.”
Ramsey County

Some neighborhoods of St. Paul, meanwhile, show great stress from the housing market collapse. Other areas, such as the Downtown and Capital Heights area, are actually showing increases in property value. Including the suburbs, Ramsey County and its principal city of St. Paul are reflective of the housing problems found in and around the 13-county Twin Cities metropolitan area.

On Jan. 18, the St. Paul Pioneer Press published a listing of 2008 home sales in the Twin Cities metro area, including the median price for the 12 months in each of the 128 real estate market districts tracked in the Regional Multiple Listing Service database.

The median price for the year reflects a 12-month statistical median, and not where median home values were measured in December after what was generally a yearlong slide. Pulling out the data for the districts that are all or mostly in Ramsey County show where prices are heading and that there is no end in sight unless there is a market intervention program.

The median 2008 price for single-family homes in Ramsey County shows great disparities among neighborhoods in the city of St. Paul and suburbs. However, the faltering housing and finance markets affect all real estate districts—and that would include the condominium sales cited in the graphic.

Business cycles over time usually experience a reversion to mean that smoothes out exaggerated swings—either from inflation or deflation—bringing back prices or values to a more historic trend line. (See section on Economic Reasoning.) There is a valid question to ask if the current meltdown in financial markets and in investments is a business cycle, said University of Minnesota economist Pederson. Unless we are into some catastrophic economic condition in which neither federal financial rescue plans nor economic stimulus packages restore the economy, there should be a reversion forthcoming to investments—both securities and home values. Such a reversion would restore from $20,000 to more than $40,000 in home equity for homeowners in Ramsey County, in the different districts; and less in southwestern Minnesota where market prices are less deflated but trending downward.
Social Costs of Falling Home Values, Foreclosures

We are paying tremendous social costs from the housing and mortgage crisis. We haven’t hit bottom yet.

Barb Jacobs, formerly with the Minnesota Housing Partnership, says the collapsing housing market affects all aspects of housing in Minnesota, from single-family housing of all price ranges to multiple housing units and manufactured housing that usually fall under a broader category known as “affordable” housing.

What’s more, the Minnesota Housing Partnership notes that for many Minnesotans the current crisis didn’t start with the softening of the real estate market in 2007 that reached contagious proportions in 2008. It has a comprehensive report on its www.mhponline.org Web site that shows housing costs were increasing rapidly in Minnesota from 2002 to 2007, creating a burden for households before the economic downturn. That Sept. 23 report is entitled, “The ‘Quiet’ Before the Storm: New Housing Data Reveal Thousands of Minnesotans Were Cost Burdened Entering Economic Nosedive.”

Part and parcel with that report, the Housing Partnership also offers an important companion report, dated May 2008, that looks at how government budget cuts have stressed public housing and the work of public housing agencies. The report, “Investment at Risk: Public Housing in Minnesota,” shows the squeeze on public housing even as increasing numbers of Minnesotans are losing their homes.

The squeeze on public housing grows tighter as Minnesotans lose their jobs and their homes. This condition cannot change until credit for housing construction, assistance to housing, and mortgages for home purchases begin to flow again. In other words, the housing situation cannot improve until there is confidence in the real estate market for seller, buyer and lender.

The above addresses the painful personal costs of the housing crisis. Some of us may be living in a mortgage-paid home, but even we are impacted by the problems of the housing industry. What’s more, these problems are mounting.
Rachel Walker, manager of policy analysis for the League of Minnesota Cities, points out there is a one-year lag time between slumping property values and real estate, or property tax, collections. As a result, local units of government are now increasing tax rates on property in 2008 to cover lost values in 2007. And that is only a hint of what’s to come in 2009 when property value declines are calculated for 2008 declines.

That should concern us all. While we have a shrinking property tax base to support local governments—counties, cities and school districts—the regressive nature of property taxes has to be shifted to those of us who remain in our homes and pay property taxes. Walker said, “We already have problems. We know it will be much worse next year.”

