

The Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System

Memo to the Commission on Foreclosures

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With real estate bubbles bursting around the world, many countries are facing a problem with foreclosures. Unless something is done to address the problems of foreclosures, banks will continue to face losses, and there is a risk of overshooting of real estate prices, as the effects of forced sales are felt. Given the externalities generated, government assistance to enable especially poor families to stay in their homes may be warranted. There are large deadweight losses when houses are left vacant.

The underlying problem is simple: banks made loans based on inflated housing prices; the mortgages were beyond many individuals' ability to pay. The following memo outlines a comprehensive approach to dealing with the problem of foreclosures.

1. Dealing with the current foreclosure problem: a homeowners chapter 11

There are a number of easy ways of dealing with the foreclosure problem—such as bailing out the lenders at the same time as writing down the loans—which, in the absence of budget constraints and worries about future moral hazard would make everyone (other than ordinary taxpayer) happy. Individuals could stay in their homes and lenders would avoid taking a hit to their balance sheets. Knowing that the government is taking this risk off of balance sheets would contribute to alleviating the credit crunch.

The challenge is how to save the homes of the hundreds of thousands of those who otherwise would lose their homes, and *not* bail out the lenders, who should be made to bear the consequences of their failures to assess risk. (Clearly, borrowers also share in the blame, but, for the most part, the lenders were, or should have been, far more financially sophisticated than the borrowers, especially most of those taking out sub-prime mortgages.)

One answer is a “homeowners’ chapter 11”—a speedy restructuring of liabilities of poorer homeowners, modeled on the kind of relief that we provide for corporations who cannot meet their debt obligations. Chapter 11 is premised on the idea that keeping a firm going is critical for the firms’ workers and other stakeholders. The firm’s management can propose a corporate reorganization which the Courts review. If found acceptable, there is a quick discharge of debt—the corporation is given a fresh start. The homeowners’ chapter 11 is premised on the idea that no one gains from forcing a homeowner out of his home. There are large transactions costs associated with

foreclosure. And typically, following foreclosure, there is a deterioration in house maintenance, and adverse effects on the community.

Eligibility standards This relief should be available for households with income below a critical threshold (\$150,000) and with non-household, non-retirement wealth below some critical threshold (perhaps dependent on age). But an argument could also be made that it should be more generally available.

Procedures The house would be appraised, and the individual's debt would be written down to, say, 85 to 90% of the level of that appraisal (reflecting the fact that were the lender to have to proceed with foreclosure, that would be substantial transactions costs).

An assessment of the individual's ability to make mortgage payments at the lowered value and current market interest rates would then be made (at a conservative standard—it again does no good to hope that the individual will be able to make payments that are beyond his ability.)

If the borrower could still not make the now reduced payments, the borrower could then get a government loan as described in the next section, which takes advantage of the government's lower cost of funds. (To reduce the likelihood of foreclosure, this possibility could be extended more generally.)

2. Voluntary Restructuring of existing loans

With the government assuming an increasing role in the financial sector (through ownership of Fannie Mae and Freddie Mac and equity injections), it can use its role to push mortgage restructurings (as it has already been doing in some cases.)

The threat of a homeowners chapter 11 action would always promote voluntary restructuring.

In the next section, we discuss how government can use its lending programs to induce restructuring.

3. Expanded government mortgage lending

The usual argument *against* government lending is that the private sector does a better job of screening loan applicants and designing appropriate mortgages. The evidence against that view is now overwhelming. A simple rule based government mortgage program could provide mortgages at better terms and with a lower risk of default than the private sector. There are a number of variants of this proposal (some already in place at a limited scale.) By passing on the government's lower cost of capital, and using the enforcement capacities of the IRS, loans could be provided at lower interest rates, without adversely affecting the government's budgetary situation, and these lower mortgage rates would then lower default rates.

We can think of this as a form of benchmark competition. If the private sector can provide loans at a lower interest rate, so much the better. But there is one not insignificant problem: the government competition will erode profits of the private banks, and weaken the very institutions which, through other efforts, we are trying to strengthen. And it raises a fundamental question: if the government is better at lending, do we really want to replace private sector lending with government lending? And if so, why limit the government lending to housing? There are other areas of even higher social return.

