

By Chris O'Leary and Antony Currie

# The Search for a *Light* in the **Dark**

*The mortgage industry is trying to make it through a long, dark night. Fears grow of a recurrence of the Depression-era jingle mail epidemic if borrowers decide to cut and run on loans as house prices tumble. The distractions of the presidential election don't help. Various plans are being hatched to help bolster the market — but none yet has widespread backing.*



One moral hazard meeting another?

Reuters

It's as if someone created a recipe for the perfect mortgage industry disaster and followed it through to the letter. First, gather the ingredients for a bubble: low interest rates, skyrocketing house prices and capital markets investors' voracious hunger for extra yield. Then measure out the right proportions of excess: borrowers overreaching, independent brokers, monoline lenders, investment banks and money managers trying to keep the fee train rolling. And for the *pièce de résistance*, use derivatives to broaden exposure to the riskiest parts of the market around the globe. Leave it to cook long enough, and voila -- the unsavory stew the mortgage market is now.

But can anything be done to rescue it? And just how far should any measures to remedy the situation go? These are questions that have dogged the industry, regulators and virtually all levels of government for the past year. It doesn't help that some of the institutions, whose role includes stabilizing the mortgage markets, like Fannie Mae and Freddie Mac, are themselves smarting from the excesses of recent years.

That said, some ideas have already been put into practice — such as the American Securitization Forum-led initiative to mitigate mortgage loan losses that was announced by President Bush in December. Others are still being debated in Congress and elsewhere.

A further complication is the demise of Bear Stearns in March. The Federal Reserve's rapid response to that crisis, including putting \$29 billion of taxpayers' money at risk, stands in stark contrast to the drawn-out debates about how to help homeowners. Of course, corraling the troops to rescue one

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firm, even though complex, is an easier task than devising plans to deal with the varying circumstances of millions of individual borrowers. And without Fed support JPMorgan might not have kept its admittedly low offer for Bear on the table. The investment bank would then almost certainly have gone bankrupt — it was already essentially insolvent when the Fed and JPMorgan stepped in — and that could have precipitated a much broader systemic crisis that risked, among other things, putting even more homeowners out on the street.

Nor would individual borrowers particularly want similar terms to Bear shareholders. If they did, they would have got back barely a tenth of the current value of the equity in the house — assuming they had any to start with — and up to half their family would have been kicked out and replaced by a bunch of relative strangers ordering them about. But it's hard not to have sympathy with homeowners whose precarious financial situation is dragging on for months, or longer, while Bear's crisis seems to have been resolved, for good or ill, within a week.

#### Competing lifeboats

The crux of the matter in both crises is the fear of moral hazard: would intervention effectively reward people and institutions for their mistakes, and would measures to ease a problem now actually cause greater pain down the road? Take Bear Stearns: on the first aspect of moral hazard, it was revealed during testimony in April before the Senate Banking Committee that Treasury Secretary Hank Paulson himself insisted shareholders should only receive a minimal payment from JPMorgan. As to the broader second point, had the Fed opened the discount window to investment banks earlier, perhaps Bear would not have collapsed. On the other hand, doing so may have created a broader crisis, even the collapse of a Wall Street firm, by sending the signal that the Fed thought matters were much worse

than previously believed. Arguably, using the discount window only became acceptable because of Bear's demise.

Paulson summed up the dilemma for the housing markets in a recent speech: "We must work to limit the impact of the housing downturn on the real economy without impeding the completion of the necessary housing correction."

That is no easy trick, not least in an election year where politicians are busy posturing ahead of the November polls. Senator Hillary Clinton is touting a plan in which the federal government would provide a \$30 billion bailout fund to help state and local governments stem foreclosures. Meanwhile, Senator Barack Obama has come out in favor of the Dodd proposal, along with a \$30 billion stimulus package again meant to limit foreclosures — though is rather vague on how to do that. Even Republican candidate Senator John McCain is in favor of a plan to refinance subprime mortgages with government-backed fixed-rate mortgages. He envisages allocating no more than \$10 billion to the project.

These are little more than gestures, though — few would counsel waiting until one of these three takes office next January to enact a rescue. Of course, an earlier generation did have the foresight to plan for a crisis like this. That's partly why the government-sponsored agencies were created. But Fannie Mae and Freddie Mac have themselves been hobbled by the mortgage crisis. "In fact, where they were intended to be countercyclical stabilizers, Fannie and Freddie are actually procyclical in that they have to write down their equity when losses rise, which limits their ability to buy and guaranty mortgages," wrote Ronald Temple, a managing director at Lazard Asset Management, in a recent analysis. "When times are good, they can increase leverage, effectively increasing the probability of boom and bust cycles."

