OPINION

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Resolving Underwater Home Mortgages:
A Hazard to Whose Morals?

Much has been made of the moral hazards supposedly inherent in residential loan modifications, which offer borrowers a reduction in outstanding principal that reflects the massive drop in home prices since July 2006. But this begs the following questions: Who shares in the responsibility for the ballooning volume of underwater mortgages? And whose morals are really at risk of hazard today: homeowners' or lenders'?

Overview

We have, for the better part of three years, been unstinting in our calls for swift remediation of underwater residential (and commercial) mortgages. As the housing market declined by more than 30% nationally and near or exceeding 50% in several markets, more than a quarter of all mortgaged homes are now worth less than the debt securing them. A dramatic nosedive commercial properties' value has placed many underwater, relative to some $3.4 trillion in aggregate commercial mortgage debt outstanding in the United States (there is, by contrast, ~$11 trillion in home mortgage debt outstanding).

We believe the greatest risk to households, the banking system and our prospects for economic recovery lies in failing to address seriously undercollateralized mortgage debt, which is likely to continue to pose a drag on future capital formation and growth. In early 2007, we were one of few observers noting that the failure to remedy the same problem in Japan was the principal contributor to that country's near zero net annual growth over the past dozen years, since the final collapse of its debt-driven bubble. Our view is now much more readily acknowledged, but little is being done to avoid a similar outcome.

The resolution of commercial real estate loans, in the absence of creating improper incentives with regard to future lending and borrowing behavior, is not problematic. Owners and lenders lose money, assets are revalued and eventually liquidated, and excess capacity will be absorbed over sufficient time. The impact on owners and lenders isn't pleasant, and this narrative will pose increasing and continuing challenges to a banking system that has so far sought to postpone this process in the hope of an intervening miracle. But barring such a wondrous outcome, the inevitable will transpire over the coming years.

Home mortgage debt, however, presents a very different conundrum.

Gimme Shelter

Because everyone requires daily shelter (and it is clearly an economic good that shelter be available to members of any productive society), housing is a real estate asset like no other. The United States is projected to have about 114 million households in 2010 and currently has about 130 million housing units of all types (primary residences and second homes, owned homes and rental residences). We have just emerged from a massive, debt-fueled homebuilding bacchanalia, which saw the number of homes in excess of the number of households rise by 2.6

million units, to a total of 15.5 million units over the past decade. During this period, we nevertheless saw housing prices rise by nearly 80% before plummeting back to a point nearly in line with the other housing-related metrics (rents, median incomes, construction costs, etc.), from which prices had completely disconnected. There are now about 5.5 million existing homes currently seeking buyers (both visible and shadow inventory) and 300,000+ new foreclosures each month.

Home mortgage debt, however, exploded to a peak of $11.2 trillion in 2008, from $5.5 trillion at the beginning of the decade. With the collapse of mortgage collateral value to a level that's now substantially below the aggregate outstanding amount of mortgages secured thereby, homeowners and lenders alike are faced with a tragedy of epic proportions—and, as set forth in our companion report today, Foreclosures, Fish Food and the Final Fall in Home Prices, one that continues to worsen.

Breaking Down the Issues

The situation gives rise to two principal questions:

1. What's the right thing to do, from an economic perspective, to minimize the impact of the crisis on housing, families, banking and the economy as a whole?

2. Who, if anyone, is at fault for the debt and housing debacle? Accordingly, how should losses and disruption be allocated?

The first question is a bit easier to address. The economic dislocation caused by the housing crisis has the capacity to be controlled and minimized. Keeping families in homes by continuing to pay a portion of their mortgage debt (based on the current market value of their houses) is almost always a better outcome than foreclosing them out of ownership and attempting to remarket a home in the face of excess inventory and a weak overall economy. Losses to lenders from foreclosing, repossessing and reselling are often nearly twice that of merely reducing principal and payments to match off against market declines.

As for the banking system, limiting losses in the above fashion is undeniably a benefit. But the problem arises in the timing of the banks' recognition of losses (which, when mortgages are restructured through principal forgiveness, is pretty much immediate) and in asking banks to surrender the possibility of "self-curing" of some loans if housing values increase significantly because of a rising economy. This is a complex algorithm; after all, it must take into account the overall prospects for inflation vs. deflation in the economy and, more particularly, in the cost of shelter (rents).

