WEIGHING ALTERNATIVE POLICIES FOR TACKLING THE MORTGAGE MESS

A HAMILTON PROJECT POLICY NOTE

Douglas W. Elmendorf

The Brookings Institution

February 2008

This note is a preliminary draft of part of a larger paper being written with Martin Baily and Robert Litan. The larger paper will examine the causes of the current financial turmoil and recommend policies for remedying existing problems and reducing the likelihood that similar problems will recur in the future. Work on this note has been supported by the Hamilton Project at Brookings and the Brookings Initiative on Business and Public Policy. I am grateful for comments from several colleagues. The note reflects my current views, which may evolve in response to further developments and further research. The note does not represent the views of Martin Baily, Robert Litan, the Hamilton Project Advisory Council, or the Brookings Institution.

Summary

Without government action, mortgage foreclosures will rise steeply for the next several years, mainly because declining house prices will leave many property owners with negative equity. Proposals for addressing this problem can be grouped into four categories—improving mortgage-market functioning, exhorting certain private-sector actions, forcibly reducing amounts owed, and using significant government funds. Policies enacted or suggested within the first two categories likely will have just a moderate effect on foreclosures. Policies advocated in the latter two categories could have a larger effect, but only through notable changes in the legal backdrop or government financial commitment to mortgage lending. In deciding how to proceed, policymakers should weigh the fairness of alternative approaches and effects on future mortgage credit together with the consequences of inaction for households and the overall economy.

Introduction

This note provides an overview of policies that have been put forward to address the current mortgage problems. I focus on presenting the advantages and disadvantages of different policies rather than building the case for the particular policies I favor. (Also, most of the factual assertions in this preliminary draft are not documented; appropriate references will be added later.)

The note covers the following topics in turn:

- What is the Foreclosure Problem?
  - Three broad issues in housing and mortgage markets
  - Which households will face foreclosure?
  - Mortgage servicers and lenders will modify fewer loans than they should
  - Why should the country try to reduce upcoming foreclosures?
  - Evaluating alternative policy responses

- Policies to Improve the Functioning of the Mortgage Market
  - Ease monetary policy
  - Relax restrictions on Fannie and Freddie
  - "Modernize" the FHA
  - Support mortgage counseling
  - Encourage shared-appreciation mortgages
  - Clarify servicers' fiduciary responsibilities
  - Compile information on mortgage holders

- Policies of Government Exhortations for Private-Sector Actions
  - Coordinate the "teaser freezer"
  - Expand the teaser freezer to cover more borrowers and principal writedowns
  - Encourage forbearance on foreclosures

- Policies that Forcibly Reduce Amounts Owed
  - Change treatment of primary residences in bankruptcy
  - Block interest-rate resets
  - Block foreclosures for a specified period
  - Legislate mortgage writedowns
  - Allow current homeowners to stay as renters

- Policies Based on Providing Government Funding
  - Change tax treatment of mortgage writedowns
  - Create a tax credit for home buyers
  - Direct money to state and local governments
  - Make loans to mortgage lenders through the Federal Home Loan Banks
  - Have a federal agency or corporation handle widespread refinancing of mortgages

What is the Foreclosure Problem?

To make sense of the possible responses, one should begin with some background on the problem.

Three broad issues in housing and mortgage markets

First, housing is overbuilt and overpriced. Construction has fallen in half from its peak and shows no signs of bottoming out, nor have stocks of unsold houses diminished. Real house prices will likely drop 20 percent or more in this episode, which amounts to a 10 percent or larger nominal decline. The loss in housing wealth will directly deduct about ¼ percentage point or more from average annual GDP growth for the next four years.

Second, absent policy action, several million households will likely default on their mortgages in the next couple of years.[1] In some cases this will occur because people cannot meet their mortgage payments, especially after their interest rates reset.[2] In other cases this will occur because people choose not to make mortgage payments after realizing they owe more than their houses are worth.[3]

Third, uncertainty about the value of mortgage-backed securities and derivatives of those securities has created uncertainty about the solvency and liquidity of banks, investment funds, monoline insurers, and other financial actors. This uncertainty is impeding financial intermediation and thereby slowing the overall economy.

