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From the Los Angeles Times

Dust-Up

Putting off the real day of reckoning?

Does Obama's mortgage plan promise real recovery or just delay a few foreclosures several months? Christopher Thornberg and Richard K. Green debate.

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Today's topic: The streamlined approach to modifications that the administration advocates has the potential to avert far more foreclosures than the case-by-case approach taken by many lenders. Yet it also ignores personal debt loads, which are a critical factor in determining a borrower's ability to repay. Is there a better way to speed the process so that more needless foreclosures can be averted without simply kicking the foreclosure can down the road a few months?

This week's complete Dust-Up: Day 1 | Day 2 | Day 3 | Day 4

The pain is temporary, and we must go through it
Point: Christopher Thornberg

The homeowner rescue plans so far have been failures. Either few troubled borrowers have signed up or, more significantly, within just a few months of having their loans modified a shockingly large portion of the borrowers are back in default. The entire rescue process has accomplished little more than increasing the cost to the banks by extending the foreclosure process that much longer.

There are two possible explanations for this re-default problem. One is that the programs simply don't acknowledge that with loans sharply underwater, folks have little incentive to maintain their mortgages even when payments are being lowered to something more affordable.

It has been claimed that past studies have shown that being underwater is a necessary but not sufficient condition for foreclosure. I would argue that we have never had a housing downturn as dramatic as this one, with people so desperately underwater, and we have never had so many families with such small stakes in the game (witness no-money-down mortgages with initially negative amortization payment levels). As such, past data points offer little in terms of comparison to the current situation. From this perspective, borrowers go along with the mortgage modification plans simply to maintain their housing situation for a few extra months.

The second potential explanation is that these mortgage programs do not screen their applicants for other potential issues, such as the loss of income due to the downturn, debt burdens outside the mortgage or perhaps even verifying income to see if the new "affordable" payment is in fact affordable. As we now know, even with mortgages where incomes were supposedly verified, brokers quickly learned how to game the system in such a way as to not trigger further verification efforts. In other words, many of those prime loans were not.

President Obama's plan is another one-size-fits-all scheme without much effort to distinguish between those who have a reasonable chance of having a workout succeed and those for whom the workout represents little more than a few extra months of free rent. It relies on one streamlined effort to reduce payments with little effort made to try to distinguish those who might be helped from those for whom help is useless.

Is there a better way? Should we study these mortgages on a case-by-case basis? Perhaps -- but the industry has little incentive to make the investments to deal with such complexities. Remember that during the bubble, a mortgage company earned 2% or 3% of the value of the loan for closing a mortgage. This amounts to $5,000 to $10,000 per mortgage in higher-priced markets with little cost to the broker, given all the rapid computerized systems being used to place the money. With this revenue flow gone, the industry has rapidly shrunk. Now the administration is offering a paltry $1,500 per mortgage to servicing companies that try to work things out. This time, however, the cost to mortgage companies will likely be much higher because more individual verification is needed. This simply isn't realistic.

The other option is to have the government pony up even more cash to facilitate the process, with the intent of simply shrinking the potential pool of applicants. And of course we will still have the legal and ethical minefield to negotiate as we work to rescue people from their own really bad financial decisions.

If this sounds like a hopeless situation, you know what? It is! And it is about time we have an honest and open discussion that acknowledges the hopelessness and stops using expensive knee-jerk policies in place of rational approaches. As a nation, we need to allow this process to take place naturally.

Do we need to worry about empty homes and depressed neighborhoods? Sure. But this process is much easier on the back end than the front. How about a national tax break for buying not just any home, but only a foreclosed property? How about generating a new group of potential buyers by simply not allowing current defaults to be recorded on people's credit reports? How about streamlining the foreclosure process, making it quicker and easier for banks to clear properties and find a new buyers, thus reducing their losses?

And most important, we need to think ahead to the changes that need to be made so that we never end up with such a mess again.

Christopher Thornberg is a founding partner with Beacon Economics.

Government inaction would only prolong the pain
Counterpoint: Richard K. Green

I disagree with you on a number of points, Chris.

First, we do have precedent for what is happening now: the Great Depression. While data from that time aren't as good as we would like, we do know that during the early 1930s, home prices fell at a rate similar to today and unemployment was considerably higher. Housing construction declined by 90% from peak to trough (if January's construction number is representative for the year to come, we are at about an 80% peak-to-trough decline now). Despite this, the federal government at the time developed a mortgage modification program that worked rather well, about which I will say more soon.

Second, I continue to think some of the older models of mortgage default are informative. University of Michigan economist Robert Van Order and National University of Singapore economist Yongheng Deng (among others) calibrated sophisticated models of default that looked at markets (such as Texas in the 1980s and California in the early 1990s) that went through substantial price declines. Although I agree that the new world in which we live means we should be modest about how much we actually know, it doesn't mean we should ignore the work that has been done before. The idea that families will not default if they have an equity stake in their house remains compelling to me.

Third, for the government to largely stand back and let nature take its course is, in my view, a really bad idea. Prices have fallen enough in many places that the cash-flow cost of owning now looks very favorable relative to renting -- at least by historical standards. Yet existing and new home sales in January were abysmal. Why? People lack confidence in the future. The Reuters-University of Michigan consumer confidence index is near a 28-year low. Even people who once considered themselves to be recession-proof fear they will be laid off. Under such circumstances, I am not sure we can expect people to run and buy homes whose occupants are in default.

I have long been an admirer of John Maynard Keynes, who talked about the importance of animal spirits to economic health. I do not see Americans' animal spirits recovering until house prices stop dropping. Prices will not stop declining until inventories stop rising. While home builders are doing their part (they have stopped building), allowing many more foreclosures to occur will not help this process.

During the Great Depression, the Roosevelt White House rolled out the Federal Housing Administration to insure mortgages and the Home Owners' Loan Corp. to buy defaulted mortgages. The HOLC bought the mortgages from lenders at prices below the value of the houses that were collateralizing the mortgages. It then modified payments, changing interest-only mortgages with balloon payments into 20-year self-amortizing mortgages. The HOLC worked: It bought mortgages from only 1933 to 1936, but it bought a large number during these years. It put itself out of business when the last mortgage it bought was retired in 1951. The program reduced the default rate on these mortgages by 90%. Because the government could borrow so cheaply, the HOLC actually turned a small profit for taxpayers.

To me, the HOLC (perhaps modified to include a claw-back provision) is the model for going forward.

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