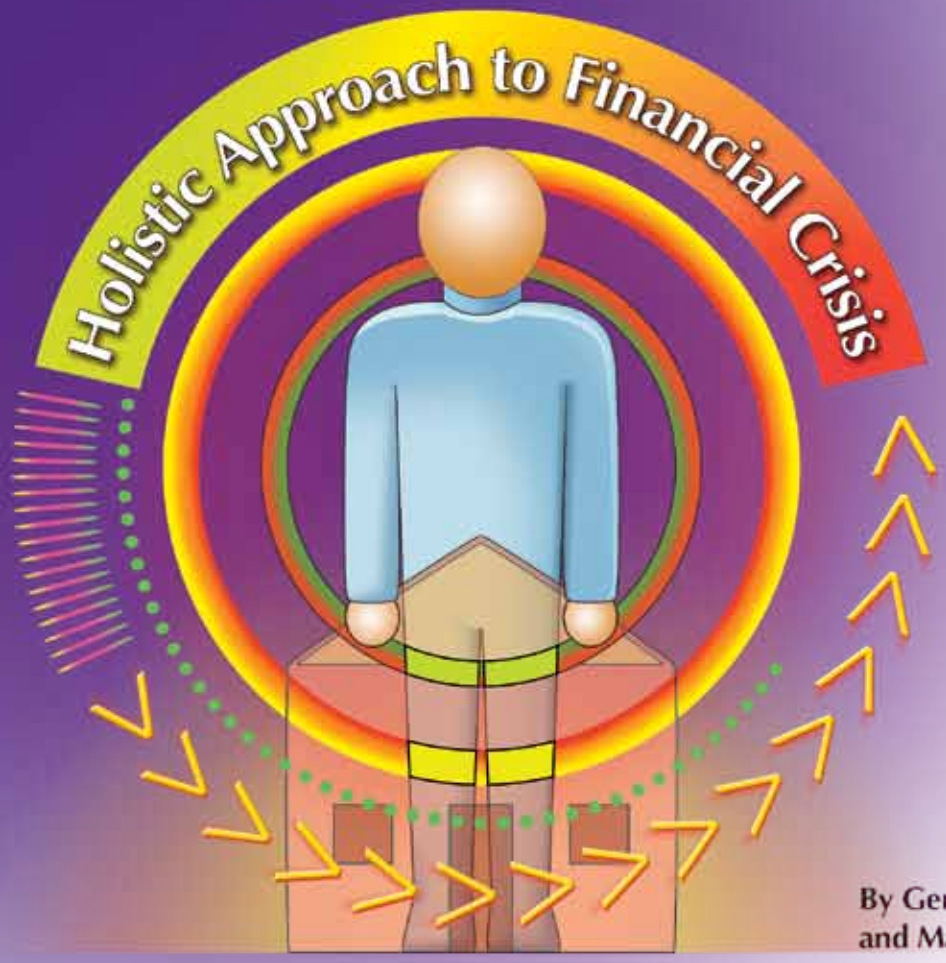
A Reprint from *Tierra Grande*

Holistic Approach to Financial Crisis



By Gerald Klassen
and Mark G. Dotzour

The current global crisis is a complex brew of interconnected problems that are pitting various social, business and political groups against each other in the search for a solution. Each proposed solution or rescue plan is just another way of allocating losses based on the economic interests of the solution designer.

It all started as a housing crisis in 2007 with the sudden rise in mortgage defaults and home foreclosures (Figure 1). Those affected were primarily subprime and Alt-A borrowers.

Then it morphed into a financial crisis as banks and financial institutions experienced losses in their holdings of mortgages and mortgage-backed securities (MBS). Finally, it spurred an economic crisis that is producing massive job losses, which are in turn escalating the housing crisis.

If corrective action is not taken soon, a second, much larger housing crisis will occur, this time affecting prime borrowers. The domino effect could produce another round of even more severe losses because of the size of the prime mortgage market.

