WebMemo

Published by The Heritage Foundation

No. 1604
September 10, 2007

The Subprime Mortgage Situation: Bailout Not the Right Solution

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A carefully targeted governmental response to the rising default rate and other problems in the subprime mortgage market is needed to head off further financial market volatility. However, this response should be limited to dealing with the immediate problem and should not become a vehicle for expanded housing programs or pushing other agendas.

Commendable Response, but Risks Remain. President Bush, Federal Reserve Chairman Bernanke, and the financial services regulators responded swiftly and appropriately to a potential global financial panic that threatened to undermine the health of the U.S. economy. Chairman Bernanke's late August use of open market operations and the discount window provided financial markets with needed liquidity. With financial markets on a more even keel, the President subsequently announced a change to the Federal Housing Administration's (FHA's) mortgage insurance program: Homeowners facing a scheduled increase in their monthly mortgage payment will be able to refinance their subprime mortgages with FHA-insured mortgages that carry lower interest rates and monthly payments. At roughly the same time, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Federal Reserve announced special guidance urging mortgage servicers to work with borrowers to re-tool existing loans to make them more affordable and less likely to cause borrowers to default on them.

All three initiatives are welcome. Absent some level of concessionary refinancing opportunities, many financial analysts feared that rising mortgage defaults would lead to a record number of foreclosures and a further weakening of the housing market. However, this concern must be balanced with the recognition that temporary measures often become permanent laws that last well beyond the crisis that spawned them, eventually causing significant harm down the line. In addition, because of inevitable delays in both passing and implementing legislation, often the crisis has passed before they go into effect. Well-intentioned initiatives should not shift risk from individuals and financial institutions to a government entity that subsequently needs to be bailed out with massive amounts of taxpayer dollars. Any action by Washington should be both limited in size and scope and carefully targeted.

While the President's plan—with improvement—could help restore confidence to the shaken mortgage market, as currently proposed it could also induce even more loan defaults and shift billions of dollars of loan losses to the federal government. The proposal contains a potential moral hazard: After interest rates on their loans increase, homeowners might stop making payments in order to take advan-

This paper, in its entirety, can be found at:
www.heritage.org/Research/Economy/wm1604.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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tage of the FHA program. This could greatly increase the number of loans that would be refinanced with an FHA guarantee. On the other hand, the proposal has a short lifespan and can be implemented without action by Congress. These two factors are likely to limit the potential moral hazard.

The subprime mortgage situation creates two problems for policymakers. The first, which the President's proposal addresses, is the difficulty faced by existing mortgage holders in repaying their loans. The second is how to improve lending standards and disclosures so that this situation does not develop again. This paper focuses exclusively on the problems faced by existing borrowers.

How the Subprime Mortgage Problem Developed. The problem now challenging financial markets and the economy stems from historically low interest rates that encouraged millions of Americans to refinance their fixed rate mortgages. The lower interest rates meant that buyers could afford larger mortgages. Effectively, a bidding war broke out that raised the prices of homes. While some markets had larger price appreciation than others, higher prices limited the number of potential buyers. In response, the home financing industry developed new products that allowed otherwise unqualified individuals (by income, assets, and/or credit history) to receive loans to buy or refinance a house.

These same products also allowed creditworthy households to buy more expensive houses or to refinance their current houses to obtain cash for other uses. These riskier mortgage instruments, referred to as "subprime" loans, in recent years have come to account for an ever larger share of the mortgage finance market. By 2005, they accounted for about 20 percent of all outstanding mortgages, up from just 5 percent in 1994. Among the several distinct types of subprime loans on the market, the one causing considerable concern is the subprime hybrid called "2/28" or "3/27," which allows borrowers a low monthly payment during the first two to three years, but then resets to a higher interest rate and payment for the remaining 27 or 28 years. The first wave of these mortgages is now in the process of resetting to the higher rate, and many borrowers are unable to meet the higher payment. As a result, defaults and foreclosures are rising. In recent testimony, the Comptroller of the Currency noted that foreclosures had increased by 93 percent over the 12 months ending in July 2007.

President Bush's FHA Proposal. It is this last type of subprime hybrid that the President's FHA/Secure proposal is intended to address. The program allows borrowers facing or experiencing a payment reset to refinance with a lower interest rate/lower payment mortgage insured by the FHA. The program will begin on January 1, 2008. To be eligible, a mortgagee must (1) have a good credit history and sufficient income to repay the refinanced loan, (2) have made regular mortgage payments prior to the reset, (3) have at least 3 percent equity in the home, (4) have an outstanding mortgage balance of no more than $362,790, and (5) have an interest rate that either has or will reset between June 2005 and December 2008. (A press release that included a 2009 date rather than 2008 was in error and was subsequently corrected.[1]) FHA/Secure is only available through December 31, 2008, and can be implemented without action by Congress.

According to the White House, mortgagees must miss some of their post-reset payments before being eligible for the program. Assuming that this requirement remains, post-reset subprime hybrid borrowers who are current with their mortgages will face a tremendous incentive to miss payments in order to be eligible for the more generous FHA program. This built-in moral hazard will likely lead to an escalation in defaults beyond the current troublesome level. Alternatively, opening eligibility to those whose interest rates must have or will reset between June 2005 and December 2008 avoids the moral hazard issue, but it does so by allowing nearly unrestricted access to the program by those who meet the other requirements.

