Order Code RL34423

CRS Report for Congress

Government Interventions in Financial Markets: Economic and Historic Analysis of Subprime Mortgage Options

Updated April 18, 2008

N. Eric Weiss
Analyst in Financial Economics
Government and Finance Division

Prepared for Members and Committees of Congress

Congressional Research Service

Government Interventions in Financial Markets: Economic and Historic Analysis of Subprime Mortgage Options

Summary

This report summarizes and analyzes four previous government market interventions (Home Owners Loan Corporation in 1933, Continental Illinois in 1984, the savings and loan insurance fund shortfall in 1989, and the Latin American debt crisis in 1989), in light of current mortgage market conditions. Current proposals to help delinquent homeowners share many features in common with all of these actions.

The Home Owners Loan Corporation (HOLC) purchased delinquent mortgages at a discount and worked with homeowners to restructure the mortgages into more manageable terms. HOLC accepted slightly more than one million applications from homeowners to refinance their homes between June 1933 and June 1935. It rejected 488,000 applications, most for "inadequate security" and "lack of distress." HOLC foreclosed on 194,000 of those it was attempting to assist. At the time, many had serious concern that HOLC could be a costly undertaking, but when it disbanded in the early 1950s, HOLC returned a small profit to the government. HOLC successfully conceived and implemented new ways to contact delinquent homeowners and, in some cases, help homeowners find new jobs.

In 1984, Continental Illinois National Bank suffered a run after loans that it had not properly underwritten failed. The Federal Reserve and the Federal Deposit Insurance Corporation led intervention efforts. There were concerns that allowing the bank to fail could have serious repercussions throughout the financial system. This led to the FDIC Improvement Act of 1991.

In the 1980s, the Federal Savings and Loan Insurance Corporation approached insolvency because of the failure of member savings and loan institutions, also known as thrifts. Working together, Congress and the George H. W. Bush administration established the Resolution Trust Corporation (RTC), which was funded by the Resolution Funding Corporation (REFCORP). The thrift industry is still paying off the intervention operation, which is estimated to have cost $152.9 billion.

In 1989, Brady bonds helped less developed countries, mostly in Latin America, restructure their debt by renegotiating terms and writing down some of the loans. The plan, proposed by then-U.S. Treasury Secretary Nicholas F. Brady, overcame coordination problems in previous restructuring efforts. In addition to writing down some loans, the plan included some interest rate reductions, and having debtor nations post U.S. Treasury bonds as collateral with the Federal Reserve. Approximately $91.8 billion was refinanced under the plan. Repayment continues today.

H.R. 5818 and H.R. 5830 are among the bills before Congress that would intervene in economic (housing) markets.

Contents

Government Interventions in Financial Markets: Economic and Historic Analysis of Subprime Mortgage Options

Introduction

Increasing delinquency and default rates on subprime mortgages in 2007 and 2008, along with liquidity problems in other financial sectors, have led some to call on the federal government to intervene in the mortgage market. The Administration and the mortgage industry have developed an approach called HOPE NOW that works with borrowers with subprime mortgages facing interest rate increases and increasing payments who could be helped with a combination of counseling and either an interest rate freeze or a new mortgage.[1] Critics of the plan believe that HOPE NOW is doing too little, too slowly to help those in need today and those who will face interest rate increases over the next few years.[2]

Foreclosure is costly for the lender, the borrower, and owners of neighboring property. Efforts to reduce foreclosures could very well be in the interest of all three affected parties. In foreclosure the lender is unlikely to recover the outstanding balance on the mortgage and the cost of foreclosure. The borrower is likely to lose any equity in the home, incur additional costs, and suffer credit impairment. A large number of vacant homes in a neighborhood can reduce the value of occupied homes. This spillover from the borrower and mortgage holder of the vacant homes to the neighbors is an example of what economists term an externality and provides a possible economic rationale for government intervention.

