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## **Bernanke Calls On Banks To Absorb Principal Loss**

Fed Chair Ben Bernanke provided an understated and elegant call for lenders to assume responsibility for mortgages “underwater” and take more vigorous steps to stem the tide of future foreclosures looming over the horizon. The thrust of the speech focused on the following;

### **Rise in Mortgage Delinquencies and Foreclosures**

“Delinquencies and foreclosures likely will continue to rise for awhile longer...many subprime borrowers are facing imminent resets of the interest rates on their mortgages. In 2008, about 1.5 million loans, representing more than 40% of the outstanding stock of subprime ARM’s are scheduled to reset. We estimate that the interest rate on a typical subprime ARM scheduled to reset in the current quarter will increase from just above 8% to about 9.25%, raising the monthly payment by more than 10%, to \$1500 on average.”

### **Distressed Borrowers**

“ Measures that lead to a sustainable outcome are to be preferred to temporary palliatives, which may only put off foreclosure and perhaps increase its ultimate costs. Solutions should be prudent and consistent with the safety and soundness of the lender. Concerns about fairness and the need to minimized moral hazard add to the complexity of the issue; we want to help borrowers in trouble, but we do not want to borrowers who have avoided problems through responsible financial management to feel that they are being unfairly penalized.

### **Modification of Contracts**

To date, permanent modifications that have occurred have typically involved a reduction in the interest rate, while reductions of principal balances have been quite rare...In this environment, principal reductions that restore some equity for the homeowner may be a relative more effective means of avoiding delinquency and foreclosure. “

“In an environment of falling house prices, however, whether a reduction in the interest rate is preferable to a principal write down is not immediately clear. Both types of modification of involve a concession of payments, are susceptible to additional pressures to write down again, and result in the same payments to the lender if the mortgage pays to maturity. However, as I have noted, when the

mortgage is under water a reduction in principal may increase the expected payoff by reduction the risk of default and foreclosure.”

“In my view, we could also reduce preventable foreclosures if investors acting in their own self interests were to permit servicers to write down the mortgage liabilities of borrowers by accepting a short payoff in appropriate circumstances.”

### **Assessment**

Mr. Bernanke put down an important marker today calling on the lending community to act in their own interests and begin to write down principal on mortgages moving at a crisp pace towards foreclosure. While, this text may be dismissed as the Fed chair preaching to the regulatory choir, we think that this is a serious statement intending to prod action out of what has been a slow moving financial community to prevent the coming foreclosure problem from being socialized by the Federal government. Our reading of Mr. Bernanke’s assessment is that it is far more preferable that the markets absorb the losses caused by a combination of unwise lending, minimal risk management practices and outright loan fraud than having Washington craft a Resolution Trust Corporation style bailout of financial institutions, banks and speculators. Thus far, the banks and the administration have been willing to see if the banks will save themselves. In part, the remarks by Mr. Bernanke are meant to buy time, but to also serve as a warning that the status quo will not stand. The longer the banks wait to take action to prevent the wave of foreclosures that have the potential to flood the financial community later this year, the more expensive-both in real and regulatory terms-it will be when the US federal government steps in, as we expect they will if the current malaise in financial markets is not addressed.