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Economic Analysis of a Mortgage Foreclosure Moratorium

Edward Vincent Murphy, Government and Finance Division

September 12, 2008

Abstract. On July 26, 2008, Congress passed legislation creating a voluntary program to enable troubled mortgage borrowers and lenders to refinance their loans through the Federal Housing Administration (FHA). Having created the voluntary program, it remains to be seen if people will be willing and able to participate under current financial market conditions. Meanwhile, the pace of foreclosures continues to rise, even as another category of loans, Alt-A, approaches the peak of its payment resets. The foreclosure process may be costly and cumbersome.³ Some have argued for a moratorium on foreclosures to give distressed borrowers and lenders time to seek financial relief. Others might argue that delaying foreclosures may also delay the recapitalization of the banking system and ultimately delay restoration of stability in financial markets. Proponents might counter that providing additional time to keep current borrowers in their homes will ultimately reduce the magnitude of bank losses and lessen the need for recapitalization.

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Economic Analysis of a Mortgage Foreclosure Moratorium

Edward V. Murphy
Analyst in Financial Economics

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Summary

On July 26, 2008, Congress passed legislation creating a voluntary program to enable troubled mortgage borrowers and lenders to refinance their loans through the Federal Housing Administration (FHA). Having created the voluntary program, it remains to be seen if people will be willing and able to participate under current financial market conditions. Meanwhile, the pace of foreclosures continues to rise, even as another category of loans, Alt-A, approaches the peak of its payment resets. The foreclosure process may be costly and cumbersome. Some have argued for a moratorium on foreclosures to give distressed borrowers and lenders time to seek financial relief. Others might argue that delaying foreclosures may also delay the recapitalization of the banking system and ultimately delay restoration of stability in financial markets. Proponents might counter that providing additional time to keep current borrowers in their homes will ultimately reduce the magnitude of bank losses and lessen the need for recapitalization.

The persistence of large unsold inventories of housing may be an indicator that house prices may fall further. Further declines in house prices might contribute to more foreclosures and more instability in financial markets. Although economists generally believe that prices adjust to clear shortages and surpluses, it could be argued that the housing market has characteristics that make that process longer and more painful than in some other consumer goods markets. In housing markets, several factors may contribute to a feedback loop (where housing market instability becomes self-reinforcing). Potential obstructions to price adjustment and market clearing in the housing market include builders hesitating to lower prices for new houses because they may have duties to previous customers; the reluctance or inability of some homeowners to sell their houses for less than they owe on their current mortgages; the addition of foreclosures to housing supply when prices fall; the tendency of some potential buyers to wait for market prices to hit bottom; and the reduction of available mortgage credit during a housing market downturn.

A moratorium would have costs and benefits. On the benefit side, it would provide all market participants with more time to assess asset prices and evaluate alternatives. On the cost side, it could delay the ability of markets to clear excess inventories and restore financial stability. Evidence from the Great Depression suggests that states that enacted moratoriums provided relief to some home owners but saw higher costs of credit and fewer loans compared with states that did not. It nevertheless has been argued that natural disasters are an appropriate analogy and that the oncoming schedule of Alt-A mortgage resets creates time pressure that, in the absence of a moratorium, could overwhelm the capacity of loan servicers.

A regulatory foreclosure freeze has been announced by the FDIC for IndyMac loans. Some have called for a foreclosure freeze for loans held by the GSEs in conservatorship. In Congress, H.R. 6076 would set up a deferment period during which home owners would make a payment calculated by formula.

This report will be updated as conditions warrant.

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Background

On July 26, 2008, Congress passed legislation creating a voluntary program to enable troubled mortgage borrowers and lenders to refinance their loans through the Federal Housing Administration (FHA).¹ Having created the voluntary program, it remains to be seen if people will be willing and able to participate under current financial market conditions. Meanwhile, the pace of foreclosures continues to rise, even as another category of loans, Alt-A, approaches the peak of its payment resets.² The foreclosure process may be costly and cumbersome.³ Some have argued for a moratorium on foreclosures to give distressed borrowers and lenders time to seek financial relief. Others might argue that delaying foreclosures may also delay the recapitalization of the banking system and ultimately delay restoration of stability in financial markets. Proponents might counter that providing additional time to keep current borrowers in their homes will ultimately reduce the magnitude of bank losses and lessen the need for recapitalization.

There have been calls to delay or freeze mortgage foreclosures. H.R. 6076, the Home Retention and Economic Stabilization Act of 2008, was introduced by Representative Matsui on May 15, 2008.⁴ This bill would grant delinquent subprime and negative amortization borrowers up to an additional 270 days prior to foreclosure. On the regulatory side, the FDIC has announced that it will halt foreclosures for loans that it administers through its supervision of IndyMac Bank, which recently failed.⁵ Some have reportedly called for the recent conservatorship of Fannie Mae and Freddie Mac to freeze foreclosures for the loans that these institutions hold.⁶

Economic Analysis of Delaying Foreclosure

Delaying foreclosure could have benefits. Borrowers who may not have fully prepared for payment increases built into their mortgages would have more time to adjust their household finances. They would also have more time to consider participating in the newly enacted voluntary program to refinance loans into FHA at reduced principal, if their lenders agreed. Similarly, lenders would have more time to consider loan modification, or participation in the new FHA program, as a loss-minimizing alternative to the costly foreclosure process, especially considering the decline in the value of houses, which serve as collateral for the loans. Other home owners trying to sell their homes would not have to compete with quite so many foreclosure sales, which often drive down prices. Neighborhoods and communities might be able to slow the growth of concentrated pockets of vacant and poorly maintained homes, which sometimes become magnets for accidents, crime, and even breeding grounds for disease carrying pests.⁷

¹ Passed as H.R. 3221, Housing and Economic Recovery Act of 2008, and enacted as P.L. 110-289 on July 30, 2008. See CRS Report RL34623, *Housing and Economic Recovery Act of 2008*, by N. Eric Weiss et al.