Some analysts and journalists have drawn a parallel between the delinquency and default problems facing homeowners with subprime mortgages and distressed homeowners during the Great Depression.[3] The Home Owners' Loan Corporation (HOLC) was created in 1933 to refinance homeowners' mortgages. This report analyzes HOLC, the Continental Illinois failure and government reaction in 1984, the savings and loan crisis of the 1980s, and the 1989 Brady Plan for bonds from developing countries.

---

[1] See [http://www.hopenow.com/].

[2] See, for example, Mary Umberger, "Rate freeze called too little, too much; Critics say it delays inevitable; others oppose intervention," *Chicago Tribune*, December 7, 2007, p. 1.

[3] Damian Paletta, "Democrat Floats Plan to Refinance Home Loans With U.S. Help," *Wall Street Journal*, February 27, 2008, p. A14.

Policy Issues

One of the first issues that Congress may choose to consider when contemplating an intervention is which home owners should be included in the plan. When there is a limited amount of aid, how should it be divided? At the one extreme, if assistance goes to only a few, those who obtain it may receive more assistance than is necessary or some in identical situations could be excluded. At the other extreme, if the assistance goes to a large number, there is a risk of spreading the help too thinly to be of assistance, or those who do not need help may receive it.

In short, who "deserves" to be helped? For example, should owners of rental property be assisted or only present owners? Should vacation and other second homes be included? Should persons with two homes who are trying to sell one be aided? Should owners of any type of housing be helped or just owners of single-family housing?[4]

If only one group, such as owners with subprime mortgages, is to be helped, should this group be further divided? For example, should those current on their mortgages be assisted? Should those who are behind on their payments be aided? What about those whose mortgage interest rates will reset in the future?

Should borrowers with certain types of mortgages be excluded? For example, should those with no- or low-documentation loans be excluded? Should an owner who made false or fraudulent statements to obtain the mortgage be aided?

Does it matter if the mortgage was obtained to purchase a home as opposed to refinancing the home? If refinancings are to be included, should there be a limit to the amount of cash equity that the borrower extracted from the house?

Finally, should there be a cutoff date? If there should, should it be a "date certain" or when a certain objective measure is reached?

One response is the HOPE NOW, which is available to homeowners through free telephone consultations with a HUD-approved credit counselor.[5] Its financial assistance is offered only to owner-occupied housing financed by subprime mortgages where the owners are current in their payments, but are not likely to be able to make payments after the mortgage resets. Some of the homeowners accepted by the program will have their mortgage interest rates frozen. Others will be helped to refinance with the Federal Housing Administration (FHA). Homeowners who are

---

[4] Single-family includes structures with one to four units. It excludes condominiums and cooperatives. In 2005, there were 84.5 million owner-occupied single-family buildings, while an additional 7.6 million were vacant. Of those occupied, 67.2 million were occupied by owners and 17.3 million were rentals. Source: U.S. Census Bureau, *American Housing Survey 2005*, Table 1A1, available at [http://www.census.gov/hhes/www/housing/ahs/ahs05/ahs05.html].

[5] For details, see CRS Report RL34372, *The HOPE NOW Alliance/American Securitization Forum (ASF) Plan to Freeze Certain Mortgage Interest Rates*, by David H. Carpenter and Edward Vincent Murphy.

delinquent on their mortgage payments may be eligible to refinance in the FHASecure program.[6]

Economists and others worry that any government intervention in market outcomes could lead to the expectation of future intervention. This expectation, called moral hazard, could lead to riskier decisions in the future as home buyers (both those helped and those who did not require aid in the current case) take more risk than they might otherwise do in the expectation that the government will assist them in the future. In turn, this could lead to resources being used in a riskier way than would have occurred without the intervention. Insurance policies usually include deductibles and co-pays to limit moral hazard and to discourage excessive use. The rationale for such standard practices is that because the policy holder would bear part of the financial loss, he or she will exert greater prudence.

