



## NEW IDEAS FOR REFINANCING AND RESTRUCTURING MORTGAGE LOANS SEPTEMBER 14, 2011

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United States Senate  
Committee on Banking, Housing and Urban Affairs  
Subcommittee on Housing, Transportation and Community Development

Chairman Menendez and Members of The Subcommittee, thank you for the opportunity to speak to you today.

According to the recent data:

- owner equity in household real estate fell around \$7.4 trillion from the peak of housing market to today (see Figure 1);
- households have been reducing their debt burden (see Figure 2);
- headline unemployment remains at 9.1% while another measure of unemployment places it at over 20% (see Figure 3);
- Real Gross Domestic Product (GDP) has grown at less than 2% growth rate for the first half of 2011; and
- Real Personal Consumption Expenditures fell in the second quarter of 2011 (see Figure 4).

A possible way to help jump start the economy and reduce mortgage defaults is to streamline mortgage refinancing. When a borrower refinances their mortgage, they may save \$150 - \$400 per month or \$1,800 - \$4,800 annually in mortgage interest.<sup>1</sup> Adding that amount to borrowers' disposable income to spend in the economy (or reduce delinquency and default) is very tempting.

Why haven't borrowers refinanced at these historically lower interest rates when it is in their own best interest? The reasons for lower than expected refinancing include:

- degraded credit after the housing market collapsed,
- negative equity, and
- servicing industry conflicts.

To be sure, streamlining the mortgage refinancing process could help American households, stimulate the economy and reduce defaults.

Senators Boxer (D-CA) and Isakson (R-GA) have proposed a bill (S.170) that reduces frictions to refinancing. Alan Boyce, Glenn Hubbard and Chris Mayer have independently proposed a streamlined

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<sup>1</sup> Of course, a refinancing can result in bigger or smaller interest saving.

mortgage refinancing proposal<sup>2</sup> that is similar in spirit to Boxer and Isakson while the Congressional Budget Office (CBO) has produced a study of a stylized streamlined mortgage refinancing.<sup>3</sup> The question is whether these streamlined mortgage refinancing proposals will be effective in jump starting the economy and/or significantly reducing mortgage defaults. Both the Boxer-Isakson bill and Boyce et al proposal feature 1) no credit requirements and 2) no loan-to-value (LTV) requirements in order to refinance.

## THE CBO'S ANALYSIS OF STREAMLINED MORTGAGE REFINANCING

The CBO, using a stylized program, estimated that 2.9 million mortgages would be refinanced and there would be 111,000 fewer defaults on those loans.<sup>4</sup> But 2.9 million mortgages being refinanced at around four percent would generate about \$7.4 billion for the economy in the first year.<sup>5</sup> Of course, depending on assumptions, this number could be either higher or lower. Also, the higher LTV mortgages are located in Florida, Arizona and California, so the stimulus effect is concentrated in those states.<sup>6</sup>

The simulative benefits of \$7.4 billion in one year (after the mortgage refinancing has taken place) are relatively small. Personal Consumption Expenditures in the U.S. were \$9.43 trillion for July 2011 and amounts to less than one-tenth of one percent in additional personal consumption expenditures (and that assumes that every borrower that refinanced their mortgage spent the additional funds rather than saving it).<sup>7</sup>

So, unless the streamlined refinancing recommendation generates more refinancing and/or greater savings per refinancing, streamlining will not generate much of a positive “kick” to consumer expenditures.

## WHO WINS AND WHO LOSES?

According to the CBO report:

*Relative to the status quo, the specific program analyzed here is estimated to cause an additional 2.9 million mortgages to be refinanced, resulting in 111,000 fewer defaults on those loans and estimated savings for the GSEs and FHA of \$3.9 billion on their credit guarantee exposure, measured on a fair-value basis. Offsetting those savings, federal investors in MBSs, including the Federal Reserve, the GSEs, and the Treasury, would experience an estimated fair-value loss of \$4.5 billion. Therefore, on a fair-value basis, the specific program analyzed here would have an estimated cost to the federal government of \$0.6 billion.*

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<sup>2</sup> Alan Boyce, Glenn Hubbard, and Chris Mayer, “Streamlined Refinancings for up to 30 Million Borrowers,” September 1, 2011, [http://www4.gsb.columbia.edu/null/download?&exclusive=filemgr.download&file\\_id=739308](http://www4.gsb.columbia.edu/null/download?&exclusive=filemgr.download&file_id=739308).

