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How to Help People Whose Home Values Are Underwater - The economic spiral will get worse unless we do something about negative equity

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More than 12 million homeowners now have mortgage debt that exceeds the value of their homes. These negative-equity homeowners have an incentive to default because mortgages are generally "no recourse" loans. That means creditors can take the property if the individual defaults, but cannot take other assets or income to make up the difference between the unpaid loan balance and the lower value of the house. As a result, mortgage default rates are now rising rapidly and are expected to go much higher.

The no-recourse mortgage is virtually unique to the United States. That's why falling house prices in Europe do not trigger defaults. The creditors' ability to go beyond the house to other assets or even future salary is a deterrent.

The negative-equity homeowner's incentive to default and become a renter rises with the size of the gap between the mortgage and the value of the house. That gap is typically already very large. Half of the homeowners with negative equity now owe more than 120% of the value of their homes. If house prices continue to fall at the current rate for the next 12 months, as experts generally expect, the median loan-to-value ratio of negative-equity homeowners will increase to more than 135%. At that level, a very high fraction of negative-equity homeowners are likely to default.

The increased supply of homes for sale will create a vicious cycle, further depressing house prices, further raising the number of homes with negative equity, and weakening the balance sheets of financial institutions. This is the primary cause of the dysfunctional credit markets. None of the existing proposals to help homeowners with negative equity would eliminate the incentive to default.

In an earlier article on this page I proposed a plan to prevent declines of house prices back to the prebubble level from pushing current positive-equity homeowners into the negative-equity group. The essential feature of that plan is to replace 20% of the homeowner's existing mortgage with a separate, full-recourse loan from the government. That "mortgage replacement loan" would have a very attractive, low interest rate. Because it would be separate from the mortgage and would have full recourse, it would establish an important firewall. Even if house prices fall another 20%, all mortgages would still have positive equity. The mortgage-replacement loan would involve no actual government spending and therefore no increase in the budget deficit.

The key to preventing further defaults and foreclosures among current negative-equity homeowners is to shift those mortgages into loans with full recourse, allowing the creditor to take other property or a fraction of wages. But the offer of a low-interest-rate loan is not enough to induce a homeowner with substantial negative equity to forego the opportunity to default and escape the existing debt. Substituting

a full-recourse loan requires the inducement of a substantial write-down in the outstanding loan balance. Creditors have an incentive to accept some write-down in exchange for the much greater security of a full-recourse loan. The government can bridge the gap between the maximum write-down that the creditor would accept and the minimum write-down that the homeowner requires to give up his current right to walk away from his debt.

Here is an example of how that might work. Consider a homeowner with a $240,000 mortgage and a home that is worth only $200,000. The $40,000 gap between the mortgage and the appraised value could be divided with the government taking one-third, the creditor taking two-thirds, and the homeowner agreeing that the remaining $200,000 loan would have full recourse. The creditor would give up about $27,000 of potentially uncollectible debt but would avoid the extra loss of value that comes with selling a foreclosed property, and would achieve a much more secure loan. The homeowner would get to keep his house and would eliminate all of the excess debt.

With 12 million negative-equity homes and an average negative equity gap of $40,000, the total cost to the taxpayers of taking one-third of the losses would be no more than $156 billion. Alternative proposals to help negative-equity homeowners do not convert their mortgage debt to full-recourse loans and would not succeed in stopping the downward spiral of house prices.

The "Hope for Homeowners" legislation sponsored by Rep. Barney Frank and Sen. Chris Dodd offers a government guarantee of the mortgage if the creditor writes the loan down to 95% of the property's current value (as appraised by professionals hired by the banks). The Congressional Budget Office estimates that only 400,000 of the 12 million homes with negative equity would benefit, because creditors are unwilling to make such a large write-down without government assistance.

One recent proposal from the FDIC calls for creditors to reduce the monthly mortgage payment to a specified fraction of the homeowner's income by stretching out the repayment schedule of the mortgage, or providing a temporary reduction in the interest rate on the mortgage. The government would compensate the creditor for this reduced monthly payment by agreeing to pay part of any loss if the homeowner defaults. But even after the monthly mortgage payment is reduced, the homeowner with negative equity would still have an incentive to default, leaving the government with the cost.

Another current proposal from various academics would force the creditor to write down the mortgage debt to eliminate the negative equity and compensate the creditor with a share of the future appreciation when the house is sold. But any homeowner who receives that debt reduction has an incentive to sell the house as quickly as possible and buy another one so that he can keep all of the appreciation on the new home. Since the creditor would therefore receive no compensation for writing down the debt, there would be great reluctance to accept such a plan.

The prospect of a downward spiral of house prices is the major risk facing financial institutions. It is also a primary source of the further falls in household wealth that will reduce consumer spending and depress the economy. Providing an incentive to shift the current negative-equity loans to full-recourse mortgages -- while also injecting mortgage-replacement loans to stabilize the current positive-equity mortgages -- should be Barack Obama's highest priority as he seeks to stabilize the economy.

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