



An Economic Analysis of Large-Scale Mortgage Refinancing Proposals: A Brief Overview of S. 3522 and S. 3085

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The bursting of the housing bubble in 2006 precipitated the December 2007-June 2009 recession and a financial panic in September 2008. With the housing market seen as a locus for many of the economic problems that emerged, some Members of Congress propose intervening in the housing market as a means of improving not only the housing market itself but also the financial sector and the broader economy. Critics are concerned that further intervention could prolong the housing slump, delay recovery, and affect outcomes based on the government's preferences rather than market forces.

This report provides a brief overview of policy proposals for the large-scale refinancing of mortgages for borrowers shut out of traditional financing methods. An expansion of this report appears in CRS Report R42480, *Reduce, Refinance, and Rent? The Economic Incentives, Risks, and Ramifications of Housing Market Policy Options*, by (name redacted). Contained in that report is longer, in-depth analysis of large-scale refinance and two other frequently discussed policy options, reducing mortgage principal for borrowers who owe more than their homes are worth and renting out foreclosed homes.

Overview

With mortgage rates at historic lows, some have proposed expanding an existing large-scale refinancing program, the Home Affordable Refinance Program (HARP),² to allow more borrowers to take advantage of low rates. When first introduced in February 2009, the Obama Administration originally estimated that HARP would aid between 4 million and 5 million borrowers.

Approximately 1.54 million mortgages have been refinanced through HARP as of July 2012.³

In a refinance, a borrower takes out a new home loan and uses it to pay off the previous loan, usually with more favorable terms such as a reduced monthly payment. A borrower can refinance with their original lender or with a new lender. HARP allows some borrowers who are current on their mortgage but have little or no equity in their home to refinance into a new mortgage with a lower interest rate if their

Example of a Mortgage Refinance

- A borrower took out a \$200,000 mortgage in 2006 with a 6.5% fixed interest rate to be paid over 30 years. The borrower's monthly payments are about \$1,264.
- Part of each monthly payment pays down the principal and the interest. In 2012, the outstanding balance is \$184,396.
- By refinancing the remaining \$184,396 into a new 30 year loan with a 4% interest rate, the new monthly payments are \$880.
- To refinance, the borrower must pay closing costs, which are estimated to be 3% of the outstanding balance, approximately \$5,500-\$6,000 in this example.¹
- The borrower lowers the monthly payment by \$384 (\$1,264 - \$880 = \$384) and saves over \$48,000 over the life of the loan.

Example created by author.

¹ For more on closing costs, see The Federal Reserve Board, *A Consumer's Guide to Mortgage Refinancings*, at <http://www.federalreserve.gov/pubs/refinancings>.

² For more on HARP, see CRS Report R40210, *Preserving Homeownership: Foreclosure Prevention Initiatives*, by (name redacted). HARP is not the only government refinance program. FHA also established the FHA Streamline Refinance Program. However, HARP is the largest of the refinance programs and the subject of several congressional proposals.

³ See Federal Housing Finance Agency, *Refinance Report July 2012*, at http://www.fhfa.gov/webfiles/24274/Jul-12_Refi_Report.pdf.

mortgage is held by Fannie Mae or Freddie Mac (the government-sponsored enterprises or GSEs). As of April 2012, more than 23% of mortgagors had negative equity, owing more than their home was worth.⁴

When to Refinance?

Mortgage interest rates are one of the major factors that influence a borrower's decision to refinance. When interest rates fall, refinances typically increase. Borrowers will not refinance every time interest rates fall because there are fixed costs to refinancing. A borrower may save a little each month from having a lower interest rate, but it is only worthwhile to refinance if the amount saved in the first few years is greater than the closing cost for refinancing. A typical estimate is that interest rates have to fall by 1 to 2 percentage points below a borrower's existing rate for it to be in the borrower's best interest to refinance.⁵

The legislative proposals discussed below aim to expand HARP to aid more borrowers with GSE mortgages that are unable to refinance through traditional methods. In particular, HARP attempts to help borrowers refinance who have little or no equity. If a borrower has little or no equity in the home and house prices fall, then should the borrower default, the financial institution could not recover the full value of its loan by selling the house. Lenders traditionally require borrowers to have at least 20% positive equity in their home to refinance. If a borrower's home is valued at \$200,000 and the borrower owes

\$160,000 or less on the mortgage (loan-to-value ratio or LTV below 80%), then the borrower is potentially eligible to refinance at a bank, credit union, or other avenue.⁶ A financial institution that is refinancing a mortgage prefers a borrower to have positive equity in the home to protect the value of the collateral in the event that house prices fall.

