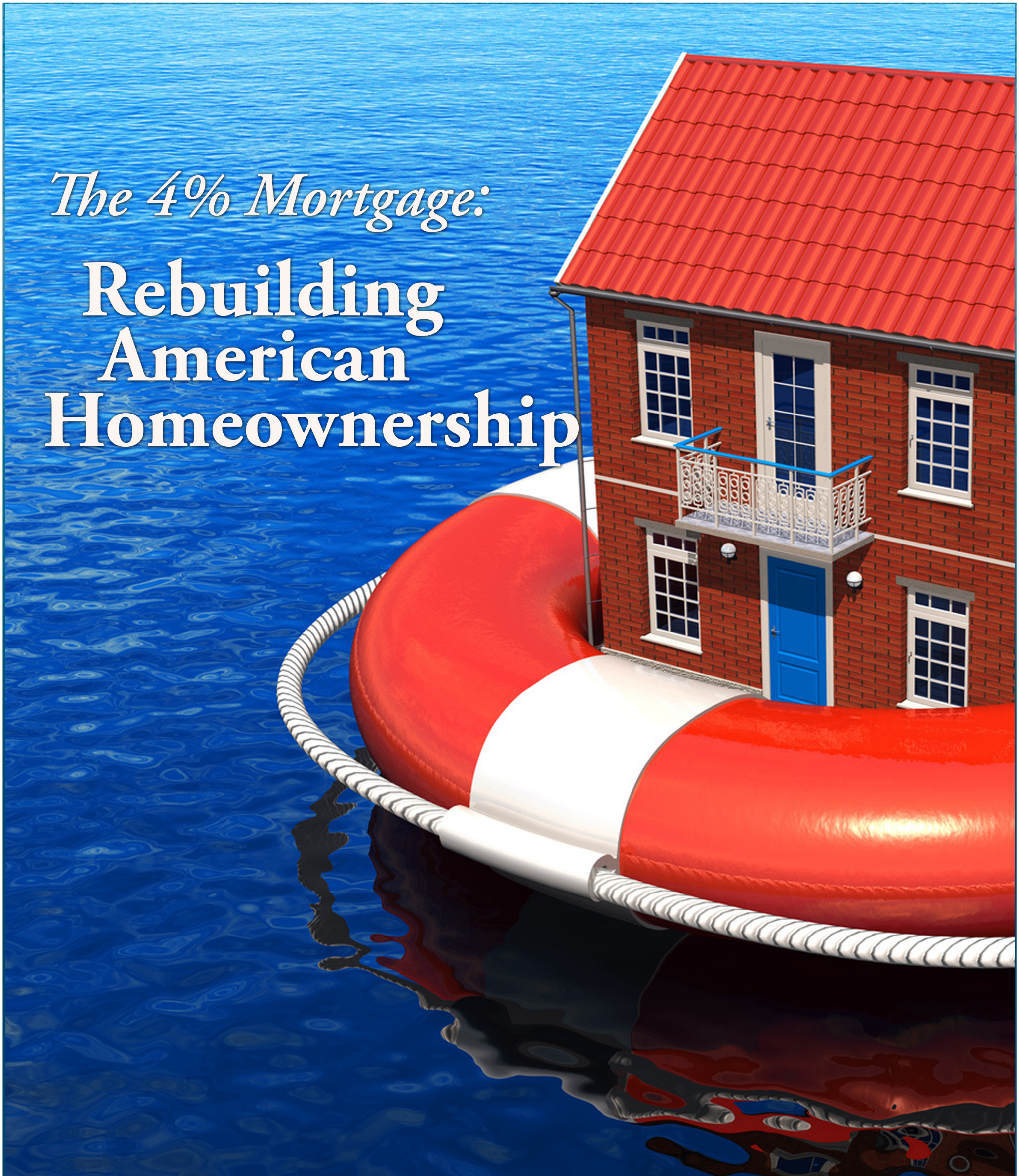


The 4% Mortgage: Rebuilding American Homeownership

Oregon's Senator Jeff Merkley

The 4% Mortgage:
Rebuilding American Homeownership

A Proposal from Senator Jeff Merkley
July 25, 2012

This proposal has been developed through the hard work of my capable and dedicated team, particularly Senior Advisor Will White and Legislative Counsel Andy Green.

Special thanks for their input and advice goes to more than two dozen housing experts from industry, think tanks, academia, and government for their assistance with this proposal. Their advice has been invaluable, but final responsibility for this paper rests with me. – Senator Jeff Merkley

The 4% Mortgage: Rebuilding American Homeownership

Table of Contents

Executive Summary

This paper proposes that the United States establish a 4% refinancing option for virtually all American homeowners who are current on their mortgages and meet basic underwriting standards. A particularly important goal is to provide this option to the roughly eight million American families who are trapped in higher-interest loans because they are underwater, owing more than their homes are worth.

This strategy would do a great deal to help stabilize American families. Families would benefit from loans that rebuild their equity more quickly or that reduce substantially their monthly payments. The reduced rate of foreclosures that would result would strengthen communities and help to stabilize or grow housing prices, improving the home construction economy and other sectors tied to the housing market. Moreover, the greater spending power of these families would help improve the overall economy.

To accomplish this objective, the US would set up a Rebuilding American Homeownership (RAH) Trust, which could be located in the Federal Housing Administration, Federal Home Loan Banks, or the Federal Reserve. The RAH Trust would buy mortgages that meet the RAH standards from mortgage originators across the country. Families would have three years to seek refinancing. After that, the RAH Trust would stop buying loans and would eventually go out of business as the loans in its portfolio are sold to private investors or paid off by homeowners.

The Trust would establish three mortgage options designed to best fit the circumstances of families. The first would be a 15-year, 4% mortgage that would rebuild a family's equity much faster. The second would be a 30-year, 5% mortgage with far lower monthly payments. The third option would be a two-part mortgage, consisting of a first mortgage for 95% of a home's current value and a soft second mortgage on the balance. The soft second, by not accruing interest or requiring payments for five years, would further lower a family's monthly payments.

This Trust would pay for itself and would probably generate a profit for the US Treasury. Its primary source of income would be from a roughly 2% interest spread between the cost of funds and the interest charged to homeowners. These proceeds, in addition to insurance fees and risk transfer fees, would cover the cost of defaults and administration.

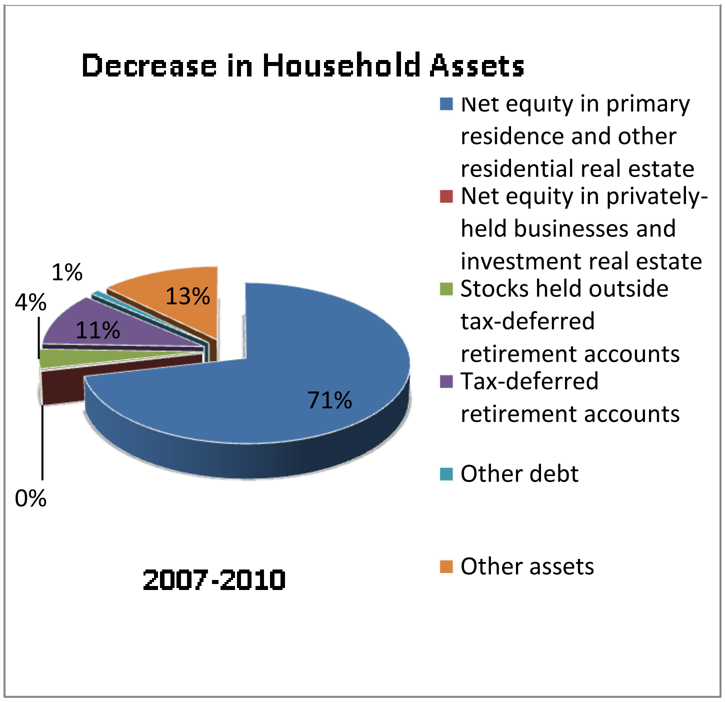
No program is without risk, but there is also great risk in the current course, with millions of families trapped in higher-interest loans, barely making ends meet, and generating high levels of defaults with adverse impacts for families, communities, and the economy.

The US acted boldly to rescue our large financial institutions on Wall Street. Let's act boldly now to throw a lifeline to American families, with beneficial consequences for the entire nation.

Introduction: We Need to Act Boldly

America's homeowners are in a world of trouble. Over four million homes have been foreclosed upon since the housing crisis began in 2007. Many experts predict four to eight million more foreclosures over the next five years. And a substantial share of these foreclosures will come from the many millions of families trapped in higher-interest loans because their homes are "underwater," which means the families owe more than their homes are worth.

Chart A



The effects are tragic.

- The loss of family wealth through foreclosures and devalued homes is estimated at seven trillion dollars, or roughly $100,000 for every homeowner in America. According to a Federal Reserve survey, 71% of the decrease in family assets between 2007 and 2010 was due to the decline in the value of housing.[1]
- Communities are impacted by empty foreclosed homes, driving down property values for neighbors and contributing to crime and blight.
- The construction industry is flat on its back, as low home values suffocate the market for new homes.
- As construction slides, so do related industries, from lumber and nursery stock to doors and windows.
- The gradually-improving economy has been held back, as homeowners' big debt overhang and high monthly payments stifle consumer spending.

