

The AGENDA

A Safety Net for Bubble Buyers: Rescuing Homeowners from Collapsing Home Values

By Bernard Wasow

Introduction

No matter how you cut it, a great many families will lose their homes in the next few years. Caught up in the housing bubble, and often tricked by lenders, they paid too much for their homes. It does not make sense for them to stick to their mortgage commitments, to pay bubble prices for their housing for the next thirty years. David Leonhardt in the *New York Times* quotes a figure of 19 million households that are likely to have mortgage debt in excess of the value of their homes by 2010.¹ This brief proposes a relatively simple role for the government in addressing these problems.

The attention of politicians is turning from distressed banks to distressed homeowners. Such homeowners should include not only those who default on their mortgages and face foreclosure, but all homeowners whose mortgage debt exceeds the value of their homes. A blanket policy to cover all of the 19 million homeowners who owe more than their homes are worth would cover almost everyone who bought a home in 2005 and 2006, plus many who bought homes earlier and took out home equity loans. Making all of these distressed homeowners eligible for government help is not only fair, it is the only practical approach, since without such a policy, there will remain the perverse incentive for everyone who has negative equity in their home to seek foreclosure in order to qualify for relief.

Several of the proposed solutions for rescuing homeowners would have a federal entity take over (purchase) mortgages from banks at full value and then offer some debt relief to the borrowers. John McCain, for example, suggested that the Department of the Treasury purchase \$300 billion worth of mortgages.² Sheila Bair, head of the Federal Deposit Insurance Corporation, also has suggested that a government entity acquire the rotten mortgages, though not at full price.³

Suggestions that the federal government acquire even more bad mortgages than it has already obtained in the Fannie Mae and Freddie Mac takeovers reflect pressure from financial institutions who want to dump their devalued assets onto the federal government at an artificially inflated price. Pressure on the government to buy up home mortgages also reflects the desire to reduce the number of foreclosures.

One problem with additional direct federal purchases of home mortgages is that many of the distressed homeowners are in over their heads and should get out of their housing investments. The notion that homeownership is the best route to wealth accumulation for the aspiring middle

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class is false, as the collapse in home prices has clearly demonstrated. The government should be helping homeowners get out of their distressed circumstances, but it should not be pushing them to hang onto their current homes by their financial fingernails, and it certainly should not be fully bailing out the institutions that made the bad mortgage loans.

The Proposal

A sensible resolution of the current mortgage-lending crisis should include the renegotiation of some mortgages to reflect lower housing prices and interest rates. But some borrowers still will default, and those homes should be taken over by lending institutions. Of those homeowners who default and become renters, some will want to stay in the areas in which they bought their homes and some will want to move to new locations. The plan proposed in this brief aims to facilitate each of these possible resolutions by offering distressed homeowners subsidized loans together with a new right to rent the home they once owned. These measures then will leave it up to the lenders and the households to resolve their credit problems in a mutually acceptable way.

All distressed homeowners will face substantial “transaction costs.” Even those families who are able to renegotiate the terms of their mortgages, obtaining a complete or a partial “cram down” of their debt toward the market value of their homes, will face substantial legal and refinancing costs. Owners-turned-renters also may need legal help, and they all will need to put up rental deposits. Those who move to new places will face additional moving costs.

Public measures should support these distressed homeowners, introducing ways to reduce the transaction costs of renegotiating mortgages or becoming renters and providing help to meet those costs. We propose a plan with three parts:

1. The law governing foreclosure should be rewritten to allow a distressed homeowner to surrender ownership rights to the house and become a renter in it for a period of, say, six years. This suggestion follows the ideas first proposed by Dean Baker of the Center for Economic and Policy Research⁴ and by Daniel Alpert, as presented in the *New York Times* by Joe Nocera.⁵ In these plans, the former owner is guaranteed the right to shift from owner to renter in the house that faces foreclosure. Rent would be determined by closely regulated professional property appraisers to match going market rental rates; it would be adjusted periodically and face challenge from either side. We propose that the right to rent should lapse if the former owner no longer lived in the house (if it were sublet), if the house were subjected to unacceptable levels of wear and tear, or if rent payments fell more than two months into arrears. A rental deposit equal to four months’ rent would be payable at the time of the shift from ownership to tenancy.
2. Every homeowner with a mortgage worth more than the assessed value of the home would be eligible for a subsidized adjustment loan of up to 2 percent of the assessed value of the home (with a loan ceiling of \$10,000). These loans would have an interest-free grace period of three years and would then become repayable over ten years with an interest rate of 3 percent.

