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The Responsible Homeowner Refinancing Act
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Christopher Papagianis is Managing Director of e21: Economic Policies for the 21st Century. e21 (also known as Economics21) is a nonprofit, nonpartisan organization dedicated to economic research and innovative public policy development. Mr. Papagianis was previously Special Assistant for Domestic Policy to President George W. Bush. In this role, he guided the collaborative process within the Executive Branch to develop and implement policies, legislation, and regulations across numerous agencies, including the Departments of Treasury and Housing and Urban Development. He was responsible for briefing the President directly on housing and finance issues. Prior to joining the administration, Mr. Papagianis worked in the U.S. Senate as one of the top policy advisers to Senator Jim Talent. Before serving in the U.S. government, Mr. Papagianis was awarded the prestigious Peabody Fellowship by Harvard University to pursue public policy research. Mr. Papagianis is also a graduate of Harvard College.

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify at this legislative hearing on "The Responsible Homeowner Refinancing Act of 2012." I am the Managing Director of the non-profit think tank e21: Economic Policies for the 21st Century (also known as Economics21). We aim to advance free enterprise, fiscal discipline, economic growth, and the rule of law. Drawing on the expertise of practitioners, policymakers, and academics, part of our mission is to foster a spirited debate about the way forward for democratic capitalism. We are supportive of free markets while recognizing the need to devise and implement a reasonable structure of law and regulation that will help ensure our markets avoid catastrophic events in the future. We are therefore focused on developing policies that advance market performance and implementing rules to prevent market malfunction.

Previously, I was Special Assistant for Domestic Policy to President George W. Bush over the last few years of his Administration. In this role, I helped guide the collaborative process within the Executive Branch to develop and implement policies, legislation, and regulations across numerous agencies, including the Departments of Treasury and Housing and Urban Development.

Today, I will focus on the following themes and provisions:

1. **Reflections on the "evolving" housing market – supply and demand dynamics.**
2. **Micro-policy uncertainty (servicing, underwriting, and GSE reform).**
3. **The Responsible Homeowner Refinancing Act – Overview.**
4. **Realistic expectations for "more" refinancing – HARP 2.0 to 3.0.**
5. **Expanding the initial objective of HARP.**
6. **Addressing representation and warranty issues (i.e. putback risk).**
7. **Loan Level Pricing Adjustments and other fees.**
8. **Mortgage insurance and second liens.**
9. **Moving the cut-off date and "re-Harping" loans.**
10. **Efforts to increase homeowner awareness of HARP.**

1. Reflections on the "evolving" housing market – supply and demand dynamics.

Six years have passed since aggregate house prices started to decline. Yet, the housing market remains weak and any looming rebound in 2012 or 2013 is uncertain.

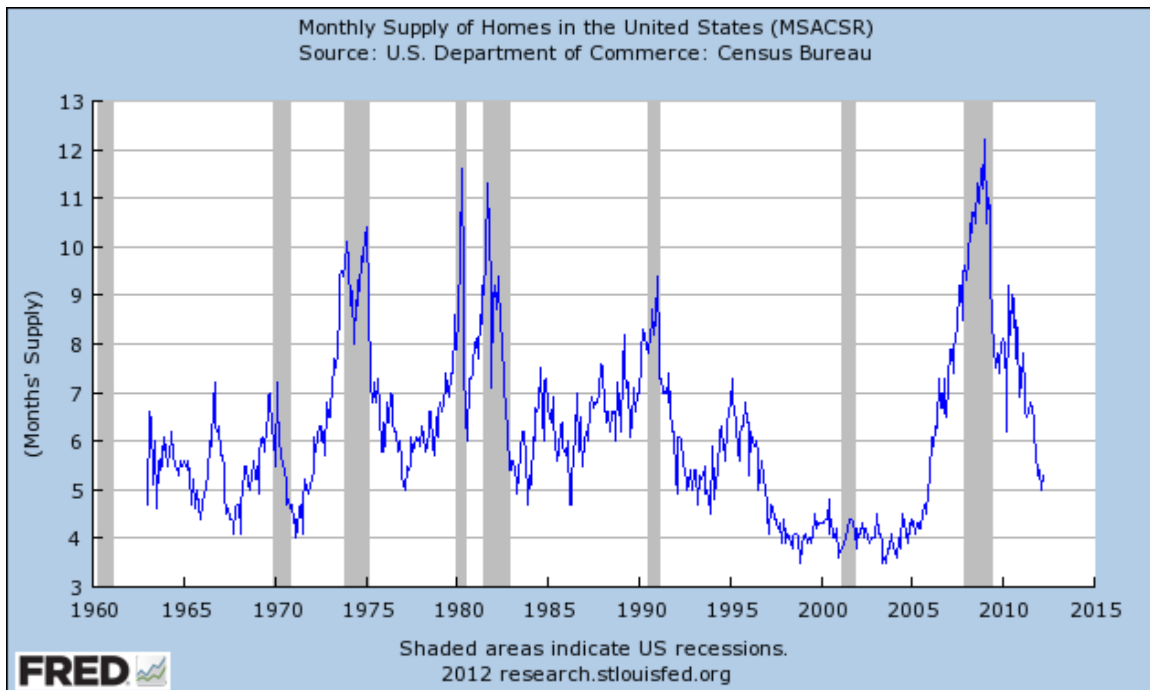
Over the last few years, house prices have been under tremendous downside pressure. Distressed sales from foreclosures and the shadow inventory have been large contributing factors. Broader economic forces have also been at work, including high levels of unemployment, stagnant income or wage growth, and negative wealth effects from the decline in home equity.

