Testimony of

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House Committee on Financial Services

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Thank you, Mr. Chairman. I am pleased to testify today about the Treasury's Troubled Asset Relief Program and about other steps that I think are needed to deal with the current economic situation.

The Problem

I am very worried about the U.S. economy. The financial crisis and the economic downturn are mutually reinforcing. Without further action by the Congress, the current recession is likely to be longer and more damaging than any that we have seen since the 1930s.

The fundamental cause of our current problems was the underpricing or risk and the resulting excessive leverage of both individuals and institutions.

But the primary condition that now threatens the economy is the expectation that house prices will continue to decline, leading to more defaults and foreclosures. And those foreclosures will put more houses on the market, driving house prices down further.

This potential downward spiral reflects the fact that in the United States – unlike every other country in the world – home mortgages are "no recourse" loans. If someone stops paying his mortgage, the creditor can take the home but cannot take other assets or look to the individual's income to make up any unpaid balance. This no recourse feature gives individuals whose mortgages exceed the value of their homes an incentive to default and to rent until house prices stop falling.

Because defaults are now rising rapidly and are expected to go on increasing, financial institutions cannot value mortgage-backed securities with any confidence. That's what stops interbank lending and lending by financial institutions that cannot judge the value of their own capital.

<u>The TARP</u>

The actions of the Federal Reserve and the FDIC have done a lot to prevent a run-off of funds from the banks and the money market mutual funds and to maintain the commercial paper market. In contrast, I believe that the TARP itself has not done anything to resolve the basic problems of the financial sector.

The Treasury's original plan to buy impaired loans as a way of cleaning the banks' balance sheets simply could not work. Even $700 billion is not enough to deal with the more than $2 trillion of negative equity mortgages. The plan to buy impaired assets by a reverse auction also could not work because of the enormous diversity of these securities. And even if the Treasury had succeeded in removing all of the toxic assets from the banks' portfolios,, they would have done nothing to stop the flow of new impaired mortgages and the fear of more such toxic assets in the future. It was good that the Treasury abandoned this asset purchase plan.

Injecting capital into selected banks is also not a way to resolve the problem and get lending going again. A bank like Citigroup has a balance sheet of some $2 trillion. Injecting $25 billion of government capital does not provide a significant amount of loanable funds. Nor does it give anyone confidence that Citi would have enough capital to cover any potential losses on its mortgage-backed assets. Although it raises Citi's tier one capital, that is not the binding constraint on lending by Citi or on its ability to attract funds. It was good that the Treasury abandoned this equity infusion plan as well.

Last week the Treasury announced that it will now concentrate on propping up credit for student loans, auto loans, and credit cards. I do not know how it plans to do this. But doing so will not stop the lack of confidence caused by the expectd continuing meltdown of mortgage-backed securities that is driven by the process of defaults and foreclosures.

In light of this record, the Treasury's announcement yesterday that it will not seek any of the remaining $350 billion of the initial $700 billion TARP funding seems quite appropriate.

What Needs to be Done?

Stopping the financial crisis and getting credit flowing again requires ending the spiral of mortgage foreclosures and the expectation of very deep further house price declines. Doing this requires a new government policy that deals with homeowners who have positive equity and a different government policy for homeowners with negative equity. Here is a possible way of dealing with these two groups.

Consider first the problem of stopping homeowners with *positive* equity from falling into negative equity as house prices decline to the pre-bubble level. Earlier this year I suggested that the government offer all homeowners the opportunity to substitute a loan with a very attractive low interest rate, but with full recourse, for 20 percent of the homeowner's existing mortgage. This "mortgage replacement loan" would establish a firewall so that house prices would have to fall more than 20 percent before someone who now has positive equity would decline into negative equity. Since the mortgage replacement loan is essentially a swap of the homeowner's IOU for the government loan, it would involve no actual government spending and therefore no increase in the budget deficit. (For more details, see my Wall Street Journal article of March 7, 2008 "How to Stop the Mortgage Crisis.")

The key to preventing further defaults and foreclosures among the current *negative* equity homeowners is to shift those mortgages into loans with full recourse, allowing the creditor to take other assets or a fraction of wages if the homeowner defaults. But the offer of a low interest rate loan is not enough to induce a homeowner with substantial negative equity to forego the opportunity to default and escape the existing debt.

