Insight

A Cure for the Housing Blues

OCTOBER 31, 2011

The biggest impediment to economic growth is the housing overhang, a fact that's beginning to be acknowledged by both parties. In the last three weeks Glenn Hubbard and Martin Feldstein—two former Council of Economic Advisers chairmen for Republican presidents—published op-eds with plans for writing off some portion of the mortgage debt for homeowners whose mortgage exceeds the value of the house, a status typically referred to as being "under water." Meanwhile, the Obama administration last week chimed in with its latest plan to spur refinancing by homeowners whose under-water loans are held by Fannie Mae and Freddie Mac, hoping that lower interest rates will keep these borrowers from defaulting.

The weight of the collapsed housing sector on the economy means that no amount of stimulus, whether a short-term Keynesian fix or a conventional pro-growth package, will fix this problem. Not only are nearly 25 percent of homeowners holding mortgages for more than their houses are worth, there are also nearly four million households that have stopped making mortgage payments at all. In the time it takes—usually one to two years, sometimes longer—for the legal system to put them into foreclosure and make them move out, these families (and the mortgage holders) find themselves in an uneasy limbo: The mortgage holders aren't getting any money and the families aren't spending all that much either, with the result being that consumption, lending, and the overall economy stagnate.

We don't need another stimulus to fix what ails the economy. We need to fix the housing market. And the way to do that is to allow a mortgage cramdown in the context of a personal bankruptcy. Put simply, someone who owes $450,000 on a house worth $300,000 isn't going to be helped that much by a lower interest rate. He would be helped—as would the housing market and the larger economy—if the lender could be compelled in a bankruptcy proceeding to write down the loan amount to $300,000, which is all the lender would recover in any case were it to foreclose on and then auction off the property.

Bankruptcy Made Simple

A person who files for bankruptcy can choose to do either a standard or so-called Chapter 7 bankruptcy (named for that portion of the bankruptcy code), or he can file for bankruptcy reorganization, also known as a Chapter 13 bankruptcy. Under the latter plan the debtor and his lawyer present a list of his assets and debts to the judge and bankruptcy trustee, acting on behalf of the creditors, and they negotiate a repayment plan. Such plans usually cover three to five years, with the trustee receiving periodic payments from the debtor and doling them out to his various creditors.

Completing a Chapter 13 bankruptcy plan discharges most debts even if they are not paid in full, save for taxes, student loan debt, and a few other exceptions. Among the most important exceptions are home mortgages. A bankruptcy judge is not allowed to reduce the value of a home mortgage.

In this, a primary mortgage is unique among debt that is secured by some sort of collateral. If the debtor has a car, a boat, or a second home for which he owes more than the current market value of the asset, the judge can reduce the amount of the debt to the market value. It is in both sides' interest for the judge to have this power:

Otherwise, debtors who file for bankruptcy would simply relinquish title to the property, and the creditor would then have to go and find a buyer, at some cost to him. Writing down the value of the debt gets the creditor the same amount of money as if he had taken possession himself and sold it, but without the hassle.

Allowing such a cramdown for a mortgage on a primary residence would require us to acknowledge a simple fact: The person who owes $450,000 on a house that is currently worth $300,000 is almost assuredly never going to pay the full amount he owes; eventually, he will either be granted a loan modification to reduce the principal or else he will walk away—no matter how much we try to shame him into "doing the right thing." The cost of walking away in most states amounts to little more than the inability to buy another house in the next five years, since most mortgages are in practice nonrecourse loans, meaning that the debtor does not have to make up any deficiency if he returns the house to the mortgage holder and it sells for less than the mortgage.

At the moment, mortgage loan modifications are entirely at the discretion of the lender. But thanks to the disintermediation of the mortgage market in recent decades, negotiations between the mortgage holder and the debtor can be nearly impossible to initiate, despite a plethora of administration programs designed to ameliorate this problem. (The mortgage holder is typically an investment bank or some other investor who holds it along with a host of other mortgages in a mortgage-backed security.)

Ironically, one of the arguments offered for exempting home mortgage loans from being crammed down in the 1978 bankruptcy reform was that the community banks and savings and loans that issued most home loans were well-positioned—and had an incentive—to negotiate with a financially troubled homeowner to avoid foreclosure. As that is no longer the case, bankruptcy judges should be given the power to impose cramdowns.