Without a doubt, there is still a great deal of stress across both the demand and supply dimensions of the housing market, as demonstrated by the thousands of borrowers that are still struggling to make their payments and stay in their homes.

However, it's important to acknowledge that many of the major negative trends that have dominated the headlines since the crisis are now well off their post-crisis peaks. New delinquencies are trending lower on a percentage basis.[1] The decline in home prices also appears to be leveling off or approaching a bottom on a national basis. While prices are only flat to slightly down year-over-year, there is finally some optimism in this area for probably the first time in more than three years. Data from CoreLogic suggests that house prices have increased, on average, across the country over the first three months of 2012 when excluding distressed sales.[2]

A somewhat under-reported development in the market is the relative decline in the supply of homes for sale.[3] The chart below shows how the existing stock of homes for sale is now approaching a level equal to 5-6 months of sales.[4] This is a very promising development. According to the Commerce Department, the housing inventory fell to just over 5 months of sales in the first quarter, the lowest level since the end of 2005 (see the chart on the following page).

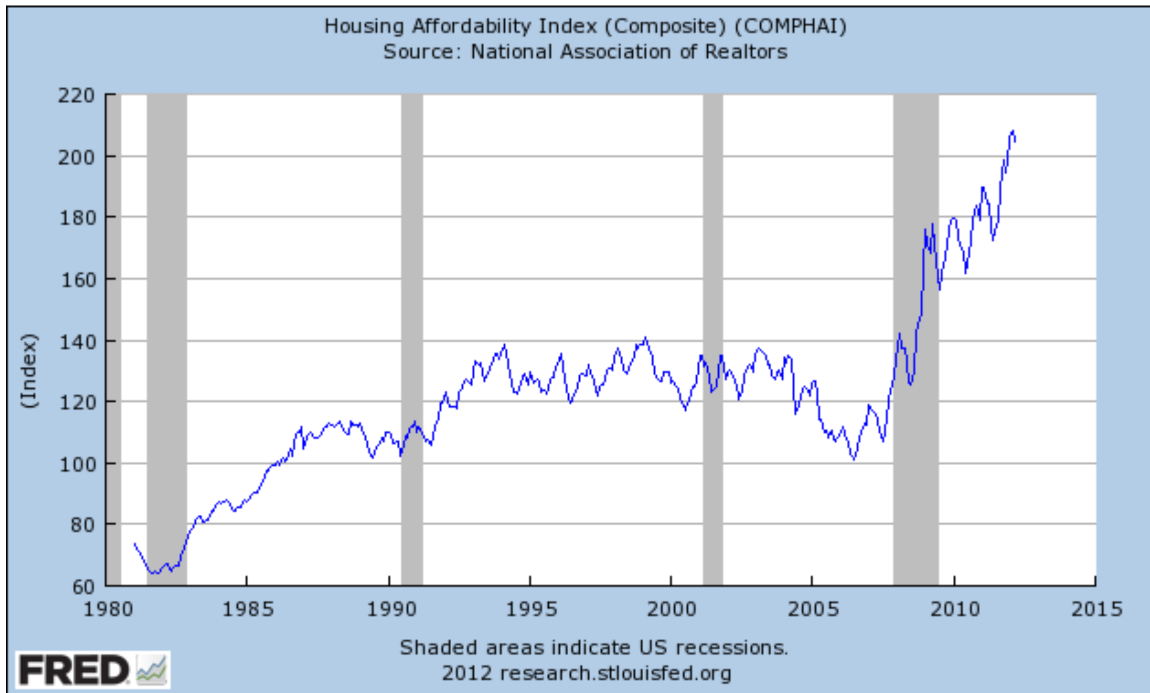
[1] http://www.lpsvcs.com/LPSCorporateInformation/NewsRoom/Pages/20120424.aspx
[2] http://www.corelogic.com/about-us/news/corelogic-march-home-price-index-shows-slight-year-over-year-decrease-of-less-than-one-percent.aspx and http://www.calculatedriskblog.com/2012/05/corelogic-house-price-index-increases.html
[3] http://online.wsj.com/article/SB10001424052702304723304577366294046658820.html



In short, the level of housing supply today suggests that the market is close to equilibrium, which implies house prices should rise at a rate consistent with rents. Market analysts often look at a level above or below six months of sales as either favoring buyers or sellers respectively. It's not surprising then that the recent stabilization of home prices nationally has occurred as the existing inventory, or supply level, has declined.