The challenge now is to break the gridlock of competing interests vying to control the rescue process. These interests and their concerns are:

- Taxpayers do not want to give a free handout to distressed homeowners who took on mortgages they could not afford or who lied on their mortgage applications.
- Distressed homeowners feel taken advantage of by deceptive lenders who did not tell them about escalating monthly payments.
- Distressed homeowners who made down payments or improvements to their homes do not want to be foreclosed on and lose their investments.
- Politicians want to prosecute lenders who deceived their constituents.

- Private investors do not want bankruptcy judges to have the ability to break contracts and force cramdowns on lenders.
- Banks that are forced to write down mortgage principal to help owners by restructuring their distressed mortgages are losing equity capital.
- Politicians want banks to lend more to stimulate the economy even though bank capital is being destroyed by foreclosure losses and principal reductions.
- The market for MBS is no longer functioning because MBS investors do not trust the value of these securities. Without an active market, banks are unable to sell their MBS to raise cash to meet their operating needs.
- Financial institutions like AIG that sold credit default swaps on collateralized debt obligations (CDOs) and MBS are being forced to pay more collateral to counterparties as the value of the CDOs and MBS fall. Taxpayers and politicians are growing increasingly angry over providing bailout funds to meet these collateral calls.
- Owners of the highly rated tranches of CDOs want servicing agents to foreclose and liquidate collateral before conditions get much worse while owners of the low-rated tranches threaten to sue the agent for foreclosing because of the losses they will incur.
- The Federal Reserve Bank is being forced to act as a lender and the U.S. Treasury as a guarantor in the securitization market because private investors no longer want to participate. The freeze in securitization is the leading cause for the credit crunch faced by consumers and businesses.
- MBS investors in foreign countries feel cheated by American homeowners who are defaulting on their mortgages.

Many experts have said that this crisis will not end until there is a floor under housing prices or the foreclosure problem is resolved.

U.S. taxpayers and politicians do not want the U.S. government to make these foreign investors whole because the money is needed here to stimulate the economy.

Many experts have said that this crisis will not end until there is a floor under housing prices or the foreclosure problem is resolved. But the government does not have enough financial resources to do this or the capability to intervene so extensively in private markets. And debates about ways of preventing foreclosure bring a host of arguments about moral hazard while the differences between government sponsored enterprise–backed and private label MBS only serve to complicate matters.

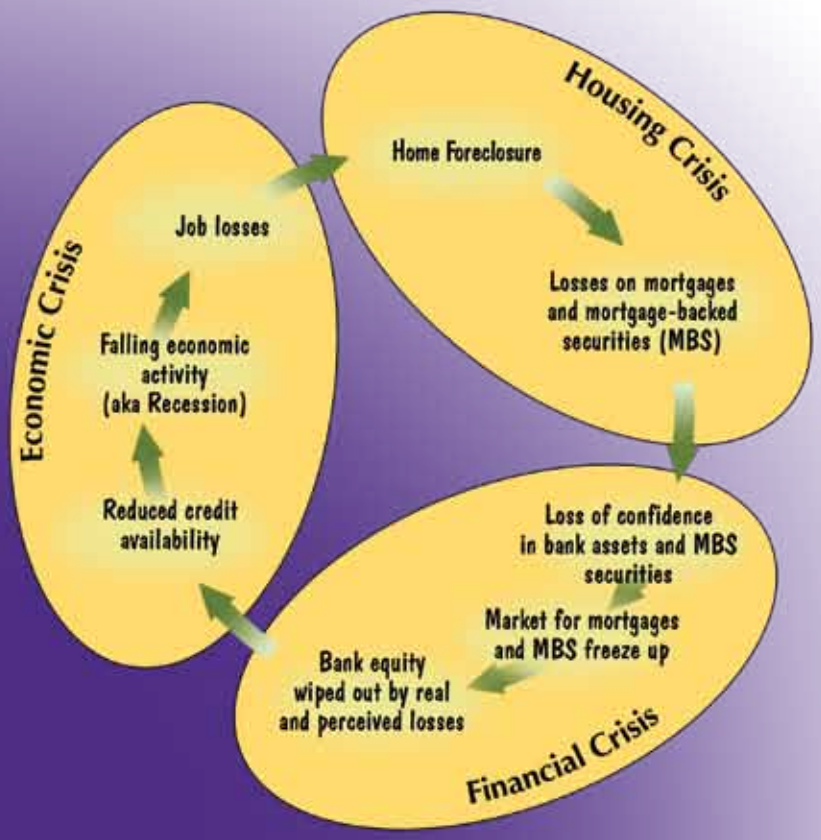
The result is that the majority of government resources have been dedicated to indirect efforts like manipulating mortgage rates, facilitating private sector investment in "toxic" assets and restoring securitization markets. Only a fraction of resources have been directly committed to stopping the foreclosures that created the housing crisis in the first place.

