Everyone seems to agree that the hemorrhaging of foreclosures needs to be stopped and a prime goal of Congress in passing the TARP legislation was to do something about foreclosures. The question is what is the most effective and cheapest way to stop the hemorrhaging. We believe the answer is the Blind Trustee plan that we have proposed.

The trustees would be blind to the particular securities (and diverging interests) that sit atop the mortgages and would be charged with modifying any loan where it was reasonable to expect that more money will be realized over the life of the loan by modifying it than by foreclosing. They would recommend foreclosure to be carried out by existing servicers for loans not meeting that standard. The bondholders would get the income stream from either the modified loan or the foreclosure per their original rights. For details on how our plan would work see the outline of legislation that would implement our plan.

Below we summarize the reasons for our assertion that our plan is better and cheaper than the most commonly mentioned alternatives.

1. Our plan takes the modification/foreclosure decision away from servicers who are not doing the job and transfers it to unconflicted agents: trustees (local bankers, in all likelihood) that would be blind to the particular securities that sit atop the mortgages and would modify any loan when it could reasonably be expected to yield more than a foreclosure.

   * Why not just pay servicers to do a better job.

   Plans that pay servicers to do a better job, a key component of Sheila Bair’s plan, will not work as well because the servicers’ lack of compensation is only one reason for their poor performance. They have other conflicts. Paying conflicted agents is not a good idea.

   * Why not immunize, freeing them from fear of litigation [and also pay them] to do better?

   Plans that immunize servicers (w/or w/out more compensation) are also a bad way to get better servicer performance. First, immunizing a conflicted agent is a worse idea than paying them. For example, immunity would allow unchecked self-dealing in selecting how to modify a loan. Consider that some big servicers are subsidiaries of large financial institutions that own bonds that might be made more valuable than bonds held

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by others (other tranches) based on the manner of modification chosen by the servicer.

* If someone has to be substituted for the servicer, why not a bankruptcy judge?

On its face, the bankruptcy option (and bill now being much discussed in DC) seems on its face to substitute a bankruptcy judge for the conflicted servicers. Putting aside for the moment, that bankruptcy is astoundingly unsuited to stem future foreclosures (although it may provide some warranted relief for homeowners already in extremis), it is a poor way of “substituting” an unconflicted agent for the servicer.

First, the bankruptcy option (as everyone in Congress is fond of pointing out) is designed to force servicers to modify loans as a way to prevent a cram down by a bankruptcy judge, not really to substitute a bankruptcy judge, but merely the threat of a bankruptcy judge. The bill gives the servicer x amount of time to modify the loan from the time a homeowner files for bankruptcy and if the loan is modified (even if modified in a manner not likely to be sustainable in the long run), the mortgage will not be subject to the bankruptcy judge's control. So, the bankruptcy option is designed to leave the conflicted agents (servicers) in place for the vast majority of loans. All supporters of this option admit this. Just consider: There are at least 4-10 million loans that will probably need to be considered for modification or foreclosure. The bankruptcy courts cannot handle anywhere near that many and we wouldn't want to have all those folks file bankruptcy in any event. Talk about destroying confidence in our economy.

Second, for those mortgages not modified by the servicer in time and thus subject to the bankruptcy judge's control, this substitution for the servicer is more costly for all involved than our plan. The bankruptcy judge will hire a trustee, which is two layers of agents, versus our one. Bankruptcy is an expensive, complicated process, for the homeowner as well as the servicers and government: lawyers and community help-agents are not easy to find and are costly for the government to provide.

2. Our plan protects bondholders (not just homeowners), but unlike other plans it does not provide hidden windfall to bondholders or, to put that another way, a hidden subsidy to financial institutions under the guise of helping homeowners.

* Our plan is the only extant plan that uses this simple formula for unconflicted agents to apply (our blind trustees): a mortgage should be modified whenever the money that is reasonable to expect from the modification is greater than the money it is reasonable to expect from a foreclosure.

That protects bondholders, even though it will often result in a write-down in principal when a homeowner has negative equity in a home because it is not reasonable to expect that a homeowner will continue to make payments over the long term when she has negative equity in her home. (Our plan contemplates just such write-downs in principal, see standards section in outline of legislation implementing our plan.)
Our plan thus gets bondholders the most that can reasonably be expected from their investments, given that the housing market has tanked, but no more. It does not compensate them for having bet wrong on housing.

As for whether our trustees will have the right set of incentives. We have built into the plan spot check audits, a method of comparing how trustees in similar markets perform, development and implementation of a best practices regime, and other oversight checks. Our plan also has room for monetary incentives to be apportioned and paid only after a sufficient number of years have passed from the modification decisions to ensure that only those trustees are eligible that have redefault rates lower than trustees in similar housing markets.

* In what way are other plans “windfalls” or hidden subsidies to bondholders?