In this note I focus on mortgage defaults, recognizing that policies to address that problem could also ameliorate the problems of overbuilding and financial uncertainty. Within mortgage defaults, I focus on households with negative equity rather than those facing rate resets. Although both conditions pose substantial risks, most experts are more concerned about negative equity. A careful study of Massachusetts data showed that mortgage default is highly correlated with house price movements. In addition, a sizable number of mortgages initiated in the past few years have gone into delinquency before their rates reset. Moreover, declines in interest rates since last fall have reduced the magnitude of the reset problem.

---

[1] Before the recent turmoil, about 900,000 households per year had foreclosures initiated against them; a significant share worked things out with their lenders before losing their homes, and the rest ultimately lost their homes. About 1½ million foreclosures were initiated in 2007, and ¾ million or more of these households will eventually lose their homes. In recent Congressional testimony, economist Mark Zandi of Moody's projected that 2 million households will lose their homes in the next two years. For comparison, about 1 million houses were built last year, and about ½ million unsold new houses are on the market.

[2] In recent Congressional testimony, FDIC Chairman Sheila Bair projected that 1.3 million subprime loans will undergo their first reset in 2008 and another 400,000 in 2009.

[3] In a recent report, Mark Zandi projected that a 20 percent drop in house prices from their peak would leave 14 million households with negative equity.

Which households will face foreclosure?

If a family defaults on its mortgage, the lender or servicer can throw them out of their house through foreclosure—a procedure that varies significantly across states in complexity and duration. Some homeowners with negative equity will choose to default on their mortgage—essentially, to walk away from their houses. Lenders have the legal right in most states to collect the remainder owed, but they generally have not done so. (However, this situation might change in the next few years: Lenders may not have followed up in the past because households walking away had very little wealth; going forward, households with substantial wealth may walk away because they bought houses with high loan-to-value ratios.)

Most families will not want to walk away as soon as they have negative equity:

- Moving to a different house or becoming a renter is costly. On the financial side, there are realtors' fees, perhaps taxes and new mortgage fees, movers, and the cost of damaging one's credit history. On the emotional side, there is time involved, the loss of neighbors, friends, and schools, and perhaps guilt about not paying one's debts. Further, people are often reluctant to admit investment losses—they try to hold onto losing stocks until they rebound, and they keep houses on the market instead of cutting the price—and they may not expect declines in house prices of the size seen in house-price futures.
- The costs are smaller if one is living somewhere else and this house is an investment, or if one bought one's house recently and is less emotionally attached to it. But the costs are larger if one's mortgage payments are resetting upward—that is, the rate reset and negative equity problems will be interrelated if resets are a trigger for people to assess whether to stay in their house or leave. On balance, the negative-equity threshold may be close to zero for some people but easily 15 percent or more for others.
- One implication is that writing down a mortgage all the way to the value of a house is probably going further than optimal from the lender's perspective.

Regional variation in house price depreciation makes the problem worse:

- The differential housing appreciation across regions in the past decade probably owes to differences in both fundamentals and bubbles. As the bubbles deflate, one should expect differential depreciation going forward. Suppose that everyone puts down a 20 percent downpayment. If house prices fall 20 percent everywhere, no one is under water. But if house prices fall 10 percent in some places and 30 percent in others, half the people are underwater. (More technically, mortgages are options with a highly nonlinear payoff.)
- Also, places with the biggest run-ups in prices probably saw lower downpayments as people reached to get the houses they wanted. This accentuates the pattern of ending up with more people under water than a national-average calculation suggests.

Mortgage servicers and lenders will modify fewer loans than they should

Foreclosures are very costly to lenders, owing to transactions costs, carrying costs until the process is completed and the house can be sold, and reduced sales prices of houses. Estimates suggest that the losses can be 20 percent or more of house value. Thus, significant reductions in amounts owed appear to be better than foreclosure for lenders as well as borrowers.

