Legislation Would Short-Circuit a Severe Recession

[Editor's note: These comments by Mark Zandi, chief economist at Moody's Economy.com, are edited excerpts from his testimony to the U.S. House Subcommittee on Commercial and Administrative Law on January 29, 2008.]

Policymakers' efforts to date in response to the mounting problems in the housing and mortgage markets and broader economy have been helpful, but they may very well prove inadequate. Recent studies conducted by the Mortgage Bankers Association and Moody's Investors Service based on information provided by mortgage loan servicers through last fall indicate that hard-pressed homeowners are receiving some increased relief. The Moody's study found that 3.5% of subprime adjustable rate mortgage loans that reset in the first eight months of 2008 had been modified. This is up from only 1% in an earlier survey conducted by Moody's.

However, this improvement, given the substantial impediments to loan modification efforts, is unlikely to forestall an unprecedented number of foreclosures through the remainder of this decade, with negative repercussions for the broader economy. Some tax, accounting and legal hurdles appear to have been overcome, but large differences in the incentives of first and second mortgage lien holders and the various investors in mortgage securities are proving to be daunting. Although forestalling foreclosures significantly benefits the whole economy, these benefits do not accrue to all of the parties involved in determining whether to modify a loan. Given the overwhelming number of foreclosures, loan servicers are also having difficulty appropriately staffing their modification efforts. Servicers are being asked to also act like mortgage originators, and many are ill-equipped to do so. Moreover, loan servicers remain nervous about being sued by investors for not adhering to contracts that bar or limit loan modification. It is also important to consider that for loan modifications under the U.S. Treasury Department plan, many borrowers will have to produce more personal financial information than they did when they obtained their original loans. More than half of subprime loans in 2006, for example, were so-called stated-income loans, for which borrowers were not required to produce W-2s or tax returns to document their incomes. These borrowers may be reluctant or unable to do so now.

These significant impediments to the effective implementation of the Treasury plan via Hope Now suggest that, at best, an estimated 250,000 borrowers will benefit from loan modifications. Although the Hope Now effort is laudable, it should not preclude passage of HR 3609 to give hard-pressed homeowners more protection via Chapter 13 bankruptcy. If Hope Now is successful in helping many borrowers, they will not need to avail themselves of Chapter 13 as provided in this legislation. However, if Hope Now is not sufficiently successful, which may very well become the case, this legislation will prove invaluable.

This legislation would give bankruptcy judges the authority in Chapter 13 cases to modify mortgages by treating them as secured only up to the market value of the property. This would significantly reduce the number of foreclosures. More than one-fourth of homeowners—or an estimated 570,000—are likely to lose their homes by the end of the decade. This calculation is based on the number of homeowners who face a first payment reset through the end of the decade and who would meet the means test required in Chapter 13 cases and are still current on their mortgage payments. This would be very helpful in reducing the pressure on housing and mortgage markets and would measurably reduce the odds of recession next year. Note that in order to limit any potential abuses in this Chapter 13 modification process, Congress should provide firm guidelines to the bankruptcy courts, such as a formula for determining the term to maturity, the interest rate, and the property's market value.

This legislation would not significantly raise the cost of mortgage credit, disrupt secondary markets, or lead to substantial abuses by borrowers. Because the total cost of foreclosure to lenders is much greater than that associated with Chapter 13 bankruptcy, there is no reason to believe that the cost of mortgage credit across all mortgage loan products would rise. Simply consider the substantial costs associated with navigating through 50 different state foreclosure processes in contrast to one well-defined bankruptcy proceeding. Indeed, the cost of mortgage credit to prime borrowers could well decline. The cost of second mortgage loans, such as piggyback seconds, could rise, as they are likely to suffer most in bankruptcy, but such lending has clearly contributed to the current credit problems. It is also important to note that the legislation being considered here today applies to existing first mortgage loans, and thus should have no bearing on interest rates on loans in the future.

There is also no evidence that secondary mortgage markets will be materially affected after a period of adjustment, since other consumer loans that already have similar protection in Chapter 13 have well-functioning secondary markets. Moreover, the nonconforming residential mortgage securities market has already effectively been shut down by the financial shock, and will revive only after there are major changes to the securitization process. The changes proposed in this legislation are immaterial by comparison.

It is unlikely that abuses by mortgage borrowers would increase as a result of this legislation, given that a workout through Chapter 13 is a financially painful process. Indeed, the number of bankruptcy filings has remained surprisingly low since the 2005 bankruptcy reform, likely reflecting the now much higher costs to borrowers in a Chapter 13 proceeding. Short-term housing investors, known as flippers, who borrowed heavily looking to make a quick profit in the housing boom, would certainly not consider Chapter 13 a viable solution to their financial problems.

The housing market downturn continues to intensify, and mortgage foreclosures are surging. A self-reinforcing negative dynamic of mortgage foreclosures begetting house price declines begetting more foreclosures is under way in many neighborhoods across the country. The odds of a full-blown recession are very high. There is no more efficacious way to short-circuit this developing cycle and forestall a severe recession than by passing this legislation.