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ADDRESSING THE FORECLOSURE CRISIS:
A HAMILTON PROJECT POLICY DISCUSSION

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Welcome:

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Citigroup Inc.

Opening Remarks:

LAWRENCE H. SUMMERS
Harvard University

Roundtable Discussions:

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P R O C E E D I N G S

MR. RUBIN: Good morning. I'm Bob Rubin. I'm here on behalf of the Hamilton Project and on behalf of all of us we welcome you to our discussion of mortgage policy in the context of what our, very complicated as you well know, complicated financial market conditions.

We began Hamilton project in 2006. We began with a strategy paper with respect to the economy overall. The objectives of which were to promote broad based growth or broadly shared growth I should say, and increased economic security. We then had a number of events on specific topics: healthcare, energy, much else, which were based on papers that were prepared by well respected policy analysts and involved panels. The papers were subject to rigorous academic review. But we've also had two events which dealt with issues that were much more immediate and pressing and didn't allow for the timeframe that I just mentioned. And today we will be doing that for the third time.

Our prior two events were the financial market disruptions and then an event on the stimulus. Today's event as you know, deals with mortgages. We will be posing two basic questions. Number one, should additional measures be put in place in the mortgage area? Number two, what are the various possibilities and what are the pros and cons of each?

I'm not going to attempt to answer these questions myself, but what I would like to do is make a few observations that help to frame the issue. Before doing that though let me recommend and I believe you had this distributed to you, a superb policy paper on all of this by Doug Elmendorf who will be on the panel. It was released by Hamilton Project last week and it is entitled, “Weighing Alternative Policies for Tackling the Mortgage Mess”, which lays out the pros and cons of a whole array of options.

Let me start my observations with an obvious comment, which is the credit markets are very highly strained today. In my view the tendency toward cyclicality which seems to be inherent and inevitable in financial markets was exacerbated in today’s environment by a number of factors. The duration of the market expansion which resulted, lead to ever less caution. Low short-term interest rates which lead to reaching for yield. Massive and complex financial engineering, which I think played an important role in the duress we’re experiencing today. And triple A ratings that lulled market participants for the super senior tranches of collateralized debt obligations. And that’s independently of the question whether market participants should have relied on them or not.

The consequence of putting all of this together is a complex, highly strained and consequential set of conditions in the credit market. Moreover, in the credit markets if you have disruptions – today’s credit markets with this disruption, in any one piece of the market that has been tending to lead to more general loss of confidence and then disruption in other areas of the credit markets.

The result is serious economic risk and very, very importantly many families, especially low income families are facing the terrible possibility of losing their homes and that in turn is having an effect on communities more broadly.

Quite a number of commentators raised the possibility that financial market, that excesses were developing in the financial markets over the last two or three years. That certainly occurred at discussions that we had at the Hamilton Project, but I think few if any anticipated a serious likelihood of the complex of factors that have come together in the multifaceted credit market duress that we're experiencing today.

Credit market disruption as you know began with subprime mortgages and then spread to leverage finance and then to most other credit markets but although now, it's spread out to affect credit markets more generally. I think in many ways mortgages remain at the heart of today's credit market duress contributing pressure on housing prices, balance sheets, the lending appetite of creditor institutions, foreclosure rates, confidence more generally and other credit markets. In that context the policy makers are grappling with the question of whether substantial additional measures should be adopted with respect to the mortgage markets beyond those already in place and if so, should public monies be used.

As many of you know I work at a major financial institution, but the views that I'm expressing are mine. Not the institution's. And they relate solely to the question of economic risk and risk to homeowners.

With respect to economic risk, I've been around financial markets for a long, long time but I believe we are in somewhat uncharted waters and that the outlook for both the credit markets and the economy is relatively uncertain. It is certainly possible that the markets will work their way through all of this without inflicting significant additional damage on the economy. But having said that, I think the risk is serious enough to call for substantial additional action in the mortgage area assuming that measures can be adopted that when the pros and cons are weighed out, are on balance, sensible.

One question obviously is finding measures that have that characteristic. Another question is whether we should accept the undesirable side effects of moral hazard and bailing out as the Administration did in 1995 with respect to the Mexican financial crisis in '97 and '98, with respect to the Asian financial crisis because of the seriousness of the risks involved.

With that framework I look forward to the deliberations of our panel. Before introducing the panel let me thank the Hamilton Project staff. This was put together on very short notice and was done as these events are always done by our staff, exceedingly well.

Let me now briefly introduce our outstanding panelists. They are Michael Barr, a professor at the University of Michigan whose work is very heavily focused on low and moderate income households. Let me also note that Michael served in our Treasury Department and he was our leader with respect to community development and poverty.

Kenneth Wade, Chief Executive Officer of Neighbor Works America. A national network of more that 240 affordable housing and community development organizations. Ken has more than 25 years of experience in the very important field of community development.

Doug Elmendorf is a Senior Fellow at Brookings, Senior Fellow with the Hamilton Project and Doug has worked at the Treasury, the Federal Reserve Board, Congressional Budget Office, and the Council of Economic Advisors. So Doug is experienced.

And finally, Molly Sheehan, Senior Vice President of JP Morgan Chase and a member of the Executive Committee for its Home Lending Division. The moderator of our panel will be Larry Summers, Charles W. Eliot University professor at Harvard University and advisor to D.E. Shaw Group, a New York based hedge fund. Larry as you know, was former Secretary of Treasury, former President of Harvard University.

We're going to begin with remarks by Larry. Then we'll have our panel, then Larry, well at the end of the panel I will come back and with Larry for maybe 10 or 15 minutes have a more general discussion. Or I'll participate in the discussion with the panel, raise a few questions, and then at the end we will have questions from all of you.

Larry, it's all yours.

MR. SUMMERS: Thank you Bob, I want to make some comments placing the mortgage issue in the context of our general economic situation. These comments were prepared before the events of this morning; they are not made less true by the events of this morning.

I think there is now an overwhelmingly preponderant body of evidence suggesting that the economy is currently in recession and will be so judged by the NBR Dating Committee. If one looks at the monthly indicators on which it relies: employment, personal income, industrial production, the level of real retail and wholesale sales. They are all suggesting that we are currently in recession.

The question for forecasters and more importantly for policy now is how serious and how prolonged that recession will be. My judgment has been less optimistic than the consensus for quite some time and I continue to be seriously concerned about the economy's prospects.

In essence, what is happening to the economy now is the simultaneous operation of three troubling vicious cycles that are mutually reinforcing. The first which one might refer to as the liquidation vicious cycle is the process where the law of demand works in opposite directions. Normally in economics when the price of something falls, the demand for it increases. In the world of many securities today which are held on margin or are held by entities with scarce capital, when their price falls they are pressured to sell them and so the demand for them falls and when you have a situation where falling prices lead to falling demand you have a vicious cycle in the making with falling prices, falling demand, further falling prices, and so forth.

Second, you have the Keynesian mechanism characteristic of all economic downturns in which reduced spending leads to reduced incomes, leads to reduced spending and the cycle continues.

Third and less conventionally, you have in the current context what economists label the credit accelerator vicious cycle mechanism. Reflecting the reality that a weakening economy leads to lower profits, lower ability, reduced ability to service debts leads to increased financial distress, which leads to less lending and a weaker economy which leads to still further financial distress.

All three of these mechanisms are now operating with substantial virulence in the U.S. economy. This is very rare. In 1987 or 1998 in the LTCM period, the mechanism involving liquidation was operating at very substantial virulence, but because the underlying economic fundamentals were strong there was not nearly the same force in the other mechanisms. In previous recessions there was the Keynesian recession mechanism operative but there was not the large scale reliance of the economy on securitized finance that made the liquidation mechanism a major aspect of the situation.

To that extent we are in uncharted and troubling territory within my judgment a very real risk of the most serious economic downturn in a generation. By which I mean an economic downturn more serious than that in 2000 or than that in 1990.

At the center of the operation of all three of these mechanisms is the question of the capacity of the financial system to intermediate capital and to provide lending. The events of recent weeks suggests an increase in risk that the principal policy tool on which we have relied. Federal Reserve lending in one form or another to banks has the character of fighting a virus with antibiotics. It is not addressed to the central constraining element. The central constraining element increasingly appears to be that intermediaries with scare capital have a desire to reduce the size of their balance sheets and in any event can support only so much lending. If that is the case making available loans to them on evermore attractive terms will not lead to an increase in their lending capacity, therefore will not lead to increased support for asset prices and will be availing only at the margin in the same way that antibiotics with respect to a serious viral infection can be constructive in treating some opportunistic infections but do not address the core of the problem.

In my judgment, ultimate success here is likely to require, voluntarily or involuntarily, privately or publicly, means be found to infuse significant increases in capital into the nation's financial intermediaries so that they are enabled to increase the volume of their activities while remaining creditworthy so as to permit a resolution of these difficulties. I would note in this regard that the traditional emphasis on capital ratios, as important as it is, looks past a crucial aspect of the current situation, namely, that an institution under pressure to reduce leverage can do so in two ways: by reducing the size of its balance sheet or by increasing the size of its assets. If its shareholders are indifferent between those two at some point because increasing equity leads to dilution and a reduction in the value of existing shareholders, the nation is not. Adjustments achieved through increased capital may be less appropriate and less desirable for shareholders but are much more desirable for the national economy. For this reason, it is my strong suspicion that sufficient levels of capital will not be attained simply by relying on voluntary private action in pursuit of individual shareholder interest.

