Center for American Progress

Throwing Homeowners a Lifeline

A Proposal for Direct Lending to Qualified Troubled Borrowers

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Introduction and Summary

With each passing release of housing-related data, the picture becomes bleaker for the estimated 1.8 million homeowners with subprime mortgages whose interest rates have reset this year or are due to reset before the end of next year.[1] Many of these borrowers and their families hold the 22 percent of adjustable rate subprime loans currently delinquent[2] or the 3.84 percent of subprime loans that entered foreclosure in the second quarter of this year.[3] For those still current on their loans, they can look forward to increases in monthly payments averaging 30 percent to 50 percent when their rates reset.[4]

There have been a number of proposals offered to help these and other troubled borrowers, but the range of solutions suggested to date still leaves a significant number of families without any solution to their problems. This paper will focus on solutions for those borrowers who have the wherewithal to make reasonable mortgage payments but lack enough equity in their homes to refinance because the value of their homes are "underwater," or worth less than the value of their mortgages.

To understand which distressed homeowners would qualify for which type of mortgage relief, this paper divides borrowers into broad categories in order to demonstrate where a solution for each set of homeowners may be found. For some borrowers, recent initiatives—FHASecure and a proposed rate-freeze agreement—offer workable solutions. The Bush administration estimates that up to 600,000 borrowers would be eligible for FHASecure or a rate freeze,[5] but many analysts estimate the maximum number to be half that.[6] Other borrowers with the best credit and positive home equity can turn to Fannie Mae and Freddie Mac and the private sector to refinance.

Then there is a final group of homeowners who would be aided by our proposed Family Foreclosure Rescue Corporation, which we will detail in this paper. See the table below for an illustration of the various mortgage relief programs and how they would work for different types of borrowers.

POTENTIAL SOURCES OF ASSISTANCE FOR SUBPRIME BORROWERS

	POSITIVE HOME EQUITY	NEGATIVE HOME EQUITY
WEAK CREDIT	FHASecure	Fast-track modification
SOLID CREDIT	Fannie Mae, Freddie Mac, and private lenders	**Family Foreclosure Rescue Corporation**

We would be remiss, however, if we did not first acknowledge that there remains a sizeable number of borrowers who were explicitly or implicitly steered into loans they would never have any hope of repaying. For the time being, we must work carefully and compassionately to help them transition back into rental housing.

The Center for American Progress intends to address this group's particular needs in future work. For all borrowers at risk of default or facing foreclosure, housing counseling offered by counselors approved by the Department of Housing and Urban Development, such as NeighborWorks and their partners, often are the conduit directing borrowers to their servicers for help during the foreclosure process.

The Borrowers at Risk

At the end of the day, some of the borrowers with resetting mortgages will be able to refinance into fixed-rate loans on the open market. They may have had specific reasons for taking out an adjustable-rate mortgage at the time they did, but since that time their scores have improved, their incomes have risen, or their other debts may have declined.

These homeowners may now present a low risk to lenders and are able to refinance with little trouble. These individuals used credit and debt wisely and reflect the potential that many saw in arguing on behalf of expanding credit to riskier borrowers through subprime lending.

Other creditworthy borrowers who nonetheless cannot cope with looming interest rate resets, particularly those with sufficient equity in their homes, will likely find help through the Federal Housing Administration's new FHASecure program or through refinancing into conforming loans under Fannie Mae and Freddie Mac's minimally expanded portfolios. These types of solutions are tailor-made for borrowers who can qualify for these insurance-backed refinancing options, which require financial resources and credit histories that most subprime borrowers do not possess (see FHASecure, How it Works, page 14).

Other troubled borrowers, such as those facing temporary financial setbacks due to unforeseen medical expenses that put them behind a mortgage payment, are most likely to be able to take advantage of the HOPE NOW Alliance, a partnership between lenders, mortgage servicers, and housing counselors, which in October first announced they would work together to help troubled homeowners on a case-by-case basis.[7]

Most recently, U.S. Treasury Secretary Henry Paulson introduced a plan earlier this month to freeze interest rates for a subset of borrowers facing resets between January 2008 and July 2010 on loans originated between January 2005 and July 2007. A large group of lenders and investors have agreed to voluntarily fix rates on some loans for five years for borrowers with credit scores below 660 who are current on their loans.

This proposal falls short of recommendations by Federal Deposit Insurance Corporation Chairwoman Sheila Bair, who has called for a moratorium on interest rate resets to be applied across the board. The rate freeze introduced by Paulson will effectively be made one homeowner at a time—even though the Bush administration plan spells out in detail the criteria for eligibility (see The HOPE NOW Alliance and the Interest Rate Freeze, page 3).

The HOPE NOW Alliance and the Subprime Interest Rate Freeze

In October, Treasury Secretary Hank Paulson introduced HOPE NOW, an alliance that describes itself as "a cooperative effort between counselors, investors, and lenders to maximize outreach efforts to homeowners in distress."[8] Its members include the housing counselors, large lenders and servicers, Fannie Mae and Freddie Mac, and trade associations from the financial services sector. Its major efforts to date have been to contact delinquent and soon-to-be delinquent borrowers and urge them to contact their servicers or counselors.

Indeed, servicers have been slowly moving toward developing criteria for loan modifications, though so far they have shied away from automatically making modifications to entire classes of borrowers, opting instead to address requests for assistance on an individual basis. FDIC Chairwoman Sheila Bair first called for converting all adjustable-rate mortgages to fixed-rate mortages,[9] but servicers at the time did not shown an interest in following her suggestion. The closest we have seen is Governor Schwartzenegger getting the four largest servicers in California to extend the initial interest rate on adjustable mortgages for a "substantial" period[10] and the recent rate-freeze agreement brokered between the Treasury Department and the servicers.