<sup>3</sup> Mitchell Remy, Deborah Lucas, and Damien Moore, “An Evaluation of Large-Scale Mortgage Refinancing Programs,” Working Paper 2011-4, Congressional Budget Office Working Paper Series, September 2011, [http://www.cbo.gov/ftpdocs/124xx/doc12405/09-07-2011-Large-Scale\\_Refinancing\\_Program.pdf](http://www.cbo.gov/ftpdocs/124xx/doc12405/09-07-2011-Large-Scale_Refinancing_Program.pdf).

<sup>4</sup> See Boyce, Hubbard and Mayer for optimistic assumptions.

<sup>5</sup> 2.9 million mortgages x \$200 savings per month x 12 months = \$7 billion

<sup>6</sup> Thanks to Andrew Davidson, Eknath Belbase and Dan Szakallas

<sup>7</sup> Rajashri Chakrabarti, Donghoon Lee, Wilbert van der Klaauw, and Basit Zafar, “Household Debt and Saving During the 2007 Recession,” NBER Working Paper, No. 16999, April 2011.

I am not convinced of the estimated savings for the GSEs and FHA of \$3.9 billion due to lower default rates since the primary drivers of mortgage default are unemployment, divorce and negative equity.<sup>8</sup> I remain skeptical about the merits of lower interest payments in preventing default. And since principal reductions are not included, I have my doubts as to the measure of \$3.9 billion for GSE and FHA credit guarantee exposure. I would score this benefit as zero.<sup>9</sup>

But I do believe that there will be a loss of \$4.5 billion to Federal investors in MBS (including Fannie Mae and Freddie Mac).<sup>10</sup> And I agree with the CBO that non-federal investors would likely experience a loss of \$13 to \$15 billion; most of that wealth would be transferred to borrowers in the form of lower mortgage rates.

So, in a sense, the streamlining of mortgage refinancing represents a \$7.4 billion *per year* wealth transfer to borrowers.<sup>11</sup> So, non-Federal MBS investors are the big losers while the borrowers are the winners.

### SAVINGS PER DOLLAR LOSS TO NON-FEDERAL MBS INVESTORS

Using the CBO's assumptions, 111,000 loans saved from default at a loss to non-Federal MBS investors of \$14 billion amounts to \$126,126 per loan saved. If the loss to non-Federal MBS investors is \$15 billion, the loss per loan saved jumps to \$135,135. If lowering mortgage rates has less of an impact than the CBO has assumed, the loss to non-Federal MBS investors could be extremely large. For the sake of discussion, assume that only 50,000 loans are saved from default and non-Federal MBS investors suffer a loss of \$15 billion. That would raise the loss to non-Federal MBS investors to \$300,000 per loan saved.

### MORTGAGE INVESTOR RISK

Mortgage investors take the risk that frictions will increase or decrease, but they did not purchase MBS understanding that the government would unilaterally alter contracts.

It is important to understand that a change in expectations in refinancing is a cost (although the CBO was careful to note that their analysis was not a cost analysis). But while this is a wealth transfer from investors to borrowers, there has also been a wealth transfer from borrowers to investors as borrowers seem to be unable to fully exercise the prepayment option.

If the changes are limited to easing some underwriting requirements or limiting Loan Level Price Adjustments (LLPAs), then those are risks that investors have assumed. If the GSEs send every borrower who has a six percent or higher interest rate loan a preapproved application to lower their rate to four percent then that would be a violation of existing obligations to the investor.

My recommendation is that easing underwriting requirements and/or limiting LLPAs would be appropriate, if FHFA thinks that it will not harm taxpayers.

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<sup>8</sup> Andrew Davidson, Anthony B. Sanders, Anne Ching and Lan-Ling Wolff, *Securitization: Structuring and Investment Analysis*, Wiley Finance, 2004.

<sup>9</sup> Boyce, Hubbard and Mayer use a different set of assumptions that are more optimistic.

<sup>10</sup> See Satya Thallam and Anthony B. Sanders, "Brother can you spare a refi? The costs and benefits of the Administration's massive mortgage scheme," The Mercatus Center, 2011 for an alternative and large refinancing plan.