There is the real possibility of a fourth vicious cycle mechanism to compound the three that I spoke of, and that is falling housing prices leading to increased foreclosures, leading to an increased number of houses on the market, leading to a larger supply of housing, leading to further declines in housing. Whether this mechanism is currently operative or not seems to me very much in doubt. It is far from clear that at current prices, the housing market downturn has overshot what is necessary for a return to fundamentals. In any event, housing prices are currently down 10 percent, and the best available market forecasts suggest that they're likely on average nationwide to decline another 15 percent. At these levels, it is likely that as many as 15 million homes will have negative equity and projected foreclosures -- though there is not great experience with -- not great deal of historical experience with which to base judgments about foreclosures in the presence of negative equity -- are certainly in the two to three million range and perhaps more.

Policymakers and other advocates, including some of those on our panel this morning have rightly focused on a critical insight, namely, that the foreclosure process itself is enormously expensive. In many cases, the act of foreclosing on a home once all the transactions costs, the costs of the disorderly liquidation, are taken account of, can absorb as much as 40 percent or more of the value of that home, and so it is natural to seek -- to find ways to minimize the number of foreclosures, to reduce the risks of the fourth vicious cycle mechanism that I described, and, in any event, to alleviate the very real distress that concentrated foreclosures in particular communities may bring about. It is not clear to me that any approach to the foreclosure problem is sufficient to address the economic concerns that we are facing. It does seem, however, that finding constructive approaches to the housing market is necessary if we are to avoid a great deal of collateral damage, human suffering, as well as economic risk from the current housing downturn. And that's why I think it is very appropriate that the Hamilton project has convened a group of experts on the dynamics of the housing market, which are so crucial a piece of our underlying economic problem at this crucial moment.

So, why don't we move forward for the panel.

(Applause)

DR. SUMMERS: The organizers of this event have advised me that each of our panelists has particular recommendations that they feel would be very constructive at this particular instant, and so I'm going to ask each of them to speak for three or four minutes about the policy measure or policy area they feel is most important, beginning with Michael Barr.

PROF. BARR: Thank you very much, Larry, and thank you to the Hamilton Project and to Bob Rubin for inviting me here to talk about the current crisis. I think what you saw in the introductory remarks is that there is a growing consensus about the nature of the housing crisis and the crisis that spread to other credit markets. That's a kind of growing consensus that I think has been absent over the previous six-month period, and I think that helps move the process forward.

I think we're trying to figure out what to do about the current crisis that we're going to focus on today. We also need to take the opportunity to think about reforms in the mortgage market going forward and I'm encouraged that we're doing that.

The key principles I think, in terms of resolution of this crisis, as I see it are three-fold. One, we want to find a process to help unfreeze the capital markets and allow the flow of capital that Secretary Summers described to take place. The second is to find a way to get homeowners into affordable loans that are sustainable to reduce the threat of future foreclosures and the disruptive harm to neighborhoods; and, third, that we want a set of proposals that's based on the ideal of shared responsibility -- shared responsibility among the market borrowers and the government for the crisis we're in, because I do think that there are plenty of problems in each of these ways.

I've been working with colleagues at the Center for American Progress on a proposal called the Safe Loan Plan to try and address this problem, and it's a proposal that has formed a conceptual basis now for Chairman Frank and Chairman Dodd's legislation that is being introduced this week.

The key features of this plan are threefold. One, a process to arrange for the bulk transfer of mortgages that are potentially in distress from their existing holders that face immense conflicts of interest and legal and tax barriers to the prompt and efficient restructuring of these loans to arrange an auction process for those assets to be transferred to new holders, to new lenders. That auction process would permit the loans to be transferred at a steep discount to current investors if there's no bail-out and would be allowed to be transferred in a way that opens up the space for the second key element, which is a restructuring of these loans on affordable terms to borrowers, terms that make it much less likely that there'll be default and foreclosures. And the third key element is a proposal to get funds into the hands -- through state and local governments into the hands of local nonprofits and others that can help deal with the very real crisis in neighborhoods in foreclosures that I'm sure Ken Wade will talk about is really desperately needed across the country. And I think with those three key elements of an auction process for bulk transfers efficiently transferring assets at a steep discount with no bail-out to terms away through FHA and the GSEs to get new affordable loans through expanded programs. And three, an effort to help our local communities. We have a chance of lessening some of the harms that are already occurring and are going to get worse across the United States.

DR. SUMMERS: Thank you, Michael. Could you just describe one particular aspect of the proposal? Does the homeowner put up his mortgage for auction? Does the servicer put up his mortgage or put up a collection of mortgages? Who's buying at the auction? Who's selling at the auction? If you could just say a word -- say a few words about how the auction works.

PROF. BARR: And you know, I think that's a critical point that it's not a borrower-initiated loan-by-loan process for the auction. It's a bulk process in which the servicer puts up a collection of loans, a sub-pool of loans, for auction, and the buyer, a lender -- a new lender -- purchasers invoke a pool of loans, and that transfer permits a much more efficient process than what we're currently seeing of a loan-by-loan process of modification, which, if it continues at the pace that -- even the more rapid pace of the last quarter that's been continuing on will not get us out of the current housing crisis. So, this is a process for loans to be transferred as pools from one private holder to another private holder through a Treasury or Federal Reserve auction. The new holder of the loans or the opportunity to refinance these loans in affordable terms through an expanded program of FHA and the GSEs.

DR. SUMMERS: I guess just to ask one more question about the mechanism, because it's obviously at the center of it. If I were to try to auction my wallet off among the people in this room, the auction probably wouldn't work very well, because all of you would assume that at any price I was willing to sell you probably didn't want to be willing to buy because I was informed about my wallet and you weren't. In the same way, the servicer probably has a relatively clear idea of what the mortgage pool is like and the potential -- how do you assure that the potential bidders are well enough informed that you can sort of have a real and effective auction?

PROF. BARR: So, a key part of the proposal is that the existing holder would be required to provide all of the loan level information, servicing information, and other records that the servicer currently has. So, for example, you could use as a proxy for whether the property is truly owner occupied the data on whether the tax bill is being sent to the same address as the mortgaged property. You would have full information from the existing servicer together with certain representations and warranties about that information. That would be available to all potential buyers prior to the submission of a sealed bid.

DR. SUMMERS: Maybe we can come back, because this is obviously a set of ideas for doing this.

I'm supposed to call on Doug Elmendorf next.

Doug.

DR. ELMENDORF: Thank you, Larry.

A central theme in my thinking and writing about the mortgage mess since the fall, and I think in other people's thinking and writing as well, is that maybe families that will face foreclosure deserve public health and with a modest amount of help can stay in their homes, while other families who face foreclosure are less deserving of government help and are not capable, with any reasonable amount of help, of staying in their homes. That is unfortunate, because every foreclosure is painful for the families involved and also for the neighborhoods and communities in which they live, but I think it is an unfortunate truth, and it implies that solutions to the mortgage mess need to be able to distinguish among households.

I'm going to elaborate briefly. The reason I think it's an unfortunate truth several-fold. To start with, we need to remember that even in very good years, many families lose their homes because they've entered into mortgages that are not sustainable. In the earlier years of this decade when the housing and financial markets were doing well, a quarter million to half a million families lost their homes each year. In the last few years, the sharp deterioration in underwriting standards for mortgages suggests that even more households end up mortgages that they cannot effectively sustain. In addition, unfortunately some families bear some culpability for the situations they're in. Those families that are underwater with their mortgages, that will be underwater with their mortgages, are disproportionately those that borrowed a very large share, put little money down when they bought a house or those that refinanced and withdrew much of the equity that they had.

And a third problem is that any effort to help all of the households that will be underwater with negative equity, which may be, as Larry mentioned, 15 million households, any effort to help all of them while they involve a tremendous amount of money or will provide not enough help per family to effectively change their circumstances.

So, that implies to me that, as I said, any approaches for dealing with the mortgage problem that we should pursue are those that can distinguish effectively among households.

With that in mind, there are five particular paths that I think make sense. The first -- this is not at all controversial -- is that we should support all of the mortgage counseling that can effectively be done, and we should increase government support as much as the right people can be trained and put in place and do their jobs.

Secondly, I support the cause for mortgage services to write down a principle and the many cases where that will be less costly for the investors than going through a foreclosure proceeding. I think it makes sense to clarify the legal liability of servicers that they are responsible for maximize the total payoff of the mortgage and need not worry about maximizing the payoff till each individual holder of some piece of that mortgage, which is perhaps impossible given the complicated forms and derivatives.

Third, I think it makes sense to direct money to states and localities to help with their local problems, although I have several concerns that I hope are partly addressed by this panel. One is what sort of money can be used and how would it be used effectively to help in communities; and, secondly, do we have ways to direct money to the right states and localities, because of course the foreclosure problem is not a national average but is very concentrated in particular places.

Fourth, I have reluctantly come to support reform of bankruptcy law. I think there is a particular reform as to allow bankruptcy judges to write down the principle on mortgages of people in bankruptcy. I think that will have some deleterious effects on future credit supply. I think it will induce additional bankruptcy declarations, which will have other spillover problems. But I think this here proposal has a key advantage, which is that it targets health on the families most in need of that help.

