A COMPARISON OF HOME MORTGAGE LOAN DEFAULTS AND FORECLOSURES IN THE UNITED STATES AND IN CERTAIN EUROPEAN UNION COUNTRIES, INCLUDING A DISCUSSION OF GOVERNMENTAL RESPONSES AND SOME OBSERVATIONS CONCERNING CONTRIBUTING CAUSES

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I. Introduction

Europeans have watched in bewilderment and amazement as the United States mortgage market cratered. I hope in this paper to describe what happened in the US to cause such a mess and, by comparisons to some of the European Union nations, to consider safeguards in place in these EU countries which have, at least to date, avoided a repeat of the US experience here. Indeed, these EU markets seem more resilient and less vulnerable to the problems the US has experienced.

Much has been written about the mortgage crisis in the United States, and the interplay of many factors which have contributed to the worsening situation there, including: (a) the issuance of inappropriate mortgage loans, some to victims of predatory lending, often involving sub-prime mortgages to people ill-equipped economically to handle their repayment, (b) the fall-out of the housing bubble that the United States experienced for several years, with the air leaking out of the balloon beginning in late 2006, resulting in falling house prices, (c) the development and wide distribution of derivatives and other securities in the secondary mortgage market, and other secondary market forces, and (d) the economic recession and its concomitant rise in unemployment figures, adding to the woes of homeowners already strapped to make payments.

This paper examines these factors, and then compares the contribution of each to the United States crisis, highlighting the impact of these factors by comparing the situation in several European Union countries, where the mortgage markets have followed a different course. This comparison allows one to derive a better sense of the causal factors operating, and allows one to propose some practices that could potentially alleviate and, in the future, perhaps prevent some of the difficulties presently facing the United States and, although needed to a lesser extent, some of the European Union countries examined.

II. Overview

We will look first at individual countries' and Euro Area data, and examine some of the factors which affect the health of the mortgage markets. We will then investigate some of the specific policies, practices, attitudes and legal infrastructure which help shape this market, as well as the economic profile within which the markets are working. Finally, we begin to draw some

conclusions about the better practices which have resulted in such different outcomes in the mortgage market between the US and the EU countries considered.

At the outset, it must be noted that, because statistics are kept differently in different countries, it is hard to make comparisons. Different measures, different definitions, different time periods and delays in reporting are but a few of the elements of unreliability when we make cross-country comparisons. In some cases, certain data was not readily available to the author, resulting in some gaps in knowledge. Accordingly, some of the data contained in this paper are neither comprehensive nor strictly comparable, but I hope they will prove somewhat meaningful, in the aggregate.

III. Data and Discussion

1. Sources. An excellent and fairly current paper produced by the European Central Bank in March 2009 (referred to in this paper as "ECB"), entitled "Housing Finance in the Euro Area," and addressing the period 1999 – 2007 provides thorough and thoughtful data on the topics covered, for the EU countries that have adopted the euro (the "Euro Area"). I found it, together with some follow-up communications, most informative. Additional sources for data are noted below and in the Tables.

2. Basic Statistics.

In **Table 1**, we examine basic population and homeownership data for Denmark, Germany, Italy, UK and US. The percentage of home ownership in these countries ranges from 43% in Germany to 68% in Italy and the UK, with the US slightly lower at 67%, and with Denmark in a mid-position at 51%. Various factors affect the percentage of home ownership, including availability of credit, availability of housing stock, perceived value of home ownership in the society and other historical legacies, and governmental support levels which may encourage ownership or rental, including tax treatment.

Other noteworthy facts and ratios include: (1) the percentage of homes carrying mortgage debt is highest in the US, at 42% (47%) [where more than one number is given, this reflects different numbers provided by different sources], while the UK follows at 38%; the Euro Area average is only 20%, a significantly lower percentage of homes encumbered by mortgage loans (ECB, 14, 16, 68; Streitfield, November 20, 2009). A similar contrast with the Euro Area is seen with the ratio of household debt to disposable income, highest in the UK at 154%, standing at 128% in the US, and at merely 97% in the Euro Area (ECB, 67). Similarly, although there is a wide spread within the Euro Area countries, the average ratio of mortgage debt to GDP in the Euro Area countries is considerably lower than the same ratio for the UK and US (Hess & Holzhausen, 4; ECB, 12)

Table 2 sets forth selected facts reflecting how mortgage markets differ in different countries – in terms of required down payments, the centralized (or not) nature and control of the lending community, whether or not lending institutions retain on their balance sheets (and thus, the financial risk of loss with respect to) the loans they have originated, and how lending officer compensation is structured. This data demonstrates that all EU countries examined have more

conservative and more regulated mortgage markets than the US did during the housing and mortgage boom, where down payment requirements were relaxed, credit histories and repayment risks were not evaluated closely, free-wheeling lending practices thrived, and a strong securitization market took over, in which originating lenders did not retain the risk of loss on transferred mortgage assets. All of these factors, and certainly other factors as well, contributed to the crisis presently being played out in the US markets. As reflected in the Table, the numbers for the UK, statistically, lie somewhere between the US and the other EU countries looked at.