<sup>11</sup> See CBO Report, pg. 3

## ONE YEAR INCREASE IN CONFORMING LOAN LIMIT

Another way to help stimulate the housing market is to raise the conforming loan limits for 1 year. As I opined in a previous testimony before the House Financial Services Committee, I felt it was appropriate to reduce the conforming loan limit to allow the private sector back into the market; however, I stated that if the housing market stalled, then alternative strategies should be considered regarding the conforming loan limit.

Raising conforming loan limits, which are almost always above the median house value in any county, is a subsidy to more expensive housing markets. As long as the conforming loan limit returns to current limits after one year and continues to decline after that point, I would be agreeable to a temporary increase in the conforming loan limit.

## THE SHARED APPRECIATION MORTGAGE

Senator Menendez (D-NJ) has proposed a shared appreciation solution to try to overcome the negative equity problem.<sup>12</sup> The shared appreciation mortgage (or SAM) has been used in the United States for decades (although in low volumes) and has been tried in the United Kingdom to permit borrowers who have paid down their principal to sell a 50 percent share in the equity in return for, say, 50 percent of future gains in home price. The Menendez Proposal has a similar intention – the borrower receives a write down of principal in exchange for giving away a percentage of any appreciation in property value in the future.

The Bank of Scotland SAM experience is worth examining.<sup>13</sup> It was very popular with borrowers, but secondary market participants were nervous about a bond where the payoff was tied to home prices and no more SAMs were originated by Bank of Scotland. But a variation of the Bank of Scotland SAM emerged in the United States in the form of the Reverse Mortgage from Financial Freedom.

As an example, a borrower that is 40 percent upside down on their home can obtain a write down on principal in exchange for the borrower paying the lender a percentage of any appreciation on the house (and it could include an additional mortgage payment or coupon for the write down) to be settled at some future date or upon sale or refinance.

The problems with the SAM are twofold. First, capital markets have shown little interest in it as a product for investment. Second, there are moral hazard problems (the incentive to maintain the property once someone receives the capital gain). The Menendez proposal has solved one of the lingering problems with appraisals by requiring several independent appraisals.

I agree that a trial program for SAMs would be reasonable. The question I have is – who will insure the risk: the Federal government or private insurance companies? I would prefer the private market issue and insure these mortgages.

Thank you for the opportunity to testify.

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<sup>12</sup> “Anthony Sanders: A Voluntary Private Market Solution,” Knowledge@W.P. Carey, December 17, 2008, <http://knowledge.wpcarey.asu.edu/article.cfm?articleid=1727>.

<sup>13</sup> Anthony Sanders and C. Carlos Slawson, "Shared Appreciation Mortgages: The UK Experience," *Journal of Housing Economics*, Vol. 14, pp. 178-193, 2005 and Anthony Sanders and F. Page, "On the Pricing of Shared-Appreciation Mortgages," *Journal of Housing Economics*, Vol. 5, pp. 49-57, 1986.

