Center for American Progress

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The precipitous collapse of Bear Stearns Cos., Wall Street's fifth-largest investment bank and one that had prospered through 85 years of turbulent markets, makes it clear that the current chaos in U.S. credit markets has implications far beyond the million or so families expected to loose their homes in the coming months. It should also provide a clear signal why policies the Bush administration has thus far agreed to put in place do little to address the central challenges presented by the subprime mortgage debacle.

As Federal Reserve Chairman Ben Bernanke explained to bankers several weeks ago, we face not one but two interrelated sets of problems. One is the "toxic waste" of subprime mortgage contracts that now afflict financial institutions around the globe. The other is the collapse of the speculative bubble in U.S. real estate prices that these lending practices helped to create. Finding an effective solution to either of these now intractable problems requires addressing both of them together. Failure to do so could easily lead to a downward economic spiral in which each of these crises continues to feed off of the other.

Bernanke urged the banking industry to utilize "loss-mitigation" arrangements to curb "preventable home foreclosures." Put simply, he told bankers that it is in their interest to voluntarily write down the principle and interest on mortgages so that financially troubled homeowners can become current on their payments and remain in their homes. As the Fed chairman pointed out, the number of vacant, unsold houses hit an all-time high of two million in December, and the number continues to grow, month after month, in 2008.

Measured in dollars, the value of unsold homes has more than doubled since 2004 and is currently in excess of $1 trillion dollars. Equally disturbing, real estate markets have shown no sign of stabilizing. In just the first month of this year, foreclosure actions were initiated against 153,000 homes nationwide while home sales took only 43,000 houses off the market. More than 700,000 of the 3.6 million subprime adjustable rate mortgages are seriously in arrears and will soon be facing foreclosure. Even worse, many more mortgages are likely to go into arrears in the coming months as interest rates are adjusted upwards.

According to Bernanke, 40 percent of the 3.6 million subprime adjustables are scheduled to reset during 2008. Further, the problem is not limited to adjustable rate loans. Troubled fixed rate subprime loans are growing, and a weakening economy and declining real estate prices are likely to result in higher default rates even among conventional mortgages.

The Fed chief's assessment is clear: "This situation calls for a vigorous response." That is true, but a vigorous response requires more than $600 tax rebates spread across the entire U.S. population, and loose credit policies similar to those that helped create these problems in the first place. To date, neither the Federal Reserve nor the Treasury Department has been willing to come forward with a proposal that does more than offer words of encouragement to get those who own distressed mortgages to move rapidly in writing down losses and restructuring loans—the only path to stabilizing real estate and financial markets without serious further deterioration in those markets and the overall economy.

Alternative Plans

One possible course of action would be for the federal government to simply buy up troubled mortgages and refinance them. That is substantially what happened in 1930s when unemployment and collapsing real estate markets triggered the creation of the Home Owners Loan Corporation, which offered financially troubled homeowners the opportunity to hold on to their homes by refinancing the prevalent short-term (five year) mortgages to longer-term (fifteen year) mortgages with substantially lower monthly payments.

Nearly one-fifth of all of the houses in the country were refinanced between 1933 and 1936. Hundreds of thousands of families were able to hold on to their homes, and hundreds of thousands more were able to make mortgage payments and still afford food, heat, and medical care. Furthermore, the HOLC returned a small profit to the Treasury after the last loan was repaid in 1951.

Undoubtedly, the U.S. government today could contribute significantly toward the stabilization of home prices if such an effort were undertaken and successfully executed. But much about real estate has changed in the last 75 years, and the logistics of such an effort in today's business environment would be daunting. The amount of qualified staff the government would need would be enormous. Analysts would be required to determine which borrowers would be qualified for refinancing, to verify the income and credit worthiness and residence of borrowers, to establish a fair value under current market conditions for the real estate in question, and finally to draft purchase offers to lenders.

Considering the universe of more than 6 million subprime loans, the effort would likely require the examination of at least 2 million of those mortgages with possible refinancing occurring on well over a million. If processing of each mortgage required 5-to-10 days of work it would require upwards of 40,000 people more than one year to process a million mortgages. Even more problematic is the fact that no refinancing would occur until the responsible agency was able to recruit and hire staff—a process that would require months even under the most optimistic of scenarios.

