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The Freedom Recovery Plan: Daniel Alpert Responds

By JOE NOCERA

Daniel Alpert's plan to help homeowners with impaired mortgages, which was the subject of my column on Saturday, received many thoughtful comments. Many readers were as enthusiastic about his plan as I was, but many other raised objections that deserve to be addressed. I asked Mr. Alpert to respond to the critics. Here is what he wrote:

I greatly appreciate all the comments and emails I received this weekend about the Freedom Recovery Plan (FRP). They reflect considerable thought and attention from respondents from all over the country. It is clear that this is a subject that resonates profoundly and with great emotion. For those who are just coming to this debate now, you can read my detailed description of the plan here. (It's the document on the bottom right.)

In no particular order, I'll address the major themes that were broached by readers:

1) Concerns About Rent Levels for Recovery Leases
The plan provides for lease rents to be set at prevailing market levels. Some respondents have been concerned that the rents may be as high as, or higher than, the existing mortgage debt service payments. Under the plan, however, the rental burden should be significantly lower than the costs of ownership, for the following two reasons:

a) Throughout the country, housing prices (and therefore the debt service attributable to mortgages used to acquire or refinance homes at their inflated values) completely disconnected from rents over this decade. On real terms (inflation taken into consideration) rents actually declined slightly during the bubble; at best they were flat. The typical comparison of home prices to rents, the so-called Price to Rent Multiple, ballooned to almost 26x at the peak of the bubble, from its traditional range of 14x to 16x from the end of World War II until the beginning of the current decade. Monthly rents in many markets are still significantly below the carrying costs of owning a home bought during the bubble. For more information on this subject I ask your readers to consider perusing our paper of August 15, 2007, entitled "Putting a Floor Under American Homes" which can be found here.

b) Added to the mortgage payments involved in home ownership are the additional costs of real estate taxes, insurance premiums and general maintenance – which the former homeowner would be relieved of under the plan. Such expenses would be the responsibility of the new landlord under the Recovery Lease.

The plan is all about getting home prices back into line with the true value of shelter, represented by rental cost alternatives (which is where they are going to eventually end up, no matter what we do), but doing so more rapidly, without wave after wave of foreclosures, without throwing people out of their homes, and without vastly over-shooting the point of natural equilibrium. It is decidedly not about trying to keep home prices supported at artificial levels. Rents should be neither punitive nor discounted under the plan so that we avoid the notion of encouraging yet another round of mis-pricing of homes.

2) Mandatory Element of Plan with Respect to Lenders
This is an issue we struggled greatly with. A principal goal of the plan is to live within the constitutional definitions of property rights and contract law, while providing relief consistent with the nature of the financial emergency. Moral hazard has been raised by a number of respondents, and that is certainly something to be concerned about. Of at least equal concern, in our opinion, is the notion of unilaterally abrogating all contract rights – in this case the rights of a lender to the collateral underlying a defaulted loan. Would anyone be interested in having other properly contracted property rights be unilaterally abrogated? For example, how about if the government passed a law that would cause you to lose all rights to any bank deposits or investments you own? That is why we have a problem with, for instance, plans that call for bankruptcy courts (outside of actual bankruptcy proceedings) to unilaterally modify loans (or to force all affected homeowners to file for bankruptcy in order to achieve a workable solution).

Nevertheless, we recognize that a significant majority of residential mortgage loans are held in securitizations and other similar special purpose vehicles. We are very concerned that trustees and servicers representing the interests of various groups of mortgage backed and derivative securities-holders, will simply not act to further this or any other plan to modify mortgages unless compelled to do so, regardless of whether the arrangement is a good one or not – for fear of being sued by numerous bondholders, the approval of which, as a practical matter, is unobtainable. Consequently, we believe that the public interest requires a modest imposition on the property rights of lenders – not depriving them of their collateral, but mandating how and when they can use and liquidate it during this emergency (we look to rent control and stabilization laws in various parts of the country for comparable examples of restrictions on the use of housing property that were not deemed unconstitutional). The plan is still voluntary as to homeowners - as it is clearly better than the alternative from their perspective.

Some have also asked about the impact on second mortgages and/or home equity lines (HELOC's). Seconds and HELOC's would be taken into consideration as QIM's under the plan – and the total of all loan principal outstanding on a given home would be considered in determining qualification. However, a second mortgage or HELOC lender will not be the controlling party in any settlement, unless such a lender is willing to step up and purchase the underlying first mortgage on a given property. Barring that outcome, second mortgage and HELOC lenders would only be entitled to any sale value from the Recovery Leased property after the first lender is repaid in full with interest – which may result in no recoveries at all for such lenders in many situations (as it would be in the case of most foreclosures).

