SPECIAL REPORT

THE GREAT HAIRCUT

A radical plan to jumpstart the U.S. economy may have to involve massive write-downs of U.S. consumer debt

More than 2,000 homeowners were seeking to renegotiate their loans at JPMorgan Chase's foreclosure consultation event in March in New York. **REUTERS/SHANNON STAPLETON**

BY JENNIFER ABLAN AND MATTHEW GOLDSTEIN
NEW YORK, OCT 2

MORE THAN THREE YEARS after the financial crisis struck, the U.S. economy remains stuck in a consumer debt trap.

It's a situation that could take years to correct itself. That's why some economists are calling for a radical step: massive debt relief. Federal policy makers, they suggest, should broker what amounts to an out-of-court settlement between institutional bond investors, banks and consumer advocates – essentially, a "great haircut" to jumpstart the economy.

What some are envisioning is a negotiated process in which cash-strapped homeowners get real mortgage relief, even if it means forcing banks to incur severe write-downs and bond investors to absorb haircuts, or losses, in some of the securities sold by those institutions.

"We've put this off for too long," said L. Randall Wray, a professor of economics at the University of Missouri-Kansas City. "We need debt relief and jobs and until we get these two things, I think recovery is impossible."

The bailout of the nation's banks, a nearly trillion dollar stimulus package and an array of programs by the Federal Reserve to keep interest rates near zero may have stopped the economy from falling into the abyss. But none of those measures have fixed the underlying problem of too much U.S. consumer debt.

At the start of the crisis, household debt as a percentage of gross domestic product was 100 percent. Today it's down to 90 percent of GDP. But by historical standards that is high. U.S. households are still more indebted than their counterparts in Austria, Germany, Spain, France and even Greece - which is on the verge of defaulting on its government debt.

Tens of millions of U.S. citizens remain burdened with mortgages they can no longer afford, in addition to soaring credit card bills and sky high student loans. Trillions of dollars in outstanding consumer debt is stifling demand for goods and services and that's one reason economists say cash-rich U.S. companies are reluctant to hire and unemployment remains stubbornly high.

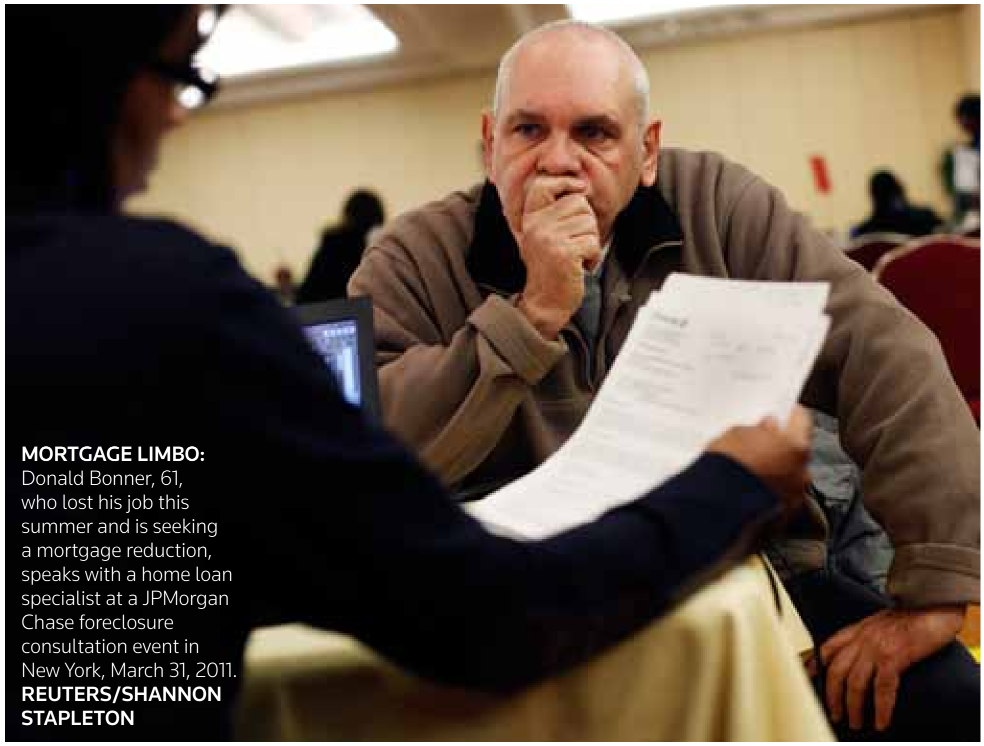
Take Donald Bonner, for example, a 61-year-old from Bayonne, New Jersey, who lost his job working on a dock in June. Back in March, he attended a "loan modification" fair held by JPMorgan Chase in New York. He has lived in his home since 1970, but was on the verge of losing his job. After falling behind on his $2,800-a-month mortgage, he sought to reduce his monthly payment. Bonner says the bank denied the request on the grounds that he is ineligible because his income is higher than the minimum threshold set by the Federal government for loan modifications.

