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SPECIAL REPORT

Improved HARP Will Expand Refinancing, Boost Recovery

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Improved HARP Will Expand Refinancing, Boost Recovery

BY MARK ZANDI AND CRISTIAN DERITIS*

The Obama administration has taken a substantive step to rejuvenate mortgage refinancing. The Home Affordable Refinance Program, introduced in 2009 to help underwater homeowners with loans backed by Fannie Mae and Freddie Mac, is being restructured. Previous efforts to help the housing market have fallen short, and skepticism regarding this one is warranted as well, but with some good oversight, the changes should make a meaningful difference.

Under reasonable assumptions about future mortgage rates and how the program will be implemented, the restrung HARP is expected to refinance 1.6 million additional homes, bringing total refinancings under the program to 2.85 million.

If correct, this would give a small but meaningful boost to the housing market by reducing future mortgage defaults and lift the broader economy by giving households that refinance extra cash to spend. Homeowners should save more than $4.5 billion in mortgage interest payments next year and nearly $2 billion in 2013.

The changes to HARP are overdue. The Obama administration initially thought the program would allow between four million and five million homeowners to take advantage of lower mortgage rates. Yet to date, there have been fewer than 900,000 HARP refinancings, fewer than 100,000 of them involving underwater homeowners—those who owe more than market value of their homes.

HARP has fallen well short of expectations for a range of reasons that the program's changes address. These include increasing the number of homeowners eligible to participate; boosting the savings for homeowners who refinance, creating a larger incentive to participate; and substantially increasing incentives for mortgage servicers who enable more refinancing.

Wider eligibility

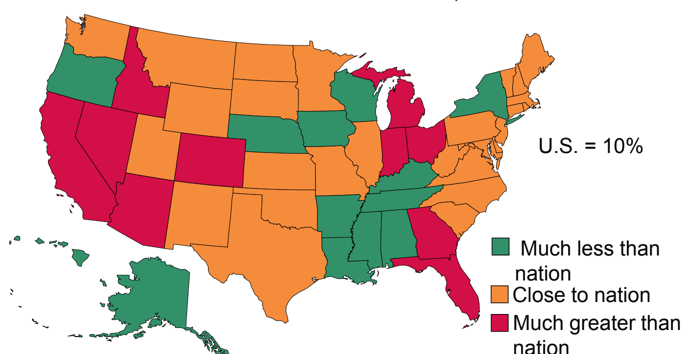
The restrung HARP relaxes a number of eligibility requirements, significantly expanding the pool of potential refinancers. This now includes all Fannie and Freddie borrowers with loan-to-value ratios above 80%. Previously, homeowners could not participate in HARP if their LTV ratios exceeded 125%. The change is especially important in states hit hardest by the housing bust, where more homeowners are under water (see Chart 1).

Credit history requirements are also relaxed under the new rules. Homeowners can qualify if they are current on their payments for six months and no more than 30 days delinquent during the past 12 months. Under the old HARP, borrowers had to have been current for at least a year. The new rules require only verification of employment, not income, increasing the eligibility pool. Previously even many employed borrowers could not meet the program's income requirements.

Given these changes, nearly four million homeowners could benefit from restrung HARP refinancing at current mortgage rates, which hover just above 4% for prime borrowers. The estimate is derived from the LPS—Applied Analytics Servicing Database using the following calculation: There are

Chart 1: Which States Benefit From the Restrung HARP

% of homeowners with LTV ratio over 125%, June 2011

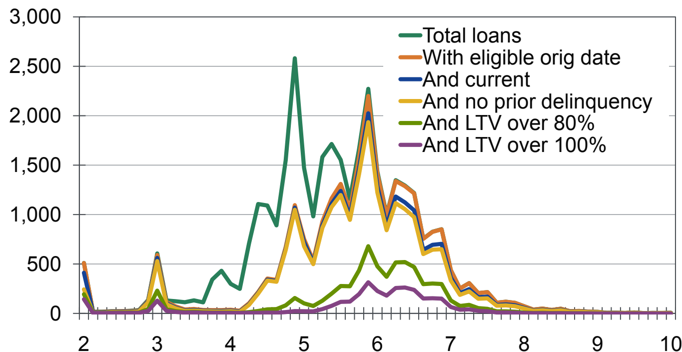


Sources: Equifax, Moody's Analytics

* I would also like to thank Jonathan Weiner and Kyle Lundstedt of LPS Analytics.

