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OP-ED CONTRIBUTORS

Matters of Principal

By JOHN D. GEANAKOPIOS and SUSAN P. KONIAK

TO stanch the hemorrhage of foreclosures, we don't need another bailout. What we need is a fix — and the wisdom to see what is in our own self-interest.

An avalanche of foreclosures is coming — as many as eight million in the next several years. The plan announced by the White House will not stop foreclosures because it concentrates on reducing interest payments, not reducing principal for those who owe more than their homes are worth. The plan wastes taxpayer money and won't fix the problem.

For subprime and other non-prime loans, which account for more than half of all foreclosures, the best thing to do for the homeowners and for the bondholders is to write down principal far enough so that each homeowner will have equity in his house and thus an incentive to pay and not default again down the line. This is also best for taxpayers, who now effectively guarantee the securities linked to these mortgages because of the various deals we've made to support the banks.

For these non-prime mortgages, there is room to make generous principal reductions, without hurting bondholders and without spending a dime of taxpayer money, because the bond markets expect so little out of foreclosures. Typically, a homeowner fights off eviction for 18 months, making no mortgage or tax payments and no repairs. Abandoned homes are often stripped and vandalized. Foreclosure and reselling expenses are so high the subprime bond market trades now as if it expects only 25 percent back on a loan when there is a foreclosure.

The taxpayers need not and should not be responsible for making up the difference between the payments due bondholders before a loan is modified, and those due after modification. Why? Because the bondholders and the banks, the ultimate beneficiaries of homeowner payments, will be better off if mortgages are modified correctly and foreclosures stopped. The government "owes" them nothing more than that.

Why is writing down principal, which the Obama plan rejects, so critical to stopping foreclosures? The accompanying chart, courtesy of Ellington Management, an investment firm in Old Greenwich, Conn., tells the story.

It shows that monthly default rates for subprime mortgages and other non-prime mortgages are stunningly sensitive to whether a homeowner has an ownership stake in his home. Every month, another 8 percent of the subprime homeowners whose mortgages (first plus any others) are 160 percent of the estimated value of their houses become seriously delinquent. On the other hand, subprime homeowners whose loans are worth 60 percent of the current value of their house become delinquent at a rate of only 1 percent per

month.

Despite all the job losses and economic uncertainty, almost all owners with real equity in their homes, are finding a way to pay off their loans. It is those “underwater” on their mortgages — with homes worth less than their loans — who are defaulting, but who, given equity in their homes, will find a way to pay. They are not evil or irresponsible; they are defaulting because — for anyone with an already compromised credit rating — it is the economically prudent thing to do.

Think of a couple with a combined income of \$75,000. They took out a subprime mortgage for \$280,000, but their house has depreciated to a value today of \$200,000. They’ve been paying their mortgage each month, about \$25,000 a year at a 9 percent rate including principal and interest. But the interest rate is not the problem. The real problem is that the couple no longer “own” this house in any meaningful sense of the word.

Selling it isn’t an option; that would just leave them \$80,000 in the hole. After taxes, \$80,000 is one and a half years of this couple’s income. And if they sacrifice one-and-a-half years of their working lives, they will still not get a penny when they sell their home.

This couple could rent a comparable home for \$10,000 a year, less than half of their current mortgage payments — a sensible cushion to seek in these hard times. Yes, walking away from their home will further weaken their credit rating and disrupt their lives, but pouring good money after bad on a home they do not really own is costlier still.

President Obama’s plan does nothing to change the basic economic calculation this hard-pressed family and millions of others like it must make. The Obama strategy — which involves reducing their interest rate for five years and giving them, at most, \$5,000 for principal reduction over five years — will still leave them paying much more than the \$10,000 it would cost to rent.

And five years later, after the Obama plan has run its course, this couple will still not “own” this house. Those who accept an interest modification under that plan are likely to realize at some point that they are essentially “renting” a home and paying more than any renter would. Many of those families will re-default, and see their homes foreclosed.

Bondholders today anticipate making as little as \$70,000 on a foreclosed home like that in our example. But consider how much might change simply by writing down the principal from \$280,000 to \$160,000, 20 percent below the current appraised value of the house. The homeowner might become eligible to refinance the \$160,000 loan into a government loan at 5 percent, which would be impossible on the \$280,000 mortgage.

Even if the couple couldn’t refinance and still had to pay the original rate of 9 percent, the payments would be reduced to \$14,400 a year, considerably less than the \$25,000 now owed, and no longer wildly more than renting would cost. And the couple would have \$40,000 of equity in the house: a reason to continue to pay, or to spruce up the house and find a buyer. Either way, the original bondholders would have a very good chance of making \$160,000, instead of the \$70,000 expected now. Everybody wins.

If writing down principal is such a good idea, why aren't banks and servicers (the companies that manage the pools of mortgages that have been turned into investment vehicles) doing it now? Many banks are not marking their mortgages down to the foreclosure values the market foresees, hoping instead that we taxpayers will buy out mortgages at near their original inflated value — another government bailout. Reducing principal would force them to take an immediate markdown, but a smaller one. The servicers, meanwhile, are afraid that bondholders, their clients, will sue them if they write down principal — a real prospect because the contracts that allow servicers to modify securitized mortgages put restrictions on the kinds and number of modifications they may make. Moreover, making sound modification decisions is costly; servicers don't want to spend the money and lack the personnel to do the job.

Beyond all that, the servicers have a conflict that all but guarantees they will not modify loans to maximize bondholder value. Once a homeowner is in default, the servicer must advance that homeowner's monthly payments to the bondholders, getting repaid itself only when the house is sold or the loan is modified. So cash-strapped servicers want to foreclose prematurely or do a quick-and-dirty modification (without due diligence and thus without considering principal reduction) to get their money back fast.

Paying servicers, these conflicted agents, \$1,000 per mortgage to reduce interest payments, as the Obama plan provides, is a bad use of scarce federal dollars. Last October, on this page, we proposed that Washington pass legislation that would remove the right to modify loans or decide on foreclosure from the servicers and give it to community banks hired by the government. These community organizations would have the power to modify mortgages (including reducing principal) when doing so would bring in more money than foreclosure — particularly loans that are now current but are in danger of delinquency. Those now current would be presumed ineligible if they default before the trustees arrive to modify. Our plan is simple and would require little government spending, somewhere from \$3 billion to \$5 billion over three years, as opposed to the \$75 billion or higher price tag for the Obama plan.

We know there are some who will be outraged at the idea that their neighbors might get a break, while they — so much more responsible — get nothing. To these outraged folks we say, you would benefit too. It is not just your home values and your neighborhoods that will deteriorate if you insist that your underwater neighbors not get relief; it is your tax dollars and that of your children that will be needed to make up for the plummeting value of those toxic assets held by banks, which we taxpayers now guarantee and may soon own outright. It is your job that will be at stake when your neighbors can no longer afford to buy goods and services, causing more companies to cut jobs. So you need to act responsibly again, for your own sake and for the welfare and future prosperity of the entire nation.

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