

# Subprime Rescue Plans Backdoor Bank Bailouts

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## **About the Author**

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## **Acknowledgments**

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## Executive Summary

There are a number of proposals being circulated that are ostensibly designed to help low-income homeowners who are facing foreclosure. This paper points out that these rescue packages actually will provide little benefit to moderate income homeowners. The major beneficiaries of these plans are likely to be banks and other current holders of bad mortgage debt, who may earn tens of billions of dollars at taxpayer expense.

The paper notes that:

- Under most of these plans, it is highly unlikely that homeowners will accumulate any equity in their homes. For example, under the proposal put forward by the Office of Thrift Supervision, homeowners may have to see increases in the current value of their home by 10 percent or more before they have earned any equity. This seems very unlikely since house prices are currently falling at double-digit rates and the median period of homeownership for low-income families is less than four years.
- During the period that they remain in their home, monthly housing payments for the homeowners who are helped under these plans are likely to be close to 85 percent higher than what they would be if the homeowner rented a comparable unit. If low- and moderate-income homeowners would ordinarily spend 30 percent of their income on shelter costs, the excess costs incurred as a result of this plan are the equivalent of an additional 26 percentage point income tax imposed on the families who are part of this program.
- Foreclosure rates are likely to continue to be high for the families who benefit from these plans, since most will still have zero equity in their home and little prospect for acquiring equity. The paper shows that if the foreclosure rate ends up being 10 percent, then the losses to the government will be close to 2.5 percent of the money made available for the bailout. If the foreclosure rate is 20 percent, then the losses will be 7.5 percent of the money used in the bailout, and if it is 30 percent, then the losses will be 15 percent of the money made available for the bailout.
- The cost per homeowner benefited is likely to be quite high, since many of the homeowners covered by such a plan likely would have held onto their homes in any case. For example, in the optimistic case where only 10 percent of the loans end up in foreclosure, the cost for each additional family who remains a homeowner will be more than \$8,000. In the case of a 20 percent foreclosure rate, the cost per additional homeowner will be \$30,000, and in the case where the foreclosure rate is 30 percent, the cost for each additional homeowner who remains in their home will be \$75,000.

This implies a very high cost in taxpayer dollars for a very questionable benefit. By comparison, the government can pay for a year's worth of child care for not much more than \$6,000 or a year of health care for \$3,000.

The paper suggests more narrowly directed policies as an alternative. In particular, if foreclosure rules were temporarily altered, to give moderate-income homeowners facing foreclosure the option to rent their home at the fair market rent, it would provide a large element of security to the millions of moderate-income families at risk of losing their home. Furthermore, this temporary change in foreclosure rules would provide a very strong incentive to lenders (who do not want to become landlords) to negotiate terms under which homeowners can stay in their house as homeowners. This plan also has the advantage that it requires no government money and no new bureaucracy.

## **Subprime Rescue Plans: Backdoor Bank Bailouts**

There is growing support in political circles for a large-scale proposal to bail out families with subprime mortgages who are at risk of losing their homes. In the last week, two prominent economists, former Treasury Secretary Lawrence Summers and Alan Blinder, who had been Vice-Chairman of the Federal Reserve Board, both joined the bailout bandwagon, the newest in a long list of politicians and pundits who had previously endorsed plans for bailouts.

However, before Congress puts hundreds of billions of taxpayer dollars at risk, it is important to ask what these plans are intended to accomplish and who they are designed to help. While the stated purpose of these bailout plans is to help homeowners, many of whom were victimized by predatory mortgages, the main beneficiaries are likely to be banks and other investors who made bad investment decisions.

This basic point can be seen by examining the plan put forward by the Office of Thrift Supervision (OTS), which has featured prominently in recent discussions and is typical of the sort of proposal being put forward. This plan recognizes that many homeowners are now underwater, owing more on their mortgages than the value of their house. This is the main factor leading to the record foreclosure rates of recent months.

When a mortgage is underwater, the homeowner has no equity against which to borrow to allow him to make mortgage payments during bad times. Homeowners with underwater mortgages also have a large incentive to simply walk away from their home, turning it over to the bank, since the mortgage debt is greater than the value of the home.

Under the OTS plan, the mortgage would be broken up into two parts. A new mortgage, equal to current value of the home, would be issued and guaranteed by the government, through the Federal Housing Authority (FHA). The second part of the mortgage would take the form of a tradable certificate. The face value of the certificate would be equal to the difference between the original mortgage and the current value of the home. This certificate would be a claim against any equity (up to the face value of the certificate) in excess of the debt remaining on the new mortgage. This is the money that homeowner would otherwise pocket when they sell their home.