[1] Jesse Bricker et. al., Changes in U.S. Family Finances from 2007 to 2010, as published in Federal Reserve Bulletin, June 2012.

Mortgages and the Great Depression

The Great Crash of 1929 came about when banks drove a stock bubble by selling, on margin, more and more complex and leveraged securities backed by increasingly shaky companies. When the bubble burst, the stocks – and the banks backing them – collapsed. The fallout from that crash fed directly into the broader economy, fueled in part by the structure of mortgages at the time.

As the banks went down, they "called in" their loans to homeowners and others, driving the families and the economy deep into the ditch. As most mortgages were also "balloon" mortgages, families couldn't get a new mortgage to replace loans that had reached their refinance date. These features meant that a stock market crash on Wall Street cost millions of families their homes.

To help chart a course out of the Great Depression, the Franklin Roosevelt Administration established the Securities and Exchange Commission, separated loan-making banking from high-risk stock and bond trading, and established the federal deposit insurance for bank deposits.

A critical but lesser known element of Roosevelt's reforms was the Home Owners' Loan Corporation (HOLC). HOLC refinanced families out of the unhealthy mortgages and into long-term, fixed-rate mortgages.

Although it took the combination of strategies to get us out of the Great Depression, a stabilized housing market laid a critical foundation for restoration of economic growth. Perhaps even more importantly, it laid the foundation for a new American middle class.

Thus, a Roosevelt-era HOLC provides valuable insights for solving our current mortgage crisis.

The continuation of these bleak conditions is not inevitable. Although new housing starts suggest some improvement of late, significantly stronger improvement could result from much bolder action.

Indeed, there is one powerful tool that could make a substantial difference - a refinancing program for the roughly eight million families who are underwater, but current on their loans. For these families, the proposed Rebuilding America Homeownership (RAH) program would restore homeownership as a path to middle-class wealth for millions of households, stabilizing families and strengthening communities. It would also provide a valuable lift to the American economy, helping to restore home values and putting the construction industry back on its feet.

The RAH program is designed to be a modern version of President Franklin D. Roosevelt's Home Owners' Loan Corporation, and it would work as follows:

- Families who are current on their mortgages and who meet ordinary underwriting criteria would be able to go to any bank, credit union, or other qualified mortgage lender, and refinance into a new mortgage that meets their needs.
- There would be three options for new mortgages: one that speeds the rebuilding of equity; one that lowers monthly payments; and one that provides flexibility through use of a two-part "soft second" mortgage.
- The participating lender would then sell the new mortgages to a newly established, but temporary, Trust.
- The Trust would operate only to serve these specially refinanced mortgages and would wind itself down, at a modest profit, as the mortgages are sold or repaid.

Many say this cannot be done. It can. Many say it would be prohibitively expensive. It would not be. In fact, it is likely to make a profit.

America moved boldly and generously to rescue Wall Street and the auto industry. Let's move boldly to restore the wealth-building power of homeownership for America's families!

Mortgage Options

The Rebuilding American Homeownership program would offer three different mortgage products, enabling families to choose the one that best fits their particular circumstances: a shorter-term "Rebuilding Equity Mortgage;" a standard thirty-year mortgage with lower monthly payments; and a two-part soft-second mortgage that further reduces monthly payments.

RAH -1: Rebuilding Equity Mortgage.

This mortgage would be a 4% fixed-interest fully amortizing 15-year mortgage. The mortgage would be beneficial for some families because the shorter term of the mortgage results in the family gaining equity and paying off the loan faster. Consider the example family presented in Chart A (below). The time it would take for the family to get out from under water is just over three years, rather than seven and a half years.

However, because the family's monthly payments would not be reduced as they would under a longer-term mortgage, this option would not be right for all families. Families choosing this

Mortgages and the Great Recession

In 2007-08, the financial crisis came about when the nation's largest financial firms fueled a mortgage bubble by selling and trading increasingly complex and levered securities and swaps backed by increasingly shoddy mortgages, among other assets. When the bubble burst, the toxic assets – and the banks holding them – collapsed. As with 1929, the ensuing banking crisis led to economic devastation, which many still feel today.

Subprime mortgages began to be marketed extensively in 2003 and commonly had three lethal features: a teaser interest rate that exploded to a much higher rate after two years; a large prepayment penalty that made it impossible for families to refinance to a normal mortgage; or large undisclosed kickbacks to mortgage originators who successfully steered families into riskier products over prime mortgages for which they were often eligible. The kickbacks also incentivized the creation of "no-doc" loans, in which the originators did little to no underwriting to determine the income and credit worthiness of the potential homeowner.

Wall Street packaged subprime loans into securities and created trillions of dollars in swaps – bets on whether the securities would fail. When the subprime mortgages did begin to fail, the securities and swaps did too, throwing shockwaves through the financial industry and driving many firms into bankruptcy.

As the banking system froze, credit dried up across the economy. Families and businesses cut back, workers were laid off, and home prices dropped. Families who had nothing to do with subprime mortgages suddenly found themselves underwater on their home, out of a job, or both.

Just as subprime mortgages helped paved the path into the crisis, consumer-friendly and affordable mortgages can help pave the path out. A broad refinance program would help bring American families and the economy out of the recession more rapidly, and, as history has shown, provide a powerful tool to rebuild middle class wealth and sustain long-term economic growth.

mortgage would be taking the risk of having less disposable income and greater risk of default should the family hit an economic setback. The Rebuilding Equity Mortgage would be most appropriate for borrowers who have not been stretched to make their current monthly payment.

This mortgage option would have significant benefits for both families and taxpayers. A recently published analysis from the Columbia Business School demonstrates that a program incentivizing borrowers with government insured loans to refinance into shorter term mortgages could save taxpayers more than $6 billion in anticipated default losses, while enabling families to quickly rebuild the equity in their homes.[2]

Under the sample RAH-1 mortgage in Chart A (below), based on a $240,000 15-year mortgage with a 4% interest rate, the monthly payment would be $1,775, virtually unchanged from their current payment, but as noted above, they would be out from under water much faster.

RAH-2: Standard Thirty-year Mortgage.

A second mortgage option would be the thirty-year fixed-rate mortgage, the workhorse of the American housing market. It would enable a family to stabilize its finances through lower monthly payments over a longer period of time. The homeowner benefits from having more disposable income, and the economy benefits as the family spends that income.

Under the sample RAH-2 mortgage in Chart 1, based on a $240,000 30-year mortgage with a 5% interest rate, the monthly payment would be $1,288, a savings of nearly $500 per month. Five hundred dollars per month can make an enormous difference for a working family that must take care of health problems, fix a leaking roof, or pay participation fees for a child who wants to play on the school soccer team or join the Constitution team.

RAH-3: Two-part Soft Second Mortgage.

A third option is to break the 30-year mortgage into two parts, with benefits both to the RAH program (the Trust holding the mortgages) and to the homeowner. The homeowner would have a collateralized first mortgage for 95% of the home's current value, and a mostly-uncollateralized second mortgage for the balance. Because the first mortgage would be collateralized, it gives the RAH Trust the option of selling it into the private mortgage market.

[2] Alan Boyce, R. Glenn Hubbard, Christopher Mayer, and James Witkin, Helping Underwater Borrowers Save Themselves: Accelerated Amortization, Columbia University Business School, June 21, 2012, http://www4.gsb.columbia.edu/realestate/research/housingcrisis

The second mortgage would be structured as a "soft second." Under a soft second, no payments would be charged and no interest accrued for five years. This soft second mortgage has much the same effect as reducing principal in terms of stabilizing families through lower monthly payments, but it avoids both the "moral hazard" problem and the fairness problem that would be created if principal were reduced for some homeowners but not others.

Under the sample mortgage presented in Chart A, the payment on the two-part $240,000 mortgage would be the lowest of the three options, at $1,020/month during the first five years – an extra $750 per monthly in the family's bank account. Payments would rise to $1,288 after year five, when payments begin on the second mortgage.

Chart B

Rebuilding American Homeownership Mortgage Comparisons

Mortgage	Principal Owed	Current Market Value	Interest Rate	Loan Term (yrs)	Monthly Payment	Balance after 5 years
Original Loan*	$240,000	$200,000	7%/8%	30	$1,770	$217,386
RAH 1	$240,000	$200,000	4%	15	$1,775	$175,342
RAH 2	$240,000	$200,000	5%	30	$1,288	$220,389
RAH 3**	$240,000	$200,000	5%/0%	35	$1,020	$224,475

Note: Monthly payments cover principal and interest, and do not include mortgage insurance or taxes.

* Principal owed is based on a calculation assuming that 72 months of payments have been made on an initial mortgage that consisted of a first loan for $200,000 at 7% interest and a second loan for $60,000 at 8% interest, both with 30-year terms.

**Monthly payment would increase to $1,288 after five years of soft second loan.

Program Design

The Rebuilding American Homeownership program could be carried out in several different ways.