Temple proposes that the federal government invest directly in Freddie and Fannie by backstopping a new round of extensive capital-raising by the two GSEs. In return, both would have to reduce their leverage: "While neither entity will like this idea,

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it should be clear that their business model is not sustainable when the 100-year flood occurs," wrote Temple. "Ironically, the model is not built to survive the very cycle these entities were created to address. We may well be at the beginning of such a flood. From a systemic perspective, we should not allow excessive leverage to return to the GSEs after this cycle."

Done properly this would be appealing to current shareholders: "With the proceeds obtained above the new higher capital levels, Fannie and Freddie would be expected to invest

the capital and take advantage of the dislocation in the credit markets. While providing liquidity to creditworthy borrowers, Fannie and Freddie would also be investing profitably, adding to their capital through the earnings they would accrue on the high-yielding assets.”

### Confronting the moral hazard

Nor, continues Temple, addressing the moral hazard dilemma, should the government’s injection of capital be permanent: “[T]he terms should be such that Fannie and Freddie would be required to buy back the government shares as mortgage credit spreads narrowed to predefined levels. By setting the return of capital based on a series of credit spread levels, we would ensure that the capital is pulled when markets are functioning properly and in increments that do not create shocks in the system.”

It’s a bold plan. But not one that Fannie and Freddie’s regulator, the Office of Federal Housing Enterprise Oversight seems to be contemplating. In March Ofheo announced it was relaxing by about a third its stricture that the two maintain capital ratios at least 30% above the minimum required. This, Ofheo estimated, would allow Fannie and Freddie to pump some \$200 billion of liquidity into the markets immediately and allow them to buy or guarantee, in total, up to \$2 trillion of mortgages this year. But the agreement came with a big caveat: in return the two agencies agreed to keep their capital ratios well above the newly reduced level. Admittedly, the plan also envisaged both raising more capital, but six weeks after the announcement neither had done so.

Some more recently devised plans are already in operation. The ASF-led initiative to prevent foreclosures and mitigate losses is the largest. Its remit is to help those homeowners who could afford their mortgages if only it weren’t for what just a few months ago were expected to be interest-rate increases of three or four percentage points as adjustable-rate loans came up for reset.

The program as of March 2008 had reworked a million mortgage loans, according to Paulson. Of these, some 278,000 loans underwent term modification, such as freezing interest rates or extending introductory rates for a longer period. Recently, of course, resets for those homebuyers who qualify for help have become less of an issue due to the rapid series of interest-rate cuts by the Fed. By April Libor, the benchmark for most adjustable-rate mortgages, had dropped more than two percentage points to around 3% which would allow many monthly payments to stay at roughly the same level as before the reset.

That’s no long-term solution, of course: after the initial reset two or three years into the life of the loan, the rate can change every three, six or 12 months, depending on the terms. So if Libor rises again, so does the specter of higher payments. Critics argue this remedy, and those like it, ignore the plight of the majority of borrowers. They have a point. But it is intentional, in part because the plan was designed to toe the line on moral hazard: borrowers such as those who cannot even afford

the teaser rates or those who had stumbled after buying multiple houses as investment properties are not eligible.

The problem is that moral hazard is a target that shifts with the market. Rate resets might not be such a big issue any more



Would more intervention make this better or worse?

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— replaced instead by the rapid drop in house prices. That could prove to be much more of a shock. A borrower with a 100% mortgage who can still afford the monthly repayments may decide to throw in the towel rather than pay off a loan on a house that will never be worth what he or she paid for it. Those who only put in a sliver of equity, and even those whose 10% or more has already been wiped out, could be coming to the same conclusion. What happens if the concept of jingle mail returns to the mortgage market — the practice, rarely seen in scale since the Great Depression, whereby underwater borrowers simply post their house keys back to the lender? Moral hazard would then be defined in this instance as precisely not helping anyone other than those who couldn’t pay resets.

Perhaps that’s why, when it comes to such loss mitigation plans, “there is a lot of skepticism from regulators that ‘you’re not giving us your best shot,’” says Walter O’Haire, a senior analyst with Celent and a former VP at U.S. Bancorp Piper Jaffray. “There is a slow dance unfolding now between regulators and the industry, but at some point it will be seen as having taken too long.” But that is where it becomes a government issue — the mortgage industry would probably be unable to combat a nationwide jingle-mail capitulation.

## No consensus

Such financial Armageddon is, one hopes, unlikely. But analysts expect some sort of federal program that goes beyond current initiatives will be enacted before the Democratic National Convention in late August. Each of the plans under consideration has its advocates and generates suspicion among its detractors of being driven by ulterior motives. Few expect the mortgage industry to coalesce behind a particular package.

Of those plans that cater more to the needs of the borrower, the proposal from Congressman Barney Frank, chairman of the House Financial Services Committee, appears to be attracting the most attention. Both chambers of the House were due to debate its merits in early May.

