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What the New Treasury Must Do

Professor Hockett

by ROBERT C. HOCKETT

After a number of heady false starts, against the backdrop of threatened financial catastrophe, Congress and the White House enacted a stopgap financial "bailout" plan early in October 2008. From that point onward the "plan" has repeatedly morphed, morphed again, and morphed back through a string of remarkably fleeting guises. One suspects this dynamic will continue, at least for a while, as a new president and Congress find their footing in the first half of 2009.

Late in September 2008, the Bush Treasury first projected the plan we're now living with as a "buy-up" of mortgage-backed securities (MBSs) said to be clogging the credit markets. The Treasury next began speaking, in mid-October 2008, of "buying-in" to financial institutions. By early November, the Treasury had announced that the "buy-in" plan would entirely supplant the earlier "buy-up" plan. About mid-November, however, the Treasury announced it would enter the short-term debt markets as well. Then, near the end of that month, the plan changed again when the Treasury announced it would resume purchasing "toxic" assets, but more than just MBSs. The term "erratic," it seemed, could be used to describe more than presidential candidates.

Throughout all the abrupt changes of direction, a few voices, softer than Treasury's, persistently offered proposals geared toward the actual primary cause of our present financial worries—the ongoing mortgage foreclosure crisis afflicting our post-bubble real estate markets. With time and continued tumult, these proposals have gradually gained a hearing. Now it is not only Sheila Bair, of the Federal Deposit Insurance Corporation (FDIC), but even Ben Bernanke, at the Federal Reserve, who can be added to the small, growing list of those focusing on the mortgage foreclosures that lie at the core of our woes.

It is good news that many are at last looking for solutions to the foreclosure crisis as the

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best means of addressing the present financial crisis. However badly the Treasury's $700 billion "transfusion" might have been needed to keep alive the "patients" that are our national and global financial systems, the fact is that those patients—or the public fisc—will continue to hemorrhage until we end the wave of foreclosures that is still underway. The only real question is how best to do that.

A brief bit of forgotten institutional history supplies our answer. The best way to solve the mortgage crisis, and thereby a looming national and indeed global financial crisis as well, is to instruct the Treasury to work through twinned institutions we already have. These both originally were, and still are, designed to deal efficiently with low-end mortgage finance and refinance. Indeed they were founded precisely to deal with a real estate crisis that immediately preceded and led to (one shudders to say it) a notorious Wall Street contraction that commenced in October of 1929. Our present woes, moreover, stem directly from under-regulated private firms intruding upon these institutions' original missions during the decade-long housing bubble that ran from 1996 through 2006.

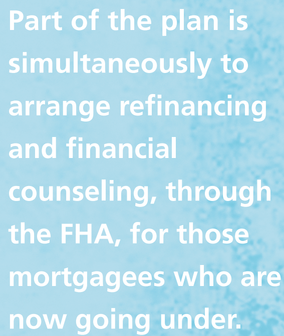
I am referring to the Federal Housing Administration (FHA), working in tandem with entities originally conceived of as its sibling organizations. These entities include the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, which were recently refederalized. Any properly focused plan for financial bailout will critically involve these institutions' original, and recently restored, bailiwick.

To see why and how this is so, begin with a brief refresher on the cause of the problems we currently face. Economists generally agree that there are two particularly important components of the present crisis. The core component is the doubtful value of an uncertain number of "subprime" MBSs. These are held in varying quantities by a large number of financial institutions all over the world. The securities are widely understood to be "toxic" because many—but not all and not even a majority —of the mortgages backing them are troubled.

Many of these mortgages are troubled, in turn, because they were imprudently or in some cases "predatorily" financed by a shadow industry of scarcely regulated "mortgage banks." These institutions, which are not actually banks at all—they take no deposits and are accordingly not regulated as depository institutions—sprang up and grew rapidly with our recent real estate bubble, indeed helping to fuel it. Naïve and in some cases even uncreditworthy borrowers not only received loans from these institutions, but were lured with offers of low front-end "teaser" payments that later "ballooned."

While ordinarily lenders would not have found this a profitable practice, bubbles have a funny way of changing people's calculations. Borrowers not unreasonably assume they can refinance inexpensively on the strength of the underlying collateral's apparently inexorable appreciation. Primary and secondary lenders naturally assume likewise and convince borrowers of the same, lured by the returns on investments that are there to be had during any bubble. For a time in such cases—typically a decade or so at most—everyone wins. But bubbles have a way of bursting too. And when they do, the erstwhile winners who have not left the ship go down with it. The housing price slump that commenced in mid-2006 quickly threw ill-structured, bubble-vintage mortgages into default, threatening homeowners and creditors alike.