Chart C

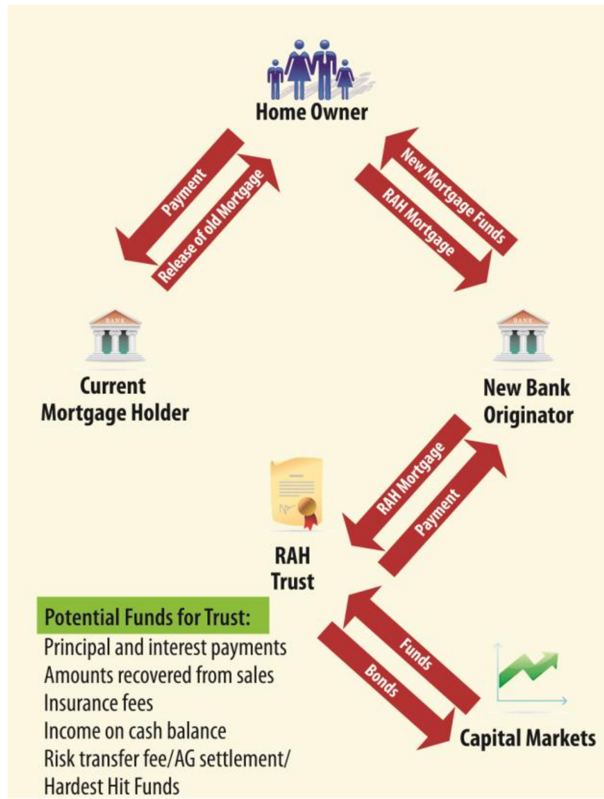


Chart B

One approach would be for the US government to directly guarantee loans that meet the specific RAH requirements, much the same way the Federal Housing Administration today guarantees mortgages. A second approach would be to set up a trust that buys the loans that meet RAH requirements, which is closer to how the Home Owners' Loan Corporation operated in the 1930s.

Both approaches are acceptable and both depend on the US government to stand behind the loans, either directly through purchase or indirectly through a government guarantee. One of the two approaches is necessary at this point in the housing crisis because the private market for collateralized mortgages is deeply damaged, and there is no private market for underwater mortgages. The reality is that without government action, there is simply no way to ensure these loans are available to worthy homeowners.

For simplicity, this paper only addresses in detail the process of setting up a trust. This approach is useful in analyzing the feasibility of this refinance program, since one can model potential income and expenses for the trust and examine if the trust would remain solvent over its life. This approach also allows for an explicit presentation of various assumptions, such as the foreclosure rate or home appreciation rate, and a mechanism for testing the impact of changing those assumptions.

The RAH program would work like this:

- Families would enter into a mortgage that meets the RAH program criteria from one of many competing banks, credit unions, and loan originators. Any entity that can originate mortgages could originate RAH mortgages.

- Those banks, credit unions, and originators would sell their RAH mortgages to a newly-established Trust (discussed below), which would create a secondary market for this product.
- The Trust would sell bonds to raise the funds for purchasing the mortgages. Because the US government is standing behind those bonds, the cost of capital would be equivalent to the cost of other government borrowing, such as Treasury bonds of similar maturities.
- As when banks hold mortgage loans on their books rather than selling them, the Trust would make money on the difference between its cost of funds and the interest rates charged to homeowners on the loans. This would constitute the primary source of funds to pay for losses when mortgage defaults occur.
- The program would not entertain short sales during the first four years of a loan. Because the goal is to allow homeowners who are committed to staying in their homes to do so, and since the homes are likely to still be underwater in the early years, short sales would be permitted only in very limited circumstances.
- Homeowners would pay mortgage insurance on their RAH mortgages until the value of the home is 1.25 times the mortgage balance owed (i.e. an 80% loan-to-value ratio), in keeping with standard industry practice.
- Another source of income would be from the banks (and other parties) that hold the families' current high-interest loans on underwater homes. The banks benefit by getting off their books loans that do not have enough collateral to cover them.[3] This proposal assumes that the banks, in order to participate, would pay a "risk transfer fee" to reflect this benefit. Alternatively, Congress could assess the risk transfer fee through a fee on the entire banking sector, similar to what the FDIC charges in exchange for guaranteeing bank deposits. Details on the risk transfer fee are presented in Appendix I.
- Another source of funds for a pilot program could be state funds from the Hardest Hit program (foreclosure prevention funds administered by the Treasury), or funds awarded through the Attorneys General settlement.
- Unused money from other federal foreclosure prevention programs is an additional option to fund this program.
- To be eligible for participation, homeowners would have to be current on their loans and demonstrate the ability to pay through standard underwriting criteria. This greatly lowers the risk of defaults. If a family has been underwater for years and has been consistently making the monthly payments on a high-interest loan, then the family is very unlikely to default on a more beneficial low-interest loan. Moreover, because these families are current on their loan, they generally have good credit ratings and

[3] Mortgages with a loan-to-value ratio exceeding 140% would need to be written down to 140% LTV to qualify for the program.

would have a lot to lose should they default. Finally, the requirement that the borrower be current significantly reduces moral hazard and avoids the risk of encouraging strategic defaults.

- This program is designed to break through many of the obstacles that have bedeviled earlier efforts to fix our housing market. By utilizing competing lenders, the program would end the voluntary, sole-source system that has bogged down mortgage modifications. By being open to persons whose mortgages are not currently guaranteed by a federal agency, it would ensure much broader availability and impact. By refinancing both first and second mortgages, it eliminates the complex transactions that have stymied many families seeking refinancing. Finally, by taking advantage of today's extraordinarily low borrowing rates, it would operate at a modest profit, reduce risks to the taxpayers, and inject much needed support into the real economy.

The Rebuilding American Homeownership program is designed to deal with a once-in-a-century crisis. It would refinance loans over a limited period of three years and would exist thereafter solely to service those mortgages. Once all the loans it holds are paid off by the homeowner or sold by the Trust to investors, the Trust would be closed down, following the model set by the Home Owners' Loan Corporation.

Testing Trust Fund Performance

The Rebuilding American Homeownership program envisioned in this paper would pay for itself. In fact, it is highly likely that it will return a profit to the federal Treasury. This conclusion is based on extensive analysis conducted in three phases.

The first phase was to establish a model to track all potential income and expenses to a RAH Trust, on a year-by-year basis, for each of the three types of mortgages. This model was constructed to look at a bundle of 1,000 loans for each mortgage type. To construct the model, base assumptions for key parameters—such as interest rates, default rates, and home appreciation—had to be clearly identified. These initial base assumptions (see Appendix I for a full list) were chosen to present a conservative, less than ideal, set of conditions. For example, the default rate for the first four years is set at 4% per year. Over the life of the Trust, cumulative default rates are projected to range from 23% to 27% for the three mortgage types. These are conservative assumptions, given that participating families must be current on their loans. The HAMP model, by way of comparison, projects a 17% lifetime default rate for loans that are refinanced into a 15-year term.

In addition, when there is a default, the model assumes that the funds recovered by the Trust after foreclosure will only be the lesser of 60% of the current market value of the home or the balance due on the loan, recognizing that there are often substantial costs in marketing a home after foreclosure.

One way to analyze the Trust is to observe the year-by-year balance that results from this modeling. That balance is presented below, in Charts B, C, and D. The starting number on the graphs is the balance in the Trust after the first year of operation. The model demonstrates that, under the base assumptions described above, the Trust balance for each of the three loan models stays positive over the full length of the program. The balance for the RAH-1 Trust, at the end of 15 years and after all obligations of the Trust have been repaid, is a net positive of $31 million. The corresponding balance for a Trust for RAH-2 loans, at the end of 30 years, is $53 million. And for a RAH-3 Trust, at the end of 35 years (because of the 5-year delay on the soft second), the balance is $35 million. Since these models are based on 1,000 loans, this translates to a net positive balance per mortgage of $30,635 on RAH-1 loans, $52,706 on RAH-2 loans, and $35,295 on RAH-3 loans.

