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Foreclosure levels unlikely to fall

By Mark A. Calabria

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Why have efforts of President Barack Obama's administration to reduce foreclosures had so little impact?

In response to this embarrassment, the Obama administration has called the largest mortgage servicers to Washington, and Congress has held at least three hearings over the last few weeks. Undoubtedly, pressure will be applied to the lenders to do more. However, these efforts will largely be fruitless until the administration recognizes the true driving forces behind mortgage foreclosures.

The efforts of the Obama administration, just as those of the Bush administration and the Federal Deposit Insurance Corporation, have failed because they have grossly misdiagnosed the causes of mortgage defaults. The vast majority of mortgage defaults are being driven by the same factors that have always driven mortgage defaults: being "underwater," that is, you owe more on the mortgage than the home is worth, combined with a life event that results in a substantial income decline, such as a job loss. Until both of these pieces are addressed, foreclosure levels are unlikely to fall.

All efforts addressing the foreclosure crisis implicitly assume that the current wave of foreclosures is almost exclusively the result of predatory lending practices and "exploding" adjustable rate mortgages, where upward shocks on the rate reset cause mortgage payment to become unaffordable. This was true of former Treasury Secretary Paulson's HOPE NOW and of FDIC Chairwoman Sheila Bair's IndyMac models. The Obama administration's current foreclosure efforts are based on the same mistaken belief.

If payment shock were driving the defaults, then we would observe most defaults occurring around the reset of the mortgage rate, specifically just after the reset. But that is not the case. The vast majority of defaults occurred long before the reset. It could be that this is due to such loans being "unaffordable" from the time of origination. According to analysis done at the Boston Federal Reserve, though, the borrower's initial debt-to-income had almost no impact in terms of predicting subsequent default. Additionally, if payment shock were the driver of default, fixed-rate mortgages, where payments did not change, would display default rates significantly below that of adjustable rate mortgages. Differences in performance between these different mortgage products largely disappears once differences in owner equity and credit score are taken into account. Even mortgages insured by the Federal Housing Administration – which are almost exclusively fixed rate with no prepayment penalties and substantial borrower protections, and are generally considered among the "safest" – perform, on an apples to apples basis, as badly as the subprime market in terms of delinquencies.

FHA mortgages and most of the subprime market share one important characteristic: zero or very little equity in the mortgage at origination. Zero or negative equity also explains the poor performance of most subprime adjustable rate mortgages. Many of these loans also had little or no equity upon origination. The borrower was left with little equity cushion when prices fell. The question then is, what exactly it is that homeowners with no equity are losing in the event of a foreclosure?

In addition to the administration's efforts, several members of Congress are attempting to bring back the failed mortgage "cramdown" proposal to allow bankruptcy judges to reduce the value of a mortgage to reflect the decline in the value of the home. Cramdown will do little for most delinquent borrowers. According to Freddie Mac, speculators make up about 40 percent of those foreclosed upon. An additional 50 percent of foreclosures are likely due to job loss, eliminating the income a borrower would need to put forth a repayment plan under Chapter 13 of the bankruptcy code. Combining speculators and the unemployed reveals that cramdown will do little to help at least 90 percent of borrowers currently in foreclosure.

As demonstrated by this week's release of comparisons of individual bank modification numbers, the Obama administration is intent on using its recent meeting with mortgage servicers as simpy an excuse to deflect blame from themselves onto "greedy lenders." The Obama administration has from the start been more focused on redistributing wealth rather than creating it, which explains why it views mortgage modifications as simply a way of taking from lenders (in reality investors such as state employee pension funds) and giving to delinquent homeowners. Instead, the administration should be focusing on avenues for increasing employment and getting the economy growing again. Creating wealth and jobs is the best way to help Americans keep their homes.

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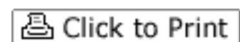

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