"They keep asking me for additional documentation," Bonner said on Friday. "It seems to me there is never enough documentation and it has to be renewed every month. It does make you wonder with all this bailout money these banks have received, they don't want to lend the money."

THE IDEA OF substantial debt restructurings and a haircut for bondholders has been raised by financial pundits, including Barry Ritholtz and Chris Whalen, two popular analysts and bloggers.

Renowned economist Stephen Roach, currently non-executive chairman of Morgan Stanley Asia, has gone a step further, calling for Wall Street to get behind what others have called a "Debt Jubilee" to forgive excess mortgage and credit card debt for some borrowers. The notion of a Debt Jubilee dates back to biblical Israel where debts were forgiven every 50 years or so. In an August appearance on CNBC, Roach said debt forgiveness would help consumers get through "the pain of deleveraging sooner rather than later."

But it's not just the liberal economists and doom-and-gloom financial analysts calling



MORTGAGE LIMBO: Donald Bonner, 61, who lost his job this summer and is seeking a mortgage reduction, speaks with a home loan specialist at a JPMorgan Chase foreclosure consultation event in New York, March 31, 2011. **REUTERS/SHANNON STAPLETON**

"WE NEED DEBT RELIEF AND JOBS AND UNTIL WE GET THESE TWO THINGS, I THINK RECOVERY IS IMPOSSIBLE."

for a great haircut. Even some institutional investors, who might suffer some of the impact of debt reductions on their portfolios, are seeing a need for a creative solution to the mess.

"If there is something constructive that can be done it should be," said Ash Williams, executive director of the Florida State Board of Administration, which oversees $145 billion in public investments and pension money. "You don't want to reward bad behavior and you don't want to reward people who were irresponsible. But if there is a way to do well by doing good, then let's take a look at it."

To be sure, consumer debt levels have been coming down since the crisis began. The Federal Reserve Bank of New York reported in August that outstanding consumer debt has fallen from a peak of $12.5 trillion in third quarter of 2008 to $11.4 trillion. (NY Fed report: http://tinyurl.com/3uuvk8d) That's a sign that consumers are getting less indebted.

But U.S. households are still carrying a staggering burden of debt.