But there is another way that government could quickly and effectively encourage a rapid conversion of subprime "toxic waste" mortgages into investment grade paper and simultaneously keep families in their homes and homes off the already bloated real estate market.

Quite simply, the government could provide those lenders holding mortgages or those investors who own mortgages through mortgage-backed securities with an immediately refundable U.S. tax credit to offset a portion of the loss incurred from the writing down mortgaging to levels that the borrowers are able to pay.

There is an easy standard for performance. A mortgage qualifies for a Federal Housing Administration loan if among other things:

- The amount of the mortgage does not exceed 95 percent of the current assessed value of the house
- The borrower occupies the house
- The total monthly amount of the mortgage (principle, interest, taxes, and insurance) does exceed 29 percent of gross monthly income
- The borrower has two years of steady employment, preferably with same employer
- The amount loaned cannot exceed a specific amount based on real estate prices in the locality in which the home is located. (Newly revised limits restrict loans on single family homes to no more than $341,250 in a medium range market such as Columbus, Ohio, while home buyers in more expensive markets such as Fairfield, Connecticut, can borrow up to $708,750.)

An investor holding mortgage-backed securities who agreed to such a write down would be rewarded not only by converting a portion of its loan portfolio from mortgages of highly questionable commercial value to a government guaranteed contract that would be viewed as "investment grade" or very low risk. In addition, the lender would receive a tax credit to restore a portion of the capital lost.

While it is clear that the Fed Chairman is correct in saying that large scale write downs are very much in the collective interest of the financial system, it is less clear that they will be perceived to be in the interest of specific individual financial institutions or mortgage holders whose cooperation and participation are necessary. From the perspective of a bank holding $250 million in subprime loans (about two-hundredths of one percent of all subprime loans), the loss absorbed on a write down is easily quantifiable while the impact of their small share of the total write downs on local or regional real estate prices will seem negligible.

This is an instance in which an action that benefits all participants (by reducing further downward pressure on the U.S. housing market) may require action by individual security holders which may not appear (given current incentives) to be in their individual interest. Attempting to ride out the crisis without making write downs may make sense on an individual basis, but it could be cataclysmic if it becomes the choice of significant numbers of mortgage holders, or even if it is weighed as a choice by mortgage holders for a period of time as markets continue to deteriorate. That is why direct targeted incentives are needed to get subprime mortgage holders to do the right thing.

Many of these mortgage holders can already use their tax liability to absorb part of the loss from a mortgage write down or foreclosure. A profitable bank can generally recapture 35 percent of its losses by deducting them against their taxable corporate income. These U.S. lenders and investors would also be able to use their immediately refundable tax credits as well.

Other holders of these mortgage assets, such as foreign-operated and possibly government-owned investment funds, may have to accept more of the burden of the loss posed by a write down or foreclosure themselves. Offering an immediately refundable U.S. tax credit, however, would provide all owners of subprime mortgage contracts with an incentive to immediately write down their damaged U.S. housing assets.

Here's how it would work. In recent years the average size of subprime mortgages has been in the neighborhood of $200,000. If a mortgage holder possesses a $200,000 mortgage on a home now valued at only $175,000 and the borrower has a gross monthly income of $4,380 (annual income of about $52,500) then the most the borrower could pay in order to qualify for an FHA-insured loan would be $1,270 a month. If the lender or investor were to write down the mortgage by $40,000 to $160,000 it could be financed at a fixed rate over 30 years at $1,270 a month (including the estimated cost of property taxes and insurance.)

With a 20 percent immediately refundable tax credit, such a mortgage holder would get a check from the U.S. Treasury for $8,000. The remaining loss to the mortgage holder of $32,000 would be treated as a normal business loss and deductible against taxable income.

Why would this be in the interest to those holding potentially troubled mortgages? First, many mortgage holders are suffering not only from the potential loss posed by the possible default of mortgages now in their portfolio but from a contagion of fear surrounding the whole financial services industry. This has clobbered not only stock valuations but also the cost of capital—and with it the ability of these institutions to do business as either borrowers or lenders in U.S. and world credit markets. Converting "toxic waste" now on the books of these financial institutions would contribute greatly to restoring confidence in the institutions, credit markets more generally, and the U.S. and global economies in general.