Chart 2: Fannie, Freddie Loans Outstanding by Coupon

Number of loans, ths (y-axis); coupon rate (x-axis)



Sources: Moody's Analytics, LPS Analytics

17.5 million Fannie- and Freddie-backed loans carrying current interest rates above 5.5%; 16.9 million of these were originated before June 2009; 14.1 million are current and have not been delinquent in the past six months or more than 30 days past due in the past year; 5.4 million of these have LTVs of more than 80%; close to four million of these have a large enough mortgage balance and long-enough tenure that a refinancing makes sense for borrowers given the closing costs (see Chart 2).

Lower borrowing costs

The restrung HARP significantly increases incentives for homeowners to refinance by reducing interest rate charges that Fannie and Freddie had added to many HARP refinancings and by reducing closing costs. Homeowners who refinance under the restrung HARP should save measurably more—as much as half a percentage point—than under the old HARP.

Fannie and Freddie tack on additional interest rate charges—called loan level price adjustments—for refinancers with higher LTVs or lower credit scores. Under old HARP, these adjustments added as much as a half percentage point to the interest rate on a newly refinanced loan for underwater or less creditworthy borrowers. The adjustments were especially large in areas where the housing market crash and economic downturn were most severe—ironically, the areas HARP was supposed to help, including states such as Arizona, California, Florida and Nevada.

Under the restrung HARP, these adjustments will be made simpler – based solely on borrowers' LTV – and add no more than 20 basis points to the average HARP loan.

Fannie and Freddie aren't breaking precedent in charging higher interest rates to borrowers with less equity and weaker credit. The two government-sponsored enterprises have always done so, to account for the fact that such borrowers are more prone to default. But this standard practice has undermined HARP. The traditional rules are also of questionable use in the current situation, since Fannie and Freddie already insure these loans and will suffer the loss if they default. Lowering borrowers' monthly mortgage payments increases the chance they will stay current, reducing insurance losses to Fannie and Freddie.

The restrung HARP also cuts closing costs, by eliminating the need for a credit score and income verification and allowing appraisals via automated valuation models in most cases. Title insurance could also be streamlined, further trimming costs. Under the old HARP, average closing costs per loan were probably as high as $4,000, while under the restrung HARP they are expected to be about half that. Closing costs can be folded into the mortgage balance, raising the interest rate but lowering the amount of upfront cash required.

Policymakers are also hoping to tap so-called hardest-hit funds to help cover at least some of the closing costs. Eighteen states received such funds as part of the fiscal stimulus, to address severe foreclosure problems. Supporting more HARP refinancings would be a good use of the money.

Removing income verification will appeal to homeowners, given their widespread concern about being put under a lender's microscope. This concern will not go away, but it should be ameliorated by a less intrusive verification process.

Lower put-back risk

In what is arguably its most important change, the new HARP lowers servicers' so-called put-back risk. Servicers have been reluctant to participate in refinancing, for fear that reopening a loan file might expose mistakes made when the loan was originated. Under existing rules, servicers who misrepresented the quality of their underwriting to Fannie, Freddie, and mortgage insurance companies must buy back troubled mortgage loans; many have been forced to do so in recent years.

With the restrung HARP, Fannie and Freddie will significantly relax these rules, and mortgage insurers will agree to give up recession rights. The logic here is that since HARP loans had to be originated before June 2009, those that are still current were likely underwritten properly. Moreover, mortgage insurers are typically unable to investigate loans more than four years past origination.

