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Editorial

Real estate reality

Government and the financial sector must do more to stem the rising tide of foreclosures.

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As lawmakers look for a way out of the recession, it's worth remembering how we got into this mess in the first place. The collapse of the housing market sucked trillions of dollars worth of real estate wealth out of the economy, starting a vicious cycle of cutbacks by consumers, lenders and businesses. But the collapse wasn't a one-time event. It's an ongoing process that could take a larger human and economic toll this year than it did in 2008, when the number of troubled homeowners nearly doubled from the year before. According to RealtyTrac, lenders made foreclosure filings on 2.3 million properties last year (more than half a million in California alone), including nearly 2% of all housing units. New laws here and in several other states reduced the pace of foreclosure filings, but they haven't helped homeowners pay their bills. As a consequence, the FDIC projects another near-doubling of housing misery, with 4.4 million mortgages falling 60 to 90 days past due by the end of 2009.

It's no coincidence that more banks are sliding toward insolvency as defaults mount. The financial industry placed a huge bet on Americans paying their mortgages, along with an intricate web of side bets on the U.S. housing market. Keeping more homeowners out of foreclosure could help end the sickening slide in home values, solidifying the ground under the financial industry and coaxing more buyers back into the housing market. It's not as simple as that, of course; rising unemployment has become a major factor in the market, driving more homeowners into default with no hope of recovery. Still, if lenders don't do more for those whose homes could be saved, the situation will only get worse.

Some argue that government should let the market take its course. More banks are modifying loans for buyers who can afford somewhat reduced monthly payments, and repossessing homes from buyers who shouldn't have received loans at all. Foreclosure, they say, is a fitting resolution for such people and the lenders that encouraged them. We agree that rescuing people and businesses from their own risk-taking poses a significant moral hazard. That's why we believe that policymakers shouldn't try to shield borrowers or banks from drastically lower property values and lost returns. But government can and should help them adapt to the collapsing market. Given the links between the wave of foreclosures and the overall health of the economy, everyone fares better when lenders and homeowners can strike deals that cost less and preserve more of a home's value than a foreclosure sale would.

Finding the right way to help borrowers, however, is a tricky business. Congress' biggest initiative, the Hope for Homeowners program, was supposed to refinance 400,000 defaulting loans into government-guaranteed mortgages over three years. In its first three months, it received only 412 applications and provided a grand total of 17 loans. The near-complete disinterest in the program stems from the restrictions and fees that Congress imposed to limit the cost to taxpayers -- a penny-wise, pound-foolish strategy. Meanwhile, lenders' early efforts to help borrowers fared poorly, with a high percentage defaulting again on their mortgages. But more recent efforts, such as the FDIC's handling of defaulting IndyMac Bank loans and Fannie Mae's modification of loans bought from investors, show that 60% or more of the borrowers in trouble can be rescued with the right set of terms.

Those successes and failures help draw the outlines of the right response to the foreclosure problem. Lenders need to follow the lead of the FDIC, Bank of America and JPMorgan Chase in setting affordability formulas that enable them to reevaluate borrowers and modify mortgages on a mass scale. As shown in a recent study by Alan M. White, a Valparaiso University law professor, the first round of modifications frequently failed because they didn't reduce monthly payments and often provided only temporary help. The changes need to yield mortgages that buyers can afford over the long term, giving them more reason to keep paying.

The government can help on this front by providing financial incentives for loan servicing companies and reducing barriers to modifications. In particular, servicers should have more freedom to modify the loans owned by investor groups, which held 61% of the long-overdue mortgages at the end of December. Any modification should be fair game if it would yield more for investors than a foreclosure sale. (That's a fairly low bar; by White's estimate, the average foreclosure in November resulted in a 55% loss for the lender.) A trade group for mortgage-security investors agreed in 2007 to provide such flexibility for subprime loans, but the mortgage crisis has already advanced deep into other borrowing categories. Congress could also encourage modifications by letting bankruptcy judges rework home mortgages, rather than forcing bankrupt homeowners to sell.

One other factor that needs to be addressed is a borrower's incentive to abandon a home when the value falls below the amount owed. The problem is exacerbated by the popularity of loans that required little or no down payment, which generated a class of buyers with no equity stake in their homes. Some economists have suggested that taxpayers should cover the gap between a homeowner's debt and the current value of the house, but we're not comfortable with that idea at this point because it would rescue lenders from their careless practices. We'd rather see Congress fix the Hope for Homeowners program, which encouraged lenders to write down enough debt to restore a borrower's stake in the home.

Even with an aggressive effort to avert foreclosures, millions of people are likely to lose their homes because they just can't afford them in this recession. That's all the more reason to try harder to help the ones who can be helped.