² See CRS Report RL33775, *Alternative Mortgages: Causes and Policy Implications of Troubled Mortgage Resets in the Subprime and Alt-A Markets*, by Edward V. Murphy.

³ See CRS Report RL34232, *The Process, Data, and Costs of Mortgage Foreclosure*, by Darryl E. Getter et al.

⁴ See CRS Report RS22943, H.R. 6076, by Edward V. Murphy.

⁵ Federal Deposit Insurance Corporation, "Loan Modification Program for Distressed Indymac Mortgage Loans," press release, August 20, 2008, available at <http://www.fdic.gov/consumers/loans/modification/indymac.html>.

⁶ "Democrats call on Fannie, Freddie to halt foreclosures," *Los Angeles Times* online, September 12, 2008, available at <http://www.latimes.com/business/la-fi-fannie12-2008sep12,0,1383031.story>.

⁷ Reportedly, vacant homes with pools that have not been maintained have become breeding grounds for mosquitos (continued...)

The benefits for some of a delay could come at a cost to others. Renters who may desire to purchase a home but were priced out during the previous housing boom might have fewer opportunities than they would without a foreclosure deferment program. Some banks, who are already experiencing liquidity and solvency problems, would lose at least one potential avenue of recapitalization (selling the collateral of under-performing loans). It is possible that a deferment plan could simply delay the bottoming out of the housing market and extend the period of large unsold housing inventories, in which case potential buyers who are waiting for prices to trough might remain on the sidelines. If the return of potential home buyers were delayed on a large scale then it would be possible that mortgage markets and related financial institutions might remain in turmoil for an extended period, disrupting the financing of student loans, auto leases, municipal funding, and other seemingly unrelated markets.

Trade-offs, such as the potential benefits and costs of foreclosure deferment, are central to the economic approach. Although competitive markets are said to allocate resources efficiently (under certain assumptions), the persistence of large unsold inventories of houses is not consistent with a market in equilibrium.⁸ Rapid declines in house prices have not as yet drawn buyers back in on a large scale. In economic theory, the ability of private actors to effectively evaluate trade-offs and reach efficient outcomes depends upon transaction costs, the availability of relevant information, and the presence of competing buyers and sellers.⁹ These theoretical conditions for economic efficiency can be useful for diagnosing potential obstacles to private bargaining solutions.

The central trade-off in evaluating a deferment is the cost and benefits of quickly moving the ownership of assets from distressed hands to secure hands. Many observers recognize that delays in reallocation has opportunity costs: at least some of the policy considerations in bankruptcy are intended to facilitate this asset transfer and minimize the costs of delay. But economists recognize that speed itself has costs; for example, two researchers of financial crises have observed that "... speed can actually work against a well-functioning procedure if time is required to properly assess the value of assets and claims, allow for negotiations, search for potential bidders, and generally increase the liquidity of the bidding process."¹⁰ From an economic perspective, analysis of a moratorium on foreclosures in the current housing cycle focuses on the factors that could affect the speed of reducing the inventory of unsold homes, including the uncertainty faced by market participants.

(...continued)

capable of carrying viruses. Blair Robertson, "Mosquito District Treats more Abandoned Pools: Homeowners in Foreclosure or Who Feel Financially Squeezed are a Likely Factor as Workers Fight West Nile Transmission," *Sacramento Bee*, July 8, 2008, p.B3.

⁸ The National Association of Realtors reports that the unsold inventory of homes, expressed as the number of months required to sell all homes for sale at the current sales pace, is above 11 months supply. A more normal supply would be five to six months. Available at http://www.realtor.org/press_room/news_releases/2008/ehs_down_in_june.

⁹ More formally known as the Coase Theorem, private bargaining is likely to reach economically efficient outcomes when property rights are well defined, transaction costs are zero, all necessary information is available, and prices reflect opportunity costs (as in competitive markets). Economic efficiency is usually defined as the state in which it is no longer possible to rearrange resources to make one person better off without making someone else worse off (Pareto Standard), or alternatively efficiency is when all possible moves in which the gains to winners are larger than the losses to losers are taken advantage of (Kaldor-Hicks Standard).

¹⁰ David Smith and Per Stromberg, "Maximizing the Value of Distressed Assets: Bankruptcy Law and the Efficient Reorganization of Firms," Chapter 8 of *Systemic Financial Crises*, Patrick Honohan and Luc Laeven editors (Cambridge: Cambridge University Press, 2005), p. 271.

The Economics of Excess Inventories in the Housing Market

In a relatively free market, prices are expected to adjust up or down to eliminate surpluses and shortages. Persistent surpluses, such as excess inventories of unsold homes, are often a sign that quantity supplied at the current price is greater than quantity demanded. In the current housing market, the inventory of unsold homes in many formerly appreciating markets is far above the historic average, an indicator that prices could fall further.¹¹ The expectation of further price declines could itself discourage new buyers and delay the restoration of more normal conditions.