Fannie and Freddie will lose nothing as the loan level pricing adjustments they charge will cover any costs associated with relaxing their reps and warranties. The Federal Housing Finance Agency—Fannie's and Freddie's regulator—believes it has a fiduciary responsibility to limit the cost to taxpayers. Whether the FHFA needs to charge a fee to meet its responsibility is an open question, but getting past this debate to implement the restrung HARP as quickly as possible is much more important.

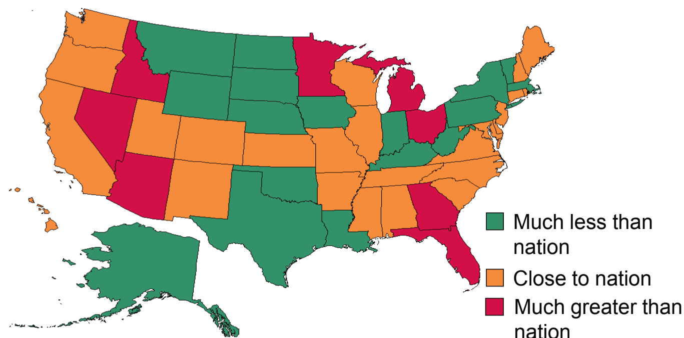
While the benefit of the reduced put-back risk to mortgage servicers is difficult to quantify, it appears to be significant and, more importantly, will reduce servicers' uncertainty. It should be sufficient to encourage servicers to improve their ability to do more refinancings, which is necessary for the program to work.

Possible impediments

Despite the changes to HARP, there remain significant potential impediments to its success. Particularly difficult to gauge is whether homeowners will con-

Chart 3: Eligibility for Restrung HARP

% of Fannie, Freddie loans eligible for restrung HARP



Sources: Moody's Analytics, LPS Analytics

tinue to shun the program even though it seems clear that is in their financial interest to refinance. Even under the best of circumstances, a perplexing number of homeowners do not take advantage of their ability to refinance. That will likely increase given the current circumstances. Many have been severely chastened by their dealings with mortgage servicers and the government agencies; they simply do not trust the process.

Mortgage servicers will also have to increase their refinancing capabilities and solicit eligible households. There is nothing in the restrung HARP that compels them to do anything; the program is voluntary. While incentives to participate have been significantly sweetened, they may not be sweet enough.

It will be costly for servicers to expand their refinancing capabilities, particularly since much of the activity will be temporary. It may make more financial sense to them to manage refinancing by raising interest rates. Given the consolidation of the mortgage industry during the Great Recession, servicers appear to have more market power than before. With many smaller mortgage brokers and banks gone, it will not be as easy for a homeowner to shop for a better refinancing rate.

The nation's largest mortgage servicers have also committed under the restrung HARP to subordinate second mortgages to a refinanced first mortgage. To date, second-lien holders have not been very cooperative, perhaps because they will be required to take a write-down and perhaps because of the time, paperwork and other costs involved. Some second-lien holders have even viewed refinancing as an opportunity to pressure first-lien holders to buy them out. This should be less of a problem under the restrung HARP, but it will depend on whether servicers follow through on their voluntary commitment.

The response of investors in securities backed by Fannie and Freddie mortgages also matters. Such investors should not have a problem with the restrung HARP given that the changes are within expectations and nothing close to the massive refinancing programs that some economists and policymakers have advocated. It is also worth noting that the nation's largest investors in mortgage-backed securities include the Federal Reserve Board, through its quantitative easing efforts, and Fannie and Freddie themselves. Nonetheless, MBS prices have fallen and interest rates have risen a bit in the wake of the announced changes. This bears close watching.

Quantifying the impact

The restrung HARP is expected to result in 1.6 million more refinancings through 2013 than would have taken place under the old program. Given that the original HARP was expected to result in 1.25 million refis through June 2012, when it was legislated to expire, a total of 2.85 million HARP refinancings can be expected. Assuming approximately one million HARP refinancings are completed by the end of 2011, there will be approximately 1.2 million HARP refinancings in 2012 and 650,000 in 2013.