In **Table 3**, we highlight the health of the mortgage market in the two countries that most resemble each other, the US and the UK, noting that delinquencies, repossession and loss of value in the housing market are considerably lower in the UK. We reflect the state of delinquencies, foreclosures and repossessions (called possessions in the UK), and various projections for the coming period. From Table 1 we note that the US, with approximately 5 times the population of the UK, has an approximately equal percentage of home ownership, and a similar percentage of homes carrying mortgages. Nevertheless, in the aggregate, the US has far more mortgage debt than the UK, and a higher percentage of delinquencies and foreclosures (8.8%, contrasted with 1.6% in the UK). Foreclosure/possessions paint an even starker picture. While headlines in the UK blasted the government for allowing 46,000 homes (0.4% of homes) to be possessed in 2009, the US figure for 2008 was 880,000 (1.6%), or about 4 times higher as a percentage of all mortgages, with the US number is still climbing –the 4th quarter of 2009 saw 129,000 completed foreclosures, and in January 2010, there were 88,000 repossessions in the US. This number is not expected to peak and begin to decline until 2011, according to industry estimates (although the most recent statistics may be somewhat more encouraging).

Table 4 sets forth some economic indicators which have affected (and at times been affected by) the mortgage market, including unemployment figures and declines in housing prices. Here we note that, again, the US has been hardest hit. Unemployment is higher there, and the housing market has seen a more serious downward slide, although the economic contracvtion in the US is less sthan that in the UK and even with that in Denmark.

3. An Examination of the Causal Factors in the US.

A quick summary of the factors that precipitated the mortgage crisis in the US is that it was caused by problems at every stage of the loan process: (1) easy money available to homeowners, given by lenders applying loose lending standards, and (2) secondary market problems, such as: originating banks having no ongoing responsibility for the quality of loans once sold, fee compensation to lending officers based on originations, and the debilitating effects of the securities derivatives market in the private sector.

In addition to these, the US experienced a housing bubble and collapse, worsened by the general downturn in the economy. This has resulted in a downward spiral of housing prices, and an upward spiral in defaults and foreclosures on homes, which has yet to end, although some commentators are beginning to say that the turnaround is at hand. Finally, greed, and in some cases fraud, became endemic in the industry. We will not dedicate a separate section to a discussion of this, as it will seep into other parts of the discussion.

This created the "perfect storm" conditions that the US is now experiencing in the collapse of its mortgage and housing industry.

Easy Money and Loose Standards. It became clear fairly early that the problems that began in the subprime market in the mid-2000s were not confined to that sector, and as the housing bubble burst, problems increased in the more general mortgage market.

Subprime Loans . Subprime loans, which grew rapidly in the early 2000s, were often targeted to lower income or other vulnerable populations of borrowers, who would not qualify for traditional mortgage loans. Once made, these loans often carried predatory terms, with escalating payments that borrowers were ill-equipped to pay. Often the loan terms had not been clarified in advance to the borrowers, and came as rude surprises. Defaults mounted. By contrast, "[there is] no significant subprime market in the euro area" (ECB, 8).

Loosening Credit Standards. Even home loans that were deemed lower risk when made suffered from the pervasive temptations of easy money, rising prices, and lax lending standards. For several years, loans nick-named "liars' loans" became common – loans where neither the income nor assets of the applicants were verified. In some cases, appraisers gave estimates of value based on speculative comparables, ramping up the values. Down payment requirements decreased, often to near zero, leaving little equity cushion for lenders to fall back on should prices decline, which, in fact, they began to do, in 2006 (JCHS/HU, SON 2009, 1), resulting in properties having negative equity, often referred to colloquially in the US as being "under water," meaning that more was owed to the bank than the home was worth on the market.

Home Equity (also known as Second) Mortgages . These are loans taken out by homeowners in order to leverage the equity in their homes after home prices rose, in order to withdraw cash representing the increased value of the home. Often, these loans reflected responses to a need for cash, either to make ends meet for the family, or to secure funds to pay for a child's college tuition or other capital requirements. These loans now represent a significant proportion of the total outstanding mortgage debt in the US, and it complicates work-out efforts. As housing prices fell, these second tier loans contributed further to the percentage of homes which have negative equity.

In the UK, which has often been described as lying between the EU countries and the US in its policies and practices (for example, ECB, 73), repossession of homes by banks, and other problems, have not been as grave as in the US. CML ascribes this to the fact that "[l]ending standards have been more rigorously upheld in the UK" (CML, News & Views, 6), compared to the US. In other words, down payment requirements relaxed, but not as much and not as pervasively; home equity loans exist, but not to the same extent; and, while there were some sub-prime mortgage loans made, they were not nearly on the scale, nor on as disadvantageous terms to borrowers, as in the US.

Secondary Market Forces. Here a little background is perhaps worthwhile.