3) Termination of Leases by the Homeowner/Renter
As the objective of the plan is to give homeowners the option of staying in their homes for up to five years, the plan assumes a right on the part of the homeowner to terminate the Recovery Lease at any time. If that should happen, the home becomes free and clear of any encumbrance under the plan and the bank/investor is free to dispose of it or re-rent it in any legal manner. The costs of foreclosure will have been saved of course.

4) Tenants in Existing Investor Owned Rental Units
A few respondents have mentioned their concern about tenants in homes owned by investors with underwater mortgages. They are concerned that such tenants will be evicted because the plan does not cover non owner-occupied homes. This is a conundrum to which there are few good answers, either under the status quo or under the plan. However, as the plan does not cover investor-owned units – it really has no effect on that dilemma, one way or the other.

5) Potential Problems at the End of the Five Years
The current draft of the plan envisions a fixed five-year term for leases that would

commence over the next 18 to 24 months. Several respondents have raised the concern of a relapse of the current glut of for-sale home inventory at the end of the Recovery Lease terms. This is a natural concern, but it is mitigated by several factors:

a) At the conclusion of the current crisis, there will be neither the funding nor demand for another round overbuilding of new homes. Existing resale inventories should tighten to normal levels of six months or so and homes coming off Recovery Leases will be facing a very different market than the glut currently facing newly foreclosed homes.

b) Normal continued population growth will continue to normalize supply.

c) Many Recovery Leased homes will be acquired by their original owners after they have had the time to reclaim their financial well-being.

d) Not all Recovery Leases will end on the same date. Some would have terminated early due to relocation or default of the original homeowner. The original mortgage settlements will also not all occur on the same date, so the end dates of the Recovery Leases will not be the same either.

Nonetheless, a further tweak to the plan that addresses this concern might be a “soft” lease termination provision – offering a wider window on the purchase option (which needs to be delayed somewhat in fairness to the landlord, so that the market has an opportunity to stabilize) and perhaps a slightly longer final maturity. Perhaps a window of between four and six years, during which the now-tenant can re-acquire the home or make other arrangements to move. In all events, this heavily mitigated concern pales in comparison to the onslaught we face today in our severely impaired housing and financial markets.

6) Shared Mortgages, Government Insurance and Other Alternatives
The plan was developed primarily to keep the government and taxpayer as far as possible from the resolution of the housing crises (which is unfortunately not entirely achievable, see #7 below), while forcing the settlement of distressed loans and the accelerated elimination of the overhang in housing inventory. We don’t see this happening with other proposed solutions. The percentage of renting households will increase and the number of homeowners must decrease as a percentage of all households, no matter what road we take to resolve this crisis. Prices of homes will come back to historic norms relative to rental alternatives and incomes. The plan is designed to induce this without the need for costly foreclosures and the further disruption of, and additional economic damage to, a sizable portion of households in the U.S. The value of the homes under Recovery Leases will be limited to their resale value after the immediate crisis ebbs – with a suitable incentive given to existing lenders and third-party investors to hold the homes for investment until we reach that point.

7) Impact on the Recapitalization of Financial Institutions
No matter what we do, we believe the losses to mortgage lenders/holders will total some $1.25 trillion from uncollectible residential loans and their derivatives. A substantial portion of the losses will impact the major U.S. financial institutions that our government is, of necessity, being forced to recapitalize and stand-behind as additional losses materialize. They (and we, as taxpayers) effectively “own” those losses already, whether they materialize in the ordinary course or in the more controlled manner suggested by the plan. If anything, the plan – by avoiding the enormous costs of adversarial foreclosure – should result in some limited reduction in ultimate losses. More importantly, however, the incentives we have suggested to enhance the ability to sell the Recovery Leased homes to private investors will enable the orderly monetization of such homes – with cash, at this juncture, being far more valuable to our financial institutions than underperforming or non-performing mortgage loans and securities, or

conventionally re-possessed real estate.

Finally, I have received some additional feedback and suggestions regarding the plan from several political leaders and from an economist I have unstinting admiration for, Dean Baker of the Center for Economic Policy Research. This feedback has suggested that the plan's proposed deductibility of rents on Recovery Leased homes will set off a political firestorm among conventional renters unable to deduct conventional rents. As a renter myself (we sold when the market was high and stood back from real estate in anticipation of current events), I certainly empathize. I had hoped, however, that other renters would understand the extraordinary nature of the crisis, that was clearly not of their own causing, and could nevertheless see clear to supporting rent deductibility for Recovery Leases. If this is not politically possible, I bow to the regrettable reality and acknowledge that the rent deductibility feature is not an absolutely essential element of the plan – just another way of assisting distressed homeowners in their transition to renting. Mr. Baker has also pointed out the advisability of instituting an absolute dollar cap for mortgages that would qualify under the cap. He suggests that a $1 million cap is probably a politically desirable concept, and I agree. Such a cap would incorporate a huge majority of distressed mortgages under the plan and avoid accusations of assistance to those who likely have sufficient other resources to get through this crisis.

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