

October 7, 2010

**SPECIAL REPORT**

# Restraining HARP: The Case for More Refinancing Now

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# Restraining HARP: The Case for More Refinancing Now

BY MARK ZANDI AND CRIS DERITIS

**W**ith mortgage rates near record lows, millions of American homeowners could save money by refinancing their home loans. Such savings would not only give individual households a little extra to spend each month after meeting their financial obligations, but it could also offer the struggling U.S. economy a quick boost. Yet, for too many, this opportunity is being blocked by impediments that policymakers could simply address at little or no cost to taxpayers.

Refinancing has increased in recent months, but much less than it should have, given the sharp decline in mortgage rates following Europe's debt crisis last spring. Particularly disappointing was the falloff in refinancing (according to the Mortgage Bankers Association's applications index) after the Freddie Mac conforming loan rate for a 30-year fixed rate mortgage dropped to an all-time low of 4.32% at the end of September.

Refinancing has also been disappointing in the broader historical context. In 2003, when fixed mortgage rates were between 5.5% and 6%, home loans were being refinanced at an annualized rate above \$4 trillion. The current level of activity is

less than half that, despite fixed rates well below 4.5% (see Chart 1). The 2003 boom was fueled by the large number of mortgages that had been originated when rates were much higher, making a sub-6% rate very attractive. Yet even today, more than half of all outstanding mortgages carry coupons above 5.75%. More U.S. homeowners should be refinancing.

## Refi roadblocks

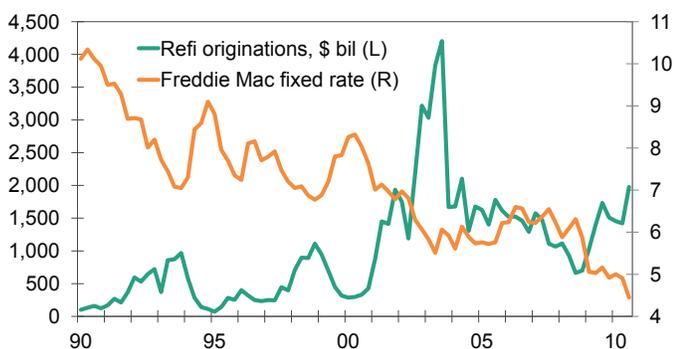
One reason they are not doing so is that mortgage lenders are withholding their best interest rates from potential refinancers whose credit scores and home equity have eroded, even if their mortgage payments are current. Fannie Mae and Freddie Mac—the huge mortgage finance institutions that failed in 2008 and are now wards of the federal government—appear to be emulating private lenders. This is significant, since Fannie and Freddie own and insure about half

the nation's outstanding mortgage loans. At a time when every dollar counts for stressed homeowners and the recovery is tenuous, the situation is disheartening.

The Obama administration has been trying to facilitate more refinancing, but its efforts have fallen flat. The Home Affordable Refinance Program was introduced in early 2009 to help refinance loans insured or owned by Fannie and Freddie; at the time, the administration said the program would allow between 4 million and 5 million homeowners to lower their interest rates to current market levels. Yet only around 380,000 borrowers have refinanced using HARP through the second quarter, and only 12,000 borrowers with underwater mortgages—loans that exceed the home's market value—have participated.

This is surprising, since HARP provides significant incentives for borrowers to refinance at up to 125% of a property's value, specifically in order to help underwater borrowers. To qualify, a homeowner's recent payments must have been on time, meaning no more than 30 days late within the past year. Borrowers also must be able to show they have sufficient income to meet the new payment schedule. HARP refinancing is even available for vacation homes and investment properties.

## Rates Plunge, Refis Putter



Sources: Federal Reserve, Freddie Mac, Moody's Analytics

TABLE 1

## Loan Level Price Adjustments

Basis points, %

Credit Score	Loan-to-Value Ratio								
	< 60	60.01 - 70	70.01 - 75	75.01 - 80	80.01 - 85	85.01 - 90	90.01 - 95	95.01 - 97	97.01 - 105
> 740	-25	0	0	0	0	0	0	0	0
720 - 739	-25	0	0	0	0	0	0	0	0
700 - 719	-25	50	50	50	50	50	50	50	50
680 - 699	0	50	75	75	75	75	75	50	50
660 - 679	0	100	150	175	175	175	175	125	125
640 - 659	50	125	200	225	225	225	225	175	175
620 - 639	50	150	250	275	275	275	275	250	250
< 620	50	150	300	300	300	300	300	300	300

Source: Fannie Mae

But none of this has helped raise the level of participation, because Fannie Mae and Freddie Mac have at the same time imposed additional interest rate charges—called “loan level price adjustments”—for refiners with higher loan-to-value ratios or lower credit scores. Specifically, borrowers’ credit scores must be above 720 to qualify for the current market rate (see Table 1). This is a high bar, as according to the credit bureau Equifax, some 46% of the nation’s households score below that level. For context, in times past, a subprime borrower was defined as one with score below 620. A HARP applicant with a sub-720 credit score or a high LTV ratio would be offered interest rates several percentage points above the current market level. For example, a borrower with a 90% to 95% LTV and a 640-659 score would pay nearly a half percentage point more. At these levels, the incentive to refinance is very low.