A couple of important caveats should be kept in mind, however. First, almost any discussion of national inventory trends can gloss over regional problems, or acute supply challenges in individual state markets. Second, the transaction data around home sales suggests that any near-term demand-supply equilibrium is occurring off of an extremely low base. In essence, weak demand for single-family homes appears to have eclipsed the supply challenge moving forward for the housing market.

Consider that the National Association of Realtors Home Affordability Index is at its highest level in decades.



The Realtor's index measures the "affordability" of a median-income family purchasing a median-priced home (using a 20% downpayment for a 30-year fixed rate mortgage). All of which is to say that house prices look low on a historical, user-cost basis.

So, this begs the question – why are existing home sales still so depressed? After all, the Mortgage Bankers Association has reported that their index for purchase activity is at an approximately 15-year low.

One of the major impediments to a rebound in demand for housing is tight lending or underwriting standards. Earlier this month, Federal Reserve Chairman Bernanke commented on this trend by reviewing information from the latest Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS):

> To be sure, a return to pre-crisis lending standards for residential mortgages wouldn't be appropriate; however, current standards may be limiting or preventing lending to many creditworthy borrowers. For instance, in the April SLOOS, we asked banks a hypothetical question about their willingness to originate GSE-eligible mortgages relative to 2006 for borrowers with a range of credit scores and available down payments. The SLOOS found that even when the loans were accompanied by a 20 percent down payment, many banks were less likely to originate loans to borrowers with given GSE-eligible credit scores, despite the originating bank's ability to sell the mortgage to the GSEs. Most

> banks indicated that their reluctance to accept mortgage applications from borrowers with less-than-perfect records is related to "putback risk"— the risk that a bank might be forced to buy back a defaulted loan if the underwriting or documentation was judged deficient in some way.[5]

Other analysts have presented evidence before this committee on how credit availability remains tight, including Laurie Goodman of Amherst Securities.[6] Federal Reserve Governor Elizabeth Duke also gave a speech earlier this month on this theme, providing yet even more detail on the conclusions from the April SLOOS:

- Compared with 2006, lenders are less likely to originate GSE-backed loans when credit scores are below 620 regardless of whether the downpayment was 20% or not.

- Lenders reported a decline in credit availability for all risk-profile buckets except those with FICO scores over 720 and high downpayments.

When the lenders were asked why they were now less likely to offer these loans:

- More than 84% of respondents who said they would be less likely to originate a GSE-eligible mortgage cited the difficulty obtaining mortgage insurance as factor.

- More than 60% of lenders pointed to the risks of higher servicing costs associated with delinquent loans or that the GSEs might require them to repurchase loans (i.e. putback risk).[7]

Another important market development to acknowledge is that lenders are capacity constrained today. Anecdotal evidence suggests that some lenders are simply struggling to keep up with processing loan applications. Part of the problem appears to be the structural shift in the market towards full and verified documentation of income and assets, which has lengthened the processing time for mortgage applications.

But if lenders and servicers don't have enough capacity, why are they not just hiring more staff or upgrading their infrastructure so they can handle more loans or business? This seemingly innocent question is really important. Don't market participants still perceive this business as profitable over the medium to long-term with a comparatively good return on investment when viewed against other business lines?

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[5] http://www.federalreserve.gov/newsevents/speech/bernanke20120510a.htm

[6] Goodman: "In reaction to the extremely sloppy underwriting standards prevailing in the 2005–2007 period, the GSEs and bank originators have dramatically tightened origination standards. The average GSE origination for 2009–2011 has a 762 FICO, and a 68 LTV. The average bank portfolio loan has a 756 FICO, 67 LTV." See: http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=0f96e0ff-8500-41a5-a0f2-0139d0df2e07