Chart D

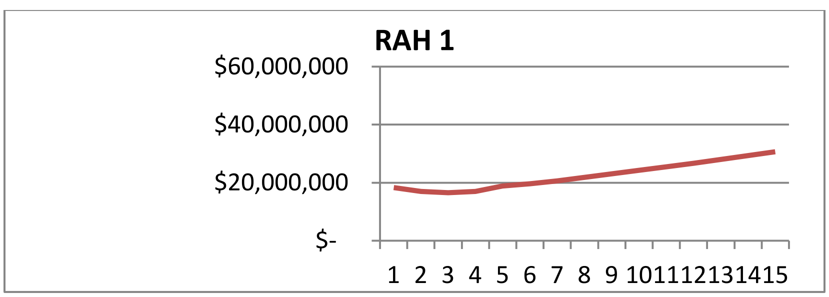


Chart E

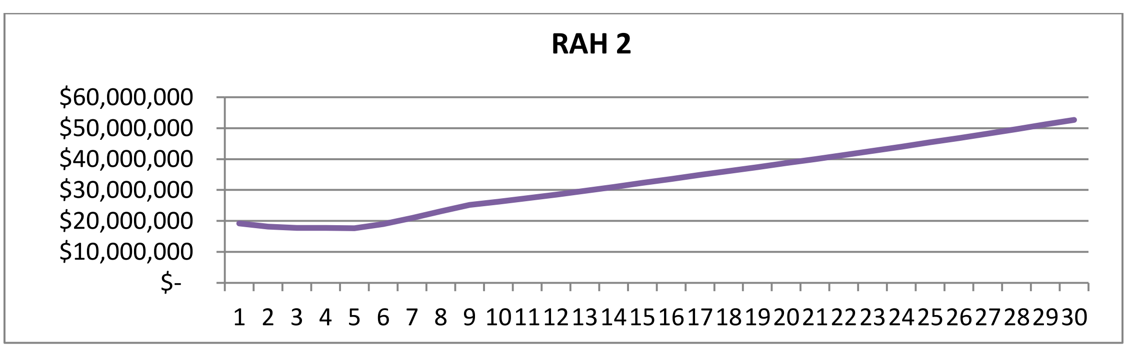
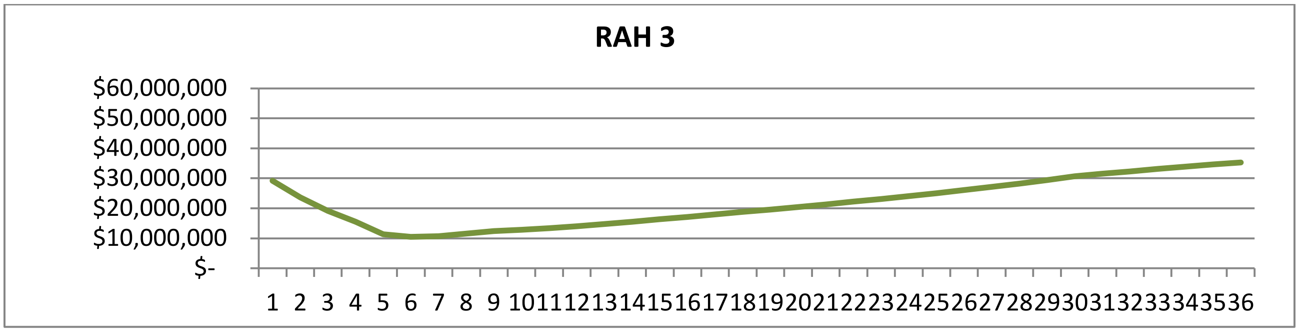
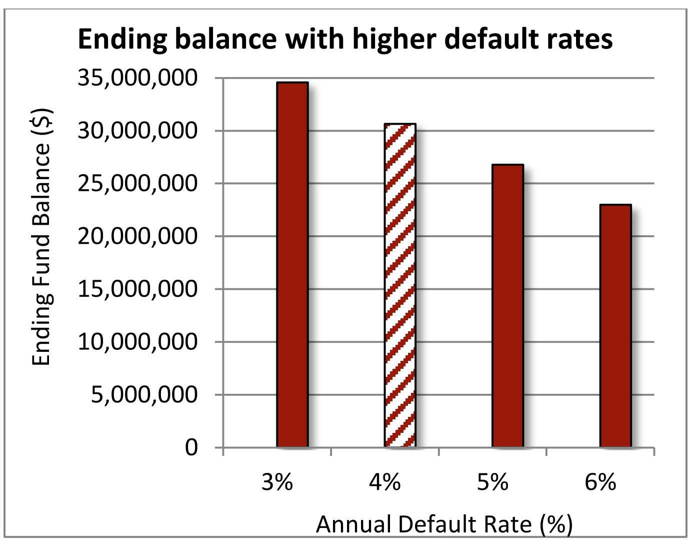


Chart F



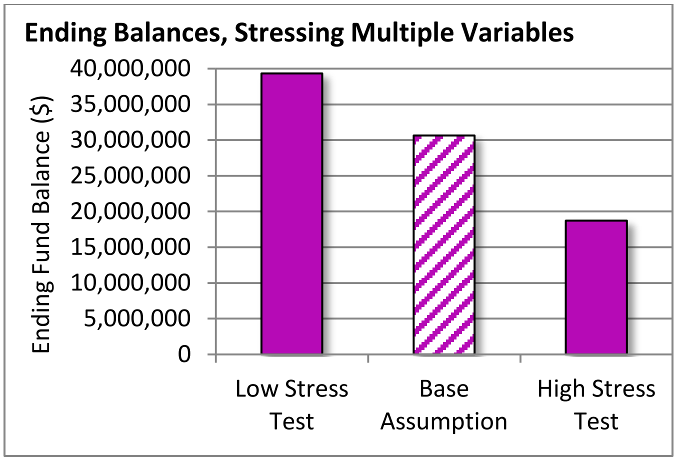
The second phase of the analysis was to test the model by changing individual parameters to make base assumptions more positive or more negative. For example, what happens if the default rate rises to 5% per year or 6% per year or if the appreciation rate for homes is lower than anticipated? A sample of the stress test results is shown in Chart E, with the striped bar representing the base assumptions. All of the results are presented in Appendices II, III, and IV. Under these tests, the models show that each of the Trusts would continue to stay solvent.

Chart G – Default Stress Test for RAH-1 Mortgages



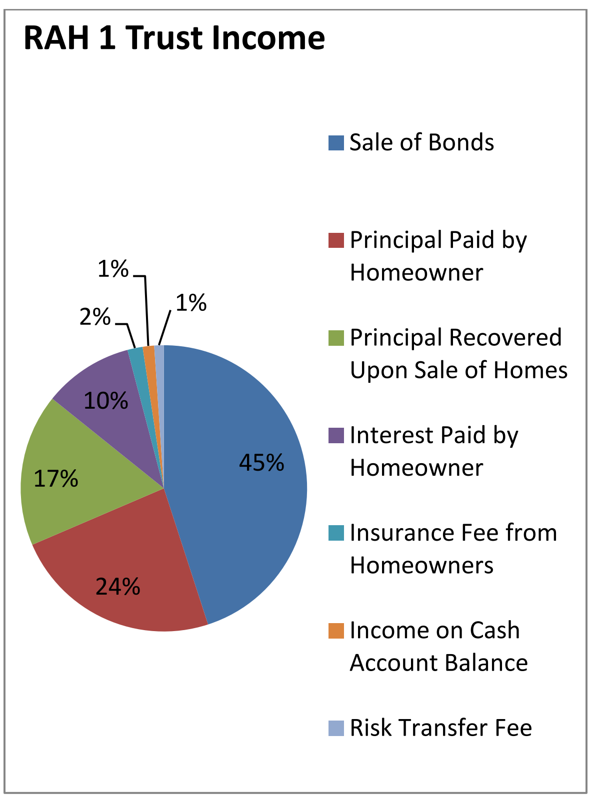
The third phase of the analysis has been to conduct high-stress tests of the model by changing multiple parameters in a positive or negative direction at the same time. The results are partially presented in Chart F, and more extensively in Appendix VI. Here, too, the results show that the ending balance of the Trust would remain positive.

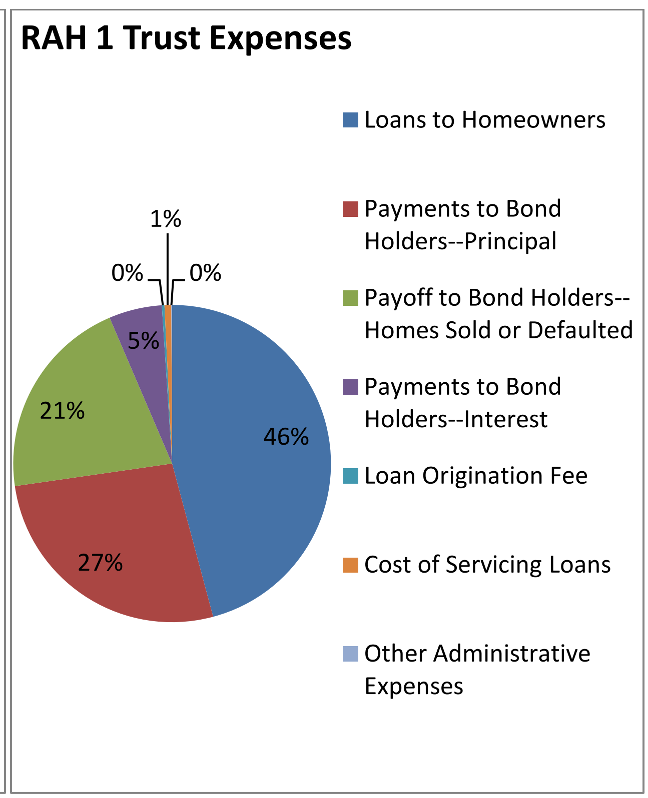
Chart H - Combined Stress Tests for RAH-1 Mortgages



Finally, it is important to understand the income and expenses related to the Restoring American Homeownership program. Pie charts representing income and expenses appear below, and more detailed figures are provided in Appendix VI.

Charts I and J





A Home for the Trust

Three main options were considered for housing the Rebuilding American Homeownership program: the Federal Housing Administration (FHA), the Federal Home Loan Banks (FHLB), and the Federal Reserve System.

Federal Housing Administration

The FHA is an agency within the Department of Housing and Urban Development. It was established in 1934 to stabilize the housing market during a period of unprecedented foreclosures. FHA created new standards for mortgages, and increased the flow of housing capital by insuring private lenders against mortgage default.

