

Chapter 16: Executive Summary

Mortgages and Households

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Background

The damage caused by the collapse of the housing and housing finance sectors of the economy is spreading at an alarming rate. Foreclosure activity jumped 81 percent in 2008, with more than 3 million foreclosure filings on 2.3 million properties. The ever increasing number of households who are upside down on their mortgages poses a growing threat to the financial system and the economy as the actual losses, and the uncertainty about their extent, pass through the financial system to the holders of the underlying mortgages and mortgage-backed securities.

While policy makers have paid lip-service to the mortgage problem, the solutions that have been offered so far have been astonishingly ineffective. Without a more thoughtful policy response than we have seen so far, we risk more unfocused programs that have little chance of success. Moreover, many of the proposals that have been on the table are potentially extremely costly and will saddle our children with massive tax obligations. Our generation will effectively be dimming the lights for the next generation.

It does not help matters that the underlying question of how policy makers should respond to the crisis remains unsettled. On the one hand, there are those who view mortgage problems as private, not meriting government intervention. At the other extreme are those who advocate brute force intervention that would pass the vast majority of costs on to taxpayers. We adopt a more nuanced approach, and present a five point plan of action for policy makers that is aimed at overcoming a specific market failure.

The market failure that we highlight derives from the incompleteness of the standard mortgage contract. While this contract calls for the borrower to make a fixed stream of payments, it is implicitly understood by both borrower and lender that such payments will not be possible in various states of the world. Rather than try to specify all such contingencies up front, both parties understand that the contract terms can be revisited in unusual contingencies and suitable adjustments made. In some such contingencies of non-payment, economic logic dictates enforcement of the original contract terms, in which non-payment of the full amount due leads to default and foreclosure. In others, it dictates renegotiation that may fundamentally change the terms of the contract. This is the situation in which we find ourselves today. It was not foreseen in the initial contracts that home values around the country would crash simultaneously with massive declines in income. Given that this negative outcome was largely out of the control of the individual homeowner, renegotiation is a viable solution that can balance the

interests of both. In fact it is hard to see who benefits when masses of households default on their mortgages. Default and foreclosure are long, slow and expensive processes, with the cost of foreclosure estimated to be at least \$70,000 on a median home price of \$200,000. Moreover there are externalities that are associated with properties that do foreclose in that they contaminate the value of neighboring properties

The form of the renegotiation of under water mortgages that we propose involves debt for equity swaps. Such swaps are common in the corporate sector: for example, the recent recapitalization of GMAC and many other lending institutions is based on debt holders agreeing to swap debt for equity in the newly reorganized firm. The rationalization of such a swap is that it replaces the fixed obligation of the debt contract with the more flexible obligation of the equity contract, in which the amount of the ultimate repayment depends on how well the business does. Economic logic dictates that similar forms of debt for equity swap be made available for households that find themselves thrust into problems by forces largely beyond their control. Unfortunately, the institutional realities have hitherto prevented such swaps from being undertaken.

We present a five part plan of action to overcome barriers to rational equity-based renegotiation of existing mortgage contracts. The first stage involves regulators and legislators specifying terms of debt for equity swaps. The second involves their creating an appropriate fiscal and accounting framework. The third involves their setting up projects to demonstrate the economic viability of debt for equity swaps. The fourth involves addressing legal obstacles posed by securitization. The fifth involves the simplification of secondary default for borrowers who swap debt for equity.

Some critical advantages of the plan are:

- It aligns the interests of lenders and borrowers, in that they share costs associated with the fall in house prices, and potential gains associated with their recovery.
- It avoids creating incentives for default or delinquency.
- It respects borrowers' ability to pay in the short run and the long run to avoid secondary default.
- It bridges the contractual divide that separates borrowers from investors in securitized mortgages. This cannot be left to the household.
- It provides a contractual form that is useful in the long run.
- It encourages owners of mortgages and mortgage-backed securities to renegotiate at an earlier stage in the default cycle than they do at present.
- It relies to the maximum extent possible on creative use of regulations to provide incentives for restructuring, greatly reducing costs to the taxpayer.

Overall, our plan would greatly speed market normalization, reduce default and foreclosure, increase asset values of holders of mortgage-backed securities, all the while costing taxpayers far less now than they will be due later. Moreover, it works simultaneously to resolve short run problems and to rectify longer term structural problems of mortgage markets.

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