Intervening to Reduce Foreclosures: Why and How

Testimony of
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Mr. Chairman, members of the Committee, I'd like to thank you for the opportunity to testify on this important piece of legislation. Our nation's credit markets have been in turmoil now since last August, at times improving for a while, but then deteriorating once again. Unfortunately, the overall trend since August has been down, not up. While ameliorating the mortgage foreclosure problem will not cure all the ills that afflict our credit markets, I believe that doing so is central. Indeed, it will be difficult to extricate ourselves from the overall financial mess without doing something major to limit foreclosures. Thus I view this bill, or some similar piece of legislation, as probably necessary but not sufficient to escape from the current financial problems.

There is, of course, another view—one that holds, first of all, that housing prices are too high and must be allowed to fall to their market-clearing levels, and second, that homeowners and lenders who made foolish or irresponsible decisions should suffer the consequences. There is some legitimacy to each point, of course. I would not favor either putting a literal floor under house prices or bailing out homeowners 100%. But the Social Darwinist sentiment reminds me of one-time Secretary of the Treasury Andrew Mellon, who gave the following (bad) advice in 1931:

Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate. It will purge the rottenness out of the system... People will work harder, live a more moral life… and enterprising people will pick up the wrecks from less competent people.

I thought we outgrew this attitude in the 1930s. It reminds me of using bleeding to cure disease.

Why Intervene?

In sharp contrast to the Mellon treatment, I believe the federal government has a duty to intervene to reduce the magnitude of the current foreclosure problem. Why?

First, there is *the human dimension*. Millions of home loans are now in or headed for foreclosure, in the biggest wave of defaults since the Great Depression. While some of these homeowners knowingly made unwise bets that ever-rising house prices would bail them out, many were victims either of their own lack of financial literacy or of dubious (if not fraudulent) lending practices. Furthermore, a massive wave of foreclosures will exacerbate many economic and social problems facing families, communities, and governments at all levels.

Second, the act of *foreclosure destroys value unnecessarily*. Think of the house and the mortgage, jointly, as representing a certain amount of value. Experts estimate that foreclosing on a property typically destroys about 30% of that joint value. But renegotiating the mortgage often can preserve most of it. Unfortunately, our modern system of mortgage finance makes such renegotiations difficult. Nowadays, the majority of mortgages have been securitized and sold to buyers who do not even know the names of the original borrowers. The resulting mortgage pools were then sliced, diced, and tranched into complex derivative instruments that no one really understood—and that were sold to investors all over the world. A mortgage workout presents one set of problems when the borrower and the lender can sit down together to renegotiate terms. But how do you conduct a negotiation when the borrower and the lender don't even know each other? That's one reason why the renegotiation process needs a helping hand.

Third, a massive wave of foreclosures would feed the vicious cycle--depicted schematically by the inverted pyramid in Figure 1--that now runs from falling home prices, to more delinquencies and defaults on mortgages, to lower values for mortgage-backed securities (MBS), to even lower prices for related derivatives, and finally to strains in the entire financial system. By reducing the number of homes being dumped onto an already depressed market, reducing foreclosures can help limit the decline in housing prices at the base of this pyramid, and thereby improve the entire financial picture.