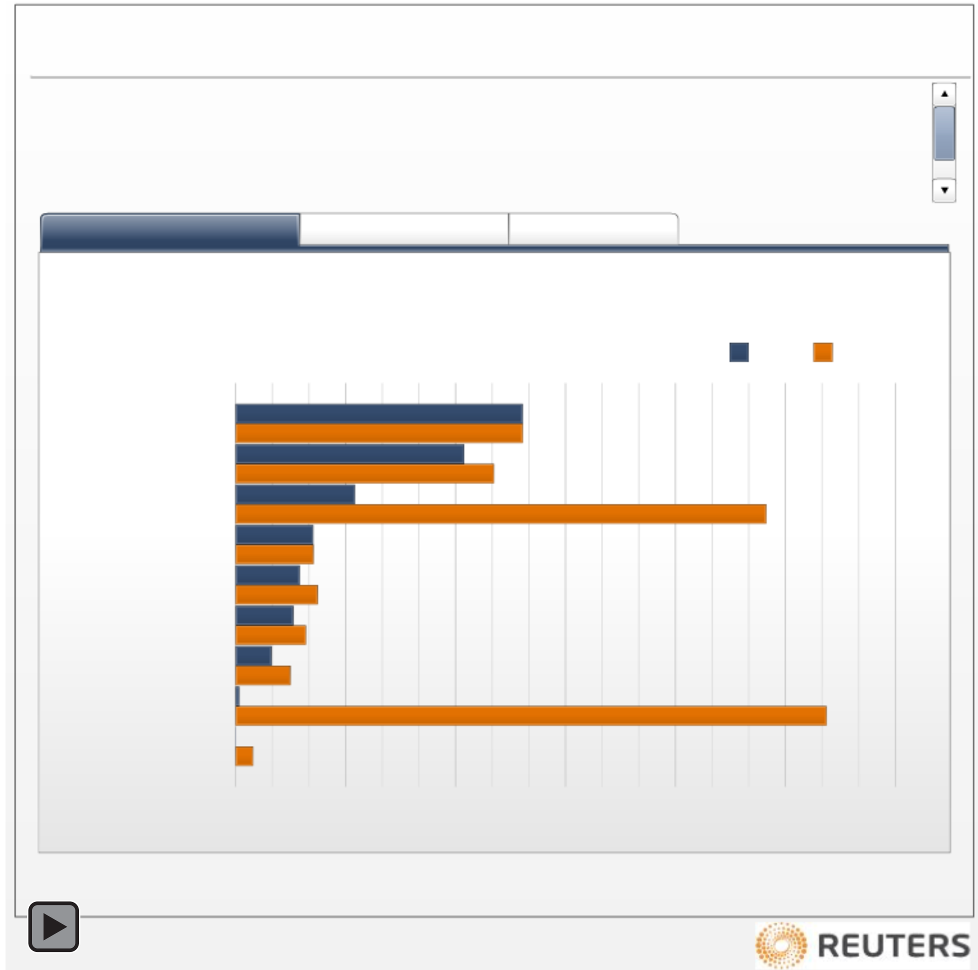
As of June 30, roughly 1.6 million homeowners in the U.S. were either delinquent on mortgages or in some stage of the foreclosure process, according to CoreLogic. And the real estate data and analytics company reports that 10.9 million, or 22.5 percent, of U.S. homeowners are underwater on their mortgage -- meaning the value of their homes has fallen so much it is now below the value of their original loan. CoreLogic said the figure, which peaked at 11.3 million in the fourth quarter of 2009, has declined slightly not because home prices are appreciating but because a growing number of mortgages are entering foreclosure.

The nation's banks, meanwhile, still have more than $700 billion in home equity loans and other so-called second lien debt outstanding on those U.S. homes, according to SNL Financial.

Debts owed by American consumers account for almost half of the nearly $9 trillion in worldwide bonds backed by pools of mortgages, car loans, credit card debt and student loans, which were sold to hedge funds, insurers and pension funds and endowments.

And that doesn't include the $4.1 trillion in mortgage debt sold by government-sponsored finance firms Fannie Mae and Freddie Mac.

BOND INVESTOR: Tad Rivelle, chief investment officer of fixed income at TCW, said an across-the-board restructuring would be a poor policy choice. **REUTERS/BRENDAN MCDERMID**



Kenneth Rogoff, professor of economics and public policy at Harvard University and former chief economist at the International Monetary Fund, has said the ongoing crisis should be called the "Second Great Contraction" because U.S. households remain highly leveraged. He says the high level of consumer debt is what distinguishes this from other recessionary periods.

FOR THOSE IN FAVOR of a radical solution, there are a lot of headwinds.