While the Administration estimates that as many as 240,000 families could be helped by the program, the number of applicants could be substantially larger. An analyst at Barclay's Capital

1. The corrected press release can be found at *www.hud.gov/news/release.cfm?content=pr07-123.cfm.* The incorrect date was near the bottom of the page in item two in the list of five criteria that a homeowner must meet in order to qualify for the program.

Research contends that about 2 million subprime hybrids will reset over the next 12 months, while an analyst for Merrill Lynch notes that about 92 percent of subprime loans nationwide would fall below the FHA/Secure cap. The Chairman of the Federal Deposit Insurance Corporation testified that the volume of subprime mortgages that will reset by the end of 2008 could cause "serious financial distress" for more than 1.5 million households, and notes that nearly 490,000 subprime loans were "already seriously delinquent or in foreclosure" as of March 2007.

The number of loans that are refinanced through FHA/Secure is important. If the actual program enrollment is significantly higher than expected, there could be a larger than expected shift of risk and financial loss from the individual's responsible for the loans to the federal government—and ultimately to the taxpayer if losses exceed FHA reserves. Even though FHA/Secure refinancing will include a mortgage insurance premium that is individualized to meet the risk of each mortgage, the potential remains that a substantial number of these loans could default at some point. It is important to remember that the program only covers subprime loans, which by definition have a lower credit quality than other mortgages.

What the Administration Must Do. The below measures will help to avoid the possibility of a broad and costly bailout that provides unwarranted benefits to both borrowers and lenders, as well as the guilty, innocent, careless, foolish, and vulnerable alike:

1. *Require that borrowers and lenders on all loans currently in default enter a mandatory 60-day period to attempt to work out a refinancing plan that avoids foreclosure.* These negotiations should follow the recent guidance from the financial regulators (see below). In order to discourage lenders from simply running out the clock before sending the loan to the FHA, FHA/Secure should also require some concession from the lender or mortgage servicing agent in the form of either fees or a residual exposure to loss in the event of default.
2. *If the borrower fails to reach an agreement during the mandatory 60-day period, include greater protection of the FHA in the event of a subsequent default and foreclosure.* To hold the borrower responsible for losses and expenses exceeding the value of the collateral, such protection could involve tighter eligibility or a modification of the standard non-recourse provisions common to most mortgages.
3. *Limit access to FHA/Secure to a defined time period.* The Administration must ensure that FHA/Secure reflect only an urgent response to a current financial emergency. To a large extent, the Administration has already met this goal by limiting the program to mortgages where the interest rate will reset before December 2008, but it should also resist efforts to renew or expand the program.
4. *Maintain FHA's current threshold for a minimum downpayment.* President Bush has also proposed a modification of the existing FHA program to allow FHA to insure mortgages for borrowers who have invested less than the currently required 3 percent downpayment in the house. Given that the actual FHA downpayment may be as little as 1.5 percent because FHA allows for the financing of half of the settlement costs, any further reduction from this level gets perilously close to 100 percent financing. And inasmuch as the absence of a meaningful downpayment is among the several factors accounting for the subprime problem, FHA should not be permitted to incorporate such risky practices into the program.

The Financial Regulators' Guidance. Because of the weaknesses in the President's FHA proposal and the likelihood that necessary congressional action could both delay its implementation and expand it into a general bailout, the voluntary guidance proposed by the FDIC, OCC, Federal Reserve, and others is likely to have a more immediate impact. This guidance is already in effect, and it applies to borrowers who might not qualify for the FHA program. Lenders would be wise to act now before Congress passes new regulations that could greatly increase their costs.

According to the guidance, one appropriate strategy to avoid a default is converting the loan from an adjustable rate loan to a fixed rate mortgage. This move alone would eliminate the problem

of loan payments increasing beyond the ability of the borrower to pay. Another possible modification would be increasing the length of the loan—a strategy that stretches out the amount to be repaid over a longer period, thus reducing the size of each payment. Lenders are encouraged to avoid temporary fixes and work toward long-term, affordable solutions. The guidelines recognize that in many cases, the company collecting monthly mortgage payments is different than the company that wrote the original mortgage.

Conclusion. Any federal intervention in the mortgage market must meet several strict criteria: be carefully targeted to those who need help most; utilize to the greatest extent possible existing programs; be strictly limited in duration; not increase the taxpayers' exposure to risks that should be held by the private sector; and not unintentionally make the current problem worse. As described by the White House, FHA/Secure—with a few key modifications—would meet most of those tests. The program will need to be closely monitored, and the White House must be willing to make rapid changes if it is used by lenders and/or borrowers to dump onto taxpayers loans that should never have been given in the first place. Also, the program must end on time.

However, there is the possibility that Congress may enact legislation that further broadens FHA and/or FHA/Secure eligibility. As noted earlier, the President's plan appears to cover only one of the many types of subprime mortgages and does nothing to alleviate the default problems confronting borrowers with other types of loans. Some loans were given under deceptive circumstances to unqualified buyers, many of whom have low-to-moderate incomes and now risk losing their house. Furthermore, with the advent of the FHA/Secure program, it will be even more difficult for Congress to avoid extending the same type of relief to borrowers with better credit records who are now squeezed by increasing loan payments. These borrowers are even more likely to benefit from the financial regulators' guidance, and Congress should resist any impulse to include them in an FHA/Secure-type program.

Legislators—even with the best of intentions—have a tendency to produce massive permanent responses to temporary problems. Often, other program expansions are attached. In addition, because of the inevitable delays in passing a new law and then starting a new program, they often become available only well after the current crisis has ended. The current mortgage problems should not become an excuse to enact housing program expansions that would not be approved in normal circumstances and could even further destabilize the housing market.

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