And, fifth, I support expanded eligibility for FHA refinancing. To use FHA Today, you need to be either current with your payments or delinquent only because of a rate reset. We can expand eligibility rules to allow people who are delinquent for -- on fixed-rate mortgages or with adjusted rate mortgages for other reasons besides a rate reset. It's worth limiting this eligibility to households that have had some history of making mortgage payments. We want to avoid households that just bought a house and immediately weren't able to make payments and are clearly playing some sort of game. But we can -- if we limit it to households that have made some consistent set of payments but are delinquent for a variety of reasons now, we can expand eligibility quite significantly, and that will -- I think that is really the crux of Barney Frank's proposal to use the FHA as a way of stimulating people to stay in their homes.

I think I should stop there.

Thank you, Larry.

DR. SUMMERS: Doug is our panel economic expert.

I have two questions for you.

DR. ELMENDORF: (Inaudible)

DR. SUMMERS: Oh, no, no. No, no, you --

MALE SPEAKER: What do you really think?

DR. SUMMERS: I'm just a humble -- I'm just a humble ex-bureaucrat.

You said quite lightly that -- you referenced two things that are happening right now. One is the deteriorating underwriting standards in 2005, 2006, 2007; and the second is that we're having sharply falling house prices. And both of those are contributing to heavy increases in the number of foreclosures and the number of people who are underwater. Do you have any sense of if you wanted to say the foreclosure rate is up fivefold roughly from 250 to a bit over a million, how much of that is because we used to have rising prices and now we have falling prices? And how much of that is because lenders went crazy in 2005 through 2006? Do you have a sense of the relative importance of the two factors?

DR. ELMENDORF: That's a great question. Unfortunately, I do not have an answer. I don't how to break that down. I think -- one thing I would note there is that there's a correlation I think across regions, so the regions that had -- the lawyers ran up the house prices also had the greatest relaxation underwriting standards, because people were reaching to try to afford these very expensive houses and the lenders basically went along with that without being sufficiently cognizant of the risks. So, I think the foreclosure problem is accentuated by the fact that the places that have had the largest run-ups in house prices are likely to have some of the largest declines -- are also places where people were in fact most leveraged. I think that probably increase --

DR. SUMMERS: But I (inaudible) some of the failure of underwriting standards was the failure to appreciate the house prices could start going down as well as up, so they interact.

My other question was whether you had studied or examined -- FHA has this rather large -- has this fair-size portfolio of currently guaranteed mortgages. I think it's probably -- can safely be assumed that the FHA doesn't operate on a heavily mark-to-market basis. Does one have a sense of the magnitude of the liability that in fact the government is bearing with respect to the past activities of the FHA, I mean, which did do a lot of guaranteeing 97 percent -- 3 percent -- 3 percent down mortgages on low- and moderate-income properties. Do we have a sense of the magnitude of liability that they already have but the FISK hasn't faced up to and of how large the liability would likely be per extra some amount of lending that they were going to take on?

DR. ELMENDORF: I think the liability now is not particularly great, because the FHA did not do much lending over this period of particularly large run-up in house prices. Their share of the market was quite small. But it's undoubtedly true that if we expand FHA eligibility and have them take on hundreds of thousands of additional new mortgages now at a moment when house prices are heading down, not up, that raises greater risk, and I think it -- what the -- this depends crucially on how one sets the parameters of what the FHA can do. There's a tradeoff here. The larger loan to value ratio the FHA will allow, and the more people will be able to afford new mortgages and be helped. But the greater risk the government is taking on. And the tighter the FHA makes its process, the tighter the writing standards, the greater down payment required, the safer government's FISK will be, and the fewer households can be helped.

Barney Frank in his proposal as I read it, and it's a work in progress, as he says I think strikes a balance in a pretty cautious way. So he says that the households -- the FHA will only refinance this greater set of households the loan to value of 90 percent, and they will actually only pay 85 percent of the value of the house to the lender getting out of the loan and keep that 5 percent as a buffer to protect the government from the risk. Also the government will take something that's called a soft second, which is to say that it will take some piece of appreciation after that if there is any. My guess is that's not worth very much today given the declining house prices that we expect and, again, particularly that we expect larger declines in the areas where more people will probably avail themselves of this option. I don't think it's worth very much, but it's probably worth something. I think the more important part probably is to limit this to a loan devaluation of 90 percent. Now, that's not great; that's what we used to think of as a pretty loan devaluation, but it's not the 97 percent at least that you mentioned.

DR. SUMMERS: Molly.

MS. SHEEHAN: Okay. I want to echo some of the comments that have been made by the other participants on the panel. I think there is a great opportunity for us to continue to develop solutions in an iterative way the way we have been over the last year and, you know, attempt to address the problem, not just one big silver bullet but a series of solutions. Some of those solutions are (inaudible) already through the Hope Now Alliance, Economic Stimulus Recovery Act, the actions of the Fed -- all of those things that have been ongoing and have already eased the severity of the situation. But I agree that we have a very long way to go. We definitely support pushing FHA modernization over the finish line.

It's been close for several months now, but I think it's very important, particularly in the current environment, because not only the opportunity to refinance existing customers but, really, new customers who need loans are going to look into FHA because the conforming market has tightened credit very significantly in the last several weeks, and the market spreads on the GSEs have gone up so that the price that's available to the consumer. Frankly, the best deal in town right now as we speak on our rate sheet is FHA.

And I think also in line with what Doug said, there is an opportunity, I think, to do some modest modification to the current FHA secure program and to make it available to more homeowners who need to refinance, and the type of modification is exactly what Doug was talking about. There's some very, very particular requirements that could be tweaked.

We also think it's very important, whether it's in the context of FHA secure or in the context of some of the new proposals that we see coming out there, that we be very mindful of the risk to the fund and maybe think about whether there's an opportunity to treat the mortgage insurance premium differently in the case of those riskier loans and not use the standard 1.5 that's used across the board today.

So, those are some things that we've been thinking about. In addition to that, we do support Senator Schumer's ideas. I think he's had some excellent ideas about funding the counselors. We have through (inaudible) now found that our relationship with the counselors has been tremendously beneficial in reaching to homeowners and getting them in to talk to us about their options in terms of restructuring their loans. So, I think the counseling process that we've put in place is very, very important and deserves to be supported.

I also believe that the proposals to give the local state housing finance agencies additional funding and caps through their -- you know, through their bonding authority could be very, very beneficial. I know a number of them have spoken to us about the opportunities that would be there, but it requires two things. First of all, they need to be able to make those programs available, not just for purchase or first-time buyers, which is traditionally what they've been used for, but also for refinancing existing customers; and, secondly, they need some additional room in their caps, which are set by legislation.

And I do think we have to confront the problem collectively of how we deal with negative equity. There is today no standardized methodology across the industry dealing with determinations around who is deserving of a principal breakdown on their loan. I think as we learned with the ASF fast-track framework for loan modification, to the extent the servicers have an accepted process to go through and evaluate the portfolios that they service on behalf of their investors, that will help them make those determinations as to what's in the best interests of the investors and also help deserving homeowners. So those I think are the major points I want to make in my opening remarks.

DR. SUMMERS: Molly, I'd ask you two questions. One, JP Morgan has been a leader in talking about and addressing these issues. At this point I don't know the facts, but as I understand it, JP Morgan holds a rather substantial mortgage portfolio. In how many cases has there been a multiyear reduction in the interest rate on mortgages and in what percentage of your mortgages has that taken place and in what percentage has there been a reduction in principal?

MS. SHEEHAN: Let me talk about the modification process first. Maybe that would be helpful. I would note that we think of our portfolio as large. Compared to our servicing portfolio, it's actually quite small. So if we service approximately $750 billion worth of loans for others, we service $20 or $30 billion for Chase. So on a relative basis, our portfolio is small. Clearly we have a lot of flexibility where we both own and service the loans. We have the ability to go in to look at the rate resets, modify them into the life of the loan at a fixed rate. That's a very easy process to do. We've done that for Chase. We've also done that for other portfolio lenders that we service who have come to us and said we would like to take all of our ARMs and reset them for the life of the loan. So there's a lot of opportunity in those kinds of situations where you're either dealing with loans that you own or loans where there's a clear party on the other side whether it's Fannie or Freddie or another public investor.

In terms of principal reduction, I think until recently that wasn't something that was actually top of line, it certainly has not been an industry standard only because frankly we haven't had this problem of rapidly depreciation in house prices since securitization became an accepted practice. So there's a lack of clarity around that. Again, when you're working in your own portfolio, it is a very easy thing to go in and make a judgment. You know a lot about that borrower. Frequently it's a customer. It's very easy to go in and make that determination as to what's in your own best interests and the best interests of your customer. It becomes more complex when you bring the third parties and the trusts into the equation and that is part of what I think we need as an industry, regulators, government, to deal with as we sort of seek these solutions.

DR. SUMMERS: I guess I'm trying to ask a little more quantitatively. I don't know the facts. There are a lot of people out there who claim that the hope now and that the other voluntary initiatives have really been very small in terms of what's actually happened and so I thought JP Morgan was maybe a good test case for seeing whether that was different particularly since you had a case where with $30 billion that you both owned and serviced, some of the traditional problems that people are worried about didn't exist. So maybe to ask the question a different way, if the typical interest rate on these mortgages is around 8 percent, then $30 billion of mortgages would be around $2-1/2 billion of payments a year roughly. If you look at all the adjustments you've made and what they've done to that $2-1/2 billion of payments, would it take it down to $2 billion, to $2.4 billion? Do you have a sense of how much this has actually been felt on the ground with respect to your portfolio?