Supply and Demand

The recent fall in house prices in formerly booming areas was not a random event that no one could have predicted; rather, a period of rising prices followed by a period of falling prices is the expected economic outcome when demand for a good rises and suppliers are delayed in their ability to respond to the increased profits (although it is often difficult to determine the timing and magnitude of price changes). That is, the increased demand initially bids up prices and increases producer profits, but eventually producers are able to increase capacity. Prices are then expected to fall back to reflect producer costs. This basic supply and demand approach is consistent with the recent experience of many formerly booming housing markets, including in Florida, California, Nevada, and Arizona. That is not to say that the housing market does not have various features that affect the speed by which house prices reduce shortages and surpluses; for example, producers must comply with zoning restrictions, and home purchasers are typically restricted by the availability of mortgage credit.

From an economist's point of view, the good news is that we do not have to wait for a random shock for the housing market to recover; rather, the market is expected to recover as (1) producers reduce construction (which has already happened in many areas), (2) normal demographic household formation increases the number of potential home purchasers, and (3) price declines bring affordable home ownership within the reach of a greater percentage of an area's population. The combination of fewer housing units for sale and more potential home buyers will eventually stabilize the housing market. From the point of view of many policymakers, however, the bad news is that this process may take longer, and the amount of dislocation caused may be greater, because of several features of the mortgage market—features that may be subject to amelioration. Five factors may tend to prolong surpluses of unsold homes and delay the stabilization of housing markets: builder attitudes toward prior home buyers, nominal mortgage contracts, foreclosure supply feedbacks, potential buyers waiting for prices to bottom out, and financial problems of the providers of mortgage funds, such as banks and government-sponsored enterprises (GSEs). A moratorium on foreclosure could potentially address some, but not all, of these factors.

Attitude of Developers Toward Prior Home Purchasers

Home builders who develop large neighborhoods are often reluctant to lower prices because this can anger earlier buyers. Rather than lower the asking price of the home, the builder might prefer to offer other incentives, such as reduced financing costs or discounted options (such as granite

¹¹ The National Association of Realtors report 11 months supply. Available at <http://www.realtor.org/research/research/economicindicator>. Note the emphasis on the term “excess” inventory; the existence of at least some unsold inventory can be a healthy sign because it means consumers have a variety of choices.

countertops or a jacuzzi tub). Because builders may raise prices when conditions allow but seek alternatives to recording price declines when conditions are reversed, a period of slowing sales may occur rather than a period of falling prices. As a result, potential buyers may not know that the real cost of homes has fallen into their price range and other sellers (such as owners of existing homes) may not realize that they will be unlikely to find a buyer if they do not lower their asking price. This reluctance of builders to lower asking prices was observed earlier in the housing cycle but many builders have since capitulated.

In the current housing cycle, builder reliance on financing incentives and construction options rather than price reductions is probably no longer a significant obstacle to the clearance of unsold inventories. Builders began aggressively cutting prices and trying to clear their own inventories in many areas earlier in the housing cycle. Builders have also reduced new construction, as measured by housing starts, and have cancelled, or failed to exercise, many of their options on land for development. A moratorium on foreclosures would be unlikely to affect the incentives of builders to try to avoid lowering asking prices.

Nominal Mortgage Contracts, Inflation, and Sticky House Prices

Prices that are not adjusted for inflation are called nominal prices. The vast majority of mortgages do not directly adjust the monthly payment for changes in the inflation rate. Because the United States has generally experienced inflation since World War II, most Americans have had the real (as opposed to nominal) price reflected in their monthly mortgage payment decline over time. Similarly, inflation has masked periods of declining real house prices. Nominal house prices continued rising in some areas even though the real prices of houses declined once inflation was taken into account. In individual cities, even nominal house prices had been known to fall, sometimes sharply. The claim that the United States as a whole has not experienced a house price decline is not true for real house prices.

The distinction between nominal and real prices is important. First, some Americans may have been overconfident that the price of their home would never decline. As a result, they may have accepted mortgage terms that would commit them to refinancing their houses quickly even if they could only do so if house prices continued climbing. Consistent with this analysis, the use of mortgages with low down payments and low introductory monthly payments is concentrated in areas that formerly had rapid price appreciation. Now the default and delinquency rate on these loans, for all classes of borrowers, has risen significantly. The wave of payment resets caused by the expiration of these introductory periods in areas in which the expected appreciation did not occur is one of the reasons that some policymakers wish to quickly facilitate mortgage refinances.

The second reason why the nominal mortgage contract is important is because it may create an obstacle to clearing the unsold housing inventory. A homeowner who cannot make the current monthly mortgage payment can avoid foreclosure by selling the house as long as there is positive equity in the home. Falling house prices reduce the homeowner's equity; in some areas prices have fallen enough that many recent home purchasers, even prime borrowers, now have negative equity. A person cannot sell his or her home to avoid foreclosure if he or she does not have adequate equity or sufficient savings to pay off the current creditor and any other selling costs, such as the real estate agent. Unless the lender agrees to accept less than the amount owed on the original loan (e.g., a short sale), there is a nominal price floor below which these homeowners cannot go—a price floor prolongs an economic surplus, such as the inventory of unsold homes. Historically, it was common for distressed debtors to advocate for greater inflation, which is consistent with a desire to lower the real price when it is difficult to lower the nominal price.

A moratorium on foreclosures could affect nominal mortgage contracts because it would increase the length of time that inflation can affect real house prices. That being said, the current inflation rate is significantly below the magnitude that is probably necessary to lower real house prices enough that prospective buyers could meet many sellers' nominal price floors. The inflation rate as measured by the consumer price index from July 2007 to July 2008 was 5.6%, which is significantly less than nominal price declines in some areas.¹² For example, the nominal price decline for San Francisco measured by the Case Schiller home price index from May 2007 to May 2008 was -23%.¹³ If inflation is included, the real price declined even further. Another example, from an alternative measure of housing prices from the Office of Federal Housing Enterprise Oversight (OFHEO), which is generally less volatile than the Case Schiller index, reported a nominal price decline in Sacramento, CA, of -13.2%.¹⁴ Because it would take two to three years for the current rate of inflation to compensate for even one year's nominal price decline in some areas, it is unlikely that a brief moratorium on foreclosures would significantly reduce that part of the impediment to equilibrium that is caused by the use of nominal prices in mortgage contracts.