Yet, such modifications are very rare. Here are some possible explanations:

- The dispersion of ownership through securitization and structured finance:
  - Servicers do not have an unambiguous right to modify contracts. The PSAs (pooling and servicing agreements) generally give servicers the legal authority to make modifications that are in the interest of the lenders. However, the degree of latitude varies across contracts, and this is always a judgment call, which opens the door to legal challenges.
  - Structured products create different incentives for different investors. Those who get paid first in the event of foreclosure might prefer the certainty of that step to a loan modification with higher expected value but more risk. The American Securitization Forum (ASF) has said that servicers should look to the interests of bondholders "in the aggregate," but this does not resolve all legal uncertainty.
  - Servicers bear the transactions cost of renegotiating mortgages and generally receive no extra compensation from the lenders. (But servicers also bear some of the costs of the foreclosure process.)
- Writing down principal for defaulting borrowers will induce other borrowers to default in order to get that deal:
  - If many borrowers will be a little under water but will try to stay in their homes and avoid default, then offering writedowns to some could induce many others to default. Servicers will rationally incorporate this effect into their decisions.
  - This problem will be especially acute if writedowns become a widely used technique.
- Lenders generally think that writing down principal will be more costly in the long run:
  - Many modified loans default again. If the costs of foreclosure are not ultimately avoidable, then there is little reason to bear the costs of modification now.
  - If house prices are declining, then selling the house later could yield less return.
- Many people who will have negative equity will be in that position because of second ("piggyback") mortgages and not because of their primary mortgages. First lien holders do not want to write down principal unless the second lien holders agree also:
  - A second lien is junior to a first lien, so the holders will get next to nothing if a house goes to foreclosure, and they should be very cheap to buy off.
  - However, second lien holders are often different from the first lien holders, so coordination is complicated. And they have an incentive to extract some rents from the first lien-holders.
- Servicers may also have an irrational resistance to principal writedowns, perhaps simply from inertia because they have not done this (or needed to do this) very much in the past. The sheer number of people who will be looking for mortgage modifications at the present time poses a challenge as well.

Some of these obstacles to mortgage modifications represent real social costs. However, other obstacles stem simply from institutional obstacles to coordinating large numbers of lenders. And the negative externalities of foreclosure (discussed below) are not incorporated by servicers. All told, it appears that many writedowns that would be socially efficient will not occur.

Why should the country try to reduce upcoming foreclosures?

First, widespread foreclosures are unfair because they hurt vulnerable people and because people did not fully understand the mortgages they were taking on (for which regulators bear some responsibility in terms of inadequate disclosures and inadequate supervision).

> *But …* Many people who will lose their homes: a) had little equity in their homes (that is why they end up under water); b) enjoyed living in nicer housing than similar people who did not take a chance on a bigger mortgage; c) are not poor; and d) have not lived in their homes very long and are likely to be less attached to them. In addition, many people are complicit in stretching for mortgages they could not really afford: Borrower fraud seems to have occurred widely, leading one commentator to refer to "predatory borrowing." In sum, the households being foreclosed upon are a tremendously varied group, and until more research is done, even assessing their average characteristics is difficult.

Second, widespread foreclosures are inefficient because they amount to a game of musical chairs: Picture a family being thrown out of its house and then buying another house that is as nice as its first house but cheaper to buy (and thus affordable with a smaller mortgage) because it is being offered as a foreclosure sale after another family was thrown out; that other family might then buy the first house which will also be marked down. In the words of one commentator, this amounts to everyone moving one house to the left. The game is even worse because families that lose their homes may not be able to buy another since their credit history will be messed up and risky mortgage lending has been halted. With housing demand low, the units may ultimately be bought up and used for rental housing, but that will leave houses empty and families without good places to live for a long time. This deadweight loss might arise if servicers and lenders cannot overcome the problems noted above.

> *But …* It is not just musical chairs. Lower prices will open homeownership to other families that did not stretch for a more expensive house and bigger mortgage earlier. Why should the country try to keep current occupants in their houses, especially when some occupants are in way over their heads? Also, the cost of moving is apparently not that high for people who choose to walk away.

Third, widespread foreclosures would cause damage beyond the homeowners and houses directly involved. Selling foreclosed houses reduces the value of neighboring houses, which reinforces the downward slide of house prices. A concentration of foreclosures could have very negative impacts on the affected communities. Moreover, the downside risks to aggregate economic activity are especially pronounced right now, and continued distress in the housing sector and financial markets could launch a reinforcing downward spiral in which financial turmoil begets economic weakness, which causes further turmoil, and so on.

