Center for American Progress Action Fund

Congress Must Act Now to Prompt the Rapid Refinancing or Modification of At-Risk Mortgages to Stabilize Housing and Credit Markets

Barriers to restructuring must be removed before it is too late!

To prevent the continued acceleration of foreclosures, government must promptly facilitate the bulk transfer of mortgages into the hands of new private owners with the incentive and ability to modify or refinance the loans. Time and servicer capacity limitations do not allow the continued loan-by-loan evaluation of options by servicers who must serve the often conflicting interests of investors in complex securitization structures. Government must create a mechanism for the transfer of mortgages from securitization trusts with limited flexibility to new owners who will be responsible for helping homeowners stay in their homes with viable loans on responsible terms. Servicers willing and able to refinance existing loans in bulk by offering new loans on the same responsible terms need not transfer their loans to a new party. When homeownership is not sustainable for current borrowers, as it will be in some instances, these new note holders will have the responsibility to terminate the mortgage using strategies that minimize adverse consequences for the borrowers and their communities.

Bills proposed by Chairmen Frank and Dodd would accomplish this goal. These bills provide FHA credit enhancement for restructured or refinanced mortgages on affordable and sustainable terms. They also allow for the Federal Reserve and Treasury to establish an auction mechanism to determine a fair market price through "customary business practice" for the transfer of mortgages to new owners or the bulk refinancing of at-risk loans by the current note holder. While a variety of technical changes are required to ensure this program is as effective as possible, there is time in the legislative process to make further improvements. But in the interest of stabilizing the American economy, it is urgent to express broad bipartisan support now for the goal of refinancing millions of mortgages threatened by foreclosure.

Legislation pending includes important elements of American Progress's SAFE Loan Plan

The overarching goal of SAFE is to transfer, efficiently and transparently, large numbers of existing loans from the current holders of the mortgages, stymied by conflicting interests, to new owners, who will, as needed to avoid unnecessary foreclosures on owner-occupants, refinance them on affordable and responsible terms.

The SAFE plan is designed to solve two problems. *First, it would facilitate the refinancing of millions of mortgage loans in a timely manner, to avoid unnecessary defaults, foreclosure and more severe home price declines.* The loans would be transferred to new owners with greater freedom to restructure the mortgages. Credit enhancement would be available for the newly restructured loans on responsible terms to encourage private lenders to make capital available. More federal funds also would be available for housing counselors to work with homeowners through the restructuring process. Important loan provisions would ensure that the borrowers who benefit from the reduced balance loan would not receive a windfall.

At the same time, *SAFE would help to restore liquidity and stability to the capital markets.* A market mechanism would quickly reprice existing mortgage pools and restore financial stability. Current investors will exchange the mortgage-backed securities they hold, whose value is uncertain, for the liquidity and reduced market risk of Treasury securities or cash. The resulting transfer also will help to unfreeze the capital markets.

The Auction and Transfer

- Treasury and the Federal Reserve would organize auctions, through which existing loans could be efficiently sold in bulk to FHA lenders and the Government-Sponsored Enterprises, as well as their seller-servicers.

- The auction would determine the price the new lenders would pay (with assurance that loans meeting certain criteria would be eligible for credit enhancement) and the price at which the current holders would sell, establishing a market price.

- The "haircut" will ensure there is no bailout of the financial institutions and existing investors, many of whom uncritically and irresponsibly created the bubble by lending in the hope that continued house price appreciation would make up for the absence of meaningful credit evaluation.

- Investors would take a hit, trading a reduction in asset value and yield. However, the widespread swap of now-illiquid pools of mortgage-backed securities for liquid Treasuries or cash could alleviate the credit crisis that has spread beyond housing-related securities.

- Servicers could receive cash or Treasury bonds for their loans, potentially allowing servicers to mimic, at a market-determined discount, the income stream anticipated by investors for a loan pool.

- The resulting transfer also will help to unfreeze the capital markets. Current investors will exchange the mortgage-backed securities they hold, whose value is uncertain, for the liquidity and reduced market risk of Treasury securities or cash. Restoration of liquidity and transparency will help to restore financial stability to credit markets.

- When the auction-determined price for loan pools gets within a predetermined margin to the face value of the loan, the auction program will automatically shut off because the close-to-par pricing will indicate that it is no longer needed.

Portfolio Triage

- Under SAFE program rules, purchasers of the pools of mortgages would refinance eligible loans for owner-occupants into new, SAFE loans. (See below.)

- Loans that were currently performing and not at imminent risk would remain intact.

- Loans that would be unsustainable even if restructured would be foreclosed, or otherwise terminated, under program rules designed to prevent unnecessary adverse community and homeowner impacts.

Loan Restructuring: With Government Credit Enhancement under Rules to Prevent Borrower Windfall Gains

- Responsible originators working with the Federal Housing Administration, Fannie Mae, and Freddie Mac would restructure loans, when restructuring would reduce the likelihood of default, foreclosure, and liquidation. Only loans on owner-occupied homes would be eligible for refinance. Speculators would be excluded.

- Most of the refinanced loans would take the form of new fixed-rate 30-year mortgages underwritten to 80 percent to 90 percent of current home value. New loans would be originated with sound underwriting, based on the current value of the property, not the original loan amount. Borrowers would only be offered loans they could afford to repay, significantly reducing the risk of default and foreclosure on the new, SAFE loans.

- The bulk of these refinanced and restructured loans would not be eligible under current standard FHA or FHA Secure underwriting standards, but a new FHA-insured SAFE loan product would be offered, segregated from the existing FHA insurance fund. The SAFE program would include its own risk-adjusted insurance premium structure to compensate the taxpayers for insuring these loans,

- SAFE loans originated by Fannie or Freddie seller-servicers could potentially be eligible for a Treasury credit enhancement against catastrophic loss, in a program segregated from the rest of the GSE portfolios.

- To reduce risk, mortgages would be restructured at lower LTV ratios, but the borrower would assume a soft second mortgage, payable at resale, for an amount up to the difference between the current value of the property and the new principal amount. A shared equity approach could be used to share benefit of future appreciation among the home owner, the originator-funder, and the insurer of the loan, up to the original loan amount. Sharing in the equity returns from a soft second insured by the FHA SAFE program or new GSE program could also comprise a portion of the risk compensation charged.