

Fixing Part of the Mortgage Meltdown

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The current mortgage meltdown has caused a staggering increase in home foreclosures. For many homeowners, foreclosures have meant personal financial bankruptcy, giving up long-time residences, and losing their largest financial assets. For metropolitan areas, foreclosures have created large swaths of metropolitan real estate with vacant or abandoned houses. For financial institutions, foreclosures have led to serious financial malaise. There have been numerous calls for lawmakers to do something.

Policy-makers are uncomfortable dealing with the *whole* problem. They wish to protect overextended borrowers, but they do not want to protect borrowers who bought far more housing than they could afford, or borrowers who lied to get their mortgages. They wish to protect the liquidity of our financial system, but they do not want to bail out reckless lenders. Those lenders almost surely knew that the loans would not perform well, but didn't care, because they wouldn't be holding the loans when the value was lost. There are millions of mortgages in the economy, each one a separate (and complicated) financial document. Any potential solution to the mortgage meltdown must distinguish between the deserving and the less deserving, must explain itself clearly to both lenders and borrowers, and must provide incentives for both to be truthful.

My proposed solution is a variable payment fixed interest mortgage (call it a VPFIM), with a large prepayment penalty. Begin with households whose long term financial prospects are OK, but whose short term prospects are shaky because their incomes may currently be low (an earner unemployed, lack of overtime, or a new job). Assume that these households have variable

interest rate (and possibly subprime) mortgages, that are likely to reset at payment levels hundreds of dollars per month higher than their current payments.

Under the VPFIM, an individual homeowner can trade the current variable rate mortgage for one with a *fixed* interest rate, but with scheduled payments that will *increase* over time. The monthly VPFIM payments will start lower than the current monthly variable rate payments, and in the short term may even result in negative amortization where the borrower loses home equity. Over fifteen years, for example, the VPFIM payment schedule is structured so that its *present value* (adjusting future payments as if they were to be made now) will equal the present value that lenders would have earned had they held the current adjustable rate mortgage for fifteen years.

This is good for homeowners and good for lenders. The owners get lower initial payments, the opportunity to keep their homes, and possibly some property appreciation. The lenders get their returns and do not have to manage or liquidate foreclosed property. The key feature of this instrument is the prepayment penalty. It keeps borrowers from trading current mortgages for VPFIMs and then defaulting, leaving the lenders high and dry.

The penalty protects the lenders by preserving the present values of their loans. Why? Borrowers essentially promise to own their homes for a long time – if they are not truthful, they will lose the penalty, which I calculate to be about \$10,000 to \$12,000 for a \$200,000 mortgage. Lenders promise to hold the mortgages until they mature – they do not get the larger future payments unless they do.

VPFIMs will *not* bail out liars and they will not make housing affordable for borrowers whose long term income and wealth cannot support their purchases. They will not magically indemnify lenders who have bought bad loans. VPFIMs cannot undo the damage in major cities

and (increasingly) in suburban areas where whole neighborhoods contain dozens of foreclosed houses that are pushing down housing values, and leading to vacancy and abandonment. They will not render solvent those developers who built far too many homes on the speculation that “someone” would buy them.

They will however maintain a system that has brought home ownership to over 65 percent of the population. By providing a certain stream of payments, they will give borrowers incentives to borrow and to refinance. By avoiding after-the-fact penalties on lenders by unilaterally changing the terms of the mortgages that they issue and hold, they will give the lenders incentives to lend at reasonable interest rates. They will preserve much of the mortgage market as we know it, and they will provide an important building block for a somewhat chastened, but recovering housing sector.

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