Fannie Mae. The United States mortgage market has for many decades been fostered by a strong secondary market, in ways that generally do not exist in EU countries. The Federal National Mortgage Association ("FNMA" or "Fannie Mae") was created in the post-depression period. As Fannie Mae has evolved, it has, together with its companion organizations, and with implicit government backing, purchased mortgages, pooled them, and usually resold them to institutional holders (traditionally, insurance companies and pension funds) who were looking for relatively predictable, long-term sources of regular income. The funds generated by the purchase were used by the mortgage lenders to initiate more mortgages. By using standard documentation and insisting on certain loan terms, such as a free (that is, non-penalty) repayment option, this secondary market made the mortgage market in the US fairly standardized, and national in scope, allowing more money to flow generally, including into less advantaged areas.

The originating banks no longer held the repayment risk of the mortgages they made, once they were sold to FNMA; however, because of the intermediation of FNMA the banks were expected to subscribe to certain lending standards which were, by and large, fairly conservative, setting requirements for, among other matters, down payment amounts, valuations by accredited appraisers, and verification of assets, income and other relevant economic data regarding borrowers. Lenders provided underlying evidence and attested to their purchasers that appropriate standards were applied. Since the mortgage sale transactions between a given bank and FNMA occurred on a regular basis, any irregularities were noted, and any pattern of improper lending could lead to intervention, or exclusion of the bank from FNMA participation.

Mortgage-Backed Securities Market. These patterns changed when, during the 1990s, a new source of funding for home mortgages was developed. Recognizing that there was a potential market on Wall Street for its customers to purchase interests in home mortgages, investment firms began packaging pools of home mortgages which they bought from originating lenders, creating bond securities backed by the mortgages (hence, "mortgage-backed securities" or "MBS"), and then selling the bonds, in large or smaller face amounts, on the securities markets. Then, more sophisticated securities, often "sliced and diced" in different formulations, were developed and labeled "derivatives," owing to their having been "derived" from the mortgages. A good description of some of the derivative products appears in Green & Wachter (107-08) although, at the time of that writing, the derivatives were still being described as safe and innovative contributions to the functioning of the mortgage market. As supplementary protection to investors, and as a means to secure high credit ratings from the rating agencies, the derivatives were guaranteed or otherwise protected (generally through a device called a Credit Default Swap), by a handful of seemingly impregnable companies, including the now-infamous AIG.

Of all outstanding mortgages in the US, approximately 50% have been placed into securitized MBS. These were sold widely, and ended up in many hands, from local and foreign governments, to private companies and individuals. Many of the derivatives were purchased for their own accounts by many of the world's largest banks, many of them in the US. Many of the riskiest tranches of the derivatives were retained by the originating bank or packager.

Tremendous fees were earned by the investment banks which packaged and resold interests in these loans. Accordingly, there was every incentive, financially, to the bankers, to issue the derivatives and rely on others, earlier in the mortgage chain, to attest that due diligence had been done, and they were satisfied that the loans were good.

One result of this change in the market is that there was no on-going relationship of trust and repeat business between the originators of the loans and the ultimate purchasers, as there had been between banks and FNMA. The market became very diffuse, and as long as the loans were generated and placed in the hands of ultimate buyers, there was relatively little sense of responsibility on the part of the intermediate players. Loans became unverified, or less verified, standards became loose, resulting in the "liars' loans" described above. In addition, the number of lenders proliferated, and standards and regulation in this area were uneven – in some cases nonexistent. Mortgage brokers sprang up everywhere, and these brokers were compensated based on the number and value of mortgages generated – accordingly, they had little incentive to ascertain that their applicants were truthful, and that their facts were checked. Any such formalities would only result in fewer, or lower value, loans, resulting in a loss of personal income.

In the Euro Area, by contrast, securitization is far less prevalent, with banks continuing to rely principally on deposits to fund loans (ECB, 8), with little securitization by MBS sales (as distinguished from covered bonds, discussed in Section IV.3 below). Of Euro Area mortgage loans outstanding in 2007, for instance, only 21% of the value was placed into MBS, representing only 7% of the total number of Euro Area mortgage loans. *See Table 2.*

A final factor affecting the market, which we will discuss more below, has to do with the land records system in the US. Generally, deeds and mortgages must be recorded, and this is generally handled at a county level. In Pennsylvania, for instance, there are over 80 counties. Nationally, this means that, rather than having 50 places to file records, as would be the case if this were handled at a state level, there are hundreds of different county seats, each with its own recordation process. Each time a mortgage is assigned or sold, a form of assignment is required to be recorded in the county office. Thus, by examining the local county records, it is possible to know who the current owner of the mortgage was. This is essential when refinancing or selling a home, to find out a balance, to defend against a lawsuit, for notice in the event of a tax sale, etc.

As the derivatives market, and Wall Street, took control of the mortgage secondary market, this involved several transfers of ownership of mortgages, from the originating entity, to the pooling and derivatives entity – and then often pieces of interests in the mortgages, through the derivatives process, ended up in many different hands. Accordingly, in 1997 the lending industry created a "Mortgage Electronic Recording System" or "MERS," under which the nominal owner of the mortgage in a county's records was MERS. Then, on the books of MERS at its offices, it kept track of the various changes of ownership that the mortgage went through, leaving the county records unchanged. This system, it is estimated, saved the industry about $1 billion. You can imagine some of the many problems that this effort at efficiency and centralization could produce. Later we will discuss problems created by MERS in the area of defaults and foreclosures.