Foreclosures and Unmanageable Resets Increase Supply

There are some problems in housing markets that create a feedback loop that can increase the number of homes being offered for sale when prices are falling. In areas where the direction of prices unexpectedly switches from rising to falling, for example, people who counted on further price appreciation to enable them to refinance their homes on more favorable terms will be frustrated, and some may try to sell their homes to avoid foreclosure.¹⁵ Price reductions also increase the number of home owners who owe more than their home is worth, especially if there have been a large number of buyers who put little or nothing down. The combination of home owners who cannot afford a scheduled increase in their monthly mortgage payments and those who no longer have sufficient incentive to continue paying down a loan because their negative equity is large (more than \$100,000 in some areas) tends to increase the number of homes offered for sale in precisely those areas that once had rapid price increases but are now experiencing rapid price declines. Although the peak period of payment resets for subprime mortgages reportedly is passing, other mortgages with a reset feature (e.g., so-called Alt-A and Hybrid ARMs) that are even more highly concentrated in formerly rapidly appreciating regions will be triggered in 2008, 2009, and 2010.¹⁶ The net result is that falling house prices can also increase supply (over some range) through a feedback process between negative equity and default rates.

A foreclosure moratorium may, under some circumstances, help to reduce the supply feedback effect of falling house prices. In the short run, it would slow down the number of distress sales in

¹² Unadjusted twelve month calculation, Bureau of Labor Statistics, July 2008, available at <http://www.bls.gov/news.release/pdf/cpi.pdf>.

¹³ Calculated from May 2007 to May 2008 from Standard and Poor's Case Schiller Price Index, available at http://www2.standardandpoors.com/spf/pdf/index/CSHomePrice_History_072943.xls.

¹⁴ Calculated from OFHEO's house price index data from first quarter 2007 to first quarter 2008, not seasonally adjusted, available at http://www.ofheo.gov/media/hpi/1q08hpi_cbsa.csv.

¹⁵ See CRS Report RL33775, *Alternative Mortgages: Causes and Policy Implications of Troubled Mortgage Resets in the Subprime and Alt-A Markets*, by Edward V. Murphy.

¹⁶ Christopher Cagan, "Mortgage Payment Reset," Presentation at the Real Estate Research Council of Southern California, May 30, 2007, available at <http://www.csupomona.edu/~rerc/RERCSC%20Chris%20Cagan%205.30.07.pdf>.

the marketplace and reduce the downward pressure on prices. Because foreclosure sales also affect the existing homeowners' perceptions of the value of their own homes, it could be argued that foreclosure sales increase the incentive of people to choose to default opportunistically when their negative equity is high.¹⁷ On the other hand, negative equity is a necessary but not a sufficient condition for foreclosure (because a pre-foreclosure sale can avoid default if there is positive equity). One study of borrowers in Massachusetts with negative equity in the 1990s, for example, found that more than 90% retained their homes, suggesting that opportunistic default may be overstated in some cases.¹⁸

A moratorium might also allow households that have unmanageable payment resets to adjust their household finances. Eligible families may be able to refinance into a more affordable loan or negotiate new terms with their existing creditors, perhaps by taking advantage of the new FHA program.¹⁹ Some people who used mortgages with low introductory payments and were surprised when house prices failed to continue appreciating would have time to adjust both their expenses and their earnings. Household earnings can be raised in some cases, for example, by having a family member return to work or by renting a room to a boarder.²⁰ In some cases, there may be a delay between realization that a payment reset will be unaffordable and the family's ability to adjust earnings and expenses.

The effect of a moratorium on the supply feedback of foreclosures and unmanageable resets is hard to project. On the one hand, a delay in foreclosure is unlikely to reduce the incentive of people with large negative equity to opportunistically default. If these people will eventually default anyway then a moratorium merely delays the inevitable and extends the period of destabilizing unsold inventories. On the other hand, a delay in foreclosure could provide those families whose expectations of market conditions were frustrated and now face a large payment reset additional time to adjust their finances to new market realities. These families might avoid foreclosure altogether given extra time, which would tend to reduce the total supply feedback, both during the moratorium period and after its expiration.

Fence-Sitters, Potential Buyers May Wait for Prices to Bottom Out

Just as price declines can cause a foreclosure supply feedback process that extends, rather than shortens, the period of large unsold inventories, price declines may also have a negative demand feedback effect by deterring potential buyers from entering the market. Buyers who believe that prices will continue to fall may decide to wait until the market bottoms out, yet by waiting as a group they have the cumulative effect of encouraging the price decline.²¹ That is, expectations of

¹⁷ See CRS Report RL34232, *The Process, Data, and Costs of Mortgage Foreclosure*, by Darryl E. Getter et al.

¹⁸ Christopher L. Foote, Kristopher Gerardi, and Paul S. Willen, "Negative Equity and Foreclosure: Theory and Evidence," Federal Reserve Bank of Boston, Working Paper No. 08-3, available at <http://www.bos.frb.org/economic/ppdp/2008/ppdp0803.htm>.

¹⁹ A fact sheet for the FHA Secure program can be found at http://portal.hud.gov/portal/page?_pageid=73,3947211&_dad=portal&_schema=PORTAL.