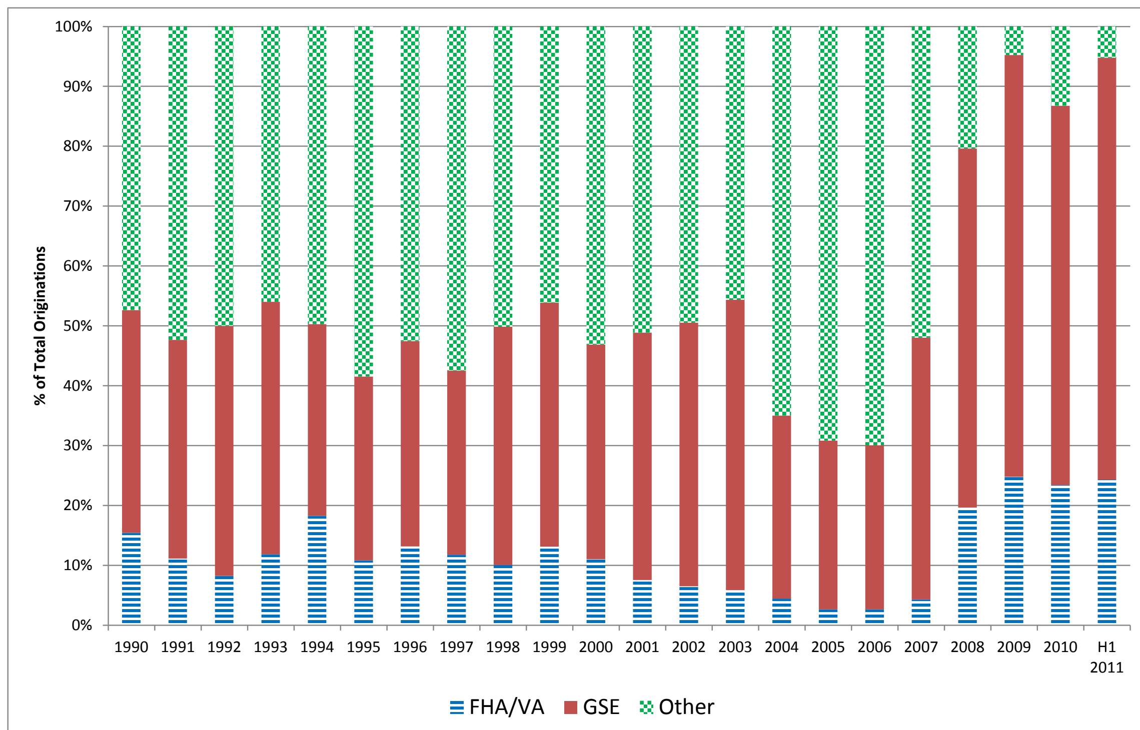
[7] http://www.federalreserve.gov/boarddocs/snloansurvey/201205/fullreport.pdf

Like Governor Duke, I believe that lenders or servicers are hesitating to make these investments in the near-term because they just don't have a good sense of how profitable the housing-finance and servicing business will be over the medium-to-long term.

2. "Micro-policy uncertainty.

Over the past few years, many analysts have held out the "uncertain" macroeconomic outlook as a key reason why business investment remains depressed generally and the labor market continues to be weak. The connection or ripple effects to underperforming sectors of the economy is fairly straightforward. For example, a liquidity shock like a job loss is one of the key triggers for mortgage delinquencies and it's reasonable to expect lenders to remain flexible, or on the sidelines and not "fully" invested, until the labor market improves.

That said, there is perhaps no other major industry that faces more micro-policy uncertainty than housing today. And, it's important to remember that basically all loans made today do not involve lenders actually assuming any of the credit risk in the event that a borrower defaults on their mortgage.[8] The following chart from CBO reviews mortgage originations by the entity that bears the underlying credit risk.[9]



[8] There is some private mortgage insurance – but the broader point still holds.

[9] Source data is from Inside Mortgage Finance. CBO Working Paper: An Evaluation of Large-Scale Mortgage Refinancing Programs. September 2011.

If lenders are capacity constrained but are not even helping to originate mortgages that have them *not* taking on new credit risk, the implication is that there are probably other discrete micro-policy uncertainties that are holding back a broader recovery in housing, including the legal risk that mortgages are transferred back to the originator (along with the underlying credit risk). I group these micro-policy risks into three buckets: servicing, underwriting, and GSE reform.

A. Uncertainty within Servicing.

- The Consumer Financial Protection Bureau (CFPB) recently announced that it plans to propose new industry-wide servicing rules for all mortgages. The end result could certainly be a positive for all stakeholders over the long-term, but there is a lot of uncertainty about how this will impact the cost-structure of servicing in the future. In turn, this may be a factor in servicers delaying the decision to make new investments in their servicing infrastructure.

- FHFA has a pending initiative to change the way that servicers are compensated by the GSEs. Many industry stakeholders believe that this new compensation regime could quickly become the de facto industry standard, even for non-GSE loans. As servicers discovered during the crisis, they were not charging sufficient fees to cover the costs associated with large-scale modifications, which require a much more robust infrastructure.

- The Basel process has changed the capital treatment of the asset known as "mortgage servicing rights" (MSR), which in essence is the expected cash-flow or revenue that servicers expect to earn off a book of mortgages. In short, the implementation of the new Basel rules is set to limit how MSRs can be counted as regulatory capital. This means that banks or lenders may seek to sell or shrink their servicing business since MSRs will not have the same capital management advantages.[10]

B. Underwriting requirements and securitization.

- The Dodd-Frank Act directed regulators to set requirements that ensure a borrower has the ability to repay a mortgage (also known as “qualified mortgage” or QM) and to establish the definition for a “qualified residential mortgage” or QRM, which is the subset of QM that would not be subject to risk retention requirements.

[10] From the April SLOOS: 38.6% of banks mentioned new MSR capital treatment as a factor. This process could also impact perceptions of whether MSRs should be considered “tangible” book value for extra-regulatory capital assessments performed by analysts as part of their valuations.