A Brief Overview of Subprime Delinquency and Default

In mortgage finance, delinquency occurs when a payment on a loan is overdue. Default occurs when a borrower has failed to meet any of the terms of a mortgage contract, including timely payment. Foreclosure occurs when the lender files to seize the house (collateral) because the borrower is in default. Foreclosure procedures vary from state to state.

Foreclosure is a costly process: one widely cited study estimates that the total cost to a lender of foreclosure, including lost interest, legal fees, and the cost of disposing of the house, is $58,759, and takes an average of 18 months.[7] A more recent report by the staff of the Joint Economic Committee (JEC) estimated the direct loss of property value at $53,493, and the loss of neighborhood property value at an additional $24,163.[8] The JEC estimated that each foreclosure would reduce property tax collections by $692. The JEC estimate did not include legal costs and interest foregone during foreclosure. A Federal Reserve Bank of Chicago report cited an estimate that a lender loses more than $50,000 per foreclosure.[9]

---

[6] For more details, see the FHA Web page at [http://portal.hud.gov/portal/page?_pageid=33,717446&_dad=portal&_schema=PORTAL].

[7] CRS Report RL34232, *Understanding Mortgage Foreclosure: Recent Events, the Process, and Costs*, by Darryl E. Getter. See, also, Amy Crews Cutts and Richard K. Green, *Innovative Service Technology: Smart Enough to Keep People in Their Homes*, Freddie Mac Working Paper #04-03, July 2004, p. 5, available at [http://www.freddiemac.com/news/pdf/fmwp_0403_servicing.pdf]. (The paper cites a study by Craig Focardi, Servicing Default Management: An Overview of the Process and Underlying Technology," *TowerGroup Research Note*, No. 033-13C, November 15, 2002).

[8] U.S. Congress, Joint Economic Committee, *The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here*, October 2007, p. 13 and CRS calculations.

[9] This estimate by GMAC-RFC (Residential Funding Corporation) is cited by Desire
(continued...)

The Nature of the Subprime Reset Problem

As long as home prices were rising, lenders and borrowers had less need to worry about the ability of the borrower to make payments after a mortgage reset because the mortgage would be refinanced before the reset, and the borrower would profit from the price appreciation.[10] If a borrower could not make the mortgage payments, house price appreciation made certain that the lender was paid and the borrower might also make a profit. One reaction to this was the popularity of no-documentation or low-documentation mortgages in which borrowers supplied little or no information about their financial situations. Another response was the extension of subprime mortgages to borrowers with impaired credit histories. All of these mortgages depended heavily upon home price appreciation to provide repayment in case of foreclosure. Where home prices stop appreciating rapidly, the collateral represented by the home can be insufficient to liquidate the debt without a loss to the lender.

Selected Previous Government Interventions

The federal government has intervened in the past to modify market outcomes. In keeping with the current debate on the subprime mortgage actions, this section analyzes in greater detail those previous government actions that directly affected individuals and those that are most relevant to the current discussion on assisting homeowners.

This report examines four government market interventions: (1) the Home Owner Loan Corporation (HOLC) of 1933; (2) Continental Illinois in 1994; (3) the savings and loan crisis of the 1980s; and (4) Brady bonds in 1989. HOLC is included because it has been widely mentioned as a possible model for government action. Continental Illinois, in 1984, is included because the bank failed to properly underwrite loans, and because the Federal Reserve and the Federal Deposit Insurance Corporation led assistance efforts. The savings and loan crisis of the 1980s is included because the problems were closely connected to the financing of homes. Brady bonds are discussed in part because previous attempts to solve the international financial distress failed and also because the comparison between earlier attempts and then-U.S. Treasury Secretary Nicholas F. Brady's proposal might be useful.

---

[9] (...continued)
Hatcher, "Foreclosure Alternatives: A Case for Preserving Homeownership," *Profitwise News and Views,* February 2006, p. 1, at [http://www.chicagofed.org/community_development/files/02_2006_foreclosure_alt.pdf].

