WebMemo
Published by The Heritage Foundation
No. 1941
June 2, 2008

The Dodd–Shelby Housing Bill: A Bad FHA Refinance Plan Hijacks Good GSE Reforms

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The Senate Banking Committee's housing package contains some very important reforms and one very bad idea. Chairman Chris Dodd's (D–CT) version of legislation to use the Federal Housing Administration (FHA) to refinance at-risk mortgages at a lower interest rate in return for a cash fee is still as wrong a way to deal with the housing finance problems as the House-passed version. Dodd has improved his FHA refinancing language by including amendments by Senators Jim Bunning (R–KY) and Jon Tester (D–MT) that would limit the ability of those who have lied on their loan applications or otherwise abused the system to gain FHA-guaranteed refinancing of their mortgages. However, the overall concept remains bad policy that should not be approved.

The inclusion of such a flawed approach in the Senate Banking Committee's package is unfortunate, as the rest of the bill contains several very important provisions that would improve housing finance and help to protect the taxpayer against the need to bail out Fannie Mae, Freddie Mac, or the 12 Federal Home Loan Banks. Legislators have been working to improve regulatory oversight of Government Sponsored Enterprises (GSEs) for many years, and the recent housing turmoil makes this improvement all the more important. The Senate package also includes an FHA reform that has bipartisan support and would reduce the chance that the agency will require a taxpayer bailout of its existing programs. Rather than packaging these needed changes with a seriously flawed mortgage refinancing plan, Congress should consider them separately.

Seven Flaws of the Dodd FHA Mortgage Refinancing Plan. Chairman Chris Dodd's response to the subprime mortgage problems is very similar to that proposed by Representative Barney Frank (D–MA) of the House Financial Services Committee. Under the legislation, lenders that chose to take part in the voluntary program would agree to receive 85 percent of the current assessed value of the house, while the borrower would receive a refinanced loan equal to 90 percent of that new assessed value.[1] Refinanced loans would be 100 percent guaranteed by the FHA, and the new lender would have no further credit exposure if the borrower subsequently defaulted. If the homeowner subsequently walked away from the new loan, the taxpayers would have to cover any losses.

The main difference is that while Frank's plan would be financed with government tax money, Dodd's would be financed by imposing a 1.2 basis point (0.012 percent) fee on Fannie Mae's and Freddie Mac's portfolios. The portfolios are the housing loans and securitized mortgages that Fannie Mae and Freddie Mac hold for investment purposes or use to back mortgage-backed securities. The fee is expected to raise about $500 million annually that will initially go to finance the new

This paper, in its entirety, can be found at:
www.heritage.org/Research/Economy/wm1941.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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FHA program but will then go to fund a Housing Trust Fund.[1]

The proposal has many flaws:

1. Like the Frank plan, it is essentially a government buyout of problem mortgages disguised as a refinancing plan. It is an extremely bad precedent, as lenders will quickly request that this guarantee be made available for all loans to borrowers with poor credit histories or lower incomes. Until now, the mortgage market has operated under free market–oriented principles with a moderate level of government regulation, but this program would be a slippery step toward government micromanagement. As a significant number of the loans now facing problems were made by irresponsible mortgage brokers using inaccurate and even false data, it would also signal that there are no real consequences for poor lending practices.
2. Many of these refinanced mortgages will be likely to default. The Congressional Budget Office (CBO) estimates that fully one-third of refinanced mortgages under H.R. 5830 (the Frank legislation) will subsequently default, and those numbers have been criticized by some as being overly optimistic. The risk of default is historically best measured by the size of a down payment. The smaller it is, the more likely that the borrower will walk away from the loan. While the Dodd plan essentially gives refinanced homeowners an amount equal to 10 percent of the current value of the house, this is a gift, and the homeowner has none of his or her own money at risk. Experience with similar "gift equity" programs already causing problems for the FHA shows that these loans have a default rate that is two to three times that of loans where the borrower has made a cash down payment.
3. The plan would reward two different groups of homeowners: those who took out a speculative loan they never had a chance of repaying in hopes of flipping the house in a rising market and those who fell into trouble through no fault of their own. In doing so, it sends a message that it is acceptable to renege on an obligation because a government buyout will cut your losses.
4. Even if legislation were passed tomorrow, it is not possible to implement this plan rapidly. FHA says that it does not currently have the people necessary to implement such a plan. It will take time to hire and train them. In addition, mortgages must be refinanced individually. It will take a great deal of time to refinance the 1 million–2 million loans that supporters say could benefit. While supporters talk of refinancing loans in bulk, this is not possible under current laws or industry practice, nor is it advisable.
5. The estimate for the number of homeowners who would be helped by the Dodd–Frank plan continues to drop. First, supporters claimed that about 2 million homeowners would have loans refinanced. Since then, that number has steadily dropped, and now the CBO says that only 500,000 loans worth about $85 billion would be refinanced over the next four years.
6. Borrowers with legitimate problems are already being assisted by the voluntary Hope Now program. In the first quarter of 2008 alone, the Hope Now program assisted over 500,000 homeowners—the same number that the CBO says the Dodd–Frank plan will assist over the next four years. The Hope Now program is certain to help even more homeowners than Dodd–Frank in coming quarters because it is already up and running. Dodd–Frank merely duplicates the existing private program at a cost of billions of dollars and transfers all risk of default to the taxpayers.
7. Dodd–Frank will not stop foreclosures, even for many who would otherwise qualify. During the time it will take to put the program in place, mortgage servicers will be legally bound to follow the terms of the existing contract for fear that the refinancing might fall through, including taking steps toward foreclosure. Further, as CBO points out, many lenders will refuse to take part because it would require them to accept heavy

