Caution: Mortgage Payments May Be Losing Their Priority*

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There are certain baked in assumptions in all of our economic models. If you pay more, generally speaking you can buy a better product. Most people will try to earn more money in their jobs. And in mortgage finance, most people will try to pay their mortgage payment every month because without doing so they could lose their home.

It is not at all clear that the last assumption — mortgage payments come first every month — remains valid. More and more servicers are finding that there are other recurring payments that have gained a priority over mortgages. The general pecking order now probably more closely resembles this hierarchy — cell phones, cable TV, car payments, credit card payments and then mortgage payments.

That is not a problem if there is plenty of money to pay everything, but if something has to be deferred or skipped this month, then it makes a difference. How much a difference depends, of course, on a variety of questions. But if we assume that the hierarchy is changing, what does that portend?

At a minimum, it would seem that the industry would have to begin pricing its products differently. Currently, residential mortgages are provided at a very low price relative to other products and services with comparable risk (right now, the price is absurdly low). The reason the interest rates for mortgage loans are so low is that the product is secured — if you don't

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pay, then relatively quickly the creditor can get the property and sell it to compensate for the fact that you failed to repay the loan.

That secured feature makes a dramatic difference in price. An unsecured loan for an amount necessary to pay for an average house is simply not available to many individuals, but to those to whom it is available, the price is dramatically higher than if security is provided. A world of unsecured lending for home purchases is a world that hasn't been contemplated for a very long time — perhaps never in this country.

We're probably a ways away from that, but there does seem to be a drift in the risk placement of those loans caused in part by the reaction to the collapse of the housing bubble. Blame for the collapse was placed on lenders easily because (in part) no one is fond of those to whom money must be repaid. They're okay when one wants to borrow from them, but are Simon Legrees when they have to be repaid.

That drift has resulted, in part, from the devices adopted by many states and localities to make it harder for lenders to use the security in the homes against which the loans have been made. In some states, the security for the residential loan has lost a good deal of its strength. In New Jersey and New York, servicers report, foreclosures are nearly nonexistent. In other states such as Florida, borrowers in foreclosures remain in their houses even though they have not made payments over 3 years. They live in the houses, notwithstanding they have not made any payments because of laws passed by the state, requirements that a judge must approve even the most technical details surrounding the paperwork, court decisions upholding technical mistakes over non-payment, and a public ever ready to find that the lenders have in some way been at fault. It has been found to be irrelevant that the borrowers couldn't afford the loans.

If a lender cannot have relatively quick access to the secured property to liquefy it, then a lot follows. First, the lender is denied the time value of money for whatever delay ensues. Second, it must add to its fixed labor costs the special servicers that deal with defaulted loans and foreclosed property. In addition, the property itself no longer is being cared for by anyone that

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has a long term interest in its maintenance, and thus the value the lender ultimately receives from the collateral is reduced. New penalties relating to matters incidental to the lack of payment of the mortgage (who signed the affidavit) have followed, adding to cost.

In this environment, particularly when unemployment is high and not apparently dropping significantly to a "normal" 4-6 percent range any time soon, is it any wonder that lenders are asking for more of a down payment and better proof that the borrower both has the ability to repay the loan and the propensity to do so. Perhaps they should also be considering the method by which they determine if a borrower should qualify for a loan. Residual income may be the most important element now, not statistical references to the amount of debt the borrower has compared with his or her income. The only true test may be — how much money does the borrower have left each month after paying his debts and his cell phone bill and his cable TV bill and his credit card bill and his car loan. Unlike previously, those now appear to come first, so they must be considered in the calculations of both ability and propensity to repay the loan.

The current environment contains lingering effects, notwithstanding that in better times many will forget the difficult situation that now exists. For example, many of the changes in the legal and regulatory environment have been lodged in statutes and regulations. They won't just simply go away. The diminished reputation of the mortgage finance industry, in all of its aspects, has burrowed into the thinking of a very large number of not only financial reporters and columnists, but more general media professionals. Like it or not, that makes a difference and effects employee morale, investors, and prospective customers.

Most important, it is resounding proof that trust has been severely damaged. Trust between the industry and the regulators or legislatures, between the regulators and the legislatures, between the industry members themselves, between investors and securitizers, and on and on. With the absence of trust, an additional layer of cost has been imposed, since no longer can parties assume certain practices to be followed in the future. For example,

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should a GSE require put backs of thousands of current loans because appraisals were by AVMs instead of humans? Is that sufficient reason even if the contract says it is sufficient reason when there is no proof that such appraisals increased the risk to the GSE? In a situation in which there is a conservator for the GSEs, and the mission of the conservator is to conserve the value of the GSEs for its client — the U.S. Government — it now seems to be sufficient reason.

That is symptomatic of the diminution of the ability of lenders to rely upon accepted practice in the industry, practice that has guided the obligations of all parties in the industry for decades. With that trust destroyed, sharp penciled green eyeshades technicians will soon take a hard look at the cost of mortgages compared with the risk of timely repayment.

Absent a change in attitude on the part of all parties, and absent a return of some reasonable level of trust, it will at best be some time before foreclosures will be permitted to proceed as smoothly and efficiently as before the collapse. While mortgages will most likely never receive the same risk recognition as unsecured loans, all parties will have to reconcile themselves to the understanding that the changing position of mortgages in the payment hierarchy will result in increased costs of mortgages, perhaps a differentiation in rates among states based on the laws of the states and a reduction in credit availability from the heady days of the late 90s when most thought that the traditional 64 percent home ownership could be pushed up closer to 70 percent.

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