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From the Los Angeles Times

Dust-Up

Why not just reduce borrowers' debt?

Should the government force lenders to write down balances on troubled mortgages? Richard K. Green and Christopher Thornberg debate.

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Today's topic: A high percentage of modified mortgages have re-defaulted, and some critics say that's because the modifications haven't been aggressive enough -- in particular, they haven't written down debt. The Obama proposal would not reduce a borrower's debt, either. Isn't that a problem?

This week's complete Dust-Up: [Day 1](#) | [Day 2](#) | [Day 3](#) | [Day 4](#)

Write down the shaky mortgages, but not without conditions

Point: Richard K. Green

The absence of principal balance reduction in the Obama plan (as well as other plans) is a problem. But before we get to borrowers, it is important to note that the unwillingness of financial institutions and investors to modify principal balances reflects a kind of denial that continues to hamper the financial system's ability to unfreeze. Until mortgage balances are written down to levels that are lower than property values, lenders are banking on the good graces of borrowers -- rather than economics -- for repayment. Consequently, there is a great deal of uncertainty about the value of underwater mortgages. Certainly one of the reasons banks are getting killed in equity markets is their deteriorating capital. But another reason is that investors have no way of knowing the value of assets on bank balance sheets; if institutions wrote down mortgage principal to levels below house prices, investors would have far more certainty about the value of bank assets. Forcing banks to write down principal on underwater mortgages would help separate the zombie banks from the relatively healthier ones.

From the borrower's perspective, a payment reduction based on a cut in interest rates has a de facto impact on principal. While the face (or par) value of the mortgage remains the same, the present value (or market value) of the remaining payments falls. For anyone who doesn't need to move, this has the effect of reducing the amount owed (the mortgage) relative to the amount owned (the house).

As for those who do have to move, they are still stuck with the par value of the mortgage. On the other hand, a lower interest rate allows for more rapid amortization. A 30-year mortgage with an 8% interest rate and \$100,000 balance amortizes by about \$835 in its first year, while a 5% mortgage amortizes by \$1,475 -- not a huge difference, but every little bit helps.

Nevertheless, being underwater is a necessary condition for default. When a family's house is more valuable than its loan balance, default is all but impossible because in the event that the borrower has trouble making payments, the home can be sold and the mortgage can be paid off. But for underwater families, any kind of economic trauma (unemployment, divorce or illness) will lead them to contemplate going into default unless the lender is satisfied with a short sale. But then again, a short sale is essentially an acknowledgment that the principal needs to be written down.

I think policymakers are worried that writing down principal will give borrowers something for nothing. But the same is true for reducing payments via a subsidized interest rate.

We could help deal with the fairness problem by having a claw-back provision for borrowers whose loans are modified. Suppose someone has a \$200,000 loan on a house valued at \$150,000. We write the loan down to 90% of the property's value, or \$135,000. Some years later, the borrower sells the house for \$180,000. The claw-back provision would require the borrower pay taxpayers half of the \$45,000 difference between the modified loan balance and the sale price.

Richard Green is director of the Lusk Center for Real Estate at USC, where he is also a professor in the School of Policy, Planning and Development and the Marshall School of Business.

Don't let bankruptcy courts meddle with mortgages

Counterpoint: Christopher Thornberg

It is quite correct to say that all these loan modification programs have largely failed because they don't address the fundamental issue of loans being considerably underwater. I would argue that even if a modification could make the monthly payments more affordable, keeping a lower-income family tied to a debt larger than the value of the asset is hardly good public policy to promote long-run financial health. Such families would be much better off starting from scratch.

If this is the case, then why weren't cram-downs (reductions in principal balances) part of the Obama plan? The answer is because we still live in a nation that respects property rights and where government can no more force the reduction of the principal values on outstanding mortgages than it can simply take away your home without some valid public policy reason, due process of law and compensation. It has amazed me that the same people who are ardent supporters of the work done by the ACLU seem to be the same folks pushing for violations of the basic rules of private ownership.

To even venture down such a path would provoke, rightly, a legal storm that would take years to settle. Such a move is functionally the same thing as eminent domain: the government is taking the mortgage, writing it down and handing it back. Eminent domain, as far as I know, has never been used in the context of financial claims. And even if it has, it would necessitate financial compensation that would yet again burden the taxpayer with more bailouts for the fiscally imprudent home buyers. And furthermore, eminent domain must have some public value -- which, as I have argued over the last few days, is highly dubious in the case of foreclosures.

I have to believe that policymakers have recognized this issue and, as such, most of the effort to push cram-downs has come by trying to move mortgages under the one major legal mechanism that relieves debt holders who are under financial stress -- bankruptcy court. I believe this would be bad public policy for a number of reasons.

First, it would clearly lead to higher interest rates and more stringent restrictions on future buyers. Even if the rules pertain only to mortgages taken out say, from 2004 to 2007, the precedent would still be set and lenders would be doubly anxious in the future. Furthermore, enabling bankruptcy courts to force cram-downs would reward speculative behavior on the part of buyers. And in any case, I wonder if it would even be all that effective. After all, could a judge truly put a cram-down on a note when the borrower fraudulently claimed an inflated income, as was the case for many of the mortgages currently slipping into foreclosure?

As I have already noted, the problem with foreclosures is the cost of the process and the empty houses they leave. Wouldn't we be better off simply trying to reduce these costs as opposed to tilting at windmills?

Christopher Thornberg is a founding partner with Beacon Economics.

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