Substituting a full recourse loan requires the inducement of a substantial write down in the outstanding loan balance. Creditors have an incentive to accept some write-down in exchange for the much greater security of a full recourse loan. The government can bridge the gap between the maximum write down that the creditor would accept and the minimum write down that the homeowner requires to give up his current right to walk away from his debt. (For more details, see my Wall Street Journal article of November 18, 2008 "How to Help People whose Home Values are Underwater.")

If these things are done, the financial sector would be stable and credit would again begin to flow. But while that is a necessary condition for getting the overall economy expanding again, it is not sufficient.

To achieve economic recovery the nation needs a program of government spending for at least the next two years to offset the large decline in consumer spending and business investment. To be successful, it must be big, quick, and targeted at increasing production and employment

I am a fiscal conservative. I generally oppose increased government spending and increased fiscal deficits. But I am afraid that that is now the only way to increase overall national spending and to reverse the country's economic downturn.

If these two things are done -- stopping the incentive to default on home mortgages and increasing government spending –- I will be much more optimistic about the ability of the economy to begin expanding before the end of 2009.

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OPINION

NOVEMBER 18, 2008

How to Help People Whose Home Values Are Underwater

The economic spiral will get worse unless we do something about negative equity.

By MARTIN FELDSTEIN

More than 12 million homeowners now have mortgage debt that exceeds the value of their homes. These negative-equity homeowners have an incentive to default because mortgages are generally "no recourse" loans. That means creditors can take the property if the individual defaults, but cannot take other assets or income to make up the difference between the unpaid loan balance and the lower value of the house. As a result, mortgage default rates are now rising rapidly and are expected to go much higher.

The no-recourse mortgage is virtually unique to the United States. That's why falling house prices in Europe do not trigger defaults. The creditors' ability to go beyond the house to other assets or even future salary is a deterrent.

The negative-equity homeowner's incentive to default and become a renter rises with the size of the gap between the mortgage and the value of the house. That gap is typically already very large. Half of the homeowners with negative equity now owe more than 120% of the value of their homes. If house prices continue to fall at the current rate for the next 12 months, as experts generally expect, the median loan-to-value ratio of negative-equity homeowners will increase to more than 135%. At that level, a very high fraction of negative-equity homeowners are likely to default.

The increased supply of homes for sale will create a vicious cycle, further depressing house prices, further raising the number of homes with negative equity, and weakening the balance sheets of financial institutions. This is the primary cause of the dysfunctional credit markets. None of the existing proposals to help homeowners with negative equity would eliminate the incentive to default.

In an earlier article on this page I proposed a plan to prevent declines of house prices back to the prebubble level from pushing current positive-equity homeowners into the negative-equity group. The essential feature of that plan is to replace 20% of the homeowner's existing mortgage with a separate, full-recourse loan from the government. That "mortgage replacement loan" would have a very attractive, low interest rate. Because it would be separate from the mortgage and would have full recourse, it would establish an important firewall. Even if house prices fall another 20%, all mortgages would still have positive equity. The mortgage-replacement loan would involve no actual government spending and therefore no increase in the budget deficit.

The key to preventing further defaults and foreclosures among current negative-equity homeowners is to shift those mortgages into loans with full recourse, allowing the creditor to take other property or a fraction of wages. But the offer of a low-interest-rate loan is not enough to induce a homeowner with substantial negative equity to forego the opportunity to default and escape the existing debt. Substituting a full-recourse loan requires the inducement of a substantial write-down in the outstanding loan balance. Creditors have an incentive to accept some write-down in exchange for the much greater security of a full-recourse loan. The government can bridge the gap between the maximum write-down that the creditor would accept and the minimum write-down that the homeowner requires to give up his current right to walk away from his debt.

Here is an example of how that might work. Consider a homeowner with a $240,000 mortgage and a home that is worth only $200,000. The $40,000 gap between the mortgage and the appraised value could be divided with the government taking one-third, the creditor taking two-thirds, and the homeowner agreeing that the remaining $200,000 loan would have full recourse. The creditor would give up about $27,000 of potentially uncollectible debt but would avoid the extra loss of value that comes with selling a foreclosed property, and would achieve a much more secure loan. The homeowner would get to keep his house and would eliminate all of the excess debt.