These estimates depend on a wide range of assumptions, the most important being the future path of mortgage rates. The current outlook is based on the Freddie Mac 30-year fixed rate averaging 4.25% in 2012 and 4.75% in 2013. A swing of as little as half a percentage point in mortgage rates will significantly impact the number of refis. The amount of participation also critically depends on closing costs, which are assumed to decline from close to $4,000 on average under the old HARP, to $2,000 under the new program. A few hundred dollars in closing costs would make a big difference.

More refinancing will provide a small but measurable boost to the economy. The mortgage interest saving to stressed homeowners will act like a tax cut, and much of it will be spent quickly. With current mortgage rates near 4% and the median rate on outstanding mortgages above 5.5%, the potential rate reduction could average almost 200 basis points. If 1.3 million homeowners refinance in 2012 as anticipated, and given that the average mortgage balance is $175,000, their interest saving next year will be more than $4.5 billion. This would provide a quick cash boost for middle-income homeowners. Some will be used to repay other debt, but the bulk will likely be spent on home improvements or other needs.

It is important to note that some of this economic benefit will be offset by less spending by investors in mortgage securities who will be hurt by a reduction in their interest income. However, this impact should be very small. Almost three-fourths of the impacted securities are owned by the Federal Reserve, Fannie and Freddie themselves, banks and other depository institutions, and global investors and will have no direct impact on spending. Moreover, the impact on U.S. households via their pension plans and mutual funds will be modest and given that these households are generally wealthier is unlikely to have much fallout on their spending.

The benefits of the restrung HARP will vary substantially across the country. States that benefit the most are Nevada, Michigan, Arizona, Georgia and Florida (see Chart 3). More than one-fourth of GSE loans in these states will qualify for the restrung HARP. States that benefit least are North and South Dakota, New York, Alaska and Okla-

homa. No more than 5% of GSE loans in these states will qualify.

More refinancing would also further the Federal Reserve's immediate goals to support economic growth. Monetary policymakers have conducted two rounds 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. The Fed has not ruled out a third round. The recent decline in mortgage rates is due in significant part to the Fed's actions. Anything fiscal policymakers do to support the Fed's effort would be a plus for the economy.

There could be some potential unwelcome side effects of boosting refinancing activity today—most notably, less labor mobility in the future. Borrowers who lock in record low mortgage rates today 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, and it seems small against the sizable near-term benefits of more refinancing. It is also worth noting that those homeowners who shift from adjustable-rate to fixed-rate mortgages will be insulated from rising interest rates when those ultimately arrive.

Further government intervention in the mortgage market could also send the wrong message to current and potential homeowners, encouraging them to delay decisions in hope of receiving more federal assistance in the future. The housing tax credits implemented over the past several 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.

There are also concerns that mortgage servicers will get off the hook for any indiscretions in their lending, including inaccurately establishing the chain of title. That is, that they actually own the loan. While possible, this seems like a stretch and if it is determined that there is a systemic problem with the way title has been established, a refinancing is unlikely to be sufficient to insulate servicers from the implications of this.

Policy suggestions

Policymakers may eventually want to consider a number of additional steps to facilitate more refinancing. One potentially effective step would be to allow HARP refinancings on all Fannie and Freddie loans, not just those with LTVs above 80%. This would increase the pool of eligible refinancers from four million at current mortgage rates to nearer 10.5 million. If just half were to refinance, then the annual interest saving would approach $10 billion.

MBS investors could well have a problem with this much bolder step, which they are not currently expecting. As such, it could be counterproductive if investors became less avid buyers of MBS and mortgage rates rose. This may be less of a concern if coupled with another round of quantitative easing that involved MBS purchases by the Federal Reserve.

It may also make sense to open HARP to homeowners in an early stage of delinquency. While many such borrowers likely have other financial problems that make loan modification or another foreclosure mitigation more prudent, refinancing may help. Under current rules, borrowers who refinance under HARP are then ineligible for loan modification through the government Home Affordable Modification Program. This restriction should be eliminated.

