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OP-ED CONTRIBUTOR

Mortgage Justice Is Blind

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THE current American economic crisis, which began with a housing collapse that had devastating consequences for our financial system, now threatens the global economy. But while we are rushing around trying to pick up all the other falling dominos, the housing crisis continues, and must be addressed.

We start with this simple fact: Too many families are being thrown out of their homes when it makes more sense to let them stay by “reworking” their mortgages — adjusting terms to make it possible for the homeowners to meet their responsibilities. In many cases, adjusting loans would help the homeowners and the lenders: the new mortgages would have lower monthly payments that homeowners could afford to pay, and would end up giving the lenders more money than the 50 cents on the dollar that many foreclosure sales are bringing these days.

The presidential candidates have proposed plans to help some homeowners and mortgage-security holders by buying out loans or putting a moratorium on foreclosures. We have a plan that would be much less costly than buyouts and more comprehensive than a moratorium.

In the old days, a mortgage loan involved only two parties, a borrower and a bank. If the borrower ran into difficulty, it was in the bank’s interest to ease the homeowner’s burden and adjust the terms of the loan. When housing prices fell drastically, bankers renegotiated, helping to stabilize the market.

The world of securitization changed that, especially for subprime mortgages. There is no longer any equivalent of “the bank” that has an incentive to rework failing loans. The loans are pooled together, and the pooled mortgage payments are divided up among many securities according to complicated rules. A party called a “master servicer” manages the pools of loans. The security holders are effectively the lenders, but legally they are prohibited from contacting the homeowners.

In place of the bank lender, the master servicer now holds the power to rework the loans. And, as we have seen in the current crisis, these servicers aren’t doing that, as house after house goes into foreclosure.

Why are the master servicers not doing what an old-fashioned banker would do? Because a servicer has very different incentives. Most anything a master servicer does to rework a loan will create big winners but also some big losers among the security holders to whom the servicer holds equal duties. So the servicers feel safer doing nothing. By allowing foreclosures to proceed without much intervention, they avoid potentially huge lawsuits by injured security holders.

On top of the legal risks, reworking loans can be costly for master servicers. They need to document what new monthly payment a homeowner can afford and assess fluctuating property values to determine

whether foreclosing would yield more or less than reworking. It's costly just to track down the distressed homeowners, who are understandably inclined to ignore calls from master servicers that they sense may be all too eager to foreclose.

Yes, the master servicer is paid to oversee the mortgages, but those fees were agreed on during the housing boom, and were based on the notion that reworking mortgages would be a relatively small part of the job and would carry little litigation risk.

Last, some big master servicers are part of, or have now been bought out by, the very companies that own the securities that can be affected by the reworking or foreclosure decisions the master servicer makes. This conflict further increases the chances of litigation and contributes to inaction.

Thus it is no surprise that so few mortgages have been reworked, with devastating consequences for the economy. It is also no surprise that trading in the securities tied to the mortgage pools has drastically declined, because potential buyers cannot be sure what the servicers are going to do with the underlying loans.

To solve this problem, we propose legislation that moves the reworking function from the paralyzed master servicers and transfers it to community-based, government-appointed trustees. These trustees would be given no information about which securities are derived from which mortgages, or how those securities would be affected by the reworking and foreclosure decisions they make.

Instead of worrying about which securities might be harmed, the blind trustees would consider, loan by loan, whether a reworking would bring in more money than a foreclosure. The government expense would be limited to paying for the trustees — no small amount of money, but much cheaper than first paying off the security holders by buying out the loans, which would then have to be reworked anyway. Our plan would also be far more efficient than having judges attempt this role. The trustees would be hired from the ranks of community bankers, and thus have the expertise the judiciary lacks.

Americans have repeatedly been told that the distressed loans cannot be reworked because these mortgages can no longer be “put back together.” But that is not true. Our plan does not require that the loans be reassembled from the securities in which they are now divided, nor does it require the buying up of any loans or securities. It does require the transfer of the servicers' duty to rework loans to government trustees. It requires that restrictions in some servicing contracts, like those on how many loans can be reworked in each pool, be eliminated when the duty to rework is transferred to the trustees.

Under our plan, servicers would provide the homeowner's name and other relevant information on each loan to a central government clearing house, which would in turn give trustees the data on homes in their local area. Once the trustees have examined the loans — leaving some unchanged, reworking others and recommending foreclosure on the rest — they would pass those decisions to the government clearing house for transmittal back to the appropriate servicers.

The servicers would then do exactly the same work they do now, passing on the payments they collect from the reworked mortgages to the securities' owners in each pool. The servicers would also foreclose on those properties the trustees had decided did not qualify for reworking. For performing those tasks, the servicers would continue to receive the fees due under their existing contracts.

The rules governing the trustees must ensure that only homeowners in true financial distress qualify to have their mortgages reworked, so that homeowners do not see the program as a free ride to a cheaper mortgage. Luckily, there is already a rough set of guidelines in place for making these sorts of loan-modification decisions, thanks to the Hope Now Alliance, a joint effort of the Treasury, the Department of Housing and Urban Development and private lenders.

Our plan would keep many more Americans in their homes, and put government money into local communities where it would make a difference. By clarifying the true value of each loan, it would also help clarify the value of securities associated with those mortgages, enabling investors to trade them again. Most important, our plan would help stabilize housing prices.

We need an innovative approach to overcome the gridlock that plagues our housing markets. Otherwise, we imperil millions of homeowners and — through the alchemy of derivatives — the American and global economy.

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