Under the agreement in December with the Treasury, "fast track loan modifications"—what is being touted as the rate freeze—will be open only to borrowers with less than three percent equity in their homes, who are current on their loans, and who live in their own homes, have current FICO credit scores of less than 660, and whose credit scores have not risen by more than 10 percent since the loan was originated.[11] This leaves a relatively small window of opportunity for at-risk borrowers to qualify for fast-track modifications, since those already in default are excluded as are those whose rates have already reset and are having difficulties.

The FICO credit-score limits will likely exclude most troubled borrowers from this latest program because making timely payments on loans is touted as the best way to build up a credit score. If a borrower's score has risen by more than 10 percent since the loan was originated, then that borrower would be ineligible. Many subprime borrowers not surprisingly had low credit scores at the time they took out their loans. If they are still current on their loans then it is hard to see how they would not have improved their FICO scores by less than 10 percent, though some may have paid their mortgage while becoming delinquent on other debts.

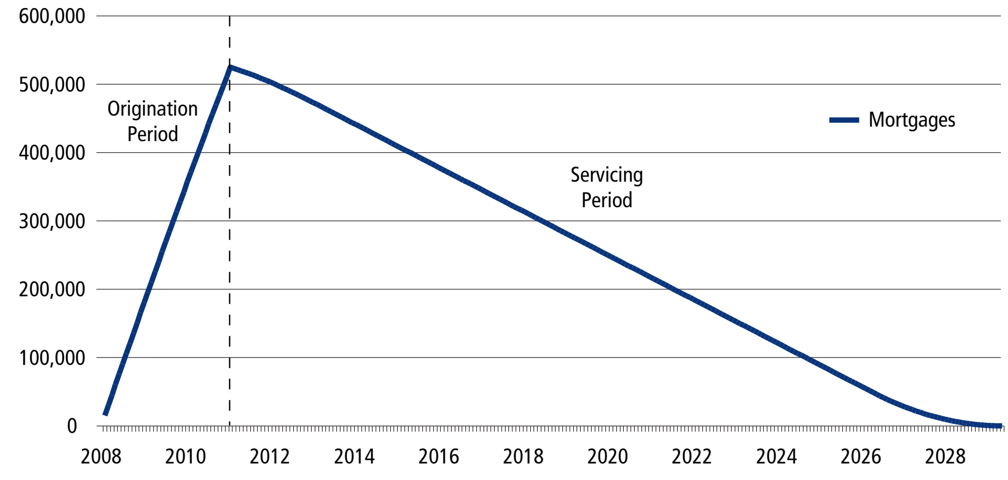
Servicers will consider other borrowers for modifications, but there is no consensus or agreement as to what form, if any, a modification might take. Nor is it known whether servicers will charge additional fees to make modifications, particularly on the large number of requests that would not qualify for the fast-track modification—but chances are they will.

"Big lenders are originating fewer mortgages, servicing revenues make up a greater percentage of earnings," says University of Iowa law professor Katherine Porter. "Because servicers typically keep late fees and certain other charges assessed on delinquent or defaulted loans, 'a borrower's default can present a servicer with an opportunity for additional profit.'"[12]

In short, counselors can provide valuable assistance to borrowers in trouble by helping them navigate the complex and challenging negotiations that can arise while working out a delinquency or striving to prevent foreclosure. But at the end of the day, the decision to offer some sort of workout rests solely with the servicer, which is why the FFRC is now required.

Unfortunately, there remain a growing number of families who face resetting loans and will not be deemed worthy of an interest rate freeze. They also remain unable to refinance through FHASecure, Fannie Mae or Freddie Mac, or the various initiatives of the HOPE NOW Alliance. In many cases, these families have decent credit histories, but the local housing market has declined to the point where their loans are now "underwater." That is, they owe more on their mortgages than their homes are worth. As of this writing, the Case-Shiller House Price Index, which measures sales prices in the 20 largest metropolitan areas, is down 4.9 percent since last year, with a record quarterly price drop in the third quarter of this year.[13]

FFRC MORTGAGE VOLUME



With that decline in prices, it is estimated that 21 percent of adjustable rate mortgages issued in 2005, and 38 percent of those issued in 2006, are now "underwater."[14] Lenders will simply not refinance loans for more than the value of the underlying property and families in that situation are regarded as high-risk. If a borrower "underwater" fails to meet the nearly impossibly narrow criteria set out by the American Securitization Forum, they currently have no options.

