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How to Save an ‘Underwater’ Mortgage

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An epidemic of mortgage defaults and foreclosures is threatening the economic recovery. The problem is serious and getting worse. More than three million homes are now in serious default (nonpayment for 90 days or more) or foreclosure, nearly double the number a year ago. Sales of properties in foreclosure or serious default made up one third of all home sales in May and June.

Despite a slight uptick in house prices in some markets recently, the sales of foreclosed properties continue to dampen house prices and weaken banks' balance sheets. The uncertain pace of future losses makes banks nervous about the adequacy of their capital, which discourages bank lending and economic growth.

There are two separate but mutually reinforcing reasons for the surge in defaults and foreclosures: the reduced affordability of mortgage payments and the high loan-to-value ratios of many houses.

The affordability problem is the familiar one. Many homeowners become unable to make their payments when they lose their job or have to accept part-time work. Others are unable to cope with the increase in monthly payments that occurs when the interest rates on their adjustable-rate mortgages automatically reset.

The Obama administration is trying to fix the affordability problem by sharing with banks and other creditors the cost of reducing monthly payments to 31% of household income. So far only about 200,000 mortgages have been modified this way, far fewer than the administration's goal of modifying three million mortgages.

More importantly, experience with such mortgage modifications by the FDIC is not promising: Nearly half of all modified mortgages go into default within six months. That's partly because, even when they can afford the reduced mortgage payments, many homeowners default anyway because they owe more on the house than it is worth. Thanks to this "negative equity," they just walk away.

These defaults happen because in the United States, unlike almost every other country, mortgages are effectively no-recourse loans. If a homeowner defaults, the creditor can take the house but is unable to take other assets or income to make good on the remaining unpaid mortgage balance.

In some states creditors have the legal right to pursue other assets or income. But personal bankruptcy rules limiting what they can take give them little incentive to do so. No-recourse mortgages increase foreclosures, resulting in more properties being thrown on the market, and lead to an excess decline in house prices.

Homeowners are not likely to default if they can afford their monthly payments and if their mortgage is only 10% or 20% more than the value of their house. But when the loan-to-value ratio gets higher, many homeowners do choose to walk away and find another place to rent or buy. Today one-third of all homes with mortgages have mortgage debt that exceeds the value of the home. Among these homeowners, half of the loan-to-value ratios exceed 130%.

If home prices continue to decline, this problem will get even worse. Although the recent uptick in some markets provides some hope that house prices are close to the bottom, this improvement may only reflect temporary features such as the sharp drop in mortgage rates in April and May before they bounced back in June and July; the bankers' recent moratorium on foreclosures that temporarily reduced the supply of new homes for sale; and the introduction of an \$8,000 first-time home buyer's credit. But the risk remains of a continuing downward spiral of house prices.

The Obama housing plan does not solve the problem of defaults driven by high loan-to-value ratios. Instead the administration has pinned its hopes on lowering mortgage rates to raise house prices and on the Public Private Investment Partnership (PPIP) to remove the high loan-to-value mortgages from the banks' balance sheets. But mortgage rates have risen and the PPIP is a moribund at best.

The administration should work with creditors and homeowners to reduce the principal on mortgages that are at risk of default. This would not appeal to every homeowner with negative equity, but it may induce enough of them with high loan-to-value mortgages not to default, and thus prevent or reduce the downward spiral of home prices.

Here's how such a plan might work in a way that homeowners and creditors could both welcome, that is fair to taxpayers, and that would help the economy:

Any homeowner with a loan-to-value ratio over 120% could apply for a reduction in his mortgage balance. The government and the creditor would then share equally in the cost of writing the loan balance down to 120% of the value of the home. But the homeowner who opts for this write-down would be obliged to convert the remaining mortgage to a loan with full recourse that could not be discharged in bankruptcy. Federal legislation would be needed to modify state mortgage and bankruptcy rules to allow homeowners to obtain the new type of mortgage.

An example shows how this would work. Consider someone with a home worth \$200,000 and a mortgage of \$280,000, i.e., a loan-to-value ratio of 140%. If the borrower and the creditor both agree, the loan could be reduced by \$40,000 to \$240,000 (120% of the home value.) The government would give the creditor \$20,000 to offset half of the write-down. The homeowner would convert the remaining \$240,000 mortgage to a bank loan with full recourse that could not be discharged in bankruptcy.

The bank takes a \$20,000 loss (as part of the \$40,000 mortgage write-down). But it would be better off, because it has a more legally secure loan of \$240,000. The homeowner owes less, but he is now personally responsible to repay the loan in full.

All other homeowners would also benefit from such a plan because reducing defaults stabilizes house prices. Indeed, everyone benefits because with a stabilized housing market the recovery is more secure.

If this plan succeeds in stabilizing house prices at the present level, the one-time cost to the taxpayers would be capped at \$200 billion, even if every homeowner with a loan-to-value ratio over 120% accepted the government-assisted write-down. That \$200 billion is less than a 2% fall in house values.

Slowing the downward spiral of house prices will protect the solvency of the banks and the net worth of households. The failure to do that could mean a deeper and longer recession that imposes much higher costs to the government.

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