Given the lack of consensus about the appropriate role of government in lending and the downside risk from harm to current good lenders, the government lending program should presumably be circumscribed—focused on low and middle income homeowners, with interest rates consistent with long term interest rates when markets are functioning reasonably well given current long term inflationary expectations (say 5% to 6%). We should not be in the business of giving away large gifts, or of supporting housing prices at levels that are not sustainable. We should be addressing current market distortions, but it is questionable whether we should go beyond that.

Refinancing existing mortgages With long term interest rates at record low levels, it may be possible to refinance large numbers of mortgages in ways which will make them affordable—and still leave the government earning a return. The threat of the government doing so may itself provide an incentive to encourage banks to restructure their loans. For if the government refinances, say, a 6% mortgage, the bank receiving the money may have few good investment opportunities.

The government could, for instance, offer to refinance all mortgages that have not been restructured according to government specifications. The low interest rates have, in effect, given mortgage lenders a windfall gain, though the mortgage may still have a low value because of the risk of default.

In some cases, there is a pre-payment penalty. The savings from the lower interest rate would, presumably, in most cases more than offset the pre-payment penalty, and the government could provide finance for the pre-payment penalty as part of the refinanced mortgage. The government could use the homeowners' chapter 11 to override the pre-payment penalty, or alternatively offer to pay, on behalf of the homeowner, the pre-payment penalty. The costs of such payments are likely to be low, especially in relationship to the costs of the current disruptions in financial markets. Alternatively, the government could combine an override under a version of a homeowners' chapter 11 with a partial payment of the pre-payment penalty in those instances where the lender could establish that he (i) had fully disclosed and explained all the terms of the mortgage to the borrower, including the pre-payment penalty; (ii) had not made any representations about the likelihood of price increases; (iii) had not engaged in other abusive lending practices; and (iv) but for the government intervention, would have had a likelihood of having the loan fully repaid.

Government Subsidies Some have proposed using TARP to provide subsidies to homebuyers, though not to help subsidize refinancing. The argument is that such subsidies (proposals being currently discussed amount to a 10% reduction in price) would encourage more demand for housing, and thus boost house prices. We face a quandary: we want house prices to adjust to the “equilibrium level,” which may entail a further reduction from the current level. Resisting that will simply extend the duration of adjustment. (One can debate whether a longer and possibly shallower downturn is preferable to a shorter and deeper downturn. But at the very least, one should be aware of the downside risk associated with interfering with the adjustment process.) On the other hand, we do not want “overshooting.” We are not yet at the point where we are likely to have overshot. But we may be at that point within a year or so.¹

Recourse loans In addressing the mortgage foreclosure problem, there is one modification that should be considered. If the mortgages provided by the government were full recourse mortgages, default rates would be greatly reduced, because individuals would know that they could no longer simply walk away from their debts. This would enhance a “credit culture,” which would improve the functioning of credit markets.

A recourse mortgage should, obviously, be less attractive to borrowers, but most borrowers do not plan to default, and therefore they would probably be willing to access such a mortgage at an interest rate little different from that on a non-recourse mortgage.

But this restructuring of debt provides a major gift to lenders, for the reduced likelihood of default increases the value of that part of the mortgage which they retain. They should not be given this “gift” freely. There are social gains from the reduced likelihood of default that need to be equitably distributed.

Here is one way that that could be done: In the case of banks willing to go beyond the framework of the “Homeowners chapter 11” outlined above, and say write down the mortgage to 75% or 80% of current market value, the government would provide a *recourse* mortgage, charging the homeowner a slightly lower interest rate (say 25 basis points lower). Everyone wins from this proposal.

Model bankruptcy restructurings for other cases (e.g. homeowners with an income beyond the \$150,000 limit, or who can afford to pay the written down value of the mortgage) could easily be designed.

Separating speculators from true homeowners

¹ The benefits may be limited by the fact that, if the interest rate is too much below rates at which current homeowners have financed their homes, some individuals may be induced to sell their homes, to get the low interest mortgage. Thus, the program may have supply side effects partially offsetting demand side effects.

One of the objections to these restructuring proposals is that speculators as well as true homeowners may reap the benefits. It is the latter, of course, whose welfare is of particular concern.

One way of addressing the problem is to restrict eligibility to those who are and have been living in their home. Only primary residences would be eligible.

But there is a second approach, based on what economists call the general theory of self selection. After the write down, the lender would retain a share (perhaps all) of the capital gain, to be paid when the property is sold. Speculators would have little (or no) interest in participating, since the debt restructuring would take away all of his speculative gains.

