Housing Crisis Policy: A Creditor's Playland

November 7, 2011

By Mike Konczal

Last week we talked about a worldview in which all the laws, customs, norms and policy was geared towards only serving the interests of creditors. A libertarian vision of defending power where "benefiting creditors is the only thing that the rules of debt should consider."

On Thursday, Mark Calabria, director of financial regulation studies at the Cato Institute, gave five steps to fixing the housing market on Cato's blog. Check this out:

1. **Speed up the foreclosure process.** The massive shadow inventory of homes yet to hit the market, numbering in the millions, is keeping potential buyers on the sidelines. Why buy now when a future massive increase in supply will likely depress prices more? It is best to get that supply to the market now. We also, by my estimate, have about 500,000 borrowers still in their homes that have not made a single payment in over 2 years. These borrowers will likely never get current.
2. **State Attorneys General need to either put-up or shut-up.** Holding back lending by depressing bank equity values, and not to mention dragging out the foreclosure process, is a massive 50 state targeting of bank foreclosure practices. If the state AGs have some real evidence, then why aren't we in court? Either the AGs should go to court, where we can all see the facts, or they should drop what only looks like a shakedown.

And this was #5:

5. **Exercise recourse when possible.** Many federal loans, like FHA, have a recourse option. In the case where borrowers can pay, but simply don't want to (due to price declines or otherwise), they should be held to account. When FDR did mass re-fis and modifications in 1930s, he also demanded strong recourse, which was regularly exercised. If its harmful for a bank to start a foreclosure, then it's also harmful for a borrower, who can avoid it, to also do so.

In the first and second point, when a bank initiates a foreclosure, it is just the market working its magic. If a bank needs to foreclose we should encourage it to immediately. Changing bankruptcy laws to protect homeowners, forcing mandatory mediations at the state level, swapping debt for equity and other government policies would just get in the

way of Nature running its course. Demanding accountability through investigations on whether or not a bank follows the proper property trail for a securitization and a foreclosure is a "shakedown", stopping virtuous market work of getting banks executing foreclosures immediately.

In the last point, when a homeowner defaults and thus initiates the steps towards a foreclosure, the government needs to use maximum power to discipline and stop them. By "recourse" we mean follow the debtor who is foreclosed on to the ends of the earth to collect every last penny that can be taken. For when a debtor ends up initiating a foreclosure, it is not the virtuous logic of the market working its magic through the aggregation of choices and prices the way it is when a creditor does it. It is something wrong that needs to be fought and combated in our laws and rules.

I like this form of libertarianism, where policy is simply the things that defend the power and hierarchy of creditors, the rich and the elite, much better than the normal "gee whiz markets are cool" kind. There's almost a Nietzschean zeal for the wonk world to first and foremost accept creditors as a master class to whom all policy bends. Let's get a quick quote from Nietzsche's On the Genealogy of Morals, Second Essay: Guilt, Bad Conscience, and Related Matters, which would make a nice follow-up point: (h/t Debt: The First 5,000 Years):

Have these genealogists of morality up to now allowed themselves to dream, even remotely, that, for instance, that major moral principle "guilt" *[Schuld]* derived its origin from the very materialistic idea "debt" *[Schulden]*?…By means of the "punishment" of the debtor, the creditor participates in a *right belonging to the masters*. Finally he also for once comes to the lofty feeling of despising a being as someone "beneath him," as someone he is entitled to mistreat—or at least, in the event that the real force of punishment, of executing punishment, has already been transferred to the "authorities," the feeling of *seeing* the debtor despised and mistreated. The compensation thus consists of an order for and a right to cruelty.

Wonk Points

Allright, enough fun. Time for the wonk work. The logic of each of these points is wrong. Watch the logic in the first point – a large "shadow market" of real estate owned housing inventory is holding back the housing sector (which it is), so it is best to increase the shadow market as quickly as possible. I would say it is quite easy to model the logic of not forcing firesales into a depressed market, especially when the market is characterized by principal-agent problems of servicers.

If you are just being introduced to the foreclosure fraud issues brought up in the second point, remember that these issues aren't trivial. In a real sense securitization is entirely about manipulating certain legal technicalities, ranging from trust law to bankruptcy remoteness to REMIC, in order to take advantage of certain legal and tax structures in the "financial engineering" of these financial instruments. If the paperwork wasn't followed, that has massive consequences for other investors and for homeowners. Remember the

foreclosure moratorium last year was initiated by the servicing banks themselves, not activists or the government, because they knew things have gone horribly wrong, and the real revolt is coming from bankruptcy judges who are tired of having a mockery made of their courts.

I love how the concept of "moral hazard" plays out here. Homeowners need to be disciplined at even the slightest hint that they aren't paying up, but there's no need for an investigation into the disaster of the biggest banks and their servicing and securitization divisions. As Matt Stoller pointed out, with no threat here there's even less of a reason for the banks to follow the rules in the future. And as Yves Smith pointed out (with a great chart), the way that the government in getting in the way of foreclosures is just enforcing the actually existing laws on the books, or by making it a felony to submit false representations to the courts. What's the moral hazard if we *don't* do these things?

There doesn't seem to be any wave of strategic defaults. In the words of the Federal Reserve Board:

The fact that many borrowers continue paying a substantial premium over market rents to keep their homes challenges traditional models of hyper-informed borrowers.

But for the last point – "In the case where borrowers can pay, but simply don't want to" – is actually a difficult thing to figure out. What is a good formula? Who would we trust to determine who can pay what – the creditors themselves? One person we trust as a society is a bankruptcy judge, hence the push for modifications.

Also, a 6th point:

6. **The Fed should start raising rates.** First, what bank wants to make a mortgage at 4% when their cost of funds in a few years will easily be above that? Just like any price ceiling, artificially low rates cause shortages. In this case, current Fed policies are reducing the supply of credit, making it harder for potential borrowers to get mortgages (yes, if you can get a mortgage, the price is great). When rates do go up, which they will, such will put downward pressure on prices. Better to take that hit now.

Low interest rates are causing shortages in the housing market? Here's Calabria arguing in 2010 that "The Federal Reserve's extremely loose policies earlier this decade resulted in a massive reallocation of resources from the rest of the economy into housing" – I thought it was sacrosanct among the Right that too low interest rates caused housing to skyrocket and that QE was a desperate attempt to re-inflate the housing bubble instead of suppressing it.

Wouldn't raising rates trigger a double-dip recession almost immediately? The interest rate should be negative, but it can't be – raising rates would be a signal that the Fed was never going to try for either part of its mandate. Indeed, if we want to help with the balance sheet part of the recession, the Federal Reserve should go after the mortgage rate

to help with refinancing – more aggressive monetary policy, the opposite of raising rates – in order to bring down the monthly debt payment on the household's balance sheet. See Joe Gagnon, who suggests the Fed "should announce new large-scale purchases of agency guaranteed mortgage backed securities (MBS) with the goal of keeping the 30-year mortgage rate between 3% and 3.5% through the end of 2012," along with HARP revisions.

Is this how the entire Right sees the housing market in the aftermath of the bubble?