After the Housing Crisis: Avoiding Contractual Problems with Mortgages in the Future

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Once in a generation opportunity to redo mortgage finance in a way that benefits consumers and reduces the costs of future housing and financial crises
What were some inefficiencies that we would want to prevent in the future?

- Consumers paid high fees to refinance into mortgages that left them with high debts
- Servicers of privately securitized mortgages renegotiate “too few” loans, leading to excessive numbers of socially costly foreclosures
- Large number of second liens have led to “too few” mortgage modifications of first liens and excessive number of socially costly foreclosures (and possibly too much borrowing by homeowners)
Key themes in this paper (and others)

- Liquidity is important benefit of securitization
- Government will always step in to stop inevitable runs on lenders (moral hazard)
- Mortgage guarantee should be priced appropriately
- “Too much” housing investment; get rid of subsidies
- Affordable housing mandate should be removed from new housing finance system given to FHA or other govt agencies
Foreclosure Starts

Source: Mortgage Bankers Association
Foreclosure Starts
Current as of Quarter 4, 2010
Excessive refinancings

- From 2003 to 2005, about 27 million mortgages were refinanced.
- Least financially sophisticated consumers pay higher costs and make worse decisions about when to refinance.
- Some borrowers who could otherwise get credit might get shut out of the market.
Loans Sold, Purchases, and Refinances (source: HMDA)
Excessive refinancings

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- Least financially sophisticated consumers pay higher costs and make worse decisions about when to refinance
- Some borrowers who could otherwise get credit might get shut out of the market

(Well maybe not in this cycle…but in the future)
Policy solution: Mortgages w/Prepayment Penalties

- Prepayment penalties are similar to a requirement that everyone maintain health insurance
  - In health insurance, the low risk (healthy) households opt out of buying insurance
  - For mortgages, least risky borrowers refinance, leaving only riskiest borrowers in a pool

- Didn’t Prepayment Penalties help cause the crisis?
  - Answer: No. Evidence shows poor underwriting led to high defaults
    - Risky borrowers benefitted most from prepayment penalties (rates were about 0.1% to 0.6% lower)
Why use prepayment penalties?

• Contract can replicate refinancing without the costs to consumers
  – Can create a fixed-rate mortgage with downward-only rate adjustments if rates fall substantially
  – Short-term fixed rate mortgage, with medium term adjustments (common in Europe, with prepayment penalty)
  – Adjustable-rate mortgage with a cap might also be a good solution

• Provide insurance for borrowers, ensuring lower rates for riskiest borrowers
Regulatory barriers to prepayment penalties

- Fed rules limit the use of prepayment penalties
- Fannie/Freddie will not enforce prepayment penalties on existing contracts
- Prepayment penalties dominate in most other countries

Opportunities
- Fed policy can change
- Dodd-Frank rules can allow Qualified Residential Mortgages (QRM) to have skin in the game
- CFPB should encourage well-disclosed mortgages with prepayment penalties
Securitized mortgages are modified too infrequently

- Evidence suggests that servicers of privately securitized mortgages foreclose about 1/3 more frequently than lenders on their own loans
  - Note: This means that moral hazard is not an excuse for not doing more modifications
  - With 2 million foreclosures among privately securitized mortgages, this means 500k “too many” foreclosures

- Investors complain that servicers are conflicted: do not modify enough mortgages or properly enforce reps and warranties
Potential conflicts of interest with servicers

- Large banks have second liens on their balance sheet (modifications may require wiping out second liens)
- Servicers may earn fees through the foreclosure process that exceed fees from modifications (less so with HAMP)
- Servicers may also be originators and thus be liable for “reps and warrants” violations
- Servicers are not fully compensated for “effort” in mortgage modifications
Why should policy makers regulate these conflicts of interest?

• Conflicts of interest lead to excess foreclosures at large social cost
  – Downward spiral of house prices
  – Increasing losses to financial institutions and investors
  – Increased homelessness and welfare costs
  – Depreciating houses and neighborhoods

• Stability of financial system

• Securitization might help institutions get around capital regulation
Possible policy solutions

• Require “skin in the game” by servicer (Note this is a broader rationale than Dodd-Frank—want to align incentives)

• Reduce or eliminate requirements of collective action by investors to challenge trustee & servicer decisions (Note: potential for greenmail is a constraint)
  – Possibly require judicial review to ensure that any payments are in the interest of investors as a whole

• Disclose or ban certain business relationships between trustees and servicers/investors and possibly tie trustee fee to their efforts to enforce contract
Possible policy solutions, ctd...

- Disclose investors in securitization to encourage collective action
- Government requirement to disclose relevant information
Mortgages with second liens are not modified frequently enough

- While commentators focus frequently on second liens, it is important to distinguish barriers to modification.
- Many commentators point to the fact that majority of borrowers in default on their 1st mortgage are delinquent on their second lien.
- Suppose you look at credit cards or student loans instead of second liens. What would those delinquencies be?
- Second liens typically convert to unsecured debt in bankruptcy.
Where are barriers with second liens?

- Key barrier is with principal reduction modifications
- Second liens have an incentive to not approve a principal reduction without getting “paid off”—classic hold up problem
- Understand why second lien holder is not willing to take a small payoff to go away—We do not ask credit card or student loan lender to reduce their recoveries to facilitate a repayment of mortgage
Example

- Borrower has $140 first mortgage and his highly likely to default
  - Lender reduces mortgage to $100
- Borrower has $110 first mortgage and $30 second lien
  - 1st mortgage lender unlikely to reduce first mortgage by $40 without cooperation of 2nd lienholder
  - 2nd lienholder will not write down already worthless lien without compensation (“hold-up problem”)
Inefficiencies

• With a hold-up option available, incentives exist for a lender to choose to make a second lien instead of asking to rewrite the first and second
• Thus second liens might encourage excess borrowing since second lien has greater value with hold-up
• Note: first mortgage lender should charge a higher interest rate/lend less money when hold-up is available
• Once again: reduced 1st mortgage lending was not an issue in this crisis, but could be going forward
Policy solution

• Require that every 2nd lien include a provision that automatically eliminates the 2nd lien (convert 2nd lien into unsecured debt), if:
  – The 1st mortgage lender (or servicer) agrees to reduce the principal balance of the first lien
  – The appraised value of the home indicates that it is worth less than the first lien (i.e., LTV<100)

• This solution permits automatic “strip down” of 2nd liens when those liens are worthless in foreclosure and threaten to hold-up efficient modifications

• Allow appeal by 2nd lien holder with clear rules
Why not bankruptcy cramdown to modify first mortgages?

- Bankruptcy is a slow and expensive process compared to our solution
- Borrower can still file for bankruptcy if they have excessive unsecured debt after conversion of 2\textsuperscript{nd} liens
- Cramdown undercompensates lenders. Lender would prefer to acquire the collateral (house) and then sell it for cash than to get a mortgage that is potentially at risk of future failure
Don’t borrowers need a big stick to negotiate with lenders?

- Negotiations between one borrower and one lender should not require such a “stick”
- Two circumstances where negotiations are inefficient
  - Mortgages with second liens (use our proposal)
  - Mortgages with conflicted servicer (State litigation should push for stronger incentives—carrot or stick—for servicers to behave properly)
Observations & Conclusions

- Opportunity to manage 3 key issues going forward
  - Excess (costly) refinancing
  - Conflicted servicers
  - Inefficient second liens

- Other comments
  - Look for additional solutions to 4.3 million delinquent borrowers (rental conversion)
  - Covered bonds should not be lost as another solution to securitization problems (worked in Europe)
  - Consider mortgage interest deduction and excess housing investment