Just how much worse remains to be seen.

During the December state budget forecast presentation on Dec. 4, Star Tribune writers Pat Doyle and Patricia Lopez pointed out the obvious “double-whammy” effect of the state budget deficit. They quoted Tom Hanson, commissioner of state Budget and Management, as saying a large portion of a projected 6.1 percent increase in state spending in the next biennium would be for human services.

They further noted that Governor Pawlenty is looking at ways to trim those expenditures. That’s what governors have been known to do. In the real world, however, that also means two things: either human needs go unmet or the burden of providing for those needs is passed along to lower units of government—counties, cities and schools. That, in turn, means placing more demands on regressive property taxes.
The Mortgage Crisis Can Spread to Farms, Businesses

It already has spread to businesses, and it threatens to extend to agriculture (Egerstrom 2009). The impact of the weak national and state economies had shown itself on Dec. 4 when state officials projected state revenue shortfalls for the current fiscal year and for the next biennium. The ink was barely dry on that budget projection when state officials and State Economist Tom Stinson were back with even weaker projected numbers. Tax revenue collections fall as business activity slumps; this won’t end until there is an economic recovery.

By year’s end, reports from southern Minnesota and northern Iowa indicated that farmland prices were moderating and had started to decline in some areas from record high prices paid for farmland during the winter months of 2007-2008. Most farmland sales occur in the winter months between crop growing seasons.

Minnesota 2020 warned that a “bubble” in farmland prices could burst as commodity prices returned to more normal trend lines. (See Minnesota’s Bubble Economy: The Critical Need to Prevent Our Farmland Boom from Busting. Minnesota 2020. May 6, 2008.) This, too, works like a “reversion to mean” that brings farm commodity prices back to earth after reaching records early last year. Commodity market stimuli are varied, including public policy stimulus such as ethanol programs, and need not be in step with broader business cycles. At the same time, land prices and land purchases are, in the end, investments and should reflect investment cycles. That happened with the 1980s farm financial crisis. By year’s end, a reversion to more historic land price trends appeared underway as commodity prices—measured by futures contracts—showed corn and wheat prices had fallen in half from highs reached in June 2008, and soybean prices had retreated by more than a third from highs earlier in the year. Anecdotal evidence in early winter suggested only a small amount of land was changing hands.

Whether farmland values follow home values into another downward spiral will largely reflect demand for farm commodities that strengthen farm incomes. There is a connection: Demand for commodities—agricultural, mineral and timber—is directly tied to the health of the broader economy. The broader economy was toppled by financial problems in the housing markets that engulfed the financial markets. It includes consumer spending and that is depressing our huge retail industry. It is logical, then, to assume anything that begins to shore up the housing market will begin propping up the broader economy as well. Such cause-effect relationships are needed to keep the agricultural economy from crashing and to resuscitate our mining and forestry industries.
Bailouts at the Top Don’t Reach the Ground

The cost of federal financial rescue efforts has changed almost daily since Fall 2008. To summarize: The direct cost to taxpayers and implied future public costs keep going up. The value of real estate property underlying the financial industry keeps going down.

This top-down, or “trickle down,” approach isn’t working. A lengthy list of source material regarding federal efforts to date is contained at the conclusion of this report. We will summarize some of the source findings here.

It should be realized, however, that a total of 22 federal programs are being used to stimulate financial activity. Some programs are specifically authorized and funded by Congress. Some, such as the $700 billion emergency so-called “bailout bill” in late 2008, was loosely authorized by Congress but administratively disposed by the Treasury Department and federal agencies. Still other programs, such as actions taken by the independent Federal Reserve, may commit taxpayers and future generations to costs that are not directly authorized by elected representatives in either the legislative or executive branches of government.

It is also evident that these extraordinary federal measures are not reaching down to neighborhoods of Minneapolis, Mankato, Marshall, Moorhead, or small cities like Maynard and Milan.

