



**SHADOW
FINANCIAL
REGULATORY
COMMITTEE**

COMMITTEE MEMBERS

GEORGE G. KAUFMAN
Co-Chair
Loyola University Chicago

RICHARD J. HERRING
Co-Chair
University of Pennsylvania

GEORGE J. BENSTON
Emory University

MARSHALL E. BLUME
University of Pennsylvania

CHARLES W. CALOMIRIS
Columbia University

KENNETH W. DAM
University of Chicago Law School

ROBERT A. EISENBEIS
Economic Consultant

PAUL M. HORVITZ
University of Houston

EDWARD J. KANE
Boston College

ROBERT E. LITAN
Brookings Institute and
Kauffman Foundation

KENNETH E. SCOTT
Stanford Law School

CHESTER SPATT
Carnegie Mellon University

PETER J. WALLISON
American Enterprise Institute

An independent committee
sponsored by the
American Enterprise Institute

<http://www.aei.org>

Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

Statement No. 250

For Information Contact:

Edward J. Kane
617-552-3986

Kenneth Scott
650-723-3070

Chester Spatt
412-268-8834

Statement of the Shadow Financial Regulatory Committee on
Treasury Department's Mortgage Foreclosure Program

December 10, 2007

The simultaneous bursting of bubbles in subprime lending and structured securitization is producing substantial turmoil in housing and financial markets. Policymakers are particularly and perhaps disproportionately concerned with foreclosures that will arise from resets of interest rates scheduled on subprime adjustable-rate mortgages (ARMs).

According to FDIC Chairman Bair, 1.3 million ARM resets are anticipated by the end of 2008 with an additional 422,000 loans scheduled to reset in 2009. Because of weaknesses in underwriting the underlying mortgage loans, it is projected that many subprime borrowers will not be able to meet their stepped-up obligations in full.

A major problem is that recent vintages of mortgage loans have been sliced and diced into securitization structures that separate the investors that are exposed to losses from any contact with the particular borrowers whose distress creates their loss exposure. Although renegotiating distressed loans might serve joint interests, responsibility for choosing between modifying securitized loans or foreclosing on the underlying property lies with "servicers" of the loan pools into which the borrower's obligations have been aggregated. Everyone agrees that foreclosures are costly to investors,

homeowners, and the communities in which the homes are located and should be limited to cases in which reasonable modifications could not enable borrowers to stay in their homes. The public policy issue is what kinds of coordinated action can help servicers identify these borrowers and to determine the particular modifications that would serve the best interests of society.

Last week, the Treasury announced an initiative designed to help servicers accomplish these difficult tasks. The Treasury program is only one of many proposals aimed at mitigating problems in the subprime mortgage market. Some involve government-mandated changes in contract terms, while others combine interest-rate forgiveness with the injection of public funds. Regardless of the approach suggested, all presently suffer from incomplete identification of the interests of affected stakeholders and unfairly advantage some groups at the expense of others. Stakeholders include borrowers, lenders, investors, servicers, and other homeowners.

Some proposals would interfere with the legal structure of contract rights which is central to a well-functioning financial system and economy. The parameters of the Treasury initiative are extremely detailed and the relief being offered is tightly prescribed and being offered to only a subset of affected stakeholders. The modification proposed would freeze the interest rates on eligible subprime ARMs at their starter rate for 5 years. Eligible households would have to meet a number of criteria. Their loans could not be delinquent and their FICO scores would have to lie between 575 and 660. The loans would have to be first liens on owner-occupied housing and initiated and scheduled for reset during particular windows of time. A homeowner's particular lender and servicer have to choose to participate in the program.

What would be the consequences for lenders and investors? The argument is that costs of foreclosure, repossession, and resale would be avoided in most cases and would be less than the lost expected interest. That is the kind of determination that mortgage servicing firms are authorized to make if they find it not materially adverse to investors and in accordance with accepted servicing practices. The Treasury plan seeks to provide a specific (re)definition of industry standards of practice, though it would face challenges in court.

The Treasury plan has several loose ends and raises a number of difficult issues. The over-riding issues are those of fairness and efficiency. It is likely that more flexible contract modifications and eligibility criteria could have been worked out between servicers and borrowers working within the particular geographic areas for which the potential for defaults and foreclosure was most pressing. The interest-rate freeze appears to reward borrowers who made bad decisions and does not address the urgent needs of the large number of fixed-rate borrowers and of households that have already fallen behind in their payments. Eligibility criteria will encourage credit-score gaming. Borrowers whose score lie below 575 can be up to that lower threshold and borrower whose score exceeds 660 can be helped below it.