> *But …* There is little evidence yet that the economy is entering a deep or prolonged slowdown, so perhaps more aggressive action should be considered but not yet implemented. A good deal of monetary and fiscal stimulus is now in the pipeline, and economic forecasters generally expect real GDP to increase at a modest pace in the second half of the year after a very slow first half. Moreover, forestalling foreclosures

may or may not clarify the value of mortgage-backed assets, and restoring clarity to that market may or may not resolve problems in other parts of the financial markets.

Evaluating alternative policy responses

The multitude of proposals for addressing the foreclosure problem can be grouped into four categories: a) policies to improve the functioning of the mortgage market; b) policies of government exhortations for private-sector actions; c) policies that forcibly reduce amounts owed; and d) policies that use government funds. These general alternatives have framed the public debate since last fall, although the specific policies put forward have evolved over time. Moreover, growing concerns about the scale of the coming foreclosure problems and the overall macroeconomic risks have increased the attention given to the more vigorous proposals included in the latter two categories.

Policies to Improve the Functioning of the Mortgage Market

Several policies in this set have been adopted.

Ease monetary policy

Past and prospective easing of monetary policy supports overall economic activity, but it also addresses the housing and mortgage problems in particular:

- Lower mortgage rates support housing demand and thus construction. Interest rates on prime, conforming mortgages are about ¾ percentage point below their level before the subprime meltdown. Rates on prime, jumbo mortgages are up only a little despite the tightening in credit markets (although lending standards have tightened as well).
- Lower interest rates reduce the size of interest-rate resets.
- Lower rates encourage refinancing of prime, conforming mortgages. This frees up cash flow and enables households to withdraw equity from their homes, both of which support consumption.

Relax restrictions on Fannie and Freddie

The fiscal stimulus law raised the threshold for conforming mortgages from about $417,000 to 125 percent of the median house price in an area, with an overall cap of $729,750; this increase applies only to mortgages originated between July 1, 2007 and December 31, 2008. Raising the conforming threshold is helpful because securitization of prime, jumbo mortgages has diminished significantly. Origination of such mortgages continues, at a reduced pace, with lenders holding them in their portfolios rather than securitizing them (and therefore raising the interest rate relative to the rate on conforming mortgages). Moreover, this change does not substantially affect the risks or costs imposed by Fannie and Freddie, which depend primarily on their portfolio holdings rather than their securitization activities.

Some observers have proposed also raising the Fannie and Freddie portfolio caps. This action would have little benefit if Fannie and Freddie just bought more securities backed by conforming loans, because the market for those loans appears to be functioning well. In addition, the action would have a notable cost, because it would increase government risk and the implicit subsidy to Fannie and Freddie shareholders.

"Modernize" the FHA

Since the 1930s, the FHA has guaranteed mortgage payments and charged borrowers an insurance premium for this guarantee.

Last fall the administration proposed several steps to extend the reach of FHA lending. These steps would help more homeowners refinance mortgages on which they might otherwise default and help more low-income people move into homes:

- Some changes were made by executive action in the so-called "FSASecure program." This program offers FHA-guaranteed refinancing to adjustable-rate borrowers who are delinquent on their payments due to an interest-rate reset and who were timely on their payments for the six months prior to the reset. (In the basic FHA program, refinancing help is offered only to borrowers who are current on their loans.)
- The stimulus law raised the limit on loans covered by FHA from about $360,000 to the conforming limits for Fannie and Freddie, as urged by the administration.
- Other changes have been passed by the House in a so-called "FHA Modernization" bill but have languished in the Senate. These changes include giving the FHA authority to charge risk-adjusted insurance premiums (which would enable them to serve riskier borrowers) and to reduce downpayment requirements (which would enable them to serve borrowers with no equity). The administration estimates that the higher loan limit and these other changes would help another 200,000 households.

Larger changes in FHA policy are discussed below under policies that use government funds.

Support mortgage counseling

Many homeowners who lose their houses to foreclosure never contact a credit counselor or their mortgage servicer in advance. Yet, counseling by local organizations, and the interaction with mortgage servicers that results, has had a high success rate in the past. (For example, Maryland now requires servicers to tell the state government before foreclosing, so that counseling can be applied.) Federal funding to support local counseling organizations is widely supported in Congress, and some funds have been allocated. An important question is how much money could be used effectively by these groups, which cannot scale up to an arbitrary extent overnight.