[10] CRS Report RL33930, *Subprime Mortgages: Primer on Current Lending and Foreclosure Issues,* by Edward Vincent Murphy.

Home Owners' Loan Corporation

HOLC was established in 1933 to prevent mortgage foreclosures.[11] Mortgages at that time usually were for three to five years, were generally expected to be renewed, and did not amortize (i.e., were not designed to be paid in full by a series of monthly payments). HOLC exchanged its bonds for mortgages that were in default and mortgages held by financial institutions that were in distress. In HOLC's first year, the federal guarantee increased from interest only to interest and principal. Mortgages were limited to one- to four-unit structures, with an HOLC-appraised value of $20,000 or less ($321,791 in 2008 dollars), could be for no more than the lesser of $14,000 ($225,254 in 2008 dollars) or 80% of HOLC appraised value, carried a maximum interest rate of 5%, and required monthly amortizing payments for not more than 15 years.[12] The $14,000 maximum mortgage meant that a house worth the maximum value of $20,000 could not have a mortgage for the maximum 80% loan-to-value (LTV) ratio.

HOLC was authorized to issue up to $4.75 billion ($76 billion in 2008 dollars) in bonds that could either be exchanged for defaulted mortgages or for cash. The cash could be used to purchase mortgages from lenders who did not want to take the HOLC bonds. The bonds carried a maximum interest rate of 4% for a maximum of 18 years and were exempt from all state, local, and federal taxes.[13] HOLC lent homeowners money to pay taxes and insurance.

Contemporary Issues. At the time that HOLC was created, some were concerned that lenders would not accept the HOLC bonds. This was addressed by allowing the defaulted mortgages to be purchased for cash and increasing the government guarantee on interest to a federal guarantee on both principal and interest. Today, both private and FHA mortgage insurance guarantee payment of principal and interest.

Results. Not all of those eligible applied, and not all those who applied were eligible. Approximately 40% of those eligible for HOLC mortgages applied and half of these were rejected or withdrawn. Of this 50%, 16% were withdrawn, 18% were rejected because of inadequate house value, and 13% were rejected for lack of distress.[14]

HOLC employees were not civil servants, and the corporation did not follow federal procurement regulations. Although some forecast that HOLC would lose

---

[11] C. Lowell Harriss, *History and Policies of the Home Owners' Loan Corporation* (New York: National Bureau of Economic Research, 1951). 48 Stat. 128 et seq. created the HOLC.

[12] Interest-only payments were later allowed for the first three years. All historic dollar amounts in this report are update to 2008 dollars using the Consumer Price Index and the calculator available from the Federal Reserve Bank of Minneapolis at [http://woodrow.mpls.frb.fed.us/research/data/us/calc/].

[13] This exclusion included estate, inheritance, and gift taxes, but not a progressive surtax.

[14] Harriss, p. 24.

money, it ended up making a relatively small profit when it was liquidated in 1951, in part because declining interest rates and the government guarantee allowed it to borrow inexpensively.[15] HOLC developed its own mortgage processing and servicing system. It supervised and trained appraisers.

HOLC negotiated flexible repayment terms, but it sought eventual full repayment of the mortgages. It developed new methods of working with borrowers who became delinquent, including personal contact with the borrowers. HOLC would try to find jobs for unemployed homeowners and suggested renting out spare bedrooms. Beginning in 1937, it rewrote loans to make them more affordable. Of the one million loans HOLC issued, it acquired 200,000 homes from borrowers who were unable to pay their mortgages; the national foreclosure rate was 19.4%, but there was wide variation in different states.[16] New York and Massachusetts had foreclosure rates of more than 40%, but foreclosure rates in Michigan, West Virginia, Florida, Montana, Idaho, Wyoming, New Mexico, Nevada, and Oregon were less than 10%.[17] HOLC set the price on the foreclosed homes, included financing, and worked with local real estate agents. At its peak, HOLC had 20,000 employees in 458 offices where applications were accepted.[18]

Although there were provisions to purchase mortgages held at troubled banks, HOLC was designed to work with homeowners.[19] Based on the appraised value, the amount of the new mortgage could be less than the original mortgage, and the lender could take a loss on the mortgage. From an economic point of view, this was providing the lender with financial incentives to mark the mortgage to the current (market) value and to recognize the loss.