MS. SHEEHAN: I think in terms of the Chase portfolio, most of those loans were probably not as high as 8. At the time that they were put on the books rates were lower. And I would say the bulk of the loans that have been fixed through the life are coming in in the 5 to 7 percent range, actually not far off the prime rate today.

DR. SUMMERS: But I guess, how much saving has there been? The question I think a lot of people are interested in, have there been meaningful savings as yet for consumers relative to what would have happened if all the resets had just happened as scheduled and is there any quantification of those savings? That's I guess a question that a lot of people would be interested in.

MS. SHEEHAN: I don't have the dollars, but I think if you think about it, when we look at the fast-track analysis we were looking at people who were going to experience a payment shock of approximately 30 percent in their monthly payment. And if you take that same borrower and you just fix them at their initial rate, in essence the savings is the difference between that monthly payment and where it would have reset, the savings to the consumer.

DR. SUMMERS: How many times have you done that fast track and saved the people the 30 percent?

MS. SHEEHAN: We have done that on our own portfolio for the last year now and we do it on a rolling basis. And we have done that for a number of other investors, and we're talking about tens of thousands of loans, not just a few.

DR. SUMMERS: Tens of thousands of loans on the $750 billion?

MS. SHEEHAN: Right.

DR. SUMMERS: Ken?

MR. WADE: I thank the Hamilton Project for inviting us to be here. We don't have a specific policy proposal as such, just some elements that we think need to get addressed in the context of whatever will eventually happen.

I think the whole issue earlier on, earlier on meaning in the year, about whether there ought to be any government intervention seems to be somewhat a settled question. I think the market is in such condition that I think everyone suggests that something ought to be done, and some steps have already been taken. Obviously the work that the Fed has done with interest rates, the work that the treasury secretary has done with the lenders and the investors and the Hope Now Alliance is in a sense government intervention. And then as well Congress did appropriate some funding that we're administering to support more counseling out there to help consumers.

It is pretty clear that the challenge that's happening at street level in working with consumers is clearly complicated by the way that these loans are securitized. You've got a variety of challenges that we're up against and I think as one counselor described the process right now, it's like hand-to-hand combat. You're working with one consumer and a servicer on a one-off basis without a lot of guidance about what's possible, what the rules are and the like.

Clearly we have an historic challenge with moving the servicing practices so that they're much more flexible. There are limitations driven by the rules in these securities. I was in one meeting and the issue of prepayment penalties just to give you an example of how it plays out came up as an issue and folks said why you can't you just waive those. Someone said you got to remember, we sold that cash flow to somebody. We can't just give that away. So it's a very complex set of issues that we're struggling against. Then you don't have unity of interest among all the investor classes. So what you might do with one group may not be in the interests of the other. So it seems that the servicers are somewhat concerned about opening themselves up to litigation and not being more flexible than they could be.

Clearly we've got to be able to create, number one, an opportunity to refinance people into loans. We think the driver ought to be the borrower's ability to pay and we think you can construct a framework where you can look at a consumer, it gets back at the issue of in a sense who's worthy of assistance or maybe a better way to say it is who's really in a situation that you can create a sustainable homeownership opportunity with, and those folks who eventually will likely go to foreclosure anyway. So we think you can construct something that's based on the borrower's ability to pay. We have a tool that we're piloting right now. We call it the Best Fit tool. It will allow the counselor to work with the borrower. Obviously they have to document the current borrower's income. That's a problem with a lot of these loans. As you know, a good portion of the loans that are in trouble are these no doc or low doc loans. So you don't even know what the consumer's income is in a sense today. It also has an automated valuation tool built in so that you can be able to understand what the current value of the property is today and not when it was taken out. And then it has the ability to do some fraud detection as well to make sure you're dealing with an owner occupant and not an investor. We think if you have those elements and something that's done like this that can be done in an automated way you can expedite at least creating a profile of the consumer that you can put into a sustainable mortgage in the long term.

Clearly we've got to be able to get mortgages either out of these securities or some other vehicle that would allow for greater flexibility because currently they're just stuck the way that they're constructed today. And then we've got to have some tools whether they be expanded authority of FHA or the VA in order to be able to refinance people into sustainable mortgages that will work. And then the other element that we think is critical which has been touched on is obviously we've got to be able to address the rising inventory of REO because if we don't get a handle on that particularly because that's going to be concentrated in certain types of communities and neighborhoods, it will just lead to further destabilization of the communities. And so while you think you might be making progress in one arena, it's only going to further exacerbate the problem. And in past cycles we all know what's historically happened. The properties get dumped back on the market, investors pick them up, they throw a little bit of paint on them, they often times end up being foreclosed on two and three times again, and really it doesn't help create stability for the market. So those are the things that we're seeing that have to be critical to whatever the next wave of intervention would be as we go forward.

DR. SUMMERS: The REO as you referred to as I understand it refers to the inventory of previously foreclosed properties, to be clear.

MR. WADE: Right.

DR. SUMMERS: I understand that because I just asked, so my understanding has been 20 seconds in duration. The dump it back on the market, you don't like that policy. What types of policies would you favor with respect to the foreclosed properties? Some people would worry that as long as there was an inventory held off on the market that was about to be dumped on and it was going to be dumped on the market at some point, it would be hard for the market to find a level where it was attractive to buy.

MR. WADE: Right.

DR. SUMMERS: So what type of approach would you favor with respect to those foreclosed properties?

MR. WADE: A few things. As Doug mentioned earlier, it does play out differently in different markets. Obviously the industrial Midwest has a different kind of challenge than Florida and California. So I think you do have to have to a certain extent a market-specific approach as to how you take a run at this. We're working with a couple of other national nonprofits, Lisk Enterprise, the Housing Partnership Network. We're going to create a vehicle that we can bid on these distressed assets because we think that there's still great opportunity. The affordable housing needs have not gone away in this country. And we think that organizations like that can put this inventory back out so that it's either affordable rental or affordable homeownership opportunities in these communities.

In addition, there are some communities that are struggling with the issue of how much population they will have in the near term, so we know that cities like Cleveland and others are struggling with that issue. There is some notion that amount of that inventory will likely be scheduled for demolition because they have to find that new equilibrium for where the population can support whatever the number of units will be.

Then in addition we think that you in some cases will have to be able to purchase loans themselves. We have heard anecdotally that there are certain servicers that are not even foreclosing, they're just leaving their houses out there to sit maybe hoping that the city will take them for taxes or something. They've already got enough REO inventory in certain places and so adding more doesn't really help them at this point so they'd rather just let the asset sit, and that becomes a problem in another kind of way because it's creating a limbo situation where you really can't even get at the asset. It usually ends up being a place that's a magnet for crime where people go in and strip out all the copper and the siding and all of that.

DR. SUMMERS: In the last case, if they're not foreclosing and they're leaving it in limbo, maybe I'm missing something, why isn't the person who lived in it continuing to live in it?

MR. WADE: What's happened in those cases as we understand it is obviously the foreclosure process began and in most cases that borrower left. They left the property. And so rather than foreclose, they just let the property sit.

DR. SUMMERS: I see.

MR. WADE: Why take another property on your books that creates that kind of problem for you when you've already got a bunch in certain communities?

DR. SUMMERS: What's your interpretation? Your organization is very close to the ground in a lot of these situations. One of the things that's sort of surprising in at least some of the press accounts on all of this is they say that 50 percent, I have no idea whether this is true but it's a claim that's sometimes made, of the people who are foreclosed never contact the bank, never answer a phone call from the servicer, never call a counselor, just resist any and all contact and then are foreclosed. Some people have the suspicion that some of those people are probably not really owner occupiers or were investors or had misled on the form and don't want to get in a lot of dialogue with people who might discover that. There are I suppose other interpretations about people being intimidated by the system. How would you interpret that 50 percent figure and what it means for thinking about working on the ground in these situations?

MR. WADE: There is no question there's a small slice of that group that are probably investors or people involved in some kind of other fraud activity. No question about it. But the work that we've done definitely supports the notion that there are a good number of owner occupants who intended to be homeowners for the long term that don't respond to the servicer, that don't respond to the phone calls, the mail that gets sent out. We've done focus groups. Freddie did a Roper study that kind of tried to get at what it is that is going on with the consumer and they they're not responding. I think it's pretty clear that there are a number of things.

First you got to understand the whole notion of how the collection field works. It's not a very consumer friendly interface. These folks, their job is to collect payments. They are typically incented that way. So usually they're calling to ask the consumer how much can you send me. When people are behind in their mortgage they're usually behind in other consumer debt too. So it's a number of folks that have been hounding them as they describe it for a good number of months and they're just not anxious to talk to anyone.

There are other folks who assume that they can work things out on their own and eventually things will correct. Others have said that they think that by contacting the lender it will only accelerate the foreclosure process so why would I want to do that. And then people being in denial.

In addition to that, the study we did with our affiliate in Chicago, when people finally reached out for help, they were often times so far in arrears that there was very little you could do with them. So a number of years ago in Chicago the average consumer was 5 months behind when they finally showed up at our local affiliate for help. And I think the hotline figures are similar. That number is coming down as more work is being done to encourage consumers to contact someone for help and that's why we were instrumental in launching this public education campaign with the Ad Council to reach out to that sector of consumers.