In addition, the 20 percent refundable tax credit could be added immediately to bank capital and reducing pressure to raise new bank capital from other sources such as sovereign wealth funds.

The Case for Action

But beyond protecting and rebuilding their own reputation for creditworthiness, the failure of financial institutions to recognize the peril they now face and accept the losses described in the example above make them highly vulnerable to much greater future losses.

Some recent studies indicate that the traditional metrics of what may be expected by lenders in terms of lost capital in the event of a foreclosure may significantly understate the losses that lenders should expect in the midst of the current crisis. Foreclosures in previous periods have wiped out about 50 percent of the unpaid balance of a secured mortgage.

Some estimates indicate that under current market conditions losses can be expected to approach or even exceed 70 percent. And then there is the possibility of vandalism against unoccupied homes and the further risk of fines and other expenses levied by localities for failure to protect properties from becoming havens for drug users and criminals.

Perhaps a more important question, however, is why is it in the interest of the government to give up tax revenue to financial institutions that made poor business decisions and on behalf of individuals who mismanaged their affairs and committed themselves to contracts that they did not have the means to honor? The answer is that all other things being equal it would not be in the interest of the government to reward bad judgment and outright misbehavior on the part of either individuals or businesses.

But all other things are not equal. The U.S. mortgage and housing crises poses a serious threat to the overall economy and the well being of all Americans. Even a minor downturn in the economy has major costs to the government itself in terms of lost revenues and added social safety net expenditures. Literally millions of individuals and businesses who lived and borrowed entirely within their means and contributed nothing to the subprime crises are likely to become victims.

If we look at the example above of the federal revenue lost as a result of a 20 percent tax credit provided to cushion and encourage a $40,000 mortgage write down, it would cost the Treasury $8,000. If it is assumed that the absence of the credit increases the prospect of foreclosure even modestly, the impact on revues is profound. A $200,000 mortgage that loses 60 percent of its value for a $120,000 loss could cost the U.S. Treasury $42,000 in lost revenue. And that is before the downward impact on the value of other housing and their associated mortgages is calculated.

Perhaps of greater importance is that the valuation of the mortgages under this proposal is left to be negotiated between mortgage holders and borrowers—both of whom have the greatest knowledge of the assets in question, and the greatest at stake in terms of insuring a satisfactory outcome.

While tax credits do increase moral hazards at the margin, mortgage holders are still very much a risk, and will pay a substantial portion of the loss that resulted from their bad judgment in making or purchasing the loan in the first place.

This may well not be true under any plan that places the responsibility on the government to establish a price for troubled mortgages, purchase, and then renegotiate mortgage terms with the borrower.

Also, a tax credit tied to FHA-insured financing may involve some additional effort by government employees in that agency, but it will not entail the creation of a major new segment of bureaucracy. It can be done as quickly as the Congress can adopt new tax legislation and lenders and investors can determine it is in their interest to renegotiate their mortgages.

A Much Cheaper Solution

What's more, this is far less expensive than passing out tax breaks to the entire population or pumping up the nation's money supply to improve bank balance sheets. If we were to assume that there are roughly 1 million troubled but salvageable subprime mortgages, and further assume that the average write down on those 1 million mortgages will average 20 percent, then the total amount of all write downs (given the average size of subprime mortgages is $200,000) would be $40 billion. The cost of a 20 percent tax credit would be only $8 billion (Since the tax credit would offset part of the loss that would otherwise be deducted from income, the net revenue loss to the Treasury could actually be no more than $5 billion).

That's chicken feed compared to the $146 billion stimulus package signed by the president last month. And unlike the stimulus package, the revenue losses are tightly targeted to induce actions that will get the economy out of the soup.

Finally, the tax credit approach may be a more obvious and more easily quantifiable subsidy to banks and other mortgage holders than the current expansionary monetary policy being pursued by the Federal Reserve but it is a far smaller subsidy and is far less costly in terms of the sacrifices it demands from individual citizens outside the banking community or the long term health of the American economy.

In order to improve bank balance sheets, the Fed has undertaken a massive manipulation of the money supply, lowering the interest rates it charges banks below the current rate of inflation. That has directly touched the life of virtually every American.

