



Proposal for Government-Backed Mortgage Substitution Loans of Up to 20% of US Homeowners' Current Mortgage Balance

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CMPS Institute supports the proposal initially outlined in March, 2008 by economist Martin Feldstein, chairman of the Council of Economic Advisers under President Reagan, professor at Harvard University and President/CEO of the National Bureau of Economic Research. The original proposal can be found here:

<http://online.wsj.com/article/SB120485260049218269.html>

The proposal is outlined below, along with more detailed expansion of some of its points as recommended by CMPS Institute. We strongly urge Congress to consider this proposal as a viable solution to the housing and mortgage crisis. The proposal calls for government-backed loans to homeowners of up to 20% of the homeowner's current mortgage balance.

This proposal would:

- Reduce the number of impending negative equity situations
- Empower homeowners to refinance otherwise "unrefinanceable" mortgages on their primary homes into more affordable payments with no increase in existing debt levels
- Stem the rising tide of foreclosures
- Help to create a bottom for housing prices
- Shore up consumer confidence and stabilize the economy
- Avoid the excessive risk to taxpayers and/or limited benefit to homeowners inherent in some other proposals
- Avoid the expense of creating a new federal agency or bureaucracy

The Problem

About 6% of all mortgage borrowers are behind on their payments, and 17% of all sub-prime borrowers are behind on their payments. The majority of these defaulting loans are adjustable rate mortgages where the initial low payments have expired. Approximately 10% of all US mortgage borrowers owe more on their mortgages than the value of their homes, thus making their mortgages "unrefinanceable" for the most part. Furthermore, the liquidity and credit crisis in the financial markets has caused many flexible loan programs to simply evaporate. Lending standards have tightened excessively as lenders and Wall Street investors who issue and purchase mortgage backed securities have become exceptionally averse to any form of risk in the mortgage market. These factors have resulted in the following problems:

- Homeowners are being forced into foreclosure due to unaffordable mortgage payments and non-existent refinancing options. They cannot refinance because:
 - They owe more than the home is worth; and/or,
 - Higher loan-to-value (LTV) loan programs that would have normally allowed 90% - 95% financing are very limited and/or no longer available due to lack of liquidity in the secondary mortgage market
- Homeowners and real estate investors who can afford to keep making their payments have little incentive to do so as much of their equity has also evaporated with no bottom in sight for local property values
- Homeowners and real estate investors who can buy into their local market are unwilling to do so due to the fear that property values will continue to decline
- Housing values are continuing to be pressured downward as supply continues to grow and outstrip demand

Most loans that are currently in default are owned by bond market investors. Lenders and mortgage servicers are often precluded by their agreements with these investors to modify the terms of the loans unless the borrower is actually in default. This situation acts as an incentive for borrowers to default on their payments in order to get relief, which in turn lowers borrowers' credit ratings. These lower credit ratings fuel a downward spiral that traps borrowers into higher cost loans even if they do somehow find a way to refinance or buy a new home.

In terms of government intervention in the crisis, some of the more aggressive proposals before Congress would drive the mortgage industry toward nationalization, while some of the more limited proposals would do little or nothing to solve the crisis.

The Solution

This entire situation can be greatly remedied by reducing homeowners' mortgage balances to the point where they are no longer in a situation of little or no equity. Doing so would give all homeowners incentives to keep up their mortgage payments as property values continue to stagnate or decline. Further, distressed homeowners would be empowered to refinance their otherwise "unrefinanceable" mortgages into more affordable loans without an increase in their overall debt level. This will in turn stem the rising tide of foreclosures and create a bottom for housing prices. Here is how such a proposal would work:

- The federal government would issue mortgage replacement loans of up to 20% of a homeowner's current mortgage balance on their primary residence
- The loans would only be available to homeowners who can afford the payments.
- The homeowner could either keep up the payments on their current primary mortgage with the reduced balance, or refinance their primary mortgage into a more affordable loan without increasing their balance.
- The loans would be priced at a margin of 2% above the yield on two-year Treasuries and adjust every 2 years thereafter
- The loans would be amortized over a 15 year timeframe and allow the borrower to make extra principal payments at any time without penalty

- Individuals who accept the government loan would be prevented from increasing their existing mortgage balance until they first pay off the government loan
- The government loan would be *full recourse* to the consumer unlike a traditional mortgage that is typically non-recourse. In other words, the debt to the government would need to be paid back regardless of the consumers' future financial or home equity situation (e.g., even if they default on their primary mortgage, sell their home, walk away from the home, etc.).

Example #1 – how this plan would help someone who would be nearing a situation of little or no equity as local property values continue to stagnate or decline:

Current situation:

Tina has an average credit rating and she owns a home that is currently worth between \$230,000 and \$240,000. She owes \$220,000 on her adjustable rate mortgage that is set to adjust at the end of 2008. However, real estate values in her area are expected to fall 5%-10% over the next 12 months and lending guidelines are so tight that she is unable to refinance into a more affordable mortgage at such a high loan to value ratio in a declining real estate market. Once her loan adjusts at the end of 2008, Tina will be faced with a very real dilemma - why continue making unaffordable payments if she has no equity remaining in the home or if she is in a negative equity situation? Even if Tina had an affordable fixed rate loan on this property, what would be her incentive to keep up the payments? In other words, whether her loan is fixed or adjustable, Tina will have an incentive to default on her mortgage and walk away from her home because of the impending negative equity situation.

