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An Equity Kicker

Ian Ayres and Barry Nalebuff

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Treasury Secretary Henry Paulson has stated in simple terms the Administration's position on the mortgage crisis: "I'm not interested in bailing out investors, lenders and speculators," he declared at the Economics Club of Chicago in February. "I'm focused on solutions targeted at struggling homeowners who want to keep their homes."

Absent a bank bailout, what options exist? One approach is to rescue the borrowers by beating up the banks. Hillary Clinton has called for a five-year freeze of payments on certain adjustable-rate mortgages. Under this plan, contracts between homeowners and lenders would be torn up and the current teaser payments would be extended; homeowners would not make up the shortfall later.

It seems that any scheme for helping strapped homeowners involves either using taxpayer money or robbing Peter to pay Paul. But with some creativity it is possible to find ways to keep the monthly payments low without adding to the banks' burdens. If borrowers can't afford to pay more today, then they need to pay more tomorrow. Here are two such solutions:

People assume that an adjustable-rate mortgage means that the monthly payment goes up and down with the interest rate. That isn't required. Instead of raising the monthly payment, the lender could extend the term of the loan. It's much easier for people to pay the same amount for a longer term than to pay more per month. A borrower who can't afford a jump in the monthly payment from \$600 to \$800 might still be able to pay \$600 monthly for an additional five or ten years.

Lenders ought to think about offering new mortgages that have adjustments in the form of payment stretch-outs rather than jump-ups. Such terms are not contemplated in existing mortgages, however, so the solution to today's crisis will involve some renegotiation. The government could facilitate this process. In many cases the homeowner could stay put without causing much shrinkage in the value of the bank's income stream. That is, the extra money at the end could

give the lender as much value as the additional monthly payments forgone right now.

Adjustable-term mortgages won't work for everyone. Someone who signed a 30-year mortgage in middle age can't be expected to keep paying for 40 years. But a **Fannie Mae** (nyse: [FNM](#) - [news](#) - [people](#)) study suggests that more than a quarter of subprime mortgages originally had a 15-year term.

For mortgages where extending the payment term won't work, there is a second strategy. In return for getting a cap or reduction in the monthly payment, homeowners could agree to give the bank part of the home's equity upon resale. Think of this as a partial default rather than a full default. The borrower is, in effect, selling two call options, one with a strike equal to future mortgage balance and the other with a strike equal to today's appraised value on part of the home to the lender. If the home eventually appreciates to a point above the loan balance, the lender gets to keep some of that appreciation.

The repossession process is terribly inefficient. Both homeowners and banks are losers. Homeowners lose a place to live along with their credit standing. Banks lose money to delays and to foreclosure costs.

Trading future appreciation for lower payments can work. In Australia a company called Rismark provides homeowners with an amount equal to 20% of the value of their home. In return Rismark gets 20% of the eventual sale price plus another 20% of the appreciation. Years ago (circa 1982) a few U.S. lenders experimented with such "shared appreciation mortgages," ... It's time for both borrowers and lenders to reconsider the concept.

We appreciate that many homes are underwater, and so a 20% claim on sale proceeds that stands second in line behind a bank's mortgage claim isn't worth much. But in this case the appreciation sharer is the bank itself, and the bank stands to lose money if it throws the homeowner onto the sidewalk and auctions the property.

Either of these approaches could be implemented by lenders and borrowers working together. But enlightened government action can inspire them. Regulation can ease the way by establishing secondary markets for trading these new

mortgages. Putting the government's imprimatur on a standard form contract also means that borrowers can have faith that these new mortgages make sense for all involved.

Ian Ayres and Barry Nalebuff are professors at Yale Law School and Yale School of Management. Ayres' latest book, *Super Crunchers*, was published in August. Visit their homepage at forbes.com/whynot.