Written Testimony of Mark Zandi
Chief Economist and Cofounder Moody's Analytics

Before the Senate Banking Committee

"The Responsible Homeowner Refinancing Act of 2012"

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The U.S. economy has made significant progress since the Great Recession ended three years ago. Payrolls have increased by 3.75 million since job growth resumed, and the unemployment rate has fallen by nearly two percentage points from its peak. Businesses and households have reduced their debt loads significantly, and the financial system is much better capitalized.

Despite this progress, the recovery is still struggling to take root. The U.S. economy is growing, but at a disappointing pace, and the unemployment rate remains uncomfortably high at more than 8%. The economy also faces significant threats, including turmoil in Europe and the federal government's rapidly approaching fiscal cliff. Policymakers also need to credibly address the nation's long-term fiscal challenges.

Another significant impediment to stronger growth is persistent weakness in the housing market. Home sales and construction are off bottom but still extraordinarily low, and house prices remain weak in many parts of the country. With millions of foreclosures and short sales certain to hit the housing market over the next several years, prices could fall further.

The economy will not be in full swing until house prices are rising consistently. For most Americans, the home is still the most important asset, and consumers will be reluctant to spend while their wealth erodes. Many small-business owners use their homes as collateral for business loans, and local governments rely on property tax revenues, which are tied to housing values, to fund schools and other important public services. Other serious longer-term effects of falling house prices include a reduction in labor mobility and the erosion of retirement savings for low- and middle-income homeowners.

There are some reasons to be optimistic that the housing slump is ending. Prices have fallen enough to make single-family housing affordable and attractive compared with renting. Investors are putting up cash to purchase distressed properties. Overbuilding remains a problem, but a diminishing one, given a record low pace of construction and increased household formation.

But this optimism will be easily overwhelmed if house prices fall further, risking a vicious cycle that puts more homeowners under water, accelerating foreclosures and distress sales and driving prices lower still. During the recession, only an unprecedented monetary and fiscal policy response short-circuited that cycle.[i]

In light of the risks, policymakers should consider additional temporary help for housing. Once expectations for home prices turn positive, the foreclosure crisis will abate quickly and the recovery will gain traction. Given that house prices in many parts of the country are already low relative to incomes and effective rents, it wouldn't take much additional effort to accomplish this. The key is to reduce the number of properties in delinquency or foreclosure before they reach the market as distress sales. House prices will rise significantly once the distressed share of home sales declines definitively.

Moving more properties out of the foreclosure pipeline before they go to distress sales would reduce the downward pressure on home values. A key to doing this is to get private investors and property managers involved in converting distressed properties to rentals. Investors show a healthy interest in doing this, attracted by the combination of low purchase prices and sharply rising rents. Most investors are not house-flippers looking for quick profits—considering the state of the housing market, this wouldn't be a winning strategy—but have investment horizons of three to seven years. Such investors will likely be willing to rent properties purchased from Fannie Mae, Freddie Mac, and the Federal Housing Administration for at least several years, selling them after house prices begin to rise again.

Facilitating more loan modifications, including those involving principal reduction, would be a much larger and costlier step but would bring the housing downturn to a quicker and more definite end. Principal write-downs have economic positives and negatives, but are a net positive if well designed. The main concerns are moral hazard and fairness. To deal with these, modifications must be well targeted, with clearly articulated eligibility requirements. A long vesting period and some type of clawback provision for future capital gains to guard against potential fraud would also be helpful. The number of modifications and the amount of principal reduction necessary to stabilize house prices can be reasonably financed with funds from the recent mortgage settlement and the president's proposals to expand Home Affordable Modification Program, or HAMP.

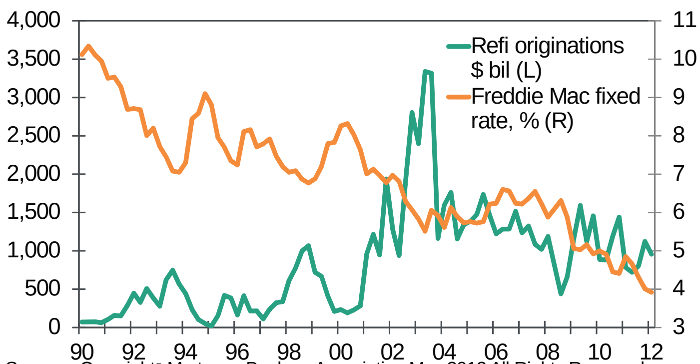
Arguably the most straightforward policy step would be to provide further support to mortgage refinancing. Despite record low mortgage rates, many homeowners continue to have difficulty refinancing. Recent changes to the Home Affordable Refinance Program appear to be helping more of these households, but policymakers can take further steps to encourage refinancing. Legislation being considered by Congress, including the Responsible Homeowner Refinancing Act, the Expanding Refinancing Opportunities Act, and the Rebuilding Equity Act, would be very helpful in this regard. More refinancing will mean fewer borrower defaults and more money in the pockets of homeowners, supporting the recovery through a quick and sizable cash infusion at no meaningful cost to taxpayers.

