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TO: Interested Parties

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RE: The Case Against a Foreclosure Moratorium

In recent weeks, home mortgage lenders have come under increasing scrutiny and criticism for filing potentially faulty foreclosure paperwork in roughly 23 states where a court order is required for foreclosure.[1] Among the various practices now under fire is "robo-signing," in which document processors purportedly signed thousands of affidavits without reviewing the underlying paperwork or without the required notary.

As egregious as these practices are, they still do not justify a national moratorium on foreclosures. The nation's housing market is far from robust health. Even with interest rates for a 30-year fixed-rate mortgage at just 4%, new and existing home sales are still at or near record lows,[2] and home prices have continued to decline. In August, the median home price in America was $178,600, down 18.4% from 2007. Inventories are also high. In August, existing housing stock was 3.98 million units (or an 11.6 month supply).[3]

Given the fragile state of the housing market, a blanket moratorium—while well-intended—would only prolong the crisis. Here's why:

1. It would only forestall—not prevent—foreclosures.

In the overwhelming majority of instances, a moratorium would only serve to delay the inevitable. Aside from some isolated instances of mistaken seizures,[4] the current problems surrounding servicers and the foreclosure process involve borrowers who were delinquent to begin with—not borrowers who were current on their loans.

In the original case that brought "robo-signing" first to light, which involved a Maine homeowner who fell behind on payments after losing a job, the homeowner's own attorneys acknowledged that, "[h]ad GMAC [the lender] followed the legal requirements, she would have lost her home a long time ago."[5] While some proponents of a moratorium claim that borrowers are being "defrauded" or "declared in default … when they aren't,"[6] there's currently no evidence that a large number of homeowners who are not delinquent on their loans are facing foreclosure.

Unquestionably, policymakers need a robust set of ideas that will mitigate the human impacts of foreclosure and prevent foreclosures that are unnecessary. But processing errors cannot justify a national policy to prevent foreclosures from happening at all. Such a solution fails to address the root causes that are leading to foreclosures in the first place—such as unemployment and the need for more effective home mortgage modification programs.

A moratorium would not change the fact that many borrowers facing foreclosure would be unable to keep up with their mortgages, regardless of the circumstances. And once a moratorium is lifted (since that is inevitable), these borrowers would simply find themselves at status quo ante, if not worse off than before.

2. It would worsen the crisis by encouraging more defaults.

At the end of the first quarter of 2010, 11.2 million, or 24 percent, of all residential properties with mortgages were "underwater"[7]—meaning that homeowners owed more on their mortgages than their homes were worth.

While the fact of so many underwater borrowers is a drag on the overall economy, these borrowers also present a specific threat: they are the most likely to walk away (i.e., "strategically default"). By doing so, they would cause home values to fall even further, which in turn would put yet more borrowers at risk of going underwater as well. To stop this vicious spiral, policymakers must encourage underwater borrowers both to stay in their homes and stay current on their mortgages.

A foreclosure moratorium, however, would have the opposite effect by essentially eliminating the penalties of a default. If a homeowner is underwater, why not stop paying the mortgage if they can't be forced to leave the house?

In June 2010, the national default rate was 13.20%.[8] In battered states like Florida, Nevada and Georgia, the delinquency/foreclosure rates were an astounding 23.6%, 21.8% and 15.8% respectively. The housing market can't recover unless these rates come down. But a moratorium could in fact encourage the delinquency rate to rise.

States with Highest Mortgage Delinquency Rates (June 2010)

Florida	23.6%
Nevada	21.8%
Mississippi	18.4%
Georgia	15.8%
Arizona	14.7%
National	**13.2%**

Source: LPS Mortgage Monitor[9]

3. It would put a brake on pending home sales and erode demand.

One gauge of the housing market's health is whether people start buying homes again. Even as home sales activity in general is still slow, sales from foreclosures have been picking up. In fact, as many as one in four homes sold during the second quarter was in some stage of the foreclosure process, according to RealtyTrac Inc.[10]

This is a positive trend. Foreclosure sales allow banks to get bad loans off their books so they can make new loans to new borrowers. They prevent houses from standing vacant and lowering the value of neighboring properties. (In the second quarter of 2010, as many as 18.9 million homes stood vacant).[11] Processing foreclosures, especially vacant foreclosures, enables many new buyers to find a home at a relatively reasonable price.

A moratorium would bring all this to a halt. It would jeopardize thousands of sales contracts already in process and potentially push many buyers to the sidelines when restoring demand is critical. And given that one in four home sales is currently a foreclosure, a moratorium would essentially dry up 25 percent of the available market.

Moreover, in addition to drastically reducing the number of available homes on the market, a moratorium would further delay the availability of more homes coming to the market. As it is, an analysis by LPS Analytics found that nationally, foreclosures now take an average of 478 days, while in states such as Florida, foreclosures take an average of 573 days to complete.[12]

Foreclosure Sales as a Share of Home Sales

Nevada	56%
Arizona	47%
California	43%
Rhode Island	37%
Massachusetts	35%
Florida	34%
Michigan	33%
National	**24%**

Source: RealtyTrac[13]

4. It would weaken community banks and credit unions.

Unlike mortgage banks, many community banks and credit unions are more likely to keep the mortgage loans they make on their books instead of selling them to the secondary market.[14] As of June, residential loans made up 54.7% of credit unions' portfolios.[15]

Community banks and credit unions were not immune from making bad loans, which has worsened the health of many of these institutions. By October 2009, a year after the rescue of "Too Big to Fail" banks, one hundred "too small to save" banks had been taken over by the FDIC.[16] The total number of small bank takeovers to date this year now stands at 132.[17] These failures continue to put an enormous burden on the FDIC, which is now supported by taxpayers because the premiums paid by banks have been insufficient to cover losses.

