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From an Approach to a Plan: The Key is Fairness

by Stephen Figlewski[1]

Uncertainty Arising in the Housing Sector is Paralyzing the Financial System

In a companion article, "Viewing the Financial Crisis from 20,000 Feet Up," I describe how the financial system consists of zero-sum contracts: If one party loses $1, the counterparty on the other side receives that $1 as a gain, such that the gains offset the losses and the sum is always zero. However, it has become painfully clear in the current crisis that, while actual losses arise in the real sector of the economy and the financial system simply transfers them dollar for dollar through to the ultimate investors, extreme uncertainty about which firms will ultimately bear those losses and be driven into insolvency greatly magnifies the impact because it destroys the confidence and trust the system needs to operate effectively. In this environment, banks hunker down and refuse to lend to each other even over night, because they can not be sure the loan will be repaid as scheduled and they may desperately need that capital to defend themselves in a day or two. The credit market freezes up.

Today the drop in housing prices is producing huge losses in the real sector on the order of several trillion dollars. These are hitting the financial system, but it doesn't have the capacity to carry such large losses and it is breaking down. It is as if an electrical device designed to operate at 110 volts has been plugged into a 220 volt outlet and parts of it are catching fire. The current "bailout" plans are aimed at propping up the parts of the system that are beginning to short out: the banks and other financial institutions. But it will be very hard to bring the crisis under control as long as the system remains attached to the source of the risk that is too strong for it to bear.

Stabilizing the Cash Flows on Mortgages Would Defuse the Crisis

When an electrical device catches fire, the first thing to do is to disconnect the power. The financial system is connected to the real estate sector by mortgage loans, and it is being severely damaged by the uncertainty over how many of those loans will default and how much the lenders will lose when defaults occur. The companion article presents a direct and effective way for the Federal government to pull the plug and disconnect the financial system from the risk: It should step between the homeowner and the mortgage

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lender to remove the risk from the mortgage payments. The article does not try to develop this principle into a full fledged plan to stabilize the financial markets and defuse the crisis. Rather, it describes a basic approach that the zero-sum analysis makes clear would work, and that an implementable plan could be built upon.

In the basic approach, the government would eliminate the risk of default and prepayment by guaranteeing to the lenders that all mortgage payments under existing loans would be made as scheduled and in full. As soon as the cash flows from mortgage loans into the financial system became fixed and free of risk, every mortgage-backed security, no matter how complex, would become as safe as a US Treasury bond. Rather than being dangerous to own but impossible to sell, the "toxic" mortgage-backed securities that are driving banks and other financial institutions into insolvency would become free of default risk, traded in highly liquid markets, and universally acceptable as good collateral.

Keeping Borrowers in their Houses would Minimize Human and Financial Losses

At the same time, the government would work with homeowners who are in danger of defaulting to reschedule their loans so that the payments become manageable. The objective would be to allow as many families as possible to remain in their homes and to eliminate the highly damaging and costly process of foreclosures, evictions, and fire sales of repossessed properties in an overloaded housing market. If necessary, a house could be converted into a rental unit, with substantially lower monthly payments but with ownership equity in the property passing to the government.

The companion article explains in non technical terms why the approach of guaranteeing mortgage payments would stabilize the financial system. The current article will address several critical issues in turning that general approach into an implementable plan, and will suggest some specific steps to deal with them.

The most important issue is fairness. To gain political support and to defuse potential legal challenges that could delay or derail implementation, it is essential that the plan be widely regarded as fair to all parties. A related issue is that one of the fundamental principles our capitalist system is built upon is that legal contracts should be enforced. Finally, there is the key question of cost.

A Back of the Envelope Analysis of the Cost

I will address the last point first. This approach could be surprisingly cheap, especially relative to many of the alternative proposals. The main reason is that it does not envision buying up mortgage loans, but just guaranteeing the monthly payments on them. It is the same difference in cost the homeowner would see between paying off a $200,000 loan immediately versus paying the $1300 a month required by the mortgage contract.