There are some technical difficulties. One would have to take some account of investments in the house made subsequent to the restructuring. The effectively high tax on capital gains could lead to a locked in effect. It would make it costly for individuals to move, since they would then have to pay a potentially large sum to the lender.²

Note that with such conversion of the former creditors into equity claims, the analogy with the Chapter 11 is complete. In Chapter 11, the equity owners are wiped out (here the equity owner is the homeowner, and, if he retains none of the capital gain, his equity claim is fully eliminated), and the former bondholders become the new equity owners.

One could design variants around this theme. One could, for instance, give homeowners a schedule, with large write downs of the mortgage granting larger fractions of the capital gains to the lender.

4. New Mortgages

Ironically, the financial sector, for all of its claims at innovation, has not innovated in ways which are directed at shifting risk from poor Americans to those who are more able to bear the risk. Indeed, variable rate mortgages shifted risk of interest rate variations to homeowners. Other products with balloon payments were even worse.

There are a number of products which have been developed in other countries which could be introduced into the United States.

For instance, even if mortgages are variable rate, poor Americans struggling to make ends meet need to know what their monthly payments are going to be. One can have fixed payments, even with variable rate mortgages, if one lets the maturity of the mortgage be variable.

² There might also be problems of circumvention: two homeowners in a similar position could exchange their homes after the restructuring, wiping out the future capital gain claim, though it should be easy to restrict or discourage such attempts at circumvention.

The Danish mortgage bonds are an alternative structure which has proved successful for more than two centuries.

The government has repeatedly had to take the initiative in innovating financial products (like making mortgages widely available) that meet the needs of ordinary citizens. When they are proven, the private sector often steps in. This may be another instance where government will have to take the initiative in designing new forms of mortgages and in ensuring an adequate supply of mortgages, because of the failure of the private sector to do what it should.

5. Expanded homeownership initiative

Advocates of the reckless subprime mortgages argued that these financial innovations would enable large numbers to become homeowners for the first time. They did become homeowners—but for a very short time, and at a very high cost. The fraction of Americans that will be homeowners at the end of this episode is likely to be lower than at the beginning. The objective of expanding homeownership is, I believe, a worthy one, but clearly the market route has not worked well—except for the mortgage brokers and investment banks who profited from them. They encouraged individuals to buy housing beyond their ability to afford and to repeatedly refinance, generating large transactions costs for themselves. Now, the problem is that these people are not only losing their homes; as they lose their homes, they are also losing their life savings. Mortgage brokers and lenders should have encouraged homeowners to purchase houses that were appropriate to their income.

The underlying problem is simple to state: median household income has been falling and house prices rising. This means that housing is becoming less and less affordable to more and more Americans. There are no easy fixes to the declining incomes (other than shifting the burden of taxation away from these individuals and towards those who have been doing well. Nor is there any way (short of public housing programs) that we can quickly reduce housing prices. (The market correction currently going on is likely to make housing more affordable.)

In general, most economists worry about the distortions from our tax system in encouraging excessive consumption of housing. But given the magnitude of the current economic crisis, further assistance may be warranted.

A particularly strong case can be made for helping low income individuals with their housing costs. Note that we do this with upper income individuals—tax deductibility of mortgages and property taxes means that the government pays a large fraction of the carrying costs. But ironically, we do not do that with those who need the help the most.

A simple remedy is converting the current mortgage and property tax deduction into a *flat rate cashable tax credit at say 25%*; the reduction in the subsidy to upper income Americans could help pay for the subsidy for poorer Americans. (Even better would be a

progressive subsidy, with a higher rate for the poor than the rich). A 25% tax credit would increase the affordability of housing for many Americans.

6. Regulations

Many countries restrict predatory lending practices and even loans which impose excessive risk burdens on low income individuals (and which, as we have seen, not only risk the well being of those individuals, but also impose systemic risk on the economy). We should do the same. We should not allow mortgages that present a risk that payments might exceed a particular fraction of household income, and mortgage programs that, as a matter of routine (e.g. as a result of patterns of refinancing), generate transactions costs that are in excess of a certain fraction of the value of the mortgage.

The proposed Financial Products Safety Commission might be an appropriate institution for reviewing what are “safe” mortgages, and setting out guidelines on the appropriateness of particular mortgage structures for individuals in different circumstances.