The proponents of this plan suggest that this is a win-win scenario in which the housing market is stabilized, homeowners facing foreclosure are allowed to keep their house, and the taxpayer is left unharmed. In fact, the homeowners “helped” under this plan are likely to see no benefit, and the taxpayers are likely to incur substantial liability.

From the standpoint of the homeowner, they are likely to be kept in a situation wherein they own a home in which they have zero equity. Furthermore, they have very little chance of gaining any equity before they sell their home. In addition, they are likely to be paying substantially more in mortgage payments and other ownership related costs than they would if they were to rent a comparable unit.

This situation can be easily explained using the example that the OTS highlighted in its description of the bailout plan. The OTS assumed that a homeowner had a mortgage for \$220,000 on a home that is currently worth \$200,000. In this case, a new mortgage for \$200,000 would be issued by a bank and guaranteed by the FHA. The current mortgage holder would get a check for \$200,000, and a certificate that is worth up to \$20,000 that is a claim against money collected by the homeowner when he sells his home. This means that the homeowner will not be able to earn any equity when he sells his house unless the price increases by at least 10 percent from its current level.

Prices have been dropping at more than a 16 percent annual rate, so there will have to be a huge turnaround in the housing market before homeowners will have any equity whatsoever under this plan.<sup>1</sup> With the median period of homeownership for moderate income families less than 4 years, it is unlikely that most of the homeowners who fall under this plan will ever acquire any equity in their home.<sup>2</sup> In the OTS example, a homeowner who gets a 30-year fixed rate mortgage at 6 percent interest will have accumulated less than \$15,000 in equity after 5 years, which means that even if prices just stayed flat, the house price would still be \$5,000 too low to give them any equity after the certificate is paid off.

Over this five-year ownership period, the homeowner's mortgage and ownership costs are also likely to be far more than their rent on a comparable unit in the same neighborhood. Suppose that the ratio of the sales price to annual rent is 20 to 1, which would be common given the extraordinary run-up in house prices over the last decade. If we assume, again using the numbers from the OTS example, a homeowner gets a 6 percent fixed-rate mortgage, and has property tax and maintenance payments each equal to 1 percent of the house value, then the total payments would be 9.3 percent of the house price or \$1,541 per month. By comparison, the rent payments on a comparable unit would be just \$830 per month. This comparison is shown in [Figure 1](#).

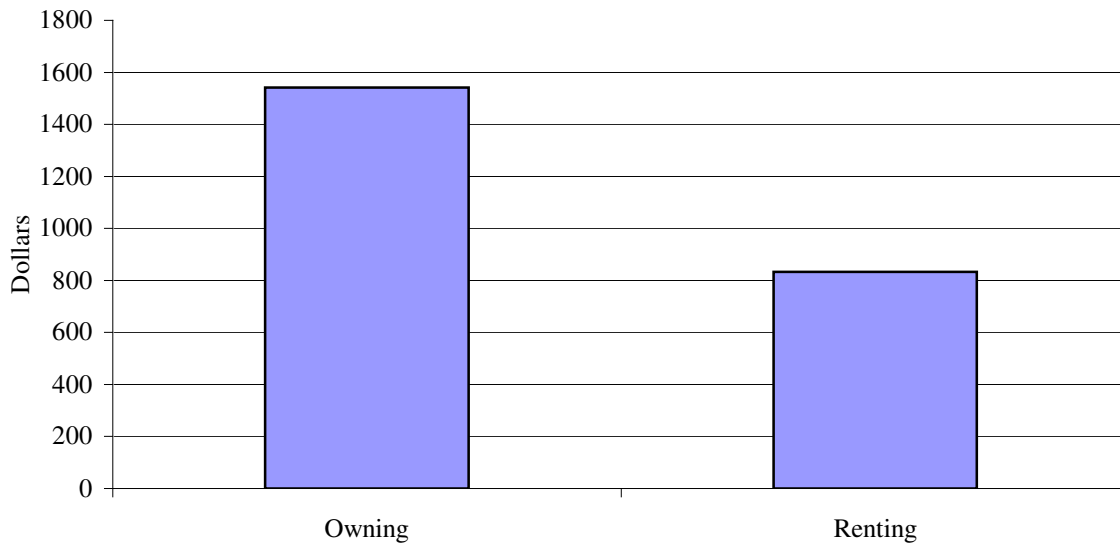
In this particular example, the monthly cost of owning is 85 percent higher than the cost of renting. If these families would ordinarily spend 30 percent of their income on shelter costs (the overall average), then the excess payments under this plan are equivalent to a 26 percentage point tax on the income of the families who take part in this program. This is driven primarily by the high ratio of sales price to rent. Until this ratio adjusts to more normal levels, most families are likely to be hurt by owning. The situation is especially bad for homeowners who enter into a bailout arrangement like that laid out by OTS, since the certificate held by the initial mortgage issuer, giving them first claim on any equity built up by the homeowner, virtually guarantees that most homeowners will never accumulate equity in their home. As a result, their higher monthly housing payments are simply wasted.