The costs of foreclosure are high for individuals, lenders and communities. In March 2009, the Congressional Oversight Panel (COP) supervising foreclosure mitigation efforts by Treasury released a report called "Foreclosure Crisis: Working Toward a Solution." The report states that after accounting for foreclosure costs and the lower prices from foreclosure auctions that lenders lose an average of $60,000 per foreclosure.

Communities lose, too. COP estimates that "each of the 80 closest neighbors of a foreclosed property can suffer a nearly $5,000 property value decline as a result of a single foreclosure." Communities with a high concentration of foreclosed properties also suffer from urban blight and higher crime rates.

The intangible costs are reflected in the emotional toll on families forced to relocate and cut community ties with friends, families, schools and medical care. The cost to the greater economy is manifested through constrained consumption by families who have had their finances devastated by foreclosure.

Figure 1. Evolution of Current Crisis



Proposed Fixes Sidestep Foreclosures

The alphabet soup of solutions designed to address various parts of the current crisis represent a significant commitment of resources by the Federal Reserve and U.S. Treasury. Yet only one of the programs focuses directly on foreclosure mitigation (see table).

The programs focused on reducing mortgage rates seek to solve the housing crisis by making mortgage payments more affordable *if* distressed homeowners can qualify for refinancing. The programs focused on expanding consumer and business credit hope to solve the crisis by providing financing for more consumption, which is what got us into this mess in the first place!

Other programs focus on lifting toxic assets out of financial institutions to improve bank balance sheets and allow banks to start lending to businesses and debt-strapped consumers again.

Millions of homeowners are at risk of defaulting on their mortgages because they do not have enough equity in their homes and their monthly payments are too high.

But how does having a private equity group service a troubled mortgage add any more value to the economy than having a bank service the mortgage?

The $75 billion of direct assistance to homeowners represents just 1.5 percent of the approximate $5 trillion in capital that the U.S. Treasury, Federal Deposit Insurance Corporation and Federal Reserve are willing to commit to indirect efforts to solve the crisis.

The challenge for decision makers is to find a solution that focuses directly on foreclosure mitigation in order to put an end to the downward spiral started by the housing crisis. The solution must creatively meet the needs of the multiple parties currently stuck in gridlock. Most importantly it must be backed by adequate resources to prevent as many foreclosures as possible. A solution like this has a better chance of bringing about stabilization in the financial sector and broader economy.

Holistic Solution: Home Equity Assistance Program

Millions of homeowners are at risk of defaulting on their mortgages because they do not have enough equity in their homes and their monthly payments are too high. Typically, the homes were purchased with a high loan-to-value (LTV) mortgage, and now the home value has fallen below the mortgage amount.