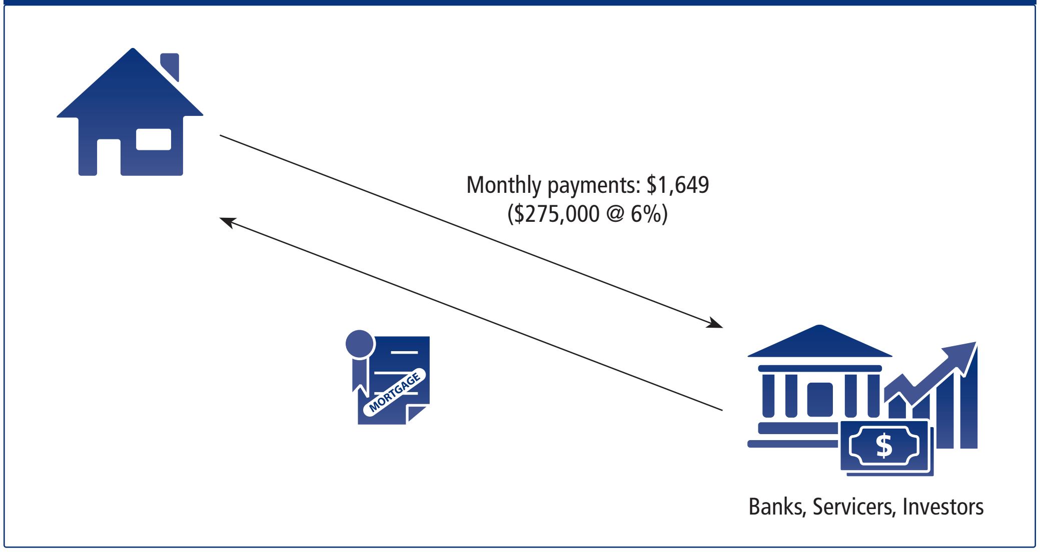
A Unique Solution with a Precedent

It is this last category are home owners who would be assisted by a direct lending program modeled on Franklin Delano Roosevelt's Home Owners Loan Corporation, or HOLC, which for three years during the Depression bought up existing mortgages from the banks and issued new fixed-rate mortgages in their stead.

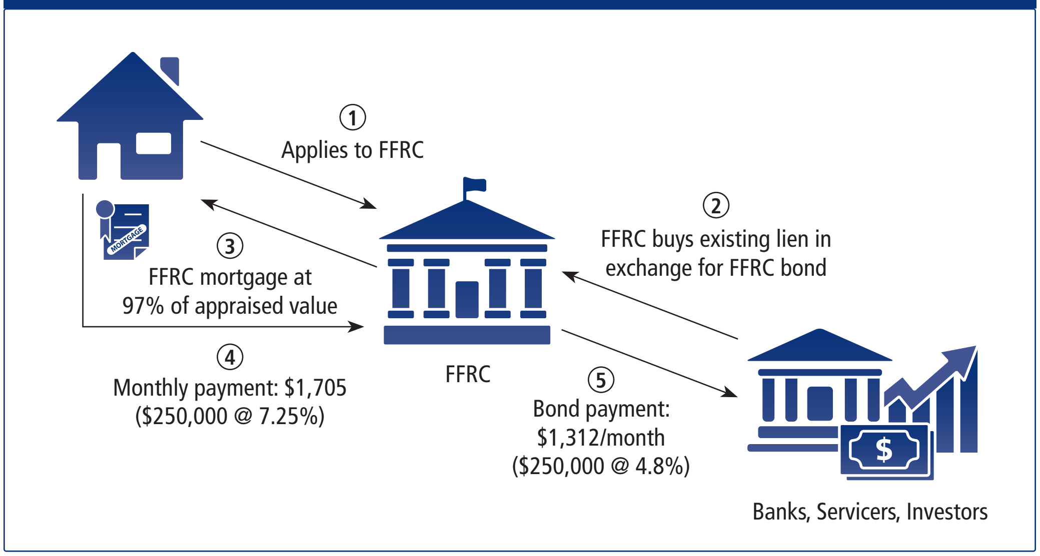
Until the New Deal, nearly all home mortgages in the United States were short-term, non-amortizing (interest-only) loans with a balloon payment due at the end of the term, usually after five years. Borrowers rarely paid off their loans in full, instead relying on their ability to roll their current loan balance over into a new mortgage. Throughout the 1920s, this system seemed to work well, as many American families were able to purchase their first homes.

When the stock market crashed in 1929, followed by runs on local banks, the expected new loans were nowhere to be found. Instead of signing papers for new loans, millions of Americans faced foreclosure papers. In 1931, 1.4 percent of all homeowners lost their homes to foreclosure.[15] To put this seemingly low number in context, as of the end of October, 2007, 1.69 percent of all outstanding loans were in foreclosure, with 0.78 percent of all loans starting the process in the prior three months.[16] While not all loans that begin the foreclosure process ultimately lead to forfeiture or repossession, we are potentially on the cusp of widespread repossessions. The sheer volume of loans

TYPICAL MORTGAGE PAYMENT STREAM



MODEL OF FFRC OPERATIONS



entering foreclosure—the highest number since data has been reported—may lead to banks and servicers rushing to foreclose and sell at auction to minimize their losses.

The similarities between the 1920s and recent subprime lending practices are notable. Many of today's subprime borrowers were given implicit or even explicit promises that they would never need to address a rate reset because they could always refinance into a better loan. With the recent credit crunch, the anticipated refinancings have not happened. Instead, many borrowers find themselves trapped in loans they will be unable to pay once their rates adjust.

The average monthly payment after reset for loans originated between 2004 and 2006 is estimated to increase by 42 percent.[17] For many households, this presents a severe hardship. What's worse, there is a measure of bitter irony that a substantial number of borrowers who could have taken advantage of the New Deal innovations in mortgage finance introduced by the HOLC and later criteria for FHA and Fannie Mae loans—fully amortizing, long-term, fixed-rate loans—were steered into far riskier and more dangerous subprime loans. The culprits: mortgage brokers without fiduciary responsibilities to their clients, the borrowers, but rather incentivized by payments called yield spread premiums from loan originators for closing higher interest rate mortgages.[18]

A modern HOLC, the Family Foreclosure Rescue Corporation, can help homeowners and the mortgage marketplace cope with this subset of the subprime mortgage crisis. The FFRC would issue new, fixed-rate mortgages to those borrowers "underwater" and facing default or foreclosure—in the process buying up the old adjustable-rate mortgages from lenders and investors and replacing them with new, tax-friendly government-rated bonds equal to the current value of these homes.