²⁰ One press report of households trying to adapt to avoid foreclosure is Kareem Fahim and Ron Nixon, "Behind Newark Foreclosure Data, Ruined Credit and Crushed Hopes," *New York Times*, Mar 28, 2007, p. A1.

²¹ Reportedly, home builders believe there are a number of potential first time home buyers who are waiting for house prices to reach their bottom. See Rex Nutting, "Single-family home starts drop to 17-year low," *Marketwatch*, July 17, 2008, available at <http://www.marketwatch.com/news/story/single-family-home-starts-drop-17-year/story.aspx?guid=%7BB9547567-8849-4400-9F8F-9A5761A0D99F%7D>.

a future price decline reduce the number of potential buyers at the current price (and all other prices), which has the effect of putting downward pressure on prices.

The effect of a moratorium on fence-sitters would depend on their expectations, which may be difficult to anticipate. If fence-sitters believe that a moratorium will be effective in stabilizing the housing market (perhaps there will be income growth for families, or wide scale refinances, or rapid inflation during the moratorium period), then fence sitters would gain little by waiting. On the other hand, if fence-sitters believe that a moratorium will merely delay inevitable distress sales then the moratorium could have the perverse effect of further discouraging fence-sitters from entering the market.

Financial Problems of Banks and GSEs Reduce Demand for Houses

The mortgage finance system is another factor that could tend to limit the ability of housing markets to restore equilibrium quickly. In the United States, the vast majority of home sales require mortgage financing so the supply of mortgage funds is a critical component of the demand for houses. Falling house prices create a negative feedback loop in the mortgage finance system because mortgage funds tend to dry up as housing markets decline. First, when housing prices are declining, lenders tighten lending standards and require larger downpayments to reduce the probability of negative equity and default because the decline in the value of the collateral (the house) increases the risk to the lender in the event of default. Second, the higher delinquency rate on existing loans that usually occurs concurrently with falling house prices also reduces the revenues of banks and other mortgage lenders. Because financial institutions that provide mortgage financing are typically leveraged (they have liabilities that are many times their capital), the failure of existing borrowers to repay their loans can force the lenders to curtail new lending by a multiple of the lost revenue. As a result, the ability of potential house buyers to obtain financing can be reduced when prices fall, which can further reduce prices. In the current housing market downturn, the financial condition of many mortgage lenders and related financial institutions, such as Fannie Mae and Freddie Mac, is significantly troubled.²²

A moratorium on foreclosures is unlikely to help mortgage lenders, except those that might wish to modify loans on a wide scale but are uncertain whether and under what terms they may legally do so.²³ For those lenders and loan servicers with unencumbered ownership of their loans, they already have the option of delaying foreclosure proceedings. One reason for not delaying foreclosure is that the declining housing market is already eroding their capital position and the inability to recover any funds from a loan exacerbates their problems.²⁴

It is difficult to assess the effect of a moratorium on the factors that tend to frustrate stabilization in the housing market. In some cases, such as the reaction of fence-sitters and financial institutions, it depends on expectations and calculations that policymakers may not be able to anticipate. The primary economic benefit of a moratorium, in terms of facilitating a return to equilibrium in the housing market, is that it gives market participants time to evaluate relevant

²² See CRS Report RL34661, *Fannie Mae's and Freddie Mac's Financial Problems*, by N. Eric Weiss.

²³ CRS Report RL34372, *The HOPE NOW Alliance/American Securitization Forum (ASF) Plan to Freeze Certain Mortgage Interest Rates*, by David H. Carpenter and Edward V. Murphy.

²⁴ Despite having greater than minimum capital, banks and thrifts are having to set aside increasingly large loan loss reserves. "Testimony of John Reich, Director of the Office of Thrift Supervision, before The Senate Committee on Banking, Housing, and Urban Affairs," June 5, 2008, p. 3, available at <http://files.ots.treas.gov/87166.pdf>.

information, such as the existence of new programs and the completion of new appraisals, after which existing borrowers and lenders may reconsider their options and negotiating positions. The next section focuses on the uncertainty in the current housing market.

Uncertainty Affecting Housing Market Participants

Uncertainty is one of the factors contributing to continued instability in mortgage markets and the financial system. It is difficult in the present circumstances to know if loan servicers have the capacity to conduct effective loss mitigation, including alternatives to foreclosure, in the face of rapidly rising delinquency rates and falling house prices. Press releases by the HOPE Now Alliance, a coalition of loan servicers and counselors, list hundreds of thousands of loan workouts but it is difficult to know if these are actions merely begun or actions completed.²⁵

Loan Servicers

Uncertainty about the value of houses in declining markets, for example, complicates the ability of loan servicers to evaluate the returns to loan modification compared with completing the foreclosure process. Similarly, uncertainty about home values also complicates the funding of new loans that could serve to bring buyers back into the marketplace because lenders generally raise qualification standards and down payment requirements if they believe house prices might fall after the loan is finalized.²⁶

In addition to uncertainty about the value of homes, loan servicers had a period of uncertainty with regard to the extent of their discretion to modify loans in anticipation of payment problems. Innovations in financial services had allowed for a fracturing of ownership of the loans with the result that there was not a single lender to authorize changes in loss mitigation strategies. This may have resulted in over-reliance on loan-by-loan loss mitigation efforts instead of greater use of broad-based action for loan categories experiencing delinquencies on a large scale. Over the past year, some of this uncertainty has been reduced by a series of industry standards, Securities and Exchange Commission (SEC) announcements, and Internal Revenue Service (IRS) rulings.²⁷ Given these recent developments, it is difficult to establish the accuracy of statements by HOPE Now that loan modifications are proceeding at an increased pace.