FIGURE 1: Owner's Equity in Household Real Estate

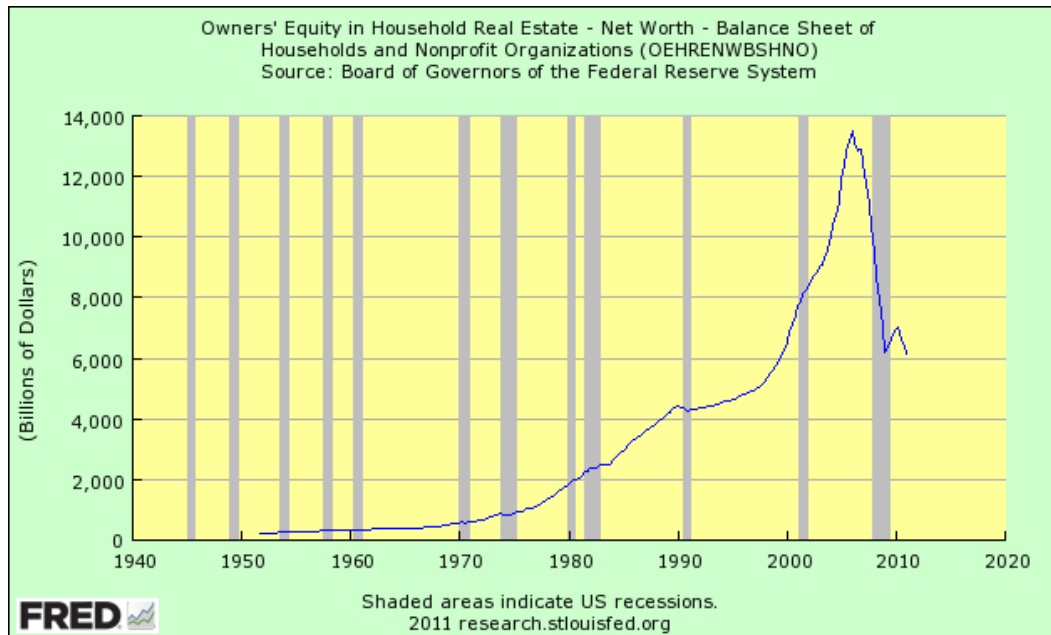


FIGURE 2: Household Debt Services as a Percentage of Disposable Income

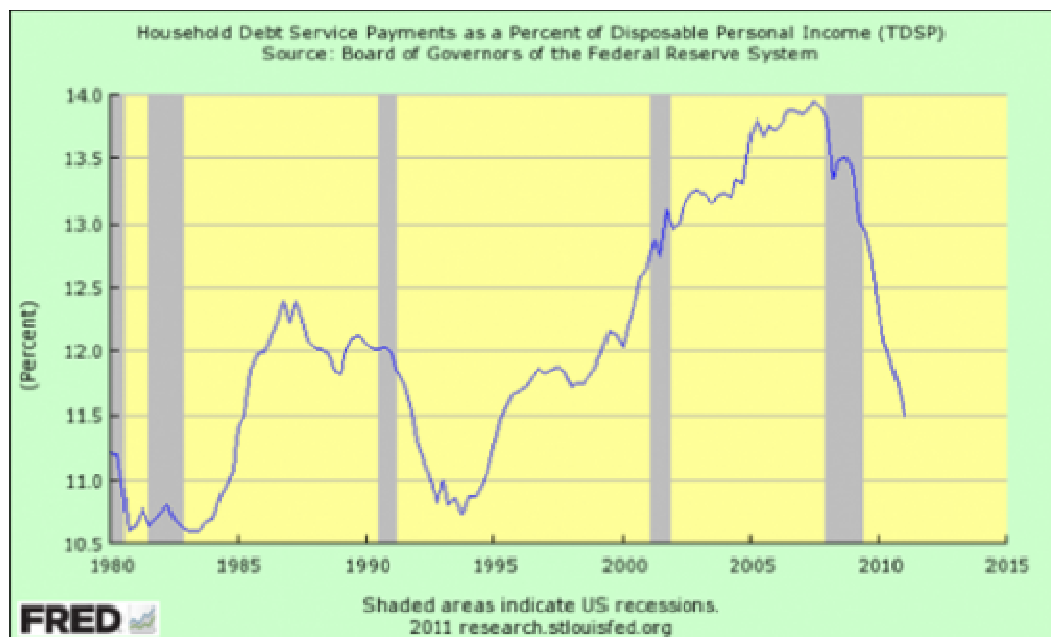