** The Bair Plan

The Bair plan provides not just for the payment of servicers that we’ve already mentioned, but also for a government guarantee to bondholders if the mortgage modified by the servicer defaults more than 6 months after the modification

A smart servicer will be able to craft a modification that will last 6 months and not much longer and the government guarantee gives them an incentive to do just that.

Moreover, the government guarantee in the original Bair plan was for 50 or more % of the original loan amount because the plan did not require write-down of principal. This is a windfall (and hidden subsidy) to bondholders, servicers and generally to financial institutions because these bonds have already been written-down more than that (or should have been).

** The Felstein Plan

Martin Feldstein's latest plan contemplates write-down of principal (which is essential if foreclosures are to be stemmed and which our plan contemplates as well), but he proposes that the government and bondholders split the cost of the write-down. This is an unjustified government expense and potentially quite costly. It is unjustified because the loans have already been written down (or should have been). If the government wants to provide yet more funds to banks or other bondholders, it should do so in the open and not under the rubric of helping homeowners.

** In sum, our position is: The bondholders took the risk when they
invested in these instruments.

They are entitled to an unconflicted agent who does not foreclose when more money can reasonably be expected to be realized by a modification (in cases where there is negative equity in a home a sustainable modification will involve a write-down in principal, which our plan contemplates). They are not now getting that and instead are suffering unjustified losses from foreclosures that are uneconomic, but they are not entitled to a bailout, particularly not a hidden bailout. (Neither Bair’s nor Feldstein’s plan substitutes an unconflicted agent for the servicer).

3. Our plan **stems** foreclosures because it gets to homeowners **before** they are so far under water that no modification will help.

* Our plan has trustees seeking out and crafting modifications for all homeowners who might reasonably be expected to default, not just or even primarily homeowners already have defaulted.

Private label securitizations, as opposed to Fannie/Freddie contracts, almost always allow this kind of preventive modification and our bill would change any outlier contracts that do not provide for this now so that they allowed preventive modifications (and we are not sure that any such outlier contracts exist). This preventive modification is not now occurring (because of servicer incentives and conflicts) but it is the key to stemming future foreclosures because all data available support the idea that getting to homeowners before they are too far in arrears is the key to successfully loan modification, i.e., avoiding redefault.

* Our plan also gives homeowners a powerful incentive to “hold on” (continue making mortgage payments) until the trustee gets to them.

We provide (see attached outline for legislation) that any homeowner who is current in mortgage payments at the time the bill is announced or enacted and who defaults before a trustee gets to them for a modification is presumed to be ineligible for a modification. That presumption can be overcome by a showing by homeowner that some external circumstance led to delinquency during the time-out period, e.g., illness, loss of job etc... This greatly helps bondholders in that it may well help staunch the flood of new delinquencies now occurring each month.

* Note that our bill puts in place a de facto moratorium on foreclosures because once it is passed it divests the servicers of the right to modify or foreclose pending a decision by the trustees.

* In contrast, the bankruptcy bill (at least, if adopted without our plan being adopted at the same time), encourages new delinquencies and defaults.
If filing for bankruptcy gets a servicer's attention to modify, why not stop paying immediately, file bankruptcy to get one's modification and not pay until that mod gets done? Moreover, one cannot craft onto a bankruptcy bill a similar presumption to the one we incorporate because filing bankruptcy means one cannot pay one's bills and admitting that one can pay just makes a discharge in bankruptcy less likely.

4. Our plan is cheaper, supports local banks and credit unions and creates some local jobs (skilled and unskilled).

* Our plan is cheaper because we are not subsidizing bondholders unlike the Bair or Feldstein plans. While we do not have hard numbers on costs, it will be in the hundreds of millions of dollars, not billions.

* Because our blind trustees would be in many instances local banks and credit unions, government money will be helping to support those institutions, preventing layoffs that might otherwise occur, encouraging hiring in some cases and maybe helping some of those institutions better weather the hard times ahead.

* Because our plan (see attached bill) specifically provides that the trustees go door to door to contact those homeowners who are not now answering servicer calls, there will be job creation for some unskilled workers, which we will need in the year ahead.

* None of the other plans have these ancillary benefits and they all cost much more because of their subsidies for bondholders.

5. There is no viable Constitutional challenge to our proposal

* The “Takings Clause” of the Constitution is the only non-frivolous objection that could be raised. The Takings Clause does not prohibit any government legislation, but requires just compensation when a “taking” occurs. Our proposal does not involve a “taking” under the Supreme Court's jurisprudence. See attached memos by David Dana, Northwestern University. Note that, a successful Takings challenge would require the government to compensate bondholders only for any loss they could prove was created by the change in contract rights that our legislation envision—good luck.

* Members of Congress often speak as if changing a contract was per se unconstitutional or always a Taking that would require compensation. This is wrong. It is a hold over from Reagan/Clinton years in which “voluntary” efforts to solicit concessions from business and the corporate world took hold as the only legitimate way to proceed. It is ideology masquerading as law.