Borrowers

Borrowers must acquire information about their alternatives. Although there have been outreach efforts, many borrowers might not respond to loan servicers even when the servicers may be willing to renegotiate more lenient terms. Similarly, many borrowers may not be aware of the

²⁵ Prior to the December 2007 HOPE Now mortgage freeze plan, the Conference of State Bank Supervisors (CSBS) did an analysis of HOPE Now data and found that HOPE Now had not distinguished between loss mitigation begun and loss mitigation completed. Only a small percentage of the borrowers listed by HOPE Now had completed a new workout plan. See State Foreclosure Prevention Working Group, April 2008, at <http://www.csbs.org/Content/NavigationMenu/Home/StateForeclosureApril2008.pdf>.

²⁶ *Supervisory Insights*, FDIC, Summer 2008. Banks are reminded to tighten lending standards in declining markets for commercial real estate sector. Similar principles apply to the residential sector. Available at <http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum08/sisum08.pdf>.

²⁷ 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 V. Murphy.

existence of the new voluntary FHA refinance program or if their lenders might be willing to participate. Even if they know of the existence of the program, they may not know if they qualify, or under what terms. For example, the new program requires the new loan balance to be reduced to 90% of the current appraised value, but no one can know the current appraised value without conducting a new appraisal. Without knowing this new balance, troubled borrowers may not be able to accurately assess their own ability to meet the new monthly payments and so may not know if they themselves would be willing to participate in the new program.

Lenders

Just as borrowers require information to assess their alternatives, lenders might require information to assess their alternatives. Before deciding to participate in the new FHA program, lenders also need information on current house prices, as determined by a host of new appraisals. The shelf-life of an estimate of an area's house prices might not be very long in areas with rapidly declining prices; therefore, it may be difficult, at least on a large scale, to get information on current house prices to determine new balances under the voluntary FHA program. Depending on their assessment of house prices, banks may wish to pursue their own broad-based alternatives, such as the one put forward by the Federal Deposit Insurance Corporation (FDIC), rather than participate in the new FHA program, even if the banks decide to forgo the foreclosure process.²⁸ Similarly, the willingness of banks to lend to new customers in an area depends on the bank's changing perception of the area.

Foreclosure Moratoriums in Historical Perspective

Although inflation-adjusted house prices have occasionally fallen in the past 30 years, nominal house prices have not fallen on a national scale since before OFHEO began collecting house price data in the late 1970s (falling house prices on a national scale was more common prior to World War II). In part because inflation generally adds to the home equity of borrowers with traditional 30-year fixed rate mortgages and holds down foreclosure rates, it has been several generations since there has been a call for a mortgage moratorium on a national scale. There have been localized programs for natural disasters (the aftermath of Hurricanes Katrina and Rita is an example) in recent years, and there were national efforts prior to World War II. The following section discusses historical examples of mortgage moratoriums.

Great Depression

The Great Depression saw falling asset prices along with growing, and persistent, unsold inventories for many commodities and for farm mortgages. The magnitude of the problem during the Great Depression was far greater than problems in the current housing market but some of the same basic economic principles of housing markets, mortgage defaults, unsold inventories, and financial turmoil might still apply. Prior to becoming chairman of the Federal Reserve, Ben Bernanke was a recognized expert on the economic connection between mortgage defaults and broader credit market turmoil during the Great Depression. Evidence of the effect of state mortgage moratoriums during the period is found in the work of economist Lee Alston. The

²⁸ The FDIC instituted its own wide scale loan modification plan for the borrowers it deals with when it took over IndyMac Bank. Details of the FDIC plan can be found at <http://www.fdic.gov/consumers/loans/modification/indymac.html>.

following sections describe, for the Great Depression, the supposed feedback loop between mortgage defaults and financial market turmoil, reported efforts of market participants to address unsold inventories, and economic analysis of the mortgage moratoriums during the period.

Mortgage Defaults and Financial Turmoil Feedback in the 1930s. In drawing lessons from the Great Depression, Bernanke says that a “...major aspect of the financial crisis (one that is currently neglected by historians) was the pervasiveness of debtor insolvency. Given that debt contracts were written in nominal terms, the protracted fall in prices and money greatly increased debt burdens.”²⁹ Bernanke goes on to explain how debtor insolvency also caused problems for lenders, contributed to a banking crisis, and ultimately damaged the ability of financial markets to provide credit intermediation. In Bernanke’s analysis, when a wave of insolvencies causes a big shock to the lending system, the cost of credit intermediation (the ability to distinguish “good” borrowers from “bad” borrowers)³⁰ rises and provides a separate, nonmonetary channel, through which problems in the banking sector can negatively affect the real economy. Bernanke cites Depression-era sources who say “...that the extraordinary rate of default on residential mortgages forced banks and life insurance companies to practically stop making mortgage loans, except for renewals.”³¹ Bernanke concludes that economic institutions matter—that “institutions which evolve and perform well in normal times may become counterproductive during periods when exogenous shocks or policy mistakes drive the economy off course.”

