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EDITORIAL

Only Half a Bailout

A week into the big bailout, banks are beginning to charge each other less for loans and companies are finding it easier to borrow short term. The Dow has been up and down, but so far this week, it is back above 9,000.

So has the worst passed? Probably not.

The unfortunate reality is that as long as millions of Americans continue to default on their mortgages and housing prices continue to slide, banks will continue to suffer big losses. Unless something is done quickly to help American homeowners avoid foreclosure and stay in their homes, those losses could swamp the bailout effort by exceeding the sums being spent to rescue the banks.

Despite the danger posed by foreclosures — to the bailout, homeowners, taxpayers and the economy — the Bush administration and Congress are still depending on banks and other participants in the mortgage industry to voluntarily modify troubled loans, say, by giving borrowers more time to pay or by reducing interest rates.

The voluntary approach hasn't been enough to stanch foreclosures. As things now stand, some 3.2 million homeowners will likely lose their homes to foreclosure this year and next, and millions more will struggle to catch up on delinquencies. Vacancies and defaults will continue to push house prices down; they have already fallen by 20 percent nationwide and are now expected to fall by at least another 10 percent. There is no time to waste to reverse the spiral.

Unfortunately, the bailout legislation does not require banks to modify loans in exchange for the infusion of taxpayer dollars. That means the administration and Congress will have to turn up the political pressure on financial institutions that avail themselves of the government's largess. The Treasury Department should also set up a team to modify any troubled mortgages it gains control of through the bailout.

Both John McCain and Barack Obama have recognized that this crisis won't be solved until a way is found to keep many more Americans in their homes.

Senator McCain's plan — to buy troubled mortgages from banks at full value and replace them with mortgages at the house's lower market price — may sound humane, but it is an unjustifiable waste of taxpayer money. It doesn't require the lender to accept any loss before the government buys up a bad loan.

Senator Obama has a better idea. Rather than relying solely on the banks to do what is right and needed, he supports legislation that would allow bankruptcy judges to modify mortgages for bankrupt borrowers. That makes far more sense. Most lenders would invariably prefer to modify loans rather than be taken to court. But the bankruptcy fix faces stiff political opposition, and even if passed, would help about 500,000 homeowners — versus the millions now in distress.

Mr. Obama has also called for federal agencies to work more closely with the states on efforts to modify mortgages. Attorneys general in 11 states recently imposed the first mandatory loan modification program on Countrywide Financial as part of a legal settlement over what the states said was predatory lending. An estimated 400,000 borrowers will get $8.4 billion in direct loan relief, like reduced interest rates. More lawsuits and more settlements could lead to more modifications, and with them, a more stable financial system.

Still, it may get to the point, early in the next administration, when the president and Congress will have to require lenders to modify bad loans and take the losses.

Mandatory modifications, bankruptcy, lawsuits — no one likes them, but they are tough tools for a tough problem. The bailout has dealt with only half of the problem: the credit freeze. Unless the government deals as aggressively with foreclosures, the system will likely face the abyss again.