Dissenting views on H.R. 5830, the FHA Housing Stabilization and Homeownership Retention Act

Current conditions in the housing market -- declining prices, increasing numbers of defaults and foreclosures, and illiquidity in the secondary market -- have resulted in calls for the government to attempt to stabilize the market by offering Federal assistance to borrowers who owe more on their mortgages than their houses are worth. H.R. 5830 seeks to achieve this objective by making available $300 billion in Federal guarantees to transition borrowers in "underwater" mortgages into more affordable loans, by significantly reducing the principal on their existing mortgages and offering them new loans insured by the Federal Housing Administration (FHA). In doing so, the bill would transfer the downside risks currently being borne by the borrowers, lenders and investors in such mortgages to the American taxpayer. Because we believe that H.R. 5830 is both profoundly unfair and unlikely to achieve its stated objectives, we oppose this legislation and voted against reporting it favorably to the House.

Roots of the Subprime Problem

Economists agree that the roots of the current problems in the mortgage market can be traced to earlier this decade, when falling interest rates encouraged lenders to significantly relax - and in some cases abandon - sound underwriting criteria when qualifying borrowers for mortgages. Borrowers who at one time might have been denied credit or granted limited credit found themselves able to borrow larger sums, and they took advantage of this opportunity to buy larger, more expensive houses than they otherwise would have been able to afford.

As a consequence of low interest rates and weak underwriting standards, the availability of mortgage credit exploded from the late 1990s through 2006. Homeownership rates rose from the 64 percent range in the 35 years prior to 1995 to an all-time high of 69 percent in 2004. The growing demand for houses, fueled by cheap and easily available credit, caused home prices to skyrocket: according to the National Association of Realtors, the national median home price went from $110,500 in 1995 to $190,000 ten years later.   Economists have pointed out that these inflated prices reflected the euphoria of a market fueled by easy credit. Compared to other economic fundamentals, such as rental prices or incomes, these soaring housing prices were simply unsustainable, and the market is now in the process of correcting these excesses.

Despite the higher risk associated with mortgages to borrowers with checkered credit histories, the opportunities to earn higher rates of return from subprime mortgages induced many lenders to further loosen their underwriting standards during the period 2005 to 2007, introducing even more risk into the system. Instead of protecting themselves against this increased risk by requiring borrowers to make higher down payments, lenders engineered new loans that permitted borrowers to buy with little or no money down, and compensated for this increased risk by charging these borrowers higher interest rates and fees. Lenders further eroded the integrity of the underwriting process by permitting borrowers to sign up for so-called "low documentation" or "no documentation" loans, which became known in the mortgage industry as "liar loans," so named because they often featured loan applications characterized by misstated or falsified income.

As long as housing prices continued to rise, the risks inherent in such shoddy underwriting practices remained hidden.

Borrowers who had stretched to purchase homes that they otherwise could not afford either refinanced their mortgages against home price appreciation or sold to other buyers and paid off their mortgages. Investors in mortgage-backed securities believed their risk was limited: even if risky borrowers defaulted, home price appreciation all but guaranteed that the houses that secured the underlying mortgages could either be resold to other buyers through voluntary sales or, if necessary, foreclosed upon and resold at auction with only minimal impairment of the collateral securing the loan.

As the subprime market began to collapse in late 2006, the assumption that home prices would rise forever was exposed as fundamentally flawed. The Wall Street Journal recently reported that home prices in 20 major U.S. metropolitan areas have plunged 10.7 percent, a record. As a result of declining property values, many borrowers now owe more on their homes than those homes are worth. One economist has estimated that 8.8 million mortgages are now "underwater," and expects that figure to rise as housing prices further decline. Some analysts believe that even if some significant percentage of these borrowers can afford to make their mortgage payments, the difference between what they owe on their houses and the home's market value - a difference that has come to be known as "negative equity" - may encourage these borrowers to walk away from their homes. Some commentators have even gone so far as to say that in these circumstances, it is economically rational for borrowers to purposefully default on these mortgages.

The so-called "negative equity" problem has shifted the terms of the discussion of the "foreclosure crisis." Last year, the discussion focused on foreclosures that some believed would be brought on by steep interest rate resets on adjustable rate subprime mortgages that borrowers would not be able to afford. But due largely to aggressive reductions in the federal funds rate by the Federal Reserve beginning in mid-2007, the impact of mortgage rate resets has not been nearly as dire as many had predicted. Indeed, in some cases the Fed rate cuts have actually resulted in lowering borrowers' monthly payments when their rates reset.

The Boston Federal Reserve examined 1.5 million homeownerships over twenty years and found that the overwhelming reason for subprime foreclosures was not that homeowners lacked the ability to make their mortgage payments, but rather that borrowers chose to walk away from their mortgages when the value of their homes had declined. Thus, rather than focusing assistance on those homeowners unable to afford their monthly mortgage payments, H.R. 5830 tries to keep these homeowners from walking away from mortgages for which they may be able to afford to make the payments but choose not to. As Representative Mel Watt said during Committee consideration of H.R. 5830, "one of our intentions was to try to capture those people whose loans were under water . . . who are intentionally walking away because the mortgage is substantially greater than the value." But as Treasury Secretary Henry Paulson has noted, "[A]ny homeowner who can afford his mortgage payment but chooses to walk away from an underwater property is simply a speculator. Washington cannot create any new mortgage program to induce these speculators to continue to own these homes, unless someone else foots the bill." Under H.R. 5830, that "someone else" is ultimately the U.S. taxpayer.