FIGURE 3: Case-Shiller Home Prices Versus Unemployment

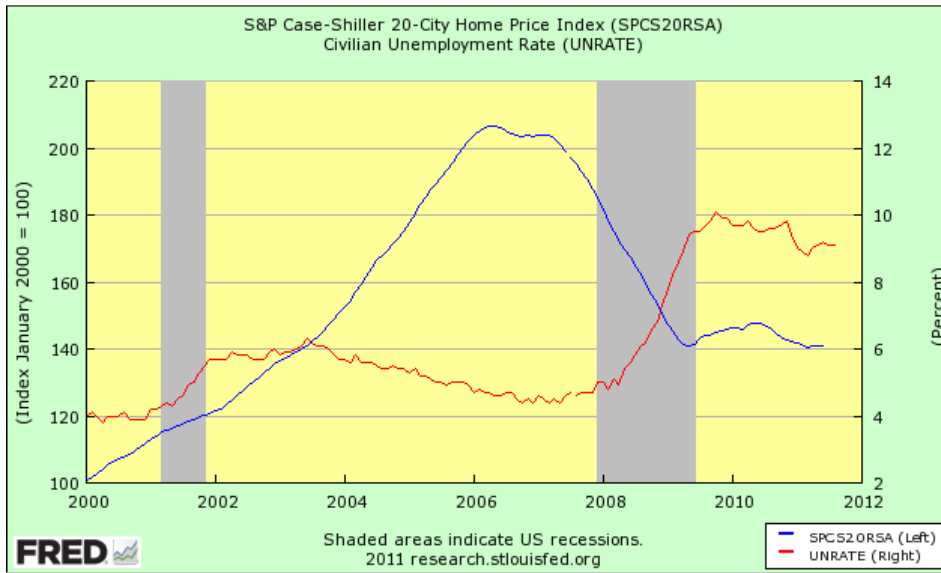


FIGURE 4: Real Personal Consumption Expenditure Growth

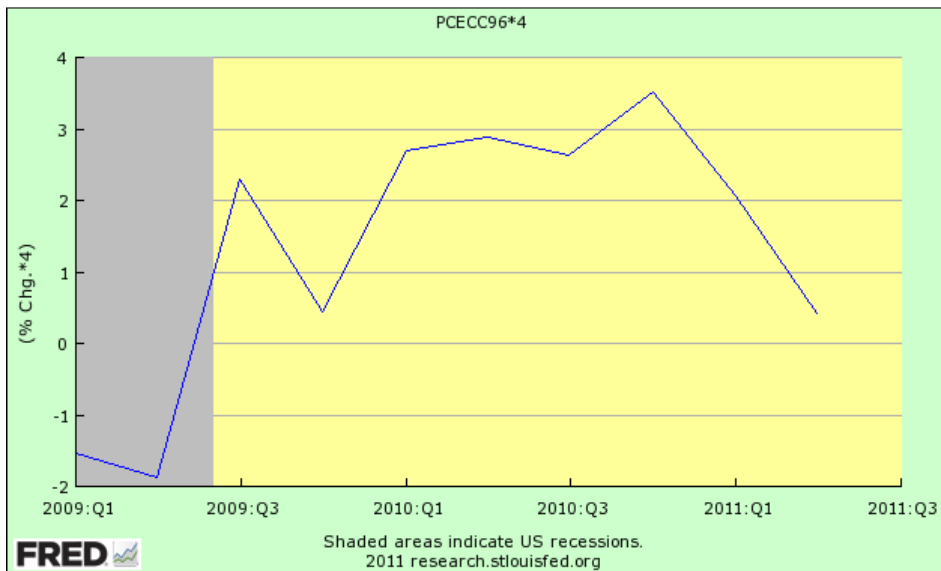