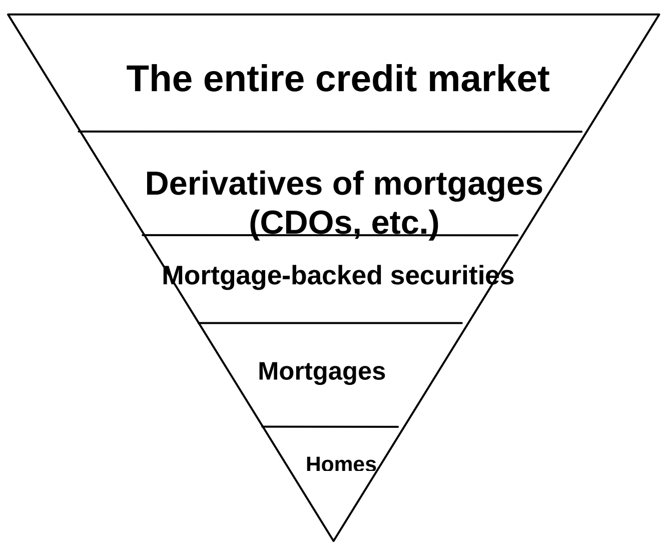

Figure 1
The Inverted Pyramid

Fourth, the *financial contagion* from the mortgage mess has been truly stunning; and it seems not even to have abated, much less stopped. Indeed, new problems keep cropping up in markets far removed from home mortgages (e.g., municipal finance). More and more credit markets of all kinds are functioning poorly; some are not functioning at all. As I said, it seems unlikely that we can find our way out of the credit mess without first fixing the mortgage mess. While no one can know for sure, I believe that limiting foreclosures, and thereby enhancing the depressed values of MBS, stands a good chance of easing overall pressures in the credit markets—in a kind of "reverse contagion" (see again Figure 1).

Fifth, and related, for whatever reasons, private capital is not pouncing on the bountiful buying opportunities that now exist in distressed assets—at least not much. I believe that some sort of *galvanizing event*, whether from the private or public sector, stands a chance of reversing the psychology of panic that now grips the markets. Passing this bill just might be that galvanizing event. And, by the way, as private capital starts pouring in, the government should start withdrawing from the market.

Finally, and perhaps most important, because all modern economies run on credit, the malfunctioning of the credit markets *threatens the overall economy*. Mellon's stern attitude notwithstanding, it is dangerous to put the whole economy at risk in order to teach a moral hazard lesson. Were I a voting member of Congress, I would not want to run that experiment.

How to intervene

If we are not just going to liquidate, liquidate, liquidate, we need a sensible, administratively feasible, cost-efficient way to intervene to limit foreclosures—something that hopefully mimics much of what markets would do if they were functioning properly.

In a *New York Times* column in February, I advocated one possible approach: creating a modern version of the Depression-era Home Owners Loan Corporation, which bought up old mortgages and issued new, more affordable ones in their place.[1] The bill now before this committee would accomplish something very similar, but in a different way. It would use the FHA to make the federal government a big mortgage *insurer* rather than a big mortgage *lender*. But the effects would be much the same: old, unaffordable mortgages would get replaced by new, more affordable ones; and the government would assume the risk of default going forward.

In a follow-up column in *The New York Times* just a few days ago, endorsing this bill, I discussed a few of the more important aspects of The FHA Stabilization and Homeownership Retention Act.[2] Much of what follows is based on that article. Here are some of the key decisions that need to be made.

First, we need to recognize that those who oppose bailouts have legitimate arguments. The plan must not be too generous in shielding people and businesses from the consequences of their own mistakes, for at least two reasons. Economically, mistakes must be punished in order to minimize the danger of repeat performances--the moral hazard argument. Politically, we must be able to give reasonable answers to responsible citizens who ask why their tax money should be put at risk bailing out people who behaved irresponsibly and cannot pay their debts. It's a fair question. And to answer it, both lenders and borrowers must bear some losses.

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[1] Alan S. Blinder, "From the New Deal, a Way Out of a Mess," *The New York Times,* Sunday Business Section, February 24, 2008, p. 6.

[2] Alan S. Blinder, "How to Cast a Mortgage Lifeline," *The New York Times*, Sunday Business Section, March 30, 2008, p. 6. There are some minor differences between the House bill and the Senate bill. But, for current purposes, these are inconsequential

The loss to the lender depends mainly on the "haircut"—that is, the discount below face value--that is applied when old mortgages are purchased and refinanced. Conceptually, the correct haircuts would reflect current market values. That would be the truest application of the no-bailout principle and, as I understand it, is at least consistent with the intent of this legislation. But there's a big catch: With the resale market for mortgages virtually shut down, there are hardly any market prices to use for reference. This poses a knotty problem, which the draft legislation "solves" by making the haircut depend on the market value of the house and the face value of the mortgage.

My suggestion is a bit different. It is that the new FHA post *initial* buying prices for mortgages of various qualities, based on its own best estimates of what constitutes fair market value. Then it should adjust those prices according to whether mortgage owners rush in to sell (meaning that prices were set too high) or stay away (meaning that prices were set too low). In that way, the government can mimic what the market would do until a real market re-emerges.