We believe the prospects for additional losses to banks' mortgage loan portfolios (based on underlying continued deterioration of home prices by our projection of another 8% to 10%), however, are far more likely than the opposite outcome. And the pressure this will place on bank capital will continue the Japan-like stagnation to which we are unfortunately becoming inured. As such, the "right" thing to do for the economy (if not for bank shareholders and possibly bondholders) appears very clear to us.

As to what to do with, or for, the underwater homeowner, the answer is considerably murkier.

The Morality Play

In this country, we're taught from an early age (or at least we used to be) the importance of financial responsibility and the concept of bearing the risks and rewards for our financial decisions. The notion of creating favored classes of individuals or businesses who do not participate in our economy or legal system in accordance with these principles is anathema to the vast majority of U.S. citizens. Evidence the public disgust at the privileges extended to financial-services companies that, to stem the banking system's freefall, socialized the impact of the industry's foolish risks while allowing it to retain most of the rewards received therefrom.

So, the notion of "bailing out" underwater homeowners is equally distasteful to most Americans. After all, there are plenty of prudent homeowners who fully paid for their homes before the run-up in home prices and resisted the temptation to borrow against them during the bubble. And if the matter simply rested there, as a moral rebuke to the irresponsible who deserve to suffer, we could leave it at that.

But, as with many concerns about the collapse of the debt and housing bubbles, the issue is more complex and requires further analysis.

First, let's take a look at lender culpability in the charade. Of course, no lender was standing over a borrower with a gun, forcing him to borrow money. But from the perspectives of marketing and promotion, teaser interest rates and other novel payment formulas—and a near absence of underwriting for credit suitability, loan originators and those who packaged bubble-era loans into securities—were certainly enablers. They were pushers of debt, an addictive drug in all but name. We prosecute drug pushers in the United States, although we don't have much sympathy for addicts, so lender misconduct does not fully excuse bad borrower behavior.

But scratching the surface a bit more, we need to look at how—among very sophisticated real estate brokerage firms, appraisal firms, mortgage loan originators, large bank "warehouse" lenders, investment banks, rating agencies and prudential regulators—there was absolutely no party that recognized what was happening, while it was happening, and attempted to curtail the bubble. Do the parties that collectively promoted, pursued and, with the exception of regulators, profited mightily from the housing and finance industry during the bubble bear some of the responsibility? And, if so, why?

Here's the answer we believe has been largely absent from the debate thus far:

They could have known, should have known, and elements of management of the involved institutions fully knew, what was going on and why it made no sense. But there was just too much money moving around for any involved party to put a stop to it, even to the long-term detriment of the businesses involved and the U.S. government.

Anyone looking at the bubble period as it was unfolding could (and some did) readily see that the metrics that, in normal times, determine the value of housing had become severely uncoupled from home prices, and the derivative thereof, residential land prices.