This is an especially large problem in parts of the country where the housing market crash and economic downturn have been most severe—ironically, the areas that HARP was supposed to help. In Florida, for example, 52% of households have credit scores below 720. In the Central Valley of California, 54% of households fall below the bar; in Nevada, an astonishing 56% do.

Fannie and Freddie are not breaking precedent in charging higher interest rates

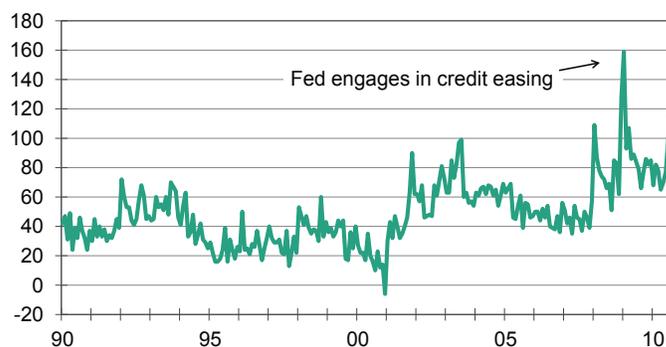
to borrowers with less equity and weaker credit. The companies have always done so, to account for the fact that such borrowers are more prone to default. But this standard practice is undermining HARP. It also is not clear what use the traditional rules have in this situation, since Fannie and Freddie already insure these loans and are on the hook if they default. HARP refinancing would lower borrowers’ monthly mortgage payments, increasing the chance they will stay current and reducing the number of payouts on the insurance Fannie and Freddie provide.

Another current impediment to refinancing is the wide spread between rates being offered by mortgage lenders and the rates Fannie and Freddie are charging. The difference between the Freddie Mac primary rate—the rate offered by commercial lenders to borrowers with pristine credit—and the rate the finance agencies are receiving on mortgage securities backed by such loans is nearly 120 basis points. This is almost double the spread that

prevailed at the beginning of this year and much wider than the 50 basis points averaged in the years before the financial crisis (see Chart 2). The only time the spread was wider was in the midst of the crisis, when the Federal Reserve said it would purchase Fannie and Freddie mortgage-backed securities as part of its credit-easing efforts.

One reason the spread between the primary and secondary rate is so wide is that mortgage lenders are stretched. The industry is already struggling to keep up with the foreclosure crisis and with loan modification efforts, and it was taken by surprise by the decline in rates and increased refinancing. At the beginning of 2010, the industry was scaling back its workforce, expecting interest

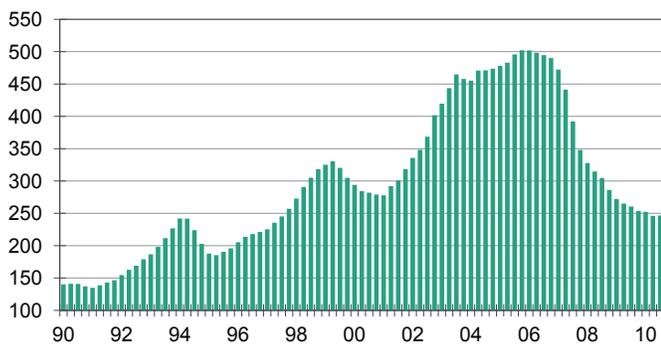
### Primary-Secondary Spreads Balloon Out



Sources: Fannie Mae, Freddie Mac, Federal Reserve, Moody's Analytics

### Mortgage Lenders Are Slow to Gear Up

Employment in real estate mortgage lending, ths



Source: Bureau of Labor Statistics

rates to rise and loan volumes to fall. When rates fell this spring, the industry was slow to respond, unsure whether they might not quickly rise again. More mortgage underwriters are being hired, but it will take time before lenders have sufficient capacity (see Chart 3). Until they do, the rates borrowers are offered on refinancing deals will remain inordinately high.