Housing Bubble Collapse. All of this new approach to mortgage lending seemed to be working well. Indeed, as long as prices of homes were rising, the pieces all came together and everyone was a winner. However, voices started to sound that the housing market was experiencing a bubble. Too many homes were being built – who could afford these homes? Often the purchasers (that is, borrowers) were speculators, buying a house under construction and, before it was even completed, flipping the home to a new buyer, meanwhile making a profit and putting the gains realized into another home investment. Starting in 2006, home prices flattened, the subprime default wave began to be undeniable, new housing construction slowed sharply, and the derivatives market had its first big losers, reducing public interest in these products [new issues of which have all but disappeared]. This situation only continued to worsen in 2007, 2008 and 2009.

Nationally, home prices in the US have declined 35% from their peak in 2006. Housing starts are down 50% compared to their peak (JCHS/HU SON 2009, Fact Sheet), and sales generally are down 30% (JCHS/HU, SON 2009, 5,6). This encompasses much regional variation, of course, with some areas much harder hit than others (JCHS/HU, SON 2009, 20). By one measure, over 27% of homes are currently under water. *See Table 4.*

Recession and the Economic Picture. The housing collapse, and the subprime mortgage crisis, contributed significantly to the general economic recession the US entered into. Coupled with the serious risk of collapse in major sectors of the financial markets in the fall of 2008, the US, and much of the world economy, has been in recession and trying to recover ever since. Together with rising unemployment, falling house prices, and the difficulties borrowers face in securing credit since the crisis, this clouds the recovery of the mortgage market further, and it is only now that, in the US, there beginning to be tentative signs of turn-around.

4. Further Concerns at Present in US. Compounding the problems in the US, there are further challenges just coming to the surface which have yet to be fully exposed and dealt with.

Toxic Assets. For one thing, banks still hold in their portfolios substantial amounts of the riskiest derivative products, sometimes referred to as "toxic assets," and it will be quite a while before the banks can dispose of these assets. Some of these have been purchased by various government-related entities, as part of the financial institutions bail-out, but much remains in the banks (Kestenbaum). These assets, like the non-performing loans discussed below, remain on the banks' books at face value, contributing to the weak balance sheets of those banks. This means that the home mortgage market will remain unsettled in the US for some time to come, unless some further intervention by the government is successfully undertaken.

Non-Performing loans. For several reasons, lenders are also sitting with a lot of non-performing mortgage loans on their books, and they are not yet bringing foreclosure actions to wipe out all non-performing mortgage loans. For one thing, they are held by the banks on their books at their purchase prices, and have not been written down for accounting purposes to their current value (which, in any case, might be difficult to ascertain). A write-down occurs only when the loan is sold, foreclosed or otherwise independently valued – wholesale write-downs would adversely affect the banks' balance sheets, often already compromised. So there

has been a reluctance on the part of banks to hasten to deal with these loans. In addition, banks say they have limited staff to administer the loans, and they are often overwhelmed by the magnitude of the challenges. Finally, once the bank forecloses, it takes the mortgaged property into its own real estate portfolio, becomes responsible for maintenance, taxes, insurance, and other costs, and then must turn around and try to sell the asset in a down market. The more foreclosed homes on the market, the lower the prices will fall before a new equilibrium is established. Indeed, much of the drop in home prices can be attributed to the unusually high number of foreclosed homes on the market, which banks are beginning to sell at distress prices, just to move them out of their portfolios (The New York Times Opinion). An unappealing set of choices, resulting in slow movement back to equilibrium.

"Under Water" Homes. Another serious problem impacting recovery relates to the "under water" issue. This in US parlance means that a home is worth less than the amount outstanding on the mortgage loan. Because of falling prices in the US, at this point this applies to no less than 20% - 27% (Thaler, New York Times Opinion; Goodman, January 2010) of the total number of homes with loans in the US. This fact alone chills the already depressed home sales market, because a sale will not generate enough proceeds to satisfy the debt, "trapping" people in their homes (JCHS/HU SON 2009, 1). In many cases, a bank will accept a "short sale," where the bank takes the net proceeds of a sale in lieu of full loan repayment. However, in general, the negative equity syndrome leads to additional foreclosures, with borrowers wondering why they are continuing to pay the lender for a home with negative equity; in some cases, therefore, borrowers stop making payments. In some states, as in EU countries, after a mortgage has been foreclosed, the borrower is still obligated to the lender for any shortfall in the value of the home, compared to the amount owed. In the US, this is called a "recourse loan." In other states, including several that have been hit hardest in the boom/bust, all home loans are "non-recourse," meaning that once the bank has taken the home by repossession, no further amount can be claimed from the borrower. In non-recourse states, especially, we are beginning to see homeowners who are significantly "under water" walk away from their homes, handing the keys to the lender, even if they could afford to continue their payments. This is sometimes referred to as a "strategic foreclosure." Certainly in states with non-recourse laws, this is a potentially huge problem only beginning to affect statistics. In the 10-county San Francisco area, for example, of approximately 1.4 million mortgage loans, approximately 28% are under water, with about half that number under water by 25% or more (Said). In Nevada, nearly 2/3 of all homes have negative equity (Thaler). Thaler, for example, suggests that there is no moral issue in walking away from such a home in a non-recourse situation – it was part of the understanding that was bargained for in the beginning, and he finds it remarkable that as many homeowners pay their under water mortgage loans as do, when banks "only act to maximize profits."