DR. SUMMERS: Do any of the panelists have comments on the other panelists and other parts of the discussion we've heard? Doug?

DR. ELMENDORF: May I ask a question?

DR. SUMMERS: Yes.

DR. ELMENDORF: I'm curious about the role of second mortgages. I thought maybe you could address that. My understanding is that many of the families that have negative equity in their homes, it's not just the first loan, but they have a second loan on top of that. As I understand it, part of the problem in working out mortgage modifications is that the second lien holder will be a different institution or servicer perhaps than the first lien servicer and that there's not a lot of coordination and it's very hard to get that together. I wonder if that is a problem and also how ideas like FHA expansion will navigate through that problem.

DR. SUMMERS: If I could add slightly to the question, there's a question of coordination with each other, but there's the reality that if we take the Frank thing for example just to sort of go through the numbers, if I had a $200,000 mortgage and I'm in this plan and we're discussing this all with respect to me, it's probably because I've got negative equity in my house so I have $200,000 in mortgages, so let's say I had $160,000 first mortgage and a $40,000 second mortgage. If we're discussing this with me it's because my house is only worth $180,000. According to the Frank plan, the new amount is going to be 15 percent less than that so that $180,000 is going to be $153,000. So if we do this plan, it's over for the second mortgage. It's worth zero. It's for sure game over finished. You can coordinate it all you want, the second mortgage owner gets zero in that case. The question isn't just a matter of getting him to the table because the path that's being advocated wipes him out. So how do we legally achieve his being wiped out if that's our goal?

PROF. BARR: I think that if you look at the economic reality of these seconds now, they're economically gone. So the question is how do you develop a process for recognizing the economic reality. It seems to me there are two ways of doing that, two options for doing that. One is effectively trying to through the option process include a provision for a small partial payment to the second in exchange for participation which is embodied in part in the Frank plan. The second is effectively having a cram down process for the seconds as a condition of participation in a new program, and I think that anybody's plan that deals with how to get out from these mortgages is going to have one of those two things in it.

DR. SUMMERS: To just pursue it for a second, and you may want to come in here, Molly, the second seems to have a pretty strong hold-up right. At one level this thing may not be worth at lot, at another level they've got the ability to block something that's pretty good for everybody. There are a lot of people who do very well in life being in the hold-up business.

PROF. BARR: If you ask my judgment about which of those two options is more likely to occur, it is much more likely --

DR. SUMMERS: Is there a legal framework contemplated to achieve cram down, and that just means in a situation of financial distress telling somebody that they thought they were owed $100,000 but actually now they're owed $30,000? That's called cramming them down. Is there a theory of how to achieve cram down absent the individual going bankrupt? In other words, do we have some legal mechanism for achieving cram down without bankruptcy?

PROF. BARR: You would have to as part of any legislative solution along the lines of the Frank bill or others include in that a mechanism that again either contains this partial payoff option as a voluntary matter or partial payoff option as a legal matter. Then you're shifting some liability risk from the private sector to the public sector. Then the question is was the mechanism consistent with the due process rights of the second holder. You probably don't want to go into the whole legal issue.

DR. SUMMERS: You're right, but I'm going to ask one more question. You can write in a mechanism that says when these things happen, second mortgages will get paid off 15 cents on the dollar and the government will offer that. That's easy. If the second mortgage holder is inclined to say no, without getting into something that's fairly egregious on abrogating contracts, is there some mechanism for forcing them to say yes other than bribing them an amount that will make it feel attractive to them to take it?

PROF. BARR: Again I think there are these two options. There's the partial payoff option which is voluntary, and there's the partial payoff option which is the equivalent of saying a loan that goes through this process of refinancing whether directly or through an option process is the equivalent of foreclosure. So you would in that second option have a legal mechanism for doing it, and again there is some liability risk associated with that.

DR. SUMMERS: Does anybody know what fraction of these houses have second mortgages?

PROF. BARR: It depends on the portion of the market that you're talking about, but if you look at Alt A ARMs or subprime ARMs, it's in the neighborhood of about a third, sometimes up to a half depending on whose portfolio you're looking at.

MS. SHEEHAN: I was going to say typically today it's essentially a case-by-case negotiation between the second lien holder and the first lien holder who is looking to get a subordination of that second lien in order to effectuate a new refinance. Normally that would be an economic type of analysis. So if the consumer is going to get a lower payment and they're going to be in a better place as a result of the refinance you would think that would benefit the second lien holder and encourage subordination. So I think a lot of this is going to have to do with how much it will improve the position of the consumer, and that may help that issue. Clearly back to your original question, yes, there is a coordination issue and I think we've been talking about different industry solutions for how we can manage that process.

DR. SUMMERS: Are there other questions or comments from the panel?

PROF. BARR: I would just say that I think that there is a lot of agreement on many elements of the program both in your introductory remarks and in Bob's introductory remarks, both in the understanding of the problem. So I think the kinds of issues we're talking about now are really how do you make any of these particular things work in the world as opposed to five principles where there seems to be quite significant agreement.

PROF. SUMMERS: Let me ask you or Doug or anybody who wants to comment. I've been having a little trouble thinking through the relationship between this discussion and the kind of more macro discussion that people engage in that I spoke a little bit about in my opening remarks. Michael, suppose did your plan in one of its evolutions and suppose we did it successfully and it realized all your hopes. It is clear that a great deal of community distress would have been avoided and it's clear that there would have been enormous gains to families and a tremendous amount of economic inefficiency would have been avoided. Is it your analysis or instinct that house process in an aggregate in America would have been caused to fall significantly less and that this is propelling them downwards further? If you looked at the aggregate value of mortgage-backed securities which is well in the trillions of dollars, is the feeling that supporting these writedowns in this situation would have a quantitatively significant impact on that? This doesn't go to the merits of doing it which I think are heavily argued in terms of the benefits for communities or individuals, but in terms of analyzing it, to what extent would taking some number of hundreds of thousands of mortgages through a principal reduction process impact the broader macroeconomy?

PROF. BARR: I think that you're right to focus on that question and I agree with the set of comments you made in your introductory remarks about the limitations of monetary policy and fiscal policy in getting us out of the crisis. I think that the argument would be that the transparent repricing of these pools would improve the efficiency of the capital markets and help unfreeze the capital markets, help reduce the uncertainty in the capital markets, and if you had this not loan by loan but bulk transparent repricing of assets, you can help avoid the problem that Japan had in the early 1990s where it had run through its fiscal policy tools and instead of trying to look at it transparency repricing of assets, they were pumping fake money into the system. So I think what the auction process is designed to do in terms of the market perspective is to have that transparent repricing of assets occur.

PROF. SUMMERS: I guess that depends in part on your answer to my first question when you started when I raised the question of who was going to bid. I raised the issue of if JP Morgan is selling, why are you buying since they presumably know much more about it than you.

PROF. BARR: I assure you I won't be the buyer.

PROF. SUMMERS: And your answer was they'll give you all the data on all the stuff that's underlying it. The question is whether that constitutes enough when you haven't been the person in possession of the actual relationships and all of that to constitute transparency that you would get a good and attractive set of bids, and that's in a way the premise of the auction idea.

Say something about the relationship between your auction idea and as I understand it some of the legislate proposals in which the government is the buyer rather than through this auction mechanism and their relative merits.

PROF. BARR: The structure of the auction at least in our auction at least in our conception now is that it would be faster, easier, more feasible, and more efficient to have private purchasers of the mortgages. For some obvious reasons, the private purchaser is probably going to be a better judge of price and quality of the pool. You have the potential for many, many bidders instead of having a single buyer for the mortgage pools. The risk is transferred only according to the government rule for the new refinanced program and not for the whole pool of loans that may or may not be eligible. And you can rely on existing market institutions. So for those reasons I was quite attracted to the idea of having private parties on either side of the transaction with Treasury or the Fed providing the transparent pricing platform and then FHA and the GSEs making additional financing available as an exit strategy for the loans that qualify.

DR. ELMENDORF: Larry, can I tap into your macro question?

PROF. SUMMERS: Sure.

DR. ELMENDORF: I think I'm more skeptical than Michael. Partly I'm less persuaded that the auction of these pools is going to work effectively so I'm not sure that as your stipulation. But also my own instinct, and maybe I should defer to others in the room, is that the financial market freeze-up is not around the amount of the subprime losses themselves which as many people have noted are fairly small relative to other financial magnitudes. It's around two things. One is the spillover, the sudden realization that mortgages might not be paid off seems to have reminded that financial market participants that have invested in a lot of assets in a highly leveraged way in the last several years that may not be paid off. So probably what we have seen is simply a recognition of risks in lots of other asset categories and there is no reason to think that's going to be pulled back in by resolving mortgages.

Secondly, I think is just the magnification of a given amount of basic subprime loss into looking at very large gross losses and gross gains for other people, but there is an asymmetric effect of that so that the gross losses are the things that push financial institutions into illiquid and potentially insolvent positions. So that magnification I think is really the problem in a way. It's the way in which a several-hundred-billion-dollar problem has become a several-trillion-dollar problem and I think that unless the government were to buy up all of the outstanding mortgages and guarantee that all mortgages would be paid off, it seems to me there will still be a sufficient amount of uncertainty about just how far house prices will fall and how much mortgages will be paid off, enough uncertainty remaining that with the magnification of that problem given the fear in markets today that a lot of that fear would still remain. My view I guess is that the right proposals are very good for the people directly involved in the communities and so on and are directionally correct for the aggregate problems but would not be a particularly large step toward resolving the aggregate financial market concerns.