C. GSE reform and the future of mortgage finance.

- By the end of 2012, more than four years will have passed since Fannie Mae and Freddie Mac were put into conservatorship. The Dodd-Frank law was enacted in 2010, but didn't address the two failed enterprises. It's key for the government to announce a clear framework and timetable so homebuyers, sellers, and suppliers of capital can adjust and make plans for the future.[11] The counterargument that today's fragile housing market should be left alone to heal is no longer sustainable. Congressional inaction still represents a choice, albeit one that assumes that the current degree of uncertainty around the future model of mortgage finance in this country is not holding back a housing recovery. Schedule and speed are two discrete issues.[12] Congress could establish a framework but then set a deliberate transition schedule that would allow for monitoring market conditions.

- GSE reform is also increasingly connected to the housing-demand problem. Rather than having the government (through Fannie, Freddie, and FHA) so comprehensively involved in setting mortgage underwriting standards, it would be better for the private sector to take on the risk and rewards of credit decisions. While the temptation for public officials to involve themselves in the details of credit standards is logical given the current conservatorship arrangement, it's important to take a step back and at least question whether this trend is at least partly responsible for the lack of private sector interest in the space.

All of these elements affect the cost structure and opportunity cost associated with mortgage lending, which of course factors into the relative appeal of the mortgage finance and servicing business. They also impact the future of house prices, as credit terms and availability are intimately linked to the user-cost of housing.

The urgency to resolve all of this uncertainty is all the more important because while there are clear short-term impacts on the market, there are also potential long-term consequences. For example, if lenders decide to hold off on making new near-term investments in their mortgage business, the long-term potential of a full rebound in housing may be diminished as the existing or legacy infrastructure and skills can be expected to atrophy further.

Mortgage servicers are not in business to lose money. Moreover, the total volume of societal resources devoted to performing this function – employees, investment in computers and telecommunications infrastructure, legal compliance officers, sales staff – is not static. It adjusts upwards and downwards based on perceived opportunities,

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[11] http://www.bloomberg.com/news/2012-01-23/put-fannie-and-freddie-on-federal-books-papagianis-and-swagel.html
[12] http://dailycaller.com/2011/11/10/time-to-end-the-taxpayer-guarantee-of-mortgage-investors/

expected future revenues, and government involvement. Today, it is clear that investments that could be made are not because of concerns that regulations will impose cost burdens on the industry that cannot be recovered through servicing fees or other revenue streams that may look like "hidden charges" to regulators. At the same time, no one really knows who the ultimate purchasers of mortgages are likely to be five years from now. Since the ultimate holders of mortgages – currently the GSEs – are the servicers' client base, the current lack of clarity on who or what is likely to fund mortgages in the future has obvious ripple effects on servicers and all other professions exposed to mortgage finance.

A similar phenomenon is casting a shadow over the mortgage insurance industry. The difficulties in obtaining mortgage insurance are constraining lenders from selling to Fannie and Freddie, even if they have found buyers and are willing to originate the loans. Several mortgage insurance companies have failed in recent years, others are no longer offering insurance on a forward-looking basis and are just managing their existing exposures.

While I believe this backdrop is crucial to understanding the challenges that face the housing market moving forward, I don't want my comments to be interpreted as precluding any new legislative or regulatory action that is aimed at addressing a near-term friction in the market.

My view is simply that resolving the aforementioned uncertainty holds by far the greatest potential, on a comparative basis, for positively and responsibly impacting the housing market moving forward.

3. Overview – The Responsible Homeowner Refinancing Act.

The expansion of HARP (2.0) announced in October 2011 and fully implemented in March, along with the additional expansion contemplated under Menendez-Boxer, is meant to both reduce foreclosures (by improving affordability) and provide a stimulative boost to the economy. This stimulus effect would come from increased spending by borrowers who would have more money as a result of having to make lower monthly mortgage payments as a result of a refinancing.

I agree with the comments from Professor Phillip Swagel before this committee earlier this year that these types of refinancing efforts are analogous to the stimulus plans that would send a monthly check to qualifying households.[13] My view is informed by the fact that the previous HARP expansion, and the one being contemplated today, would be limited to borrowers who have been in their homes for at least three years and have made all of their payments on-time over the preceding year (with an allowance for one

[13] http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=b56a771b-99a0-46ae-ad6b-ea7437c8a83d

30-day late payment in the previous 6 months).

In short, HARP expansions are aimed at borrowers who have kept up on their payments despite a very challenging economic environment. While each additional HARP participant will receive a benefit that will help them on the margin, the broader point here is that the targeted population is not particularly “at-risk” of foreclosure on a comparative basis.

Approaching the issue from the other side, the households most in need of relief are also precisely the borrowers most likely to increase the credit risk exposure of the GSEs (on net). It’s this conclusion that leaves stimulus as the main driver of the refinancing program – not foreclosure prevention.