We will not list these programs here. What’s more, they are likely to change between the time this report is written and you read it. In round numbers, however, there’s about $1 trillion in Treasury programs in play; about $1.9 trillion in FDIC guarantees to banks; about $700 billion in aid to the Federal Housing Administration, Fannie Mae and Freddie Mac, and pending support for U.S. automakers, and the largest—more than $4.4 trillion, has been allocated by the Federal Reserve. This is an unprecedented response to a financial crisis by the federal government.

In late November, CNBC, Bloomberg and Agora Financial data pegged the current financial rescue effort at $7.4 trillion, totaling actual money spent, pledged, “swapped and borrowed.” Adjusted for inflation, the current total equaled the combined costs of most of the major U.S. government programs in past history.

World War II accounted for nearly half of the past historical program costs ($3.6 trillion), while the inflation-adjusted cost of the Vietnam War was $698 billion. The invasion of Iraq was priced at $597 billion, although those costs keep rising.

Other major programs that contribute to the historical $7.4 trillion price included the Louisiana Purchase, the race to the moon, the New Deal ($500 billion), NASA expenses, the Korean War and the 1980s’ Savings and Loan Crisis ($256 billion).

Since that tabulation was made, subsequent government initiatives have increased expenses or commitments to $7.7 trillion, by Bloomberg accounting, and recent stories in the San Francisco Chronicle and Boston Globe suggest current programs on the drawing board would raise the total price tag of government programs to more than $8.5 trillion.

Rays of Hope

The early efforts were all top-down, or what critics would call “throwing money at Wall Street.” We’re not that critical. We fear the cost to the American and Minnesota economies would have been far worse had financial institutions started falling like dominos. But it is also evident that these extraordinary federal measures are not reaching down to neighborhoods of Minneapolis, Mankato, Marshall, Moorhead, or small cities like Maynard and Milan.
That might be changing, however. As this report was being completed, the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), members of Congress and the new Obama administration in Washington were floating ideas for buying down mortgage interest rates, buying up stressed mortgage paper, and insuring reworked mortgages in danger of failing.

Moreover, public awareness is growing that home values are the quicksand under the entire financial system. Deborah Solomon (Feb. 18, 2009), points that out in a Wall Street Journal story looking at emerging Obama administration housing and banking proposals. Earlier Bush administration efforts involved voluntary plans implemented by the mortgage industry, “most of which had little impact. Until housing prices stop falling, economists say, banks won’t be certain about the extent of their losses, prolonging the lack of confidence that has slowed lending, as well as consumer and business activity.”

Any new efforts will help strengthen the housing and mortgage markets. Still, it must be emphasized, such efforts would only help; they would not stop home values from falling. For starters, Tom Fabel of the Hennepin County Attorney’s Office points out a relatively small percentage of all troubled home loans are in banks insured by FDIC. What’s more, investors in high-risk portfolios are likely to object to restructurings that would lower interest rates—a sure prescription for legal battles, he added.

Federal Reserve Chairman Ben Bernanke is currently looking at ways to prevent and reduce foreclosures, but not at ways to put a floor under home prices. Jeannine Aversa, Associated Press economics writer, quoted Bernanke on Dec. 4 as saying the housing market is “a serious drag on overall economic activity. Steps that stabilize the housing market will help stabilize the economy as well.”

But those steps don’t lead down the sidewalk to your front door.

“I don’t think we would be either willing or able to target house prices,” AP’s Aversa quoted Bernanke as saying, “I think that would probably be an impossible thing to do given the size of the national housing market.” It partly reflects the difficulty of reaching hundreds or thousands of micro-markets with federal programs when the market needs a shock from the ground up within those markets.
Minnesota Can Stop the Bleeding

Minnesota’s economy doesn’t need a bandage. It needs a tourniquet. A pilot program should demonstrate how floors can be put under home values and restore consumer confidence. The pilot area, involving Ramsey County in the metropolitan Twin Cities area and a group of counties along the Iowa and South Dakota borders, should staunch the bleeding and help the Minnesota economy start to mend.