FIGURE 5: MBA Purchase Index for 30 year Fixed-rate Mortgages

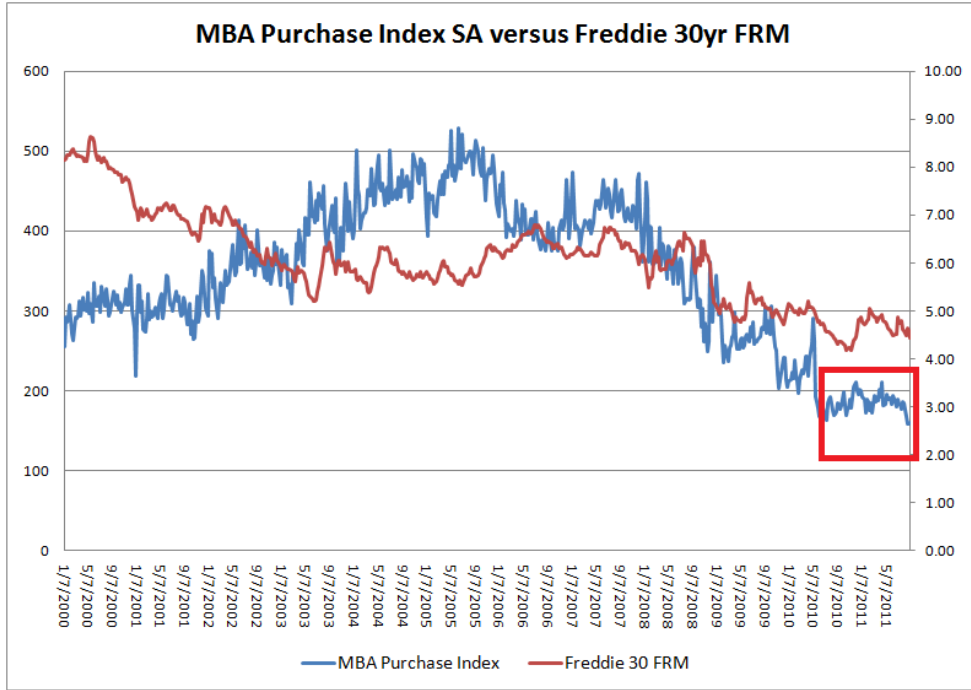


FIGURE 6: MBA Refinance Index

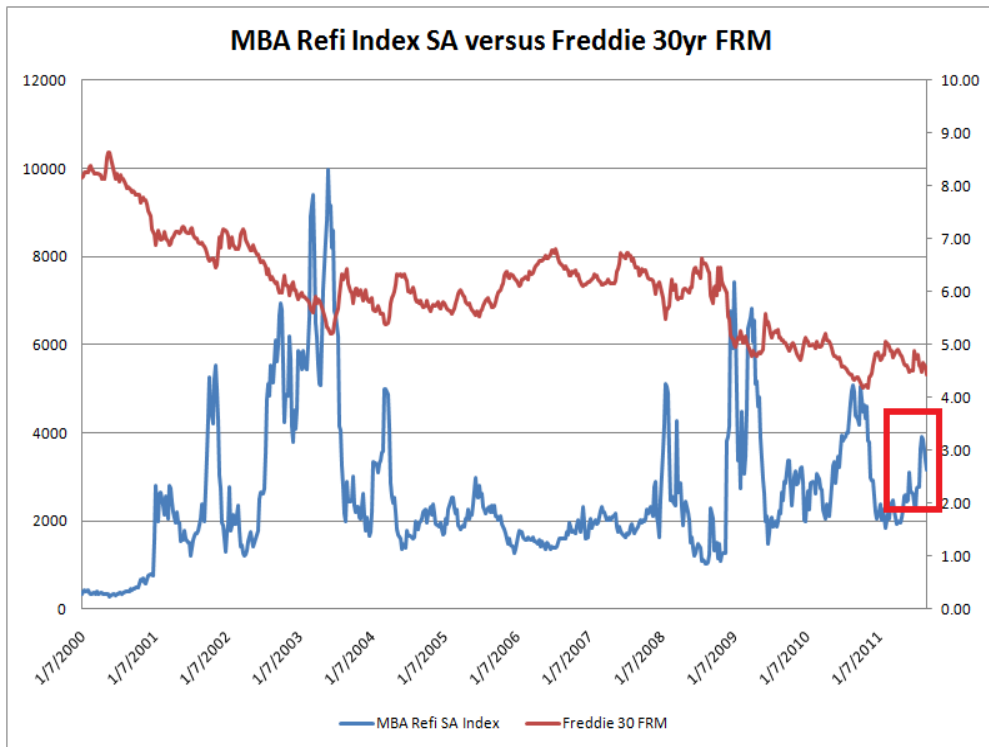
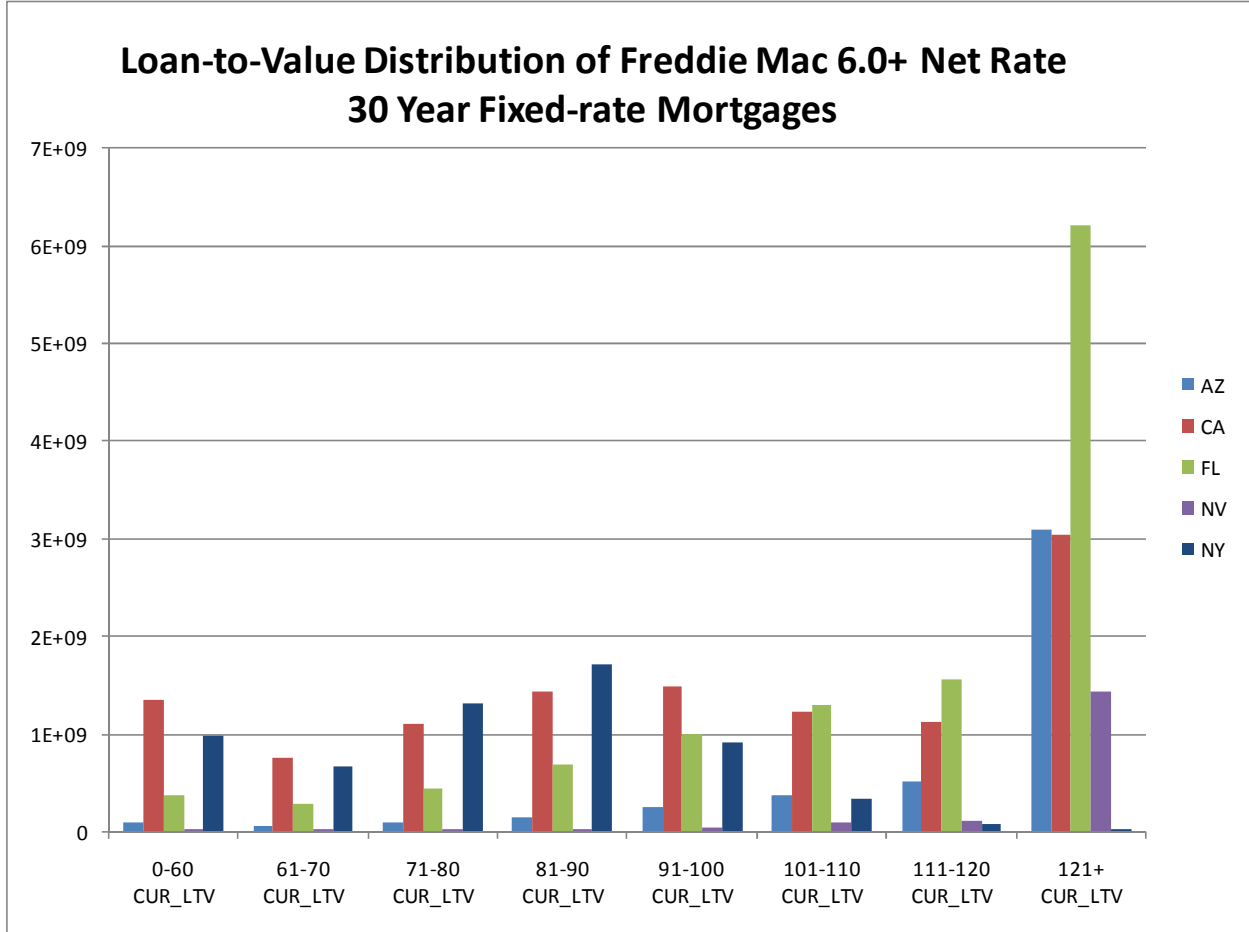


