

The Best Way to Help Homeowners – and the Economy

John D. Geanakoplos* and Susan P. Koniak†

The current economic crisis began with a housing crisis, and then spread with devastating consequences through our financial system, and soon may spread through our economy as a whole. But while we are rushing around trying to pick up all the other falling dominos, the housing crisis continues and must be addressed.

We start with this simple fact: Too many homeowners are being thrown out of their homes when it makes more sense to rework their mortgages and let them stay. In many cases, reworking loans would help the homeowners and the lenders: the new mortgage would involve monthly payments the homeowner could afford to pay, and would leave the lender with more money paid over time than the 50 cents on the dollar that many foreclosure sales are bringing these days after fees.

Senator McCain has recognized this problem. That's why he announced last week that the government would buy out all distressed home loans and then rework them to make the mortgages more affordable. The details of his plan are still somewhat unclear: how much is the government going to pay for the loans? But one thing is clear: his plan will be enormously expensive.

Senator Obama recognizes it too. He just proposed a 90 day moratorium on foreclosures that would provide time to set up a plan for reworking mortgages, but it leaves open what that plan would be. His camp first suggested that judges be allowed to rework mortgages. One version of that idea, which has been floating around for some time, is that bankruptcy judges be given authority to rework mortgages of bankrupt homeowners. That may help some. But not all homeowners with troubled mortgages will file for bankruptcy, nor should we want them to. It would be better to be able to intervene at an early stage to rework mortgages and make bankruptcy unnecessary. Others in the Obama camp have floated the notion of using judges or other court personnel to rework mortgages outside of bankruptcy. That would be cheaper than McCain's idea as it would eliminate the need for the government to buy loans, and get right to the reworking. Nevertheless, we don't think using courts to rework mortgages is the best solution. First, our courts are already overburdened. Second, our judicial system has traditionally not been in the business of reworking mortgages, so judges have little expertise in this complex area. Third, our judicial system is not set up to reach out to solve problems. It is organized to deal with cases brought to it. But whether a reworking succeeds in avoiding foreclosure down the road is in large part a function of how quickly intervention occurs: the less delinquent the mortgage, the greater the chance that reworking the mortgage will ultimately succeed. Quick, aggressive outreach is precisely what our court system is ill-suited to do. The court system, whether bankruptcy court or courts more generally, is not an early intervention tool.

* James Tobin Professor of Economics, Yale University. The reader should know that I am also a Partner in the hedge fund Ellington Capital Management, which trades primarily in mortgage securities.

† Professor of Law, Boston University School of Law, 1993-2005.

We write to propose a different solution.

In the old days, a mortgage loan involved two parties, the homeowner borrower and the bank lender. If the borrower ran into difficulty and was unable to pay, it was in the lender's interest to lower his burden and rework the loan whenever the borrower could reasonably be expected to pay more than the house would bring at foreclosure. The result, particularly in a failing housing market, was that most endangered loans would get reworked, which in turn would help stabilize housing prices.

The world of securitization changed that. There is no longer any equivalent of "the lender" who has the incentive to rework failing loans using the same metric that the old fashioned bank lender would have used. The loans are pooled together, and the pooled mortgage payments are divided up among many securities according to complicated rules. The security holders are effectively the lenders, but legally they are prohibited from contacting the homeowners.

In place of the bank lender, master servicers now hold the power to rework loans. But the servicers are performing poorly and cannot be trusted to perform well.

Why are the master servicers' not doing what the old fashioned banker would do—reworking loans when more money could be made that way than by foreclosure? Because the servicer has very different incentives. The problem is that depending on how the master servicer reworks the mortgages in the pool, some security holders above the pool will benefit -- sometimes massively -- and others will lose out -- sometimes drastically. In short, the interests the servicer is supposed to protect do not all point in the direction of reworking mortgages; they point in widely divergent directions. Because anything a master servicer does to rework a loan will create some big winners and some big losers among a group of security holders to whom the servicer holds equal duties, servicers feel safer doing nothing (allowing foreclosures to proceed without much intervention) because that is the best way for the servicer to avoid potentially huge lawsuits by injured security holders. But doing nothing means letting house after house foreclose that would have brought in more money had the mortgage been reworked. Everyone talks about mortgage backed securities being enormously complex without explaining why. An important reason for the complexity is the existence of these conflicting interests, which are now preventing master servicers from doing what would most help distressed homeowners, many security owners, and our economy as a whole.

