WebMemo
Published by The Heritage Foundation
No. 2269
February 4, 2009

The Senate's Flawed 4 Percent Mortgage Refinance Plan

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Recently, there has been a great deal of discussion about the Senate Republicans' 4 percent housing stimulus and mortgage relief plan (proposed earlier by Chris Mayer and Glenn Hubbard of Columbia Business School). While this plan is correct in assessing the severity of the current housing situation, refinancing mortgages at very low interest rates would be a costly initiative and a massive new government intervention in housing and finance markets that would yield few if any of the promised benefits.

High Mortgage Rates Are Not the Problem. Too-high mortgage rates are the least of the problems facing housing today, and mortgage interest rates on the open market are already approaching the level that Mayer and Hubbard propose without government interference, mandates, or subsidies. In fact, the 5.25 percent interest rates first proposed by Mayer and Hubbard in *The Wall Street Journal* are already higher than the rate offered to many borrowers, which led them to revise their proposal to a 4 percent rate.

The biggest issues currently facing the market include:

- The low credit quality of the existing group of non-owners;
- The continued declines in home prices in many areas as previous speculative bubbles continue to deflate;
- The enormous stock of excess housing units; and
- The fact that the uncertainty of future employment is deterring many potential home buyers.

A decrease in mortgage interest rates will do little to address these issues.

As Mayer describes it, this new 4 percent mortgage interest rate will also be available to those wishing to refinance their mortgages, which he claims will add an extra $175 billion per year of disposable income to households and thereby provide a significant stimulus to the economy. Why our government would also want to provide deep subsidies to those not needing them is unexplained. However, the truly catastrophic aspect of this proposal is that the $175 billion represents a transfer of income from the badly battered and nearly insolvent financial sector to 25 million relatively untroubled homeowners. Raising the purchasing power of individuals and families is sensible to stimulate the economy, but it should be done directly through reductions in marginal tax rates.

Mayer contends that now is a good time to implement the Mayer–Hubbard plan because "home prices have already fallen at or below where fundamentals suggest." This assertion fails on two counts: First, housing prices are set locally. In some

This paper, in its entirety, can be found at:
www.heritage.org/Research/Economy/wm2269.cfm

Produced by the Thomas A. Roe Institute
for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

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markets, housing prices were slightly elevated and have come down modestly; in others—largely those subject to restrictive land use regulations—prices were highly inflated and may have further to fall to reach normal levels. Statements about housing prices nationally are almost always empty.

Second, if it were so obvious that housing prices were approaching normal levels, the market would respond accordingly. But with median home prices in many U.S. metropolitan areas still more than four to nine times median household income in the area, housing prices in many of the most distressed areas remain well above their historic norm. With the housing finance industry now refocused on more responsible lending practices, house prices will continue to fall in these least affordable—and most troubled—housing markets as previous, lower-quality borrowers are now properly denied mortgages on which they are likely to default and for properties they cannot afford.

Mayer further argues that this mortgage rate reduction will yield between 800,000 and 2.4 million additional home sales per year. This, too, is not supported by any reasonable evidence. There are many econometric models of the housing market that might predict such an impact, but their results are largely determined by a long-term pattern of growing economic prosperity, rising home prices, and stable financial markets and thus are not valid in times of unprecedented turbulence like the present.

Come One, Come All. Of particular concern is that under Mayer–Hubbard, lower mortgage interest rates would be available to all borrowers regardless of whether they can afford their current mortgages. Already, mortgage lenders are swamped with the number of good-quality borrowers who want to refinance their loans to take advantage of the low rates available on the private market. This glut will only grow exponentially as homeowners seek to take advantage of the "once in a lifetime" lower rates. Faced with such a demand, lenders are almost certain to focus first on larger loans that provide the highest risk to the lender and second on the loans of good customers. The rest of the market will simply have to wait their turn.