Encourage shared-appreciation mortgages

In a shared-appreciation mortgage, the lender has an equity interest rather than just a debt interest in the house; conversely, the borrower is not as highly leveraged. OTS just proposed a version of these mortgages in which lenders refinancing people with negative equity would receive a "negative equity certificate" that could be redeemed in the house were sold for more money.

This sort of mortgage might be a valuable addition to mortgage markets in the long run.[4] However, it does not seem likely to have a big effect as a short-run fix: First, borrowers would apparently receive none of the gain from any increase in house price up to the amount of the certificate, which reduces their incentive to take care of the house or wait for a high sales price. Second, most experts expect house prices to be lower than they are now for several years to come, which means that the expected value of the certificates will be quite low and their existence will not provide much inducement for lenders to refinance.

Clarify servicers' fiduciary responsibilities

Servicers appear to have significant latitude to modify mortgages. But there is also the possibility of legislation that would establish a clear standard for servicers' fiduciary obligations, such as the ASF view that servicers' responsibility is to the mortgage pool as a whole rather than to each tranche of ownership individually.

Compile information on mortgage holders

Because coordination among servicers of first and second mortgages poses an obstacle to modifying mortgages, the government could take the lead in compiling a database of lienholders for each property in the country.

Policies of Government Exhortations for Private-Sector Actions

These policies aim to encourage voluntary mortgage modifications, principally by overcoming the servicers' inertia and by establishing a standard that reduces the risk of legal challenges. Such policies are important but ultimately limited in impact.

Coordinate the "teaser freezer"

In December the administration announced an agreement by the "Hope Now" alliance of mortgage servicers, the ASF, and other industry participants to put some adjustable-rate mortgage borrowers on a "fast track" to mortgage modifications that would maintain the initial low interest rates for five more years. The extension of the teaser rate reduces the present value of mortgage payments by roughly 15 percent in a standard case, which is less loss to lenders than would come through foreclosure. The "teaser freezer" reduces legal challenges by limiting the fast track to borrowers that are highly unlikely to keep paying their existing mortgage but likely to pay a modified one, and by using collective action to establish a presumption that servicers following the guidelines are acting in the lenders' interests.

The impact of the plan is modest because the limited eligibility for fast track means that many borrowers do not meet the criteria and because the plan only addresses reset problems and not

[4] On the bright side, this mortgage reduces leverage without pushing up downpayments, which are the main barrier to people buying houses. On the dark side, its greater complexity puts a greater burden on disclosures, and it creates a risk that people will be surprised when they sell their houses to discover how little wealth they have accumulated.

negative equity problems. Both of these limitations are intrinsic, to a degree, in the desire to make modifications are so clearly in lenders' interests that servicers will avoid legal challenges.

In recent Congressional testimony, Mark Zandi estimated that the plan may eventually help up to 250,000 households. However, the success to date is unclear.

Expand the teaser freezer to cover more borrowers and principal writedowns

A key question is whether stronger government arm-twisting and further deterioration in the housing and mortgage markets might persuade mortgage servicers that it is clearly in lenders' interest to expand the teaser freezer. For example:

- They could broaden the pool of eligible borrowers to include people with better credit histories, presuming that declining house values have made them less likely to pay than one might otherwise expect.
- They could broaden the pool of eligible borrowers to include people who have already missed some payments, presuming that reducing their payments is still less expensive than foreclosing. Of course, this reduces the incentive to keep current with payments.
- They could broaden the mortgage modifications to include principal writedowns. For example, the industry could develop a standard for appropriate writedowns of principal when borrowers have negative equity.

A significant expansion in voluntary mortgage modifications would have an important effect on future foreclosures. However, given the constraints and attitudes of servicers described above, one should probably be skeptical that such steps will be taken.

Encourage forbearance on foreclosures

The administration recently announced a voluntary agreement by servicers to delay foreclosures by 30 days while a potential loan modification is evaluated. This "Project Lifeline" is a positive step but is unlikely to have much effect on the ultimate number of foreclosures.