Lenders may also be holding rates higher to compensate for Fannie's and Freddie's recently more aggressive efforts to repurchase problem loans. If lenders violate the agencies' guidelines and their loans go into default, Fannie and Freddie can require the loan originators to shoulder the financial burden themselves. Expecting more such repurchases, lenders may be building that into their current rates.

Any refinancing includes closing costs—fees to process applications or obtain appraisals and other taxes or costs. With so many households facing uncertainty about employment and the time before they may need to relocate, borrowers may prefer to conserve cash rather than pay such fees up front. Under the HARP, these fees can be capitalized into the borrower's mortgage balance, but such a "no-cost" refinancing increases the borrower's interest rate. For underwater borrowers, it also delays the day when they will again be able to accumulate equity in their homes, thus reducing the incentive to refinance.

Other impediments to refinancing seem more modest and temporary. Some borrowers may believe rates will go even lower,

particularly if the Federal Reserve takes further steps to support the economy by purchasing long-term financial assets. If current rates do not make a compelling case for refinancing, why not wait and see?

Private mortgage insurers who provide insurance on Fannie and Fred-

die loans with LTVs above 80% must also agree to continue coverage on refinanced loans (although they do not need to increase their risk exposure if a borrower's loan-to-value ratio has increased since origination.) Holders of second liens (such as home equity lines and closed-end second loans) also need to agree to put their claims on a refinanced home after those of the first mortgage holder. Although mortgage insurers and second-lien holders should have little incentive to block a refinancing that will leave the borrower less likely to default, the incentives for cooperation may not be strong, given the time and paperwork involved. Some second-lien holders may even see the refinancing as an opportunity to pressure first-lien holders to buy them out. First-lien holders in turn may be unwilling to do this, believing that the second-lien holder should in many cases be wiped out.

### Restraining HARP

Jump-starting HARP could be straightforward: Simply require Fannie and Freddie not to charge add-on rates, even for refinancing borrowers who have lost a lot of equity or have relatively low credit scores. Keep in mind that Fannie and Freddie already bear the credit risk on these loans; anything that makes it easier for borrowers to pay their mortgages on time and avoid default will reduce the agencies' ultimate cost.

Even borrowers in an early stage of delinquency may benefit from a HARP refinancing, although many of these bor-

rowers likely have other financial problems that make loan modification or some other foreclosure mitigation the more prudent choice. But refinancing may help. Under current rules, borrowers who refinance under HARP are then ineligible for loan modification through the government. This restriction should be eliminated.

To accelerate the refinancing process, Fannie and Freddie should help identify which homeowners are the best prospects for refinancing—highest coupons, best credit scores, lowest LTVs—and provide this information to its network of mortgage lenders and brokers who will contact the homeowners and originate the refinancings. Fannie and Freddie could also provide more streamlined refinancing that forgoes income verification and a full-blown appraisal to facilitate the refi process and keep costs down. Unlike new borrowers, HARP candidates have already proven their ability to pay by making timely payments throughout the recession. Streamlining the process will not materially change the risk the GSEs are exposed to, but it may limit the ability to securitize the loans in the future. Refinance costs cannot be eliminated completely, as process checks and controls must be in place to avoid fraud and keep loans eligible for securitization.

A bolder step for providing borrowers with an incentive to refinance would be to subsidize refinancing closing costs either directly or through a tax rebate. With labor market uncertainty, many borrowers fear that they will be unable to recoup the upfront closing costs of refinancing if they have to move in a year or two. Despite some economic gains in recent months, many borrowers are still operating with a survival mentality and a preference for conserving cash rather than paying for a refinance with long-run benefits.

At a cost of \$2,000 per refinance, the HARP program could be easily enhanced to overcome borrower anxiety and allow millions of borrowers to take advantage of the lower interest rate environment. This plan would come at no additional cost, as Congress already allocated \$50 billion to the Making Home Affordable program. Al-

locating \$20 billion to fund 10 million refinancings would have an immediate impact while still leaving plenty of funding available for other modification programs.

### Economic logic

The economic logic of an expanded government refinance plan is compelling. With current mortgage rates closing in on 4.25% and the median rate on outstanding mortgages above 5.75%, the potential rate reduction could average almost 150 basis points. If all agency and government borrowers with rates above the median refinance at 4.25%, the gross cost savings to borrowers would be around \$56 billion a year (18.5 million borrowers times \$200,000 average mortgage balance times 1.5%).

Clearly, not all that savings would be realized. Some borrowers would be unable or uninterested in refinancing; they are too deeply under water, or unemployed, or have such small loan balances that it is not worth the closing costs to refinance. Borrowers who expect to sell soon will also not want to incur the cost. Given these considerations, more like 8 million borrowers are in a good position to refinance at current market rates, saving up to \$24 billion per year in interest payments.