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<sup>1</sup> The Case-Shiller index showed house prices dropping at a 16.2 percent annual rate from the third quarter to the fourth quarter of 2007. The National Realtors Association data for existing homes sales showed that the median house price nationwide was declining at a 14.5 percent annual rate in the three months ending in January compared with prior three months.

<sup>2</sup> This is taken from an analysis of new homebuyers using data from the Panel Study of Income Dynamics, see Reid, C. 2004 "Achieving the American Dream? A Longitudinal Analysis of the Homeownership Experience of Low-Income Families," Department of Geography, University of Washington.

**FIGURE 1**  
**Monthly Costs of Owning and Renting**



Source: Author's calculations, see text.

The homeowners are likely to not be the only losers in this story. The taxpayers are obligated to guarantee the value of the new mortgage. If the guarantee fee is set at the right level, then the homeowners would cover the cost of the guarantee (this guarantee fee, along with other transactions costs associated with issuing the second mortgage will further cut into any potential for the homeowner to acquire any equity). However, it is quite likely that the fees charged to homeowners will be too little to cover the cost of defaults, especially if house prices keep falling.

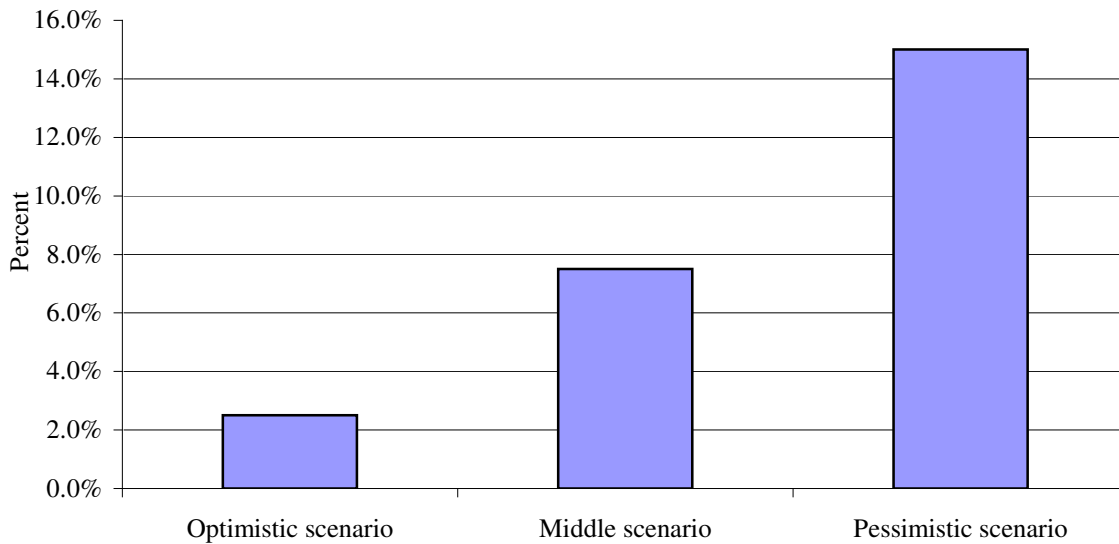
Even in an optimistic scenario, there is likely to be a high default rate, since homeowners will not have any equity in their house until they have lived there for several years. A default rate of 10 percent over the life of the mortgage (this is a bit more than half of the one-year default rate on subprime loans at present), is probably an optimistic scenario.

In this optimistic case, where house prices do not fall, the loss on a default is likely to be in the range of 25 percent.<sup>3</sup> A more extreme case, in which house prices drop an average of 20 percent, is likely to produce far higher default rates and much greater losses on each default. Suppose in this case that the default rate is 30 percent and the average loss per foreclosure is 50 percent of the initial mortgage value. Finally, we can construct an intermediate scenario with a default rate of 20 percent and an average loss of 37.5 percent of the initial loan value.