4. Realistic expectations for “more” refinancing – HARP 2.0 to 3.0.

When HARP was first established in 2009, the Obama Administration projected that 4-5 million people would be helped. Before HARP 2.0 really took effect in March 2012, the program had helped approximately 1.1 million borrowers refinance.[14]

It is still way too early to project with any real confidence how many additional people will be helped as a result of the HARP 2.0 expansion. Putting aside the challenge of properly categorizing beneficiaries as having only been able to participate as a result of the programmatic changes rolled out in March (versus 1.0), the recent spike in HARP applications suggests that HARP 1.0/2.0 could see a significant jump in take-up or participation.

Secretary Donovan commented to this committee earlier this month that servicers have already started processing applications from nearly a half-million families. FHFA Director DeMarco estimated that by the end of 2013, HARP refinancings could double from their current level.[15]

Let me encourage this committee to request specific data on these applications and projections to learn more about how lenders and borrowers are responding to HARP 2.0. In fact, its hard to recommend that policymakers move forward with additional changes to HARP without first reviewing this new data. After all, I’m not aware of any official presentation on how HARP 2.0 will impact total take-up for the program.

This exercise could also go along way towards narrowing the enormous range for potential take-up estimates that analysts are using for this HARP 3.0 proposal. Against this fluid backdrop around projections, I would also recommend that proponents of this bill remain cautious about setting unrealistic expectations with regards to the number of incremental borrowers that would be helped under a further HARP expansion.

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[14] http://www.fhfa.gov/webfiles/23906/Feb2012ForeclosurePrevention.pdf
[15] http://www.fhfa.gov/webfiles/22723/HARP%20release%20102411QandA%20Final.pdf

For example, many commentators over the past few weeks have conflated the take-up projections from some of Professor Chris Mayer's plans in this area.[16] But an important distinction is that the Menendez-Boxer bill would keep in place the current delinquency standard for determining borrower eligibility. Under the version of Professor Mayer's plan that has received the most attention, borrowers would only need to have made their last three payments on-time in order to qualify whereas Menendez-Boxer would keep the requirement that borrowers must be current on their mortgage over the previous year (with one 30-day late payment allowed over the previous 6 months). It's reasonable to conclude that this difference would have a fairly dramatic effect on projected take-up, which means the Menendez-Boxer bill would likely fall considerably short of the projections that Professor Mayer has advanced.

Properly calibrating take-up expectations is especially important given the poor track record of practically all of the major modification and refinance programs that have been launched to-date. The committee should request, if it has not already, a detailed take-up projection from both FHFA and CBO that specifically takes into account the trajectory for HARP 2.0 refinancings and then describes the incremental take-up that would be achieved by each of the provisions in the Menendez bill. To not ask for and then review this information would open up this committee to repeating some of the more common errors that have occurred since the crisis around appropriately managing expectations.

5. Expanding the initial objective of HARP.

This HARP 3.0 proposal can be considered across two dimensions with regards to take-up and eligibility. First, what can or should be done to further increase the penetration of HARP – or the original pool of borrowers that were targeted. Second, should the scope of the HARP program get adjusted – to pull in new borrowers that would not have been eligible previously. My view is that the merits or case for the second objective is much more limited than the first.

For example, expanding the HARP program to help more borrowers that are not underwater, particularly those with more than 20% equity in their homes, will likely end up only "counting" borrowers who could have refinanced without the additional programmatic flexibility. The GSEs already have other streamlined refinancing programs for these borrowers.

If the committee is set on blurring the line or the original intention of the HARP program with regards to borrowers with more than 20% equity, one idea to consider would be a combined loan-to-value ratio (CLTV), which could help target the additional programmatic flexibility to those borrowers who are underwater (when home equity

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[16] http://www4.gsb.columbia.edu/null/download?&exclusive=filemgr.download&file_id=739308

lines of credit or second liens are factored in to the equation). Consideration could also be given to further limits on the “cash out” allowance for borrowers who pursue a HARP refinancing. While the current allowance may help boost or incent borrower participation, it’s questionable whether extracting any additional equity in the form of cash should be encouraged right now.

6. Addressing representation and warranty issues (i.e. putback risk).

The current system of relying on representations and warranties to help ensure quality originations should probably be revisited on a wholesale basis. Right now, lenders are concerned not only about assuming new putback risk when they refinance another lender’s original mortgage, but also that some of their own new originations may eventually default and then add to their overall putback exposure. Devising a system that verifies loan origination quality before an eventual default triggers a review of representations and warranties violations should be a common objective for all market participants.

