# AN EFFICIENT ALTERNATIVE TO BAIL OUT EFFORTS

by I. Christian Wulff

This economic crisis could end with less than two percent of what has been committed, proven with simple math and irrefutable logic. To begin, it should be obvious that NONE of the financial disturbance from mortgages would have occurred, had virtually all of those payments been kept current, and the housing market would not have so collapsed had there been no foreclosures. That *could* be realized, but at what cost? There were about four million foreclosures in the last three years. Had we intercepted those defaults before foreclosure, and offered a deferral of one-third of each borrower's payments for five years, that sum would be \$120 billion. But this only demonstrates the comparison (2% of 7 trillion committed) with easy math to make the point. With details, it shrinks to probably *less than \$10 billion a year for four years*. And all, or most, of that would be paid back. That comparison is shocking, but the abundance of errors by Treasury makes the current affair more outrageous.

Treasury has failed to recognize critical dynamics of this crisis. The most obvious and inexcusable is that nothing is as effective as keeping payment streams intact. Efforts made so far are focused on integrity of financial institutions, which is only one consequence of foreclosures. It misses the cause, which is foreclosures, so all consequences continue (see illustration: Leaking Pipes). Secretary Paulson has also failed to address the feedback loop between foreclosures and a declining the real estate market. More foreclosures bring down prices (by increasing supply and scaring away demand), and declining prices cause more foreclosures (as more borrowers end up "under water" from declining prices). Furthermore, compressing *any* sum of foreclosures into a tight time frame compounds damage greater than a distribution of the same sum over a much greater time span. And that assumes that the sum *would be* the same, given time. Taken with the above, it would probably be less. Therefore, any measure that extends the distribution of a surge of foreclosures is likely to reduce the number, and the damage. Paulson also fails to recognize any economic effects outside financial institutions, so much so that he ultimately fails institutions themselves. Foremost in that, is an efficiency in keeping homeowners engaged. Foreclosure, when compounded by multiples, incurs enormous cost. The direct and indirect investors lose all of the payment stream. Any compensating or remaining value is diminished by costs to remove the occupant, repair the property, and find a purchaser. The purchase price will be low in such a market, and it may be slow in coming, creating carrying costs. The neighborhood will bear the burden of decline, and the community will achieve lower tax revenues and suffer greater demands on services. Individuals will suffer losses that will translate into diminished purchasing and ultimately fewer jobs. But, when the homeowner remains in the home, he or she continues to make payments, maintain the property, pay taxes, and in effect, sustain the market by avoiding the burden of another vacant home. And, all of the chain of damaging effects listed above are avoided, too. If it requires an expenditure to carry a minor part of that borrower's payment for a number of months, that cost pales in comparison to those losses enumerated. Moreover, one has to wonder how banks could manage to lose far beyond the initial investment in bad loans. Even if they lost total principal in those four million loans foreclosed, at a median home value of roughly \$250,000, financed at 100%, the loss would be one trillion dollars. Yet, we've had to issue or commit seven times that, and the loss continues. We need an industry that handles money that poorly, like we need Osama bin Ladin managing our airlines?

**Example**
Here is a sample scenario to demonstrate an efficient application of the concept described. First, imagine a house, worth about $175,000 four years ago. The boom brought that price up at 20% appreciation per year, so the price when the borrower bought it was $250,000. Two years later, brings us to today, and the value is now $200,000. (Were it to have gone that low with 4 million foreclosures averted, could be argued. But let us assume that value, because that is where we are.) The borrower initially financed the full $250,000 price at purchase with an interest rate of 7 percent. Amortized at that rate, payments would be 1663/month, and the balance would now be about $245,000. The borrow can no longer handle that payment. Instead of foreclosing, current investors receive full payment on the balance, minus a discount fee described ahead, and a new mortgage replaces it with the nearly the same balance (minimal added for administration). The new loan is made at a rate 1 percentage point below current market, and the borrower can defer one-third of the mortgage payment for five years. The initial investors are paid off, minus a discount fee to adjust the rate on the new loan (paid to the new lender, if new loan is not made by the original lender). Still, that penalty is nothing compared to losses and complications of foreclosure. The deferred portion of the payment is provided by the government plan, so the lender receives full payments at the new rate. The borrower can now stay in the home and continue with lower payments, but in five years must pay the deferred amount. (The plan should offer a refinance program to cover that, which should be pre-committed, subject to conditions.) In five years, the balance of the loan will be about $242,000. That means the property needs only appreciate at about 3.8 percent annually over five years to reach a positive equity position. That is a reasonable expectation, given that foreclosures will have been averted almost entirely during that time, and that breakeven price is still about the same rate of appreciation (3.9%) from the $175,000 value of four years before the five year period (nine years total). The net effect in appreciation would be as if no boom or bust had occurred, so long as disposition of the property remains unchanged. This outlines the effects. The chart provided gives more detail and a better view of the relationships.