FIGURE 7: High Loan-to-Value Ratios are Concentrated in Four States





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Anthony B. Sanders is a Senior Scholar at the Mercatus Center at George Mason University. He is also Professor of Finance in the School of Management at George Mason University where he holds the title of Distinguished Professor of Real Estate Finance. He has previously taught at University of Chicago (Graduate School of Business), University of Texas at Austin (McCombs School of Business) and The Ohio State University (Fisher College of Business). In addition, he served as Director and Head of Asset-backed and Mortgage-backed Securities Research at Deutsche Bank in New York City.

His research and teaching focuses on financial institutions and capital markets with particular emphasis on real estate finance and investment. He has published articles in *Journal of Finance*, *Journal of Financial and Quantitative Analysis*, *Journal of Business*, *Journal of Financial Services Research*, *Journal of Housing Economics* and other journals. Professor Sanders has received 6 teaching awards and 3 research awards. He serves as Associate Editor for several leading journals. Recently, he has given presentations to the European Central Bank in Frankfurt, Exane BNP Paribas in Paris and Geneva and the Bank of Japan on the subject of the housing bubble and commercial real estate in the U.S. and the mortgage market. He has given other presentations in Chile, Japan, China, Poland, England and Mexico in recent years. Professor Sanders has testified in the U.S. Senate and U.S. House of Representatives on the U.S. real estate asset and debt markets. Also, he was an invited speaker to the FTC on the subject of predatory lending.

Dr. Sanders earned his PhD and MA from the University of Georgia.