To restore their health, community banks and credit unions must get bad loans off their balance sheets so they can replace them with new loans to stronger borrowers. However, a foreclosure moratorium would force these institutions to continue to carry bad loans. This not only adds additional stress to the health of these institutions, it prevents them from extending new credit to new borrowers.

Moreover, because these institutions tend to hold a portion of their mortgages in portfolio instead of selling them to another entity, a foreclosure moratorium actually puts a disproportionate burden on smaller banks.

5. It's unfair to taxpayers.

A freeze on foreclosures will also burden taxpayers because it will increase the cost to Fannie Mae and Freddie Mac, both of whom are now wards of the federal government.

The reason is that Fannie Mae and Freddie Mac are still obligated to pay interest and principal on the mortgage-backed securities they have guaranteed, even if there is no money coming in on the underlying mortgage (that's the nature of their guarantee). As long as a foreclosure isn't finalized, there will be no money coming in on the underlying loan from a foreclosure sale or otherwise. Fannie and Freddie will thus remain on the hook for any guarantee payments on securities backed by that mortgage. And as long as Fannie and Freddie are in federal conservatorship, these payments will be financed directly by American taxpayers.

Paul Miller, an analyst at FBR Capital Markets notes, "If all foreclosures are delayed for three months, that could lead to $6 billion in losses across the industry, with around half of those falling on Fannie, Freddie and government agencies such as the Federal Housing Administration."[18]

6. It would damage investor confidence.

No mortgage exists in isolation from the housing market or the financial services system—no mortgage is an island. Because of the complex and interrelated investment structure that has been built around and on top of home mortgages,[*] any policy change that affects the terms of a broad group of mortgages—such as a moratorium—will have major downstream impacts on the financial system, including investor confidence and the availability of capital.

A foreclosure moratorium would create tremendous uncertainty and risk in two ways: (1) it could potentially affect the terms of payment for tens of thousands of mortgages, thereby further degrading the "safety" of mortgage-backed securities; and (2) it could create a belief among investors that no private contract is immune from government intervention and abrogation.

Aside from the relatively small number of mortgages held by lenders in portfolio (such as by the smaller institutions mentioned above), the vast majority of mortgages made in America today aren't kept by the banks that made the loans. Instead, banks typically sell the mortgages they issue so that they can use the cash to make new loans to new borrowers. The mortgages that are sold are typically bundled into large "pools"

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[*] This structure, incidentally, is what enables broad access to mortgage capital at relatively very low rates. While defending securitization is outside the scope of this memo, we very much disagree with those who would argue that ending or restricting securitization would solve our nation's current housing crisis. In fact, limiting the securitization of mortgages would only make the crisis worse.

of loans (often by Fannie Mae or Freddie Mac), which in turn support the issuance of "mortgage-backed securities" (i.e. they're "securitized"). When investors buy a mortgage-backed security, they are essentially buying a share of the income stream that's generated when people make payments on their mortgages. In other words, when a homeowner makes a mortgage payment on a loan that's been securitized, that money will go toward the interest and principal owed to investors who've bought mortgage-backed securities.

Until very recently, mortgage-backed securities were considered "safe" investments and were bought by mutual funds, pension fund managers, investors around the world including foreign governments and ordinary people. Between 2003 and the first half of 2006, before the housing crisis, investors bought $7.772 *trillion* in mortgage-backed securities.[19]

When the housing crisis hit, mortgage-backed securities stopped being "safe" because too many homeowners stopped payment on their mortgages. The income being generated simply wasn't enough to cover the obligations on those securities. As a result, many of these securities defaulted, and investors—e.g., mutual funds, pension funds and ordinary Americans—were left facing billions of dollars in losses, as well as shrunken retirement accounts and even worse shortfalls in pension funds.

A key test of the housing market's strength will be whether mortgage-backed securities are considered truly "safe" again. The $17 trillion[20] housing market is a bedrock of the U.S. financial system and an historic driver of economic growth. Because investors in mortgage-backed securities expect a reliable stream of income, anything that would lessen that steady stream of income or make it less predictable creates uncertainty and risk.

At a time when investors are looking for more stability, not less, a moratorium would send the wrong market signals.

In fact, a principal rationale for rescuing Fannie and Freddie was to preserve the confidence of institutional and sovereign investors (e.g., China) who had bought mortgage-backed securities on the strength of an implicit U.S. Government guarantee. A moratorium would further weaken confidence in our ability to meet these obligations and raise the potential of more pressure from foreign creditors.

Conclusion

The nation's housing market cannot regain its health unless excess inventory is absorbed, demand for homes rises, delinquencies decline and banks are able to move bad loans off balance sheets so they can make new loans to new borrowers.

A foreclosure moratorium, however, would prevent the very things the market needs to regain its health. In fact, it would worsen the crisis.

Policymakers will no doubt be struggling with the right solutions for enforcing better compliance from lenders and helping homeowners stay current on their loans. A moratorium, however, should not be one of those solutions.

Endnotes

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