More mortgage refinancing

Policymakers should act to substantially increase mortgage refinancing activity.[ii] This is a propitious time for homeowners to refinance, as mortgage rates have fallen to record lows. The 30-year fixed mortgage rate for prime borrowers is currently below 4% and likely to remain low for some time in light of the Federal Reserve's stated resolve to keep interest rates modest for several years. The central bank is also keeping open the possibility of additional quantitative easing, which would likely include more purchases of mortgage-backed securities by the Fed.

Despite record low borrowing costs, refinancing has been disappointingly slow. In 2003, when fixed mortgage rates were between 5.5% and 6%, home loans were being refinanced at an annualized rate of more than $4 trillion. The current level is about one-fourth of that (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, some two-thirds of all outstanding mortgages carry coupons above 5%. Millions more U.S. homeowners should be refinancing, significantly cutting their monthly payments. This would be a boost both for individual household finances and for the economic recovery.

Chart 1: Rates Plunge, Refis Putter…



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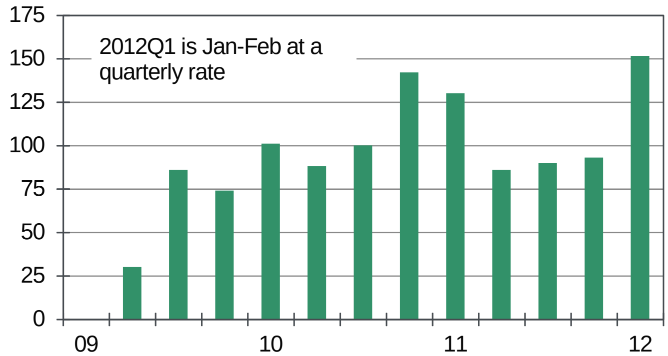
The Obama administration has worked since the introduction of the Home Affordable Refinance Program in mid-2009 to encourage refinancing among homeowners with little or negative equity whose loans are insured or owned by Fannie Mae and Freddie Mac. Originally, the administration said HARP would allow between 4 million and 5 million homeowners to reduce their interest rates to market levels. But so far, only about 1.2 million homeowners have refinanced using HARP, and just more than 100,000 underwater homeowners have refinanced.[iii]

The disappointing results prompted the administration to make a number of important changes to HARP late in 2011. These included relaxing eligibility requirements, allowing loan-to-value ratios higher than 125%, streamlining the appraisal and underwriting process, persuading mortgage insurers to drop recession rights, and requiring Fannie and Freddie to relax their reps and warranties. It has taken a few months for mortgage servicers and insurers to implement the new HARP rules, but the benefits have become evident.[iv] HARP refinancings in early 2012 appear to have run close to 50,000 per month, up from 30,000 per month since the program's inception (see Chart 2). Also encouraging has been a more recent pickup in applications for refinancing as reported by the Mortgage Bankers Association. Mortgage servicers appear to be particularly enthusiastic about the possibility of reducing their put-back risk.[v]

Chart 2: …But HARP Refis Are Picking Up…

Ths of HARP refinancings



Sources: FHFA, Moody's Analytics

In February 2012, the administration proposed even more aggressive steps to support refinancing, affecting all mortgage loans including those insured by Fannie, Freddie, the FHA and nongovernment lenders.[vi] Congress is working to implement these proposals in legislation being considered, including the Responsible Homeowner Refinancing Act, the Expanding Refinancing Opportunities Act, and the Rebuilding Equity Act.[vii] With a few changes, this legislation should be enacted. If passed quickly, it should meaningfully boost refinancing, speeding the recovery in housing and the broader economy.

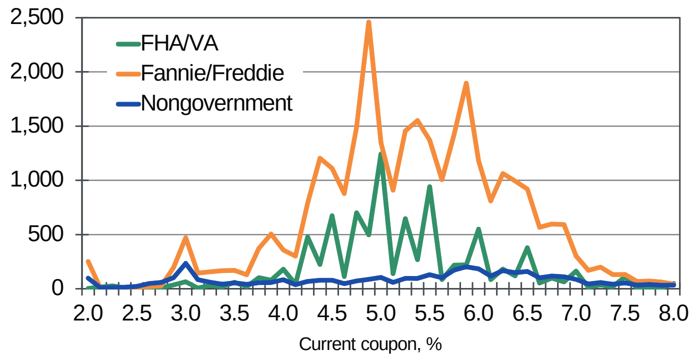
For Fannie and Freddie loans, the Responsible Homeowners Act would apply the new HARP rules to all loans, not just those with loan-to-value ratios higher than 80%, as is now the case. For nongovernment loans, the Expanding Refinancing Opportunities Act would allow servicers to refinance into FHA loans. The FHA would drop these refinanced loans from its "compare ratio" process by which the performance of lenders is assessed (analogous to Fannie and Freddie's reps and warranties). The Rebuilding Equity Act would require the government-sponsored enterprises to pay closing costs when homeowners agree to loans of 20 years or less with monthly payments equal to those on their current loans. This would allow homeowners to build equity more quickly.