Key Issues for Consideration

• **Ground-up Leadership** – The idea that solutions to national problems can come from anywhere and not only from Washington, D.C. is not new. Many of the New Deal responses to the Great Depression came out of the states of New York and Minnesota. Voluntary contamination cleanup programs came out of Minnesota. Welfare reform programs have origins in Wisconsin, and agrarian policy reforms can be traced to developments in Minnesota, North Dakota, Iowa and Nebraska. Minnesota now has an opportunity to blaze a new path back to a functioning mortgage finance market by offering the equivalent of a homeowner’s equity insurance plan.

• **Pilot Program** – A pilot program involving both urban and rural micro markets should be sufficient to demonstrate the effect of a Home Values Guarantee Program. That program could then be expanded statewide if no federal program is created to preempt state action. However, given frustrations about bank financial assistance expressed by Congressional leaders, mere launch of the Minnesota pilot project is likely to become a national model within a year.

• **Delayed Public Risk** – The state program would be backed up by state bonding authority beginning five years after start of the guarantee program. That means the program would be “budget neutral” for at least the next two biennia. Moreover, any future state bonding risk will most likely roll into future federal programs before the five-year guarantee exposure comes due.

Program Nuts and Bolts

State lawmakers, state officials, and their research experts should resolve specifics of the pilot program and where and how it should be administered. Nevertheless, Minnesota 2020 believes the following points should be considered in creating the program:

• **Bonding Authority** – The program should be housed in a state agency or department that has bonding authority. If the program is to be placed elsewhere, stand-by bonding authority should be authorized for possible later use. We suggest the state’s contingent liability under the pilot program be limited to $25 million. This should be sufficient to provide from 4,500 to 5,500 down payment guarantees.

• **Administrative Costs** – The program should pay for itself, like title insurance. A half-point or less percentage fee, or a fixed amount, could be charged to new mortgages and restructured mortgages to cover the guarantee.

• **Third-party Administration** – The appropriate agency or department should call for proposals to mortgage bankers or others who would administer the home equity guarantee. Three state authorized guarantee entities should protect against conflict of interests that might arise among parties.

• **Fraud Protection** – Criminal background checks should be conducted on any realtor or mortgage banker authorized to handle and write state home equity guarantees. This should include the buyer and seller as
well. Any homeowner who calls upon the guarantee after five years will deed the property to the state for subsequent disposition.

**Eligibility** – Anyone in the pilot counties, and not just restricted to targeted, depressed areas, should be eligible provided they qualify for a conventional mortgage and are purchasing a home in good condition as a primary residence. Realistically, the program might be targeted to property with appraised value between $75,000 and $300,000 in Ramsey County. Southwest realtors suggest a value range of from $75,000 to $200,000 in the more rural and non-Twin Cities metro counties. Both value ranges would leverage enough mortgages to have a significant impact on restoring market confidence in their housing markets.

**Phase II Restructuring**

Once home values begin to stabilize, the *Home Values Guarantee Pilot Program* would speed the restructuring of delinquent mortgages. One potential barrier—getting approval from absentee (non-local) lenders—should soon be addressed at the federal level. An administrator of the Federal Deposit Insurance Corp. is stressing that loan servicers have a fiduciary responsibility and the authority to renegotiate delinquent mortgages.

Lenders would disqualify any borrowers who were voluntarily refusing to pay their mortgages in hopes of renegotiating them on more favorable terms, and would continue to foreclose on borrowers who were simply unable to repay mortgages under any circumstances. For those caught in a middle bind, however, lenders would quantify the costs of foreclosure (lost principal and interest, taxes, insurance, heat, security and vandalism). No state intervention may be necessary. When total foreclosure costs are calculated, lenders and borrowers alike should see the wisdom of adapting a lending practice from commercial banking known as *shared appreciation*. This would mean rewriting five-year mortgages down to a level that is affordable. At the end of five years, a new appraisal would be conducted and the property refinanced at that value. If the value increased, as expected, the borrower and lender would share the increase in equity value.

