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Foreclosure Relief to Equitably Distribute the Pain

During June, the United States House of Representatives and the United States Senate continued to amend H. R. 3221 "To Provide Needed Housing Reform". This bill attempts to react to the increasing number of home foreclosures in a way that makes citizens who are not yet in foreclosure look like Congress is doing something. The competing amendments include various ways to enable citizens to refinance existing loans so as to not default, while not appearing to bail out the financial institutions who made those loans which would not be paid back absent a taxpayer bailout. A prominent component is a proposal that the FHA loan cap should be increased so the taxpayers will guarantee loans even larger than the $425,000 plus existing cap. Ravenna residents whose $125,000 loans are being foreclosed should be comforted. The final form of the legislation and the response of the President are yet to be seen.

The unusually high number of mortgage loan defaults arose from various causes. Some mortgage brokers encouraged borrowers to inflate their incomes so as to "qualify" for larger loans, and enticed appraisers to report valuations for homes in excess of "true" worth. Financial institutions bought bundles of home loans that offered stated returns in excess of what those institutions should have known was reasonable. Institutions which claimed to evaluate the risk of financial instruments told their customers that the investment quality was sound. So among the lying borrowers, lying appraisers, cheating mortgage brokers, greedy investors, and incompetent rating services, the structure failed.

The failing mortgage loan structure adversely affects the entire economy. Sheriff sales depress the market price for traditional home sales. Decreased home values lowers real estate tax revenues for local governments. Loan defaults make new credit more expensive for all borrowers and more difficult to obtain as lenders enforce responsible credit qualifying standards. So there's lots of reasons that The Government Should Do Something.

This writer's philosophy of "fairness" in the past has usually resulted in a proposal for equitable distribution of unpleasantness. This is another of those.

The Federal Government should: (1) establish a Mortgage Refinance Program funded by bonds issued by the U. S. (In a deficit world, pretty much everything the Federal government does is financed by bonds.) (2) Offer to refinance loans, up to some moderate limit (say a quarter million dollars - I have a hard time offering to bail out folks who bought houses for lots more than I did). (3) The terms to the borrower are, the loan amount stays the same, but the interest rate becomes 5% fixed for 15 years or 6% fixed for 20 years or 7% fixed for 25 years. (4) the terms to the lender whose loan is "paid off" are, the lender satisfies the previous mortgage in full, in consideration of the MRP paying to that lender only sixty percent of the mortgage loan balance due.

This distributes the unpleasantness: The borrower still must pay back ALL of what was borrowed, but at a low fixed rate. The lender gets rid of a non-performing loan at 60% of face value, probably a higher percentage payoff than would have resulted from a sheriff sale. The forty percent difference between what the borrower agrees to pay to the MRP and what the MRP has paid to the previous lender, goes toward repayment of the bonds financing the MRP. Since the borrower repayment is still high-risk, this 40% cushion may be sufficient to get the bonds repaid.

With regard to the other villains, one may only hope that Federal prosecutors will secure fraud convictions on the mortgage brokers and appraisers, and that civil damages will put the faulty financial risk analysts out of business.

- Christopher J. Mallin, Old Country Lawyer