The savings would provide a quick boost for middle-income homeowners. Some of the cash would be used to repay other debt, but the bulk would likely be spent on home improvements or other needs. Assuming two-thirds of the extra cash, or some \$16 billion, will be spent within six months, this translates into nearly a quarter-percentage point of annualized real GDP through the first half of next year. The fragile U.S. recovery could certainly use that help.

More refinancing would also further the immediate goals of the Federal Reserve. Monetary policymakers are considering a new round of quantitative easing—a process in which the Fed purchases Treasury securities in an effort to bring down long-term interest rates, including fixed mortgage rates. Indeed, the recent decline in mortgage rates is due in part to expectations that the

Table 2

### Lost Interest Income to MBS Investors Due to Accelerated Prepayments

Federal Reserve	\$4,865
Depository institutions	\$4,472
Overseas investors	\$2,526
Fannie/Freddie	\$6,128
Mutual funds	\$2,133
Insurance co. & pension funds	\$1,815
Other	\$1,609
<b>Total</b>	<b>\$23,549</b>

Source: Moody's Analytics

Fed will soon resume quantitative easing. If that happens, it arguably would help the economy most significantly by increasing the amount of home loan refinancing. Anything fiscal policymakers can do to support the Fed's effort would be a plus.

A revamped HARP should not add significantly to Fannie and Freddie's costs and therefore should not be a burden to taxpayers. The two mortgage finance agencies would lose some interest income as refinancing lowers the return on the \$660 billion of mortgage securities and \$614 billion in whole mortgage loans they directly own. Under reasonable assumptions, they stand to lose about \$6 billion in annual interest income (see Table 2). But this cost would be offset by lower default rates on the loans that are refinanced. Borrowers are more likely to stay current if their monthly payments drop by \$100 or \$200. Fannie and Freddie would break even if the probability of default on the loans and securities they own and insure falls by about 25 basis points. Even if the default does not decline by this much, it is clear that the cost to Fannie and Freddie, and by extension to taxpayers, will be small. Some \$30 billion set aside in the TARP fund to finance HAMP and HARP will certainly more than cover it.

### Downsides

While homeowners would clearly benefit from a restraining HARP, and taxpayers would be largely unaffected, global

investors in agency mortgage-backed securities would be hurt financially. As more loans are refinanced, higher-yielding MBS would be retired and replaced with lower-yielding MBS. To be precise, if a more effective HARP resulted in 8 million more refinancings, investors would receive approximately \$17 billion less in annual interest income.

These investors include a wide array of institutions (see Table 3). Through its credit easing efforts last year, the Fed has quickly become the largest owner of agency MBS, amassing \$1.3 trillion worth, or some one-fourth of the total outstanding. The Fed can easily digest the lost interest income from the increased prepayments, but this may put pressure on it to be more aggressive in its quantitative easing efforts than otherwise would be the case to forestall a counterproductive increase in mortgage rates. The interest rate spread between MBS and Treasury yields will increase regardless, but MBS yields need not rise if the Fed buys a sufficient amount of Treasury bonds.

While other private MBS investors will not be happy to get their money back when interest rates are low, they are keenly aware of this substantial prepayment risk in their securities. Indeed, they are likely already surprised that their investments have not been retired as they would have been in a more normal, well-functioning mortgage securities market. Restraining HARP can thus be seen as a way to correct a serious market failure. It is also important

Table 3

Who Owns Agency Mortgage-Backed Securities?

Jun 2010

	\$ bil	% of total
Federal Reserve	1,300	24.5
Depository institutions	1,195	22.5
Overseas investors	675	12.7
Fannie/Freddie	661	12.4
Mutual funds	570	10.7
Insurance co. & pension funds	485	9.1
Other (mostly other government)	430	8.1
<b>Total</b>	<b>5,316</b>	

Source: Inside Mortgage Finance

to note that MBS investors have been significant beneficiaries of the monetary and fiscal policy response to the financial panic and Great Recession. The Fed's massive purchases last year of agency MBS were a windfall. The myriad federal housing and foreclosure policies aiming to stem foreclosures have also significantly benefited investors through reduced prepayments.

Policymakers may be nervous that overseas investors, who are a sizable and growing source of capital for the U.S. Treasury, will be annoyed by the faster prepayments. They may also be worried about the implications for the financial health of the nation's shaky depository institutions and pension funds, who also are big investors in agency MBS. While not unreasonable concerns, they seem marginal, given the magnitude of the losses that will be distributed very widely across many investors.