The FHA already implements the FHA Short Refi program as one of the government's foreclosure prevention programs. The FHA is already in the business of insuring home mortgages, but its mortgage insurance fund is currently below the required 2% level. And historically, the FHA has not guaranteed loans beyond a 97% loan-to-value. Therefore, to independently ensure the financial stability of the RAH program, it has been designed to generate sufficient funds to cover losses that can reasonably be expected due to defaults.

Federal Home Loan Banks

A second option for housing the RAH program is the Federal Home Loan Bank system. The FHLBs were established by Congress in 1932 to provide stable, low-cost funding to financial institutions for home mortgage loans and other purposes. There are 12 regional Federal Home Loan Banks across the nation. Together, they have member banks in every state. The FHLBs are private profit-making institutions, structured as cooperatives that are owned and governed by their member banks.

A regional FHLB raises funds for mortgages by issuing bonds that are sold to the public. They pay a very low interest rate on the bonds because the public views them as quite secure due to the regional FHLBs taking collective responsibility for repayment. In essence, all 12 FHLBs stand behind each bond. The regional FHLB then provides a loan to individual member banks to fund home mortgages. After it completes the mortgage loan, a member bank can either hold the loan in the bank's portfolio or sell the mortgage and repay the loan to the regional FHLB.

Although the business model of FHLBs makes the entity well-suited to housing the Rebuilding American Homeownership program, there are several challenges as well. For one, FHLBs are private firms that might not be willing to engage in this lending without additional government support, in the form of guarantees or other credit enhancement on the mortgages. In addition, buying the Rebuilding American Homeownership refinanced mortgages would constitute a new business activity for the FHLBs, requiring approval from the Federal Housing Finance Agency.

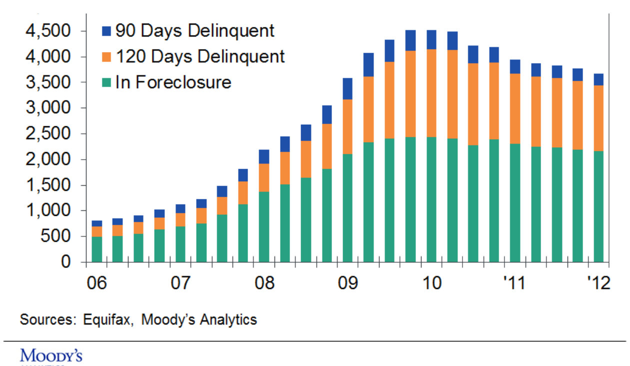
Federal Reserve

A third option for locating the RHA Trust is the Federal Reserve System. The "Fed" has wide-ranging power to intervene in financial markets, which it has exercised aggressively since the financial crisis began in 2008. In the last five years, the Fed has taken such extraordinary actions as setting up special purpose vehicles to support the JPMorgan Chase purchase of Bear Stearns, the government bailout of AIG and engaging in large-scale purchases of bonds, in addition to providing trillions of dollars in emergency lending to banks and ordinary companies. Indeed, the Fed played a key role in relieving banks of troubled assets, but American homeowners whose homes were and are the most fundamentally troubled of assets, have yet to be relieved.

Just as the Fed extended vast amounts of low-cost credit to stabilize failing financial institutions, it could extend low-cost funding to a Rebuilding American Homeownership Trust that it created and managed.[4] Alternatively, the Fed could fund a trust housed in a different government agency.

This approach would provide a dramatic and much needed reset to the housing market, and could overcome the difficulty the Fed has encountered in promoting economic growth in order to fulfill its mandate to seek full employment. The Fed has downgraded its forecast for U.S. growth for the rest of the year and Europe is facing renewed recession even in the absence of a meltdown of the Euro. Many observers are calling for the Fed, in coordination with other countries' central banks, to take more aggressive action to promote job growth than simply continuing its "Operation Twist," which sells short-term bonds

Chart K



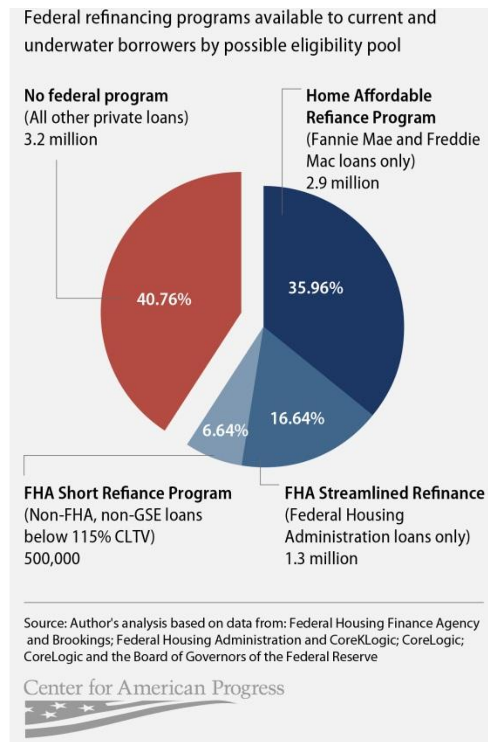
[4] The Dodd-Frank Act prohibits the Fed from using its emergency authority to establish a program that lends to a single company. Such programs must be broad based, which might require creating more than one trust.

and buys long-term bonds in order to lower long-term interest rates without increasing the money supply.

Economists have observed that the slow employment recovery from the Great Recession is due to lagging consumer demand. By implementing the Rebuilding American Homeownership program, the Fed could inject monetary expansion directly into households via the housing market, boosting the economy by putting more money in consumers' pockets via lower housing payments, and increasing employment.

One challenge in this approach is that the Fed would likely have to declare the problems affecting our mortgage markets to be an emergency. Although the Dodd-Frank Act limits the Fed's ability to engage in emergency lending, it still appears to have sufficient authority for this course to be feasible. And while the problems facing the housing market nearly four years after the collapse of the financial system are not new, they certainly qualify as emergency conditions compared to any historical norm.

Chart L



The Need for a New Program

We are more than four years into the foreclosure crisis, so why argue for a new program now? The answer is that, by many experts' estimate, we are only halfway through the crisis and millions of homeowners are still at risk of foreclosure.[5]

It is certainly true that an aggressive program for underwater homeowners could have made a big difference if implemented in 2009. But it is equally true that it will make a big difference now, both for homeowners trapped in underwater mortgages and for the broader economy.

But what about existing programs such as HAMP and HARP? Aren't they getting the full job done? They are not.

[5] Testimony of Michael Calhoun, "Hearing: Helping Responsible Homeowners Save Money Through Refinancing;" Hearing before the Senate Committee on Banking, Housing, and Urban Affairs; Subcommittee on Housing, Transportation, and Community Development; April 25, 2012

HAMP

The Home Affordable Modification Program (HAMP) offers incentives to loan servicers to modify mortgages for homeowners. Experts initially estimated that HAMP might help three to four million families, but as of May 2012, only one million have received permanent loan modifications. Many fewer homeowners have been helped than were projected because HAMP is voluntary on the part of the homeowner's current mortgage servicer, is designed to help only families on the brink of foreclosure, and is caught in a tangled web of complexities that arises from the interaction of first and second mortgages and from conflicting incentives for loan servicers.

Moreover, the models used to decide when mortgage modifications will be approved are designed to maximize benefit to the bank or trust, based on a net present value (NPV) model. The resulting mortgage modifications offered to the homeowner can look very different from a modification designed to benefit the family and society as a whole. While HAMP has been operational since early 2009, as of July 1, 2012, the program has used dispersed $3.4 billion of the $29.9 billion allocated to it.[6]

HARP

The Home Affordable Refinance Program (HARP) is designed to help homeowners refinance their first mortgages, if their mortgage is government-guaranteed, which by itself excludes half of all American homeowners. HARP also suffers from the complexities involved in first and second mortgages. In addition, HARP's rules give the current mortgage servicer a distinct advantage in issuing the refinanced mortgage.

While 2.9 million borrowers with government-insured mortgages are underwater, fewer than 170,000 of these homeowners have been able to refinance through HARP as of May 31, 2012. Many ideas have been proposed for improving HARP, and some of those have been implemented and helping. But even if all were implemented and fully successful, HARP would leave out in the cold the roughly 3.7 million underwater homeowners who are current on their payments, but whose mortgages are not covered by government insurance.

FHA Short Refi

The Federal Housing Administration Short Refinance program (FHA Short Refi) is the program designed to help underwater borrowers refinance if their mortgage does not have a

[6] Approximately $10 billion in additional funds are committed, but not yet disbursed.

government guarantee. The program, however, requires the holders of the mortgage to make a 10% principal write-down in exchange for getting FHA insurance on the portion of the new loan that is not underwater. Three to four million borrowers are estimated to be eligible for this initiative, yet fewer than 2,000 homeowners have been able to utilize the program to date. As a result, only $60 million of the $8 billion obligated for the FHA Short Refi program has been used.

The suitability of the FHA to house the Rebuilding American Homeownership program is evident because the current FHA Short Refi program addresses the same population of underwater borrowers who are current on their loan, but lack a government guarantee. In addition, both programs offer the option of splitting the current debt into two mortgages, one for nearly the entire current market value of the property, and another for the underwater portion of the debt.

