Taxpayers Shouldn't Have to Pay for Underwater Mortgages

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Markets, and society, depend upon trust and the expectation that promises will be honored. That trust is eroded when government rewrites contracts, regardless of who is supposed to benefit. Forcing either taxpayers or lenders to cover the lost equity of underwater borrowers, whose mortgages are greater than the value of their homes, is a violation of trust.

Underwater borrowers are not victims. They borrowed money at a particular rate and are paying back at that rate. They knew going in that to refinance, they'd need equity. If said borrowers wanted to take advantage of interest rate declines, they could have gotten an adjustable-rate mortgage. Instead, those borrowers chose the certainty of a fixed rate.

Some contend that helping underwater borrowers would help the economy. The argument is that when you lower mortgage rates for borrowers, reducing their monthly payments, you thereby increase disposable income and spending. That spending then helps turn around the economy.

The error in this argument is that it looks only at one side of the balance sheet. A mortgage is one person's liability, but it is also another's asset. Lowering rates may cut monthly payments, but it also drives down payments on mortgages and mortgage-backed securities. Mortgage investors are now poorer, and they will, by the same logic, reduce their spending. At best, the impact on spending will be zero. That's what you get when you redistribute income.

Worse, for government-owned or guaranteed mortgages, about half of those outstanding, taxpayers are the ones taking the hit. Because homeowners are wealthier than taxpayers in general, such redistribution is regressive.

For the remainder, the investor is often a pension or mutual fund. It is unclear why retirees should pay to benefit younger homeowners.

Even if such a plan is paid for by a tax on banks, it is far from free. The tax would reduce bank equity, thereby reducing new lending. In effect, it would punish potential borrowers by reducing the availability of credit while also increasing its costs, simply to benefit existing borrowers.

A mass refinancing is also sold as a cure for the weak housing market. Those looking to refinance, however, are not in the market to either buy or sell a home. In fact, by lowering their mortgage rates, you will reduce their offering price next time they look to trade up, because if the buyer faces higher rates in the future, prices will be depressed to compensate for giving up their current low-rate mortgage. This could reduce future home prices.

The fundamental problem facing our housing market is a glut of homes, coupled with weak demand. Giving underwater borrowers either a lower rate or a reduced mortgage does not change those fundamentals.