MERS Issues. Finally, there are a host of issues surrounding the nominal, as opposed to the actual, ownership of the mortgage asset, since the securitization process has in many cases created multiple partial owners of a single mortgage and, often, the named owner of the mortgage in the county records is the tracking company, MERS. On record, over 60 million mortgages in the US are now nominally owned by MERS (Morgenson, September 2009). This results in a homeowner frequently not knowing with whom to communicate, whether the entity communicating with them has proper credentials, and having no evidence of who owns their mortgage. This has created problems also in the judicial arena, where, in at least five states,

judges have stated that MERS has no interest in the mortgage, is only a straw (or empty) party, and cannot bring a lawsuit, thus throwing out the foreclosure or other judicial action (US Legal; Morgenson, September 2009).

Home Equity/Second Mortgages. There are additional problems arising from the high number of second (or so-called "home equity") mortgages, which are often held by a different lender than the first mortgage debt, making negotiations in case of a default that much more difficult (Goodman, January 2010; Morgenson, December 2009). Indeed, in the case where the first and second mortgage lenders are the same, it has proven to be much easier to work out compromises to reinstate a defaulted loan (Morgenson, December 2009). The amount owed in second mortgages to the nation's four largest banks alone amounts to $442 billion (Morgenson, December 2009).

5. Government and Industry Responses in the US and EU.

US. The US has had a succession of escalating responses from the federal government in its efforts to stabilize the national mortgage situation, meeting with varying – but, overall to date, limited – success (Goodman, January 2010; JCHS/HU, SON 2009, 3-4; Morgenson, December 2009).

Part of the reluctance to take more dramatic action to protect homeowners and restabilize the markets is that there are those in the US who wish no such assistance or forbearance to be forthcoming, saying that it creates a "moral hazard" to delinquent or under water homeowners, encouraging them to slack off in their responsibilities to banks, and an unfairness issue, "rewarding" people who don't pay, while doing nothing for citizens who live up to their obligations and pay their mortgages as they should. This is parallel to the "moral hazard" arguments used to oppose the bank bail-outs. The "bail-out" of the homeowner, the argument goes, encourages risky behavior, counting on a rescue from the government. There is an underlying question in these critics' minds of whether the borrowers in default "deserve" to be helped. This political conversation has slowed efforts to work out sensible, forward-looking solutions.

Other critics have begun to complain that the proposals being implemented are often designed, not to assist homeowners, who have been helped only modestly, but to assist banks, by giving them time to sort through their bad mortgage pool (The New York Times Opinion).

In several EU countries, by contrast, we have seen governmental and market responses designed specifically, and seemingly effectively, to help keep people in their homes.

Germany. In Germany, an option in many cases has been that, following a foreclosure, people are permitted to stay in their residence, paying rent to the bank as tenants. Title has passed, but the property is not vacated, thus avoiding empty homes, which encourage vandalism and deterioration, eliminating the blight on neighborhoods from having vacant properties, and perhaps avoiding a problem with homelessness or overcrowding, as foreclosed families move to smaller quarters or move in with relatives.

UK. In the UK, arguably closest to the US in its patterns, there are several indicators that the government is taking a more active role in supporting homeowners, and trying to keep people from repossession. This includes a fairly far-reaching and comprehensive set of directives of a consumer protection nature. The Financial Services Authority ("FSA") has, since 2000, been charged with responsibility for administerinig the home mortgage markets on a national basis, replacing a self-regulatory scheme which had existed previously. Mortgage lenders must be granted a consumer credit license, and are bound by FSA rules governing their conduct of business, including providing clear and balanced information to consumers, an obligation to offer a "suitable" mortgage product to a prospective borrower (including considerations of affordability); lenders must develop measures to help borrowers who face difficulties, including the requirement that lenders may only repossess a property after all other reasonable measures have failed (Kempson). There are many signposts of help at the government website (mortgagehelp.direct.gov.uk), which tells visitors to the site such things as:

> Mortgage lenders should only take possession as a last resort and there are a range of ways lenders can help you manage your monthly payments better. Your lender should think about what they can do to prevent you losing your home. For example, they may: - agree to change the terms of your loan; -accept reduced payments from you in the short term; - add your arrears to the amount you have borrowed.

In addition, a recently issued Protocol in the UK's Civil Procedures Rules, governing foreclosure courts and judges, reinforces these goals (Civil Procedure Rules, Protocol, April 2010); moreover, the FSA now requires lenders to collect, report and publish information on how they handle complaints from customers regarding home finance (among other areas) (CML, News & Views no. 5). Finally, a Financial Ombudsman Service has been established, to resolve disputes between consumers and financial services firms "fairly, reasonably, quickly and informally" (Kempson, 10), whose determinations are binding on financial firms, but may be appealed by consumers; this service handled about 46,000 home mortgage cases in 2006-07 (Kempson, 11).