Bubble, Bubble, Toil and Trouble

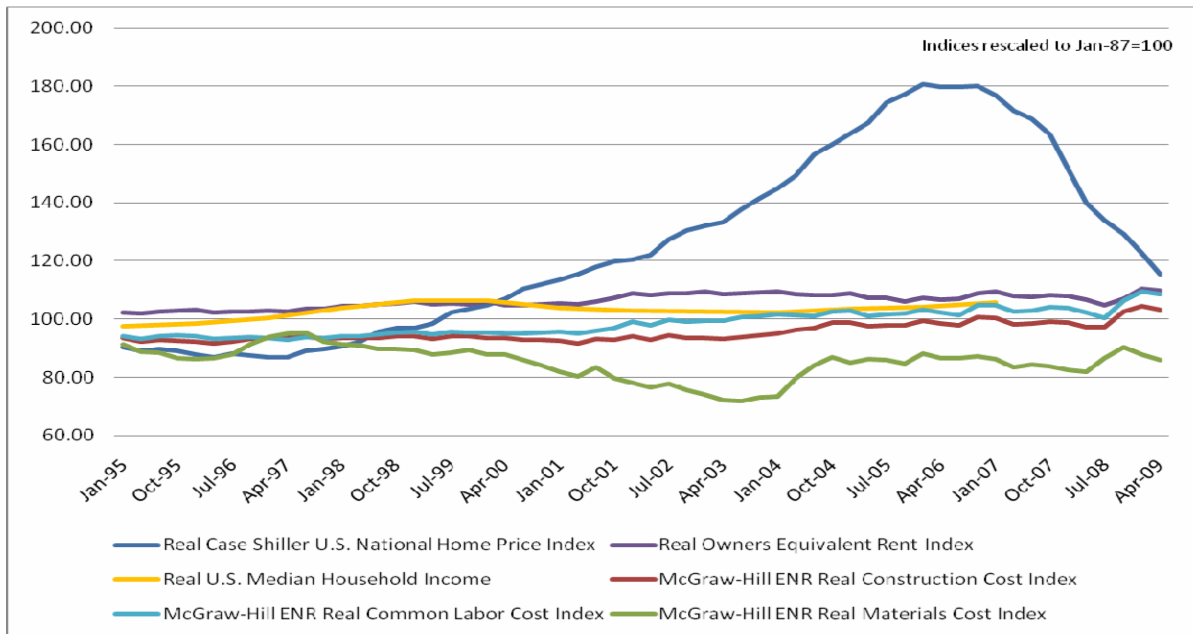
The decision and ability to purchase a home, and the price one is willing to pay to enter the housing ownership market, are inevitably linked to the following other economic realities:

- The alternative of renting shelter versus the all-in, after-tax cost of ownership;
- One's income;
- The cost of constructing a comparable home (including labor and materials);
- The home's prospect for value retention in an inflationary environment, or further appreciation (the latter being historically unlikely on average, put possible in the case of certain properties).

Interest rates, so often misinterpreted as a primary determinant of value, are merely a component in the rent-versus-buy decision, no different from the real estate taxes and maintenance costs related to an acquired home.

And as the graph below demonstrates, other than home/land prices, all of the other metrics were flat to down on a real basis when home prices went on a wild ride of their own:

Table 1: Comparison of Housing Bubble with Key Indices on Inflation-Adjusted Basis



Sources: Case-Shiller 20-City Index (SPCS20R), BLS CPI All Items and Real Owners Equivalent Rent Index, McGraw-Hill Engineering News Record

Why, then, would rational people pay 180% of what they would have paid for a home only 8 years before (on an inflation-adjusted basis, more in nominal terms) when nothing else was budging? The answer is the same as for any other craze: because everyone was doing it!

The purchase price of any financial asset is always composed of two elements: (i) its inherent value relative to the cash flow it can generate (or, in the case of homes, the rent saved); and (ii) its speculative value, which is nothing more than an assessment of what market participants' emotions determine price to be from time to time, plus a judgment with regard to future economic inflation.

Housing has historically never been valued for much more than its inflation-adjusted rental equivalent value, at a multiple of rents that, until the bubble, remained in a tight band for decades—by our calculations, 11.5 to 13.8 times equivalent rents. Why, then, did price-to-rent multiples suddenly surge to over 26.5 times rents in the bubble? Why did folks start paying nearly 50% of home purchase prices as a bad bet on future speculative value?

The answer, in a nutshell, is debt products provided by very sophisticated capital markets players and their direct or indirect agents and enablers. As long as values kept rising, market participants were content to wear blinders and base home values strictly on comparable sales data that they themselves were enabling. And as prices soared farther into the stratosphere, beyond the point where incomes could support conventional mortgages, new products were created that, in essence, relied on payments derived from the notion of infinite home price appreciation and continuous refinancing.

The moral hazard lay not only in the borrowing incentives available to homeowners and their decisions to accept them, but equally with lenders and their enablers.

This being the case, what to do about loan modifications?

Whose Moral Hazard is it Anyway?

Moral hazard, as defined by most economists, results when a participant in the economy is incentivized (or, at least, does not have a disincentive) to take inadvisable action for which he does not suffer risk but reaps any rewards, however slim the likelihood.