Some might consider the modern day rise and fall of the securitization of mortgages as another example of a shock to credit intermediation.³² For example, Laura Kodres, division chief in the International Monetary Fund’s Monetary and Capital Markets Department, is one of many critics of the “originate to distribute” model of mortgage finance. She attributes some of the lax underwriting during the boom to “Supervisors had insufficient information and clout to halt the proliferation of overpriced securities. Thus, competitive pressures to issue and sell these types of products were so intense that—as Charles Prince, Chairman and Chief Executive Officer of Citigroup, told a reporter in early July that year—top management felt that ‘as long as the music is playing, you’ve got to get up and dance.’”³³ The securitization system, which appeared to work well during the housing boom, appears to have become counterproductive since housing markets have declined. Global collateralized debt obligation (CDO) issuance was 62% lower in the second half of 2007 than in the second half of 2006.³⁴ This decline in securitization occurred despite the Federal Reserve lowering the Fed Funds rate 25 basis points between August 2006 and August 2007.³⁵ Even borrowers with good credit are reporting problems in obtaining loans.

Efforts to Stabilize Markets by Preventing Price Declines. During the Great Depression, some believed that the way to recovery was to hold products off the market to slow down price

²⁹ Ben Bernanke, “Nonmonetary Effects of the Financial Crisis,” *American Economic Review*, vol. 73 (June 1983).

³⁰ In this context, “good” and “bad” refer to the likelihood that borrowers will repay the loan.

³¹ Bernanke citing Hart, *Debts and Recovery, 1929-1937*, New York, Twentieth Century Fund, 1938, p. 163. Renewals were similar to a refinance. Many mortgages prior to WWII were for short periods, often five years or less, with a large balloon payment at the end. As a result, people would have to roll over their mortgage at regular intervals.

³² See CRS Report RS22722, *Securitization and Federal Regulation of Mortgages for Safety and Soundness*, by Edward V. Murphy.

³³ Laura Kodres, “A Crisis of Confidence... and a Lot More,” Finance and Development, IMF, June 2008, available at <http://www.imf.org/external/pubs/ft/fandd/2008/06/kodres.htm#author>.

³⁴ *SIFMA Research Quarterly*, February 2008, p. 8, available at <http://www.sifma.org/research/pdf/RRV013-2.pdf>.

³⁵ Federal reserve historical data, available at http://www.federalreserve.gov/releases/h15/data/Monthly/H15_FF_O.txt.

declines, with some actions that in hindsight might seem perverse—farmers stopping their neighbors’ milk wagons and dumping out the milk, for example.³⁶ Reducing inventory to support prices was also one of the justifications for paying farmers to reduce the amount of acreage under cultivation. Few observers believe that Depression-era price supports were effective in facilitating recovery of individual markets.³⁷ In the current housing market, there have been several efforts to reduce the number of properties for sale and support prices; for example, some state and local governments have programs to acquire foreclosed properties and the recently passed omnibus housing bill has provisions for Community Development Block Grant Funds to be used to acquire vacant properties.³⁸ A moratorium on foreclosures may give state and local governments more time to remove vacant properties to try to support prices.

Economic Analysis of Depression-Era Mortgage Moratoriums. Between 1932 and 1934, 25 states passed moratoriums on the foreclosure of mortgages. Economists might argue that interference with a lender’s ability to recover loan collateral will tend to either reduce the amount of lending or raise interest rates on new loans. Economist Lee Alston examined the economic effects of the 1930s moratorium legislation. Alston found that some borrowers gained from the temporary reprieve, “but that this reprieve was at the expense of private creditors and prospective farmers who were precluded from securing credit to purchase a farm because of the increased costs to private creditors.”³⁹ He arrived at this result by examining whether the quantity of private loans fell, or the interest rates on loans rose, in states that passed moratoriums relative to states that did not (controlling for other credit market factors). He found that the quantity of private loans fell and that interest rates rose under a variety of model specifications.

Criticism of the Depression Analogy. Some would argue that evidence from Depression-era moratoriums is not necessarily the best analogy. As discussed above, farm mortgages were often the primary source of family income so that falling commodity prices simultaneously reduced the value of the farm and the ability to make mortgage payments, unlike the present situation in which an individual household’s income is largely divorced from house prices (although aggregate regional income may affect regional house prices). Similarly, Depression era efforts to support prices by reducing supply were largely directed at commodity prices, not house prices. Also, the basic macroeconomic policy approach to recovery, especially the modern bias toward inflation and expansionary monetary policy as a response to recessions, may make evidence from prior periods less relevant. Finally, institutions for financial markets have changed significantly (including greater reliance on global sources of funding and more alternatives for federal subsidies) since the Depression so Alston’s evidence may apply to a system that is no longer in place. Finally, current moratoriums are being considered to give both borrowers and lenders more

³⁶ For one personal story of the Farm Holiday movement, see the interview of Harry Terrell in Studs Terkel, *Hard Times: An Oral History of the Great Depression*, Pantheon Books, New York, 1970, pp. 213-217. For a discussion of policies to prevent further price declines, including the “plow up the pigs” campaigns, see *Depression Decade: From New Era through New Deal, 1929-1941* (New York, Rinehart & Co., 1947), pp. 191-197.

³⁷ Other approaches to market stabilization were tried during the Great Depression, which may have been more effective. For a discussion of one such program, the Home Owner’s Loan Corporation, see CRS Report RL34423, *Government Interventions in Financial Markets: Economic and Historic Analysis of Subprime Mortgage Options*, by N. Eric Weiss.

³⁸ The Ohio Foreclosure Prevention Task Force, for example, recommended the use of authority under delinquent tax rules for communities to seize properties and in some cases demolish vacant houses. *Final Report*, September 10, 2007, p. 23, available at <http://www.com.state.oh.us/admn/pub/FinalReport.pdf>.

³⁹ Lee J. Alston, “Farm Foreclosure Moratorium Legislation: A Lesson from the Past,” *American Economic Review*, June, 1984, pp. 445-457.

time to consider alternatives to foreclosure, not necessarily to stabilize housing prices; therefore, an example of time pressure may be more appropriate.

