Creative, targeted plan needed to remedy housing, financial market crises

[Editor's note: These comments by Mark Zandi, chief economist of Moody's Economy.com, are edited excerpts of testimony he gave before the U.S. House Financial Services Committee on February 26, 2008.]

Policymakers' initial response to last summer's subprime financial shock was very tentative, as they misjudged its severity and the extent of its economic fallout. Financial markets and the economy subsequently eroded.

The Federal Reserve finally reacted in dramatic fashion in late January, substantially changing the conduct of monetary policy and slashing the federal funds rate target in an unprecedented way. Equally as dramatic was the quick passage in February of a sizable and reasonably well-designed fiscal stimulus package. In addition to a tax rebate for households and investment incentives for businesses, the stimulus raises the mortgage loan caps for the FHA, Fannie Mae and Freddie Mac. This should increase mortgage lending in particularly hard-hit housing markets such California, South Florida, and around Washington, D.C., and New York City. The stimulus also authorizes more issuance of state tax-exempt bonds to fund the mortgage refinancing efforts of stretched homeowners.

While substantial, this recent aggressive response may very well be insufficient to resurrect the global financial system and fully revive the economy. As long as credit and equity markets and the banking system fail to find their footing, the economy will struggle. The economy might even begin to recover this summer, lifted by the fiscal stimulus package. However, without a healthy financial system, any recovery will prove weak and disappointing.

Confidence that financial markets will work through their problems, aided by lower interest rates and some coaxing by the Treasury Department, increasingly appears misplaced. The financial system may not be up to the task of restarting itself, at least not quickly enough. A more aggressive response, specifically targeted to the problems in the nation's housing and mortgage markets and financial system, seems necessary. At the very least, policymakers should be planning as if their efforts to date will not be sufficient.

One such response would be proposed legislation to allow subprime first mortgage loans originated during the period when underwriting was at its most frenzied to be "crammed down" in Chapter 13 bankruptcy filings. The appropriate cramdown would be determined by a bankruptcy judge and could include reducing the mortgage principal owed to the appraised value of the home, reducing the interest rate, and changing the loan's maturity. Under current bankruptcy law, first mortgages are exempt from any such changes, so homeowners are unable to effectively use bankruptcy to avoid foreclosure. This legislation would quickly induce more substantive loan modifications.

Other, more creative steps are preferable and increasingly possible. One potentially attractive idea is to establish a taxpayer-financed fund to buy up mortgage loans and mortgage securities. This could be done via auctions, in which mortgage owners would sell mortgages and securities to the government at a steep discount; just how deep a discount would be determined by the bidding. An immediate benefit would be to provide liquidity to the frozen securities market, which would reduce pressure on the entire financial system. The process would also provide a clear price for mortgage securities, thus facilitating efforts by financial institutions to appropriately mark-to-market their mortgage holdings. Their inability to do so has resulted in widespread uncertainty and angst in the financial system.

The government, as the new owner of mortgages purchased through auction, could also work to forestall foreclosures and thus shore up the housing market. It could, for example, refinance a homeowner into a smaller, more manageable FHA loan. Although borrowers would have to make payments only on the new, smaller loan, they would still owe the government the difference between their new and old loans. When the homeowner eventually sold, any proceeds would have to be used to fully repay the government, thus ensuring that no homeowner receiving help would make a profit at the expense of taxpayers.

The total cost of the plan would ultimately be very modest. At the extreme, the upfront cost would be approximately $250 billion, assuming that the federal government purchased all 2 million loans that are expected to end up in foreclosure through the end of the decade at a 30% discount. According to the FDIC, this is just about the ultimate cost to taxpayers (in today's dollars) of the early 1990s savings and loan crisis via the Resolution Trust Corp. Of course, the government would not lose all $250 billion, as many of these homeowners would be able to remain current on their new, lower mortgage amount. Even if only half of homeowners were good payers, which seems pessimistic, then the ultimate cost to taxpayers would certainly be no more than that of the recently enacted fiscal stimulus plan.

This proposal certainly has some difficult problems to solve—how, for example, would the federal government evaluate bids by those selling mortgage securities, and how would second mortgage holders be treated? And it might sound a bit extreme. But so did freezing ARM payments and lifting Fannie and Freddie's mortgage lending caps just a few months ago.

What policymakers decide to do or not do in coming weeks will determine whether millions of Americans lose their jobs through the end of this decade and will have a significant bearing on the economic well-being of everyone else.