WebMemo

Published by The Heritage Foundation

No. 2311
February 25, 2009
Revised and updated February 27, 2009

12 Problems with the Obama Mortgage Stability Initiative Plan

Ronald D. Utt, Ph.D., and David C. John

On February 21, 2009, President Obama released his Homeowner Affordability and Stability Plan to help stabilize the deeply troubled housing finance market by providing several forms of assistance to as many as 7–9 million borrowers who may be at risk of defaulting on their mortgages. Two of the bill's three key components are designed to provide subsidies and benefits primarily to homeowners who are still current in their payments.

The first provision will assist those who may not be able to take advantage of attractive refinancing opportunities at lower interest rates because the value of their home has declined beyond the loan-to-value ratio permitted by rules governing mortgage investments made by Fannie Mae and Freddie Mac. The second such provision of the plan would provide taxpayer and investor subsidies to mortgage borrowers who have taken on more debt than they could safely manage including, in some cases, credit card and automobile debt. The third component of the plan encourages the enactment of legislation allowing bankruptcy judges to alter the terms of certain mortgage loans, a practice that to date has been prohibited by federal law.

The Obama plan suffers from 12 specific weaknesses and risks:

1. The plan's Stability Initiative bestows new and costly benefits on those who took on more debt than they could handle, including credit cards, automobile loans, and mortgages (including refinancings and seconds). Worse, the value of the benefits will vary in direct proportion to the degree of borrower financial irresponsibility, and the intensity of community land regulations. Homeowners with a first mortgage as large as $729,750 are eligible for the initiative, meaning that the well-to-do will receive more financial benefits than those of modest means. And as analysts at one nationwide financial firm noted: "The modifications would go disproportionately to borrowers who overstretched and who lied about their income." This moral hazard sends a clear message to the American people: The worse the behavior the greater the reward.
2. Under this Stability Initiative borrowers with a ratio of mortgage debt service to income greater than 31 percent can have their mortgage interest rate reduced to as little as 2 percent if that is what it takes to achieve the 31 percent ratio—with government paying half the subsidy and the investor/lender surrendering the other half. If this concession is insufficient to reach 31 percent, then the servicer (as opposed to the lender/investor holding the mortgage) can lengthen the term of the loan and/or reduce the principal amount owed to achieve the 31 percent. Eligible borrowers may also have loans that are as much as 50 percent greater than the value of the house.

This paper, in its entirety, can be found at:
www.heritage.org/Research/Economy/wm2311.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