**Bottom Line Appeal**

This is first and foremost a ground-up, homeowner’s equity insurance plan. But as the preceding paragraph suggests, it also offers protection for lenders and would help financial institutions improve their balance sheets. It would move mortgages out of non-accrual and non-performing status and restore hundreds of millions of dollars to net income that lenders have set aside for losses that will not occur. If this program were adopted nationwide, the recovery potential would be in hundreds of billions of dollars.
Economic Reasoning

Two theoretical arguments form the foundations of this proposal. A synopsis of both theories is offered here as a reference point for anyone wanting to study them further. These arguments show why the authors of this report believe that the risks to the State of Minnesota are minimal.

Mean Reversion

Mean reversion theory suggests that prices (or returns) eventually move back toward the mean or average. This mean is often assumed to be the historical average of the price (or return) series, which is logically sensitive to the particular period of time that one selects. This theory has led to the development of investing strategies that involve the purchase (or sale) of stocks or other securities where the returns have greatly differed from their historical averages.

Mean reversion was the primary theory behind the 1987 Land Values Guarantee Program offered by the Farm Credit Bank of St. Paul. The theory argues that exaggerated movements in prices (“price bubbles”) will eventually correct themselves and revert to a more sustainable trend line. This happens when “price bubbles” burst, and it eventually happens after great periods of inflation (or deflation).

We note that a problem in applying this theory empirically is that we must first agree on the set of underlying investment “fundamentals” that determine valuation (e.g., expected incomes, interest rates, demographics, etc.) and that these variables have not significantly changed over time. If those fundamentals have changed, as noted in a reference to a catastrophic economic change made earlier, the market will seek a new price level and the process will not lead us back to the historical mean value.

In the case of real estate markets, the argument is that these markets eventually self-correct, if supply and demand are allowed to adjust. On the upside, when prices have risen to levels that exceed the long-term price expectations of investors, selling pressure increases and real estate market prices begin to reverse direction and start to decline. On the downside, when prices get cheap enough (prices fall below long-term price expectations of investors), buying pressure increases and real estate market prices reverse direction and begin to rise. This additional buying pressure in the market may be a result of restored investor confidence, or optimism, that prices will continue to rise in the future.

An uncertainty in this argument is how long will it take for investors to form these expectations and how long it takes for markets to respond to new information. The attempt of this proposal is to provide buyers, sellers and lenders the necessary new information. When we look at measures such as the Housing Affordability Index (HAI), which is published by the National Association of Realtors (the index equals the ratio of qualifying incomes of homebuyers to the monthly mortgage payments they must make on a median-priced home), we can get a sense of how quickly market conditions change. The HAI stood at 142 in November 2008 compared with 120 in November 2007. This compares with a mean HAI of 112 for 2007, 106 for 2006 and 112 for 2005. In the Midwest, the HAI stood at 186 in November 2008. This reflects the declining prices of houses in recent months relative to incomes.

The median home value in the 13-county metro area fell nearly $82,000 from a peak in June 2006 to $155,000 in January this year. Without a floor under home values, increasing numbers of home mortgages are certain to fall “below water” as down payments and equity are lost to deflation.
The statistical trend line inserted in the graphic above suggests that the typical homeowner in the Twin Cities would begin recovering about $35,000 in home equity if a floor can be put under the housing market. The margin of equity recovery would not be as great in southwestern Minnesota counties, but it would halt the evolving market deflation there as well and rebuild household wealth and equity. This is important for three reasons:

First, it would give prospective home buyers assurance that down payments on mortgages would not be lost to further deflation in home values, and it would give lenders confidence to lend.

Second, American University and University of North Carolina scholars (Benjamin, Chinloy and Jud) note that such stability in home equity expands quickly into the broader economy. They find that perceptions of wealth accumulated in home values triggers consumer confidence and leads to economic activity faster than wealth accumulated in securities.

