Further Proposals for Solving the Mortgage and Housing Crises

Kenneth T. Rosen
Chairman, Fisher Center for Real Estate and Urban Economics
University of California, Berkeley

The recently released Obama mortgage foreclosure relief plan is a good first step towards stabilizing the housing and mortgage market. However, it is only a first step toward a solution to the many problems in the mortgage and housing markets. To make the plan more effective and cost efficient, several elements of the plan should be modified. In addition, several additional policies must be put in place in order to fully stabilize the mortgage and housing markets. This memo will outline the desirable modification of the existing proposals and the additional policies that must be implemented to provide the basis for a real recovery in the sector.

Problems with the Existing Plan and How to Fix Them

The proposed Obama plan has two major elements. We will summarize them and explain the modifications we believe are needed to make them more effective and cost efficient.

The first element is a modification of FNMA and FHLMC rules to allow refinancings up to the 105% of current home value from the current 80% loan to value ratio guideline. This change appears to apply to only existing loans held by FNMA and FHLMC.

We would propose two changes to these new guidelines. First, given the sharp price declines in houses in many markets and the uncertainty of what an "appraised value" is today because the deluge of foreclosures make "comparable" prices unreliable, an even broader guideline expansion is desirable. We would suggest refinancing be allowed up to a 125% of current home value as long as the borrower is current on the present loan and the borrower is willing to take on full recourse (to other assets) for the portion of the loan above current appraised house value. In addition, FNMA and FHLMC should be allowed to refinance any loan (not just those currently in their portfolio) as long as it meets their new underwriting criteria. These changes will greatly enhance the value of this proposal in distressed housing markets.
The second element of the Obama plan is the affordability initiative for loan modification. As we have said for the past two years, a massive, aggressive, and standardized program of loan modification is essential to stop the tsunami of foreclosures. The Obama plan is an important first step towards providing the help millions of homeowners desperately need. However, aspects of the plan, as we understand it, will add greatly to the cost and difficulty of administering the program.

While the guidelines for this part of the plan will not be released for several weeks the broad outlines appear to be as follows. The bank or investor in the mortgage is to bear the cost of modifying the mortgage so that the borrower payment income ratio is reduced to 38%. The cost of further modification of the mortgage to the 31% borrower payment income ratio is borne equally by the bank or investor and the government. It appears that the modification comes through interest rate reduction rather than through term extension or mortgage balance reduction, but this is not clear from the initial proposal.

It also appears that the modification proposal applies to all borrowers not just those who are delinquent or in foreclosure status on their loans. This latter provision, including borrowers who are current on their existing loans, dramatically expands the cost and difficulty of administering the program. In would be far better to deal with those facing acute difficulties first, and then deal with other borrowers who are current on their payment by offering a 4-4.5% fixed rate financing through FNMA and FHLMC.

It also appears that the loan modification plans expire after 5 years and then borrowers go back to their old mortgage payment schedules. This makes no sense, as it would simply recreate the conditions that led to the foreclosure meltdown in the first place. Again, the most efficient program here would be to get all borrowers into a low fixed rate mortgage. While we understand the desire to use the 38% or 31% payment income ratio criteria, it makes much more sense to couple it with a new fixed rate mortgage at a slightly subsidized rate rather than keeping the toxic mortgage instrument that caused this crisis. (It is possible we are misreading the proposal and the guidelines may clarify this point.)

Second, to control the cost of the proposed program, the government should impose standards on who qualifies for this affordability "subsidy". There should be a "fraud" and an "asset" test. Anyone who fraudulently inflated their income by more than 25% on their initial loan application should be excluded from this program. Anyone who has other assets of more than $250,000 should also be excluded from the program.

Third, Obama plan should address the “underwater” mortgage problem through loan modification that reduces the mortgage amount. Modification that reduces the size of the mortgage should require a shared appreciation, second mortgage as part of the program. A shared appreciation second mortgage that allocated part of the future appreciation of the home to the government and to the private lender involved in arranging the loan modification would reward taxpayers and private lenders with a portion of the appreciation of the value of the homes when housing markets recover,
while reducing the incentive for borrowers to take unwarranted advantage of the loan modification program.

Finally, it is also essential that a 60 day national moratorium on foreclosure be put in place to prevent the displacement of families while these new plans are put in place.

**Additional Policy Initiatives Needed to Stabilize the Housing Market**

Slowing the tide of foreclosures is a necessary condition for beginning to stabilize the housing market. Reviving the housing market will require additional policy initiatives.

First, we must give incentive and confidence to the potential home buyers to act in the near time to buy a home. Since home price are down substantially and mortgage rates are low, usual affordability measures should make home purchases attractive. Unfortunately, however, home mortgage credit is very tight, often requiring a 20% down payment and very strong credit.

These extremely tight mortgage credit conditions are an over-reaction to the excessively easy terms and conditions of the 2002-2007 period. They are undermining the revival of the housing market. Down payments should be highest when the market is booming and prices are unsustainably high. They should be lowest after prices have deflated. They were absurdly low during the boom and now are prohibitively high.

In order to restore the housing market to a healthy condition we need the restore the flow of mortgage credit on more reasonable terms. We need to make 5 to 10% down loans to fully documented and qualified buyers more readily available. FNMA and FHLMC can easily do this, but they will need the help of a revived private mortgage insurance (PMI) business. PMIs typically have insured most loans above a 80% loan to value ratio for FNMA and FHLMC. The five big private mortgage insurance companies have been paying massive claims for the past year and no longer have the capital capacity to write new business. While FHA has filled some of gap it is ill suited to revive the mass home mortgage market. Recapitalizing the PMIs is essential to the Obama refinancing plan and to the revival of the housing market. If $4-5 billion dollars were used to re capitalize the PMIs, this would be sufficient to insure $250 billion of new mortgages.

In addition to restoring the flow of mortgage credit on reasonable terms we need to stimulate demand for home purchases in the next year. The stimulus plan passed in mid-February had until its final stages a 10% refundable tax credit (up to $15,000 maximum) for all home buyers in 2009 as one of its key provisions. It was stripped out of the bill at the last minute and a 10% (up to maximum of $8,000) tax credit for first time home buyers was included. While this is a positive for the market it needs to be enhanced. We would propose that the tax credit be restored to the $15,000 maximum and be expanded to include purchases of newly built homes and foreclosed homes for owner occupancy as well as all purchases by first time home buyers. This will greatly increase the use of the program in high cost markets like California, Florida, and New
York. If we want to ignite a wildfire of demand and turn around the housing market we might combine this with a 4% fixed mortgage for these buyers from FNMA and FHLMC. It is critical that we combine demand stimulus with foreclosure relief if we want to revive the housing market quickly and stabilize home prices.

**Conclusion**

We commend the Obama administration for taking on the foreclosure crisis. The plan is basically sound. We believe that with some enhancements, the plan will go a long way toward providing the help needed by millions of Americans who are facing foreclosure for reasons beyond their control, while benefiting the entire economy by helping to stabilize the mortgage market.

In addition to making these enhancements, we urge the Obama administration to take the following additional steps to: 1) recapitalize the private mortgage insurance industry and 2) support a tax credit for Americans who purchase newly built homes and foreclosed homes for owner occupancy, as well as all purchases by first time home buyers who will be owner occupiers. The housing market plays an extremely important role in our economy. A large stimulus is needed to enable it to resume its role as an engine of growth and a significant source of jobs.