Application to Subprime Mortgage Restructuring. A program similar to HOLC could be adopted by Congress. Several questions would need to be answered in applying the lessons from the HOLC to the current situation:

- What is the maximum house value that could participate in the program?
- What should the maximum loan-to-value ratio be?
- What should the maximum term of the loans be?
- Should there be any restrictions on the interest rate?
- Should the government or the private sector run the program?

---

[15] Harriss, p. 6.

[16] Harriss, p. 75.

[17] Harriss, p. 75.

[18] Harriss, p. 140.

[19] In a time when all records were kept on paper, a bank failure could prevent homeowners from making mortgage payments resulting in their delinquency.

- How should delinquencies and default by those being assisted be treated?

- Should the new organization follow HOLC's experience and help delinquent homeowners find better jobs and rent out spare bedrooms?

- Should there be a predetermined ending date for the program? If so, should this be a fixed date or one at which some measurable criterion is met?

Continental Illinois

In the first quarter of 1984, Continental Illinois, a major United States money center bank, lost $140 million ($291 million in 2008 dollars) triggering a run by uninsured depositors.[20] The Federal Reserve made secret loans to Continental to provide liquidity and to prop it up. In May 1984, the Federal Deposit Insurance Corporation, the Federal Reserve, and 16 money center banks announced that they would support the uninsured deposits. Additional assistance was required in July 1984. Government assistance totaled $4.5 billion ($9.3 billion in 2008 dollars). The FDIC purchased problem loans at a discount and invested $1 billion ($2 billion in 2008 dollars) in Continental. Continental was re-capitalized giving the federal government 80% of its shares; most of the equity of the shareholders was eliminated.

Contemporary Issues. There was little congressional debate in the Continental case because there was no congressional action required. Observers expressed concern that, by giving a de facto guarantee on uninsured deposits, market discipline was being weakened. Some argued that a bank of Continental's size could not be allowed to fail because failure would impact other U.S. and foreign banks. Some questioned the effectiveness of government bank regulation that allowed Continental to engage in risky lending and incur what were then record losses.

Results. The intervention led to management changes. Bank of America purchased Continental in 1994. Congress passed the FDIC Improvement Act of 1991 to strengthen large bank regulation.[21]

Application to Subprime Mortgage Restructuring. In this case, the Federal Reserve, FDIC, and other banks engaged in the immediate intervention. This appears to be similar to the actions of the Federal Reserve and JP Morgan Chase in

---

[20] Federal Deposit Insurance Corporation, "Continental Illinois and Too Big To Fail" and "Continental Illinois National Bank and Trust Company," *History of the Eighties — Lessons for the Future*, at [http://www.fdic.gov/bank/historical/history/235_258.pdf#search=' Continental%20Illinois'] and [http://www.fdic.gov/bank/historical/managing/history2-04.pdf], respectively. A "money center bank" is one of the nation's largest and usually does business internationally with governments, businesses, and other banks.

[21] P.L. 102-242, 105 Stat. 2236 et seq.

the recent intervention leading to the JP Morgan's purchase of Bear Stearns.[22] Continental had grown rapidly and raised funds by borrowing from other banks (federal funds) and with large, wholesale certificates of deposit (CDs). Continental participated heavily with Penn Square Bank in loans to gas and oil projects. After Penn Square was closed because of defaults on these loans, other banks and CD holders became concerned that Continental might not be able to pay them back. The banks and CD holders refused to roll over their investments.

An analysis by the FDIC concluded that Continental had failed to properly underwrite oil and gas loans made with Penn Square Bank. Many analysts say that subprime lenders also failed to properly underwrite loans, but in this case the loans were to homeowners.