Here is a "back of the envelope" calculation. Total outstanding mortgage debt on single family houses is about $11 trillion. Annual interest and principal on those loans is on the order of around $1 trillion. Currently, roughly 10% of mortgage loans are either delinquent or in foreclosure, which would be a shortfall of $100 billion per year if no payments at all were made on those loans. But a key element of the plan would be to restructure the loans so that many of the currently delinquent borrowers could pay them. In other cases, the houses would be converted to rental units. If this brought in half of the cash flow required by the mortgage loans, the net payment by the government would go down to around $50 billion, much of which would actually represent loans that would be repaid over time. This would be comparable to the cost of other government programs, such as those for food stamps or unemployment compensation, and distinctly less than the $700 billion already committed to the bailout, not to mention the Iraq war.

A Viable Plan Must be Based on Fairness for All Parties

Various proposals have been floated to address the problems in the housing sector, but all of them have generated objections broadly related to "fairness." Fairness considerations lead to widespread opposition to "bailouts" of imprudent lenders who eagerly entered into high risk loans; or of foolish, and in some cases mendacious, borrowers who took on mortgages they could not afford; or of "greedy Wall Street fat cats" who packaged the risky mortgages into securities that were supposed to be extremely safe but weren't; or of anyone who had anything to do with derivatives. It is a well established principle of human behavior that people will oppose any course of action that is perceived to be unfair, even when it would be in their own self interest. Can the government guarantee all of these mortgage payments in a way that would be generally considered fair?

A different, but related concern is that heavy government intervention in the financial system is antithetical to the fundamental principles of capitalism. Many Americans would consider it wrong (and unfair) for the government unilaterally to alter the terms of the legal contracts that underlie our mortgage finance system.

This article will describe what might be called a "basic plan" that should be regarded as fair by most observers and embodies the principles set forth above: that the government would guarantee all mortgage loan payments and would help the borrowers set up payment schedules that allow them to remain in their homes. Once the basic plan was accepted as the general outline for a course of action, modifications and exceptions to deal with special cases might be introduced, hopefully in ways that did not slow down the implementation of the overall approach.

A Fair Deal for Homeowners

A principle that all should regard as fair, although they might not be happy about it, can be summed up as: "A deal's a deal." In taking out a mortgage loan, a homeowner enters into a legal contract that specifies future payments of interest and principal in return for the loan of a large sum of money to purchase a house. Forcing lenders to forgive principal or reduce interest rates would violate these contracts. This would undermine a key principle of our economic and legal system, that contracts should be enforced by the government, not abrogated when it is politically convenient, and one would certainly expect a plan that did that to be challenged in court.

But many borrowers are finding that because of changed economic circumstances, or simply through miscalculation of their ability to refinance the loans, they are unable to make the payments they have committed to. One might assume that most of these borrowers like living in their homes and would make the contracted payments if they could, but the flexibility for the lenders to renegotiate the mortgage terms quickly is not available, especially where the loans have been securitized. By stepping in as an intermediary between the homeowner and the mortgage lender, the federal government would gain the ability to revise the homeowner's payment schedule without altering the terms of the mortgage contract vis-à-vis the lender.

Restructuring a Mortgage without Altering its Economic Value

In a typical mortgage loan, the borrower commits to pay off the loan principal over the life of the contract and to pay interest on the outstanding balance at an agreed rate during that time. The standard mortgage has a "level pay" structure, in which the monthly payment of interest and principal is constant over the life of the loan. For example, a 30 year conventional mortgage with an interest rate of 7% calls for a monthly payment of $1330.

But this is a little strange. No one renting a house or an apartment would expect to pay the same rent every month for the next 30 years. Simply allowing the monthly mortgage payment to grow in the future would make it possible to lower it substantially right now. We can restructure the payment schedule and still satisfy the principle that "A deal's a deal." As long as the loan is fully paid off over its lifetime and the agreed interest rate is always paid on the outstanding principal balance, the government intermediary would be receiving the same economic value from the borrower over time that it is paying to the lender.

For example, rescheduling the monthly payment in the first year to be just equal to the interest on the loan, but to grow at a rate of 1.3% a year thereafter, would reduce the payment on the 7% 30-year loan by $163, to $1167 in the first year. This simple change in the pattern of mortgage payments would represent no real cost to the taxpayers at all. But it could make it easier for many homeowners to meet their mortgage obligations.

A Government Lending Program Can Lower Current Mortgage Payments Further

The initial year monthly payments can be lowered further by building in a larger rate of increase in the future. For example, with a growth rate of 3% or 5% a year, the first year's payments go down to $974 or $769 per month, respectively. These schedules still represent fair exchanges, in that there is no reduction of principal or interest involved. However, because the government would continue to pay $1330 a month to the lender, the homeowner would be gradually building up a debt in the early years, which would be paid off over time.