In addition to these structures, the UK has put in place at least three schemes to assist home borrowers in distress (FSA website; Farrow); however, there have been suggestions in the news media that these have been less than effective (Butterworth).

Euro Area. The ECB paper reports that, in many Euro Area countries, "some loans for house purchase explicitly provide for payment flexibility during the contract period, especially in the case of an income shortfall" (ECB, 31). Moreover, repossession proceedings, considered a last resort, require debt counseling or negotiations between lenders and borrowers, either as part of the foreclosure process or as a pre-condition for its commencement (ECB, 38, 86). This requirement would be unusual in the US (although such a requirement has been implemented in some local jurisdictions, such as the City of Philadelphia, which has had a successful program in reducing home foreclosures).

Certain initiatives seem to be appearing in the US more recently which mirror some of these better practices, such as rent-backs (Stout), some principal forgiveness (Streitfield, March 2010),

and forbearance efforts for unemployed workers (Tedeschi). To date, however, these are limited in scope and application, isolated examples, or voluntary on the part of individual banks, rather than comprehensive and mandatory.

IV. Best Practices: Preliminary Observations

We note that implementation of the practices described below, in the aggregate tending toward a more conservative mortgage market, would in many cases require considerable legislation to adopt, and would probably result in a lower proportion of home ownership in the US. This would require some changes in attitude, and the political will to make such changes. It remains to be seen whether this poltical will can be mustered in the US.

I note that, in addition to the salutary practices outlined below, commentators have also suggested that personal bankruptcy involves far more difficulties for a Euro Area person than for a US resident, and they also point to the pursuit in the EU by lenders of deficiency amounts against borrowers personally, to account for the more conservative behavior on the part of EU borrowers (ECB, 37). I, however, am not persuaded that these factors are significantly different in the US. They do contribute, perhaps, to the totality of the different compact which prevails between citizens and their government, and may have some significance when aggregated with the differing nature of public policies and the difference in perspectives regarding the appropriate role of government. It is the nature of this societal understanding, and the attitudes on the part of citizenry and institutions that, apart from economic and fiscal issues, contributes to the more exacerbated and litigious situation in the US (Kagan).

1. Equity Considerations. Of the several ways in which the EU countries we considered have differed from the US, one clear distinction is the attitude toward equity held in real estate. In order to safeguard against falling home prices, or other pricing or payment problems, it is far preferable for lenders and borrowers alike to have some borrower equity in a home. This includes insisting on some sensible rules for downpayments, some reasonable limits on withdrawing cash through second mortgages, and a strong preference for a self-amortizing mortgage, rather than interest-only (or, worse yet, negative amortization) loans. Having an equity cushion guards against a home developing negative equity, which reduces the temptation for walk-aways (especially in jurisdictions where home loans are non-recourse), and generally contributes to a healthier market and more sensible decisions by borrowers who, when they have some equity at risk, don't want to jeopardize their investment.

If public policy evolves to the point where there is a desire to assist lower income groups to purchase homes, this should be accompanied by training and education, about finances, home ownership responsibilities, and the like, and not the result of the exploitative subprime lending that took place in the last decade.

2. Lenders: Regulation and Perhaps Limitation; Compensation Not Fee Based. Appropriate regulation of lenders and their practices, as demonstrated by several EU countries, such as Italy, Denmark and UK, creates a system with clear expectations that, while at times conservative, keep lenders subject to certain codes of qualification, capital requirements, and conduct, and may, as in the UK, be deployed for substantial consumer protections, at present

absent in the US at a national level. These protections can eliminate lender over-reaching, offer better guidance and information to prospective borrowers, and provide assistance to consumers who have financial difficulties or disputes with lenders. Lenders' employees are generally salaried, not paid on commission, eliminating temptations in that area as well.

3. Lenders Retain Financial Risks for Loans Made: The Covered Bond Model. At the level of the functioning of the secondary markets, the covered bonds prevalent in Germany and Denmark offer perhaps the most sensible way of securing non-deposit funds to support new mortgage loan creation. Much attention has been addressed to the Danish mortgage market as a model (see, for example, Soros, Mortgage Professor). This system, in place since shortly after the 1795 Copenhagen fire, operates through a small number (8) of authorized mortgage banks (which do not accept deposits), called Monetary Financial Institutions ("MFI") (ECB, 6), offering fairly strictly regulated mortgage products to consumers, with a minimum 20% down payment requirement (which reduces the likelihood of home prices falling beneath the amount of the outstanding mortgage). The Danish Financial Supervisory Authority ("DFSA") regulates all aspects of the market and also acts as the intermediary between borrowers and investors (Global Property Guide). Each mortgage is pooled together with other mortgage loans offered on identical terms, and these back a bond series which is offered in the public market, generally purchased by private investors. The bonds are less complex than the derivatives market that evolved in the US, and there is no tranching into different risk segments (ECB, 47). The proceeds from the bond sales are used by the MFI to offer more mortgages. The loan, and thus the risk of nonpayment, remains on the balance sheet of the originating bank. If a borrower defaults, his/her mortgage loan is retired from the bond series and held by the issuing bank to work out. Bondholders have recourse, in the event of a default, against the bond collateral, but also against the issuing MFI. No bond default has ever occurred (Global Property Guide). A good diagram of the structure of the Danish market is found in Allen et al., 102. The bonds are matched to the mortgage loans they support and, if housing prices fall, the bond prices generally fall as well, and a borrower can, if desired, refinance or repay, by purchasing a quantity of matching bonds, at their reduced price, and retire his/her debt using these discounted bonds, thus reducing the impact of the falling price on the borrower's ability to repay the loan. As the ECB suggests (ECB, 54):

