Testimony of Dean Baker

Before the Domestic Policy Subcommittee of House of Representatives
Oversight and Government Reform Committee

Hearing on Policies to Mitigate the Foreclosure Crisis

May 21, 2008

Thank you, Chairman Kucinich, for inviting me to share my views on the mortgage crisis with the subcommittee. My name is Dean Baker and I am the co-director of the Center for Economic and Policy Research. I am an economist, and have been writing about the housing bubble since 2002.

The current situation in the housing market is potentially the largest economic crisis in the post-World War II era both for the country as a whole and the millions of homeowners facing the loss of their home. By its actions, Congress can help to either ameliorate some of its worst effects, or exacerbate the problems. For this reason, it is crucial that it consider carefully the implications of any legislation.

I would like to present to the subcommittee my "Subprime Borrower Protection Plan," the main thrust of which is to temporarily alter the foreclosure process in recognition of the unusual circumstances facing the housing market. The plan would allow low- and moderate-income homeowners facing foreclosure the option to remain in their homes as renters for a substantial period of time (e.g., 10 years) in which they would pay the fair market rent, as determined by an appraisal.

This measure could potentially provide housing security to millions of families facing foreclosure. It does so in a way that requires no taxpayer money and no new bureaucratic structures, and it can begin to have an impact immediately after Congress approves it. This temporary change in foreclosure rules would also give lenders substantial incentive to renegotiate the terms of the mortgage, increasing the likelihood that many families will be able to stay in their homes as owners.

In the rest of my testimony, I will outline some of the specifics of the proposal and highlight the aspects that are most important. I also will take a moment to respond to the main objection that has been raised against this proposal – that it would interfere with the sanctity of contract.

The Subprime Borrower Protection Plan

The basic point of the subprime borrower protection plan is to protect homeowners, who were victimized by predatory mortgages and the collapse of the housing bubble, from being thrown out of their homes. It accomplishes this goal by temporarily changing the rules on foreclosure, and gives homeowners facing foreclosure the option of renting their home, for a substantial period of time, at the fair market rate. This rate would be determined by an independent appraiser in the same way that an appraiser determines the market value of a home when a bank issues a mortgage.

The proposal can be structured in such a way as to ensure that it is limited to low- and moderate-income families and that only those who were caught up in the housing boom and subsequent bust of the last few years may apply. These limitations can be set simply by capping the value of the house to which the act would apply, and limiting the dates of the mortgages that would be affected.

For example, the change in rules can be limited to houses that sold for less than the median price at the time in the relevant metropolitan area. Congress could, of course, opt to extend the benefit more widely by allowing the change in rules to apply to somewhat higher-priced homes, for example 1.2 times the median price, or, alternatively, narrow the range of beneficiaries by setting the cap at 0.8 times the median price. This price information is readily available from the National Association of Realtors.

The benefit can also be time-limited by setting an end date for the mortgages to which the rule would apply. For example, Congress could restrict this change to mortgages that were issued before July 1, 2007. It can also set a beginning date, although very few older mortgages are ending up in foreclosure, so putting a beginning date would have little impact.

In subsequent years, rents would be adjusted by the Labor Department's consumer price index for rents in the area. If either the owner or renter believes that their rent is unfair, they can arrange, at their own expense, to have the court make a second appraisal.

In cases where homeowners opt to rent their foreclosed homes, the mortgage holder would be free to resell the house, but the buyer still would be bound by the commitment to accept the former homeowner as a tenant for the full period granted in the proposal. In effect, they could only remove the tenant through a process establishing just cause, such as non-payment of rent or damage to the property.

The Benefits of the Subprime Borrower Protection Plan

The most obvious benefit of the proposal is that it would immediately give millions of low- and moderate-income homeowners facing foreclosure protection from losing their home. There would be no need to set up any new bureaucracy or administrative structure; the protection is put in place the moment the plan becomes law.