Fairness

Republicans typically react to suggestions of mortgage cramdowns with indignation, arguing that it sets a bad precedent and rewards speculators and people who didn't play by the rules. There is some truth to this: For instance, economists Michael LaCour-Little, Vincent Yao, and Eric Rosenblatt find that a good portion of foreclosed homeowners in Southern California bought their homes well before the peak of the price bubble and managed to extract a considerable amount of equity from the home before the crash. They estimate that the typical return on equity for those with foreclosed houses approaches 40 percent—not a bad haul.

However, should meting out fiscal justice trump economic expediency? It's a question that policy-makers have asked themselves previously. In his book *The Banking Panics of the Great Depression*, Elmus Wicker notes that the Federal Reserve maintained a tight monetary policy well into the 1930s that they knew would lead to the collapse of banks throughout the country, which in turn would crater the economy. Nevertheless, they held fast to this path not just because of a Darwinian economic perspective but also because of a widely held notion (at least within the Fed) that helping these troubled banks would be rewarding failure.

Phillip Swagel, assistant secretary for policy at Treasury in the latter years of the Bush administration, wrote in a paper for the Brookings Institution that his old bosses rejected any cramdown because they feared its subsequent impact on the lending markets for middle-income households. Resorting to a cramdown, they reasoned, would lead mortgage issuers to tighten credit standards as well as demand higher down-payments. It's safe to say that this ship has sailed. Cramdown or no cramdown, credit standards are tightening and higher down-payments will be the rule.

Who Gets a Break?

Ultimately, America has a choice: Do we continue to insist that the people who made bad bets in the housing market get punished for their wagers, or do we focus on creating policies that have the best chance of ending our economic malaise? Once we decide that the latter should take precedence, the next step is easy: We allow mortgage cramdowns to occur in the context of a Chapter 13 bankruptcy reorganization.

By doing it in the context of bankruptcy, we set a high bar on who takes advantage of a cramdown: Someone who is marginally under water is not going to want to go through the proctology exam that comes with a Chapter 13 bankruptcy or to pay the thousands of dollars of lawyers' fees to fil
e. But someone $100,000 in the hole is likely to explore the possibility—exactly the incentive we want to create.

The worry that mortgage-holders are going to take a hit is valid: While granting mortgage relief through bankruptcy minimizes the costs of fixing the housing market, the government may still find it necessary to provide some sort of relief to various holders of mortgage-backed securities, which would be politically unpalatable but much less expensive than the president's proposed $447 billion stimulus plan, while having the advantage of actually providing real stimulus.

But the true cost of a cramdown will not be that significant: At the end of the day the investors holding mortgages aren't likely to get more for their mortgages than what the houses are currently worth. So the real question is who should live in those houses? The people now in them, or the people who would buy them for pennies on the dollar after the wrenching and complicated ordeal of a foreclosure and auction?

When I was a newly minted Ph.D. economist I was asked to meet with my hometown bank on behalf of a lawyer who had some clients who needed auto loans and had recently filed for bankruptcy. The terms we proposed seemed sensible: a loan for half the value of the automobile, secured by the car itself, at an interest rate 50 percent higher than what the bank charged its normal customers.

The bank refused, saying they worried that these clients would file for bankruptcy again and stiff them. Impossible, I pointed out—someone can file only once every six years, and besides that, the car would deed to the bank—insured for its full amount—should the client cease payment. And these people were now debt-free, making them good bets for at least the three-year term of the loan. All had steady jobs.

The bank president responded by asking me to leave his office, explaining tersely that it was not a matter of profits or losses—it was a moral matter, and that the bank didn't feel comfortable having clients who had previously reneged on their debts, even if such a stance cost the bank profits.

I left the premises and sold my stock in the bank shortly thereafter. The bank no longer exists, a casualty of a previous downturn, exacerbated by what I imagine were a host of poor decisions made for reasons other than maximizing returns to the shareholders.

Appeals to morality are a poor excuse for inaction. After four years of declining home prices and concomitantly negligible economic growth, it is time to abandon talk of stimulus plans and focus on fixing the housing market. Once we make that transition, the relevant question is how to most quickly and at the least cost reduce the number of homes either being foreclosed on or likely to be foreclosed on because they are so far under water. Allowing mortgage cramdowns in bankruptcy reorganization offers a way out for homeowners who are hopelessly under water and for lenders who are putting off the day of reckoning. Everyone who wants an

economic recovery would benefit from this change in our bankruptcy code.

This article appears in The Weekly Standard November 7th, 2011 issue.