Savings and Loans

In the 1980s, many U.S. savings and loan associations (S&Ls) expanded beyond their traditional business of making mortgages to local home buyers. At the same time, S&L profitability declined because of rising interest rates and a mismatch between maturing of S&L assets and liabilities, resulting in 563 S&L failures between 1980 and 1988.[23] In some cases, fraud, including land "flips," was a factor in S&L failures. The Federal Savings and Loan Insurance Corporation (FSLIC), a federal agency that insured most S&L deposits, became insolvent. Some S&Ls were chartered and guaranteed by states including Ohio and Maryland; these state-sponsored insurers also failed as depositors withdrew their money out of concern for the institutions' financial safety.

Contemporary Issues. Debate centered on estimates of the cost of restructuring the S&L industry and how to pay the cost. There was some concern over forcing high-risk S&Ls out of business.

Results. Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) to "reform, recapitalize, and consolidate" the federal deposit insurance system, but not bail out individuals or lenders.[24] Borrowers were still required to pay their loans. To the extent that federal intervention led to general confidence in financial markets, consumers benefitted. Congress provided $91.3 billion ($158.7 billion in 2008 dollars) to the Resolution Trust Corporation to pay for the restructuring. One estimate of the direct and indirect costs to the private and public sectors was $152.9 billion ($191.4 billion in 2008 dollars).[25]

---

[22] See CRS Report RL34420, *Bear Stearns: Crisis and 'Rescue' for a Major Provider of Mortgage-Related Products*, by Gary Shorter.

[23] In short, the S&Ls financed long term loans by taking in short term deposits. When interest rates increased, to keep and to attract deposits the S&Ls had to pay higher interest rates than they were earning on their loans.

[24] P.L. 101-73, 103 Stat. 183 et seq.

[25] Timothy Curry and Lynn Shibut, "The Cost of the Savings and Loan Crisis: Truth and Consequences," *FDIC Banking Review*, December 2000, p. 31, available at

(continued...)

Application to Subprime Mortgage Restructuring. The S&L intervention is included because the problems in the thrift industry were in part due to mortgage lending. However, the purpose of the savings and loan intervention was to minimize the cost to the government of honoring the federal insurance of deposits at illiquid and insolvent savings and loans. Most depositors were not at risk unless the federal government failed to honor its guarantee, and this was not considered. A few depositors were at risk for the amount above $100,000.[26] The intervention was important to the viability of the financial system; the same could be argued for much of the Federal Reserve's recent actions.

Brady Bonds

In 1982, a variety of factors combined to result in problems for Latin American nations trying to repay loans, mostly to U.S. commercial banks. Most observers blame relaxed lending standards, poor debt management by borrower countries, and a changing international economy for the inability of debtor nations to repay their debts.[27] U.S. banks accounted for $91.8 billion ($205.1 billion in 2008 dollars) of $219.4 billion ($490.2 billion in 2008 dollars) lent worldwide to 17 highly indebted countries. Initial attempts by then-U.S. Treasury Secretary James Baker to combine structural economic changes of debtor nations, and debt rescheduling including lengthening maturities did not succeed because of difficulties in coordinating action among lenders.[28] In 1989, then-U.S. Treasury Secretary Nicholas F. Brady proposed what became known as the Brady Plan — a combination of bank loan forgiveness and repackaging remaining debt into bonds that could be traded on securities markets. One key feature of the Brady Plan was for lenders to recognize that doubt over the timely repayment of the existing debt had reduced its value and to agree to allow borrowers to buy back debt at a discount.

After the buyback, the remaining loan principal was restructured using three types of bonds:

- In the first case, dollar-denominated discount bonds paying market interest rates were exchanged for outstanding commercial bank loans. These bonds were interest only; principal was repaid at maturity.

---

[25] (...continued)
[http://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf].

