THE $700 BILLION BAILOUT: TREATING THE SYMPTOMS NOT THE CAUSE OF THE MORTGAGE PROBLEM

BERKELEY Fisher Center for Real Estate & Urban Economics Chairman, Kenneth T. Rosen, today released his position on the Bush Administration’s proposed financial market bailout.

Problem I: The illiquidity and the eroding and uncertain value of mortgage securities held or guaranteed by banks, investment banks, insurance companies, and other investors.
Solution I: Massive Loan Restructuring at the Consumer Level
If we solve the foreclosure problem at the consumer level, the root cause of the present problem, we will increase the value of mortgage related securities and reduce the losses to the system. Foreclosures, all else equal, will double the loss on mortgages versus a loan modification program that keeps people in their houses. Whether or not Treasury purchases these securities, the only way to treat the mortgage problem is a massive loan modification at the consumer level. I propose an immediate 90-day moratorium on foreclosures to allow the modification plan to be put in place. With the Treasury's control of Fannie Mae, Freddie Mac, the Bear Stearns portfolio, and possibly the purchase of $700 billion of mortgage securities, loan modification can be accomplished and save perhaps 75% of homeowners and hundreds of billions for the taxpayers. To turn these portfolios over to the asset managers rather than try to restructure the underlying loans is wasting a great opportunity to actually solve the problem.

Problem II: Capital Adequacy of Banks, Investment Banks, and Insurance Companies.
Solution II: Directly address the problem by the Treasury buying Preferred Stock at a high interest rate. (The high interest rate will encourage companies to refinance as soon as possible.) Suspend “Mark to Market Accounting” for illiquid but performing loans. This will break the death spiral of asset value mark downs that require companies to raise more capital as they report mark to market losses.

Problem III: Restriction of Residential Mortgage Credit
Solution III: Aggressively use Fannie Mae, Freddie Mac, and the Federal Housing Administration to return the capital flow to the residential mortgage and housing sector. We have moved from the easiest lending standards in history to extremely tight lending standards. We need a transition period where we relax current lending standards to allow refinancing of existing problem loans and stimulate housing demand. It will be a difficult balancing act between riskless underwriting and somewhat more risky, but much needed, credit extensions.
Problem IV: House Price Declines

Solution IV: Let the market adjustment work. Stabilizing house prices is a difficult goal to achieve and in fact may be counterproductive in putting housing markets on a path to sustainable recovery. Lower house prices improve affordability for potential home purchasers as well as reducing equity of existing home owners and investors. The huge run-up in house prices from 2003 to 2006 in many markets was fueled by cheap and poorly underwritten credit. House prices that doubled in five years in many markets were not sustainable. Based on income growth and normal mortgage lending standards, house prices need to fall 20-50% in a number of markets to foster a sustainable recovery. This inevitable decline is painful to homeowners and lenders who bought or over lent at the peak, but the price adjustment after the bubble is the best way to return stability to the market.

After solving the near term economic and financial crisis, we need a systemic reform of the financial system which recognizes the importance of globalization and securitization in the 21st century capital market. We must move away from the "radical" free market fundamentalism which is just as dangerous to our country as religious fundamentalism. We must move back to basic principals of risk management, reduced leverage, and sound and sustainable lending and investing practices. This would involve tougher suitability standards for lending and investing. It would involve a move back to transparent lending and investment vehicles, and away from financially engineered opaque products.

###
Pros and Cons of the Troubled Asset Relief Program (TARP)

Positives
- Taking bad loans off balance sheets ends bleeding and prevents dumping of illiquid assets
- Reduces capital raising need of financial institutions
- May eventually encourage balance sheet stability and securitized lending

Negatives
- Exploding Deficit and rise in Treasury borrowing costs
- Potential Dollar weakness
- Details of purchase price critical in evaluating further writedowns and taxpayer burden
- Opens Pandora Box.....assets other than mortgages might be included.....other industry bailouts required----nationalization of financial system
- Likely very tough re-regulation of the financial system
- Moral Hazard