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H.R. 5830, the Frank–Dodd FHA Refinance Plan, Is Still the Wrong Policy for the Housing Mess

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Chairman Barney Frank (D–MA) of the House Financial Services Committee has proposed H.R. 5830, which would use the Federal Housing Administration (FHA) to refinance at-risk mortgages at a lower interest rate in return for a cash fee. 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. 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, and if the FHA lacked the resources to back the loan, then the taxpayers would cover any losses.

H.R. 5830 is a revised version of an earlier proposal by both Chairman Frank and Chairman Christopher Dodd (D–CT) of the Senate Banking Committee. While it is an improvement in some ways over the original plan, it still has many problems that make it the wrong way to deal with housing finance problems.

The proposal has many shortcomings. Specifically:

- 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 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 or borrowing practices.
- Many of these refinanced mortgages will still be likely to default. The Congressional Budget Office (CBO) estimates that fully one-third of refinanced mortgages under H.R. 5830 will subsequently default. Historically, the risk of default is 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 H.R. 5830 essentially gives owners of refinanced homes an amount equal to 10 percent of the current value of the house, this is a gift from the taxpayers, and the homeowner has none of his or her own savings 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.

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- 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. Unfortunately, it is not always possible to distinguish borrowers by their intentions. But in providing relief, especially relief to homeowners/speculators, this bill sends a message that it is acceptable to renege on an obligation because a government buyout will cut your losses. The CBO estimates that, on average, each of the borrowers will receive a subsidy from the government equal to about $3,400.
- Even if legislation were passed tomorrow, it is not possible to implement this plan rapidly. The FHA says that it does not currently have the people necessary to implement such a plan. It will take subsequent legislation to appropriate the funds needed to hire the appropriate additional federal work force, time to hire them, and more time yet to 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.
- 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, either costs will climb or the number of potential beneficiaries will be reduced. Moreover, doing so would also be unfair to the responsible borrowers who refinance their homes.
- The estimate for the number of homeowners who would be helped by H.R. 5830 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.
- Borrowers with legitimate problems are already being assisted by the voluntary Hope Now program, which is in place and operating. In the first quarter of 2008 alone, the Hope Now program assisted over 500,000 homeowners—the same number that the CBO says H.R. 5830 will assist over the next four years. The program is certain to help even more homeowners than H.R. 5830 in coming quarters because, unlike H.R. 5830, it is up and running. H.R. 5830 merely duplicates the existing private program at a cost of billions of dollars and transfers all risk of default to the taxpayers.
- H.R. 5830 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 in case the refinancing falls through, including taking steps toward foreclosure. Further, as the CBO points out, many lenders will refuse to take part because it would require them to take heavy losses in order to participate. Other lenders who hold second mortgages on the same property could also block refinancings.

The continued pressure on Congress to "do something" about the large number of mortgages that are either in default or at risk of defaulting once their interest rates rise to market levels is extremely intense. Unfortunately, the Frank–Dodd H.R. 5830 really won't 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. Hope Now has assisted almost 1.4 million homeowners without major government intervention. Rather than pressing for massive new programs, legislators should allow one with proven results to do its work.

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