Another potentially unwelcome side effect of boosting refinancing today could be less labor mobility in the future. Borrowers who lock in record-low mortgage rates to-

day will be less willing to move when rates start to climb. Given that homeowners tend to be more skilled than renters, this impediment to labor mobility could aggravate the U.S. economy's current skills mismatch. However, it is difficult to know the scale of this consideration; it seems small against the sizable near-term benefits of a refinancing program. It is also worth noting that those homeowners who refinance out of adjustable rate mortgages to fixed rate loans will be insulated from the increase in interest rates that is ultimately coming.

Further government intervention in the mortgage market could also send the wrong message to current and potential homeowners, encouraging them to delay decisions in hopes of receiving more federal assistance in the future. The three housing tax credits implemented over the past two years were instrumental in breaking the housing market's deflationary psychology, but the sharp decline in home sales after the most recent credit expired likely stems in part from potential homebuyers waiting for yet another credit. This concern could be mitigated by making it clear that there is only so much TARP money left for HARP; policymakers could advertise this to increase the sense of urgency among potential refinancers.

Conclusions

The federal government has intervened heavily in the residential mortgage market, but the results have fallen short of proponents' hopes. When President Obama announced his plans in the spring of 2009, the HAMP loan modification plan was expected to ultimately help between 2 million and 3 million homeowners avoid foreclosure, and the HARP plan was expected to spur between 4 million and 5 million refinancings by homeowners with little or negative equity. Instead, these programs together are on track to help closer to 1 million homeowners.

This is not to say that HAMP and HARP have failed. HAMP has mitigated nearly a half million foreclosures to date and has slowed the pace of the foreclosure process, giving the market time to stabilize. The administration has also recently implemented substantial changes to HAMP, increasing incentives for participation and encouraging principal write-downs, steps expected to bring new life to the program.

But the HARP needs an even bigger reworking if it is to make a more meaningful difference. The needed changes are conceptually and practically straightforward; the Obama administration need only require Fannie and Freddie to stop charging higher rates to their own borrowers who want to refinance. Even if the administration does not act, Congress might, as is evident in recent proposed legislation. The economic benefit is clear. If more mortgages were refinanced, fewer borrowers would default, homeowners would have more money in their checkbooks, and the fragile economic recovery would receive a quick, sizable cash infusion. HAMP and HARP are unlikely to fix all the ills that plague the housing and mortgage markets, but they have the potential to meaningfully assist homeowners at little additional cost to taxpayers.

### Endnotes

1. When HARP was first introduced in 2009, refinancing was permitted on mortgages up to only 105% of the home's value. This was increased to 125% as it became apparent that the 105% restriction was too limiting.
2. See "Selling Home Affordable Refinance – New Refinance Options for Existing Fannie Mae Loans," Fannie Mae Announcement 09-04 March 4, 2009 <https://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2009/0904.pdf>
3. The mortgage servicing industry is also in the midst of a major consolidation, most notably Bank of America's acquisition of Countrywide and Wells Fargo's takeover of Wachovia. Integrating these institutions has proved difficult, impeding efforts to gear up their loan processing operations. Critics also suggest some servicers have been slow to ramp up loan modifications and refinancings because of conflicting incentives to service loans in mortgage pools, or because of less competition in the industry.
4. See FHFA guidance <http://www.fhfa.gov/webfiles/1256/HutchinsonGSERefi22009.pdf>
5. The 8 million potential refis equals the 21.5 million Fannie, Freddie and FHA loans that have coupons of more than 5.25% less 3.25 million that are seriously delinquent or an in-foreclosure, 3.5 million with mortgage balances of less than \$75,000 and thus a reduced incentive to refinance, 3 million with LTVs of over 125%, and 4.25 million with short tenures and other financial reasons they are unwilling or unable to refinance.
6. This assumes the proposed changes to HARP are implemented by early next year. The assumed spendout rate is consistent with that of the spendout of the 2001 tax rebates and the refinancing wave of early in the last decade. See Johnson, et. Al "Household Expenditure and the Income Tax Rebates of 2001," American Economic Review, vol. 96, no 5. pp. 1589-1610.
7. The break-even change in the default rate equals the lost interest income divided by the product of the mortgage debt owned and insured and the lost given default which is assumed to be 50% of the mortgage balance.
8. Given the much less than expected take-up on HAMP and HARP, only \$500 million of these monies has been used to date.
9. This excludes the \$6 billion in interest income that would be lost by Fannie and Freddie.
10. Inside Mortgage Finance is the source for investor holdings of MBS.
11. The HOME Act introduced by California Congressman Cardoza at the end of September does precisely this. See <http://cardoza.house.gov/index.cfm?sectionid=87&sectiontree=6,87&itemid=653>

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