These low rates have some beneficial effects, to be sure, but they heavily favor banks. They also have huge negative consequences, including the weakening of the dollar, raising the price of imported goods (in particular oil), and clobbering the budgets of elderly Americans and others living on fixed incomes.

Banks make money by lending at an interest rate above that which they must pay when they borrow. In mid-September, the Federal Reserve was charging banks 5.25 percent to borrow money. On September 18, 2007 they cut the rate to 4.75 percent and over the following six months they have agreed to an additional five rate cuts. Last week they slashed the cost of money to banks to 2.25 percent—three full percentage points below where it was last September.

While a reduction in the Fed Funds Rate can also lower some of the rates charged by banks, many of the rates charged to bank customers are unaffected or move less than the interest rate decrease provided by the Fed. For instance, average interest charged on credit cards has declined from just above 14 percent last September to just above 13 percent in March. Because banks are now borrowing at three percentage points less than they paid in September, however, the $900 billion that Americans owe on their credit cards bumps bank incomes by more than a billion dollars a month.

On the minus side, the rate cuts have accelerated the decline in the dollar. Since the Fed started lowering rates in September the dollar has dropped 14 percent against the Euro and 15 percent against the Yen. Among other things, that drives up gasoline prices. Surveys indicate that the typical motorist was paying about $2.78 a gallon last September and is paying $3.26 today. If he could pay for his gasoline in Euros or Yen he would hardly notice a difference.

Other losers in the Fed's manipulation of the money supply include the millions of elderly couples who supplement their Social Security with interest income earned on their retirement savings. According to Federal Reserve data the average interest rate on 30-day certificates of deposit dropped to 2.8 percent last week from 5.8 percent last September. That represents a cut in monthly income from about $960 to less than $400, assuming a savings nest egg of $200,000.

Finally, it should be pointed out that despite the magnitude of the fiscal and monetary policy solutions that have thus far been applied to the subprime/real estate crises none of that money has been targeted to directly encouraging the specific behavior required for economic recovery. We have bled the U.S. Treasury of tens of billions of dollars in tax cuts, yet the vast majority has gone to families who are making their mortgage payments without serious difficulty. We have dramatically lowered the cost of money to financial institutions with no assurance that they will follow the steps that the Federal Reserve Chairman has recommended.

Policy makers should examine what level of tax credit provides sufficient incentive to get those who currently own mortgage securities to *"vigorously respond"* to Chairman Bernanke's calls for *"loss-mitigation."* It is possible that a tax credit at the 20 percent level is too small to get the desired results. Or conversely, it may be larger than is necessary. In either case, the fiscal consequences will not be a major stumbling block.

Congress should also consider limiting the deductibility of expenses related to foreclosures. Providing that only 80 percent or 90 percent of such expenditures could be deductible against corporate income could provide a stick as well as a carrot to encourage the maximum possible effort for loss mitigation.

Tax incentives should also not be viewed as the only solution. Proposals such as those by my colleagues at the Center for American Progress to strengthen the hand of the Federal Housing Administration to facilitate refinancing more rapidly, drawing upon the existing capacity of the Government Sponsored Enterprises, could also play an important role. At the core of these proposals is the bulk transfer of mortgages via auction from current note holders into the hands of institutions willing and able to refinance homeowners based on the current property value.

Conclusion

The task before us is to dramatically increase the number of refinancings in the months ahead. If we are to avoid substantial further erosion in property values we will have to move from what appears to be a very slow pace of refinancing to one in which hundreds of thousands of refinancings take place in a matter of months. For that task policy makers will need an array of options and incentives.

No matter what the Congress and the president decide to do with regard to the subprime crisis they will not fully address the range of credit problems facing the economy until they recognize that the rapid changes that have occurred in credit activities in the past decade have not been met with adequate regulation. This has not only left the government and consumers at risk but has severely damaged those markets that initially benefited from lax and ineffectual regulation.

Investors both here and abroad will not sufficiently trust our credit markets until a far greater degree of transparency has been imposed. And that will not happen until the U.S. government abandons the radical laissez-faire philosophy that contributed so heavily to the current mess.

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