In the near-term, it’s important to acknowledge that FHFA has already made a lot of progress with regards to rep and warranty issues as it relates to HARP. The Menendez-Boxer bill attempts to wash away the remaining rep and warranty concerns so that lenders or servicers compete more for refinancing business – without having to consider whether they are assuming more putback risk in aggregate. The mission here appears to be to lower the prices or premiums that lenders are charging HARP borrowers compared with regular refinancings.[17]

I am not opposed to this action, but I do have concerns that the expected competitive benefits may not materialize. It is still very possible, if not likely, that the lenders competing for new refinancing business will still charge a premium to take on the new underwater borrower since it is generally more expensive to service these borrowers over the long-term given that they face a higher incidence or probability of delinquency. FHFA also indicated in a letter to Sen. Boxer (dated May 17th) that the data “clearly demonstrate that the rates for HARP loans are similar to those for other Enterprise-backed refinance products,” a point which directly undermines the case for making this change. Deutsche Bank also did an analysis of HARP pricing as part of a research note published on April 18th that generally supports FHFA’s claims.[18]

[17] Laurie Goodman has made the case that the lack of servicer competition for refinancings has led to a large price differential between HARP and non-HARP refinancings and new purchase loans. FHFA’s letter to Sen. Boxer on May 17 suggests this issue is not straightforward.

[18] “Analysts and policymakers have justifiable interest in understanding the profitability of mortgage lending these days, particularly if policy has inadvertently distorted the market. Any analysis of HARP has to account for the risk- based pricing that Fannie Mae and Freddie Mac have mandated for most of the life of the program through the LLPAs. Mortgage bankers may have captured some extra revenue from the program. But the lion’s share of it looks like it has flowed from borrowers’ risk-based coupons, through the hands of the mortgage banks and the agencies and into the pockets of taxpayers.”

FHFA also made the case in this letter that the processes under same-servicer and new-servicer arrangements are comparable:

> [T]he lender is responsible for determining that the borrower meets the basic eligibility standards, based on the information available to them, and that the data used to make the determination is accurate. There are no higher-level demands on a new originator; in fact, the new originator may be at a slight advantage to an existing lender, because they have no responsibility whatsoever for the original loan, whereas the existing lender continues to be liable for any fraud or non-compliance with Federal and state laws, including the Enterprises' Charter Acts. As a result, in some instances, existing servicers choose to use the automated underwriting tools provided by the Enterprises, which are generally used by new originators, to extinguish any responsibility for the old loan.

Taking a step back, providing relief for representations and warranties can also be an expensive proposition for the GSEs (as reviewed or determined by FHFA). CBO described this very well in their working-paper from September:

> A potentially important consideration is that a large-scale refinancing program may negatively affect the value of the GSEs' and FHA's contractual right to recover money from the originating lender in some instances. Specifically, they may "put back" a defaulted loan to the originating lender if the loan was closed in violation of the lender's representations and warranties, avoiding losses associated with those loans. Once a loan is refinanced, they forgo the right to put back losses associated with the original loan (assuming the refinanced loan does not also violate those representations and warranties).

CBO went on to describe how difficult it is to estimate the cost of providing this relief to lenders. Important factors include the number of outstanding legal disputes between lenders and the GSEs and also the scope of existing settlements. Here is the key line from CBO on this issue: "For the put-back option on the incremental participating loans to have value, the borrower must default on the loan, a violation of representations and warranties must be uncovered and the loan must be from a lender that has not already negotiated a settlement with the GSEs or FHA on violations of previously-originated loans."

Before proceeding with this legislation, both FHFA and CBO should disclose how much the incremental representations and warranties relief under Menendez-Boxer would cost the taxpayer, or the GSEs.[19]

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[19] Some of the concerns in this area may be offset by how the loans from HARP-eligible borrowers are "seasoned" at this stage. See FHFA's comments from when they announced the representations and warranties relief under HARP 2.0: "Nearly all HARP-eligible borrowers have been paying their mortgages

A more minor representations and warranties issue exists for loans with LTVs below 80%. Fannie has waived lenders' representations and warranties exposure for this cohort of HARP borrowers, but Freddie has not. I do not think there is a reason why the policies for Fannie and Freddie in this area should not be in alignment. Perhaps one factor that drove Freddie not to change their representations and warranties policy for loans below 80LTV, however, is that they purposely wanted to incent lenders to target borrowers with less or even no equity. This rationale or concern should be further explored by the committee, especially since underwater borrowers are rightfully the focus of the program.

7. Loan Level Pricing Adjustments and other fees.

While HARP 2.0 greatly reduced the loan level pricing adjustments (LLPAs), the Menendez-Boxer bill would eliminate them completely. Under HARP 2.0, LLPAs are capped at 75 basis points of the loan amount. The rationale is that the GSEs already own the credit risk on these loans. While I would want to hear why FHFA has not embraced this position, absent additional information this seems like an appropriate step to consider.

That said, it's also important to recognize that eliminating these fees would result in only a minor incremental benefit to borrowers and there could be some marginal lost revenue for taxpayers under the terms of conservatorship. A broader point is also worth keeping in mind here, namely that all borrowers or beneficiaries of a government-backed mortgage should continue to expect to pay at least some amount for receiving a government insured mortgage. If the long-term objective is for the GSEs to charge a market price for a government guarantee – to reduce or limit the current and ongoing subsidy – then a change in policy that effectively eliminates even a modest risk-based fee should give policymakers some pause. There is also the issue that eliminating LLPAs would mean that the broader GSE business – and all of the other mortgage borrowers specifically – would indirectly be cross-subsidizing HARP refinancings.