To date, none of the policies or programs currently available to homeowners at risk of default or already in default target their assistance towards homeowners who owe more on their homes than the property is now worth because of rapid and widespread declines in property values. By aiding borrowers who cannot refinance in the private sector and who are ineligible for public programs, the FFRC provides additional stabilization to neighborhoods at risk of becoming blighted because of rampant foreclosures and the attendant increases in vandalism, crime, and arson.

Although it is a public corporation, the FFRC is not an entitlement program, nor is it a bailout for lenders or investors. It is structured to issue direct loans only for a short, three-year period, after which time it will exist solely to service its outstanding mortgages. All FFRC refinancing activity is borrower-initiated like traditional refinancing, and the terms offered to existing mortgage holders will be set solely as a function of the appraised value of the property. Servicers will have the ability to accept or reject a FFRC purchase offer, but there will be no negotiations. In this regard, servicers will largely be protected from investor lawsuits.

Because the FFRC will be initially funded by the U.S. Treasury, its lending ability will not be hampered by a lack of liquidity in the capital markets. Rather, it has the power to invert the existing model of public intervention in the financial markets; instead of adding liquidity at the top, with the intention of having the funds flow down to lenders who originate mortgages, the FFRC would instead introduce liquidity from the bottom up, through the monthly mortgage payments of its borrowers that are passed on to investors in the form of bond payments.

FFRC, however, is obviously not intended to be a one-size-fits-all solution to the current mortgage crisis. Rather, it should ideally be considered in the context of other public and private initiatives to address the problems facing many borrowers. It is often far too easy to paint the problem of resetting loans as a single problem—the subprime mortgage crisis—which leads to thinking there can be, or even should be, a unified solution. In truth, it is a complex problem, as those who have tried to grapple with it can attest.

As such, a range of solutions, each one tailored to a subset of the homeowners facing default or foreclosure, is likely to provide the greatest benefit to troubled borrowers and their communities. To that end, it is helpful to consider a series of attributes—credit score, ability to pay, current loan status, home equity, and current loan type—to identify the best solution for any given borrower.

In most cases, the first steps toward finding a solution, be it through the FFRC, traditional refinancing channels, loan modification, or other programs, are taken in conjunction with housing counseling. This paper will now examine how the FFRC would work in this context and illustrate exactly where its role would begin and end and where other initiatives would be better positioned to help other struggling homeowners. The paper will then conclude with the latest details on sweeping ramifications of the rolling subprime mortgage crisis—details that confirm that a modern-day HOLC, a Family Foreclosure Rescue Corp., must be established as soon as possible.

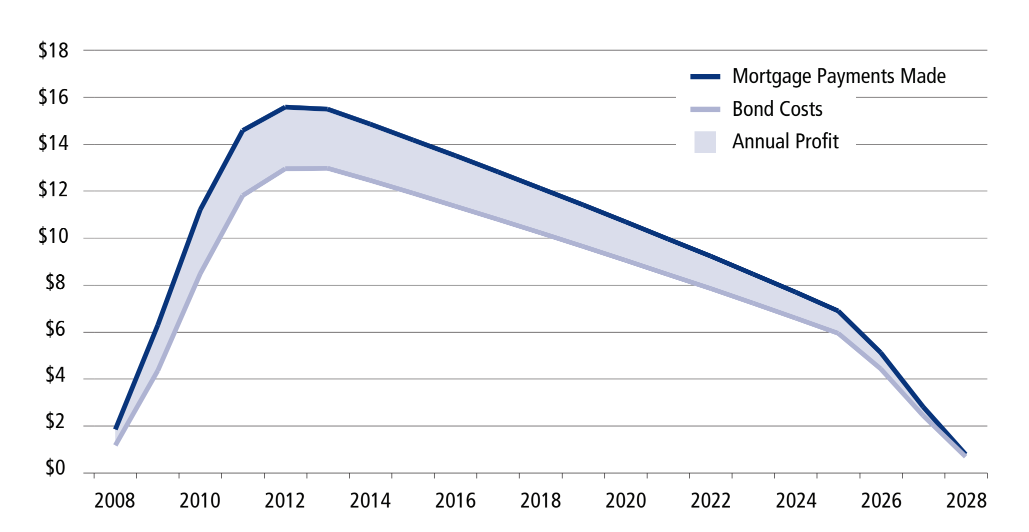
How the FFRC Works

The Family Foreclosure Rescue Corp. would directly issue new mortgages to borrowers who live in their own homes and have resetting adjustable rate mortgages, or ARMs, in default or at risk of default and are otherwise creditworthy but can't refinance because their outstanding balance is higher than their house value. This would largely help low- and moderate-income borrowers in neighborhoods with declining house values and help slow the spread of blight and abandonment.

In order to issue new loans, FFRC would buy out the existing debt from the current mortgage holders—banks and investors—but it would not pay more than the appraised value or new loan amount. It is estimated that the average foreclosure costs lenders $50,000,[19] so it would be advantageous for lenders or whoever holds the existing mortgage to accept an FFRC purchase offer.

Rather than pay cash at purchase, FFRC would issue a tax-free government-insured corporate bond that would pay off the purchase over time. This minimizes the potential cost to the taxpayers and the hit to the U.S. Treasury Department as the spread between the new loan rate and the bond payments covers the costs of the program and then some. The benefit to FFRC is that it helps troubled borrowers while avoiding duplication of other federal programs (see Housing Counseling and Loan Modification: How it Works, page 9).

FFRC PROFITABILITY (IN BILLIONS $)



Note: Assumes bond principal is paid down over time.

