

## A Silver Bullet for Toxic Mortgage-Backed Derivatives

Stephen Figlewski<sup>1</sup>

Legend has it that the only way to kill a werewolf is to shoot it with a silver bullet. Werewolves being rather rare these days, the expression is now applied to any quick fix that cures a serious problem as if by magic. Penicillin was called the silver bullet when it was discovered, because it cured intractable infections with a single shot.

In 2005-06, millions of mortgage loans were made to subprime borrowers. Special mortgage-backed securities (MBS) were designed to contain the default risk and leave the great majority of lenders well protected. When default rates began to rise in 2007, the Collateralized Debt Obligation (CDO) securities that take the first default losses suddenly became "toxic." Massive write-downs seriously depleted the capital of major banks and other financial institutions, making it hard to carry their existing asset portfolios or even to continue routine lending and other banking activities.

The problems were compounded by enormous uncertainty that gripped the entire market for MBS. The most toxic securities became unsaleable at prices close to what the banks believed were their true values. Liquidity also dried up for the higher-rated MBS that were supposedly insulated from default losses: They could not be sold for "reasonable" prices, nor could they be easily used as collateral for short-term loans.

Fears that potentially lethal MBS might be lurking on potential counterparties' balance sheets caused interbank lending to freeze up several times this fall. If an overnight loan has one tenth of 1% chance of not being repaid, while your bank may desperately need the funds tomorrow, you don't lend. And it doesn't matter how low the Fed funds rate may be.

The Treasury's original TARP bailout plan envisioned buying up the most toxic MBS, but it foundered on the question of how to value them. There was no way to fix a "correct" price for a security whose market price was 20 cents on the dollar, while the banks believed it was really worth 60. Moreover, the more fundamental unanswered question was whether buying these securities up would really cure the problem.

The plan was never implemented, and in November the Treasury formally abandoned it. Direct infusion of capital into banks thawed out the financial system for a while, but the toxic MBS remained on the banks' books. With no government support in sight, the MBS market again went into free fall. Disappointment that the chance to get the toxic MBS off their books had disappeared was cited as one of the main reasons bank stocks collapsed while the whole market fell more than 6% two days in a row.

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<sup>1</sup> Stephen Figlewski is a Professor of Finance at the New York University Stern School of Business, where he is Director of the NASDAQ OMX Derivatives Research Project. He is also Editor of the Journal of Derivatives.

So the financial system continues to be poisoned by mortgage-related securities for which there is no viable market. Capital is still in short supply, despite the government infusion, but potential new investors are rightly afraid of the default losses that are still being generated in the housing market and pumped through the financial system. Toxic MBS become ever more toxic, and the safety of those that were supposedly protected is increasingly doubtful.

We need a silver bullet that can cure the mortgage market.

I believe one is available. There is a way to intervene in the mortgage market that would immediately detoxify all mortgage related securities.

A detailed discussion is available on my website: <http://pages.stern.nyu.edu/~sfinglews/>, but the essence is this: The financial system is breaking down due to extreme uncertainty over whether the underlying mortgage loans will be paid, and what the lenders will recover in foreclosure if they aren't. If mortgage payments could be made riskfree, then all mortgages and mortgage-backed securities, no matter how complicated, would immediately become free of risk, too, and easy to value.

The government can do this simply by guaranteeing that mortgage payments will continue even if the homeowner defaults. At the point when a lender initiates foreclosure, the mortgage guarantee agency (MGA) would step in. The original loan would remain in place, but the MGA would guarantee all subsequent payments on it.

Non-delinquent mortgage loans would continue making payments as scheduled, and so would compromised loans with the support of the MGA. With risk free cash flows, previously toxic MBS would turn into U.S. Treasury bonds in a different form. They would trade at stable prices in liquid markets, and would be good collateral for interbank loans.

At the same time, the government would gain maximum flexibility to restructure loan terms for the borrowers. The objective would be to allow as many families as possible to remain in their homes and to eliminate the highly damaging and costly process of foreclosures, evictions, and fire sales of repossessed properties in an overloaded housing market.

Principal and interest might be reduced to make loans more affordable, as is being done by the FDIC and private lenders like JP Morgan Chase for whole mortgage loans. But even without concessionary terms, simply restructuring the payment schedule allows considerable scope to lower current monthly payments. If necessary, payments can be lowered further by converting the house into a rental unit, with ownership passing to the MGA.

Stabilizing the financial system does not require mortgage payments be made as originally scheduled, only that the amounts are fully known and free of default risk.

Subprime interest rates compensate for expected defaults. Roughly speaking, if 5% more losses are expected on subprime than on prime loans, the subprime interest rate will be about 5% higher. Since there will be no default losses on guaranteed loans, their yields should be lower.

Implementing a mortgage guarantee plan along these lines raises many questions, some of which are addressed on my website, while others remain open issues. How much would it cost? That depends on how loan terms are adjusted for lenders and borrowers and how many defaults occur anyway, but guaranteeing mortgage payments is a lot cheaper than buying up mortgages or MBS outright. Can we devise incentives to keep borrowers in their homes even when the loan principal exceeds the house's current market price, without making solvent borrowers want to default? Can we bail out the system without creating "moral hazard" incentives to take on too much risk in the future? Can we do it without lenders having to agree to write down loan values voluntarily (which is nearly impossible for loans securitized into MBS) or, alternatively, abrogating millions of legal loan contracts? How can we best manage the process when the MGA must assume ownership responsibility for houses that defaulting borrowers do abandon?

While these important issues would need to be resolved, the bottom line is that there is a silver bullet that could detoxify all mortgage-related securities with a single shot, if we wish to fire it.