Any debt reduction initiative must confront the issue of "moral hazard" – the appearance of giving a gift to an unworthy borrower who simply made unwise spending choices.

Institutional investors who own securities backed by pools of mortgages are reluctant to see struggling homeowners get their mortgages reduced because that means those securities are suddenly worth less. Any write-downs that banks are forced to take could imperil their capital levels.

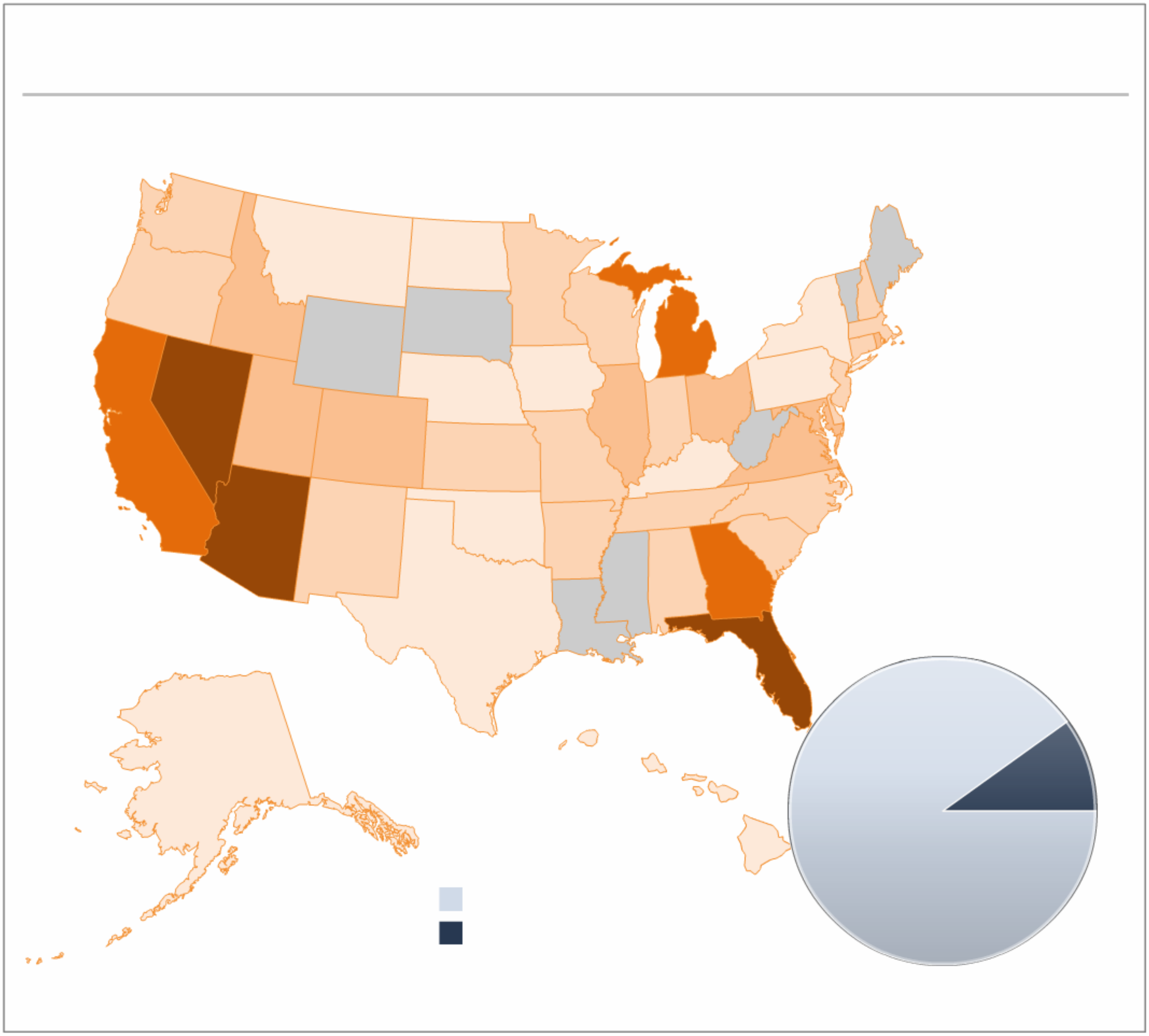
Banks and bondholders, meanwhile, have competing interests. This is because mortgage write-downs depress the value of the securities in which mortgages are pooled and sold to investors. Big institutional investors like BlackRock have long argued that any meaningful principal reduction on a mortgage must also include a willingness by banks to take their own write-downs on any home equity loans, or second liens, taken out by the borrower on the property. The banks continue to hold those second liens on their balance sheets and so far have been reluctant to mark down the value of those loans, even though the borrower often has fallen behind on their primary mortgage payments.