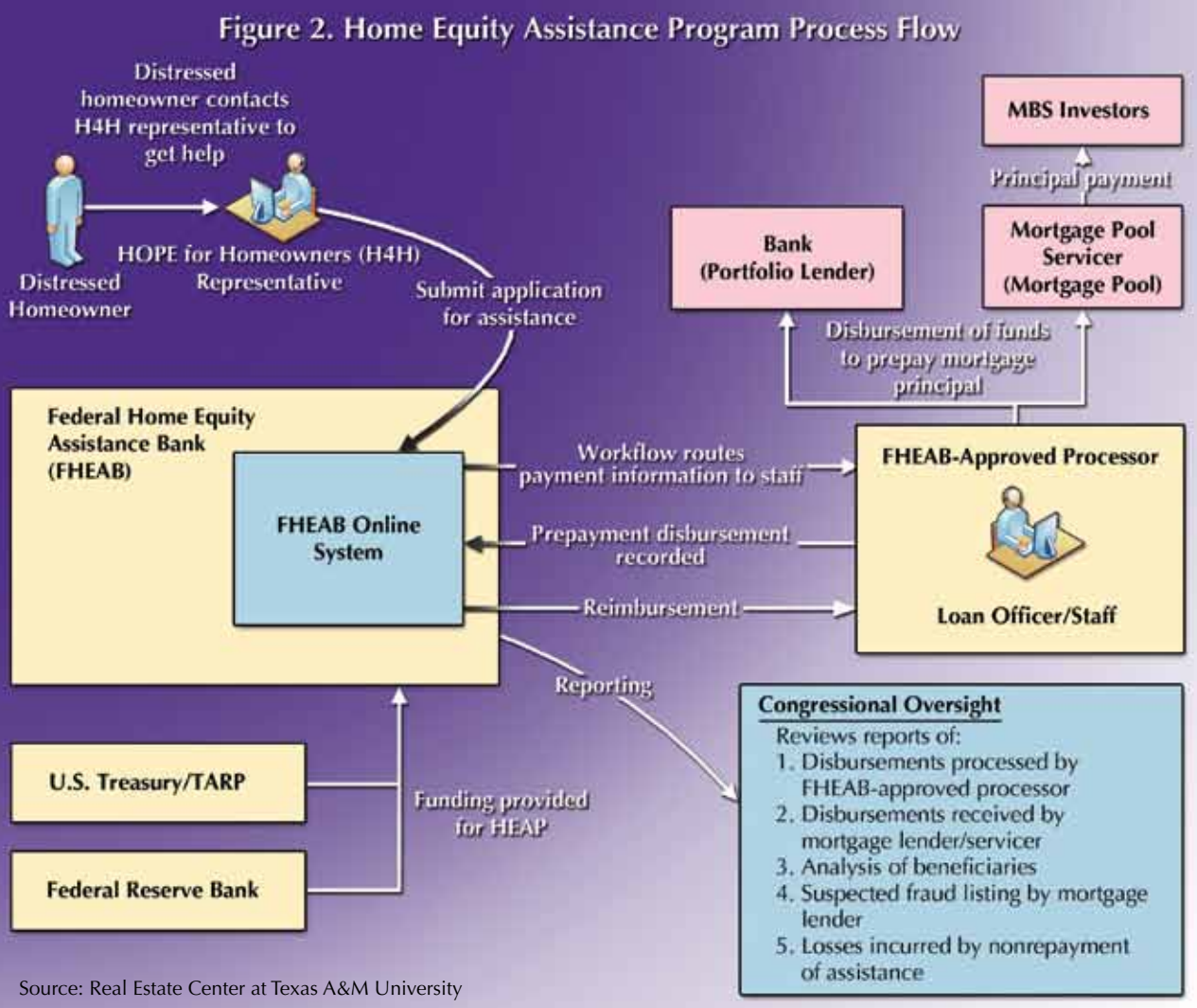
A program is needed to provide equity assistance to these distressed homeowners. The key would be to reduce the balances on their high LTV mortgages and second mortgages to a level that produces affordable monthly payments over the remaining life of the existing first mortgages. This will prevent foreclosures and enable homeowners to resume more normal consumption patterns.

