

A Proposal to Repair the US Mortgage Mess

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The current pool of US mortgages is suffering from two serious problems that continue to delay a recovery in housing markets, and in turn threaten the broader economy. First, estimates put as many as 23% of US mortgages "under water", meaning that the value of the home collateralizing the mortgage has fallen below the loan's balance¹. In most cases this resulted as ill-informed households purchased homes at the peak of a housing "bubble" while reckless lenders allowed them to over-leverage. Thus there is widespread worry about "strategic default". Second, the deep recession and slow current job growth continue to generate additional mortgage delinquencies (and subsequent defaults) as households remain unemployed. This proposal is specifically designed to solve the first problem although it could help the second as well.

To fix the underwater loan problem, existing mortgages could be restructured into two parts: (a) a standard new mortgage against the current (reduced) value of the home, and then (b) a claim against some fraction of any capital gains (above that reduced value) when the home is sold. The two parts could even be packaged separately and securitized or traded in separate markets. When a household sold their home they would have to pay off both claims and take away their share of whatever gains accrued. Mostly likely the lender's claim on future gains would be capped – for example at a value equal to the difference between the original mortgage balance and that created in part (a).

For illustration, consider the dilemma of an owner whose original house and loan were established at \$100,000, but whose house is currently worth only \$60,000. The loan is thus 40% underwater. When restructured, the loan would be divided into a \$60,000 traditional mortgage and a claim of, for example, 50% of the future appreciation – capped at \$40,000. The borrower's payments would fall by 40% but later when they moved and the property sold for, say \$90,000, they would surrender \$15,000 of the sales proceeds. The lender might even recover all its money if farther into the future the property sold for \$140,000. The owner's gain in this case would be reduced from \$80,000 to \$40,000. Since the claim is in "current" dollars, inflation alone holds out the prospect for eventual loan recovery.

For borrowers, this proposal would seem to eliminate the growing potential of "strategic" defaults, wherein owners walk from their underwater loans – suffering bankruptcy and the loss of future credit². The new loan's payments would be less and more in line with what current buyers (of similar homes) are experiencing. Owners also would maintain a sizeable stake in the value of their property which aligns maintenance incentives. A

worry over whether borrowers might immediately sell their homes to discharge their 2nd claim obligation seems misplaced. Doing so would leave them with no equity, and hence (in today's market) the inability to buy another house. Surely the combination of reduced payments and some future stake would entice most to resume their lives and move whenever true need and opportunity required it.

On the lenders side we know there is considerable resistance to restructuring mortgages – since restructured loans sometimes re-default while loans left alone often "self cure"³. The proposed restructuring actually makes "self curing" more likely, and re-default less likely. With the contingent claim, lenders also are able to add an additional (fully liquid) asset on their books relative to a conventional modification. The value of this contingent claim would vary by market. Those areas with more modest "bubbles" and subsequent price declines are quite likely to experience full price recovery. Markets that went truly overboard will take much longer – hence a lower value for a claim there.

Could the proposal help owners who are not able to make payments – even though their mortgage is still above water? Existing borrowers would surely accept a lower share of the upside in exchange for reduced payments (and balance). To induce lenders into this arrangement, the costs of foreclosure plus the value of the contingent claim would have to equal or exceed the write down in balance that each particular owner could afford. The proposed restructuring would not work for everyone but it might help some.

Interestingly, there are two historic precedents for similar forms of debt restructuring. In the early 1980s HUD suggested "shared appreciation" mortgages as a way of lowering payments for first time buyers. Pools of these bonds may have been issued, but an evaluation of them has been hard to find. Later, in 1990 the US and International Agencies together created "Brady Bonds" as a way of restructuring defaulted Latin American Sovereign Debt. Some of these bonds carried a provision in which debtor and lender both shared in bond appreciation.

In the current environment there is ample opportunity for the US government to lead in such mortgage restructuring. Trouble loans on the books of FHA and the GSEs could be so repackaged and possibly a secondary market created for the contingent claims. The private sector would hopefully soon follow. Asset bubbles and excessive credit inevitably create the need for painful adjustment. This proposal spreads the adjustment over time and splits it between lender and borrower. This seems not only "fair", but also the most likely to allow the US housing market to recover.

¹ CoreLogic.com, Press Release of August 26, 2010

² Neil Butta, Jane Dokko, Hui Shan, "The Depth of Negative Equity and Default Decisions", Federal Reserve, FEDS #2010-35, May, 2010.

³ Manuel Adelino, Kristopher Gerardi, "[Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization.](#)" FRB Boston Public Policy Discussion Paper Series, no. 09-4 (2009)