How to Help Negative Equity Homeowners

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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 implying that 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, since the creditors' potential to go beyond the house to other assets or to a portion of payroll earnings is enough to deter defaults. Officials and investors in other countries are amazed to learn that U.S. mortgages are no recourse loans. It is indeed surprising that this rule in the U.S. applies to home mortgages but not to any other type of loan.

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 percent of the value of their homes. And 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 percent. At that level, a very high fraction of negative equity homeowners are likely to default.

The defaults and resulting foreclosures mean hardship for millions of families as well as a rise in the number of homes for sale. That increased supply depresses house prices, further raising the number of homes with negative equity and weakening the balance sheets of financial institutions. The large number of negative equity mortgages and the potential for that number to grow as house prices fall are 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 and the resulting downward spiral in house prices. In an earlier article on these pages I described a plan to prevent the virtually inevitable 15 percent further fall in house prices from pushing homeowners who now have positive equity into the negative equity group. My purpose in this article is to describe a new mortgage plan focused on negative equity homeowners. After describing this plan, I will contrast it with the existing legislation and some proposed alternatives.

The essential feature of my previous plan for positive equity homeowners is for the government to substitute an attractive low interest loan with full recourse for 20 percent of the homeowner's existing mortgage. This "mortgage replacement loan" establishes a

firewall so that house prices would have to fall more than 20 percent before someone who now has positive equity would decline into negative equity. Since the mortgage replacement loan is essentially a swap of the homeowner's IOU for the government loan, it would involve no actual government spending and therefore no increase in the budget deficit.

The key to preventing further defaults and foreclosures among the 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, a typical current situation for negative equity mortgages. To be eligible for this proposed loan modification, the homeowner need not be delinquent in his monthly payments and need not be having difficulty in making his mortgage payments. The plan is available to all negative equity homes in order to eliminate the risk of more foreclosure sales and thereby to eliminate the source of impaired mortgage backed securities that has made financial markets dysfunctional.

The $40,000 gap between the mortgage and the appraised value in this example could be divided with the government taking one-third, the creditor taking two thirds, and the homeowner agreeing that the remaining $200,000 loan has full recourse. The creditor would give up about $27,000 of potentially uncollectable 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. (The technical problem of assessing house values for this purpose could be solved by using local Case-Shiller price indices or the <http://zillow.com>zillow.com estimate for individual houses. Other modifications in the loan might be needed to deal with option-ARM mortgages or other special features.)

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. While this is a large amount, it would be part of the needed short-term demand stabilization program as well as a way of avoiding the downward spiral of house prices that would occur as negative equity homeowners default.

In contrast, the existing legislation aimed at negative equity homeowners and the alternative proposals to help them do not convert their mortgage debt to full recourse loans and would not succeed in stopping the downward spiral of house prices.

The Frank-Dodd "Hope for Homeowners" legislation offers a government guarantee of the mortgage if the creditor writes the loan down to 95 percent of the property's current assessed value. 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 calls for creditors to reduce the monthly mortgage payment to a specified fraction of the homeowner's income by stretching out the amortization or providing a temporary reduction in the interest rate on the mortgage. The government would compensate the creditor for this reduced monthly payment by providing a guarantee of the mortgage principal. But even after the monthly mortgage payment is reduced, the homeowner with negative equity would still have an incentive to default. The creditor would still benefit because of the government guarantee and the taxpayer would be forced to pay the amount of the negative equity.

Another current proposal would force the creditor to write down the mortgage debt to eliminate the negative equity and would 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 the financial institutions. It is also a primary source of the further falls in household wealth that reduce consumer spending and depress the economy. Shifting the current negative equity loans to lower value but full recourse mortgages while also injecting mortgage replacement loans to stabilize the current positive equity mortgages deserves the highest priority on the agenda of the new president.