

Obama Housing Plan

This week President Obama revealed his plan for tackling the US housing crisis. It will use financial and non-financial incentives to encourage lenders to modify mortgages and help homeowners avoid foreclosure. The plan is a step in the right direction, but only a half-step. In its current form, it makes unrealistic assumptions about mortgage markets, and is unnecessarily expensive to boot. With a few important changes, however, the plan could save many more homes. As well, the excessively generous provisions to pay homeowners to make their mortgage payments on time and the call for bankruptcy cramdown raises the appreciable risk of moral hazard.

Obama's plan rightly recognizes that securitized subprime and Alt-A mortgages lay at the core of the housing crisis. These mortgages were pooled together, bundled into securities, and then sold to investors. While they represent only 15% of all outstanding mortgages, they account for more than 50% of all the foreclosures starts. The problem is that, when a subprime or Alt-A homeowner becomes at-risk of foreclosure, she can't find a lender to talk to. Her mortgage is owned by hundreds of dispersed lenders, each with a small stake ("tranche") in her loan. The homeowner can talk to one person—the servicer, who collects her monthly payments—but this servicer has few incentives (and sometimes no authority) to discuss a mortgage modification. It's costly to perform a modification—estimates put the cost at \$750 to \$1,000. And because modifications sometimes fail to prevent foreclosure, they are risky too, making it hard for servicers to recoup the costs of doing the modification in the first place. Foreclosures, by contrast, are cheap: if the servicer incurs any costs, they are compensated by investors.

The Obama plan begins to change this situation by giving servicers incentives to pursue mortgage modifications instead of foreclosure. The plan would pay every servicer an up-front fee of \$1,000 for performing a modification and an additional \$1,000 every year that the modified loan avoids foreclosure, for up to three years. Servicers can earn \$4,000 for keeping homeowners in their homes. These amounts are more generous than needed, based on our research, but they will go a long way toward reversing existing incentives that push servicers away from modifications and toward foreclosure.

But they don't go far enough. First, the Obama plan is paying for modifications, not success. Success is avoiding foreclosure, and that can be done in a variety of ways. For some loans, for example where the borrower has a mortgage facing a reset to a higher rate, early interventions to avoid a reset may be optimal. For others, maybe a borrower whose income has fallen due to a job loss in the family, early interventions may no longer be possible and large modifications may be necessary. Only servicers have the right information to know the right modification for a particular situation. Obama's plan, by contrast, imposes a one-size-fits-all approach, telling servicers what to do. We could end up with too many, overly-aggressive mortgages that impose large burdens on investors. And, remember, thanks to TARP bailouts, we taxpayers own many of these investors. A superior plan would pay for success, not modification, by paying servicers for every loan that avoids foreclosure. Servicers could be paid an amount equal to 10 percent of monthly

homeowner payments, on all outstanding loans. This would give servicers a stake in their mortgages, and give them freedom to decide the best way to save homes.

Also, it's one thing to offer incentives; it's another for servicers to respond. And there are various legal obstacles that will mute any servicer response. In roughly fifty percent of mortgage securitizations, the servicer is forbidden from performing modifications that reduce principal or interest. Even when the servicer faces no explicit barriers to modification, it still faces serious litigation risk. Though the Administration acknowledges the problem, its plan does very little to address it. It's not realistic to assume that litigation will go away. Just ask Countrywide, which is now modifying loans pursuant to a consent decree.

What's needed is a "safe harbor" that insulates servicers from liability when they pursue modifications in a reasonable, good-faith belief that they are improving recoveries for investors. Rep. Kanjorski has proposed a bill that does this; a safe harbor was also part of Sen. Dodd's and Martinez's amendment to the Senate Stimulus bill (the amendment was booted as the House and Senate reached a compromise).

What's also needed is a program for dealing with second liens. Roughly 8.9 million homes have both second liens and debt exceeding 92 percent of the home's value. Unless second liens are paid to go away, they will deter efforts to modify a primary mortgage. Why modify the primary mortgage if that will just free-up cash to pay the second lien? We have proposed that the government offer second liens up to \$1,500 in incentives to drop their claim on the property, a claim that right now has little value with house prices plummeting and the prospect of receiving nothing in a foreclosure. Fannie Mae and Freddie Mac have a similar program that, while slightly more generous for second liens, has been highly effective at eliminating problematic second liens.

Instead of dealing with these problems, and giving servicers realistic incentives, Obama's plan spends excessive sums on unnecessary payments to lenders and borrowers. It's important to keep in mind that, under Obama's plan, servicers are paid to modify mortgages only when that makes both homeowners and lenders better off than a foreclosure. Yet, though servicers are paid billions of dollars to *make lenders better off*, the Obama plan would pay still more to lenders. Billions of additional dollars will be paid to lenders, in order to encourage reductions in interest or principal. These payments are unnecessary for lenders who are already receiving massive subsidies thanks to the TARP bailouts.

And even after making payments affordable, homeowners who participate are paid \$1,000 per year to make their mortgage payments on time, something they should do anyway and something that 90% of American borrowers are doing without any financial payment. The generosity of the plan will encourage as many homeowners as possible to try to qualify.

The Obama plan would also give homeowners the option to file for bankruptcy and have a judge modify the mortgage (so-called "cramdown"). That option is deeply

problematic. It would let judges modify mortgages that, even under Obama's plan, no servicer or lender was willing to modify. If the Administration believes in its plan, there's no need for overworked bankruptcy judges to interfere. Given the poor track record of Chapter 13 bankruptcy plans—two-thirds fail—"cramdown" could just delay the foreclosure crisis for years. As well, the option of a bankruptcy cramdown may encourage consumers to forgo working hard with lenders under this plan and take their chances with the bankruptcy system where they can get permanent reductions in their mortgage balances. We know from previous downturns that reducing principal is usually unnecessary to encourage borrowers to keep paying their mortgage; what is needed is to make payments on the home affordable, which is what this plan does.

We applaud President Obama's plan, but encourage the Administration to treat it as a first step toward an effective solution. If the plan took a more realistic approach toward servicer incentives, it would be more effective and make it unnecessary to waste taxpayer money on lender payments and bankruptcy cramdown. We need a policy that doesn't ask taxpayers to overpay.