What about the borrowers? How do we make them pay for the privilege of obtaining new FHA-guaranteed financing? The bill proposes that borrowers relinquish part of any future price appreciation on their houses for as long as these concessional mortgages remain in effect. I support that idea, but would go further by also taking away their right to take out a second mortgage or a home equity loan.

What about the scale of the mop-up operation? That's a very good question, but one without a good answer. I think 2 million mortgages is a reasonable number to be thinking about for now, but no one knows if that will be adequate to turn the tide. I think we must be prepared to refinance more than 2 million, if necessary. Of course, if the sickness in our mortgage markets lifts quickly, the government might have to do less.

In part, the scale of the operation will be governed by the eligibility criteria. The bill is correct to limit refinancings to primary residences; second homes, vacation homes, and houses bought "on spec" should not be eligible. And the government should demand proof of residency. In addition, applicants must not have misrepresented their financial conditions, or committed any other kind of fraud, in obtaining their current mortgage—and they must provide the standard documentation (of income, assets, etc.) that was often missing in the "low doc" and no doc" mortgages of the 2005-2007 period. These new mortgages should, by contrast, be "high doc." I would also place explicit upper limits on both family income and house value. And, to hold down the number of applicants, the special refinancings will need to be limited to mortgages signed between certain dates--perhaps, from January 1, 2005 until the date on which the bill is introduced in Congress.

But all these are the easy parts. The new FHA will also have to develop sensible criteria (based on standard measures of affordability) that rule out (a) mortgages that are easily affordable without modification and (b) cases in which homeowners cannot afford even new, less onerous mortgages.

Importantly, the draft legislation recognizes the important principle that emergency measures should not outlast the emergencies they are intended to cure. To guard against this danger, the new FHA should cease granting these special mortgages after perhaps two or three years. And the mortgages it guarantees should be packaged, securitized, and sold back into the market as soon as conditions permit. Happily, the bill embodies these two ideas.

Finally, while I understand that this may come in separate legislation,[3] the government must provide legal comfort to mortgage servicers who are now worried (among other things) about the potential for lawsuits if they sell individual mortgages—which are, after all, owned by other people--"at a loss." Congress needs to pass legislation that makes it clear that servicers are *not* violating fiduciary standards, but rather are behaving in a way that is consistent with standard industry practice, when they sell mortgages below face value in a depressed market. Because servicers may also be worried about jeopardizing their tax status as REMICs (Real Estate Mortgage Investment Conduits), Congress should amend the REMIC statute to state that REMIC status is *not* lost when mortgages are sold at discounts.[4] Indeed, these steps should be taken in any event. Should such legal measures miraculously reestablish a viable market in mortgages on their own, the rest of the plan need not be promulgated.

A miscellany

Finally, and very briefly, I want to mention just a few other "details" that need to be addressed and could be important.

- *Second mortgages*: Many homes in danger of foreclosure have second mortgages or some other subordinated lien on them. If the first mortgage goes into foreclosure, these seconds will presumably become worthless. Yet their owners have legal rights that can hold up FHA refinancings. This is a difficult problem, and some reasonable way to deal with seconds must be found.
- *HUD*: Doing this job via the FHA puts the entire operation under aegis of the Department of Housing and Urban Development, which would not have been my

[3] Such as H.R. 5579, the Emergency Mortgage Loan Modification Act.
[4] A January 8, 2008 letter from the SEC's Office of Chief Accountant may suffice to accomplish this. I am not enough of a lawyer to judge.

chosen venue for such a large, complex, *financial* operation. Careful attention must therefore be paid to proper staffing and oversight.

- *Ramp-up*: Once the legislation passes, this operation needs to get going as quickly as possible. During its ramp-up period, the new FHA might want to concentrate, e.g., on subprime ARMs because they are in the most immediate peril. But that restriction should be temporary. The problem is bigger than subprime ARMs.

Last word

In sum, there are details that still need to be worked out—some in the legislation and others in the regulations and procedures that will be developed to implement the new law. This is not flawless legislation. (What bill is?) Nor, as I said earlier, is the bill a magic bullet that will cure all of our financial woes. Life is not that simple. But the FHA Stabilization and Homeownership Retention Act is a fine piece of legislation, well crafted and well targeted. And I am proud to support it enthusiastically.

Thank you, Mr. Chairman