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for more than three years, and most of those for four or more years. These are seasoned loans made to borrowers who have demonstrated a capacity and commitment to make good on their mortgage obligation through a period of severe economic stress and house price declines. Reps and warrants protect the Enterprises from losses on defective loans; typically, such defects show up in the first few years of a mortgage and so the value of the reps and warrants decline over time. By refinancing into a lower interest rate and/or shorter term mortgage, these borrowers are recommitting to their mortgage and strengthening their household balance sheet, thereby reducing the credit risk they already pose to the Enterprises. Therefore, FHFA has concluded that eliminating the reps and warrants that may have discouraged industry participants from taking greater advantage of HARP to-date will be good for borrowers, housing markets, and the Enterprises and taxpayers."
http://www.fhfa.gov/webfiles/22723/HARP%20release%20102411QandA%20Final.pdf

8. Mortgage insurance and second liens.

In general, the Menendez-Boxer bill would require automatic transfer of mortgage insurance and second liens and use a fine as the mechanism to ensure compliance. The goal is to make these contracts portable under the same terms with regards to the original mortgage and the refinanced one. There was some concern when HARP 2.0 was coming together that the representations and warranties for mortgage insurers would not be re-validated through the refinancing process, but I believe that this issue has been largely resolved.

Given that I think the purported benefits (with regards to additional take-up) in this area are small, I am concerned about the signal this provision sends to private suppliers of capital in the housing market. Remember, under HAMP – second lien holders are getting paid to re-subordinate. If this provision were to take effect, then HARP would take the exact opposite approach by fining these same entities to achieve the same result. In the long-term, nearly every GSE reform proposal notes the importance of attracting more private capital to bear credit risk. Provisions like this one, at least on the margin, will make that effort more difficult by further unsettling the market expectations by signaling that policymakers could continue to change the rules of road for private capital providers midstream.

9. Moving the cut-off date and "re-Harping" loans.

This is perhaps the most controversial change contemplated by the Menendez-Boxer bill. Moving the cut off date for eligibility from June 2009 to June 2010 could increase HARP take-up. But the incremental borrower pool would not be a cohort that could reasonably expect to receive a sizeable reduction in their mortgage payment through a refinancing (at least on a comparative basis). This simply acknowledges that for most of these borrowers the rate differential would be fairly marginal in comparison to other HARP beneficiaries.

One concern is that changing the date could indirectly crowd out other borrowers who would be eligible for HARP – a reflection of the fact that servicers are capacity constrained. Another concern is that the market has long worked off of this date – as it was the cut-off established when HARP was announced and it's also a date that FHA uses for some of its refinancing programs. Laurie Goodman has described this as breaking the "covenant with investors." I share her concerns and agree with her description of the issue:

> Investors have relied upon that date and developed a series of pay-ups on mortgages with this refinance friction. Changing the date would be very disruptive to this covenant. The Agency mortgage market is wide and deep, regarded as the second most liquid market in the world behind the US Treasury market. We believe that "breaking the covenant" with investors would be very

> damaging to the health of this market; if the date is moved once, market participants (investors, borrowers and originators/servicers) will assume it will be moved again."[20]

The exact consequences from a date change are difficult to predict. If lender expectations change such that they now believe that new refinancings or originations might be eligible in the future for relief from representations and warranties, then they might be incentivized to process more loans with questionable underwriting in the meantime. At minimum, I would recommend that policymakers consider whether to explicitly prohibit the re-harping of loans to limit the negative effects of changing market expectations.

I want to be clear here that buyers of MBS – and in this case GSE-backed MBS – rightfully assume any refinancing risk. They are compensated for this in the spread that is charged on rates or yields for GSE MBS above Treasury debt securities. But, when refinancing programs are continually expanded, investors may be forced to adjust their expectations about future prepayment speeds, effectively assuming that future mortgages will have an embedded policy-risk function that could give borrowers easier access to a lower rate mortgage. While that may sound like a good policy objective, the net effect could be that market participants simply demand higher yields on MBS moving forward – negating any of the near-term benefits to a change in this area over the medium to long-term. Put another way, current homeowners might benefit at the expense of future borrowers as the premium associated with the refinance option is revalued upward prospectively.

In the case of allowing for loans to be re-HARPed, the market should be expected to fold into the price that borrowers pay an additional premium to account for this additional prepayment risk. In short, it's possible that the effect of a date change could be that the prices for HARP refinancings actually go up. And it's unclear to say the least at this point if making HARP more expensive on the margin is worth the trade-off of boosting volume, again on the margin.

10. Efforts to increase homeowner awareness of HARP.

The Menendez-Boxer bill would require the enterprises to notify all eligible borrowers of their opportunity to participate in HARP. While I have some concerns that families and borrowers are now being inundated with "awareness" campaigns, the objective is clearly admirable.

[20] http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=0b61bedc-0017-4a06-9798-29b55f7f63bc