**Figure 2** shows the losses as a percentage of the amount of money used in the guarantee fund. In the optimistic scenario, the government would lose 2.5 percent of the money it puts into a guarantee fund. This means that if it puts \$100 billion into the fund, then it will eventually lose \$2.5 billion on defaults. In the pessimistic scenario it will lose 15 percent of the money that it puts into the fund. In this case, a \$100 billion fund would imply losses of \$15 billion. In the middle scenario, the losses would be 7.5 percent of the money put into the fund, so that a \$100 billion fund would incur losses

<sup>3</sup> This is based on an estimate from GMAC-RFC, one of the country's largest issuers of mortgage backed securities, that the average foreclosure led to a loss of \$50,000. This is cited in Hatcher, D. 2006 "Foreclosure Alternatives: A Case for Preserving Home Ownership," Economic Development, Federal Reserve Bank of Chicago, Page 1.

**FIGURE 2**  
**Percent of Guarantee Fund Lost to Defaults**



Source: Author's calculations, see text.

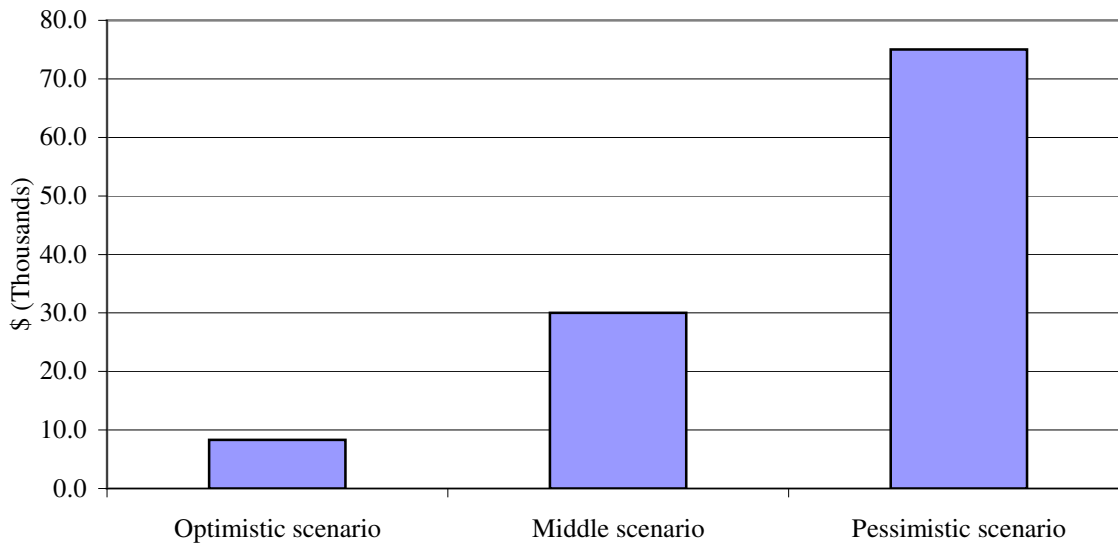
of \$7.5 billion. (In addition, the transactions costs associated with this program, which are likely to run in the range of 1.0-2.0 percent of the amount guaranteed would be a further loss associated with the program.)

By comparison with these sums, Congress had a major debate over an expansion of the State Children's Health Insurance Program (SCHIP), which would have cost \$7.0 billion annually. This is equal to three times the loss in the optimistic scenario and slightly less than the \$7.5 billion loss in the middle scenario. The annual cost of the expansion of the SCHIP program is less than half of the \$15 billion loss in the pessimistic scenario, which means that the losses in this case would be sufficient to fund the expansion for two full years. In short, the potential losses to taxpayers in the type of loan guarantee program laid out by OTS are substantial compared to other items that have been major topics of public debate.

It is also worth considering the size of the losses to relative to the number of people who are able to stay in their home as a result of this bailout plan (recognizing that many homeowners might still be better off leaving, even with the plan.) Clearly some number of homeowners would manage to stay in their home regardless. Assuming that 30 percent of these homeowners would have been able to hold onto their houses even without this plan, then it is possible to calculate the percentage of homeowners who able to keep their homes as a result of this bailout plan in each of the three scenarios described above. In the optimistic scenario, in which 10 percent of homeowners covered by the plan default, 60 percent of the homeowners covered by the plan are able to stay in their home as a result of the plan. In the middle scenario, in which 20 percent of the homeowners default, the share is 50 percent, and in the pessimistic scenario in which 30 percent of homeowners default, only 40 percent of the homeowners covered by the plan are able to stay in their homes as a result of the plan.

