Here's a new way of looking at mortgages

It's time we start looking at mortgages a new way. We need to stop thinking we can change the current mortgage mess by providing ever-increasing incentives to lenders to do the right thing and help fix the crisis. Up until now, we've been approaching the problem by asking lenders how much we need to pay them to allow the government to begin fixing the housing crisis. With an approach like that, there can be no widespread fix to the housing market unless and until the government is able to convince (i.e., pay) enough lenders and investors to give up their control over the mortgages.

This is backwards. We think it's time to put the control of these mortgages into the hands of homeowners. Nothing will change until borrowers are able to replace their upside-down loans with loans that actually give them equity in those homes. And we think that the owners of these existing toxic mortgages should have to prove what they were actually worth before getting a dime from the government.

All this is possible.

All we need to do is eliminate the existing mortgages.

It may sound crazy, but it's not. In fact, the concept is a simple one. Here's how it would work: The government would pass a law to nationalize every mortgage on every primary residence, and then satisfy every one of them. The country would immediately be filled with unencumbered houses. Every foreclosure would stop.

The government clearly has the legal right to do this if it so desires. The process is called "eminent domain," and it allows the government to take private property for a public purpose. All types of private property are taken for all sorts of purposes, including the taking of private airspace to approach a military airport, the taking of rooftop space for antennae, or the taking of interest earned in lawyer trust accounts to fund legal aid programs. The purpose of saving the nation's housing market certainly is sufficiently "public" to justify the use of eminent domain.

Under the law of eminent domain, the government must provide "just compensation" to the owner of the property, in this case, the owners of the mortgages. This plan therefore requires a mechanism for banks and investors to get reimbursement for the loans that the government would take. To claim its "just compensation," a bank or investor would have to prove what a particular mortgage loan is worth. If an investor holds a "bad" mortgage - such as one where the borrower has no income, or the loan value far exceeds the property value -- that investor would not get all of his or her money back. The result would be a healthier banking system because banks that made good loans would be "rewarded," and investors who knowingly purchased bad loans would be "punished."

Clearly, the government will have to pay a substantial amount of money to lenders. Where will that money come from? Much of it will come from the homeowners themselves, because the debt that the government forgives would be taxable income to the homeowner. Having the government eliminate your $500,000 mortgage is no different than having it hand you a check for $500,000. So, each homeowner will owe the government a substantial tax payment - let's say 35% of the amount of the loan forgiven.

But where will the homeowners get the money to pay that tax? After all, if Harry Homeowner had a $500,000 mortgage, he will owe $175,000 in taxes next April. Harry, however, will have a house that is completely unencumbered. Even if he could not convince a bank to lend him $500,000 against his house today, he should have a much easier time borrowing the $175,000 he needs to pay taxes. Indeed, we expect that banks would be competing to provide a loan to Harry. This is because the banks will have just lost their entire portfolio of mortgage loans (which are assets on banks' books), and will want to replenish that side of their balance sheets.

This plan would immediately eliminate foreclosures. It would provide homeowners with an immediate infusion of disposable income (because they no longer need to make the payments on their existing mortgages). It would also eliminate the drag on house sales caused by the lack of equity. Homeowners who want to sell would be able to do so without taking a loss, or begging the bank to approve a short sale. The housing market would immediately begin to pick up momentum.

That's the concept. There is at least one fly in the ointment that will need to be dealt with: when the government takes the mortgages owned by the banks, those assets will no longer show up on the banks' balance sheets, making them insolvent. There are ways to address that, such as by passing interim bank regulations and enabling emergency loans to prop up the banks until they can replenish their balance sheets with new loans. Another mechanism would be for the government to issue coupons to homeowners that are worth 65% of the amount of their mortgage. When a homeowner gives this coupon to her bank (plus the additional 35% in cash) to refinance her existing mortgage, the bank receives assets with the same nominal value as the original mortgage. Of course, the value of the coupon may ultimately be less if the bank cannot prove that the original mortgage was worth the face amount of the loan.

Would this plan be more expensive than the current plans under consideration? Maybe, but keep in mind that nobody can yet say what the current plans would end up costing us. Even if the cost of this plan is double or triple the cost of the plans currently on the table, the lion's share of the benefits will go directly to homeowners.

How many citizens are going to complain about that form of government spending? Think of it as "A chicken in every pot" for the 21st century.

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