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A Strategic Proposal to Combat Strategic Residential Mortgage Defaults

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More and more we are hearing that occupants of residential real estate with mortgages far in excess of the current market value of the real estate are *choosing* to default on those mortgages. It is not that they do not have the income to keep current on their principal and interest payments. Rather, they have made a calculation that it would take many years for the value of their properties to rise back to the amount outstanding on the mortgages of these properties. So, some have simply stopped sending in their monthly P&I payments and will just wait until the sheriff arrives with a foreclosure notice from the lender. This is not entirely irrational from an economic perspective, especially if one can rent a similar abode for less than the after-tax cost of home ownership.

From the lender's perspective, what might be the strategy to minimize his loss? Make no mistake, there *is* a loss. The value of the collateral is less than the outstanding amount of the mortgage. Several years ago, when the housing bust was still in its relative infancy, a regulator, of all people, came up with a strategic proposal to deal with strategic mortgage defaults. The strategy is for the lender to write down the principal on the mortgage outstanding to an amount closer to the current actual market value of the property.

Residential real estate has an important difference from, say a pickup truck. Unless that pickup truck becomes a classic or unless there is rampant inflation, the value of that pickup truck will continue to go down. Residential real estate is a different animal. Although the actual structure that sits on the land may be a depreciating asset, over time, the land itself tends to appreciate. As a result of the likely future appreciation of the land component of residential real estate, this clever regulator (if that is not an oxymoron) proposed that if the lender wrote down the principal on an underwater mortgage, he, along with the occupant of the house, would agree to split any future appreciation of the property.

Again, the lender takes a loss today. But the lender has the opportunity to recoup some of his loss by sharing in the likely future appreciation of the value of the property. Moreover, because the current occupant of the property also has the opportunity to share in the future appreciation of the value of the property, she has the incentive to maintain the property. But wait. Doesn't this reward bad behavior on the part of the borrower? It doesn't have to. The deal could be for the lender to reduce the principal amount outstanding on the mortgage, but not all the way down to the current market value. Thus, the mortgage still would be "under water," just not as much so.

This seems like, if not a win - win situation, at least a minimize loss – minimize loss situation to me. The lender does not have to throw a piece of distressed property on the market. He has someone continuing to mow the lawn. The borrower does not have to go through the hassle of

moving. And, as an added benefit, there is no need to create the deadweight loss of a government bureaucracy to oversee such a resolution.

Why Not Graduated Capital Ratios?

Most observers recognize that part of what made the recent financial crack-up so severe was the lack of capital by some big players. As financial institutions get bigger, their failure can bring down the system. How big is too big? I don't know. But why not require an institution that is getting bigger and bigger to hold higher and higher capital relative to its assets? This would provide more cushion against actual losses, thereby mitigating taxpayer liability. Moreover, graduated capital ratios would provide a market-based governor on institutions getting too big. After all, if your capital *ratio* goes up with the value of your asset base, then, unless those assets are exceptionally profitable, your return on equity will be adversely affected by your relatively reduced leverage. Yes, the trick is to figure out the optimal "progressivity" of the capital ratios. Perhaps the regulator who came up with the strategic solution to strategic defaults also could come up with a rational approach to the progressivity of capital ratios. If not him, then someone at the U. of C. business school could.

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