> In a healthy reaction to the excesses of the recent past, a shift towards simpler and more transparent deals can also be envisaged, probably in the context of a wider adoption of safer on-balance-sheet collateralization in the form of covered bonds.

4. Additional proposal to Restabilize US Mortgages: Principal Balance Write-Offs Needed. This proposal has no parallel in the EU. Increasingly, voices in the US are demanding that, as part of the effort to restabilize the US mortgage markets, in addition to other proposals and innovations, lenders need to reduce the principal balances outstanding on mortgages to a level that reflects no more than the current market value of the home in question, in order to stabilize home sale prices, and to encourage people to remain in their homes paying their mortgage debt on the adjustetd level, rather than walking away from a home with negative equity (Goodman, Jan. 2010; New York Times Opinion). Various ideas have been floated for ways to accomplish this in a fair manner, including adding payments at the end of the term, provided that

the market supports the additional money, gradual write-downs of principal (Streitfield, March 2010), and sharing any future upside value between homeowner and lender.

> Most loans are owned by investors. They are increasingly inclined to accept losses by writing down loan balances in exchange for greater assurance that borrowers will be able to make payments (Goodman, January 2010).

Whether lenders should be compensated (and by whom) for all or any part of these write-downs is an open question. The New York Times stated in a recent editorial:

> Unless the banks can be compelled to get on board – allowing principal reductions to become the norm – the antiforeclosure effort may have more success in letting the banks postpone their losses than in helping Americans keep their homes.

Other voices counter with the "moral hazard" (or "unfair to paying borrowers") argument. However, this approach misses the point of the write-down. The purpose would be to strengthen the national housing market, to help keep neighborhoods and communities strong by avoiding further declines in home prices and the decay that vacant housing frequently brings, as well as to assist the homeowner borrower who needs help. The national economy will recover only as fast as the housing sector, and a continuing downward pressure on prices delays recovery. This is not simply a question of which individuals are being helped, and whether they "should" be helped. Rather, the purpose is to staunch a wound, and stabilize the market (The New York Times Opinion).

5. Public Policy Supporting Home Owners; Consumer Protection. Looking at the various specific differences between the US and the EU countries in their approach to home ownership loans, we can begin to discern a pattern. Generally, the differences described above reveal a dramatic difference between the US and EU in the level of, and emphasis on, consumer protection. This is true both during the process of mortgage generation and, perhaps even more important, in dealing with consumers who experience difficulties.

While both the US and the EU have developed programs to assist homeowners in trouble (and there have been complaints about the effectiveness of many of these, on both sides of the Atlantic), we see nonetheless that: (1) many of the EU country programs are more extensive, and more generous to consumers, than those in the US, among other things being mandatory for banks, and (2) public attitudes in the EU specifically and positively favor keeping people in their homes. This often requires banks to negotiate with borrowers in good faith, and to make accommodations, whether deferring payments, lowering payments, adding arrearages to the end of the mortgage period, renting foreclosed homes back to former owners, or other efforts to allow people to weather a bad economic period, with dignity and less upheaval in their lives and in their communities. These initiatives are widely supported at a societal level.

In the US, by comparison, there remain mixed reactions to efforts to help those in need, and the go-it-alone mentality that is somewhat prevalent in the US remains visible in public discourse in

this area. I perceive this as perhaps the strongest single difference between the US and the EU countries.

The financial services bill that is currently being adopted in the US will, it is hoped, reduce some of the abusive practices that prior law allowed. These, however, seem to be principally prospective in nature, and do not generally address the situation of presently distressed homeowners. Although the final terms are not yet determined, some of the expected features of the new law are expected to include: (1) clearer and more centralized supervision of financial institutions, (2) more controls, security and transparency for derivatives deals, and (3) perhaps most important, a new, independently-funded Consumer Financial Protection Bureau will be established, with authority to regulate mortgage lending practices, along with other financial products. How this will evolve remains somewhat open, but proponents are expecting that this will usher in a new era in mortgage lending in the US, bringing it closer to the models found in the EU.

V. **Summary**.

The US mortgage market still faces huge problems. The current mortgage market dynamic, the incentives and the conflicts of interest among the players, make the US system deeply, perhaps fatally, flawed. As a recent Federal Reserve Board paper stated:

> [F]oreclosures [continue] to occur in cases where both the borrower and investor would be better off if such an outcome were avoided (Cordell et al., 1).