An updated FHA Short Refi program could effectively function as the Rebuilding American Homeownership Trust. Most of the $8.12 billion originally dedicated to the FHA Short Refi program has not been spent, due to limited uptake of the program. Since this program expires at the end of 2014, there is a substantial amount of funds that the FHA could use to insure Rebuilding American Homeownership mortgages, or to support the establishment of a pilot program.

Plummeting home values eroded household wealth across all groups, but Hispanics were hit hardest by the housing meltdown.

From 2005 to 2009, inflation-adjusted median wealth fell by 66% among Hispanic households, 53% among black households, and 16% among white households.

Pew Research Center, Wealth Gaps Rise to Record Highs Between Whites, Blacks, Hispanics, by Rakesh Kochhar, Richard Fry and Paul Taylor, July 26, 2011

Need for a New Program

In short, there is no robust program that enables large numbers of families trapped in high-interest loans across America to refinance. The lack of such a program hurts our families, our communities, and our economy.

That is unacceptable, especially because such a program is entirely feasible.

A Pilot Program – Testing this Proposal Immediately

One or more states could lead the way in piloting this proposal.

For example, Florida has a surplus of more than $900 million in Hardest Hit Funds. A RAH Pilot Program that used these funds to prioritize working families with lower incomes and lower home mortgages could issue about 6,000 RAH mortgages if the average mortgage refinanced were $150,000. Other states with sizeable surplus Hardest Hit Funds, such as Arizona ($246 million), Nevada ($176 million), and California ($1.7 billion), could also establish similar pilot programs.

Another strategy would be for states to utilize funds from the national mortgage settlement negotiated by state Attorneys General in combination with surplus federal housing funds.

For example, the anticipated surplus in the HAMP program is approximately $20 billion, and the anticipated surplus in the FHA Short Refinance Program is about $8 billion. The federal government could make these funds available to the ten states that provide the best grant applications for RAH Pilot Programs.

A smaller state like Oregon, for instance, could pledge $20 million to the program from a combination of its Hardest Hit funds and AG funds and apply for a $1.5-billion federal grant from surplus housing funds. The $1.5 billion could fund 7,500 RAH mortgages averaging $200,000, and the $20 million from the state could substitute for the risk transfer fee. This would enable the program to be established with great speed. After it was up and running, Oregon could consider adding an opt-in program for banks and trusts that were prepared to pay the appropriate risk transfer fee.

Current law prohibits establishing new programs funded by the money allocated to the HAMP and Short Refi programs. However, there are many common elements between these programs and the RAH program, which could facilitate the funding of RAH pilot programs as a modification of the current programs.

For example, both HAMP and the Rebuilding American Homeownership program utilize a blend of low interest rates and principal forbearance to stabilize borrowers in underwater mortgages. The FHA Short Refi program, like the RAH program, is designed to assist homeowners who are underwater, current on their loan, and not covered by a government guarantee. Both offer borrowers the option of refinancing into a first mortgage for approximately the current value of the property, plus a second mortgage to pick up the underwater amount owed. Debt above a certain loan-to-value ratio must be forgiven in order to qualify for the program. Borrower eligibility requirements for the two programs are nearly identical. The Rebuilding American Homeownership plan could reasonably be deemed to constitute a modification of these existing programs.

In Conclusion – It Can Be Done

In 1932, President Franklin Roosevelt set the tone for building a path out of the Great Depression:

> "The country needs and, unless I mistake its temper, the country demands bold, persistent experimentation. It is common sense to take a method and try it: If it fails, admit it frankly and try another. But above all, try something."

This is the philosophy we need now. HAMP and HARP have had limited success in stemming the tide of foreclosures and their impact on families and communities. It is time to try a bolder strategy.

This paper provides a roadmap for such a strategy: providing a 4% refinance option for virtually every American homeowner who has been making payments on their loan. The Rebuilding American Homeownership plan would make a significant positive impact by enabling roughly eight million families who are current on their loans, but trapped in high-interest underwater mortgages, to refinance to fair interest rates. It would stabilize the families' finances, reduce foreclosures, strengthen communities, and stimulate the economy. In short, it would help us pull this economy out of the ditch to the benefit of all of America.

There are some who would say that the risk of launching this program is too great. They are wrong. As the analysis in this paper demonstrates, the program has a high probability of not only breaking even, but of generating a profit for the taxpayers. And that analysis does not even include the dynamic impact as millions of families spend more in the economy because they have to pay less on their monthly mortgages.

And let us not forget that there is great risk in doing nothing. That, too, is a choice. A choice that would judge acceptable the current high rate of foreclosures, the stagnation in home prices, the collapse of the construction industry, and the damage all of this is doing to our families and our communities. That is a choice we should not make and cannot afford.

The government stepped in during this financial crisis to ensure the stability of major financial institutions, and it helped restore the vitality of the U.S. auto industry. Yet millions of American families whose assets are tied up in homes that have plummeted in value are still underwater, with no relief in sight. And as a result, the entire economy is still in need of a major boost.

Let us move forward with a bold, well-reasoned plan to assist America's homeowners. They are looking to us for a path forward, and we can and should build that path.

Appendix I – Detailed Notes

Base Assumptions

The base assumptions for the models are presented below. These are conservative assumptions designed to provide a fair assessment of the outcome of this strategy in less than perfect conditions.

Base Assumptions (For All Three RAH Loan Types)	
Annual default rate:	
First four years	4%
Year 5 and beyond	2%
Total defaults over life of Program:	
RAH 1	23%
RAH 2	27%
RAH 3	27%
Annual sale rate:	
First 4 years	2%
Year 5 and beyond	8%
Housing appreciation rate:	
Year 2	1.8%
Year 3	2.8%
Year 4	3.3%
Year 5 and beyond	3%

Default Rates

The model's base assumption is that default rates will be 4% per year during the first four years, while the effects of the recession and the weak housing market are still impacting borrowers. From year five forward, defaults are assumed to be 2% per year. The result is a projected default rate of 23% over the life of the RAH-1 loans, and 27% for the RAH-2 and RAH-3 loans.

The HAMP model, by comparison, assumes a 27% lifetime default rate for underwater GSE mortgages if they are not modified. After refinancing into lower-interest loans, as they would be under the RAH program, the default rates are expected to be much lower. For loans that are refinanced into a 15-year term, for example, HAMP projects a 17% lifetime default rate. The Rebuilding American Homeownership program assumes a more cautious 23% default rate for the similar 15-year RAH-1 loan.

Annual Sale Rate

By policy, the Rebuilding American Homeownership would not entertain short sales during the first four years of the program. Because the goal is to allow homeowners who are committed to staying in their homes to do so, and since the homes are likely to still be underwater in the early years, short sales would be permitted only in very limited circumstances. For example, a homeowner who was offered a much better job in a different community would be likely to be approved for a short sale. During the first four years, therefore, the model assumes that no more than 2% of homes would be sold annually. After year four, with this policy removed, the model projects that a more robust 8% of all homes would turn over each year. By comparison, the standard PSA Prepayment Model of the Bond Market Association assumes that mortgages are paid off very rarely in the initial months, rising to a 6% annual conditional prepayment rate after 30 months.

Housing Appreciation

The housing appreciation rates for the first three years are based on projections from the 2011 MacroMarkets Home Price Expectations Survey. A panel of over one hundred economists, investment strategists, and housing market analysts are surveyed every quarter regarding their five-year expectations for future home prices in the United States. The predictions of housing appreciation for the next three years were 1.8%, 2.8%, and 3.3%. After those first three years, the model assumes a housing price increase of 3% per year.

Cost of Funds

In the modeling of the Trust, this paper assumes that the Trust borrows 15-year funds for RAH-1 loans (which would have a 15-20 year term), and a blend of 10-, 20-, and 30-year funds for RAH-2 and RAH-3 loans (which would have 30-year terms). Because the model assumes a 2% spread between the cost of funds and mortgage rates, we have modeled the shorter term loans with a 4% rate, and the longer term loans with a 5% rate.

Mortgage Insurance

The model developed for this program assumes that homeowners would pay mortgage insurance fees until the value of the home is 1.25 times the amount owed on the property. Insurance rates for each loan are as follows:

Loan Type	Fee	Average Duration
RHA-1 Loan	1%	5 years
RAH-2 Loan	1%	8 years
RAH-3 First Loan	1%	4 years
RAH-3 Second Loan	2%	9 years

The average time that insurance fees are collected on the RAH-1 loans is shorter than for the RAH-2 loan because the former pays down the loan faster, reducing the default risk more quickly. Likewise, insurance fees are paid for a shorter period on the RAH-3 first loan. Because that loan begins with collateral already exceeding the loan balance, it more quickly reaches the point where collateral equals 1.25 times the mortgage balance.

Recovery Rate for Sales and Defaults

The model assumes that the recovery rate for homes that are sold is the lesser of 90% of current market value or the balance due on the mortgage. In the case of defaults, the amount recovered is assumed to be the lesser of 60% of current market value or the balance due on the mortgage.