Under the schedule in the previous subsection, the total loan balance (the amount owed to the mortgage lender plus the amount advanced by the government) would not rise above the original $200,000. But schedules with lower first year payments would require the government to lend the homeowner some of the interest due in the early years. With 3% growth, total loan value grows to about $212,000 before it starts to be paid down in year 10; with 5% growth, the total loan rises to about $242,000 before beginning to fall in year 14.

Mortgage loans in most states are "no recourse" loans, meaning that if the borrower defaults, the lender gets the collateral--the house--but has no legal right to claim anything further. This gives an unfortunate incentive to default to the many borrowers whose houses are currently worth less than what they owe on their mortgages. How many would still default if it were possible to reschedule their payments to a more affordable pattern is an important and unknown factor in this plan.

One way to structure a mortgage support loan to homeowners would be through the tax system. Interest and principal payments on the loan could simply be incorporated into the borrower's income tax. This would be with full recourse, making repayment highly probable except in cases of true insolvency, when the debtor's liabilities would be resolved in bankruptcy court.

Converting the House to a Rental Unit if Restructuring the Loan Does Not Work

Finally, if the homeowner lacked the financial resources to reasonably commit even to much lower payments under a new schedule, the house can be converted to a rental unit. The monthly payment would drop to the prevailing level of rent for the property and the government would become the owner of the house. This would have the beneficial effect of avoiding foreclosure and forced liquidation in an unaccommodating real estate market. But the government should probably not be in the housing business over the long term. The former homeowner might be given a period of a few years to try to reestablish adequate credit and to resume purchasing the house under the existing mortgage terms. Failing that, the house could be put on the market at a price equal to the outstanding loan amount. If it sold at that price, in the end there would be no default loss on either the original loan or the federal advance. For houses that can not be sold for their loan values even after the housing market has stabilized, eventually some other means of liquidating the government's ownership would need to be devised.

A Fair Deal for Lenders

This leaves a couple of loose ends with respect to the homeowners, which we will return to shortly. But first let us consider what would be fair for the lenders. In the basic approach, the government would guarantee all of the payments as specified in the original mortgage loan. No lender could reasonably object to having the government guarantee the payments they were supposed to get from the homeowners anyway (but weren't sure of). But this is actually <u>too</u> fair. It gives lenders a better deal than they agreed to originally.

Mortgage loans come with two significant risks: default and prepayment. Default requires the lender to bear the expense and uncertainty of foreclosure and liquidation; prepayment makes the cash flow unpredictable and tends to occur at unfavorable times, when interest rates are low. Mortgage interest rates are set substantially above the rates on other kinds of long term bonds, such as US Treasury securities, to compensate for these risks.

Because the lender does not expect to get back the full principal on every loan, a portion of the higher quoted interest rate just offsets expected losses of principal. For example, the quoted rate on a subprime mortgage might be 12%, but taking losses from defaults into account, the lender only expects to realize 7% overall on such loans. Guaranteeing mortgage payments would transform them, and all of the mortgage-backed securities that are produced in securitizing those mortgage loans, into riskless securities with known cash flows. The lenders should not be entitled to continue receiving high interest rates to compensate them for risk they would no longer be bearing.

What would be fair? When the loans were made originally, the lenders anticipated some losses from defaults. The expected loss rate can be estimated from the spread of the mortgage interest rate above the comparable Treasury rate plus an allowance for servicing costs. It would be fair to adjust the monthly loan payments downward to build in a reduction in the loan amount equivalent to what would normally have come from defaults.

Doing this in a really fair way is not too hard, but it would require some careful thought. Both the interest and the principal payments should be reduced to avoid having the incidence of the change fall more heavily on some types of mortgage-backed securities than on others. Also, actual loss rates have been a lot higher than were expected when the loans were issued, so it would be reasonable to reduce payments at the high end of what was expected for defaults at the time, and take account of losses that have already been experienced so the lender is not hit twice.

Adjusting Payments to Lenders without Abrogating the Mortgage Contracts

It would be very desirable to reduce the payments to the lender without abrogating the mortgage contract. One of the large problems with current plans that call for lenders to write down loan amounts or interest rates voluntarily is that when mortgage loans are securitized, there is no longer a single lender who can do this unilaterally, and securing the agreement of all of the investors who own a piece of any given mortgage is typically not feasible.