Policies that Forcibly Reduce Amounts Owed

The administration's actions have fallen entirely within the first two categories of "improving the market" and "government exhortations." If these steps are viewed as insufficient, there are two remaining alternatives—to force reductions in amounts owed, or to use government funds to reduce the amounts owed.

Change treatment of primary residences in bankruptcy

Various observers have proposed to allow judges in bankruptcy proceedings to reduce mortgage amounts to the value of the houses that serve as collateral.

The relevant bankruptcy rules are quite complicated. Some key points:

- Chapter 7 bankruptcies are liquidations, in which a household's debts are paid off to the extent possible using a household's non-exempt assets, and the excess debt apart from certain exceptions is discharged.
- Chapter 13 bankruptcies are reorganizations, in which a household's debts are written down to an amount that can reasonably be repaid in 3 to 5 years, and the excess is discharged. The 2005 bankruptcy reform restricted chapter 7 to households with below-median income or with income that just covers necessary non-debt expenses. In the first three quarters of 2007, about 370,000 chapter 7 cases were filed and about 230,000 chapter 13 cases.
- Primary residences receive special treatment in at least two ways: First, under the so-called homestead exemption, equity in a primary residence is exempt up to a threshold that varies by state but is capped at $125,000 by federal law. Second, mortgage debt on primary residences cannot be reduced—or "stripped down" (often called "crammed down")—by a bankruptcy judge like most non-secured debts.

The advantages of the proposed change are:

- By making loan modifications at the discretion of the judge, the change overcomes the obstacles to efficient modifications described above.
- By applying these forced principal writedowns only to households that declare bankruptcy, the change focuses on people who need help the most and are most likely to walk away from their loans (which means that servicers and lenders probably lose the least as well).
- In recent Congressional testimony, Mark Zandi estimated that 570,000 homeowners would benefit from this change during the next three years.

The disadvantages of the proposed change are:

- Future credit supply would likely be reduced.
    - Lending is like other businesses in that free entry and exit tends to keep profits near normal levels. If some people pay less for their loans because of stripdowns, other people will pay more. The reduction in amounts collected may be small because servicers often would not collect much from these people anyway—although one needs to account not just for the existing bankruptcy cases but also for an increase in the number of households who declare bankruptcy rather than riding through downdrafts in house prices and continuing to make mortgage payments.
    - Research has generally shown that borrower-friendly laws tend to restrict the supply of credit, although not all studies agree on this point. Also, underwriting standards are higher for second homes than for primary residences, perhaps in part because of the bankruptcy rules.
    - Tightening credit supply two years ago would have been a good thing—but tightening it more two years from now might not. Financial regulation is often criticized for reinforcing the natural credit cycle: When times are good and loans are being repaid, banks let down their guard and so do regulators; when times are bad and loans are defaulting, banks tighten up and regulators pile on. The Federal Reserve is already adding restrictions to a wide swath of mortgages; federal banking regulators have issued supervisory guidance that will tighten mortgage credit; and securities, institutions, and individuals that funneled funds to mortgage credit have

been discredited. Further tightening in mortgage credit—especially to riskier borrowers—may be undesirable.
- People are not helped unless they declare bankruptcy, which provides an incentive for more people to declare bankruptcy. One consequence is that payments on other types of household debt may decrease.
- Bankruptcy judges have a great deal of discretion, so treatment of similarly situated people might vary widely.

Block interest-rate resets

The government could overrule mortgage contracts so that interest rates would be fixed at their current levels for a specified period—the next five years, say, or the duration of the mortgages.

Compared with bankruptcy reform, this approach would benefit more people and would do so in a consistent manner nationwide. (But the consistency is somewhat illusory, because people would be rewarded proportionally to the *jump* in their interest rate rather than their overall interest payments or principal.) However, because the change would apply to so many more people and would amount to a sizable reduction in the amount owed for many of them, the detrimental effect on future credit supply would be much larger too.

Block foreclosures for a specified period

The government could halt foreclosures for a specified period. Stopping the clock would give borrowers and servicers (who may be overwhelmed by the number of people in trouble now) more time to discuss mortgage modifications. However, the proposal might ultimately have little effect because a time crunch does not appear to be the principal obstacle to modifications. In addition, foreclosures cannot and should not be avoided in all cases: As noted earlier, roughly 900,000 foreclosures were initiated annually before the recent turmoil, and the threat of foreclosure helps to ensure that people pay their mortgage bills.