3. Every homeowner who faces foreclosure and wants to move to a different residence would be eligible for an additional adjustment loan of up to, say, \$2,000 to cover moving costs (on the same terms as above).

The Advantages of the Proposal

This right to rent, combined with access to subsidized credit, provides incentives and means for lenders and borrowers to move toward resolution of the problem of widespread negative equity in the housing market.

- Overextended borrowers would gain the right to rent for a period of time at market rates. This right in itself would provide an incentive for the new owner (the bank) to agree to renegotiate the mortgage instead of facing the imposed rental. The distressed owners also would have access to low cost loans that would permit them to seek legal advice, to pay rental deposits if they become renters, or to cover other transaction fees if they renegotiate the mortgage. Finally, the distressed owners would be free to move if they prefer to live in another house in the same area or to seek a fresh start in another location. Mandatory renting alone, even combined with pressure on the bank to offer better mortgage terms, would still tie distressed owners to the houses they are in. The proposed plan adds support for the important options of moving away.
- The new owner (the bank) also would benefit from this proposal. The substantial rental deposit and clear eviction rights in cases of abuse of a property should protect the new owner against distressed former owners who mistreat the property or who fail to pay rent. Banks would benefit too through the federal government's loans to distressed homeowners, which would put them in a position to meet bank transaction fees when they renegotiate the terms of their mortgages.
- For the broader society, this plan would provide new options to all their fellow citizens who are stuck with mortgages worth more than the homes they live in. It does not favor those who do or do not default on their mortgages. Instead, it pushes both lenders and borrowers toward one of three resolutions: either renegotiate such mortgages on more favorable terms, shift the resident families and properties from the ownership market into the rental market in the same residence, or help the families move into other rental units they can afford in places they want to be. As the plan is implemented, the public also would obtain a huge new body of data on assessed housing values.

This plan obviously would cost taxpayers more than a mandated right to rent alone, but the advantages justify the cost. The cost, too, is relatively small in the context of overall bailout costs; for example, lending \$10,000 each to 19 million households (extremely high numbers, since it assumes that 19 million families, each in a house with assessed value of at least half a million dollars, will borrow the maximum permitted) would cost \$190 billion. Considering that these

adjustment loans will be repaid over thirteen years, the cost of the subsidy element of the loans, using an interest rate of 5 percent, is only 22 percent of this total, or about \$41 billion.

Whether the bubble borrowers renegotiate their mortgages to reflect the collapsed value of housing, or if they choose to exercise their new right to become tenants in the houses they had bought, or if they decide to go through foreclosure and move away, their options will be broader and their financial resources deeper to effect the painful adjustment.

It is time that the government acted to provide targeted support for these millions of distressed homeowners. The aim of this support should be neither to bail out the mortgage lenders further, nor to keep as many families as possible in the homes they ill-advisedly purchased. The aim should be to minimize the transaction costs of resolving millions of bad home purchases and bad loans, while enabling families to live in decent homes in places they prefer.

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- 1 David Leonhardt, "The Trouble With a Homeowner Bailout," *New York Times*, October 21, 2008, available online at <http://www.nytimes.com/2008/10/22/business/economy/22leonhardt.html>.
- 2 Vikas Bajaj, "U.S. Vows More Help for Homeowners," *New York Times*, October 23, 2008, available online at <http://www.nytimes.com/2008/10/24/business/24foreclosures.html>.
- 3 Damian Paletta and Michael W. Phillips, "Plans to Aid Borrowers Gain Steam," *Wall Street Journal*, October 23, 2008, available online at <http://online.wsj.com/article/SB122473086326261573.html>.
- 4 Dean Baker, "The Subprime Borrower Protection Plan," Center for Economic and Policy Research, available online at <http://www.cepr.net/index.php/op-eds-columns/op-eds-columns/the-subprime-borrower-protection-plan/>.
- 5 Joe Nocera, "Shouldn't We Rescue Housing?" *New York Times*, October 17, 2008, available online at <http://www.nytimes.com/2008/10/18/business/18nocera.html>.