The Home Affordable Refinance Program

Fannie Mae and Freddie Mac do not originate loans themselves; rather, they buy and guarantee loans that meet their criteria from lenders. Through HARP, the GSEs agree to purchase a borrower's new loan if the borrower meets the eligibility criteria and the new loan refinances one that the GSEs previously guaranteed. The eligibility criteria for HARP are set by the Federal Housing Finance Agency (FHFA), which serves as the conservator and regulator of the GSEs. The GSEs only refinance a borrower through HARP if the borrower's loan is already guaranteed by the GSEs. A refinance, therefore, does not add additional credit risk (the risk of a borrower defaulting) to the GSEs because they already own the credit risk of the borrower. If a refinance lowers a borrower's monthly payments and makes it less likely that the borrower will default, then a refinance could lower the GSEs' credit risk.

Since the program was announced in February 2009, the eligibility criteria for HARP have changed multiple times, with the most recent major changes occurring in October 2011. HARP currently requires a borrower to

- have a mortgage owned or guaranteed by Fannie Mae or Freddie Mac;
- have a mortgage on a single-family home;

⁴ CoreLogic, "CoreLogic Reports Negative Equity Decreases in First Quarter of 2012," press release, July 12, 2012.

⁵ See Sumit Agarwal, John C. Driscoll, and David Laibson, "Optimal Mortgage Refinancing: A Closed Form Solution," NBER Working Paper Series, October 2007.

⁶ If a borrower has private mortgage insurance, the borrower may be able to refinance if the LTV is above 80%.

- owe more than 80% of the value of the home on the mortgage;⁷
- be current on mortgage payments with no late payment in the past six months and no more than one late payment in the past 12 months;
- have the ability to make the new payments; and
- have had the mortgage sold to Fannie Mae or Freddie Mac before June 2009.⁸

The October 2011 changes attempted to allow more people to qualify for HARP (the post-October 2011 program is commonly referred to as HARP 2.0).⁹ When HARP 2.0 was announced, FHFA projected that the number of HARP refinances would double from the approximately 900,000 that had been performed at the time.¹⁰ Previously, HARP eligibility was restricted to borrowers with LTV ratios below 125%, but the cap on LTV ratios has been removed under HARP 2.0. The GSEs have also agreed to eliminate or reduce some of the additional fees, called loan level price adjustments,¹¹ that were charged to borrowers. They will also attempt to reduce closing costs through greater use of automated valuation models in place of property appraisals.

In HARP 2.0, the GSEs are providing incentives to lenders to refinance homeowners by waiving certain representations and warranties the lenders had made on the original loans. Representations and warranties are assurances that lenders make to Fannie and Freddie about the quality of a loan when they are selling the loan to the GSEs. If it is later determined that the loan does not meet the criteria that the lender claimed the loan met, then the lender may be required to repurchase the loan.¹² By waiving the representations and warranties against the original loan, the GSEs are allowing the lender to re-underwrite the loan to ensure that it meets the agreed upon standards. However, the waiving of certain representations and warranties applies only to refinances through the same servicer and not through different servicers.¹³

Possible Barriers

Experts have identified multiple factors that may be limiting the reach of HARP.¹⁴ One is up-front costs of refinancing. Even after the October 2011 changes, the GSEs still charge loan level price

⁷ To be eligible for HARP, borrowers must have LTVs above 80%. Freddie Mac and Fannie Mae, however, have announced that they will offer streamlined refinancing for borrowers with LTVs less than 80%. See Federal Housing Finance Agency, at http://www.fhfa.gov/webfiles/24110/PF_LettertoCong73112.pdf.

⁸ See Department of the Treasury, “Home Affordable Refinance Program,” at <http://www.makinghomeaffordable.gov/>.

⁹ See Federal Housing Finance Agency, “FHFA, Fannie Mae and Freddie Mac Announce HARP Changes to Reach More Borrowers,” at <http://www.fhfa.gov/>.

¹⁰ See Federal Housing Finance Agency, “FHFA, Fannie Mae and Freddie Mac Announce HARP Changes to Reach More Borrowers,” at <http://www.fhfa.gov/>.

¹¹ For more on loan level price adjustments, see Fannie Mae, “Loan-Level Price Adjustment (LLPA) Matrix” at <https://www.efanniemae.com>.