Legislate mortgage writedowns

The government could force lenders to write down principal under certain circumstances and to a certain extent. Like a ban on interest-rate resets, the possible breadth and depth of the change would likely have a significant negative effect on future credit supply.

Allow current homeowners to stay as renters

The government could give homeowners the right to stay in their homes as long as they pay the market-based rent, whether or not they are making their mortgage payments. However, forcing lenders to become landlords would be a notable change in property rights that would likely reduce the future supply of mortgage credit, especially to risky borrowers. Also, this new mortgage structure raises questions about rules for appropriate house maintenance and procedures if households miss rent payments.

Policies Based on Providing Government Funding

As a substitute or complement to the policies in the previous section, the government could provide funding to reduce mortgage amounts owed.[5] These proposals highlight the challenge in deciding how much public money should be used to help households who are facing serious mortgage problems but may be better off overall than many households not being helped.

Change tax treatment of mortgage writedowns

The tax law was changed last year so that the capital gain from a principal writedown is not taxable income to the borrower.

Create a tax credit for home buyers

Such a credit might spur housing demand.

Direct money to state and local governments

Federal funds could be provided to state and local governments to help households refinance their mortgages, to buy foreclosed properties and resell them or use them for rental housing, or to limit the impact of foreclosures on communities in other ways.

A number of mechanisms might be used:

- Give state governments or housing agencies the right to issue more general obligation bonds to support refinancings. For example, one proposal calls for $10 billion in new bond authority over two years.
- Provide block grants to states or localities to buy unoccupied property. For example, one proposal calls for $10 billion in additional funding for the Community Development Block Grant program.
- Direct federal money to states in some other form.

One important advantage of funneling money through state and local governments is their closeness to the particular situations and needs in their areas.

However, there are disadvantages as well:

- Not all of these entities are experienced at mortgage finance. Relying on them to manage refinancing poses risks to the households involved and to the effective use of public funds.
- Similar people in different areas of the country would end up being treated differently.
- Funds are unlikely to be allocated across the country according to need—which varies substantially across states and metropolitan areas—but rather according to factors that are more important politically and less important economically.

---

[5] A different use of government funds would be to provide help to families that lose their houses to foreclosure. This note focuses instead on policies designed to reduce foreclosures.

Make loans to mortgage lenders through the Federal Home Loan Banks

For example, the FHLB system has already loaned Countrywide about $50 billion. If repaid, this loan will not cost the government money, but there is some risk that it will not be repaid.

Have a federal agency or corporation handle widespread refinancing of mortgages

A range of specific proposals falls under this umbrella. The proposals differ in structure and amount of government funding, but they have the same fundamental logic.

In essence, mortgage servicers would have the option of selling each mortgage to a government entity at a reduced price—perhaps the current market value of the mortgage or of the house. Presumably the servicers would do this only for households that were not making their payments or were expected to stop making their payments. The government entity would issue the household a new mortgage of this reduced amount, which would be expected to restore positive equity. The new mortgage would be guaranteed by the government entity and then sold to a private financial intermediary that could either hold the mortgage or securitize it. Because participation is voluntary for lenders, the approach would not restrict future credit supply.

Some of these proposals are structured as an expansion of the role of the FHA. For example, Credit Suisse has recently advocated two significant changes in the FHASecure program:

- Cover a broader group of borrowers: fixed-rate borrowers (as well as the adjustable-rate borrowers now covered) who are delinquent for any reason (not just a reset as now) and who have made six monthly payments at any time (rather than just prior to reset as now). Most of these borrowers are risky enough that they would not be accepted under FHA's regular underwriting standards. CS claims that these guidelines—especially relaxing the requirement to be current up to the loan reset date—would qualify half of delinquent subprime borrowers (600,000 households) compared with only 3 percent in FHASecure. Unless risk-based insurance premiums worked very well, the greater risk would cost the government some money in expected value.
- Provide a loan with a lower principal balance if the lender accepts the proceeds as full payment of the loan (which amounts to a short sale).