PROF. SUMMERS: As you were speaking one way of thinking about it occurred to me, I'm not sure whether it's right and let me try it on you. One of the things that people sometimes say in advocating these proposals is there is no bailout element for investors. If it's actually true that there is no bailout element in investors, what that means is that the value of these mortgage securities isn't going to go up in value as a consequence of the government doing it. And if that's true, then presumably you're not going to derive any of the macro systemic financial concerns. To the extent that by making a market in these the government is in fact raising the value of these securities, then that might be availing with respect to reducing the burden in the capital markets but then it wouldn't be right to say that the government is coming up and buying things that a lot of people hold and the price of that is going up and then it probably wouldn't be right to say there was no bailout. But it seems like you can't have it both ways, that there's no bailout and there's collateral macro economic benefit to the financial system. Is that fair?

DR. ELMENDORF: Can I try to have one and a half ways? I think you're right that it can't help the general financial system unless it's helped some of the people holding particular securities. I think the other aspect though of whether it's a bailout is whether the government is losing through this deal. If the market is functioning efficiently and appropriately, then our normal instinct as economists is to say if we're helping somebody raise the price of their asset we're giving something up. But if we think that financial markets are behaving in an hysterical way, then I think it's possibly that by providing access to the sort of mortgage that people might have had available in many past years through the FHA that we can make people better off without actually taking on any unusual risk for the government. So it can be helpful to households and helpful to financial institutions not necessarily at the expense of the government because we're simply trying to return the market to more normal composition.

PROF. SUMMERS: So the idea there is either that the government has figured out that these things are a really good investment and is buying them and so it's not really a bailout because it's a great investment for the government and the government has figured it out and other people haven't. Or more likely that the government is able to be a larger actor and is able to finance itself in better ways and so there's this attractive investment that everybody would make but they for various reasons can't make it and the government is going to make it and therefore it's going to be profitable for the government.

PROF. BARR: Or just to be consistent with Doug's one and a half, that there are inefficiencies in the system and by squeezing down the dead weight loss to the system even if you're squeezing down in a way that transfers some of that benefit to the existing holders on net it's not a bailout.

MS. SHEEHAN: I also think there's another way to think about it in the sense that these properties are spread among many, many different pools of securities which cause those securities in several cases to be downgraded as a result of their levels of delinquency. To the extent you can find a way to address the delinquent loans in the pool, take them out of the pool, find an efficient way to refinance them, you have the ability then to look at those securities and rewrite those securities in a different way.

PROF. SUMMERS: Some of this conversation I suppose is semantic around the term bailout in the sense that when Secretary Rubin lent a large amount of the taxpayers' money to Mexico well collateralized and at a substantial interest rate premium and it was likely to be profitable for the taxpayers and ex post turned out to be profitable for the taxpayers, I suppose there would be some who would argue that it was therefore in no way a bailout of Mexico. The argument you're making is parallel and has all the strengths and weaknesses that Mexico wasn't a bailout. I think there's another argument which is that sometimes things which are a bailout have sufficiently large collateral benefits that they are worthwhile even though they have some character of that. Shall we turn to the audience for questions? Alice?

ALICE RIVLIN: I just want to follow-up on this discussion and ask the question behind it. Mexico whatever you call it turned out to be profitable for the U.S. government and as you look at this situation, clearly we had a housing bubble, we built too many houses, but we've got a pretty good economy here and a growing population and this property is going to be worth something, not all of it but most of it, eventually and it's probably a pretty good investment for somebody either the government or if you can organize it right a bunch of private investors. It's much more complicated than Mexico but what does the viability of the investment depend on and how confident are you macroeconomists that this would pay off or would break even over a few years?

PROF. SUMMERS: I'll take a crack and see if anybody wants to disagree. I think you need to distinguish between certain ones of financial securities and underlying real estate in the United States. I think if you look at what futures markets are saying or if you look at historically normal levels of the ratio of house prices to income and where it is even today after the declines that have taken place, I think it would be a brave person who was highly confident that with a few year horizon owner occupied housing, particularly owner occupied housing of the kind that's under discussion here, was going to be an attractive investment. I think that would be a very brave view to take.

I think there's a different question once certain of these mortgages have been written down to some price. It goes to that house that was bought or $220,000 with a $200,000 combination of mortgages, that the house is worth $180,000 today. Probably that $200,000 mortgage written down to $140,000 or $150,000 is an attractive investment. Different from the Mexican case or a variety of these cases, there are probably not a lot of attractive investments without a lot of writing down to set the stage for the attractive investment and part of the problem is there's a lot of reluctance to have the writing down that's necessary for some of these things to be attractive investments and one of the concerns is that if one engages in too much of this kind of operation you prevent the market from falling to a level where investments are attractive and therefore prolong the whole process and in some people's accounts of Japanese system that's what took place.

ROGER ALTMAN: Larry, you struck I thought an appropriately pessimistic note at the outset. I unfortunately would like to strike a similar one on this discussion as follows. And I will address my question to Michael but anybody can comment on it. If I understand the SAFE plan correctly, and perhaps I don't, but if I do, I don't think it's going to result in robust buying and selling and here's why, so I'd like you to tell me I'm wrong please. As I understand it, the responsibility for restructuring the mortgages would be that of the buyer. Is that correct?

PROF. BARR: Yes.

MR. ALTMAN: Here's the problem with that. I did some checking yesterday on this with some people in the actual mortgage market. The problem with that is that the returns that the buyer is going to need in order to compensate him for that task are what we would call in the capital markets, private equity level returns, 20 to 25 percent type returns, because that task is not typically a task that a buyer would take on and is not going to be viewed as an attractive task. That means that the price at which the buyers will buy, and I think Larry was just alluding to this, is going to be quite unfavorable and unlikely to induce a lot of selling. So I don't think this "auction" is going to be particularly effective, so I have two particular questions, three questions, perhaps. One, is that correct in terms of my understanding of how this works? Two, wouldn't it be more effective and despite the optics associated with the bailout debate, to have FHA responsible for that? Or am I missing something?

PROF. BARR: Let me just say the prices that mortgage pools would be bought and sold will be determined by the auction process. If the prices required don't find willing sellers and buyers in that auction process, the auction wouldn't occur. The up side of that is that no government funds have been expended in that process other than the minimal amount of holding the auction. And the exit of FHA and GSE special programs under SAFE would still be available of the loans met the program terms, so your question is an empirical one that if the legislation passed it would be proved in the market. In terms of the optics of a government entity versus a private entity, again in my judgment I don't think it's just an optical question, I think that the existing market participants will be better judges of that process, and FHA would be left in the role that FHA is used to doing which is to say insuring loans that meet eligibility criteria. FHA doesn't have the capacity intellectually or otherwise to play that broader role that you suggest.

MR. ALTMAN: I think you're misjudging the character of the buyers, and I don't mean that from a qualitative point of view, I mean just what they actually do every day and what they don't do, and that the types of players that would normally come into this have no capacity whatsoever as I've listened carefully to the discussion at the community level and your point about hand to hand combat, no capacity whatsoever to do that, and just being really honest about it, probably just as little interest. We'll see, but I think it will be quite unfortunate if we have a long legislative battle or even a medium long one, the legislation passes and nothing happens.

PROF. BARR: Again I think we'll see as time goes on. I don't have your market experience by any wild stretch of the imagination so what I do have is the conversations I've had with market participants over the last several months that lead me to believe that this would be a welcomed step in which they would be willing to participate but we won't know until it's proved out and I obviously respect your judgment in that.

MR. WADE: Could I just comment as well? I do think that the counseling sector is probably the appropriate vehicle to help whoever the buyer might be in whichever scenario to restructure the mortgages for the consumer because part of the challenge we have right now is the consumer is at a distinct disadvantage. They don't know anything and how do you help that consumer ensure that they're going to get a restructured opportunity that's going to create a sustainable mortgage? You may not have the interests of the buyer and the borrower in alignment on that issue and so somebody has got to be working with the borrower to ensure that the borrower's interests are going to be reflected in whatever ends up being the final outcome.

SPEAKER: -- author of an essay from February of last called "Fiscally Responsible Ingredients for an Economic Katrina." I've got a macroeconomic question. Aren't we in a race really on two dimensions?

One is expediency, urgency, and second, magnitude, not to let the situation continue? All the work you're doing is great and is needed. However, events of the morning suggest that --

PROF. SUMMERS: A question, please, rather than a comment.

SPEAKER: Yes. The mortgage distress is sufficient to create the conditions we're in this morning.

PROF. SUMMERS: A question?

SPEAKER: And you've got two layers of added distress, credit cards --

PROF. SUMMERS:: What is the question, sir?

SPEAKER: You're going to need an Alan Blinder type intervention.

PROF. SUMMERS:: I'm asking for the question quickly.

SPEAKER: And your comments upon that. Yes. Don't we need an Alan Blinder type of an intervention fast and of magnitude not to let the situation play out with trying to structure all these details without triggering these two other lines of derivatives going sour, credit card debt, and auto loans?