The combination of effective foreclosure mitigation and support for consumer spending will slow the decline in home values and provide a floor for general economic activity. The optimal program will provide assistance now and support services in the future to the beneficiary so that over a period of years they will be able to earn enough equity through homeownership to repay the assistance. By funding the mortgage principal reduction with cash, the market will regain confidence

Largest-Scale Proposed Solutions

Program	Program Size	Purpose
Troubled Asset Relief Program (TARP)	$700 billion	Purchase toxic assets from banks. Actual use so far has been to inject common and preferred equity directly into banks.
American Recovery and Reinvestment Act (Stimulus Package)	$787 billion	Spending and tax cuts designed to jump-start the sagging economy caused by the housing crisis and reduced consumer spending.
Term Asset-Backed Securities Loan Facility (TALF)	$20 billion equity capital from TARP and $200 billion in loans from the Federal Reserve (starting point). Program could expand to TARP contribution of $100 billion and $1 trillion in loans from Federal Reserve Bank.	Provide guarantees and incentives to private investors to purchase asset-backed securities so consumers and businesses can get more credit.
Long-Term Treasury Purchase by Federal Reserve	$300 billion	Purchase long-dated Treasuries to help bring down mortgage rates.
Purchase MBS issued by Fannie Mae and Freddie Mac	Up to $1.25 trillion by the end of 2009.	Provide reduced mortgage rates for homeowners to refinance at a lower rate.
Public-Private Investment Program (PPIP)	$75–$100 billion in TARP funds leveraged up to generate purchasing power of $500 billion; could be expanded to $1 trillion. Treasury provides 7 percent of equity capital and FDIC provides loan guarantees for 86 percent of funds.	Provide financing and loss guarantees to motivate private investors to purchase toxic assets from banks.
Homeowner Affordability and Stability Plan	$75 billion	Direct assistance to prevent home foreclosures.

Source: Real Estate Center at Texas A&M University



Source: Real Estate Center at Texas A&M University

in the value of mortgages and MBS and write them up to a higher value that will restore equity capital to financial institutions.

Such a program could be called the Home Equity Assistance Program (HEAP; Figure 2). HEAP would meet the needs of the various groups affected by the crisis. It prevents foreclosures by providing a source of funding to prepay first and second mortgages so distressed homeowners are left with an affordable monthly payment. In exchange, the homeowner accepts an obligation with recourse to repay the equity assistance in the future.

Beneficiaries of the program must accept certain reasonable conditions to participate and thereby to remain in their homes while regaining financial stability. The program helps the homeowners now and provides oversight in the future to ensure they always have affordable mortgage payments as they buy and sell homes. It does not seek to put a floor on housing prices like many believe is necessary. Rather, the goal is to restore the value of a mortgage by achieving affordable monthly payments without painful principal adjustments and cramdowns that damage the financial system. By making monthly payments affordable, homeowners will be able to successfully service their mortgages and regain the ability to increase their consumer spending.

HEAP effectively addresses each of the interconnected problems we are facing in the current crisis. It offers solutions to the conflicts raging in housing, the financial markets and the general economy.

Although the assistance provided is substantial, it is less than the total direct and indirect costs of foreclosure. Total capital required for the program is estimated to be 38 percent to 62 percent of the total capital committed by the U.S. government to all significant bailout and stimulus programs. The program deals with negative equity, can scale up rapidly and will gain acceptance from servicers of private label MBS.

For a detailed explanation of the program and a hypothetical case study illustrating how it would be implemented, go to http://recenter.tamu.edu/pdf/1906.pdf.

*Klassen (*gklassen@tamu.edu*) is a research analyst and Dr. Dotzour (*dotzour@tamu.edu*) is chief economist with the Real Estate Center at Texas A&M University.*

THE TAKEAWAY

While most of the programs designed to solve the financial crisis fail to address the foreclosure problem that began it all, the Home Equity Assistance Program does. This proposed solution starts with lowering mortgage payments, thus allowing distressed homeowners to stay in their homes, and keeps money flowing to all of the support entities in the financial markets.

MAYS BUSINESS SCHOOL

Texas A&M University
2115 TAMU
College Station, TX 77843-2115

http://recenter.tamu.edu
979-845-2031

Tierra Grande (ISSN 1070-0234) is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $20 per year. Views expressed are those of the authors and do not imply endorsement by the Real Estate Center, Mays Business School or Texas A&M University. The Texas A&M University System serves people of all ages, regardless of socioeconomic level, race, color, sex, religion, disability or national origin. Photography/Illustrations: Bob Beals II, p. 1.