Natural Disasters

Sometimes when natural disasters hit, disruptions of traditional communications can add to the obvious difficulties of distressed residents to meet their mortgage payments on time. In these situations, it is not uncommon for there to be a temporary reprieve of debt obligations until normalcy can be restored. One example of this was a moratorium on foreclosures of FHA-insured mortgages in the aftermath of Hurricanes Katrina and Rita.⁴⁰ As in most natural disasters, the event that caused the communications disruption also reduced the ability of families to raise funds to pay their mortgages and destroyed some of the housing stock. In the case of Hurricanes Katrina and Rita, flooding reportedly damaged 1.2 million housing units. Of those, 300,000 were seriously damaged or destroyed.⁴¹ The long-term impact on some communities was severe and in some cases out-migration may have permanently reduced the local population.⁴² These shocks to both the supply and demand of housing have left an area that arguably remains in disequilibrium. The moratorium likely provided time for affected residents to determine if they wished to make a long-term commitment, such as home ownership, to the affected region.

Some aspects of the natural disaster analogy seem to fit the current housing market and some do not. If forecasts of the inability of many borrowers to meet higher payments after initial reset are accurate, then some would argue that the schedule of resetting mortgages represents an “approaching tsunami of mortgage defaults.”⁴³ In this view, traditional avenues of communication between borrowers and servicers are inadequate to handle the volume of renegotiations necessary to modify loans prior to severe delinquency (most loans that become more than 90 days late never again become current). In part because of the time constraint, the FDIC has recommended simply writing down loan balances en masse to more affordable payments to keep current borrowers in their homes and prevent more housing units to be added to unsold inventory through the foreclosure process.⁴⁴

⁴⁰ HUD repeatedly extended forbearance and a moratorium on FHA insured mortgage foreclosures in the Hurricane affected region. See for example, Mortgagee Letter 2006-05, February 3, 2006, available at <http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/06-05ML.doc>.

⁴¹ See CRS Report RL34087, *FEMA Disaster Housing and Hurricane Katrina: Overview, Analysis, and Congressional Issues*, by Francis X. McCarthy, and CRS Report RL33173, *Hurricane Katrina: Questions Regarding the Section 8 Housing Voucher Program*, by Maggie McCarty.

⁴² Louisiana’s Road Home Program, for example, had difficulty complying with federal law because it proposed to adjust aid based on the ability to own in three years, with an exemption for elderly people planning to leave the state. Some of the other assistance funds, including federal Community Development Block Grant Funds, were used to turn some former housing units into green space. See “Testimony of Gil Jamieson,” Deputy Director of Gulf Coast Recovery, Federal Emergency Management Administration, before the House Financial Services Committee, February 22, 2007, p. 6.

⁴³ Concern over the capacity of servicers to meet loan modification efforts has been a subject of ongoing congressional concern. For example, the House Financial Services Committee held a hearing on July 25, 2008, entitled “A Review of Mortgage Servicing Practices and Foreclosure Mitigation.” The tsunami analogy has made its way into media coverage, for example, Christopher Hayes, “The Coming Foreclosure Tsunami,” *The Nation*, November 13, 2007.

⁴⁴ The FDIC implemented its own variation on this plan when it took over IndyMac Bank. The FDIC is trying to contact IndyMac’s delinquent borrowers to offer to write down their loans to a 38% debt-to-income level. Information on the FDIC plan is available at <http://www.fdic.gov/news/news/press/2008/pr08067.html>.

On the other hand, the natural disaster analogy may not be appropriate. Unlike a natural disaster, neither the housing stock nor the communications network have been damaged beyond the control of market participants. Rather, borrowers in some cases avoid communications with loan servicers who try to contact them. Similarly, some loan servicers might try to contact borrowers but then avoid negotiating more lenient terms both because it might make it more likely that other borrowers will seek more lenient terms (borrowers who do not necessarily have an affordability problem) and because a reputation for lowering balances may be bad for bidding for future loan servicing contracts. Unlike in a natural disaster, it could be argued that borrowers and lenders are in a position to bargain.

Other Examples

The Great Depression and Hurricanes Katrina and Rita are arguably the two extremes—an extreme macroeconomic collapse on the one hand and extreme natural disasters on the other. The historical record of moratoriums on debt collections is extensive. For example, the May 1933 edition of the *Harvard Law Review* contains a comparative study of moratorium legislation.⁴⁵ Historic examples include a court case of Demosthenes regarding a general prohibition on debt collection actions against Greek soldiers away at war, a general moratorium decreed by the Emperor Justinian when the Franks invaded Italy and Sicily, and many other moratoriums during wars. Providing a moratorium on debt recovery has not been confined to periods of war; many U.S. states attempted to provide moratoriums during times of economic stress in the 1800s. Excluding war years, the article lists 20 instances in which states tried to impose moratoriums on debt collections. Many of these attempts by states were found to be unconstitutional, but such restrictions would not necessarily apply to the federal government.⁴⁶

Author Contact Information

Edward V. Murphy
Analyst in Financial Economics
tmurphy@crs.loc.gov, 7-6201

⁴⁵ See A.H. Feller, “Moratory Legislation: A Comparative Study,” 46:7 *Harvard Law Review*, May 1933, pp. 1061-1085.

⁴⁶ Constitutional issues are beyond the scope of this CRS report. For more information, see CRS Report RL34369, *Constitutional Issues Relating to Proposals for Foreclosure Moratorium Legislation That Affects Existing Mortgages*, by David H. Carpenter.