With 12 million negative-equity homes and an average negative equity gap of $40,000, the total cost to the taxpayers of taking one-third of the losses would be no more than $156 billion. Alternative proposals to help negative-equity homeowners do not convert their mortgage debt to full-recourse loans and would not succeed in stopping the downward spiral of house prices.

The "Hope for Homeowners" legislation sponsored by Rep. Barney Frank and Sen. Chris Dodd offers a government guarantee of the mortgage if the creditor writes the loan down to 95% of the property's current value (as appraised by professionals hired by the banks). The Congressional Budget Office estimates that only 400,000 of the 12 million homes with negative equity would benefit, because creditors are unwilling to make such a large write-down without government assistance.

One recent proposal from the FDIC calls for creditors to reduce the monthly mortgage payment to a specified fraction of the homeowner's income by stretching out the repayment schedule of the mortgage, or providing a temporary reduction in the interest rate on the mortgage. The government would compensate the creditor for this reduced monthly payment by agreeing to pay part of any loss if the homeowner defaults. But even after the monthly mortgage payment is reduced, the homeowner with negative equity would still have an incentive to default, leaving the government with the cost.

Another current proposal from various academics would force the creditor to write down the mortgage debt to eliminate the negative equity and compensate the creditor with a share of the future appreciation when the house is sold. But any homeowner who receives that debt reduction has an incentive to sell the house as quickly as possible and buy another one so that he can keep all of the appreciation on the new home. Since the creditor would therefore receive no compensation for writing down the debt, there would be great reluctance to accept such a plan.

The prospect of a downward spiral of house prices is the major risk facing financial institutions. It is also a primary source of the further falls in household wealth that will reduce consumer spending and depress the economy. Providing an incentive to shift the current negative-equity loans to full-recourse mortgages -- while also injecting mortgage-replacement loans to stabilize the current positive-equity mortgages -- should be Barack Obama's highest priority as he seeks to stabilize the economy.

Mr. Feldstein, chairman of the Council of Economic Advisers under President Reagan, is a professor at Harvard and a member of The Wall Street Journal's board of contributors.

OPINION

How to Stop the Mortgage Crisis

By MARTIN FELDSTEIN
March 7, 2008; Page A15

The potential collapse of house prices, accompanied by widespread mortgage defaults, is a major threat to the American economy. A voluntary loan-substitution program could reduce the number of defaults and dampen the decline in house prices -- without violating
contracts, bailing out lenders or borrowers, or increasing government spending.

The unprecedented combination of rapid house-price increases, high loan-to-value (LTV) ratios, and securitized mortgages has made the current housing-related risk greater than anything we have seen since the 1930s. House prices exploded between 2000 and 2006, rising some 60% more than the level of rents. The inevitable decline since mid-2006 has reduced prices by 10%. Experts forecast an additional 15% to 20% decline to correct the excessive rise. The real danger is that prices could fall substantially further if there are widespread defaults and foreclosures.

Irresponsible lending created new mortgages with LTV ratios of nearly 100%. By the end of 2006, the fall in prices caused 7% of mortgages to have LTV ratios above 100%. A further 20% of mortgages had LTV ratios over 80% and will shift to negative equity as prices decline.

Most mortgages are no longer held by originating lenders, but are securitized and sold to investors world-wide. More significant, mortgages are used to create complex, asset-backed securities that are central to current credit-market problems. Investors no longer own specific mortgages, but only have rights to certain conditional payment streams. So generally, it is no longer possible to prevent foreclosures by negotiations between borrowers and lenders.

The 1.8 million mortgages now in default have created substantial personal hardship. The 10% decline in house prices has cut household wealth by more than $2 trillion, reducing consumer spending and increasing the risk of a deep recession. Defaults also damage the capital of lending institutions, causing further declines in credit and economic activity.

Rising unemployment during a downturn will force more homeowners to default, driving house prices lower. Since mortgages are generally "no recourse" loans, when there is a default the mortgage lender can only collect the value of the property. The lender does not have the right to seize other property (a car, a boat, money in the bank) or to put a lien
on future wages. Thus, a homeowner with a mortgage that exceeds the value of his house has a strong incentive to default, even if he can afford to make the monthly payments.

