SOME QUESTIONS ON PRINCIPAL REDUCTIONS

Both Felix Salmon and DDay are arguing that if the banks lower principal on some unspecified set of loans, it'll fix the "mortgage mess." Now, I agree that loan modifications are one of the things we ought to strive for to solve a number of our problems. But I've got questions about what they're proposing.

First, which mortgages do you intend to modify? Just those in foreclosure? If you do that, you're stuck with the same problem modification programs already have: the point is to modify a loan early enough to make a difference for both the homeowner and the mortgage holder.

Would you extend the principal reductions to non-performing loans? Those amount for 9-10% of all mortgages. That would prevent some homes from going into foreclosure, but probably not those of people who have lost their jobs. Moreover, this only helps a fraction (maybe a third to a half?) of people underwater on their mortgage.

Both Felix and DDay suggest this plan would do something about the underwater home issue, though, suggesting they're contemplating principal reductions on the underwater homes more generally? Those amount to 23.3% of all mortgages. This would have the tremendous value of effectively making the banks pay for the inflated prices they encouraged during the boom. But that's already a whole lot of mortgages you'd have to modify.

But even then, you haven't solved the shitpile problem. Because these percentages still leave out the majority of mortgages. And many of those were securitized during the bubble, either because relatively new mortgages (those written in the last decade) were securitized or because people refinanced and the new loan got securitized. If the problem lies in securitization—and I'm certain Felix and DDay agree that that's the problem—then to clear up the title problem you're going to have to do it for all those homes that were not securitized properly.

And we don't know how many mortgages that includes. Indeed, how would we identify those mortgages?

Just as an example, take my home. I bought it in 2002. At some point, ABN Amro either took over the loan itself or the servicing of it. After that, Citi did. Freddie Mac claims to own the loan right now. The original mortgage was written before the securitization problems got really bad, but within the window that it might be a problem. I asked Citi where my note is using the WhereIsTheNote site. And thus far, at least, they haven't responded by saying, "Oh, Freddie's got your note." Now, I'm trying to sell my house, which is just barely not underwater (I put 20% down when I bought it eight years ago, but it has lost a third of its value, largely due to the number of foreclosures in my neighborhood). Now if things go well, I'll be able to get out of my house without any principal reduction (and trust me, I am grateful that I am better off than a lot of people trying to sell now). But what happens if it becomes clear there is no clear note holder? To whom do I pay off my mortgage when I sell it? How much value would I lose on the house in the process and would that put me underwater (answer: yes)? And if so, would I then qualify for a principal reduction? But if you don't modify my mortgage and in the process give my house a clean title, then my house would for very good reasons be worth less than my neighbor's house that did get a modification.

I'm all in favor of principal reductions. But I doubt you'd ever be able to reach even those underwater homeowners who would benefit from it. But it seems to me it still doesn't fix the more general problem of shitpile.