

# Try a Little Forgiveness

The Bush-Paulson mortgage bailout.

BY IRWIN M. STELZER

American capitalism as we know it is dead; America is now the Argentina of the north, a place where no contract is sacred. So go the more apocalyptic reactions to the Bush administration's proposed intervention in the home mortgage market. "Who would invest in U.S. bonds or mortgages if the government could arbitrarily reduce the contracted interest payments?" asks Martin Feldstein in the *Wall Street Journal*, expecting the answer to be "No one at all."

All because the Bush administration persuaded—well, coerced—lenders to give some of the nation's hard-pressed borrowers a bit of breathing room. If the administration can work the kinks out of its plans, including refining the definition of intended beneficiaries, many resets—read, increases—scheduled for the next few years in about \$150 billion of subprime mortgages won't happen, at least for five years. Most repossessions won't happen either.

This has two political aspects, one bothersome to the Bush team, one considered a major plus. The negative is that it boosts Hillary Clinton, who suggested a similar "foreclosure timeout" many months ago. Unless the White House wants to add to her prestige because it feels that the senator from New York is the most beatable of all Democratic candidates, the Bush team can't enjoy hearing her inevitable "I told you so."

The political plus is that the Bush-Paulson team believes its plan will

have its major helpful impact in politically important states: California and Florida account for 28 percent of all adjustable-rate subprime mortgages, and Michigan and Ohio are in the throes of house price declines that have seen foreclosures rise even on traditional fixed-rate mortgages.

There is no denying that the administration plan has its flaws. It seems to discriminate against prime borrowers who find themselves unable to refinance, while favoring subprime borrowers in the same circumstance. And it might not be immune from lawsuits

by investors who want to prevent this change in the terms of their contract with borrowers—a contingency that Clinton proposes to cover with separate legislation.

Nor is there any denying that government pressure on lenders to change the terms of their mortgage contracts creates a new risk, and that lenders in the future will take account of that increased risk by setting the terms of new loans less favorably for borrowers. But that does not answer the difficult question of whether the Bush/Paulson plan is good policy. For against that cost must be set the benefit of easing pressures on seized-up financial markets and perhaps avoiding a recession; preventing the dumping of hundreds of thousands of houses on an already glutted market, with consequences not only for the construction industry but for consumer behavior; and stopping the eviction of hundreds of thousands of families who might in the long run be able to hold onto their homes if their incomes rise during

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*Irwin M. Stelzer is a contributing editor to THE WEEKLY STANDARD, director of economic policy studies at the Hudson Institute, and a columnist for the Sunday Times (London).*

the period in which rates are frozen.

It is difficult to know whether the benefits exceed the costs of the plan—which, it should be remembered, involves no taxpayer funds. But the answer won't be found by chanting ideological slogans about sanctity of contracts, or saving the unfortunate from rapacious bankers. And it won't be found in attacks on government intervention in the free market—no such market exists in housing, and has not for the many decades since the government set up a variety of agencies to make credit more easily available to potential homeowners. Then there is the distorting effect of the mortgage-interest tax exemption, but that is a story for another day. The point is: We are not dealing with any perversion of an otherwise free market of the sort envisioned by Adam Smith.

We do seem to be on safe ground when we question whether the standard “moral hazard” argument applies here. Presumably, policies that bail out people who have engaged in irresponsible behavior are to be avoided, lest those saved from their own sins be tempted to repeat their foolishness. And there is no doubt that some of the borrowers did engage in irresponsible borrowing, just as some of the lenders did engage in irresponsible, and even fraudulent, lending. But the administration's plan does not bail out the banks and other lenders, so it contains no encouragement to repeat the sloppy lending practices that now are causing the banks so much pain. It might encourage borrowers to think that they can take on any commitment, and when they can't pay, look to the government for relief. But these potential re-offenders would have to find a lender willing to make such loans, and even bankers with notoriously short memories are unlikely to trawl the markets for subprime borrowers very soon. So there is little reason to oppose the administration's plan solely because of any moral hazard problem it might create—that concern should be directed at the Fed as it desperately tries to make life easier for bankers, at the risk of trigger-

ing the inflation already threatened by rising food and energy costs.

A final objection to the administration's proposal is that by coming between the lenders and the flow of mortgage payments to which their contracts entitle them, the government is transferring a huge pot of wealth from lenders to borrowers. But is it? In fact, the lenders were never going to get repaid in full at reset rates that in some cases hit 11 percent, and would be stuck with repossessed houses that could be resold in many cases for only a fraction of the value of the underlying mortgages. So they might in fact be better off getting interest rates that, although lower than they had hoped, enable them to avoid loading up on difficult-to-sell repossessed houses. The banks know this, of course, but because some 95 percent of subprime mortgages are packaged into securities, they were having trouble tracking down the ultimate holders of each mortgage, and arranging one-on-one negotiations between borrower and lender. The administration's plan goes a long way towards solving that problem. It might be a bit of a blunderbuss, but that weapon does have uses when rifle shots just won't do the job.

What this plan for relief means is that even a very conservative government has come to realize that houses are not shirts. Wear a dirty shirt, with buttons missing, and you pay the price; tolerate a run-down house, with shutters askew and lawn unmowed, and you *and* your neighbors pay the price. As an economist would put it, there are real externalities at play in the housing market. And where there are externalities, the argument for activist government is hard to beat, and can be trumped only by the not unreasonable fear that the government might just make matters worse by trying to make them better.

Economists have long known that home ownership conveys benefits not only on the family for which it provides shelter, but for others who have not contributed to the cost of the home. As Treasury Secretary Hank Paulson realized when he tried to unravel the problem created by sub-

prime mortgages about to reset from low “teaser” rates to much higher levels, there is something different about a home. Paulson, whose original instinct was to steer clear of the mess—his day job, after all, is persuading the Chinese to become fair traders and stop stealing our intellectual property—finally realized that homeowners are more likely to be involved in civic activities, conveying benefits on neighbors. And that empty and/or derelict houses reduce the value of the homes of neighboring families who have fully met all of their mortgage obligations.

It doesn't take more than common-sense observation to realize that neighborhoods characterized by high rates of home ownership tend to have lower rates of crime, better schools, a healthier environment in which to raise children, more vibrant churches and civic institutions, and all of the Ozzie-and-Harriet advantages that Americans work so hard to obtain for themselves and their children. That is to paint with a broad brush, but the picture is broadly accurate, which is why owning a home is so important a part of the American dream.

So when the government intervenes to prevent an eviction, it benefits not only the poor wretch who cannot afford to keep up his payments, but the entire neighborhood. Banks are not the best custodians. Few banks successfully maintain a repossessed house in sparkling order. And even if they did, the for-sale sign planted on the lawn is a warning to neighbors that the value of their property might be dropping; get out while the getting is good.

My own studies, done in connection with long-time colleague Bill Shew with a grant from Freddie Mac, reached a similar conclusion. And one we had not anticipated. It is that even after allowing for the subsidy provided to home buyers by Freddie Mac and Fannie Mae by virtue of investors' assumption that these agencies' are too big to fail, society is more than compensated by the increase in home ownership, with all the benefits that brings.

This fact is one that even small-government conservatives have to consider when deciding whether to travel down the road to increased government involvement in the mortgage markets. Paulson, a Goldman Sachs graduate and hardly a

wild-eyed radical, finds himself on that road, and moving further and further down it. At road's end stands the man who will be his principal collaborator in Congress, a welcoming liberal Democrat by the name of Barney Frank. ♦