The second component of our mortgage-rooted financial crisis is derivative and psychological: something much like the proverbial "market for lemons," known to macroeconomists since at least the time of Akerloff's and Stiglitz's canonical articles of the early 1970s (for which both won Nobel Prizes), follows many a burst bubble. In the present iteration of this all too familiar story, no institution knows what portion of its own MBS-holdings will prove underperforming in consequence of the mortgage industry's post-crash troubles. That is partly because no one knows how low property values will fall. And it is partly because property values, hence mortgage, hence MBS values are themselves partly determined by whatever action we collectively take or do not take to prevent defaults. There is an element of self-fulfilling prophecy in whatever we do here.



Part of the plan is simultaneously to arrange refinancing and financial counseling, through the FHA, for those mortgagees who are now going under.

The self-fulfilling prophecy part of the story radiates outward. The market grows ever more jittery over the uncertainties. The longer the jitters endure, the more prone investors become to undervalue affected financial institutions' portfolios, hence stocks. The more investors shed their stakes in these institutions, the more quickly the remaining such stakes lose their short-run values. With institutions interlinked by collateralized debt obligations, credit-default swaps, and other derivative risk-sharing arrangements, even those not holding MBSs are ultimately affected. The familiar "downward spiral" and "widening gyre" of all financial crises ensues. But what goes down can be turned back up, or at any rate stabilized.

Enter here the FHA and its GSE siblings. We can quickly reverse the widening downward spiral, as the Treasury's original plan of late September 2008 contemplates, by directly addressing the cause at its core—the bad mortgages and the securities they back. This is precisely what the FHA and the GSEs originally were and still are for. The Treasury should be instructed to work through them. Here is how.

As originally envisaged by the Treasury, purchase, through the newly refederalized GSEs, the "toxic" MBSs from key financial institutions now holding them. Pay more than currently undervalued market value, but less than discounted cashflow value. The expenditure will then be recouped when the full portfolio of MBSs rises back to its true value. Finally, ensure that financial institutions that overinvested in MBSs incur some cost, hence avoiding moral hazard concerns.

Will the MBSs rise back to higher values? Yes, for two reasons. The first is rooted in the "market for lemons" and "self-fulfilling prophecy" phenomena. The problem in this case is that, while we know only a minority of MBSs are actually "toxic," we don't know which ones. During those periods of irrational despair that follow periods of irrational exuberance, individuals irrationally fear they hold toxic investments disproportionately. ("I must have the bad ones.") Fearing this individually, they then in effect make it so collectively, by stampeding to sell what they irrationally undervalue. Concentrate ownership of the full affected portfolio, then, and you solve this collective action problem. You'll restore real portfolio value, pocketing the difference between that and the current irrationally depressed market value.

The second and complementary part of the plan is simultaneously to arrange refinancing and financial counseling, through the FHA, for those mortgagees who are now going under owing to poorly structured or misleadingly packaged mortgages. This can be done at a reasonable pace once the FHA's sibling GSEs own the MBSs per the first part of the plan. The newly renationalized GSEs do not face the same financial imperatives as private lenders. (Debt workouts too are familiarly a collective action problem, as any bankruptcy expert can attest.) This is yet another benefit to concentrating ownership of these now troubled assets in the hands of our GSEs. The FHA, in the meantime, can effect mortgage refinancings much more efficiently than can judges or any new cadre of bankruptcy trustees of the sort some are proposing. For again, it is an FHA specialty.

To our detriment we have long since forgotten how effective the FHA and its GSE siblings were, upon their foundings during the Roosevelt era, in ending our last mortgage "meltdown." At literally no ultimate cost to the public fisc—none!—they cured that real estate crisis, and in so doing transformed us from a nation in which fewer than 40 percent owned their homes, to a nation in which nearly 70 percent do. Since the FHA remains both self-funding and best at what it does, and since the GSEs have been refederalized in keeping with their original, pre-privatization mandates, their complementary original missions can now be restored. Their mandates are clear, are constitutional, and still can be more or less costlessly accomplished: they exist to spread and maintain nonspeculative home-ownership on Main Street. Let them do that now and we'll save Wall Street—and the global financial system—as well. At least until the next bubble. ■

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