[26] P.L. 96-221, 94 Stat. 132 et seq., *Depository Institutions Deregulation and Monetary Control Act of 1980*.

[27] This section is based on CRS Report RL30348, *Ecuador's Brady Bond Default: Background and Implications*, by J. F. Hornbeck, and also Patricia A. Wertman, "The 'Brady Plan': A New Director in Third World Debt Strategy," *CRS Review*, October 1989, pp. 22-23.

[28] Mark Spiegel, "Collective Action Difficulties in Foreign Lending: Banks and Bonds," *Federal Reserve Bank of San Francisco Economic Letter*, August 23, 1996, available at [http://www.frbsf.org/econrsrch/wklyltr/el96-24.html].

- In the second case, dollar-denominated, below market interest rate bonds were exchanged at face (par) value for outstanding commercial bank loans. These bonds, also, were interest only with the principal repaid at maturity.

- In the third case, dollar-denominated bonds were exchanged for outstanding loans at face value and paid market interest rates.

In addition, banks provided new money to maintain liquidity of the borrower nations.

Borrower nations were required to purchase U.S. Treasury zero coupon bonds that were held in escrow at the Federal Reserve Bank of New York to partially collateralize the principal of discount and par bonds.[29] Debtor countries, also, collateralized 12-18 months of interest by making a deposit at the Federal Reserve Bank of New York or by purchasing U.S. Treasury bills. The World Bank and the International Monetary Fund (IMF) made structural adjustment loans to debtor nations.

Contemporary Issues. Discussions at the time centered over what countries would be eligible for debt restructuring and the terms of the restructuring. The analogy for aiding homeowners delinquent on mortgage payments would be the question of who should be eligible and how the mortgages should be recast.

Results. The Brady Plan is widely credited with accelerating the creation of new international financing mechanisms. By shifting much lending from bank loans to bonds, liquidity was added to the international financial system, which has grown in the intervening years, benefitting many nations. Liquidity and the multiple types of bond exchanges meant that lenders did not have to agree on a single solution.

Application to Subprime Mortgage Restructuring. On the one hand, the Brady Plan restored financial stability to U.S. commercial banks and international lending grew. More affordable terms and the assurance of long-term financing were benefits to both borrowers and lenders. Brady bonds allowed the federal government to facilitate the restructuring of debt into more affordable payments without any federal guarantee.

On the other hand, shifting the denomination debt from the borrower's currency to dollars shifted exchange rate risk from lenders to borrowers. New collateral shifted more risk from the U.S. banks to the debtor nations. Not every debtor nation was willing and able to renegotiate its loans. Banks negotiated custom agreements with some debtor nations. This was practical because of the size of the loans. Mexico, for example, had $17 billion ($40 billion in 2008 dollars) in short term debt.[30] This renegotiation might be more difficult in the case of two million

---

[29] The issuer of a zero coupon bond pays all interest and principal at maturity. The bond is sold for less than this single payment. A zero coupon bond pays compound interest — interest on interest like a saving account does — while a coupon bond pays simple interest.

[30] "Companies and Markets: Focus on Precise Terms of Mexican Debt Moratorium,"
(continued...)

mortgages that could default in 2008 and 2009, most valued in the hundreds of thousands of dollars.[31]

Lenders recognized losses on existing loans, but had more assurance that renegotiated loans would be repaid in full and on time. Borrowers had more manageable repayment schedules.

A similar approach could be used to restructure subprime loans. Some mortgages could have their principal and/or interest rates reduced. This could be viewed as an acknowledgment of the economic reality that the value of the subprime mortgage is less than its face value because of the weakened value of the home as collateral and the increased probability of default. Lenders might be willing to advance additional funds to some subprime borrowers if these funds were placed in escrow as collateral for a new loan. HOLC used a similar recognition of the reduced value of the mortgages it purchased.