The EU countries have generally evolved more conservative models, which have, on the whole, fared far better in today's difficult economic climate than have their US counterparts. This makes it less likely that the EU countries will in the future face the kinds of problems the US must deal with. And EU practices provide the US with several features which the US could well implement in an effort to improve the functioning of its mortgage market.

Differences in public attitudes and public policy, however, play a significant role in explaining the differences between the EU and the US. Greater EU societal support for homeowners, which translates into the greater consumer protections that apply, and the degree of governmental control over lenders' practices, help to explain their disparate responses in the arena of home mortgage difficulties over the past several years.

TABLES

TABLE 1: Basic Population & Mortgage Data

	Denmark	Germany	Italy	UK	Euro Area	US
Population (in thousands) (1)	5,000	82,000	60,000	62,000		315,000
% of Home Ownership (2)	51%	43%	78%	68% (72%)		67%
Aggregate Mortgage Debt Outstanding(3)	230	966	230	1,196	4,600	14,300 (USD)
% of Homes with Mortgages (4)		26%	12%	40% (38%)	20%	45% (42%) (52 million 1st lien mges)
Ratio: Household Debt to Disposable Income (5)				154%	97%	128%
Ratio: Mortgage Debt to GDP (6)	70%	53%	13%	69%	42%	69%

(1) United Nations, World Population 2008, rounded to nearest million
(2) ULI Housing and (in parenthesis) Hess & Holzhausen, 5 (2006 figures), except (a) US figure from JCHS/HU SON 2009, 16 and (b) Italy figure from Survey of Household Income and Wealth (Bank of Italy), table H1, p 80
(3) Calculated from Hess & Holzhausen, 2 (2006 figures), in billions of Euros (European total: 4,600bn), except US (mid-2008), in trillions of USD, from ECB, 71; Federal Reserve Bank
(4) ECB, 14, 16, 68 (2005 figures); Streitfield (November 19, 20, 2009) (US)
(5) ECB, 67 (2003 – 2007 average)
(6) Hess & Holzhausen, 4 (UK); OECD, 137 (US); ECB, 12 (Euro Area)

TABLE 2: Data Concerning Causal Factors

	Denmark	**Germany**	**Italy**	**UK**	**Euro Area**	**US**
LTV: average/maximum (1)	80/80	67/80	55/80	69/110		75/97%
Downpayment Requirements	20%	20%	20%	0% (in some cases)		0% (in some cases)
No. Authorized Lenders	8		few (but more than in 1990's) (2)			many
Degree of Regulation of Lenders	heavy		heavy	moderately heavy		limited
Secondary Market	covered bonds	covered bonds (3,4)	very little	yes		yes
% of Outstanding Mortgages Securitized (4)					7%	50%
Do Lenders Retain Repayment Risk? (5)	yes	yes	yes		yes	no
Compensation to Originating Loan Officer	salaried		salaried			often fees based on originations

(1) Hess & Holzhausen, 6
(2) Guiso, Casolaro & Gambacorta
(3) Green & Wachter, 103
(4) ECB, 51
(5) ECB, 46 (covered bonds)

TABLE 3: Health of the Mortgage Market

	UK (1)	**US (2,3)**
Delinquencies	188,000 (1.61%)	1.6 million (3%); 8.8% delinquent or in foreclosure (2)
Foreclosures/Possessions	46,000 (0.4%) (completed 2009 – highest in 15 years)	4.5% in foreclosure; over 4 million in foreclosure pipeline (4); completed: 850,000 (1.6%) in 2008; 129,000 in 4th qtr 2009 (5); 88,000 homes possessed in Jan 2010, a 31% increase over 2009 (4)
Projections	For 2010: 205,000 (1.85%) delinquent; 53,000 (0.48%) possession	Defaults & foreclosures expected to peak in 2011(6)
#, % Homes with Negative Equity		15 million (27%) (7)

(1) CML, Mortgage Arrears; CML, News & Views,December 2009, 2 [note: these are three month delinquencies]; Butterworth
(2) Streitfield (November 20, 2009); JCHS/HU SON 2009, 2 [note: these figures include loans 60 days or more delinquent]
(3) CML, News & Views, December 2009, 2 (data from MBA)
(4) MBA, Press Release, New York Times Opinion
(5) Streitfield (March 2010)
(6) Streitfield (November 19, 2009)
(7) Goodman (January 2010)

TABLE 4: Economic Factors

	Denmark (1)	**UK**	**US**
Unemployment (1)	3.2% (Mar 2009); expect 4.5% 2010	7.8%	10.2% (9.9% April 2010 (2))
% Fall in Housing Prices, Sales (1)	10.8% drop in 2009 from 2008	21% from peak	35% from peak (expected to reach bottom end 2010) (3); sales down 30% from 2005 levels, 30% of which are resales of foreclosed homes (4)
Economic Contraction (1)	2009 expect 4% contraction	6%, mid-2008 to mid-2009	4%, mid-2008 to mid-2009

(1) Global Property Guide (DK); CML, News & Views, December 2009, 1, 4 (UK & US)
(2) Bureau of Labor Statistics
(3) MBA
(4) JCHS/HU, SON 2009, 5, 6

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