More lifeboats

by the St. Louis Post-Dispatch

Somewhere between 145,000 and 240,000 American families will keep their homes because of the deal hammered out among major players in the mortgage industry with a strong nudge from the Bush administration.

That's good as far as it goes, but it isn't enough. The deal inexplicably excludes many thousands of homeowners who could keep their homes if their loans were modified. Given the steep losses that lenders take in foreclosures, keeping those families in their homes makes sense for everyone.

Some 1.8 million American families hold adjustable-rate mortgages that will reset to higher rates over the next two years. The mortgage industry estimates that a third of those families will lose their homes.

That would toss an avalanche of foreclosed homes onto the market, at a time when prices are already slipping. A worsening housing slump could slow consumer spending, while keeping the home construction industry stalled for years.

Meanwhile, a less visible crisis is bubbling up in the credit markets. The prices of $1.3 trillion in subprime mortgage-backed securities have fallen though the floor, and they're still falling. That's caused billions in losses at big banks and financial firms in America and Europe. The situation raises the possibility of a general credit crunch would throw a monkey wrench into an American economic engine that already is slowing and sputtering. It could mean recession.

The trick, then, is to help families and the housing market without making the credit crisis worse. The deal announced last week puts some lifeboats in the water, and that's good. It divides borrowers into categories. Borrowers who can afford the higher payments will have to pay them. Those who can't afford even the current lower rates will lose their homes. Those who are already behind in their payments also are out of luck.

Another lucky group - perhaps 600,000 families - has high-enough incomes and credit scores to refinance into prime-rate mortgages or loans through the reawakened Federal Housing Administration.

The lifeboats go to the middle group - those who can afford today's payments but not the much-higher payments due after the reset, and who can't refinance. They would get to keep today's lower payments for five years. Lenders generally would fare better by collecting interest from such families than by foreclosing on them. Meanwhile, the housing market may recover and families may dig themselves out of their rut over the next five years. This deal is a modest win all around.

But the rescue needs more lifeboats. The Center for Responsible Lending, a liberal group, thinks only 145,000 families will qualify; analysts at Barclays Capital put the figure at about 250,000. A lot of caught-in-the-middle families are excluded for no good reason.

- Only families whose loans reset after 2007 could qualify. Why exclude people whose loans reset this year? About 14.5 percent of subprime adjustable-rate loans are already in default.

- Under the rules, families don't qualify for a rate freeze if they have more than 3 percent equity in their home. Obviously, foreclosure makes sense for a lender if there's a lot of equity, but 3 percent isn't a lot. The limit should be much higher.

- Homeowners can't qualify if they have a credit score of over 660. That's the cut-off to qualify for a prime mortgage, and those who can refinance into prime mortgages certainly should do so. But lots of subprime mortgage holders have shaky incomes or lack the equity needed for a prime loan. A score of 660 won't help them.

- Strangely, a homeowner also can be disqualified if he has improved his credit score by 10 percent. Why should good credit behavior be punished?

Congressional Democrats are proposing rescue legislation, which may play well politically but could create even bigger problems. New York Sen. Hillary Clinton has proposed a moratorium on foreclosures, a step that would make mortgage investors nervous and might send the credit markets into a deeper tailspin.

Others, including Sen. Dick Durbin, D-Ill., want to let bankruptcy judges change the payment requirements on subprime mortgages. Once the current crisis passes, that might be worth considering. But right now it would create more fear and doubt among investors and make the credit crunch bigger.

For now, the best policy is the one the Treasury Secretary Henry Paulson has been following: Keep pressuring the industry for solutions that help lenders and borrowers alike. Send more lifeboats.

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