Housing Counseling and Loan Modification: How it Works

Housing counseling has long been a way for first-time homebuyers to get education and help about the purchase process, particularly with regard to the financing of the purchase. Pre-purchase counseling has long been required for low-income borrowers participating in Freddie Mac's Affordable Gold—now Home Possible—program,[20] and research indicates that one-on-one pre-purchase counseling was associated with a 34 percent drop in 60-day delinquency.

Classroom counseling and home study were slightly less effective, correlated with 26 and 21 percent declines, respectively. Telephone-based counseling was not shown to have any effect.[21] A similar study based on participants in Fannie Mae's Community Mortgage Loan Program found that pre-purchase counseling was also associated with a significant decline in defaults.[22]

Recognizing the positive impact of pre-purchase counseling, it is important to understand that it is fundamentally different than post-purchase counseling. Whereas pre-purchase counseling can guide potential buyers towards appropriate loan products and can take place over a longer period of time, "post-purchase counseling by nature tends to be crisis counseling after a household becomes delinquent."[23]

The need for crisis counseling became increasingly clear as we surpassed 1.5 million foreclosure actions—including notices of default—in the first nine months of this year.[24] That's why more non-profit organizations—such as NeighborWorks, a network of non-profit organizations that provides counseling to homeowners—need to be able to play an even larger role. NeighborWorks' members are HUD-certified counselors. They maintain a presence in over 4,400 communities across the country. NeighborWorks also partners with the Homeownership Preservation Foundation, which manages the Hope Hotline, a national call center that connects troubled borrowers to local counselors. Since the beginning of the year, the hotline has received in excess of 100,000 calls for assistance.

Counseling is most successful, according to both counselors and servicers, when contact is made early. Counselors will help borrowers contact their loan servicers and discuss the range of potential options. It should be noted that just because a borrower approaches a servicer, there is no guarantee that the terms of the loan will be changed to help the borrower. Anecdotal evidence indicates servicers have been most willing to offer forbearance or to make modifications to loans only when a borrower's problems are short-term in nature.

In these cases, modifications will often take the form of extending the length of the loan, tacking on the missed payments to the end. When a borrower has trouble making future payments because of a rate reset, servicers have made far fewer modifications. In fact, a Moody's survey of the largest servicers found that for loans that reset in January, April, and July of this year, only 1 percent of the loans were modified.[25]

Most borrowers facing difficulties because of rate resets would require modifications such as interest rate reductions or write-downs of the principal balances. In the past, borrowers who had no reasonable expectation of making payments after reset were counseled to sell their homes to pay off the debt.[26] In today's depressed housing market, that is rarely an option.[27]

FFRC Program Details

The Family Foreclosure Rescue Corp. would be authorized to issue first mortgages on owner-occupied housing units for homeowners currently in foreclosure,[28] serious default, or with a reasonable expectation of imminent, sustained default.[29] Eligible homeowners would apply for a new FFRC loan that would replace existing mortgages on the property.[30]

Borrowers would have to demonstrate their ability to make the monthly payments on the FFRC loan based on their total indebtedness exclusive of the existing lien, debt-to-income ratio, and payment history prior to reset, if applicable. Applicants who do not qualify for FFRC loans would continue to work with housing counselors certified by the Department of Housing and Urban Development who would help transition the borrowers out of their homes and back into safe rental housing.

FFRC loans would be fully amortizing loans at a fixed interest rate. FFRC would be authorized to issue new mortgages for up to 97 percent of the appraised value or to the outstanding principal balance on the existing mortgage, whichever is less.[31] This provision would protect borrowers against unreasonable fees imposed by lenders in the context of offering "workouts." Contrast this with the rate freeze agreement reached in December between the servicers and the Bush administration, where servicers are allowed to charge fees to applicants seeking a rate freeze.

Similarly, provisions could be made to allow reasonable fees and charges to be included in the calculation of the mortgage buyout, either by setting a cap on the amount added to the principal or by enumerating specific fees for which mortgagees would be reimbursed. Eligible properties would be those houses that appraise for less than 125 percent of the local area median home price or 175 percent of the conforming loan limit in higher cost regions.

In exchange for the existing mortgage on the property, FFRC would offer the current mortgage holder a corporate bond with guaranteed interest for the life

Government-Sponsored Entities: How They Work

The two government-sponsored entities, Fannie Mae and Freddie Mac, play a significant role in the mortgage market by buying up loans and offering them for sale in securitized pools. They provide a significant amount of the liquidity necessary to originate new loans. By law, however, the size of their portfolios is capped. There has been an effort under way in Congress to expand the caps, with the provision that most of the expanded capacity be targeted toward refinancing subprime borrowers into safer loans.[32]

Unfortunately, to date, the Bush administration has refused to consider any portfolio expansion without significant reform of the enterprises. We recognize that past accounting practices and lack of transparency are legitimate concerns and should be addressed through enterprise reform, but at-risk borrowers should not be denied assistance on those grounds.

Even without expanded portfolios, Fannie Mae and Freddie Mac have made efforts to address the problem of default and foreclosure by creating incentives for servicers. Freddie Mac has developed a workout incentive program that pays servicers $400 for loan modifications and $250 for repayment plans.[33] Freddie Mac also offers $1,100 for short payoffs and pre-foreclosure sales, but given the nearly 11 months of unsold homes in inventory in October,[34] it is not clear how often servicers receive those payments.

The second part of Freddie Mac's Default Management Incentives pays servicers for rapidly disposing of foreclosed properties. The faster servicers sell properties they obtain through foreclosure and the higher the volume of sales, the more they make, but the payments appear to be greater for workouts than foreclosures.