But there is an equally large category (around 600,000) of subprime borrowers who are already in default or foreclosure even under the initial starter rate, and they would be outside the Treasury plan because the starter rate has already been demonstrated to be

beyond their financial capacity. While restructuring is not a meaningful option for this category, the Committee would suggest a parallel plan be explored in which the borrower would tender a deed in lieu of foreclosure and receive a rental agreement at something less than the starter payment rate. Where feasible, this too would achieve savings of foreclosure and repossession costs and afford an opportunity to keep borrowers in their residences.

Additional problems of fairness and moral hazard are raised by wholesale adjustment of investor and lender claims to interest-rate income under pre-existing mortgage contracts. Rewriting mortgage contracts without open negotiations between servicers and investors promises to discourage future investors from participating in markets for securitized loans.

With the aim of clarifying the policy debate, the Committee finishes with a discussion of three specific issues.

To what extent do legitimate concerns about external effects from mass foreclosures justify coordinated action to develop guidelines for renegotiating the terms of subprime mortgages that are about to reset their contract interest rates?

Externalities consist of neighborhood declines in home prices, relocation costs, and social upheaval from foreclosures. A benchmark protocol for industry best practice in renegotiating mortgages can help servicers by reducing their transaction costs and might limit their legal risks by being able to modify subprime mortgage terms en masse.

However, the social costs and incidence of borrower distress are truly severe in a limited number of local and regional sections of the country. This suggests that the social costs are not really a national problem and would be better served by tailored local solutions. Taking a national approach produces a wider and more uncertain distribution of gains and losses, and the Treasury's proposal multiplies stakeholders in ways that are hard to anticipate, much less to defend.

How helpful will the Treasury initiative be?

Many mortgages are excluded from interest rate mediation and from the program of FHA refinancing assistance. An ideal program would address the problems of distressed borrowers as a class.

The particular mortgages included in the Treasury proposal are especially risky and the extremely high leverage of these loans is not reduced by the freeze. A five-year freeze on interest-rate resets may not prove to be a permanent solution to these borrowers' distress. Although leverage would improve if home prices in the affected areas rise over the next five years, the extent of any rise is uncertain and the prospects seem weakest in the parts of the country hit hardest by subprime distress.

To what extent is it desirable for the federal government to coordinate the process of benchmarking industry best practice?

It is hard to see why government is needed to establish agreement among servicers about how to standardize approaches to mitigation for particular classes of borrowers. Generally, it is better to leave the details of workout arrangements to private parties who are responsible for protecting investor interests, while searching for efficient solutions to borrower financial distress.

However, a privately negotiated benchmarking process may also subject services to significant legal risks. In this regard, government involvement may deter legal action because government involvement lends external credibility to any consensus about the appropriateness of industry practices and procedures.

The Treasury initiative would especially benefit a small group of very large servicers who are also mortgage investors. These firms face potentially huge increases in their operating costs if they proceed on case by case under existing mortgage mitigation protocols. Delays in assembling and training appropriate staff would lead to forbearance and slow efforts to take over defaulted properties.

What unintended economic costs might be associated with the guidelines established under the Treasury initiative?

The program makes arbitrary and discontinuous distinctions between borrowers who are included and excluded from the program. Many of these borrowers have struggled to repay their loans. The proposed initiative fails to reward borrowers who made good decisions and labored to meet their obligations. It also excludes borrowers whose loans have already been reset. To the extent that the mitigation program can be viewed as a “bailout” of selected borrowers, it reinforces incentives for subprime borrowers to engage in moral hazard.

The current rules for eligibility are based on a limited range of FICO scores for borrowers not already in default. Besides inviting gaming of the assistance criteria, forgiveness of interest will create moral hazard going forward. It reinforces the belief by borrowers that the risks of interest rate resets can be shifted to investors rather than borne by borrowers. This belief encourages borrowers and lenders to write imprudent mortgage contracts with insufficient equity. Excessive leverage in recent lending has been the result, in part, of government efforts to channel assistance to would-be homeowners in the form of subsidies that grow with borrower leverage. The Treasury initiative promises to reinforce the bias toward excessive leverage. It encourages borrowers to believe that high leverage increases the chance that they will be relieved of debt service requirements when home prices fall.