Consider this alternative:

- Tina receives a loan of \$44,000 (20% of her current \$220,000 mortgage balance) from the federal government.
 - Interest rate of 3.6% that adjusts every 2 years (2% above the yield on 2-year Treasuries). Low interest rate is much less than current or prospective mortgage rates. This gives her an incentive to take the loan, lower her interest rate and steer clear of a negative equity situation.
- Tina either keeps her remaining \$176,000 mortgage balance or refinances it into a traditional mortgage issued by a private sector mortgage lender – could be a conventional or FHA loan
 - LTV ratio is less than 80% which leaves plenty of room for Tina to keep out of a negative equity situation even if home prices continue to decline.
 - Tina is not allowed to increase her mortgage balance until she first pays off the government loan
- Tina will have a strong incentive to keep up her mortgage payments because she now has equity in her home to protect
- The 20% government loan is full recourse, so Tina will need to pay back the funds regardless of her future financial situation and regardless of what happens to the value of her home.

Example #2 – how this plan would help someone who is already in a situation of little or no equity:

Current situation:

Jane has an average credit rating and she owns a home that is currently worth between \$230,000 and \$240,000. She owes \$240,000 on her mortgage. Her mortgage payments have just gone up from \$1,300 per month to \$1,875 per month and she is having difficulty with the 44% increase in her monthly payment. Under the current state of affairs, Jane would be forced to default on her mortgage loan, ruin her credit rating and hope for the mortgage lender to work with her in modifying the terms of the loan. If this doesn't work, Jane would be forced into foreclosure. Due to her newly trashed credit rating and reduced wealth because of the loss of her home, Jane will be precluded from participating as a buyer in the real estate markets for probably 12-24 months. This very real scenario is causing home ownership rates to decline and home values to deteriorate due to lack of eligible buyers in the marketplace.

Consider this alternative:

- Jane receives a loan of \$48,000 (20% of her current \$240,000 mortgage balance) from the federal government:
 - Interest rate of 3.6% that adjusts every 2 years (2% above the yield on 2-year Treasuries)
 - Monthly payment of \$346 (15 year amortization)
- Jane refinances her remaining \$192,000 mortgage balance into a traditional mortgage issued by a private sector mortgage lender – could be a conventional or FHA loan
 - LTV ratio is less than 90% which is an acceptable level of risk. This means the loan is eligible to be securitized and sold on the secondary market to Fannie Mae, Freddie Mac or other investors. This completely eliminates the need for the government to buy or insure the entire mortgage and saves taxpayers from incurring the risk of mortgage defaults.
 - Interest rate would probably be around 6.75% on a 30 yr fixed rate loan (sample rate includes Private Mortgage Insurance)
 - Interest only payments would probably be approx. \$1,080; amortized payments would be approx. \$1,245
- Jane will have total monthly payments of \$1,426 - \$1,591, which is 18% - 31% more affordable for her compared to the \$1,875 monthly payment she is currently facing
- Jane will have a strong incentive to keep up her mortgage payments because she now has equity in her home to protect

The results from this approach:

- Reducing the number of future mortgages with negative equity
- Homeowners would be empowered to refinance into more affordable private sector or FHA loans
- A bottom for housing prices would emerge

- Greatly reduced taxpayer risk because the government is not buying, issuing or guaranteeing entire mortgage loans, only the much smaller 20% mortgage replacement loans
- The federal government can actually make a profit on this program as they are earning a spread of 2% above their cost of funds. This profit can be used to cover losses stemming from borrower defaults on the loans that are issued
- Number of homeowners with negative equity would be greatly decreased
- Homeowners will no longer have an incentive to default on their mortgage loans, ruin their credit ratings and be forced into a never ending cycle of higher cost loans

Variations of this proposal could include some or all of the following elements:

- The 20% mortgage replacement loans could be private sector loans that are federally insured by the FHA. This would be an alternative to having the federal government actually issue the loans outright. This would further reduce taxpayer risks and exposure.
- The interest rates on the 20% mortgage replacement loans could be fixed for 10 years based on a margin above the 10 year Treasury. The reason the 2 year floating rate is a better alternative is because:
 - Homeowners would have a bigger incentive to pay off the loan quicker
 - Interest expense would be lower because the rates are lower
 - Most homeowners would probably not keep their loans longer than 4-5 years anyhow
- The 20% mortgage replacement loans could be made available to those who own second homes and real estate investment properties, albeit at perhaps a higher interest rate. Perhaps a margin of 3-5% above the yield on 2-year Treasuries would work. The main benefit of this approach is that it would do much to shore up real estate values as up to 40% of all home sales over the past few years have been second homes and investment properties. Like primary residence homeowners, many investors and owners of second homes also have little or no incentive to keep up their mortgage payments under current market conditions. The main drawback of making the 20% mortgage reduction loan available to investors and owners of second homes is that it may encourage further speculation in the real estate markets. Even so, limits could be imposed to discourage speculation while shoring up the market. Namely, the government loan would be full recourse, unlike traditional mortgages. Other limits could include:
 - Limiting the replacement loans to perhaps 5-10% of the current mortgage balance if the property is non-owner occupied
 - Limiting the number of replacement loans issued to a single individual
 - Limiting the replacement loans to certain geographic areas that are most in need of intervention
- The 20% mortgage replacement loan proposal could be considered as an add-on or modification to some of the other proposals currently before Congress

In conclusion, we urge Congress to act quickly in considering and implementing the 20% mortgage substitution proposal that we have outlined. This simple proposal would empower many homeowners to avoid foreclosure by opening the door for them to refinance into more affordable mortgage loans. Property values will stabilize, consumer confidence will rise to shore up the economy and taxpayers will avoid incurring unnecessary and excessive risk.

Respectfully submitted,

CMPS Institute

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