Fairness and Moral Hazard

The primary basis for Republican opposition to H.R. 5830 can be found in the legislation's fundamental unfairness and skewed incentives. The bill rewards financial irresponsibility and punishes prudence. By providing "gift equity" to those homeowners who made bad choices or engaged in financial irresponsibility, it does an injustice to those millions of Americans - including the 51 million making their mortgage payments on time, sometimes at considerable personal sacrifice, and the 34 million renters - who chose a more responsible course. Those Americans must now watch as their neighbors receive a taxpayer-subsidized windfall in the form of sizable write-downs in loan principal and reduced monthly mortgage payments.

Perhaps even more harmful for those of us concerned about moral hazard and personal responsibility is the message that we risk sending to financial institutions and individuals that when they willingly take on excessive and ill-advised risks, the government will always ride to their rescue. As the Congressional Budget Office noted in a recent report on policy options for dealing with turmoil in the housing market: "If the federal government is expected to step in when economic times are bad, then lenders and borrowers do not need to consider the possibility of bad times when making decisions." Unless individual market participants receive a clear and unmistakable signal that they must bear the consequences of their own decisions, severe market disruptions like the one that has unfolded over the past year will be repeated over and over again, with grave damage to our country's economic future.

If there could be a rationale for legislation of this kind, it would be that it was targeted toward the poor or victims of fraud. Instead, H.R. 5830 has been designed to bail out the affluent too. Because the FHA is now authorized to guarantee mortgages valued as high as $729,750, some of the beneficiaries of the program established under the legislation could be quite wealthy. The Majority rejected amendments that would limit eligibility by, among other measures, imposing a means test. As a result, H.R. 5830 risks conferring a substantial government subsidy on those who are neither worthy nor needy.

Moreover, this legislation also bails out investors who willingly and knowingly purchased securities that were cobbled together from mortgages that were poorly underwritten. The investors and lenders that would benefit from H.R. 5830 are those that chased high rates of return even as they ignored the obvious risks of subprime lending and declining housing values. These market participants eagerly reaped the upside potential when housing prices soared; H.R. 5830 offers them a mechanism for offloading the downside risk on the government now that the market has soured.

The proponents of H.R. 5830 point to the "haircut" that investors must take in order to participate in the FHA refinancing program to rebut the contention that the bill would bail them out. But this argument is specious. Because participation in the plan is voluntary, no mortgage will be placed in the program unless an investor concludes that the loan is likely to fail. The incentives are perverse: investors will place the mortgages they think are worth less than the "haircut" into the program, to be refinanced with an FHA-guaranteed loan. Given the substantial risk that these loans represent - the plan is after all aimed at those borrowers most likely to default or who are "intentionally walking away" - no lender would refinance but for the FHA guarantee. The result is that taxpayers who acted responsibly during the run-up in housing prices are left to underwrite the costs of cleaning up after irresponsible borrowers, lenders, and investors. During Committee consideration of H.R. 5830, Republicans offered a series of amendments designed to mitigate these moral hazard and adverse selection issues, only to have them opposed unanimously by Committee Democrats.

Implementation Issues

Economists of every stripe have pointed out that by every conceivable measure, housing prices remain inflated and will still have to come down at least another 15 percent to return to historical levels. There is currently a 10 months' over-supply of existing homes, which H.R. 5830 will do nothing to address. Because prospective customers cannot afford to buy at current prices, those prices will have to fall, wiping out whatever minimal impact H.R. 5830 will have on home prices. Given that the Federal Reserve estimates that owner-occupied real estate is worth almost $21 trillion, H.R. 5830's goal of arresting home price declines by refinancing a maximum of $300 billion in mortgages is as futile as it is unfair.

Even if one concedes that a plan of this nature could work, because the market remains so unsettled, there is no way of knowing whether it will work. No one knows where the market's bottom is. Thus, there is no way of knowing how many distressed homeowners this would help. No reasonable person can predict whether the principal write-downs, returns on equity or exit premiums in this bill are rationally related to actual, eventual home values. And because the numbers are based on nothing more than guesswork, it is simply unreasonable to ask the taxpayer to bear the risk of that guess being off the mark.

Furthermore, many believe that FHA lacks the administrative capacity to insure an additional $300 billion in mortgages, which would represent a massive expansion of the agency's current $180 billion portfolio. Moreover, given that the program contemplated by H.R. 5830 depends on a large-scale re-underwriting of troubled mortgages, it is far from certain that the program could be launched in time to make any difference in the real estate market. Interest rate reduction and extensions of amortization periods are better options anyway: they are immediate, easier to administer and can be implemented without reliance upon a cumbersome FHA bureaucracy. Indeed, perhaps the best that can be said about this legislation is that given its inherent unfairness and potential to put taxpayers at risk for loans that investors are all too eager to be rid of, the insurmountable difficulties of implementing it may mean that whatever harm it ultimately ends up doing should be limited.

Conclusion

For all of the foregoing reasons, we must oppose H.R. 5830, and will continue to push for changes to the bill as it moves through the House to limit taxpayer exposure and discourage moral hazard.

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