1. As an example, if the original loan was for $600,000 and the current assessed value of the house has fallen to $500,000, the lender would receive $425,000 and the homeowner would end up with a guaranteed mortgage of $450,000. The lender would lose $175,000 from the value of the original loan.

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losses in order to participate. Other lenders who hold second mortgages on the same property could also block refinancing.

Important GSE Regulation Improvements. Government Sponsored Enterprises include entities such as Fannie Mae and Freddie Mac. They also include the 12 Federal Home Loan Banks. These entities have such a huge presence in the housing finance market that the failure or severe mismanagement of any one of them could have major consequences for the rest of the economy. Fannie Mae and Freddie Mac alone control about 80 percent of the mortgage-backed securities origination market.[2]

While these companies now have private stockholders, they are not really private-sector entities. Their special role was created by Congress, and many investors assume that their debt is implicitly guaranteed by the federal government. Such economic power requires a regulator with the power to protect the economy. After many false starts where the new regulator would be essentially meaningless, the Senate Banking Committee package includes two important changes to earlier bills under which the new regulator could:

1. Increase minimum capital standards for GSEs when the regulator determines that such an increase is necessary for safe and sound operation of the company. The increased capital requirement would end when the circumstances that prompted the increase change, and standards for imposition, rescinding, and how often the increases will be reviewed must be established in advance.
2. Regulate GSEs' portfolios so that not only is the health of the individual GSE protected, but portfolio holdings are consistent with the GSE's mission. This includes the ability to require that the portfolio holdings are backed by sufficient capital. Thus, the regulator would be able to take steps so that if the portfolio suffers major losses, it will not affect the rest of the financial sector. Further, the regulator would be able to restrict attempts by the GSE to use its market power and enormous assets to dominate other areas of the financial services industry.

As mentioned above, the legislation also imposes a fee on Fannie Mae's and Freddie Mac's portfolios that will be used to finance both the FHA refinancing program and then a Housing Trust Fund. After the first years, 75 percent of that fund would be used to help meet the housing needs of extremely low-income families. The fund will be administered by Housing and Urban Development (HUD) and allocated among the states according to a formula set by the Secretary. If he or she fails to set a formula, funds would be allocated using the formula of the HOME program.[3] Most funds would go to finance the construction of housing, although a small portion would be used for down payment programs.

The fee is not really a problem, but its potential use is. As noted, all of the GSEs are creations of government and have a lower cost of capital than other private firms because there is an implied federal guarantee of their bonds. The fee is a way to recapture some of that advantage, thus making the GSEs' costs closer to those of potential competitors. However, it is very worrying for Congress to treat GSEs as a piggy bank that can fund specific projects without going through the normal appropriations process.

Conclusion. The continued pressure on Congress to "do something" about the large number of mortgages that are either in default now or at risk of defaulting once their interest rates rise to market levels should not be allowed to get in the way of extremely important legislation to improve the regulation of GSEs or to improve the FHA. Unfortunately, the Dodd–Frank refinancing program is not likely to assist homeowners who are having trouble paying their mortgages any more than the House-passed bill would.

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2. For more information about the role of GSEs and their regulation, see Ronald D. Utt, "Time to Reform Fannie Mae and Freddie Mac," Heritage Foundation *Backgrounder* No. 1861, June 20, 2005, at *http://www.heritage.org/Research/GovernmentReform/bg1861.cfm* (May 28, 2008).
3. HUD's HOME program is a federal block grant to state and local governments that is designed to create affordable housing for low-income households. For more information, see U.S. Department of Housing and Urban Development, "HOME Investment Partnerships Program," at *http://www.hud.gov/offices/cpd/affordablehousing/programs/home* (May 29, 2008).

Instead, Congress should focus on the other critical parts of the package and quickly take steps to modernize and strengthen the GSE regulator and to improve the FHA. Those are steps that will help to ensure that future housing problems do not develop into crises that could threaten the stability of the overall financial system or require massive taxpayer-funded bailouts.

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