WebMemo

Published by The Heritage Foundation

No. 1864
March 24, 2008

Frank–Dodd Approach Won't Fix the Mortgage Mess

David C. John

With the financial and housing markets in turmoil and the recent actions of the Federal Reserve being cited as a reason why Congress "must" act to help overstretched homeowners, attention has been focused on several plans to ease problems in the housing market. Unfortunately, there are no simple or quick solutions to a highly complex financial situation. The most cited proposals are discussed below; all have serious weaknesses that make them more likely to create additional problems down the road than to solve the current situation.

The Frank–Dodd FHA Refinance Plan. Representative Barney Frank (D–MA) and Senator Chris Dodd (D–CT), the Chairs of the House and Senate committees, respectively, with jurisdiction over housing, have proposed a plan using the FHA under which lenders that chose to take part would agree to reduce the loan amount and refinance the mortgage at a lower interest rate in return for a cash fee. Refinanced loans would be guaranteed by the FHA, and the lender would have no further credit exposure if the borrower subsequently defaulted. This means that if a refinanced loan later defaulted, the taxpayers would cover any losses. Dodd and Frank say that they would provide $20 billion to FHA, which they believe would be enough to refinance up to $300 billion worth of mortgages. They also would provide states and localities $10 billion for buying and refurbishing vacant foreclosed houses that could be occupied quickly. The proposal has the following shortcomings:

- 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 to all loans to borrowers with poor credit histories or lower incomes. Until now, the mortgage market has operated under free-market principles with a moderate level of government regulation, but this program would be a 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.
- If separate FHA reform bills are signed into law, many of these refinanced mortgages will be likely to default. Under the Frank–Dodd plan, taxpayers would have to pay for any mortgage that defaults. The risk of default is historically best measured by the size of a downpayment. The smaller it is, the more likely that the borrower will walk away from the loan. FHA reform bills already passed by Congress would reduce the minimum downpayment for FHA loans from today's 3 percent to 0 percent in the House bill or 1.5 percent in the Senate version. Different versions of the FHA reform bill have

This paper, in its entirety, can be found at:
www.heritage.org/Research/Economy/wm1864.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.

passed each chamber and are currently being reconciled.

- 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.
- Even if the money went to the FHA immediately, it is not possible to implement this plan quickly. Mortgages must be refinanced individually. It will take a great deal of time to refinance the 1–2 million loans that supporters say could benefit.
- Closing costs for such refinancing can be expensive and are regulated by state laws. Distressed borrowers may not have the money available to pay them, and if the FHA covers the cost either directly or indirectly, the number of potential beneficiaries will be reduced. Moreover, doing so would also be unfair to the responsible borrowers who refinance their homes.
- Borrowers with legitimate problems are already being assisted by the voluntary Hope Now program. Frank–Dodd attempts to do the same thing at a cost of billions of dollars and transfers all risk of default to the taxpayers. Frank–Dodd is also likely to undermine the FHA, which is adequately capitalized now but could face huge losses from the large number of inherently risky loans that it would be forced to guarantee.
- Frank–Dodd will not stop foreclosures, even for many who qualify. During the time it would take to refinance mortgages, mortgages servicers will be legally bound to follow the terms of the existing contract in case the refinancing falls through, including steps toward foreclosure.

Senator Isakson's Proposed Real Estate Tax Credit. Senator Johnny Isakson (R–GA) has introduced legislation (S. 2566) that would provide buyers of either a newly constructed house or one that is in foreclosure or default with a one-time $15,000 refundable tax credit. The bill would apply to purchases made between February 28, 2008, and March 1, 2009. To qualify, newly constructed houses would have to have been built on or before September 30, 2007. Owner-occupied structures in default or foreclosure must have been in default prior to March 1, 2008, even though the actual sale would take place after that date, although there is no such restriction on foreclosed structures owned by a mortgage company or its agent. The problems with this proposal are listed below:

- As a general principle, an explicit federal subsidy for the purchase of certain homes is both bad tax policy and bad housing policy.
- This subsidy rewards those who have been the most irresponsible. Homeowners of any income level who either irresponsibly borrowed all of their home equity or who took out a loan that they could not repay but hoped to profit from by reselling the property in a rising market will benefit. However, those who have made the effort to pay their mortgages on time will not be assisted at all regardless of their financial circumstances.
- Homebuilders who ignored signs that the market was slowing and built houses in the hopes of finding a buyer would get assistance in selling houses that should not have been built in the first place.
- Responsible homeowners who must move for a new job or for family reasons will suffer because the sale of their homes would not qualify for a tax credit, while their less responsible neighbors would qualify for one. The potential plight of responsible homeowners could be cited as a reason to expand this credit to all home sales, thus increasing the cost to all taxpayers.
- Since the credit is only refunded after the end of the next taxable year, the money would not be available at the time of the purchase. In practice, this limits its effect to those buyers who have the money up front to make a purchase, i.e., upper-income homebuyers.
- By applying the credit only to homeowners in default before March 1, 2008, the bill leaves out those homeowners whose mortgage interest rate will reset after that date. This may be intended to reduce incentives for default, but it is so poorly written that it essentially rewards those who

The Heritage Foundation
LEADERSHIP FOR AMERICA

were irresponsible early while excluding those who were victims of circumstance after that date.

Allowing Bankruptcy Judges to Change Mortgage Terms. Legislation before the House and Senate would allow bankruptcy judges to arbitrarily reduce mortgage payments by either reducing the interest rate to the current market level or by reducing the amount owed to the current value of the house. Since mortgages are secured by using the house as collateral that could be sold in the event of a default, bankruptcy courts until now have given borrowers the choice of either paying the mortgage contract as written or surrendering the home to the lender. The Bush Administration wisely announced that it "strongly opposes" the provision and threatened a veto. Policymakers should consider the bill's flaws:

- This bill would add the government as a silent third party to all private contracts between a homebuyer and a lender. Until now, the government has rightly stayed out of these transactions. The bill would create an incentive for mortgage seekers to agree to any terms, confident that a bankruptcy court will bail them out at a later date.
- Such a move builds in a greater chance that the mortgage contract will not be paid as agreed. In order to protect their shareholders, financial institutions must price that uncertainty and add it to the cost of a mortgage.
- It will be much harder for low-income homebuyers or new homebuyers to find mortgages. Because of the even higher risk that courts may restructure loans to those groups, lenders will focus on upper-income borrowers or those with high downpayments and good credit histories.
- If the bills are enacted, this premium is likely to be higher until the industry has enough experience to more accurately price the added uncertainty.
- Even if they can get loans, low-income workers, first-time borrowers, and those with impaired credit histories will pay much higher interest rates since they have the highest probability of running into financial trouble.

Conclusion. The press for Congress to "do something" about the large number of mortgages that are either in default now or are at risk of defaulting once their interest rates rise to market levels is extremely intense. Unfortunately, none of the proposals reviewed in this paper will really do anything to solve the problem. What has worked to date is Hope Now, a voluntary, private-sector plan that allows homeowners who have the ability to pay a lower cost loan to refinance their mortgages. So far, Hope Now has assisted in refinancing 250,000 mortgages without major government intervention. Rather than pressing for massive new programs, legislators should allow one with proven results to do its work.

—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.