Hildebrand’s graphic, right, shows mean reversion for returns, not prices. Evidence of mean reversion has been found in various economic indicators (e.g., exchange rates, interest rates). Empirical research has been done on stock market prices, yet that research is still inconclusive about whether stock prices revert to the mean. These studies have looked at both “momentum” and “reversal” as the two forces that operate in the market. Some studies show mean reversion in some data sets over some periods, but many others do not.

We should note that existing empirical research is thin on mean reversion and does not definitively show that mean reversion theory works universally in financial and real estate markets. It is also not clear from empirical research that financial markets and real estate markets exhibit the same price dynamics over time. So, we cannot take lessons from the financial markets and simply apply them to the real estate market.

Despite the paucity of such studies, there remains one clear example of the dynamics of the theory. The Farm Credit Bank of St. Paul bet its future on the theory, and it lifted the bank’s balance sheet and the balance sheets and farm values for Midwest farmers.

Meanwhile, we can take a long, historical look at accumulations of wealth in America and see general increases in wealth from both home and outside investment sources, such as securities. Relationships do exist. Over time, this also links with consumer confidence and is reflected in where investments are made and where wealth is accumulated.

**Wealth Effect**

The second theoretical argument considers the effect that changing household wealth has on consumer psychology and behavior. This is the theory of “wealth effect on consumption,” said Glenn Pederson, an applied economist at the University of Minnesota. This theory was put forth in 1968 when people continued consuming at high rates even though the Federal Reserve increased interest rates; the reason, economists concluded, was that personal wealth as measured by home equity and investments continued to rise. This gave consumers confidence to keep buying (consuming) even though their purchases were becoming more costly. Studies have been conducted on this topic in recent years and they generally show that the effect of changes in wealth on consumption is significant and measurable (Benjamin, Chinloy and Jud, 2003; Case, Quigley and Shiller, 2001).

In the current housing market the psychological response to expected future market price declines suggests a negative wealth effect on consumption may also be in play. When housing prices were escalating, Pederson said, homeowners used their homes “like ATM machines” by arranging second mortgages to borrow against the increased equity value. However, logic would suggest that the reserve is also true when market prices are falling. When home equity is declining, they are not able to arrange for home equity loans and that form of consumption stagnates or falls. Consumers may also become less confident that they will have the financial resources in the future to repay additional debts and they begin to reduce their consumption expenditures.

Increasing numbers of economic observers are saying the same even though it hasn’t been carefully studied.
As a case in point, Salmon (www.portfolio.com) devotes a thoughtful blog to the subject. Samuelson (2008) in the *Washington Post* summarizes economic evidence that there is negative wealth effect on consumption and offers reasons why the current recession can run deep. This is not a comforting outlook and it begs for a psychological shock to markets and the economic system that has not resulted from federal stimulus and bailout policies.

This should not be surprising. The University of Michigan has tracked steadily weakening consumer sentiments about the economy since 2000. That monthly index has fallen sharply since mid-2006.

![Consumer Confidence - Families](chart)

**Sources: Reuter’s and University of Michigan**

It is almost impossible to believe such sentiments can change until there is obvious restoration of home equity wealth. By year’s end, Salmon (2008) notes that economists calculated that American household personal wealth had dropped by at least $4 trillion from lost home equity, based on a conservative estimate of 20 percent of value, and that’s before calculating losses from stocks and other personal investments.

Conversely, housing market research shows the promise for turning the economy around from a ground-up, home ownership foundation. Belsky, from the Joint Center for Housing Studies at Harvard University, and Prakken, from Macroeconomic Advisers LLC, found that each $1 gain in housing wealth or stock wealth resulted in 5.5 cents of new consumer spending over time. But 80 percent of housing wealth, or 4.5 cents for every dollar, occurred within a year while stock wealth benefits to consumer spending took several years.

That is all the more reason why Minnesota shouldn’t wait for federal assistance to trickle down. A bottom-up approach restoring home values would really be an economic stimulus.
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