PROF. SUMMERS: Does anyone want to comment? Doug?

DR. ELMENDORF: I don't favor these broad solutions. And you're right, there's a risk in that. If it turns out that the world was heading down the precipice more than quickly than I anticipate, we may end up having to make yet larger interventions down the road and I think there is a risk of that. On the other hand, I think that we have a general economic system which avoids making very large government interventions and I think there are practical ways to go out about helping hundreds of thousands of additional households avoid foreclosure of the sort we've been discussing and I would start with that partly influenced by my view that the broader financial problems are only influenced to small extent at this point by what's happening to a particular set of subprime mortgages even though this was the fuse that set off the explosion and I think it doesn't mean that putting out this particular piece of the fire is going to put out everything else.

PROF. SUMMERS: Martin?

MARTIN BAILEY: This is on macroeconomic consequences or the framing that you had. Northern Rock, the British bank, went broke, and I'm told by people who've looked at its books that it does not have a delinquency problem, it has mortgages and they're fine, it went broke because the rate at which they were borrowing went up 300 to 400 basis points and therefore they were out of money. It seems to me that I'm sort of on the Doug line that in the situation we have, clearly we do have a delinquency problem, but isn't it being greatly magnified by a liquidity problem? You sort of imply that the stuff that the Fed is doing to improve liquidity is like giving antibiotics, I think it's giving antiviral medication and I think they're doing what they need to do because a big part of this problem is not just the delinquencies, it's the underlying liquidity that's collapsed in the system.

PROF. SUMMERS: I think the judgment that has to be reached and will be reached over time as in any situation of financial distress is is this a situation in which the only thing there is to fear is fear itself and in which it's all caused by lack of confidence and if everybody just became confident all would be well. Or if this a situation in which there are questions about solvency and underlying questions about capital adequacy. Notice that if you had a situation where there were issues of solvency, the form it would take is a lot of people gradually becoming more and more alarmed and rushing to take their money out and it would look very much like a liquidity problem. I think what's probably fair to say is that we have been pursuing a variety of every more aggressive solutions premised on a diagnosis that is dominantly about liquidity for some months now and that the situation probably appears as serious or more serious right now than it has at any point in the last 6 months. It is possible that it really is all liquidity and that the sufficiently aggressive provision of liquidity will therefore solve the problem.

Notice that if you diagnose a solvency problem as a liquidity problem you are likely to respond by doing a variety of things that have broadly the character of throwing good money after bad so it is not an inconsequential element and I would urge the proposition that at a time when the market is requiring many major financial institutions to borrow at rates more than 2 percentage points above treasuries and the fact that the premium is that small likely reflecting the suspicion that there would be public action to prevent a default that one needs to be prepared to contemplate the questions of solvency issues and underlying creditworthiness in a serious way in formulating policy.

SPEAKER: -- from Japan. This is a question for Mr. Summers. How would you compare this current situation to that Japan has experienced during the 1990s in terms of the gravity and magnitude to the whole economy? The second question, in order to avoid that, do you think the government should participate in so-called -- of scarce capital -- future of capital infusions just like we have done?

PROF. SUMMERS: I think I'll give a very brief answer because I want to turn this to the panel. I think there are certain qualitative similarities in terms of declining asset prices and reduced capital between the current situation in the United States and the situation in Japan in the late 1980s and early 1990s. However, I think the situations are dimensionally entirely different quantitatively if one contemplates the magnitude of the bubble that was bursting in Japan and the degree of losses and the degree of delay in recognizing it. So while I think there is something to learn in thinking about policy from the Japanese experience, I think the Japanese experience would be entirely misleading as a guide for predicting what will take place in the United States. I think that the issues I raised are really important issues in think about policy in the future, but I don't have a concrete recommendation to make here today.

ALAN MADIAN: Alan Madian from LECG. I was mindful of your prediction that we have a further 15 percent for asset prices to fall and I am trying to think through how an auction is likely to work with that anticipation, and I would appreciate some reflection on that.

PROF. BARR: A quick response. The auction is clearly not for the underlying asset of the home but for the mortgage that is secured by it and the price that's being offered will reflect the judgment of the market about what that actual home value will be when the loan is reunderwritten with a new homeowner or the existing homeowner with a new loan. So it will include the market's expectation of that continued decline and the market will be right or it will be wrong.

BRUCE MACLAURY: The question is, we have heard a couple of references to the taxpayers underwriting of the Mexican loan. We haven't heard anything about the S&L crisis and the formation of resolution trust and whether that offers any indication. My recollection is that the taxpayer ended up half a trillion dollars in the hole as a result of resolution trust but it did save financial institutions.

PROF. SUMMERS: Bruce, I'm not an expert on that but I think you had in some ways an opposite situation. The resolution trust was a response as I understand it to the fact that a large number of financial institutions were judged to be insolvent. The government in effect nationalized them and took over their assets and the government's problem was then how to dispose of assets that were on the public sector balance sheet in the most way, and that's what the Resolution Trust Company did. As yet the concern we have is with the largest scale of the financial institutions who are as yet judged not to be currently insolvent, the assets reside in the private sector and the question would go to supporting the asset values like the values of homes or supporting the institutions. So the phenomenon with which the RTC dealt, namely, the government having nationalized through intervening in failed institutions large number of assets isn't the phenomenon with which we are currently dealing.

MR. ALTMAN: (inaudible) secondly, the early couple of years of that which occurred before the Clinton administration kind of get to this point about an auction and what the returns might be from the virus point of view in the early going because the early participants in those auctions let's just say bought very favorably.

PROF. SUMMERS: There is a significant debate among those who look at this history retrospectively. To my knowledge, everyone agrees with you that those who purchased early did extraordinarily well. I think many believe as Chairman Greenspan has argued very frequently that that was a terrific example of the logic of letting markets find their level even if it's a very low level therefore drawing in private capital and that you had a very successful process because the first people made a lot of money so a lot of other people tried and you disposed of the assets quickly. There are others who argue that if the government had been in less of a hurry to dump the assets that they might somehow have gotten a better deal for the taxpayers and fewer fortunes made among the buyers, and that's a debate among those who view those things.

My impression, but I'm not an expert, is that a majority of people looking at the narrow question of the RTC would tend to be closer to the Greenspan view that the approach of moving quickly to put assets on markets and letting markets find their level was well documented by that case and that efforts to delay the process so as to avoid fire sales might well have been counterproductive, but that's very much a matter for debate. Bob?

MR. RUBIN: I will cede the time I was going to have before. I find this more interesting than I think I'd find myself. Let me just make one comment, if I may, Larry, in listening to all this. I said in my opening remarks that I've been around markets for a long, long time and I do think we're in unchartered waters. Or probably. I shouldn't say we are. But I think we probably are in unchartered waters. And I at least think that the risk is sufficiently great so that I think we should be acting and acting in a very serious way in the mortgage area.

Doug, I agree with you about the subprime mortgages as just being the trigger but not that large. If you take all mortgages together and all the issues around mortgages, I think they're pretty much at the heart of this thing and I at least think that while it may be that we can get through this without taking action, I think the risks have reached the point where at least in my judgment that the right thing on balance is to act and act in a very serious way.

I then have two questions. They're not questions to the panel so much as just questions in general. One is will measures that don't involve substantial funds be adequate in their total effect to really meet the test I just laid out which is having a real impact on what's going on in the mortgage and housing area in the sense as you've been discussing, Michael. I'm not expressing a view one way or the other. I'm just raising the question, and I think Larry raises it a little bit too. Secondly, I don't think our political system is focused on this with the sense of urgency that we're going to have to have if people are going to put aside philosophies and ideologies and everything else that impedes our system from functioning and sits down and tries to engage in some serious problem solving. I think a very useful thing that a discussion like this can have and even a lot of similar discussions is while the political system may not be ready to act, I think they should be acting, but if they're not ready to act, what is useful is to set all sorts of proposals, flesh them out, work out the pros and cons, so that if it turns out that the materialization is as great as I think the risk is, and one has to hope it isn't, but if it is, then there will be fully fleshed out proposals around that should enable the political system to act more quickly.

PROF. SUMMERS: Does anyone on the panel want to respond to that?

DEAN BAKER: Dean Baker, Center for Economic and Policy Research. I was very struck by Secretary Rubin's opening comments when he said that few if anyone anticipated these sorts of problems because frankly I think that any economist should have been able to recognize the housing bubble and the sort of carnage we're now seeing, and I think that really speaks to the sort of insular environment in which economic policy is crafted.

SPEAKER: (inaudible)

MR. BAKER: That really wasn't my question. My point is whether or not this is an insular environment. I think the debate here is very much insular in that it's focused on continuing this policy of homeownership which I would say has largely gotten us into this mess and that what I would ask is it really doing someone a favor where you have places where you have sale to rent ratios of 20 to 1 and in some cases still higher to keep them as an owner in that home where they're likely paying 60 to 80 percent more than they would to rent an equivalent home and they have almost no chance of ever accumulating equity. Is that really doing them a favor?

Finally, I do just have to say I think it would be a great step for equality, the best thing since the GI Bill of Rights, if we were to take the New York banks off life support from the Fed and Northern Rock them.