Risk Transfer Fee

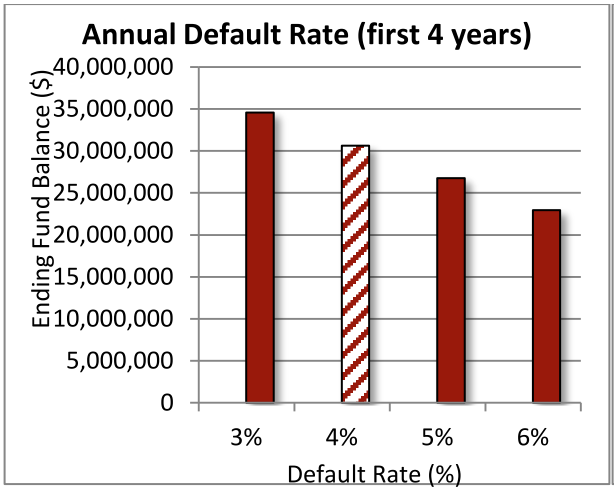
In the Rebuilding American Homeownership model, based on discussion with relevant market participants, we have assumed that banks or other entities would have a strong incentive to opt into a program that requires a modest risk transfer fee. For the model, we have assumed a risk transfer fee of 15% of the first 20% that a mortgage is underwater (i.e. up to 120% loan-to-value, or LTV), and 30% for the second 20% that a mortgage is underwater (up to 140% LTV). For a $240,000 mortgage on a house worth $200,000, the risk transfer fee would be $6,000. For a $280,000 mortgage on a house worth $200,000, the risk transfer fee would be $18,000. Any loan more than that exceeded 140% LTV would need to be written down to 140% LTV to qualify for the program.

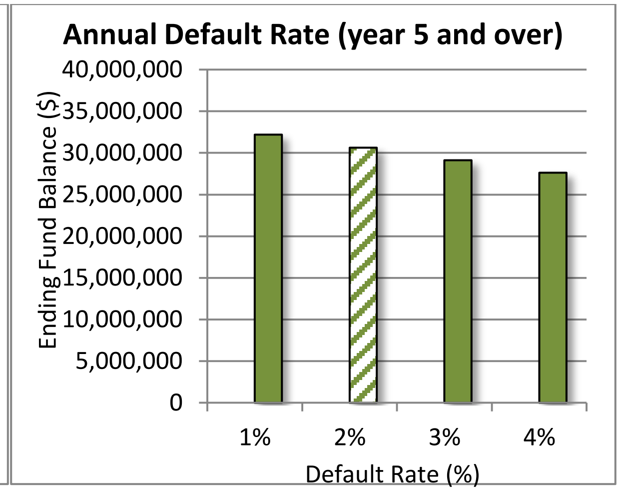
Participating lenders would agree to make all qualifying mortgages they service eligible for this program, in order to avoid the problem of adverse selection, where only the mortgages thought to be most likely to default are offered for sale.

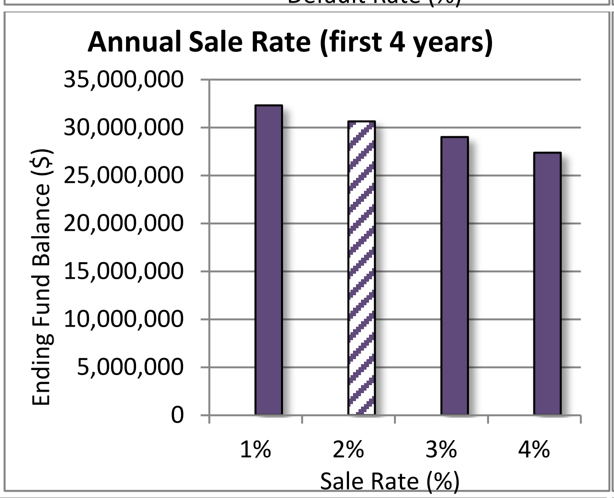
Appendix II – Stress Test for RAH-1 Mortgage

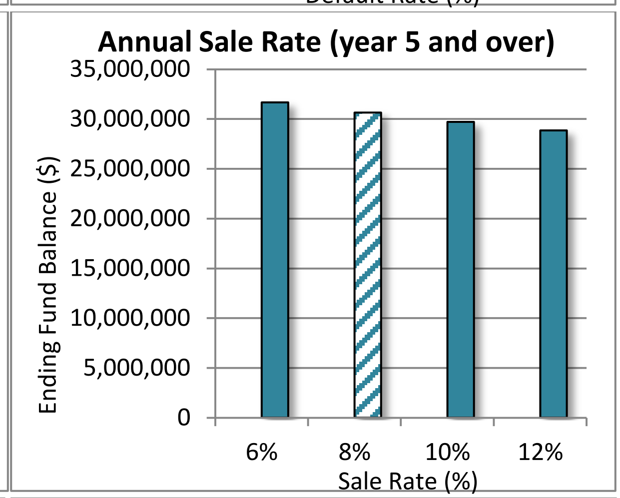
RAH-1: Rebuilding Equity Loan

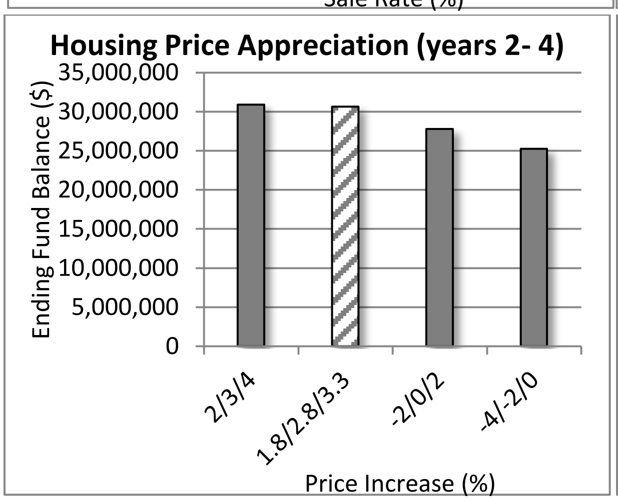
Ending Balance with Varied Assumptions

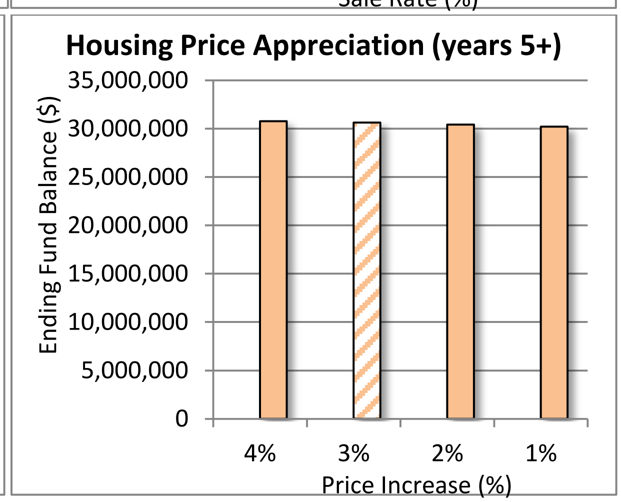












In all stress test charts, the striped bars represent the model's base assumptions.

Appendix III – Stress Test for RAH-2 Mortgage

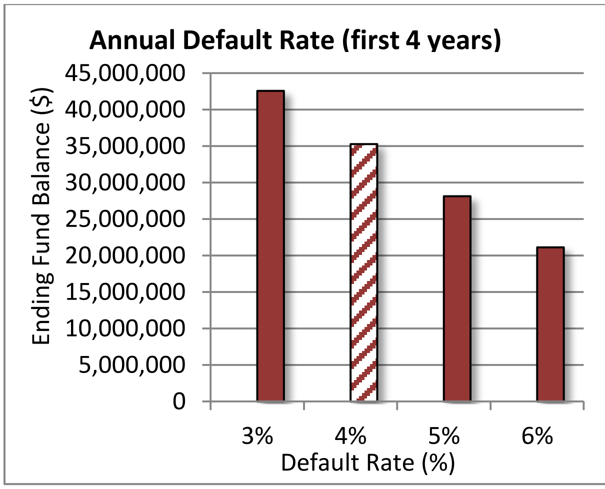
RAH-2: Standard Thirty-year Mortgage

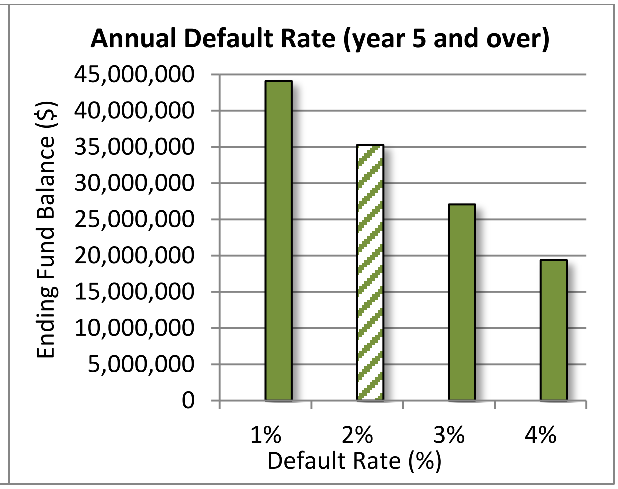
Ending Balance with Varied Assumptions

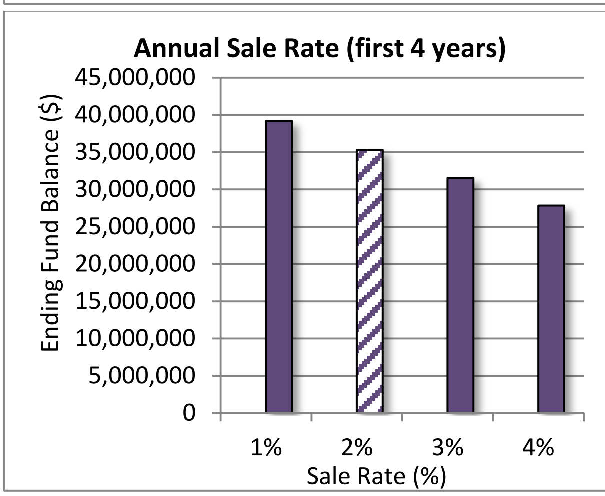
Appendix IV – Stress Test for RAH-3 Mortgage