One way to reduce the monthly payment without changing the terms of the mortgage loan itself might be to use the tax system. A "mortgage market stabilization tax" could be imposed on mortgage loan payments. The amount of the tax could be tied to the premium in the original interest rate relative to Treasuries, as a measure of the value of the guarantee in eliminating default risk for that loan.

Alternatively, the guarantee might be only available once a property is at the point of foreclosure. The lender is then expecting to write down the loan value anyway, so a government guarantee program that required an initial reduction in the loan amount might be a dominant alternative.

In any case, the key to stabilizing the financial markets is not that the underlying mortgage loans have to be paid in full as originally written, only that their future cash flows must become fully known and free of uncertainty.

Making the Program Voluntary

Current proposals to assist homeowners have been limited in scope. Some, like proposals to buy up delinquent loans, would be too expensive to be made broadly available. Plans to renegotiate loan terms, like those that are currently being implemented by the FDIC at Indy Mac and by JP Morgan Chase, would be difficult to extend to mortgages that have been securitized.

However, to stabilize the financial markets, it is essential for the cash flows from <u>all</u> mortgages to be stabilized. The program I am suggesting would do so. It would be available for all homeowners, but it would be optional for the 90-plus percent of them who are current with their mortgage obligations, because it would not matter whether they participated or not. The guarantee would only be used when a mortgage falls into delinquency. Rather than foreclosing, the mortgage lender would turn to the government program, and the delinquent homeowner would then be required to participate in order to remain in the house.

"Upside Down" Mortgages and the Incentive to Default

What about the increasing numbers of homeowners who have "upside-down" mortgages, with principal values greater than the market value of their houses? They have a strong incentive to default and simply walk away.

This is a problem, but the situation is probably more complicated in a lot of cases. Walking away does destroy one's credit rating, which is a cost. But more importantly, it also involves uprooting one's family and abandoning a house that the homeowner presumably liked enough to buy it in the first place. Many homeowners with upside down mortgages may be willing to continue paying the mortgage loan and stay in the house, if that were financially feasible for them.

Those homeowners who would choose to default anyway can not expect too much sympathy from the millions of investors with upside-down IRAs and upside-down stock portfolios that are partly the result of such behavior. If a firm causes an environmental accident we consider it fair that "the polluter should pay" to clean it up. By the same logic, to discourage borrowers from defaulting not from necessity but for convenience, it would be fair to impose a market disruption penalty of some kind on wanton defaulters. The penalty could be waived for borrowers who were forced into default by financial duress.

Reducing Interest Rates to Borrowers

As described so far, there is no "bail out" of homeowners at all. They would continue to pay the original loan amount and interest rate. Only the time pattern of that payment is modified. In many cases, the mortgage interest rates are very high, especially for the subprime borrowers who are defaulting in large numbers. If payments to lenders are to be reduced, shouldn't borrowers get a break, too?

That would certainly seem fair, especially if default losses go down under the new program. Two concerns would need to be considered carefully, however. First, we would not want to create an incentive for solvent borrowers to default just to obtain a lower interest rates. Second, if such a provision were to prove politically contentious, it could substantially slow adoption of the plan. Given the importance of stopping the disruption of the financial system as soon as possible, it could be better to proceed quickly with a program that did not involve concessionary interest rates at first and take up further assistance to homeowners in subsequent legislation.

Conclusion

The plan I have just sketched out would calm the mortgage market which has been the main driver in destabilizing the financial system. It would also turn the toxic securities that are causing large actual losses and much larger uncertainty among financial institutions, and which are paralyzing the credit markets, into benign government-backed securities. It would treat homeowners and mortgage lenders fairly. And the drain on the US budget would be relatively limited. It could even end up being nearly costless if the housing market settles down within a few years.

The plan would also have important benefits for the housing market. First, it would eliminate the severe human cost of evicting families from their homes. Second, it would eliminate the pressure on the real estate market from foreclosed homes being liquidated at fire sale prices because that is the only way for the lenders to recover any value from the defaulted mortgages. This process has very pernicious effects on home values, both for the lenders who want to recover as much of their investments as possible and also for any homeowner who simply needs to sell a house. Third, it would eliminate the collateral damage on neighborhoods and communities where a significant number of properties stand empty after a foreclosure.