¹² FHFA has filed lawsuits against at least 17 lenders in cases related to put-back claims, which are lawsuits related to potential violations of representations and warranties or other underwriting violations. See Federal Housing Finance Agency, “FHFA Legal Filings,” at <http://www.fhfa.gov/>.

¹³ The waiving of certain representations and warranties applies only to refinances through the same servicer and not through different servicers. See Amherst Securities Group LP, *HARP: Program Changes and Their Implications*, October 24, 2011.

¹⁴ The list of barriers to refinancing is not exhaustive but highlights what some experts have identified as major factors in HARP performing below what was expected by the Obama Administration.

adjustments to some borrowers. Loan level price adjustments, as well as other closing costs associated with getting a mortgage, such as an appraisal,¹⁵ may require more upfront expenses than a borrower can afford. In addition, HARP currently allows for more streamlined refinancing if performed through a borrower's existing servicer rather than through a different servicer. For example, refinances through a different servicer require additional documentation and underwriting.¹⁶ As mentioned above, servicers receive additional representations and warranties relief for refinancing loans they already service compared to loans they do not service. These factors could potentially reduce competition and increase rates faced by borrowers, preventing some borrowers from participating. Also, HARP is a voluntary program; an eligible borrower needs to find a lender willing to offer them a new loan, which can be a problem given that some have raised questions about the capacity of originators to handle increased refinance applications.¹⁷

Summary of S. 3522 and S. 3085

S. 3522, the Responsible Homeowner Refinancing Act of 2012 (frequently referred to as "Menendez-Boxer") would expand borrower eligibility and streamline the application process for HARP.¹⁸ It targets many of the barriers described above. S. 3522 would change HARP eligibility to include borrowers with more than 20% equity. The bill would also prohibit loan level price adjustment fees and other up-front fees and eliminate appraisal costs for borrowers. S. 3522 would attempt to increase the competition among servicers by allowing the same streamlined refinancing process and representations and warranties policy to apply to a different servicer as to a borrower's existing servicer. In addition, the bill would remove income and employment verification requirements for borrowers who are otherwise eligible for HARP.

S. 3522 is a modified version of S. 3085, which was also introduced by Senators Robert Menendez and Barbara Boxer. S. 3085 includes the elements described above but differs from S. 3522 in several ways.¹⁹ First, S. 3085 would extend the date of HARP eligibility by one year to May 31, 2010. This means that, to be eligible, a borrower would have to have had their mortgage sold to Fannie Mae or Freddie Mac by May 31, 2010. S. 3522 would not change the cut-off date; an eligible loan must be originated on or before May 31, 2009, unless the Director of the FHFA extends the date. Second, S. 3085 would impose penalties on junior lien holders and mortgage insurers if they prevent an eligible borrower from refinancing. S. 3522 would not impose penalties on junior lien holders or mortgage insurers.

¹⁵ As mentioned previously, HARP 2.0 attempts to reduce closing costs through greater use of automated valuation models in place of property appraisals.

¹⁶ See Testimony of Laurie S. Goodman, Senior Managing Director at Amherst Securities Group, in U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *Helping Responsible Homeowners Save Money Through Refinancing*, hearing, 112th Cong., 2nd sess., April 25, 2012.

¹⁷ See Kate Berry, "Bank of America Says It Can't Process All Refinance Applications," *American Banker*, February 8, 2012, at <http://www.americanbanker.com>.

¹⁸ S. 170 and H.R. 363 would also encourage the refinancing of GSE loans. In addition to the congressional proposals, President Obama has proposed streamlining HARP to allow more borrowers with GSE loans to refinance and allowing some non-GSE borrowers to refinance through a new program to be run by the Federal Housing Administration (FHA). S. 3047 also allows for refinancing of non-GSE mortgages through FHA.

¹⁹ S. 3522 and S. 3085 have other differences, such as the definition of "qualified lender," which may not have as large an affect on the number of refinances as the two differences described above.

The Congressional Budget Office (CBO) provided a cost estimate of S. 3085 on August 24, 2012. CBO estimated that “the net budgetary impact of enacting S. 3085 would be insignificant over the 2013-2022 period.”²⁰ In its analysis, CBO also estimated that “the number of HARP refinancings would increase by about 20,000 per month—roughly a one-third increase in monthly HARP volume—until the program expires on December 31, 2013.”²¹ However, CBO attributes most of the additional refinancings from S. 3085 to the extension of the cut-off date from May 31, 2009, to May 31, 2010. S. 3522 does not have the extended cut-off date, potentially decreasing the number of expected refinancings compared with S. 3085.