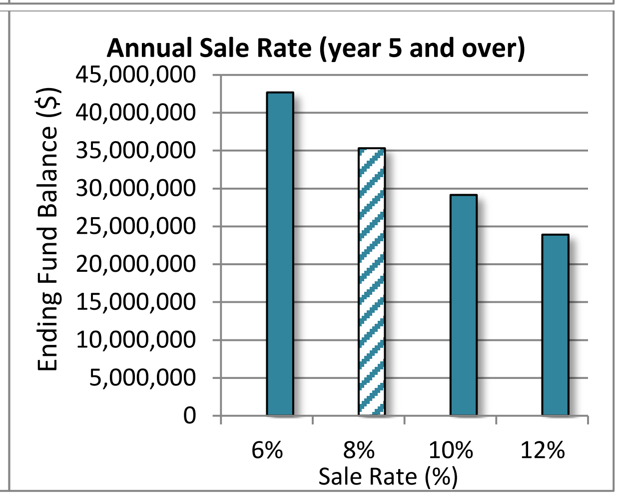
RAH-3: Two-part Soft Second Mortgage

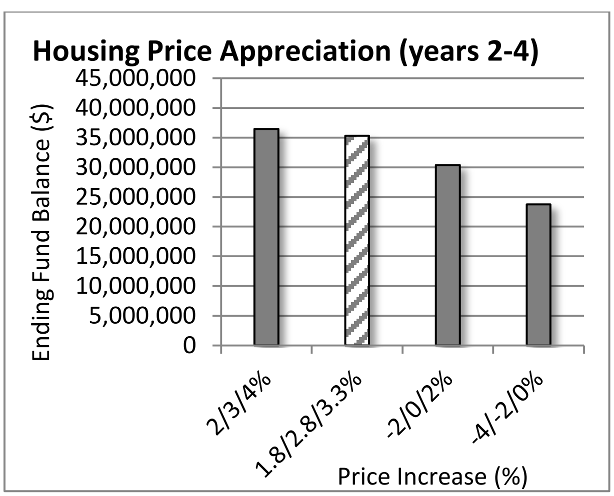
Ending Balance with Varied Assumptions

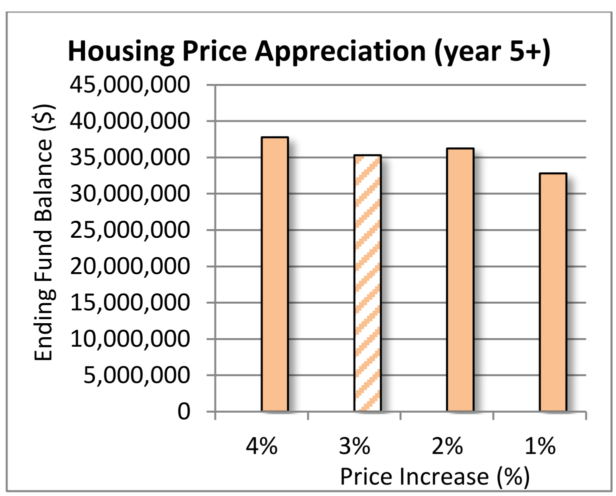








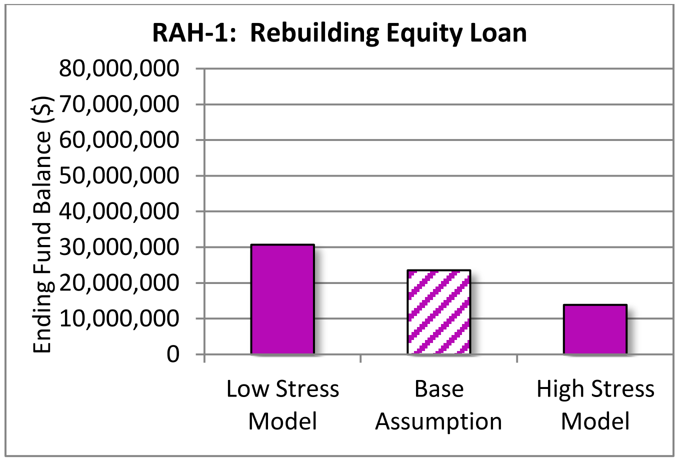


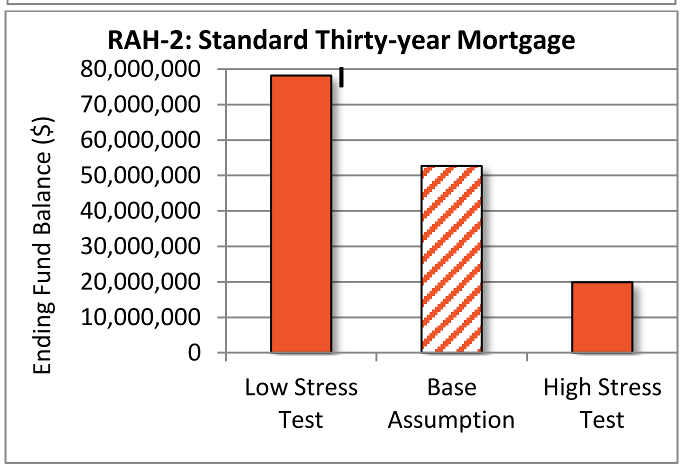


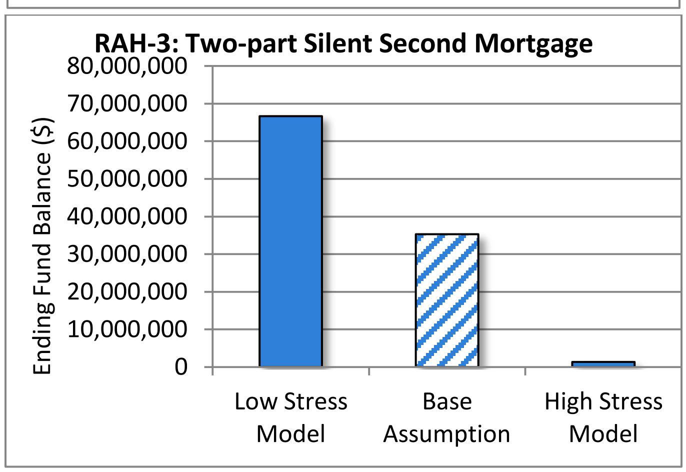
Appendix V – Combined Stress Tests for Mortgages

RAH Trust: Aggregate Stress Tests

Ending Balances with High and Low Assumptions







Low Stress Test Assumptions - Default rate: 3%/1%, Sale rate 1%/6%, Appreciation 2%-3%-4%/4%
High Stress Test Assumptions - Default rate: 5%/2%, Sale rate 3%/8%, Appreciation -2%-0%-2%/2%

Appendix VI – Cash Flow for 1,000 RAH Mortgages

Cash Flow: Rebuilding American Homeownership Mortgages (In Millions)			
Income	**RAH 1 Trust**	**RAH 2 Trust**	**RAH 3 Trust**
Sale of Bonds	$250.0	$250.0	$270.0
Insurance Fee from Homeowners	$9.5	$16.1	$13.7
Risk Transfer Fee	$6.0	$6.0	$6.0
Income on Cash Account Balance	$6.1	$18.9	$14.9
Principal Paid by Homeowner	$130.8	$59.6	$54.7
Interest Paid by Homeowner	$56.3	$105.0	$96.4
Principal Recovered upon Sale of Homes	$95.7	$156.9	$160.4
Total Income	**$554.4**	**$612.5**	**$616.6**
Expenses			
Loans to Homeowners	$240.0	$240.0	$240.0
Payments to Bond Holders--Principal	$140.8	$69.6	$84.9
Payments to Bond Holders--Interest	$28.3	$62.3	$64.9
Payoff of Bonds – Homes Sold or Defaulted	109.1	180.4	185.1
Loan Origination Fee	$1.4	$1.4	$1.4
Cost of Servicing Loans	$3.6	$5.3	$5.4
Other Administrative Expenses	$0.4	$0.8	$0.9
Total Expenses	**$523.8**	**$559.8**	**$582.7**
Balance			
Balance at End of Program	**$30.6**	**$ 52.7**	**$35.3**