OPINION

How to Stop the Mortgage Crisis

By MARTIN FELDSTEIN
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The potential collapse of house prices, accompanied by widespread mortgage defaults, is a major threat to the American economy. A voluntary loan-substitution program could reduce the number of defaults and dampen the decline in house prices -- without violating contracts, bailing out lenders or borrowers, or increasing government spending.

The unprecedented combination of rapid house-price increases, high loan-to-value (LTV) ratios, and securitized mortgages has made the current housing-related risk greater than anything we have seen since the 1930s. House prices exploded between 2000 and 2006, rising some 60% more than the level of rents. The inevitable decline since mid-2006 has reduced prices by 10%. Experts forecast an additional 15% to 20% decline to correct the excessive rise. The real danger is that prices could fall substantially further if there are widespread defaults and foreclosures.

Irresponsible lending created new mortgages with LTV ratios of nearly 100%. By the end of 2006, the fall in prices caused 7% of mortgages to have LTV ratios above 100%. A further 20% of mortgages had LTV ratios over 80% and will shift to negative equity as prices decline.

Most mortgages are no longer held by originating lenders, but are securitized and sold to investors world-wide. More significant, mortgages are used to create complex, asset-backed securities that are central to current credit-market problems. Investors no longer own specific mortgages, but only have rights to certain conditional payment streams. So generally, it is no longer possible to prevent foreclosures by negotiations between borrowers and lenders.

The 1.8 million mortgages now in default have created substantial personal hardship. The 10% decline in house prices has cut household wealth by more than $2 trillion, reducing consumer spending and increasing the risk of a deep recession. Defaults also damage the capital of lending institutions, causing further declines in credit and economic activity.

Rising unemployment during a downturn will force more homeowners to default, driving house prices lower. Since mortgages are generally "no recourse" loans, when there is a default the mortgage lender can only collect the value of the property. The lender does not have the right to seize other property (a car, a boat, money in the bank) or to put a lien on future wages. Thus, a homeowner with a mortgage that exceeds the value of his house has a strong incentive to default, even if he can afford to make the monthly payments.

Optimists note that homeowners with negative equity have generally been reluctant to default in past years. That was sensible when house prices were rising. But with house prices falling, defaulting on the mortgage is the rational thing to do.

Limiting the number of such defaults, and preventing the overshooting of price declines, requires a public policy to reduce the number of homeowners who will slide into negative equity. Since house prices still have further to fall, this can only be done by a reduction in the value of mortgages.

None of the current mortgage-reduction proposals are satisfactory. Although bankers sometimes have the incentive to reduce mortgage-loan balances voluntarily in order to avoid a foreclosure, this is usually not possible because the syndication of mortgage loans means that there is generally not a single lender who can agree to the mortgage writedown.

Proposals to force creditors to accept write-downs of interest or principal violate their contractual rights, reducing the future availability of mortgage credit and raising the relative interest rate on future mortgages. Reviving the depression-era Home Owners' Loan Corporation would have the government use taxpayer money to pay off existing loans and become the largest mortgage lender in the country. This would require an enormous federal bureaucracy of appraisers and loan agents.

If the government is to reduce significantly the number of future defaults, something fundamentally different is needed. Although there is no perfect plan, a program of federal mortgage-paydown loans to individuals, secured by future income rather than by a formal mortgage, could reduce the number of mortgages with high LTV ratios and cut future defaults.

Here's one way that such a program might work:

The federal government would lend each participant 20% of that individual's current mortgage, with a 15-year payback period and an adjustable interest rate based on what the government pays on two-year Treasury debt (now just 1.6%). The loan proceeds would immediately reduce the borrower's primary mortgage, cutting interest and principal payments by 20%. Participation in the program would be voluntary and participants could prepay the government loan at any time.

The legislation creating these loans would stipulate that the interest payments would be, like mortgage interest, tax deductible. Individuals who accept the government loan would be precluded from increasing the value of their existing mortgage debt. The legislation would also provide that the government must be repaid before any creditor other than the mortgage lenders.

Although individuals who accept the loan would not be lowering their total debt, they would pay less in total interest. In exchange for that reduction in interest, they would decrease the amount of the debt that they can escape by defaulting on their mortgage. The debt to the government would still have to be paid, even if they default on their mortgage.

Participation will therefore not be attractive to those whose mortgages that already exceed the value of their homes. But for the vast majority of other homeowners, the loan-substitution program would provide an attractive opportunity.

Although home owners may recognize that the national average level of house prices has further to fall, they do not know what will happen to the price of their own home. They will participate if they prefer the certainty of an immediate and permanent reduction in their interest cost to the possible option of defaulting later if the price of their own home falls substantially.

The loan-substitution program would decrease the number of homeowners who would come to have negative equity as house prices decline. That reduces the number of homeowners who will have an incentive to default, thereby limiting the risk of a downward spiral of house prices.

Since individuals now have the right to prepay any part of their mortgage debt, the 20% reduction in the mortgage balance would not violate mortgage creditors' rights. Creditors should welcome the mortgage paydowns, because they make the remaining mortgage debt more secure. The 20% repayments to creditors would also create a major source of funds that should stimulate all forms of lending.

The simplest way to administer the new loans would be for the current mortgage servicer to collect on behalf of the government and remit those funds to Washington. There would be no need for a new government bureaucracy, for new appraisals, or for negotiations in bankruptcy. The program could be up and running within months after the legislation is passed.

The government would fund these loans by issuing new two-year debt and rolling over the debt until the loans are fully repaid, thus eliminating any net cost to the government. The government loans would not add to the budget deficit or to the net debt of the nation. Gross government debt would rise by the amount of the new government lending, but this would be balanced by the asset value of those loans.

The current possibility of widespread defaults is a cloud over all mortgage-backed securities, and over credit markets generally. The uncertainty about the future value of such asset-backed loans has been a primary reason credit markets have become dysfunctional. And without a flow of credit, the economy cannot expand.

To lower the risk of a downward spiral of house prices and to revive the frozen credit markets, the government must move quickly to reduce the potential number of mortgage defaults. A loan substitution program may be the best way to achieve that.

Mr. Feldstein, chairman of the Council of Economic Advisers under President Reagan, is a professor at Harvard and a member of The Wall Street Journal's board of contributors.