But there is more. On top of the huge legal risks, reworking loans can be costly for master servicers. These costs include: documenting what new amount a homeowner can pay, and assessing property values to determine whether foreclosing would yield more or less than what the homeowner can afford to pay. And then there's the cost of finding homeowners who are much more inclined to hide from master servicers, whom they sense may be all too eager to foreclose, than from a neighborhood banker. The fees due a master servicer from the security owners were based on the notion that reworking mortgages would be a relatively small part of their job and would carry little litigation risk (because the housing market was booming then and

the designers of these plans did not imagine how quickly and drastically things could change). Those fees are so low, no wonder little gets done.

There is yet another important reason many master servicers are not doing what they should. Some big master servicers are now subsidiaries in larger financial institutions – institutions that own the very securities that can be affected by the reworking or foreclosure decisions that a master servicer makes. Master servicers are thus put in the impossible position of acting in a way that might harm their already distressed parent organizations, or acting in a way that benefits their parent companies (at the expense of other security owners). This additional conflict further increases the litigation exposure and contributes to inaction.

Thus, it is no surprise that the reworking of mortgages has been so slow, with devastating consequences for the economy more generally. It is also no surprise that trading in the securities above the pools has dramatically declined, because potential buyers cannot be sure what the servicers are going to do with the loans.

In response, we propose legislation that removes the reworking function from the paralyzed master servicers and transfers it to government-appointed trustees who are given no information on which securities sit atop the mortgages, or how those securities would be affected by the reworking and foreclosure decisions they make. Under our plan, the master servicers would continue to service the loans, and continue to receive the fees they are now due. The only thing taken from them essentially would be the capacity to oversee the workouts of the failing mortgage loans.

Instead of trying to maximize the value of a particular pool of mortgages, the community-based “blind trustees” would consider loan by loan whether a reworking would bring in more than a foreclosure, which in many cases would turn out to be the case. The government expense would be limited to hiring the trustees and running their operations -- no small expense, but much cheaper than first buying the loans out and then running a reworking operation, which is the McCain plan. And also much more efficient than having judges attempt this role, which is the Obama plan. Our trustees would be hired from the ranks of community bankers, and thus have the expertise that we think the judiciary lacks. No Wall Street whiz-kids need apply.

Much progress has already been made in establishing servicing guidelines, chiefly through the efforts of the Hope Now Alliance. These guidelines will make the trustees’ job easier and reduce administrative costs. Strict guidelines to ensure that only homeowners in true financial distress qualify to have their mortgages reworked is essential to avoid the moral hazard that would otherwise be created by a program that homeowners might view as a free ride to a cheaper mortgage. Similarly, the assessments of net present value that would be realized in foreclosure must be strictly documented. Efforts could be made to ensure that the trustees had the proper incentives.

Our plan would keep many more Americans in their homes, and put government money into local communities where it would make a tangible difference. By clarifying the true value of each loan, our plan would also help clarify the value of the securities sitting atop the mortgages

(and thus revitalize the trading of them). In contrast, McCain's plan of buying out the loans first and reworking them later would artificially inflate the value of some securities and arbitrarily deflate the value of others. Worse, it seems that the price he intends to pay would be too high, artificially rewarding security holders at taxpayer expense. Most important, our plan would help stabilize housing prices.

But more needs to be done to stabilize home prices. Empty foreclosed homes are a significant drag on the economy. Our plan, while decreasing significantly the number of foreclosures, would still result in some new ones down the road. So we also propose that the government offer to buy a 20% share of any purchase of a foreclosed home, or any home purchased as a primary residence by somebody not currently living in a home. This would lessen the down payment and the monthly cost of borrowing for home buyers, and at the same time reduce substantially the risk of lending for the banks because the government's share of the house would also stand as collateral for the mortgage. When the new homeowner sells the house in the future, the government would be due not just its money back, but also 20% of any appreciation in home value. This allows the taxpayers not only to contribute to stabilizing the housing sector, but also to reap a return on their investment when the house is eventually sold.

In sum, we need a bold, innovative approach that overcomes the gridlock that plagues our housing markets and imperils millions of homeowners and -- derivatively, through the alchemy of derivatives -- the American, and indeed global, economy.