The Frank plan aims to permit the Federal Housing Administration (FHA) to provide up to \$300 billion in new guarantees that would help to refinance at-risk borrowers into viable mortgages. It carries a \$10 billion price tag that the government would put up immediately, although the hope is to get most of it back through fees. His colleague in the Senate, Christopher Dodd is working on similar legislation, with \$400 billion in FHA guarantees.

In Frank's plan, homeowners would be issued new mortgages worth 90% of the new value of the home, and the government would have a 5% stake to compensate for risk. The holder of the old loan would be paid 85% of the home's new value.

For critics, this smacks of moral hazard 101 because, they argue, it appears to reward bad behavior by bailing out borrowers who took out mortgages they couldn't really afford. "If the government has ever before put in place such a powerful inducement for wholesale borrower delinquency, I can't recall it," wrote Thomas Brown, founder and chief executive of Second Curve Capital, in a recent opinion piece on his website. Brown, whose hedge fund focuses on financial institutions, argues that a substantial number of mortgage borrowers would consider going delinquent on their current loans in order to qualify for the FHA-backed loan because they would then have a smaller monthly payment.

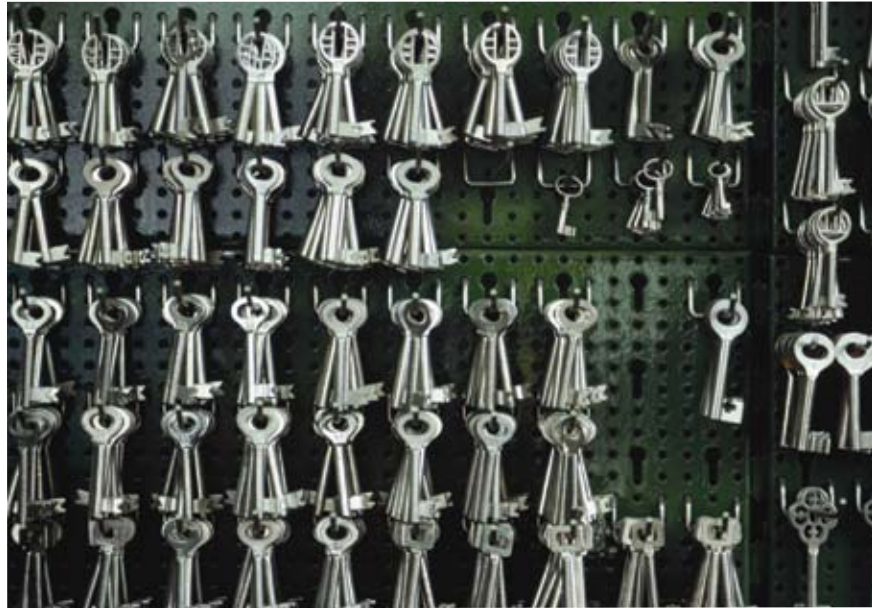
Frank is trying to reduce that possibility. His plan notes that "to remove any incentive for borrowers to "purposely default," the borrower must have had a mortgage debt-to-income ratio of no less than 40 percent as of March 1, 2008, and must

certify that he/she has not intentionally defaulted on existing mortgage(s). Regulators can make exceptions for involuntary changes after that date."

The Bush Administration is following a similar course, though its latest plan is basically a watered-down version of the Frank proposal. Announced in early April, it would expand the current FHA Secure program to 500,000 borrowers by the end of 2008 and enable the FHA to insure a new mortgage if a lender voluntarily writes down the principal, with a maximum

of 90% — or 97% — depending on the borrower's risk profile.

The chief gripe about Bush's plan — not least from Democrats — is that it does not cover enough borrowers. Meanwhile, supporters of the Frank proposal face a daunting task: putting a figure on how much it will ultimately cost. As one mortgage industry official puts it: "It



Let's hope this isn't what bank safes start looking like

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is difficult enough to value mortgage bonds right now, let alone value an unprecedented expansion of the FHA program. There are all these expectations that these plans will solve all of the problems in the mortgage market. But is it better for lenders just to engage in loss mitigation?"

Some critics agree, believing that no matter what rescue plan is ultimately enacted, it will distort the mortgage market. Says George Oldfield, an analyst at The Brattle Group: "All these plans seem designed to prevent the market from finding a new equilibrium." That it has to do so is an essential part of the recovery process. Sadly, it will involve financial pain for companies, shareholders and homeowners. No amount of intervention can avoid that, especially in a society grounded on democratic capitalism. Excessive or ill-thought-through intervention could make matters even worse. After all, one way of explaining the meaning of moral hazard is to cite the old aphorism: the road to hell is paved with good intentions. All those devising ways to alleviate mortgage market pain, be they industry executives, regulators or politicians, would do well to remember that. ▼

Christopher O'Leary is a freelance journalist based in Massachusetts. He is the managing editor of *The M&A Lawyer* and writes regularly for *Institutional Investor's Alpha*, *Registered Rep*, *Best Life* and *Investment Dealers Digest*, where he is a contributing editor.