



BUCKEYE INSTITUTE FOR PUBLIC POLICY SOLUTIONS



POLICY BRIEF

TUESDAY, FEBRUARY 24, 2009

Meddling in the Mortgage Market: Harming Homeowners through Good Intentions

By Marc Kilmer

In the midst of increasing attention to how the home price bubble is contributing to our current economic woes, some in Ohio want to enact legislation that would change the terms of mortgage contracts. The key aspect of this proposal would give judges new power to change the terms of Ohioans' mortgage contracts and reduce the amount owed on the mortgage to the home's appraised value.¹ This modification of private contracts by judges is known as "cramdown" in bankruptcy hearings. Politicians supporting this Ohio cramdown will only exacerbate the problems in the housing sector and the economy in general, hurting Ohio homeowners and ultimately Ohio workers.

Is there a Foreclosure Crisis in Ohio?

There is no doubt that many in Ohio are experiencing foreclosures, but it may not be the crisis which some politicians claim. In January, for instance, one in every 452 Ohio properties was in pre-foreclosure proceedings, being sold by auction, or in the midst of repossession by banks. That is the tenth highest rate in the nation, but January foreclosures in the state are at a lower number than December foreclosures. In addition, the rate of foreclosures in January of 2008 was 12% higher than the foreclosure rate of January 2009.²

For the entire year of 2008, 85,773 homes went into foreclosure, up from 83,230 in 2007. However, that was the smallest increase in the Ohio foreclosure rate in 13 years, and some

counties in the state saw a decrease in the number of foreclosures.³ These trends indicate that the high point of foreclosures in the state may be in the past. Looking at the states experiencing higher foreclosure rates than Ohio, such as Nevada, Florida, and California, indicates that their foreclosure problems are different than Ohio's. These states experienced higher economic growth than Ohio over the past decade and saw an influx of new residents. Their foreclosure crisis is due, in large part, to a speculative bubble.

Ohio's foreclosure problems, however, cannot plausibly be explained away by speculation. Instead, they arguably reflect an outgrowth of the state's larger economic problems. Only legislation that makes fundamental changes to Ohio's tax and regulatory structure will produce the economic growth that truly addresses the root causes Ohio's foreclosure problems.

Constitutionality

The Ohio Constitution explicitly prohibits the Ohio General Assembly from passing legislation impairing contracts.⁴ Mortgages are private contracts between borrowers looking to buy houses and lending institutions which provide them the money to do so. A law changing the terms of these current contracts is in violation of the Ohio Constitution.

The law would also face further constitutional issues if it were to affect contracts



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retroactively.⁵ The only mortgage contracts that would be affected by any cramdown proposal would only affect home loans made after the enactment of the legislation.

Hurting Homeowners

Much of the talk in the media frames the foreclosure problem as one of people versus banks. In reality, though, this is an issue of people versus people; that is, homeowners who are paying their mortgages pitted against homeowners who are not. Changing the law governing mortgage contracts may help those homeowners who are unable or unwilling to pay their mortgages but it would only do so at the expense of those who are able to pay them. Lawmakers who support this type of cramdown proposal are penalizing the vast majority of Ohioans who are paying their mortgages on time and those seeking to buy homes in the future.

Specifically, homeowners would be hurt by rising interest rates. Scholar Todd Zywicki explains it in these terms:

If judges can rewrite mortgage loans after they are made, it will increase the risk of mortgage lending at the time they are made. Increased risk increases the overall cost of lending, which in turn will require future borrowers to pay higher interest rates and upfront costs, such as higher down payments and points.⁶

This is not merely theoretical. Federal Reserve researcher Karen Pence studied state foreclosure laws and found that in those states where they were friendlier to those who default, homeowners bore higher costs:

In states with laws favoring the borrower, the supply of mortgage credit may decrease because lenders face higher costs. ... I find that loan sizes are 3% to 7% smaller in defaulter-friendly states; this result suggests that defaulter-friendly laws impose material costs on borrowers at the time of loan origination.⁷

By imposing higher costs on homeowners in these ways, a cramdown would increase the number of people unable to buy homes or pay for the mortgages they currently hold.

Hurting the Economy

While a cramdown would impose significant costs on Ohio homeowners, its effect on lending institutions should not be ignored. Modifying mortgages through a cramdown, as intended, shrinks the amount of money owed to lending institutions. That would pose serious trouble for our economy.