**Figure 3** shows the cost per retained homeowner in each of these three scenarios. In the optimistic scenario, it costs \$8,300 for each homeowner who is kept in their house as a result of this plan, more than enough to pay for health care for a kid for two years. In the middle scenario, the cost to the taxpayers is \$30,000 for each homeowner kept in their house. In the pessimistic scenario, the cost to the taxpayers is \$75,000 for each homeowner kept in their house as a result of this plan, enough to

**FIGURE 3**  
**Taxpayer Cost per Retained Homeowner**



Source: Author's calculations, see text.

pay for health care for a year for 20 kids. It is worth noting that some of the homeowners who would have stayed in their house even without this plan would benefit from having lower monthly mortgage payments as a result of this plan.

If taxpayers lose in these plans, and homeowners do not necessarily gain, then the question that should be asked is, "who gets the money?" The answer is that the mortgage holders will collect more money in a situation where the government has stepped in to guarantee mortgages than if it does not. The losses that the government would bear in each of the default scenarios illustrated in Figure 2 would be losses incurred by the mortgage holders in the absence of government intervention. In short, the sort of plan laid by OTS is likely to transfer billions of dollars from taxpayers to mortgage holders, and possibly tens of billions of dollars, while providing little benefit to homeowners.

Of course the assumption that there will be substantial losses depends on the expectation that house prices will continue to fall or at least not rise. This seems very likely given the enormous oversupply of housing and the sharp cutback in credit availability for homebuyers. While many proponents of bailout plans like that developed by the OTS claim that house prices will not continue to fall, most of these analysts never saw the housing bubble in the first place. If house prices revert back to their trend level, we can anticipate a further real price decline of 20-30 percent, in addition to the 10 percent price decline that the country has seen to date. In other words, there will continue to be much larger losses in the housing market.<sup>4</sup>

There are ways to help homeowners that do not require large amounts of taxpayer money. For example, it is possible to substantially improve the plight of homeowners facing foreclosure by offering the option to remain in their homes as long-term renters. Under this "own-to-rent" plan, a

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<sup>4</sup> See Baker, D. 2007, "Midsummer Meltdown: Prospects for the Stock and Housing Markets," Washington, D.C.: Center for Economic and Policy Research [[http://www.cepr.net/index.php?option=com\\_content&task=view&id=1266](http://www.cepr.net/index.php?option=com_content&task=view&id=1266)] and Baker, D. 2002. "The Run-Up in House Prices: Is It Real or Is It Another Bubble?" Washington, D.C.: Center for Economic and Policy Research [[http://www.cepr.net/index.php?option=com\\_content&task=view&id=405](http://www.cepr.net/index.php?option=com_content&task=view&id=405)].



homeowner facing foreclosure could request that the judge handling the foreclosure arrange an appraisal to determine the fair market rent.<sup>5</sup> The homeowner would then have the option to remain in the home as a renter for some substantial period of time.

This own-to-rent option would both provide some security to homeowners, since they could not just be thrown out on the streets, but more importantly it would improve their bargaining position relative to mortgage holders. Banks are not anxious to become landlords. It is likely that in the vast majority of cases, the own-to-rent option would lead to a situation in which the mortgage holder negotiated terms that allowed the homeowner to remain in their house as a homeowner. This would be an optimal outcome and it would not require any money from taxpayers.

## Conclusion

The proposals currently being circulated to have the government buy up or guarantee mortgage debt for homeowners facing foreclosure are likely to benefit banks more than homeowners. Under proposals similar to the one developed by OTS, most homeowners aided by the plan would never accumulate any equity in their home. Furthermore, they would be paying nearly twice as much in monthly housing costs for the period that they stayed in their homes as if they rented a comparable unit. While this proposal does little to aid homeowners, it could lead to the transfer of billions of dollars, or even tens of billions of dollars from taxpayers to banks.

The current housing crisis was allowed to develop because those in positions of responsibility somehow failed to see an \$8 trillion housing bubble. This bubble created an average of \$110,000 in housing bubble wealth for every homeowner in the country, hugely distorting the housing market and the economy. It would be unfortunate if the same people who were responsible for this massive failure were allowed to compound the economy's problems with ill-conceived bailout plans that are ostensibly designed to help homeowners, but really only benefit banks and other mortgage holders.

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<sup>5</sup> Baker, D. 2007. "The Subprime Borrower Protection Plan," Washington, D.C.: Center for Economic and Policy Research [<http://www.cepr.net/content/view/1274/45/>].