Mortgage Delinquencies and Foreclosures

Article

By Shadow Financial Regulatory Committee

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For most of the last year there has been growing concern with mortgage delinquencies and foreclosures. The focus has been on subprime adjustable rate mortgages, which after an initial period can reset to higher rates and already show uncomfortably high default rates. But the problem is also affecting conventional mortgages, though to a much lesser degree, as housing prices have started falling and have created negative equity.

Highly leveraged homeowners have little room for absorbing declines in housing value. With the collapse of the real estate bubble and increases in unemployment, many households face foreclosures and the rate of foreclosure continues to grow. Recognizing that many homeowners have

little or no equity in their homes, congressional committees and various federal agencies have generated numerous plans aimed at restoring owner equity by allowing struggling homeowners to obtain a write-off of some of their outstanding debt and to refinance the balance into a federally guaranteed mortgage loan.

The plan advanced by Treasury Secretary Paulson last November tried to address the projected consequences of resets by urging a program of freezing the initial rates for five years for those borrowers who had met their payment obligations thus far. The plan did not address the situation of those already delinquent or in foreclosure, then estimated at around 600,000 borrowers. Many of them had obtained loans with little or no downpayment and had insufficient income to meet even low initial rates.

That group is quite large enough to attract political support in claims for government assistance, under a variety of rationales. Some blame mortgage lenders for deceit or simply for having made them a loan in the first place; some now use the Federal Reserve's systemic risk assistance for Bear Stearns to say it would be unfair not to assist them too. As a result, there are numerous proposals in Congress as well as ones from the Administration and various agencies.

These plans generally entail substantial federal intervention into mortgage contracting and housing markets that provides short-term relief for eligible parties at the expense both of other taxpayers and of incentives to negotiate less-leveraged mortgages in the future. Most proposals envision haircutting mortgage lenders to some degree and would use federal monies either to guarantee the balance of the refinanced loan or to finance a second lien. A few plans earmark additional monies for cities and states to use to buy up houses that go into foreclosure.

Before embarking on federally funded programs of unclear but readily expandable dimensions, it is desirable to consider as wide a range of remedies as possible. In Statement No. 255 (February 11, 2008), the Shadow Financial Regulatory Committee briefly suggested an initiative that could be promoted by the Treasury and American Securitization Forum–as they did with the Help Now rate freeze concept–to offer an alternative to borrowers already in or facing foreclosure (with houses worth less than the loan amount). In exchange for a deed in lieu of foreclosure, the borrower could be given a rental lease on the property for a period of several years and an option to purchase it for the current (no doubt reduced) market value. The deed and lease would save the lender the costs and delay of foreclosure, eviction if necessary, property maintenance and ultimate resale. The borrowers would not lose occupancy of their homes, and because of the option would have an incentive to properly maintain them. The securitization pool into which most such mortgages were sold would take a loss, as it should, but would have a continuing cash flow from rental payments under the lease.

Is the proposal free of all issues? Of course the answer is no, but they do not seem insurmountable.

1. If the mortgage had been sold into a pool for securitization, would the administrator of the pool be able to effect such a transaction? It depends on the terms of the Pooling and Service Agreement, but most allow discretion to foreclose or obtain ownership of real estate and hold it for a period until resale. The exercise of discretion is not unlimited, but must be based on a judgment that it is not contrary to the best interest of investors. By avoiding all the costs associated with foreclosure and maintenance, it would not seem unreasonable from an investor standpoint to follow the proposed course.

2. What if the borrower had taken out a second mortgage, to obtain full financing without any downpayment? In this case the second lien would be worthless economically, but it would have to be eliminated legally. Nonetheless, to obtain the second lienholder's cooperation, no doubt some payment would have to be made. If the second followed a hold-out strategy to extract more than a modest sum, foreclosure would still have to be instituted, but after a few examples the lesson would hopefully be learned.

3. There are some questions relating to treatment of debt forgiveness under the Internal Revenue Code as income and of actively managed pools as REITs. Both seem to have been dealt with by recent legislation and IRS rulings.

The Committee has not endeavored to work out all details or obstacles, but offers the proposal as one deserving careful consideration. Its major benefits would be to facilitate private solutions that help lenders and borrowers in a balanced way, obviate the spillover costs of neighborhood deterioration, and not create incentives that would distort mortgage financing and induce even greater risk-taking by borrowers in the future.