In other words, bondholders are taking the position if they must suffer losses, so must the banks.

"Institutional investors, pension funds and hedge funds all have fiduciary obligations and they can't necessarily agree to haircuts solely because it may be good social policy," Sylvie Durham, an attorney with Greenberg Traurig in New York, who practices in the structured finance and derivatives area.

Tad Rivelle, chief investment officer of fixed-income securities at TCW, which manages about $120 billion of which $65 billion is in U.S. fixed income, doesn't support a big haircut. But he says he can see why some economists and consumer advocates would favor debt reductions and debt workouts as way of dealing with the financial crisis and freeing up more money for spending.

Barry Ritholtz, director of equity research at Fusion IQ and a popular financial blogger, said the standoff between the banks and bondholders is untenable and doing a good deal of harm. An early critic of the bank bailouts, Ritholtz says bankers and



bondholders are all in denial and both need to get far more pragmatic.

"They'd be bankrupt if not for the bailouts," says Ritholtz of the banks' position. "For their part, bondholders need to understand that we're not earning our way out of this mess and should eat losses now before they get nothing."

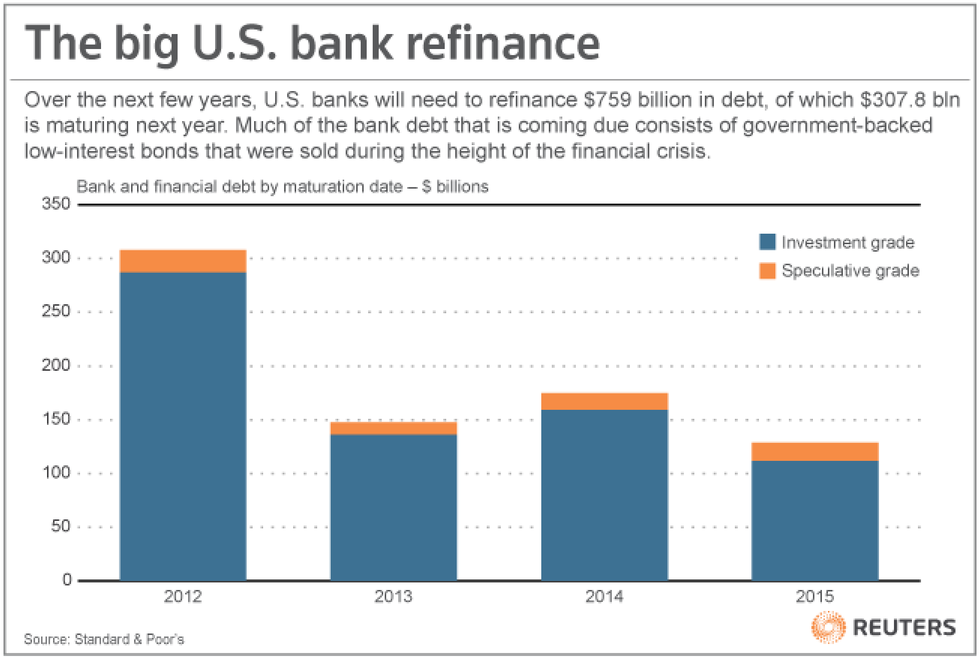
Given the standoff, there's a sense nothing will happen unless federal policymakers make the first move. The Fed reports that 71 percent of household debt in the U.S. is mortgage-related.