In the long run, the 4 percent loan rate will have a strongly negative impact on private mortgage lenders. First, once a borrower has refinanced at the lower level, he or she will be very unlikely to ever refinance that home again. Second, it is unclear from the Mayer–Hubbard proposal how markets will return to market interest rates. If there is a firm cutoff date for the subsidized rate, there will be floods of applications as that date approaches and inevitable complaints and suits from those who missed the deadline. If there is a gradual move to higher rates, it keeps the rates artificially low for an extended period of time, thus distorting the housing market for longer than necessary.

Finally, the market, not policymakers, is best suited to establish interest rates for specific loan products.

Problems with Implementation. In contrast with his proposal for setting mortgage rates, Mayer's proposed mortgage renegotiation process may be an improvement over the current situation. Whenever possible, lenders, borrowers, and the local markets generally are best served when a mortgage can be reworked so as to create a reasonable prospect of avoiding foreclosure. The magnitude of the current turmoil was not anticipated when common servicing arrangements with respect to third-party services were established. However, as past efforts have shown, renegotiating mortgages is far more complex than many appreciate, and the ultimate outcomes are often unchanged.

The Mayer–Hubbard proposal is intended to address problems arising from diverse ownership of mortgages that have been securitized and the legitimate fear of mortgage servicers that they could be liable if any of the owners object to the terms of a refinancing. However, a serious problem remains in dealing with the second mortgages that are often part of a financing package. Past evidence makes it clear that these complications are not minor and that they are not likely to be easily swept away.

It is clear, however, that to date about half of the renegotiated mortgages soon ended up back in default, and most responsible studies expect that level of redefault for future refinancings to persist. This should not be surprising for the subprime borrowers because they already had a checkered borrowing history in order to be eligible for the designation of "subprime borrower," a situation that

when the advantages of default are so much greater. However, the level of defaults is also increasing on mortgages where the borrowers had higher quality credit histories. Unfortunately, there are strong indications that these groups are also likely to have higher than expected redefaults.

Trying to Preserve a Vanished Housing Market. Although there is much to be said for trying to resolve the current housing problem in an accommodating fashion, the main flaw with the Mayer–Hubbard plan is that it is trying to preserve a housing market outcome in terms of both the absolute quantity of the housing stock and the prices paid for housing units that should never have happened in the first place. As painful as it is, the market is slowly working its way back to a sustainable outcome.

When mortgage lenders and investors were picky about risk and limited credit to those who by experience, income, and wealth had a high probability of paying back the loan, the homeownership rate in the U.S. largely remained within the 63 to 65 percent range. This level of homeownership was constant in the U.S. from the early 1960s to the mid-1990s. With the growing acceptance of subprime mortgages, low- or no-down-payment loans, and exotic repayment schemes, previously ineligible households became eligible for credit, driving the homeownership rate up to 69 percent. Unfortunately, this level was unsustainable, and the housing market is in the process of returning to the long-term sustainable norm of 64–65 percent. A side effect of this process is that it will yield something on the magnitude of about 5 million "surplus" housing units that will no longer be owner-occupied.

Mayer, Hubbard, and others like them are attempting to reverse this process and use generous subsidies and interventions to restore a level of ownership that the market has just demonstrated as unsustainable even in good times. And with the good times gone for an unknown length of time, the impossibility of their proposal having a successful outcome seems even more obvious.

What Next? This is certainly not an easy problem to resolve, and the effort that has gone into discussing the Mayer–Hubbard plan is considerable. Unfortunately, their proposal is simply not an appropriate solution. The clear implication of available data is that this country will return to a sustainable level of homeownership and that this will leave many of the unqualified owners as renters who will need places to rent. Thus, public policy should be focused on ways to redeploy this surplus of formerly owner-occupied homes to rentals.

It should not be government policy to spend massive amounts of taxpayer money to subsidize those who do not need subsidies, provide homes for those who cannot afford to keep them, and in the process destroy the private mortgage finance system. Trying to short-circuit the market's resolution of the current housing situation will be both expensive and unlikely to succeed.

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