PROF. BARR: Can I just answer the middle couple words? Though I agree that we need a better balance in our thinking as between rental and homeownership and I think we as a country have neglected rental policy as unsexy or something for quite a long time and there's enormous attention that needs to be paid to rental policy, Ned Gramlich who I wish were here with us today was a big proponent of focusing on better attention to rental policy as part of the answer to our policy, and I think he was right.

MR. WADE: There is no question, and again more work needs to be done in the rental housing arena, and while we've been more known for our work in the homeownership arena, our members own 65,000 units of affordable rental housing, and that's got to be part of the mix any way you slice it. I don't think though one of our takeaways ought to be that credit impaired or low and moderate income folks can't become homeowners notwithstanding there are some markets where you do wonder about whether that might be the best vehicle for someone at a given point in time.

Our group in Kentucky is an example. They've probably seen now 300 or 400 families facing foreclose and only one of those families had prepurchasing counseling. Our own secondary market which is minuscule but purchases loans from our network, their portfolio is performing 10 times better than the subprime market, 4 times better than the VA and the FHA, on par with prime loans, and these are low and moderate income folks who had the benefit of prepurchasing counseling, got into a loan that made sense for them, and bought a house they can afford. I think those are the things that were really missing in the market.

PROF. SUMMERS: I think there's a fair question looking to the broad contours of public policy which have homeownership in a variety of ways and one can at least ask the question with respect to the tax deduction, one can ask the question with respect to the implicit support provided to the government sponsored enterprises whether we have tilted the playing field in favor of owner occupied housing in ways that may not in retrospect have been wise. And I think one can ask the question going forward as one thinks about restructuring, and my hope would be that one of the things that I think is among the less controversial though I suspect less macroeconomically consequential parts of this discussion is the support for state and local governments and communities to be active in responding to the distress in particular communities and I would hope that a significant part of that now that I've learned the term REO inventory backlog would be recycled not into fire sale owner occupied housing but into rental housing. Of course, the great irony, and this is what I think this is a complicated issue, would be if the people who mistakenly because of public policy, because of their own mistakes or because of bad counseling all were led to decide to buy houses at a time when prices were 20 times annual rent not were led to be told to rent at a time when after the declines prices were 8 times rents because we were correcting the last error and that would be a rather unfortunate workout. Let me take a coupe more questions.

SPEAKER: Chuck -- and I'm working on a local response in New Haven. Two subjects that didn't get touched on and I'd like to see if anybody has a comment. One is particularly in light of the fact that we seem not to be cutting to the chase, at least one presidential candidate has mentioned the concept of a moratorium. Would that have any efficacy in allowing us to focus on and resolve whatever public-private things that's hanging this up? Two, it's very clear that many of these mortgages particularly in the 2005 and 2006 vintages were shall we say unfair, deceptive, and sold in a way that wasn't particularly pretty, and it's true that in at least some communities there's a very, very high concentration of these mortgages in black and Hispanic neighborhoods, neither of those were touched on and I'd just be interested in your comments on both.

PROF. BARR: Chuck, thanks for both questions which I think are terrific. I do think as I mentioned rather obliquely at the outset that while we're dealing with the crisis we do need to consider serious steps for reform of the mortgage process itself. Larry Summers when he was Secretary of the Treasury issued a report in 2000, 8 years ago, calling for many of the steps that Secretary Paulson endorsed in the president's working group report this week. So I think we need to get about the business of cleaning up what we know are the problems in the mortgage market.

I do think there's also room not just for efforts to improve the regulatory process, but perhaps encourage innovation in the financial sector in a way that's in favor of good products and against products that get people into trouble that they don't understand. I've been working for a while on figuring out ways for example to translate the lessons that we've learned about opt-out policy in savings in the retirement world and getting people into accounts that make sense for them and to translate that into the credit world. Could you develop opt-out home mortgage processes so that it's more likely that the homeowner will get into a loan that makes sense for them? And with -- Elda Shafir we've started to work that in the mortgage area and in the credit card area and I think it's potentially promising.

On your first point I think that the question about a moratorium involves a lot of the same kinds of tradeoffs that Doug talked about and so maybe I'll let Doug answer it.

DR.. ELMENDORF: Thank you, Michael. I don't support enforced moratorium on forecloses because I think as I said to start with there are forecloses that shouldn't happen and there are forecloses that should happen and I think it's a very blunt tool to stop all forecloses. I think sensible servicers will be exercising forbearance because they will recognize that the losses that they will suffer from the foreclose process exceeds the losses they will suffer from trying to work with the borrowers. And I don't think that just delaying the process by several months is going to fundamentally alter the choices that we face here and the problems that we face. Again where servicers do it to work out things for lenders that's appropriate. I don't think that calling for halt of everything for 90 days would that make that big a difference.

MR. WADE: Let me just say on the disparate impact issue there is no question that the subprime aspect of this is disproportionately affecting people of color, African Americans, and Latinos, and their communities that they're in and it even has some pretty interesting ways that that's manifesting itself. So if you look at Prince George's County here in D.C. which is considered a fairly wealthy community, there are very high foreclose rates. Incomes are pretty high out there. That suggests that for some set of reasons, and also disproportionate concentrations of subprime loans, folks are in those loans for some interesting and challenging reasons that we definitely need to take a look at. And some of the data that we've seen suggests that as many as 30 percent of the folks who ended up, 25 to 30, in subprime loans would have qualified for prime loans. So obviously something is not working in the market where people are opting for choices that aren't in their best interests and so a lot of that has to do with the difficulty in shopping for a mortgage, the challenges related to that, and at the end of the day most folks will tell you you really don't know the deal you have until you're sitting at that closing table and in many cases that's just a little too late in the day, but that's just the way the process worked.

SPEAKER: Marguerite made an observation earlier that I'd like to ask the other panelists if they might comment on. She said that the system of securitization that we had in place today has never been in place during a down market time when housing prices were depreciating and that while it was not problematic for them to restructure loans held in their own portfolio, that there was a lot of difficulty in trying to do that for the loans that were in these trusts. I was wondering if anyone wanted to comment on a new set of public policy problems we haven't really dealt with here today which is whether or not there is generally we favor complex mechanisms to entice investors with exactly the kind of investment product that meets their investment needs, but did we actually create opacity that interfered with our ability to value assets and to have a normal functioning of the market? Does anyone want to comment on that?

DR. ELMENDORF: I'd be happy to. I think that securitization has many benefits as you know but also has turned out to have some very substantial costs one of which is particularly what you highlight which is the lack of a mechanism to deal with the problems. What happens when things go wrong and the debts can't be paid? And I guess that wasn't sufficiently foreseen as an outcome. Now it's very apparent and going forward we need to make sure that we build in mechanisms for unraveling this very complicated skein of these relationships when problems develop. I'm doing some work in fact with Martin Bailey and Bob Litan as part of the Brookings Initiative on Business and Public Policy to think about change we should make across a whole set of areas that have shown to be quite problematic involving of course the structure of mortgages, disclosures related to mortgages, but also importantly the problem with banks that have ended up despite securitization and the supposed spreading of risk up with a tremendous amount of risk back on their balance sheets or close to their balance sheets and a question about how to make securitization more transparent and less subject to those problems. I think those are all very important topics that we need to make sure in addition to dealing with the current mess that we focus on ways to reduce the probability of a mess like this recurring in the future.

PROF. BARR: Let me just add to that and say I think Doug is exactly right and I think there are also a number of public policies currently in place that inadvertently lock in securitizations to structures that block exits that would otherwise be quite useful. One such areas are tax rules on REMICs, or real estate mortgage investment conduits, have locked in our existing securitizations to a much small range of solutions than either they or the public would like.

PROF. SUMMERS:: I want to just make a concluding comment that goes to the issue that Bob Rubin discussed, the need to put public money in, where to put public money in, the role of mortgages in the whole problem, and the whole of subprime mortgages in the whole problem. Doug said I think correctly that restructuring subprime mortgages even if you did it and did it successfully was not large relative to the macro problem, Bob suggested that it seemed to him that in the whole, mortgages were really very much at the center of the financial distress. I think the way to square those two beliefs is actually less about subprime versus prime mortgages than it is about something else. One set of issues we're dealing with in the focus of this panel has to do with the fact that there are a lot of houses that are near foreclose and people have negative equity and they may not pay it back. A different set of issues had to do with the fact that there are several trillion dollars of mortgages currently outstanding to which the market view used to be that that there was a quarter of a percent chance each year that they would default, and now the market view is there's a 1-1/2 percent chance that they might default. Nobody is restructuring them, nobody is doing anything, life is just proceeding as normal, but because the market has decided there's a 1-1/2 percent chance each year that they might default rather than a quarter percent chance that they might default, they have lost 8 percent or 10 percent of their value and since they were trillions of dollars, that represents a loss of several hundred billions of dollars. That several hundred billion dollar loss is not addressed by anything that this panel has discussed but it is at the center of why there are financial institutions that are potentially undercapitalized and why they face credit problems. So I think it would be a mistake to suppose that whether it is a good or bad idea, and my instinct is that it is a good idea, to find a way to infuse some public money into the set of distress around foreclose, it would be a mistake to think that doing that is addressing what is I think the central source of the broader kinds of financial distress about which I spoke which goes to the increase of default probabilities from negligible to very low that cumulatively represents a very substantial loss in value. Thank you all very much for joining us, and thank especially our panelists for what I think was a very stimulating discussion.

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