But so far Washington policymakers seem more content to rely on voluntary measures. The two main programs set up by the Obama administration to reduce home mortgage debt - the Home Affordable Refinance Program and the Home Affordable Modification Program - have had limited success.

To date, the U.S. Treasury Department reports that those voluntary programs have resulted in 790,000 mortgage modifications, saving those borrowers an average of $525 a month in payments. Many of those modifications, however, were for borrowers paying high interest rates, not ones underwater on their mortgages.

In fact, Bank of America, one of the nation's largest mortgage lenders, said it has offered just 40,000 principal reductions to its borrowers.

U.S. administration sources told Reuters that they support the concept of carefully



Reuters graphic/Stephen Culp 27/09/11

targeted principal reductions for underwater borrowers. But these sources, who did not want to be identified, say the administration cannot mandate banks and bondholders to accept any principal reductions absent Congress authorizing the procedure.

The sources point out that federal authorities don't have a "magic wand" - even at Fannie Mae and Freddie Mac, the government-backed home-loan titans.

These sources explain that even though Fannie and Freddie are effectively owned by the federal government, they are controlled by an independent regulator, the Federal Housing Finance Agency. And it's up to the FHFA, and not the administration, to approve any principal reductions on home loans involving Fannie and Freddie.

An FHFA spokeswoman declined to comment. The agency has repeatedly taken the position that its first job is protect taxpayers' return on investment in Fannie and Freddie rather than reducing mortgages for underwater borrowers.

THE FEAR OF SOME economists is that the economy may be going into a double dip recession. That means precious time is being lost if a negotiated approach to debt reduction isn't taken now.

But the banks also have their own big debt burdens to deal with. Next year alone, U.S. banks and financial institutions must find a way to either pay off or refinance $307.8 billion in maturing debt, compared to the $182 billion that is coming due this year, according to Standard & Poor's.

This maturing debt for U.S. banks comes at a time when they must start raising capital to deal with new international banking standards and are facing the possibility of a new recession that will crimp earnings. (Bank of America story: http://link.reuters.com/sys63s)

Beyond bank debt, hundreds of billions of dollars in junk bonds sold to finance leveraged buyouts also are maturing soon. S&P says "the biggest risk" comes in 2013 and 2014, when $502 billion in speculative-grade debt comes due.

Still, there are still plenty of economists who say the concern about consumer debt is overdone and that doing anything radical now would only make things worse. One of those is Mark Zandi, chief economist of Moody's Analytics, who says a forced write-down or haircut of debt "would only result in a much higher cost of capital going forward and result in much less credit to more risky investments."

He said significant progress has been made in reducing private sector debt, and draconian debt forgiveness measures would be a mistake. "Early in the financial crisis I was sympathetic to passing legislation to allow for first mortgage write-downs in a Chapter 7 bankruptcy, but the time for this idea has passed," says Zandi.

Still, the notion of a debt write-down and bondholder haircuts will probably be around as long as the unemployment rate stays high and the housing market remains depressed.

Indeed, it has been two years since the notion of a "Debt Jubilee" made it into the popular culture when Trey Parker and Matt Stone used it for an episode of the politically incorrect cartoon "South Park." In the episode aired in March 2009, (http://www.southparkstudios.com/full-episodes/s13e03-margaritaville) one of the characters used an unlimited credit card to pay off all the debts of the residents of South Park to spur the economy.

At the time, the idea seemed like just a funny satire on the nation's economic mess. But now it seems like no joke at all.

(Reporting by Jennifer Ablan and Matthew Goldstein; Additional reporting by David Henry and Joseph Rauch; Editing by Michael Williams and Claudia Parsons)

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