Fannie Mae promotes its efforts to work with servicers to keep borrowers in their homes, noting that its HomeStay Initiative offered long-term forbearance and repayment plans to 18,000 families and made an additional 27,000 loan modifications in 2006. Fannie Mae's desktop underwriter, an automated underwriting system used by many lenders to determine loan eligibility and terms, has been expanded to help subprime borrowers with a solid payment history qualify for a fixed-rate prime refinancing. In 2007, through the end of October, Fannie Mae has refinanced nearly 53,000 homeowners under the HomeStay program.[35]

While the "expanded approval" option is potentially helpful to borrowers who have not yet defaulted, borrowers already in default have far fewer options. Recently, Fannie Mae changed its payment structure for foreclosure lawyers to incentivize them to "qualify delinquent borrowers for repayment plans or loan modifications."[36] In the past, lawyers were paid only if they successfully foreclosed on delinquent properties. Under the new program, the lawyers' incentives are more closely aligned with borrowers' interests.

of the new mortgage. The bond would be issued at a fixed rate competitive with other government bonds, and would pay interest plus principal amortized over 30 years. In the event of prepayment of the FFRC loan, the corresponding bond holder would receive the principal balance. Interest payments made by FFRC would be treated as U.S. treasuries for tax purposes, which would make them attractive to investors.

In the event of delinquency on the FFRC loans, the FFRC would work with the borrowers to modify the loans to prevent foreclosure. While FFRC loans would initially be amortized over 30 years, forbearance in the form of extending the amortization period to 35 years or 40 years would be permitted. It is expected that the FFRC will end up foreclosing on some share of the homes on which it has a lien. In those cases, FFRC will be authorized to dispose of the property through a sale, with first rights to purchase going to the local housing authority or other housing-related nonprofit organizations.

FFRC's guidelines would stipulate that any disposals should be done with sensitivity to the effects on the surrounding neighborhood. If FFRC were to obtain title to a number of homes in a single neighborhood, it should stagger the sales of the properties so as to minimize the effect on local property values. FFRC would be authorized to rent out its properties and make necessary repairs prior to sale.

FFRC would be authorized to issue new loans for no more than three years from the date of authorization. After that time, it would exist solely to service its outstanding loans, with profits returned to the treasury. Alternatively, the profits could go into an affordable housing trust fund.

Buying Securitized Loans

When the Home Owners Loan Corp. came into existence during the Depression, banks held the loans they made, so it was relatively simple for banks to accept the HOLC's offers. Nowadays, most loans that are made are pooled together for sale to investors. In many cases, those sold loans can be pooled and resold several times over, with investors buying some piece of the payments made by homeowners each month.

When loans are securitized, as this process is known, they are "sold" into a trust known as a special purpose vehicle that holds the loans as collateral on the securities bought by the investors. In practice, these trusts are complex financial entities which in turn boast sub-financial entities backed by specialized insurance companies that together create the legal backdrop through which securitization can occur. These "sales" allow the lenders to move the loans off their books, eliminating the need to maintain capital-adequacy reserves against default.

These trusts hire a company known as a servicer to process the payments and generally manage the loans. The servicers are contractually obligated to act in the interests of the investors. It is the servicers that initiate foreclosure proceedings.

Today's securitization of mortgages would complicate the acceptance of FFRC bonds by lenders and investors. The currently or soon-to-be delinquent nature of the loans in question, however, gives servicers some latitude in accepting the buyouts at a reduced value without threatening the off-book accounting status of the trust or violating the servicing agreements. The FFRC would make its offers to the servicers in cases of securitized loans because the sale of a non-performing (delinquent) loan to the FFRC would generally fall under servicers' fiduciary responsibilities to their investors.

The sale of these non-performing loans to the FFRC, even at a loss, would still generate larger returns than the property would likely return at auction after foreclosure. Case in point: Among the types of loan modifications now available to servicers is a short sale, in which the property is sold for less than the outstanding loan balance and the servicer writes off the difference, terminating the loan. Acceptance of an FFRC bond would be a similar transaction from the perspective of the servicer, insofar as it would eliminate the existing mortgage.

Moreover, the American Securitization Forum has already provided guidance to servicers on subprime loan modifications. The ASF said that actions taken in "the best interests" of investors "should be interpreted by reference to the investors in that securitization in the aggregate, without regard to the specific impact on any particular class of investors."[37] This statement carries no legal weight, but it does provide some degree of cover for servicers against investor lawsuits. In any event, investors will be hard-pressed to prove damages in cases of modifications to loans in default.

In fact, the only differences between a true short sale and an FFRC purchase are that there is no transfer of title from the homeowner, and that payment to the servicer would be in the form of an FFRC corporate bond rather than funds transferred at closing. In most cases, there is nothing written into the servicing contracts that would explicitly preclude loan modification. A Moody's survey found that only 5 percent of subprime securitization contracts prohibit modifications. Of the rest, only 35 percent have clauses limiting the volume of modifications to no more than 5 percent of the total number of loans.[38]

The American Securitization Forum,[39] the Mortgage Bankers Association, the Financial Services Roundtable, and Deloitte and Touche all argue that loan restructuring if a default event is reasonably foreseeable does not eliminate the sale treatment under Financial Accounting Board Standard 140, or FAS 140, which would require the sellers to hold capital against those assets on their balance sheets. They have asked the Financial Accounting Standards Board to endorse that conclusion, but to date no ruling has been issued.