It is likely that not every subprime borrower facing an interest rate reset would be willing or able to renegotiate their loans. Lenders would be unlikely to agree to renegotiate terms that would leave them worse off than foreclosure. For example, if a homeowner cannot afford to make payments on a fixed rate mortgage based on the current value of the home, the lender is likely to decide that foreclosure is the more profitable option. If this inability to make payments is temporary, such as would be the case if someone is unemployed but likely to find a new job shortly, the longer run interests of the lender might be to negotiate a new mortgage. If, however, the inability to make payments is seen as permanent, then lenders are more likely to be unwilling to negotiate.

It is not likely that a domestic private sector, third party would make additional loans to subprime borrowers in a manner such as the IMF and World Bank did for debtor nations. This might be a role for FHA or the Veterans Administration.

Conclusion

If Congress were to consider some intervention to aid homeowners, there are a number of questions for its consideration:

- Who should be helped? Should there be an income limit? Should it be limited to owner-occupied housing?

- What should be the tax treatment of the assistance?

---

[30] (...continued)
Financial Times, August 31, 1982, p. 19.

[31] Mark Zandi, "Testimony of Mark Zandi before U.S. House Judiciary Committee," October 30, 2007, at [http://judiciary.house.gov/OversightTestimony.aspx?ID=1188].

- Who should administer the program? What should happen if foreclosure becomes necessary?

- What should be the government's continuing role? Should the program have a fixed life?

- What restrictions, if any, should be placed on the ability of homeowners that receive assistance to sell their homes in the future? What if the sale is at a profit? What if the sale is at a loss?

- If the government makes a financial contribution, how much should it be and how should it be financed?

One of the lessons from these four instances of government intervention is that those in financial difficulty are frequently reluctant to acknowledge the existence or severity of the problem. On the other hand, in these four cases, recognition that substantial losses had occurred was a key to beginning the recovery process. The question remaining was how the losses could be paid for at the least cost.

Most government market interventions have used the emergency medicine principal of triage to divide those into distress into three groups: those who cannot be helped with the resources available, those who will recover (or at least survive) without any help, and those who will recover only with immediate assistance. The difficulty is in determining to which category the affected persons or institutions should be assigned.

HOLC and Brady bonds involved negotiations between the borrower and the organizations involved in the refinancing. Not every distressed borrower was willing or able to meet the terms of the assistance effort. It is probably unrealistic to expect that any plan could keep all subprime borrowers in their homes. For example, some borrowers will become unemployed and not have the income to make even reduced mortgage payments. Even a moratorium on foreclosures would prevent loss of homes only while the moratorium lasts.

The HOLC experience was that some of those who could be helped would not contact the HOLC. It was necessary for HOLC to reach out to borrowers who became delinquent and to develop personalized plans to modify the mortgage so that it could be repaid eventually. Many of the largest mortgage lenders and associations such as those represented by HOPE NOW are urging delinquent homeowners to talk with their lenders and credit counselors.[32] HOPE NOW, also, is dividing callers into three categories trying to work quickly with the easiest situations first so that those who require more extensive help can get the resources needed.

---

[32] Members of HOPE NOW include Fannie Mae, Freddie Mac, Bank of America, Countrywide, JPMorgan Chase, Washington Mutual, and Wells Fargo. A complete list is available at [http://www.hopenow.com/]. In addition, FHA is urging borrowers experiencing financial difficulty to contact their lenders. FHA has information available at [http://portal.hud.gov/portal/page?_pageid=33,717348&_dad=portal&_schema=PORTAL].

Economists use the phrase “moral hazard” to represent the change in behavior due to insuring risks. Purchasing insurance probably makes some individuals more likely to take risks than would be prudent without the financial safety net. Economists who worry about moral hazard are concerned that a government intervention in a market outcome also encourages individuals and companies to pay less attention to risk in the future in the expectation that the government will intervene again. They worry that in the case of a government intervention to help homeowners, the possibility of a repeat of the intervention could encourage some lenders to lend more than they would, absent the history of government action. It is possible that homeowners who are helped and others who see the intervention occur also could react this way.