Others of these proposals use the Depression-era Home Owners' Loan Corporation (HOLC) as the model:

- The HOLC was launched in 1933 and disbanded in 1951. For three years it bought mortgages from banks and issued new loans to homeowners, financed by capital from the Treasury and bond issuance in financial markets. By 1937, HOLC owned 14 percent of the dollar value of outstanding mortgage loans, which would equal $1.4 trillion today.

One crucial question is how much these proposals would cost:

- As the proposals are described, they may appear to be essentially costless. For example, the HOLC ultimately returned a surplus to the Treasury. However, this view is likely too optimistic.
- First, the government could be taking on considerable risk.
    - How many households and servicers would take up these options is unclear.

- How many of the loans would succeed is unclear. For example, nearly one-fifth of HOLC borrowers ultimately defaulted, and their homes had to be sold. The HOLC operated in an overall economic environment that was much less favorable than the current one; on the other hand, house prices rose very sharply during the 1940s, and few analysts expect that to happen again over the next decade.
- Servicers will tend to refinance the better risks themselves and direct the worse risks to the government. Moreover, the servicers will likely know more about their customers than the government and be sophisticated in using that information. Unless the government can overcome this selection problem in some manner, the program will be more expensive than one might expect.

- Second, servicers might not accept this option in large numbers without some "sweetening" through government subsidies.
  - As discussed earlier, servicers are deterred from principal writedowns due to both rational reasons and inertia. For these proposals to make a difference—that is, to induce servicers to write down principal they are not willing to write down now—the servicers will need to get a better deal.
  - These proposals would: a) attract a lot of attention, which could overcome inertia; b) create a standard approach, which could establish a presumption that servicers are acting appropriately; and c) offer a one-stop process for getting an immediate and certain payoff, which is better for servicers than trying to issue new mortgages while modifying the old ones. However, this may not be enough to lure in servicers. The government might also need to subsidize the refinancing process or even pay down some piece of the existing principal.
- If any substantial amount of funding is required for each mortgage handled (including the probabilistic cost of defaults), the cost of the program could be quite large. In particular, it will be difficult—both practically and politically—for the government to discriminate in eligibility for this program between those who are likely to default and those who will keep making payments despite negative equity. Thus, the number of households helped per foreclosure reduced may be high.
- Covering one to two million households would require roughly $300 billion in lending and, using the HOLC capital ratio, $30 billion in capital.

A second crucial question is whether these proposals are a good use of public funds.

- As discussed at the beginning of this note, a robust policy response to the foreclosure problem can be motivated by the desire to protect vulnerable people, to avoid the inefficiency of widespread foreclosures, and to help communities and the overall economy. However, spending public funds to refinance mortgages should be compared to other uses of these funds in terms of equity and effectiveness at reaching these goals.
- Possible concerns about these plans include:
  - The plans would directly help a fairly narrow slice of the population. Many people who would be helped to refinance their mortgages are not more deserving of help than are many other people who have positive equity in their houses but have other economic problems like low income or lost jobs. In contrast, the stimulus law cost more than $150 billion, but it provided benefits to roughly 130 million households. Of course, refinancing mortgages would have spillover benefits for households not directly affected, but so would other uses of government funds.

  - Within the set of people who would be helped to refinance, some are victims of predatory lending or otherwise deserving of aid, while others took larger risks or made poor investment choices. Here, the problem is the breadth of the plans and the difficulty in distinguishing among households.
  - The selection problem noted above means that the people who end up in this program will be disproportionately those who are in houses well beyond the reach of their incomes. Most people would probably prefer to help households who can stay in their houses with a modest amount of help, while recognizing that other households will need to move.
- Ways to narrow the population served by these programs include:
  - Covering only mortgages for owner-occupied primary residences.
  - Covering only households that can comfortably afford the reduced amounts.
  - Covering only people who are not meeting their mortgage payments—except that this would encourage more people to stop making payments.

A third crucial question is the best structure of this new operation.

- The development of the securitized mortgage market since the 1930s suggests that the government entity could confine its role to the refinancing process and not hold the mortgages on a long-term basis itself (as HOLC did).
- The shortness of the time horizon suggests that the country should use the existing entity of the FHA rather than create a new organization. However, a new organization with a new focus would have advantages as well.