U.S. Internal Revenue Service guidance on real estate mortgage investment conduits, or REMICs, a common securitization vehicle for commercial mortgages, uses the "reasonably foreseeable default" standard. The Financial Services Roundtable argues "it can be reasonably inferred that comparable treatment would be given to residential real estate REMICs."[40] Use of REMICs for residential mortgage backed securities is not new; Fannie Mae began offering them in the late 1980s to institutional investors.[41]

Nevertheless, it may be necessary to legislate that servicers are allowed to accept FFRC bonds as payment in full or treat the FFRC purchase as a short sale. Likewise, a ruling by the Securities and Exchange Commission or the IRS that acceptance of the bonds does not jeopardize the accounting or tax status of the trust created to securitize the initial loan would remove servicers' concerns.

FFRC Program Costs

The FFRC is designed with minimal risk to the taxpaying public. In contrast to the Resolution Trust Corporation of the early 1990s, which was effectively structured to allow investors to pick off valuable assets from failed savings and loans, leaving taxpayers to foot a $91 billion bill,[42] FFRC would only require a minimal draw from the Treasury Department to cover startup costs. Ongoing mortgage payments would cover the cost of the bond payments, administrative costs, and overhead, as well as allowing HOLC to recoup origination fees.

Assuming FFRC originates 15,000 loans per month for three years, it would potentially help 540,000 families. Here's a rough estimate of how an FFRC loan would affect an individual homeowning family and their current mortgage holders: Assume FFRC would originate new mortgages at 7.25 percent and issue corporate bonds to buy up the old mortgages at 4.75 percent. Assume the average loan size is $250,000. Families with FFRC mortgages would pay $1,700 per month; the FFRC's interest payments on the corresponding bond would be the equivalent of just under $1,000 per month, if the bonds were to pay back the principal at maturity or sale of the underlying property. If the bonds were structured similar to fully amortized mortgages, such that payments to the bondholders included principal and interest, FFRC's payments would be the equivalent of $1,300 monthly.[43]

Overall, the FFRC would return in excess of $7 billion to the Treasury department if the bonds were structured to make interest-only payments for the life of the mortgage. If the bonds were structured to make principal payments as well, FFRC would return more than $33 billion in profits. If the FFRC aggressively called its interest-only bonds after it reached $5 billion in reserves, its corporate bonds could be paid off within 10 years. Under that scenario, the FFRC could give as much as $94.5 billion back to the U.S. Treasury over the lifetime of the corporation.

These figures assume the annualized prepayment rate increases by 0.2 percent per month for the first five years, after which the rate is then fixed at 6 percent.[44] They also assume an increasing default rate over time, of up to 16.18 percent of the total pool.[45] It conservatively assumes $100 annual servicing costs per outstanding loan plus $1,500 in origination costs.[46]

FFRC Operations

Given the magnitude of the mortgage crisis, it will be necessary for FFRC to be able to ramp up its activities quickly. We can leverage the best practices from our historical experiences during the New Deal in conjunction with modern technology to develop an efficient yet compassionate organization.

During the New Deal, the HOLC used a combination of private-sector con-

FHASecure: How It Works

FHASecure, an expansion of existing Federal Housing Administration mortgage programs to include homeowners who are delinquent as a result of resets to adjustable rate mortgages, is the Bush administration's most substantive contribution toward a solution to the mortgage crisis. The FHA believes that between September 2007, when the program began, and the end of 2008, when the program is currently set to terminate, FHASecure will help 80,000 delinquent borrowers refinance into a fixed-rate FHA loan.

The agency also anticipates assisting an additional 160,000 borrowers with adjustable-rate mortgages who are still current on their loans.[47] The FHA, however, does not originate loans. Rather, it insures mortgages made by the private sector and protects the lenders in the event of default. The FHA issues guidelines for lenders on the types of mortgages that can be made, but the loan terms themselves (including interest rate and length) are negotiated directly between the lender and borrower.[48] A small insurance premium is included in the monthly payment for the first seven years.

The program was initially open only to borrowers whose loans had already reset, but it was recently expanded to include all borrowers, even those without adjustable-rate mortgages. This will make tracking borrowers who were uniquely helped by the FHASecure expansion (as opposed to those who turned to the FHA in the wake of tightened lending standards) more difficult, as the top line numbers reported will include all FHA refinances.

Fortunately, the FHA also currently provides information on the number of delinquent borrowers who applied for FHA refinancing. Between September 5 and November 26, the FHA received just shy of 107,000 refinancing applications, of which 2,384 were from delinquent borrowers. Of the $3.1 billion in refinancing loans the FHA insured during that period, loans to delinquent borrowers account for only 1 percent of the total.[49]

The volume of applications for FHA-insured loans has risen significantly in recent months, but it largely reflects the disappearance of subprime lending. The FHA's share of total mortgage loans fell as subprime lending expanded. It is anticipated that the FHA share will rise again toward its normal historical levels as a function of being the sole option for risky borrowers to obtain financing. Indeed, the FHA acknowledges that much of the refinancing activity it has seen in the past few months is attributable to being the only game in town.

Under the current guidelines, borrowers are eligible for FHA-insured mortgages if their total indebtedness under the FHA loan does not exceed 43 percent of income and the monthly mortgage payment is less than 31 percent of income.[50] Perhaps most important is the requirement that borrowers must have made on-time monthly payments for the six consecutive months prior to the rate reset (or prior to application, in cases where there has been no reset). The mortgage is not allowed to exceed 97 percent of the appraised value of the property at the time of the application.[51]

In cases where the existing loan balance is greater than the maximum loan-to-value ratio, borrowers may negotiate with the servicer of the existing loan to accept the FHA refinancing as a short payoff, but it is more likely that a second mortgage will be needed cover the shortfall. Individual borrowers seeking a short payoff are likely to face the same hurdles as borrowers asking for loan modifications.

