The Foreclosure Tsunami and Loan Modification Plan: A New Approach Needed

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It has now been over two years since we made a call for a massive and standardized loan modification plan to prevent the avalanche of foreclosures that we saw coming (please see MarketWatch report from August 17, 2007 at http://www.marketwatch.com/story/real-estate-weekly-aug-17). While the Obama Administration has made a good faith effort to address a part of the foreclosure problem, the results have been far from adequate. According to a recent Treasury Department release, while 650,000 loans have entered the trial modification plan, less than 10,000 have been permanently modified. The Treasury Department unveiled in late November more efforts to cajole and monitor mortgage servicers and holders to encourage them to modify more loans. This approach is unlikely to accomplish much. What is needed is a massive, comprehensive, and simple set of programs to address the 8-10 million households who are facing foreclosure. Cajoling and “shaming” mortgage companies is just not going to get the job done.

The Obama Administration needs to take a radically different approach to a problem that has changed in its nature in the past year. The foreclosure crisis is no longer primarily caused by poorly structured and underwritten subprime, alt-A, and option ARM mortgages. The foreclosure crisis has entered a new and more worrisome phase. The major source of current and future foreclosures is the massive rise in unemployment and the "underwater mortgage" problem. In order to mitigate the impact of this massive problem we need to create a temporary public-private partnership, the MORTGAGE RESTRUCTURING CORPORATION (MRC), headed by a MORTGAGE CZAR, whose sole job would be to implement a massive refinancing of troubled home loans. This group would have required participation by the top 20 mortgage servicers, Fannie Mae (FNMA), and Freddie Mac (FHLMC), Federal Housing Authority (FHA), the top five private mortgage insurance companies, and representatives of mortgage securities investors. It is in everyone's interest to get this job done and with the $75 billion the Administration has committed to this effort the resources are available. In a short time the MRC could develop three to five easy-to-understand modification plans that would fit most situations, with full buy-in from the private sector. The MORTGAGE CZAR and the President could then unveil the plan along with toll-free phone numbers and web sites staffed with highly trained professionals to get the job done. We now discuss some more details of our plan.

The main element of the current Obama plan is the “Home Affordable Modification Program” 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 a first step towards providing the help millions of homeowners desperately need. The essence of the plan is to temporarily reduce mortgage payments to 31% of the borrower’s

income. Unfortunately, the implementation of the plan has been hampered by the complicated two-step modification process and massive bureaucratic and paperwork snafus.

The anecdotal evidence from news reports is extremely discouraging. The data on the number of permanent modifications is tiny in comparison to the problem. While we understand the desire to use the 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.

While we understand the academic justification involved with modifying the existing instrument and lowering mortgage payments to provide the household with a 31% payment income ratio, the plan is too complicated. It would be far better to “refinance” the household into a “slightly subsidized” 4.5% fixed-rate mortgage product at the current home value. If they cannot afford the payment, then they could be offered a graduated mortgage payment where the rate starts at 2.5%, rising 50 basis points each year to the 5% level by year five. Alternatively, they could be put in a version of “rent” for deed in lieu plan that FNMA is offering and be transitioned out of homeownership. We can only save those who have the financial ability to meet minimum mortgage payments.

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.

The Obama plan must address the “underwater” mortgage problem through a loan modification plan 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.

The Obama plan needs to address the issue of how to deal with newly unemployed households who would probably not have the income to qualify for a loan modification. With eight million people already losing their jobs in the “Great Recession”, this unemployment related foreclosure issue must be dealt with directly. One possible solution is for the government to consider an “unemployment bridge loan” for up to half the mortgage payments due for a two year period or until the person is re-employed. This bridge loan would be secured with a second mortgage against the house and could be administered through the unemployment compensation system. It is essential that the loan modification plan deal with the massive unemployment issue.

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 an 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.

Conclusion

The Obama Administration needs to take a radically different approach to the home foreclosure problem. The problem is evolving in a way that requires a massive, simple, set of standardized plans. We propose the creation of a Mortgage Restructuring Corporation headed by a "Mortgage Czar." The Mortgage Czar's sole job is to get the modifications done. A set of simple standardized plans should be set up to reduce monthly payments, to handle the unemployed homeowner, and address the "underwater mortgage" problem. A public-private partnership will allow the policy makers to harness the resources of the private sector to get the job done without adversarial "shaming" tactics. If we can prevent half of the potential foreclosures that are now in the pipeline we will greatly help stabilize the housing market and the U.S. economy.