This legislation would substantially increase the pool of homeowners eligible to refinance and remove impediments to more refinancing. Significantly reducing the put-back risk faced by lenders on refinanced loans would encourage lenders to aggressively compete for refinancing business. Lowering borrowers' closing costs would increase the incentive for them to participate as well.

If fully implemented, this legislation would increase the number of homeowners eligible to refinance and "in the money" to nearly 21.5 million, covering almost half of all loans outstanding (see Chart 3).[viii] Of these loans, 18 million are Fannie or Freddie loans and the remaining 3.5 million are nongovernment loans. The legislation could potential benefit mortgage loans on owner-occupied single family homes with a current mortgage rate above 5% and which have been current over the past six months. For non government loans to qualify for the expanding Refinancing Opportunities Act, borrowers would have to have been no more than one month past due in the prior 12 months, be within the conforming loan limits, and have a credit score above 580. There would be no restriction on when the loans were originated, unlike HARP's current limitation to loans originated before mid-2009.

Chart 3: …And Prospects for More Are Good

First mortgage loans outstanding by coupon, ths



Sources: McDash, LPS, Moody's Analytics

For all this, many homeowners would still not refinance. Yet under reasonable assumptions—including that the legislation is implemented by the fourth quarter of this year and that mortgage rates remain near their current 4% through the end of 2013 and rise gradually after that—we estimate that the legislation would result in 4.2 million more refinancings. That comprises 2.9 million Fannie/Freddie borrowers and 1.3 million nongovernment borrowers.

Economic benefits

The benefit to borrowers will be meaningful. Assuming the average homeowner can refinance into a 4% fixed-rate, 30-year mortgage loan, the interest saving would exceed $2,500 a year. Collectively, borrowers' mortgage payments would decrease by more than $10 billion a year (4.2 million borrowers x $140,000 average mortgage balance x 1.8%

average rate reduction). This would provide a quick cash boost for mostly middle-income homeowners. Some of the money saved would be used to repay other debt, but the bulk would likely be spent on home improvements or other needs. This would provide only a small boost to overall economic growth, but the U.S. recovery can use all the help it can get.

More refinancing would also further the Federal Reserve's short-term monetary policy goals. Monetary policymakers are considering a new round of quantitative easing—a process in which the Fed purchases long-term securities in an effort to bring down interest rates, including fixed mortgage rates. Indeed, the recent decline in mortgage rates is due in part to expectations that the Fed will resume quantitative easing. If it does, arguably the most significant benefit would involve increasing the pace of home-loan refinancing. Anything fiscal policymakers can do to support the Fed's efforts would be a plus.

Taxpayer costs

There should be no cost to taxpayers for the additional Fannie and Freddie refinancing. While the agencies would lose some interest income on their $1.2 trillion in mortgage securities and whole mortgage loans, under reasonable assumptions that would be offset by lower default rates on refinanced loans. Borrowers are more likely to stay current if their monthly payments drop by $100 or $200. Indeed, under reasonable assumptions, 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.[ix]

As the FHA refinances loans of nongovernment borrowers, it will take on added credit risk.[x] Given the FHA's fragile finances, this cost should be paid for. A reasonable way to do that would be a one-year extension of the higher guarantee fees currently being paid by the GSEs to fund this year's payroll tax holiday. Policymakers should limit any additional increase in guarantee fees solely to support the housing and mortgage markets. It also makes sense to create a separate FHA fund for this purpose, independent of the FHA's Mutual Mortgage Insurance Fund.

The closing costs associated with refinancing into shorter-maturity mortgages to accelerate the building of homeowners' equity should be very modest and borne by the GSEs. The costs will depend on the take-up by homeowners, but under most assumptions the cost to taxpayers via the GSEs should be in the hundreds of millions, and not billions of dollars.

Economic costs

While homeowners would clearly benefit from more refinancing 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

4.2 million more refinancings, private investors would receive approximately $6.5 billion less in annual interest income.[xi]

MBS investments are held by a wide array of institutions. Through its credit easing efforts last year, the Fed quickly became the largest owner of agency MBS, amassing $1.25 trillion, or about a fourth of the total outstanding. The nation's central bank can easily absorb the lost interest income from increased prepayments, but this may put pressure on the Fed to be more aggressive in its quantitative easing efforts to forestall a counterproductive rise 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.

