

## **Banks must help solve the lurking crisis in mortgage defaults**

An estimated 200,000 home loans are now 'under water'

By [Professor Sandeep Gopalan](#)

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A mortgage default crisis lurks underneath the surface. Yet all we hear is talk. Cheap talk about a government bailout, without concrete action, only creates incentives for borrowers to defer payments in the hope of a better deal, hastening a crisis.

Half measures like the mortgage relief plan and suspension of repossessions won't work. President Obama's \$75bn (€55bn) rescue plan did not stop 2.8 million foreclosure filings in the US in 2009. Band-Aid cannot stop arterial bleeding. Emergency procedures are needed.

Here's why. An estimated 200,000 Irish mortgages are under water.

Monthly payments are significantly in excess of prevailing market rents for similar properties, meaning that the payments are good money thrown after bad. It makes little economic sense to continue to make these high payments when many borrowers can ill afford them.

Given the psychological aversion to losing one's home, mortgage payments are prioritised over other expenditure. Homeowners are deferring other spending in order to keep up with their mortgages, continuing the spiral of money away from economically productive uses to prop up still unsustainably high property prices.

Mortgage tax relief contributes to this waste. We need to strip away antiquated value judgments about debt and approach mortgages from a purely economic perspective. When a similar house can be rented for several hundred euro less (in the same or a comparable neighbourhood) why stay and pay more? Why should the State subsidise an unaffordable lifestyle via mortgage relief?

No one ever complains about mortgage relief, even though this socialist-sounding, help-the-average-Joe plan is actually a wealth transfer to banks.

Would it not be preferable to allow underwater homebuyers to walk away? The answer is a qualified yes, but significant reform would be needed. First, the state must use its financial hold over the banks and change troubled mortgages to make them "non-recourse". Banks can then access only the house, in case of default, not other assets.

## **Prudent**

This would help ensure that banks only take prudent risks. If the house is not worth the amount of the loan, they bear the risk with no ability to access the borrower's other assets.

Critics complain that allowing underwater borrowers to walk away gives an incentive not to repay -- "moral hazard". It could also trigger a crescendo of defaults. They will argue that borrowers acted recklessly and should be punished.

They are right. But we have already thrown moral hazard to the winds by bailing out the banks.

Virtually every decision taken to rescue the economy from collapse entails moral hazard. How is this one any worse than those created by the many pro-lender policies of recent vintage?

Objections might be met by restricting the scheme to first-time homebuyers. But even admitting the pitfalls, such a policy has several positive results.

These include property price correction and channelling savings to more efficient uses.

Mollycoddling banks by allowing them recourse to other borrower assets only insulates them from facing reality. Just as borrowers were not forced to buy extravagant houses, banks were not coerced to lend. What is sauce for the goose is sauce for the gander.

If the nuclear option of walking away becomes a real possibility, banks face the prospect of recovering a fraction of the outstanding loan in an auction.

Painful as this is, bankers will take a hard look at alternatives. It might well persuade them to adjust monthly payments to reflect market rents for borrowers with the ability to pay similar amounts. This might still be profitable if the rental market is strong.

Desperate times call for desperate remedies and bankers might also learn to get creative in ways other than cooking the books. They could enter into equity-debt swap deals with borrowers to take advantage of an eventual turnaround in property prices in exchange for stable but affordable rent payments.

This would be a win-win for both parties. It might also signal a return to old-school customer-engaged banking. One option for government policy would be to set up a professionally managed venture capital (VC) fund to buy suitable properties at auction. Such decisive intervention will prevent protracted vacancies and minimise blight.

These properties could be leased out and sold when the market recovers. Taxpayers would derive the benefits from property prices going up under this model, in contrast to the mortgage assistance plan which is merely robbery by another name from prudent people who chose to live within their means.

## **Advantages**

The problems caused by having to hold property for long periods could be mitigated by opening up the fund to private investors.

This also has collateral advantages: offering taxpayers the ability to participate in profits from the VC fund reduces the deeply divisive political cost of rescue and sets off secondary economic activity. It is certainly superior to the alternative of higher taxes.

To be sure, borrowers need to pay a price consistent with our notions of civilised justice for their reckless decisions.

Our legal system fails here too: debt and bankruptcy laws are crude, inefficient, over-punish, and create bad incentives.

Reform is essential. Wilful default must be decriminalised.

Why should taxpayers subsidise the lender's cost of enforcement by allowing him to use state police power?

Even if many defaulting debtors are not being sent to jail, the threat of jail-time casts a serious shadow.

The civil justice system is perfectly adequate to resolve these disputes.

All debts are not moral debts. Borrowers and lenders must be free to approach paying versus defaulting as rational economic options without the threat of the law on one side of the deal.

Finally, the stigma associated with bankruptcy must be buried.

Irish law's approach to bankruptcy is reminiscent of Nathaniel Hawthorne's 'The Scarlet Letter': "It is too deeply branded; Ye cannot take it off."

Twelve years is too long for exit from bankruptcy, and even then it is not clear that reintegration is possible without continuing impediments.

The system must be based on giving a fresh start rather than on stigmatising and hanging an albatross around the debtor's neck.

The Government's policy of robbing Peter to keep Paul in an expensive house will not stop the mortgage default crisis.

Hard choices are imperative in order to stop a descent into a society of debt slaves.

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