One recent estimate forecasts as many as 1,000 bank failures in the next three to five years.⁸ Federal policy since the beginning of 2008 has been aimed at propping up lending institutions and ensuring they do not fail. Legislation that would reduce the value of their assets would counteract these efforts.

As the Heritage Foundation pointed out when discussing a national bill to allow mortgage modification:

U.S. banks and thrifts hold about \$315 billion worth of highly rated mortgage-backed securities that would suffer immediate and permanent downgrades. This, in turn, would force banks to write down these assets to reflect their lower value and set aside additional capital to satisfy regulatory requirements. Some banks' already overburdened balance sheets could not absorb those hits.⁹

The same principles apply to state legislation. Legislators backing cramdown legislation would contribute to bank failures at a time when our state and nation can least afford them.

Rewarding the Irresponsible and Unscrupulous

While proposals allowing judges to modify mortgage terms may be intended to help so-called "innocent victims" of foreclosures, that is, homeowners who through no fault of their own find themselves in foreclosure proceedings, it will inevitably benefit homeowners who have made poor financial decisions or who are seeking to game the system.



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Many facing foreclosure foolishly borrowed more money than they could afford or otherwise made bad choices when they entered into their mortgage contract. It is poor public policy to penalize those who make responsible decisions in order to give benefits to those who have acted irresponsibly. Allowing mortgage contracts to be rewritten by judges would introduce a moral hazard that shields irresponsible borrowers from the consequences of their bad decisions, making such bad decisions more likely. Is this the type of activity policymakers wish to reward?

Furthermore, by giving incentives for homeowners to become delinquent on their mortgage payments, this legislation will prompt some homeowners who are currently able to pay their mortgage to stop doing so in order to take advantage of the legislation's terms.

Another result of a cramdown proposal is that some will make an explicit profit from it. A homeowner whose appraised home value has dropped may receive a mortgage modification, only to have the home regain its value during the next economic upswing. This would create a windfall in value for the unscrupulous homeowner at the expense in higher interest rates for all future Ohio homeowners.

National Action

A Proposal for state-level mortgage modification legislation not only have a variety of policy flaws, but it also seems unnecessary given the action by both private banks and the national government on this issue. A variety of national banks have announced foreclosure moratoriums and plans to allow some borrowers to re-negotiate their mortgage terms. In mid-February President Barack Obama came out in support of federal legislation that would accomplish many of the stated goals of those pushing this Ohio legislation. Enacting an Ohio-specific proposal would interfere with these national efforts and put the state on a unique path in dealing with what is primarily a national, not a state, issue.

An Historical Perspective

While for many around the nation, these financial troubles are deeper and more widespread than any in their memory, our

nation has seen this type of problem before. In fact, the issues surrounding real estate prices and speculative bubbles go back to our nation's founding and before. So, too, do the poor policy proposals suggested by politicians to deal with the issue.

Studying the various real estate booms and busts in our nation's history, economic historians have recognized that the uncertainty caused by invalidating contractual agreements related to home loans only serves to freeze up credit and hurt those it is intended to help. As constitutional scholars note, the Federal Constitutional Convention of 1787 was actually precipitated, in part, by state legislation "interfering with foreclosure of mortgages."¹⁰

United States Chief Justice John Marshall once remarked:

The power of changing the relative situation of debtor and creditor, of interfering with contracts, a power which comes home to every man, touches the interest of all, and controls the conduct of every individual in those things which he supposes to be proper for his own exclusive management, had been used to such an excess by the State Legislatures as to break in upon the ordinary intercourse of society and destroy all confidence between man and man. The mischief had become so great, so alarming, as not only to impair commercial intercourse and threaten the existence of credit, but to sap the morals of the people and destroy the sanctity of private faith. To guard against the continuance of the evil was an object of deep interest with all the truly wise as well as virtuous of this great community, and was one of the important benefits expected from a reform of the government.¹¹

Prominent economic historians have noted that:

Unquestionably, the country owes much of its prosperity to the unflinching courage with which, in the face of attack, the Court has maintained its firm stand in behalf of high standards of

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business morale, requiring honest payment of debts and strict performance of contracts; and its rigid construction of the Constitution to this end has been one of the glories of the Judiciary. That its decisions should, at times, have met with disfavor among the debtor class was, however, entirely natural; and while, ultimately, these debtor-relief-laws have always proved to be injurious to the very class they were designed to relieve and to increase the financial distress, fraud and extortion, temporarily, debtors have always believed such laws to be their salvation and have resented judicial decisions holding them invalid.¹²

Conclusion

The issue of how to address the rising rate of home foreclosures is certainly topical in the midst of this recession. A proposal allowing judges to modify private mortgage contracts to benefit debtors would cause far more problems than it would solve. In fact, a cramdown law of this sort would hurt the state's homeowners and the economy at large. The last thing Ohio needs is legislation that will make the state's economic problems worse.