Although other private MBS investors won't be happy to get their money back when interest rates are low, they were aware of this prepayment risk when they purchased their securities. Indeed, investors are likely surprised that their securities have not been retired already, as they would have been in a more normally functioning mortgage market. The updated HARP can thus be seen as a way to correct a serious market failure. It is also important 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 of agency MBS during a previous round of quantitative easing was a windfall. Myriad federal policies aiming to stem foreclosures have also significantly benefited investors through reduced prepayments.

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

Another potentially unwelcome side effect from more refinancing today could be less labor mobility in the future. Borrowers who lock in record low mortgage rates now will be less willing to move when rates start to climb. Considering that homeowners are more likely to be skilled workers than are 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 benefit of a refinancing program. It is also worth noting that homeowners who switch from adjustable-rate to fixed-rate mortgages will be protected when interest rates ultimately rise.

Suggestions

The Responsible Homeowner Refinancing Act should drop monetary penalties on second lien holders and mortgage insurance companies for nonparticipation. The largest mortgage servicers have agreed to subordinate their second liens on mortgages refinanced via the HARP program, and mortgage insurers, except for United Guaranty, have agreed to give up their rescission rights on HARP refinancings. Indications are that second lien holders and MI companies are not a meaningful impediment to more HARP refinancing activity.

Policymakers may also want to consider adding a provision in the Responsible Homeowner Refinancing Act requiring the GSEs to provide timely information regarding approval rates for streamlined refinancing via the automated tools provided by the GSEs to servicers. There is some concern that cross-servicer refinancing is being impeded by low approval rates, and this information would be useful in determining whether this is a significant problem.

The still-fragile housing market remains a serious threat to the economic recovery. Home sales and housing construction are off bottom, but remain at exceptionally low levels, while house prices are still falling in many parts of the country. Millions of families have lost homes, and millions more are likely to follow them, given the unprecedented number of loans in or likely to soon enter the foreclosure pipeline.[xii] It is hard to be enthusiastic about the U.S. economy's prospects as long as housing is weak. One of the most effective and straightforward policy steps to ensure that the housing market gets back on track is to facilitate more mortgage refinancing. The legislation currently before Congress to support more refinancing activity would be very helpful to this end.

[i] An estimated 14.1 million homeowners are under water, 6.2 million by more than 30%.

[ii] Calls for policymakers to enable mortgage refinancing have steadily increased since late 2010. See Mark Zandi and Cristian DeRitis, "Restringing HARP: The Case for More Refinancing Now," Moody's Analytics Special Report, October 7, 2010. http://www.economy.com/mark-zandi/documents/HARP_100710.pdf

[iii] The FHFA tracks HARP refinancing activity on a monthly basis. The most recent data are available at http://www.fhfa.gov/webfiles/23906/Feb2012ForeclosurePrevention.pdf

[iv] See Mark Zandi and Cristian DeRitis, "Improved HARP Will Expand Refinancing and Boost Recovery,". Moody's Analytics Special Report, October 31, 2011. http://www.economy.com/mark-zandi/documents/2011-10-26-Zandi-Improved-HARP-Will-Expand-Refinancing-Boost-Recovery.pdf

[v] Put-back risk is the chance that Fannie and Freddie will require the servicer to take back a loan that was improperly originated. There is also a risk that mortgage insurers will rescind insurance on a poorly underwritten loan. The cost to servicers of having loans put back has been considerable.

[vi] A fact sheet describing the president's housing plan can be found at http://www.whitehouse.gov/the-press-office/2012/02/01/fact-sheet-president-obama-s-plan-help-responsible-homeowners-and-heal-h

[vii] Recent versions of this legislation can be found at: http://www.opencongress.org/bill/112-s3085/text ; http://www.feinstein.senate.gov/public/index.cfm/files/serve/?File_id=7c86b21c-6466-4684-b8ab-543c76d23ff3&SK=12CACF0005BFD88B9D24F3FC7528118F ; http://www.gpo.gov/fdsys/pkg/BILLS-112s2909is/pdf/BILLS-112s2909is.pdf

[viii] This is based on an analysis conducted by LPS using the McDash servicing database and the LPS-AA HPI.

[ix] 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 loss from default, which is assumed to be 50% of the mortgage balance.

[x] The credit risk associated with refinancings these homeowners may be relatively low. These homeowners have been paying on their mortgages in a timely way despite the tough economy, their lack of equity, and their inability to refinance.

[xi] This excludes the interest income that would be lost by Fannie, Freddie, and the Federal Reserve.

[xii] More than 5 million U.S. homeowners are believed to have lost homes through foreclosures, short sales, or deeds-in-lieu since the housing crash began in 2006. Another nearly 5 million more homeowners are expected to lose homes before foreclosures return to levels consistent with a well-functioning housing market, which we expect to happen in 2015.