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

The Heritage Foundation
LEADERSHIP FOR AMERICA

3. It is also likely that, under the Stability Initiative, borrowers with a ratio of debt service payment to income as high as 55 percent—because of combined mortgage, credit card, and automobile debt—will be eligible to receive temporary payment reductions if they merely agree to HUD-approved counseling. Such borrowers may then be eligible for permanent payment reductions. This reduction scheme will be disclosed in rules that the Administration has announced it will release on March 4, 2009.
4. Because the investor/lenders will be responsible for a portion of the mortgage rate reduction, this program will deter private sector investment in all but the best mortgages. Combined with the proposed "cram down" bankruptcy proposals, the net effect will be to require a substantial and permanent federal presence in the housing finance market to accommodate those many potential borrowers who are not highly qualified.
5. The plan also includes a formal endorsement by the President of a bankruptcy provision that allows judges to alter the terms of certain mortgages. This provision will increase the risk to lenders of all mortgages. The industry is already treating this as a permanent measure. Increased risk requires higher costs to compensate lenders, and either down payments or interest rates would have to rise, while potential borrowers with checkered credit histories would be denied access to credit. However, these costs would not rise evenly for all borrowers: Higher risk borrowers (first-time buyers and moderate-income workers) would see costs rise more and have fewer opportunities to buy a house.
6. Anticipating such criticisms, the proposal contends that it will "seek careful changes to personal bankruptcy provisions." However, because any changes in bankruptcy law must be passed in legislation, this outcome may merely be wishful thinking. As the President wants to make sure that "millionaire homes don't clog bankruptcy courts," mortgages eligible for judicial "cram down" cannot exceed $729,750 in value. Moreover, the most recent version of the legislation weakens language adopted earlier by the House Judiciary Committee to prevent borrowers who committed fraud in their mortgage application from taking advantage of cram down.
7. The plan's Refinancing Initiative creates a new right for American borrowers now current in their mortgage payments: the right to refinance their home at a lower interest rate even if the quality of the loan—as measured by the loan-to-value ratio—would otherwise pose a risk to the lender. As such this proposal establishes the act of being highly leveraged or slightly "underwater" (the amount that a borrower owes on his or her mortgage is more than the value of the house) as a legitimate reason to default, and as a policy problem worthy of taxpayer support and federal intervention. The creators of this new right fail to recognize that many other consumer credit markets operate comfortably, successfully, and safely despite the fact that many borrowers are underwater the minute they sign the contract, notably home improvements, mobile homes, automobiles, RVs and HDTVs. Though those borrowers do expect to be "underwater" for these kinds of purchases, it raises the question of whether future legislation will extend this concession to car loans and credit card debt, which are also experiencing significant levels of default?
8. Only borrowers with loans held or repackaged by the federally-controlled and subsidized Fannie Mae and Freddie Mac will be eligible to exercise this new right to refinance. Borrowers whose loans are held by private investors are denied this right, further distorting the housing markets with government-selected winners and losers.
9. To date, the several, federal loan modification programs that have been put in place have had very limited success, and the rate of failures exceeds that of successes, especially for loans where one or more payments have been missed. For loans that were four months past due at time of modification the recidivism rate is 80 percent after 12 months. For loans one month past due, the recidivism rate after 12 months is 60 percent. With the nationwide decline in house prices accelerating in recent months, the risk of recidivism under the new program could remain at high levels.

10. The program will cost $275 billion ($75 billion for problem mortgages and $200 billion for Fannie Mae and Freddie Mac).
11. Obama's plan will take a great deal of time to implement. A recent MarketWatch.com article notes that loan refinancing applications are up 47 percent at a time when a substantial portion of the loan originating infrastructure has disappeared due to bankruptcy and bank consolidation. The prospect that a shrunken mortgage lending system could expeditiously accommodate the 7–9 million borrowers expected by the Obama plan is wishful thinking. The result will be long waits for refinancing that will come too late for some borrowers, and may also crowd out efforts by unsubsidized borrowers to refinance due to the generous financial incentives offered to servicers participating in the new federal program.
12. Perhaps the most troubling part of the plan is the increased reliance being placed on the now federally-controlled Fannie Mae and Freddie Mac, whose lax and corrupt behavior over the past decade was an important contributing factor to the present economic crisis. Although nominally privately-owned, both are now run by the U.S. Treasury, whose massive holdings of preferred shares in both give it a huge implicit ownership stake. As is clear from the refinancing plan—which will reduce Fannie and Freddie's earnings and thus weaken them further—the two GSEs have become little more than the federal government's captive mortgage financing banks to be used at will for any housing policy initiatives that the President and/or Congress wish to pursue. And with the plan's many provisions discouraging the private sector from getting involved in mortgage finance, this plan substantially advances the *de facto* nationalization of America's housing finance system for all but the "jumbo" mortgages that exceed conforming limits.

Given the 12 weaknesses discussed above, there is little indication that President Obama's Homeowner Affordability and Stability Plan will provide any relief—short-term or long-term—to the beleaguered housing market.

—Ronald D. Utt, Ph.D., is the Herbert and Joyce Morgan Senior Research Fellow and David C. John is Senior Research Fellow in Retirement Security and Financial Institutions in the Thomas A. Roe Institute for Economic Policy Studies, at The Heritage Foundation.