About the Buckeye Institute

The Buckeye Institute for Public Policy Solutions is Ohio's only free market think tank and the leading independent source of research and commentary on education, economic growth and government transparency. Buckeye Institute provides agenda shaping analysis and research to legislative leaders, opinion leaders and the public.

Our scholars offer free market solutions to Ohio's most complicated public policy challenges. They advocate growing economic freedom by eliminating the income tax; returning freedom to the workplace by ending compulsory unionization; and, liberating our schools by adopting a universal k-12 voucher.

Regardless of the issue debate, the Buckeye Institute's operating philosophy is constant: Free markets enable free men and women to find prosperity.

Endnotes:

1. Marshall, Aaron, "Ohio House Democrats Seek Timeout on New Foreclosure Filings," *Cleveland Plain Dealer*, February 10, 2009. Accessed at <http://www.cleveland.com/news/plaindealer/index.ssf?base/news/1234258360249000.xml&coll=2>.
2. "RealtyTrac: Ohio Foreclosures Ease on Moratorium Efforts," *Columbus Business First*, February 12, 2009. Accessed at <http://www.bizjournals.com/columbus/stories/2009/02/09/daily33.html>.
3. "Data Shows Record Number of Ohio Foreclosure Filings in 2008, Rate of Increase Slows," *Gongwer News Service*, February 11, 2009. Accessed at http://www.gongwer-oh.com/programming/news_articledisplay.cfm?article_ID=780280206&newsedition_id=7802802&locid=2&link=news_articledisplay.cfm?article_ID=780280206%26newsedition_id=7802802%26locid=2.
4. Section 28, Article II of the Ohio Constitution states that "the general assembly shall have no power to pass retroactive laws, or laws impairing the obligation of contracts." Since at least 1875, the Ohio Supreme Court has clearly expressed that this clause means that "any change in the law which impairs the rights of either party, or amounts to a denial or obstruction of the rights accruing by contract, is repugnant to the Constitution." (*Goodale v. Fennell* (1875), 27 Ohio St. 426)
5. The Ohio Supreme Court has further clarified that "Section 28, Article II ... prohibiting the passage of retroactive laws, has application to laws affecting substantive rights." (*Goodale v. Fennell* (1875), 27 Ohio St. 426). The Ohio Supreme Court also clarified that alteration of the terms of a contract related to real property impacts "substantive rights." For instance, in 1986, the Court concluded that "the retroactive application of R.C. 5313.07 and 5313.08 to land installment contracts which were in existence at the time of the enactment of these statutes is violative of Section 28, Article II of the Ohio Constitution which prohibits the enactment of retroactive laws or laws impairing the obligation of contracts."
6. Zywicki, Todd, "Don't Let Judges Tear Up Mortgage Contracts," *The Wall Street Journal*, February 13, 2009. Accessed at <http://online.wsj.com/article/SB123449016984380499.html>.
7. Pence, Karen, "Foreclosing on Opportunity: State Laws and Mortgage Credit," *The Review of Economics and Statistics*, February 2006. Accessed at http://works.bepress.com/cgi/viewcontent.cgi?article=1001&context=karen_pence.
8. Barr, Alistair, "1000 Plus Banks Could Fail, Analyst Estimates," *Columbus Dispatch*, February 10 2009. Accessed at http://www.columbusdispatch.com/live/content/business/stories/2009/02/10/bank_failures.ART_ART_02-10-09_C7_MDCRSOJ.html?sid=101
9. Grossman, Andrew, "Mortgage Modifications in Bankruptcy Would Undermine Homeownership, Prevent Few Foreclosures," *The Heritage Foundation*, February 13, 2009. Accessed at <http://www.heritage.org/Research/LegalIssues/bg2242.cfm>.
10. Charles Warren, *The Making of a Constitution*, pp. 5,6
11. *Ogden v. Saunders*, 12 Wheat. 213, 354, 6 L.Ed. 606
12. See Dewey, *Financial History of the United States*, p. 229 et seq