The benefit can also be targeted precisely to the low- and moderate-income homeowners whom Congress and the public are most concerned with assisting. The cap on the value of the home will ensure that upper-income homeowners do not benefit under this plan. Similarly, the nature of the benefit – being allowed to stay in the home as a renter – will ensure that speculators do not benefit, since they have no interest in becoming tenants. (The law should also be written to only apply to owner-occupied housing.)

By keeping homeowners in their homes, this act will prevent the sort of disruptions to the lives of working people and their children which result from foreclosure. This proposal will also prevent the blight that afflicts neighborhoods with large numbers of foreclosed homes. Under this proposal, homes will stay occupied. Even if the family is not still a homeowner, they will be a tenant with a long-term commitment to the house that they rent. This will save local governments money they would otherwise have to spend policing and maintaining properties, and will preserve the value of other homes in the area.

At least as important as these considerations is the fact that the change in foreclosure rules will provide lenders with a substantial incentive to renegotiate the terms of the mortgage in a way that allows the family to remain in the house as a homeowner. Banks and other mortgage holders do not want to become landlords. If they became landlords as a result of this foreclosure procedure they would almost certainly find it necessary to hire a management company or to sell the home at a price that is substantially lower than what it would command as an unoccupied single-family home.

Since most lenders would view these as unattractive options, they are likely to seriously commit themselves to negotiating terms with homeowners that allow them to remain in the house as homeowners. While there will undoubtedly be cases where it not possible to reach such an agreement, it is quite likely that more families will stay in their homes as homeowners as a result of this plan than will end up as renters. For this reason, the Subprime Borrower Protection Plan should be viewed as a measure to promote continued homeownership, in addition to providing housing security.

The Subprime Borrower Protection Plan and the Sanctity of Contract

One of the main criticisms raised against the Subprime Borrower Protection Plan is that it interferes with the sanctity of contract by retroactively changing the terms under which mortgage contracts are enforced. While it is reasonable to be concerned about the sanctity of contract – Congress should be reluctant to interfere with the terms of private contracts – the events that created the current mortgage crisis are extraordinary. Furthermore, there have been other instances where Congress has shown little concern with the sanctity of contract in structuring legislation, most notably the bankruptcy reform bill that was passed in 2005.

In the bankruptcy reform bill, Congress restructured rules on bankruptcy to make it substantially more difficult for individuals to discharge debt through the bankruptcy process. This bill is relevant to the current situation because Congress applied the change in bankruptcy rules retroactively. The harsher bankruptcy rules applied not only to new debt incurred after the change in the bankruptcy law, but also to debt that had been incurred prior to the passage of the law under the previous set of bankruptcy rules.

This meant that individuals who borrowed money when one set of bankruptcy rules were in effect could suddenly be forced to repay their debts under a new set of bankruptcy laws. Congress was apparently willing to ignore the fact that both borrower and creditor presumably set their contractual terms (specifically the interest rate) based in part on the bankruptcy rules in place at the time.

In the case of the Subprime Borrower Protection Plan, Congress is effectively changing the rules of enforcement for mortgage contracts just as it previously changed the rules for collecting debts more generally when it changed the bankruptcy laws. The main difference is that the subprime borrower protection plan is a change that benefits the borrower instead of the lender.

Conclusion

The collapse of the housing bubble has created a crisis in the nations' housing market unlike any that we have witnessed since the Great Depression. While much of the harm from this crisis became unavoidable as the housing bubble inflated to dangerous levels, Congress can mitigate the pain for the most vulnerable segment of the home-owning population.

Temporarily changing the foreclosure rules to allow homeowners facing foreclosure the option to remain in their homes as renters will provide housing security to millions of families facing foreclosure. It will preserve the value of neighborhoods, and give lenders a real incentive to negotiate terms that allow homeowners to stay in their houses as owners.

This proposal requires no new government bureaucracy, nor any expenditure of tax dollars. Furthermore, it would require no lead time; it can provide protection to homeowners immediately after it is signed into law. For these reasons, I hope that the subcommittee will carefully consider the merits of this proposal.