Of course, there would not be four million defaulting borrowers applying for this program on the first day, so the effect would not appear as the simple math formula initially demonstrated. Application would likely be high at the beginning, and then taper down as recovery heals the market. So, you might get 2 million in the first year, then maybe a million plus in the second, and less still in the third. I’d bet on a faster recovery, with foreclosures halted. Then, toward the end, but not necessarily all at once, payback of deferred sums would come. Somewhere in the middle there would probably be some payback offsetting some deferrals. In addition to the outlay for support of payment deferrals, there will likely be some losses from borrowers who will not take advantage of the deferral program, for whatever reason. Submitted also is a plan to dispose of those properties in a way that recoups losses and provides incentives for a new buyer to opt for such a purchase. The key to that plan is a zero percent interest rate for five years, but other features modulate its efficiency. Losses incurred in that plan are also periodic, with an average monthly loss in the range of $300 per month. There is a chart of that example, also. Finally, there is a chart showing an example of how these cash flow events might play out, using sample volumes, just to illustrate the distribution and net effect of outlays and payback over time. Notice that the net outlay in any year is likely to be less than $10 billion. Incidentally, recognize also, that with losses that small, the industry should have been able to manage it without taxpayer help at all.

One other feature is necessary. There must be a way to avoid having all of these salvaged mortgages ending up back in the same position as they presently are, and all at the same time. We don't want millions of homeowners faced with a choice between payments they cannot afford (when the special payment term ends) and selling their homes, all at once. If borrowers cannot recover financially in the time allowed, or markets do not recover adequately, or other economic conditions interfere, and default results after all, these must not occur all in a short time frame. Any foreclosures that result, should be distributed over a long term, to avoid a compounding effect that multiple foreclosures can have on a market. Most dangerous, are initial terms that produce very low monthly payments, however low payments are probably necessary to keep many borrowers participating. The program should probably gauge payments to borrowers' circumstances to avoid going lower than needed, according to a borrower's capacity. In addition to guidelines for adjusting payment levels, there might also be adjustment for term, also according to borrower capacity or circumstances. Bureaucratic guidelines often fail to address unforeseen conditions, resulting in some improper determinations, so these should be simple and not too dramatic in effect. Better than too many imposed guidelines, would be an incentive-driven approach at adjusting the term of payment deferrals. The program should offer a range of interest rate reduction based upon the term a borrower chooses. A shorter term would get a lower interest rate, and longer terms would get less of a reduction. The incentive should adjust the length of the term, but not the payment. The purpose is to distribute terminals over a vast time frame. That way, any borrowers who ultimately fail will be less likely to be tripping over others in the same position if they need to sell their houses to get out.

The full plan should attempt to make it feasible for borrowers to ultimately succeed in keeping their homes even beyond the deferral term. It should distribute the few failures over a very long term so that most foreclosures can be avoided by selling, but not so they would be competing with many others. By minimizing foreclosures in numbers, and distributing those that do occur over an extended period, any remaining foreclosures are likely to be soaked up by speculators, as the count should be small in any given market inventory. Obviously, the cash flow chart given here does not account for all of these variations and adjustments. It is provided, however, to illustrate an average distribution of outlay and returns, at least to give a sense of the likely range. Any more detailed analysis would be even more speculative and complicated. Since the adjustments proposed should be either within the terms presented for that chart, or within a standard deviation, the conclusions should be reasonably consistent.

Notes:

The plan could work by keeping current loans intact (i.e without pay off and refinance), but re-amortization and current market rate (as done in this demonstration) adds to efficiency enough to cut deferral costs in half.

Homeowners who need to relocate (and thus, to sell their "under water" home) might also be served by creating a means to transfer their mortgage deficiency from a sale, onto the mortgage for the new home, using the same mechanisms described in this plan.

In anticipation of complaints about assisting irresponsible borrowers, note that the greater concern now is avoiding national ruin.