Optimists note that homeowners with negative equity have generally been reluctant to default in past years. That was sensible when house prices were rising. But with house prices falling, defaulting on the mortgage is the rational thing to do.

Limiting the number of such defaults, and preventing the overshooting of price declines, requires a public policy to reduce the number of homeowners who will slide into negative equity. Since house prices still have further to fall, this can only be done by a reduction in the value of mortgages.

None of the current mortgage-reduction proposals are satisfactory. Although bankers sometimes have the incentive to reduce mortgage-loan balances voluntarily in order to avoid a foreclosure, this is usually not possible because the syndication of mortgage loans means that there is generally not a single lender who can agree to the mortgage writedown.

Proposals to force creditors to accept write-downs of interest or principal violate their contractual rights, reducing the future availability of mortgage credit and raising the relative interest rate on future mortgages. Reviving the depression-era Home Owners' Loan Corporation would have the government use taxpayer money to pay off existing loans and become the largest mortgage lender in the country. This would require an enormous federal bureaucracy of appraisers and loan agents.

If the government is to reduce significantly the number of future defaults, something fundamentally different is needed. Although there is no perfect plan, a program of federal mortgage-paydown loans to individuals, secured by future income rather than by a formal mortgage, could reduce the number of mortgages with high LTV ratios and cut future defaults.

Here's one way that such a program might work:

The federal government would lend each participant 20% of that individual's current mortgage, with a 15-year payback period and an adjustable interest rate based on what the government pays on two-year Treasury debt (now just 1.6%). The loan proceeds would immediately reduce the borrower's primary mortgage, cutting interest and principal payments by 20%. Participation in the program would be voluntary and participants could prepay the government loan at any time.

The legislation creating these loans would stipulate that the interest payments would be, like mortgage interest, tax deductible. Individuals who accept the government loan would be precluded from increasing the value of their existing mortgage debt. The legislation would also provide that the government must be repaid before any creditor other than the mortgage lenders.

Although individuals who accept the loan would not be lowering their total debt, they would pay less in total interest. In exchange for that reduction in interest, they would decrease the amount of the debt that they can escape by defaulting on their mortgage. The debt to the government would still have to be paid, even if they default on their mortgage. Participation will therefore not be attractive to those whose mortgages that already exceed the value of their homes. But for the vast majority of other homeowners, the loan-substitution program would provide an attractive opportunity.

Although home owners may recognize that the national average level of house prices has further to fall, they do not know what will happen to the price of their own home. They will participate if they prefer the certainty of an immediate and permanent reduction in their interest cost to the possible option of defaulting later if the price of their own home falls substantially.

The loan-substitution program would decrease the number of homeowners who would come to have negative equity as house prices decline. That reduces the number of homeowners who will have an incentive to default, thereby limiting the risk of a downward spiral of house prices.

Since individuals now have the right to prepay any part of their mortgage debt, the 20% reduction in the mortgage balance would not violate mortgage creditors' rights. Creditors should welcome the mortgage paydowns, because they make the remaining mortgage debt more secure. The 20% repayments to creditors would also create a major source of funds that should stimulate all forms of lending.

The simplest way to administer the new loans would be for the current mortgage servicer to collect on behalf of the government and remit those funds to Washington. There would be no need for a new government bureaucracy, for new appraisals, or for negotiations in bankruptcy. The program could be up and running within months after the legislation is passed.

The government would fund these loans by issuing new two-year debt and rolling over the debt until the loans are fully repaid, thus eliminating any net cost to the government. The government loans would not add to the budget deficit or to the net debt of the nation. Gross government debt would rise by the amount of the new government lending, but this would be balanced by the asset value of those loans.

The current possibility of widespread defaults is a cloud over all mortgage-backed securities, and over credit markets generally. The uncertainty about the future value of such asset-backed loans has been a primary reason credit markets have become dysfunctional. And without a flow of credit, the economy cannot expand.

To lower the risk of a downward spiral of house prices and to revive the frozen credit markets, the government must move quickly to reduce the potential number of mortgage defaults. A loan substitution program may be the best way to achieve that.

Mr. Feldstein, chairman of the Council of Economic Advisers under President Reagan, is a professor at Harvard and a member of The Wall Street Journal's board of contributors.