Let's look first at the issue of moral hazard as applied to homeowners. Without question, those who bought their residences during the peak bubble years—especially if they did so with interest only or negatively amortizing mortgage loans—have no equity remaining in their investment. More than 25% of U.S. homeowners are underwater right now, and with our estimate of another drop to come, it's likely that 40% to 45% will eventually have negative equity. So, it's hard to see how they have not suffered for the risk they took; even if they had only a small amount of original equity, it's gone.

As to whether they should be "rewarded" by having their mortgage loans' principal balance adjusted to the fair market value of their homes (or, perhaps, slightly above), we don't see how this is much of a reward. It's an incentive to highly underwater homeowners to keep paying their loans and not go into foreclosure, thereby causing materially larger losses to their lenders, or "tossing the keys" to their lenders and going to find a cheaper place to live. It's also in the mutual interest of lenders and owners, in general, to slow the increase in vacant housing supply—and keeping families in their homes is the best way of doing this.

Opponents of this thinking put forth the following arguments:

Those homeowners who engaged in serial refinancings of their homes, pulling out bubble-era increases in value and using the equity withdrawals on lifestyle expenditures (which also, by the way, drove the economy mid-decade to no small extent), would be getting off free.

We actually agree. Americans collectively took an average of $600 billion a year out of their homes during the final three years of the bubble era and, based on consumer spending levels during those years, most of that money is gone. These are the folks who are most noxious to the average, prudent American.

To limit the freebies to the most irresponsible borrowers, we would suggest the following caps on a mortgage principal modification program: (i) limit the program to borrowers who bought their homes from 2003 on, and (ii) use title records to exclude any borrower who refinanced his mortgage during the time he owned his home and increased principal by more than 10% above the costs of the refinancings, since the beginning of 2003. This won't capture all irresponsible borrowers, but it will handle most of them.

Why should banks relinquish the ability to recapture forgiven principal when housing values "recover?"

Here we disagree, for the most part. First, the values against which the mortgages were originally written were that of a bubble—a collective insanity—and prices are returning to normal levels relative to historic metrics, not crashing because of a sudden panic. There can be no expectation of a "recovery" in such a circumstance; there is nothing for them to "recover" to. Secondly, in writing down principal to current value (or perhaps a bit more— we suggest 105%), the homeowner is being placed, for the most part, in the position of tenant. But it's an unusual tenancy—one in which you expect the tenant to pay real estate taxes on and maintain a home in which he has no equity. The only economic reason he would have to do so is the prospect of perhaps being able to reap some reward as home prices rise in accordance with general inflation, as they have in the past. And we think this rise will be painfully slow for many years.

If you offer principal reduction modifications, borrowers who are currently able to pay, and are paying timely on, their mortgages will default and demand such modifications, too.

Possibly true, but we're talking about modifying loans of severely underwater borrowers. While some may possess a strong sense of virtue and be willing to be crucified upon a cross of debt (to badly paraphrase W.J. Bryan), from a strictly economic standpoint any severely underwater borrower who does not toss the keys is making a bad decision. Therefore, it is unreasonable to believe that, over time, many severely underwater borrowers will press on—or that principal reduction modifications will materially alter the ultimate result. In fact, they will save lenders, in many cases, from the greater losses involved in foreclosure sales in an oversaturated market.

Conclusion

We've already addressed lenders' level of culpability for the debt and housing bubble. Clearly, at least as far as the banking system is concerned, the issue of moral hazard exists if exogenous, noneconomic policies result in lenders not bearing the burden of their own unwise decisions.

And this is precisely what has transpired since the Great Banking Panic of 2008. To save our entire system of commerce, governments throughout the globe undertook actions highly fraught with the creation of moral hazard—and, morals being damned in times of crisis, many of the actions were necessary and called for.

But we are still left with lenders that have not fully come to grips with the degree to which many housing borrowers (to say nothing of commercial borrowers) will be unable to pay the debts still carried on lenders' books. We have tolerated the kicking of this can down the road, and doing so has brought us some level of systemic peace.

Nevertheless, the overhang on the banking system and our economy still exists. If anything, a failure to push the banks, through regulatory action and political pressure, to address their inevitable losses on home mortgages, which affect so many individuals and further endanger the housing market, inherently increases the level of moral hazard—in addition to being a moral failure.

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