Since many potential refinancers may be reluctant to participate given their concerns about incomes and jobs, it would helpful if Fannie and Freddie solicited more actively. They could identify good prospects for refinancing—homeowners with the highest coupons, best credit scores, and lowest LTVs. The agencies could provide this information to their networks of mortgage lenders and brokers, who could then contact homeowners to originate refinancings.

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, which would cost taxpayers money and could be perceived as unfair, would be to subsidize refinance closing costs directly or through a tax rebate. With so much uncertainty in the job market, many borrowers fear they will be unable to recoup the upfront costs of refinancing if they have to move in a year or two. Many borrowers still operate with a survival mentality and prefer to conserve cash rather than pay for a refinance with long-run benefits.

To ensure that mortgage servicers do not charge extraordinary rates given their increased market power, their behavior should be carefully monitored and publicized. Perhaps the GSEs could make it clear they will do less business with servicers who do not voluntarily keep their spreads close to historical norms or follow through on their commitment to subordinate their second liens.

Finally, it is too bad that FHFA cannot find a way to completely eliminate its charges. What Fannie and Freddie will give up to the mortgage servicers by relaxing their standards for reps and warranties could very well be made up in lower default rates on refinanced loans.

Conclusions

The U.S. housing crash and foreclosure crisis are not over. Home sales and housing construction are stable but depressed, and house prices remain weak. With millions of foreclosures and short sales set to hit the housing market over the next year, prices are set to fall further.

While house prices are declining, the recovery will have difficulty gaining traction. The home is still most Americans' most important asset, and consumers will be reluctant to spend while their wealth erodes. Many small-business owners use their homes as collateral to grow, and local governments rely on property taxes tied to house prices.

There are some reasons to think the housing slump is near an end. Prices have fallen far enough that single-family housing is affordable and increasingly attractive compared with renting. Investors are putting up cash to purchase distressed properties. Overbuilding remains a problem, but a steadily

smaller one, as the pace of new household formations catches up with dormant residential construction.

But this optimism could easily be quenched if house price declines reignite a vicious cycle, putting more homeowners under water, accelerating foreclosures and distress sales, and driving prices even lower. Only an unprecedented monetary and fiscal policy response short-circuited that cycle during the recession.

The economic benefit of a restrung HARP is clear. If more mortgages are refinanced, fewer borrowers will default, homeowners will have more to spend elsewhere and the fragile recovery will receive a quick and potentially sizable cash infusion. The restrung HARP will not fix all the ills that plague the housing and mortgage markets, but it has the potential to meaningfully assist homeowners at no additional cost to taxpayers.

Given the balance of risks, policymakers should also consider providing additional temporary help to the housing and mortgage markets. Administration efforts to turn bank-owned foreclosure properties into active rental units holds some promise; providing investors in such properties with temporary accelerated depreciation benefits or even expensing could help absorb the coming wave of distressed-home sales. Efforts to develop short-term adjustable-rate mortgage products to take full advantage of near-zero short-term rates are also encouraging. A targeted, well-structured and timely national principal reduction program would be a much larger and costlier step, but would bring the housing downturn to a quick and definite end.

None of these policy steps is a home run, but few are. Policymakers must therefore continue to work hard to string together a number of policy singles. The restrung HARP program is a base hit.

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Mark Zandi is chief economist of Moody's Analytics, where he directs research and consulting. Moody's Analytics, a subsidiary of Moody's Corporation, is a leading provider of economic research, data and analytical tools. Mark is the author of Financial Shock, an exposé of the financial crisis. His forthcoming book, Paying the Price, provides a roadmap for meeting the nation's daunting fiscal challenges. He is on the board of directors of The Reinvestment Fund, a Philadelphia nonprofit that marries public with private capital to make investments in inner cities, and MGIC, a publicly traded firm that is the nation's largest private mortgage insurer. Dr. Zandi received his PhD at the University of Pennsylvania, where he did his research with Gerard Adams and Nobel laureate Lawrence Klein, and received his B.S. from the Wharton School at the University of Pennsylvania.

Cristian deRitis

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