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Bring back recourse in foreclosure plan

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A growing chorus of voices has recently been echoing the same refrain: the Obama foreclosure prevention plan has been a failure. This should be no surprise since the Obama plan, from its very beginnings, ignored the primary drivers of default: negative equity coupled with unemployment. But the solution being proffered—mortgage write-downs—is simply another dead-end. Forgiveness, either through bankruptcy courts or the Treasury, will encourage additional delinquencies, not less. The most direct way to reduce foreclosures is expecting those borrowers who can pay their mortgages to do so, regardless of the value of their homes. We need to bring back recourse, allowing lenders to seek repayment from all of a borrower's assets, not just the collateral behind a loan.

While rightly recognizing negative equity as the "but for" cause of mortgage defaults, many have also wrongly concluded that the solution is to give underwater borrowers equity. If that equity is redistributed from the lender to the borrower, lenders will take actions—such as reducing credit or raising the cost of credit—to protect them from future predation. In the end, these costs will simply be passed on to all borrowers, irresponsible and prudent alike. Perhaps worse, providing equity to underwater borrowers in default will encourage additional borrowers to stop paying their mortgages, or at minimum start haggling with their lender, so as to receive this "gift" of equity for themselves.

Of course many homeowners have suffered adverse life events, such as a job loss, that will make paying almost any mortgage difficult. There foreclosures are largely unavoidable. The problem in these cases is the life event, and should be addressed directly.

Recently there has been a growing trend of borrowers walking away from their mortgage, even if they have the ability to pay. The reason is that in many states, such as California, mortgage lenders are only entitled to collect on the collateral underlying the loan. As several researchers, mostly recently at the Federal Reserve Bank of Richmond, have documented, those states that bar recourse have significantly higher rates of foreclosure, all else equal. It should come as no surprise that California sits at the heart of the housing crisis.

Fortunately, as recognized since *McCulloch v. Maryland*, these state laws cannot bind the federal government, which currently guarantees, owns or insures 90 percent of the mortgage market. In fact, loans insured under FHA have long allowed FHA to exercise recourse, even if the agency has chosen not to. This leads to another good reason to impose recourse: to protect the taxpayers' interest, as the taxpayer is now the largest single investor in residential mortgages. Those loans without a federal interest and written in states without recourse should be respected. Just as it is illegitimate for government to rewrite contracts to favor borrowers, it is illegitimate to rewrite contracts to favor lenders.

The Obama and the Bush administrations argued that federal efforts to reduce foreclosures were necessary to reduce losses imposed on neighborhoods and communities. The logic is that stopping foreclosures would minimize the "negative externality" from vacant homes or fire sales. If such externalities do exist, and constitute a justification for government intervention, then it is only logical that those borrowers who willingly impose such costs be required to internalize them. If banks dumping homes on the market is harmful, then borrowers' walking away from homes is no less so.

The omission of recourse has been a major flaw of the Obama loan modification plans. If the taxpayer is putting something on the table, then borrowers should be expected to do the same. During the Great Depression, FDR recognized as much. The primary New Deal vehicle for addressing foreclosures was the Home Owners Loan Corporation. The HOLC required recourse and practiced it. In fact, approximately a third of HOLC revenues were from deficiency judgments against delinquent borrowers, including wage garnishment. Perhaps there are some parallels to today, as the HOLC found the second most common reason for foreclosure to be "obstinate refusal to pay."

FDR recognized that many delinquent borrowers could afford neither their mortgage nor a deficiency judgment; we must recognize the same today. Recourse is not a cure to stop every foreclosure. It is, however, a proven method for reducing some foreclosures. It also helps remind us that a mortgage is first and foremost an obligation, regardless of the value of the underlying collateral. After all, most auto loans are underwater as soon as the borrower drives off the lot; yet we do not expect auto loans to be written down to reflect this lost value.

Mark A. Calabria is director of financial regulation studies at the Cato Institute in Washington, D.C.

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