tractors and its own staff to fulfill its duties. The FFRC could contract out to HUD-approved counseling agencies to initiate the mortgage application process, including helping borrowers prepare family budgets and collect necessary documentation. This would help bring troubled borrowers into contact with counselors, regardless of the outcome of the loan application. An added benefit of using housing counselors in this way is that it becomes a way of getting money to counseling agencies in advance of the HUD funding timetable. This would enable counseling agencies to expand their capacity to help all troubled borrowers, not just those applying for an FFRC refinancing.[52]

Counselors would work with borrowers in advance of submitting the application and would provide guidance and financial education as part of the process. To come to scale quickly, the FFRC might need to tap into an existing delivery system, such as through FHA-approved lenders, although protections to ensure that consumers are not steered to their disadvantage and that taxpayers are not assuming unnecessary risk would be required. Another potential model for the application and mortgage origination process is the direct loan program employed by the Department of Education for college loans. It is important to note that at the time of an FFRC loan origination, even though it is a refinancing that pays off a previous mortgage, no funds are disbursed, as the loan payoff is done through the use of FFRC bonds paying interest in the future.

Appraisals and closings could similarly be done by local appraisers and lawyers at fixed fees. In communities where demand is likely to be high, the FFRC could hire full-time local staff to perform these functions. FFRC staff would also be required for oversight and quality control. The size of the staff would decrease with the transition from loan origination to servicing, much as it did during the New Deal.[53]

Conclusion

Facing the Magnitude of the Problem

Over the past decade we have seen a dramatic increase in the share of mortgage loans that are subprime. In 1998, subprime loans accounted for 2 percent of the originations,[54] rising to 6 percent in 2002. By the end of 2006, more than 20 percent of all loan originations were subprime.[55]

Subprime loans are not inherently problematic since they can be used by riskier borrowers to gain access to credit they otherwise could not have gotten. But when they are coupled with originators' and lenders' abandonment of any semblance of reasonable underwriting standards, or when they are used to shift borrowers from fixed rate loans to non-traditional products offering teaser rates and negative amortization, then problems arise, as of course they have over the past several years. The heretofore unchecked expansion of subprime lending presents a substantial problem not only for homeowners having trouble making their new, higher mortgage payments after interest rate resets, but for their neighbors, and ultimately for policymakers at all levels of government.

The number of families who find themselves under water increases with each passing day. Between 2004 and 2006, the percentage of fixed and adjustable mortgages in excess of 95 percent of value doubled. For loans originated in 2006, three of every eight ARMs and nearly one in five fixed-rate loans were for more than 95 percent of the house value at the time of origination.[56] The Case-Shiller 20-City Composite Index of house prices has experienced 9 consecutive months of negative annual returns, and the index has now dropped to its August 2005 level.[57] Recent buyers and those homeowners who recently refinanced their mortgages will be far more likely to have negative equity in their homes than those who have been homeowners for a long time.

Loss of home equity is a severe problem in neighborhoods with high rates of foreclosures. The reason: property values decline an average of 0.9 percent for every foreclosure within an eighth of a mile of the property.[58] In low- and moderate-income neighborhoods, where the risk of foreclosure is higher because of the greater concentration of subprime mortgages,[59] each foreclosed property is estimated to reduce house values by 1.4 percent.[60]

What's worse, vacant properties become magnets for vandalism, arson, and violent crimes, which further depresses local housing prices. When local foreclosures rise by 1 percent, violent crime rises by 2.33 percent, according to a recent study.[61]

When we consider the volume of foreclosures, it becomes clear that there are substantial social costs to inaction. Foreclosures doubled in the third quarter of this year compared to last year. Between July and September of this year, there were over 635,000 foreclosure actions taken on almost 450,000 separate homes, ranging from notice of default through notices of auction sales and bank repossessions.[62] By August of this year, there had already been more foreclosures than in all of 2006. A recent report from the Joint Economic Committee anticipates that over $100 billion in housing wealth will be lost through 2009 from foreclosures and their effects on neighboring properties.[63] Similarly, the Conference of Mayors predicts a decline of $166 billion in GDP as a result of foreclosures in 2008, as well as 524,000 fewer jobs created.[64]

The problem is particularly pronounced in low- and moderate-income communities, as well as in African-American and Hispanic communities. These neighborhoods are more likely to have been issued subprime loans, which are at a higher risk of foreclosure, and to have been recent achievers of homeownership, which leaves them far more susceptible to having insufficient equity to be eligible for existing programs or market-based refinancing.

It is critical to provide stability to these and other homeowning families and their communities hit by declining housing prices and rising foreclosures. Yet far from being a bailout program, the FFRC recognizes the delicate balance that must be struck between the very real needs of homeowners who will face default and foreclosure as their monthly mortgage payments jump and a desire to ensure ongoing faith in our financial system. Ultimately, the FFRC provides a chance for stability for borrowers who expect to be unable to make future payments at a higher interest rate, cannot find a way to refinance in the private market because their homes are no longer worth what they owe the bank, and who cannot expect to sell their homes for a reasonable price in a reasonable time period because of the glut of unsold homes currently on the market.

The failure to act now, allowing an economic loss of $2.3 trillion,[65] will affect not only today's borrowers but also the future growth of the American middle class. Today's mortgage crisis threatens long-lasting economic implications, perhaps severely circumscribing parents' abilities to help pay for their childrens' college education, or requiring less than ideal retirement goals, or destroying nest eggs set aside to start new businesses. When we are faced with the very real possibility of foreclosure rates not seen since the Great Depression and the loss of home equity—the single largest savings vehicle for most Americans—it is time for the government to provide real solutions and not simply lip service. In service of that goal, we offer the Family Foreclosure Rescue Corporation.

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