Potential Impact of Large-Scale Refinancing

Housing Market

Mass refinancing proposals for borrowers with negative equity in their homes, or “underwater” borrowers, generally target borrowers who are current on their mortgages and are therefore not necessarily borrowers in imminent danger of default. A refinancing program that lowers borrowers’ monthly payments could impact the housing market by preventing some foreclosures that would otherwise have occurred had the program not been in place. Any potential impact on house prices is likely to be through averted foreclosures. However, because refinancing programs target borrowers who are current, the number of averted foreclosures is likely to be limited.

Several studies have assessed the potential impact of expanding HARP. A September 2011 analysis of a stylized²² large-scale refinancing program for GSE loans conducted by CBO estimated that 3.8% of homeowners that refinanced through such a program would in theory have been foreclosed on in the absence of a refinance.²³ Similarly, a study by Glenn Hubbard, Chris Mayer, Alan Boyce, and James Witkin of a refinancing program for GSE loans estimates that 5% of homeowners would lose their home without a refinance.²⁴ In his testimony before the Senate Committee on Banking, Housing, and Urban Affairs, Mark Zandi,²⁵ the chief economist and co-founder of Moody’s Analytics, estimated that an expanded HARP could result in 2.9 million additional refinances, which would translate to approximately 110,000 averted foreclosures using CBO’s assumption.²⁶ However, CBO’s cost estimate projected an estimated 240,000 additional refinancings as a result of S. 3085.²⁷ This would reduce foreclosures by 9,000 - 12,000 using the

²⁰ Congressional Budget Office, available at <http://www.cbo.gov/sites/default/files/cbofiles/attachments/s3085.pdf>.

²¹ Ibid.

²² CBO’s analysis of a stylized program did not analyze a specific legislative proposal but analyzed a stylized program that was broadly similar to several proposals. CBO’s cost estimate of S. 3085, however, specifically analyzed S. 3085.

²³ Mitchell Remy, Deborah Lucas, and Damien Moore, *An Evaluation of Large-Scale Mortgage Refinancing Programs*, Congressional Budget Office, Working Paper 2011-4, September 2011, at <http://www.cbo.gov/>.

²⁴ Alan Boyce, Glenn Hubbard, and Chris Mayer et al., *Streamlined Refinancings for up to 14 Million Borrowers*, January 18, 2012, <http://www4.gsb.columbia.edu/>.

²⁵ See Testimony of Dr. Mark Zandi, chief economist of Moody’s Analytics, in U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *The Responsible Homeowner Refinancing Act of 2012*, hearing, 112th Cong., 2nd sess., May 24, 2012.

²⁶ In their analysis of a stylized program, CBO also estimated an additional 2.9 million borrowers would refinance. See Mitchell Remy, Deborah Lucas, and Damien Moore, *An Evaluation of Large-Scale Mortgage Refinancing Programs*, Congressional Budget Office, Working Paper 2011-4, September 2011, at <http://www.cbo.gov/>.

²⁷ CBO projected an additional 20,000 HARP refinances per month and assumed the program ran for approximately (continued...)

estimates described above. For comparison, RealtyTrac, a publisher of one of the largest databases of foreclosures, estimated that nearly 206,000 foreclosure filings occurred in May 2012.²⁸

Consumer Spending

Some have argued that by targeting refinancing proposals to only current borrowers, the primary motivation for mass refinancing is economic stimulus.²⁹ The magnitude of the potential stimulus depends on the number of borrowers that participate. In his testimony, Zandi estimated that refinancing would save the average borrower in excess of \$2,500 a year.³⁰ With 2.9 million additional refinances, borrowers' mortgage payments would fall by over \$7.3 billion in the first year, according to Zandi's estimates.³¹ The CBO cost estimate of 240,000 refinancings would reduce borrowers' mortgage payments by approximately \$600 million per year, assuming \$2,500 of average savings.

Arguably there is a zero-sum component to refinances, with redistribution of income from lenders to borrowers. Although a refinancing increases the amount of disposable income for a borrower, it reduces the potential income for the investor holding the mortgage. Borrowers are more likely to refinance when it is in their best interest, such as when interest rates fall. When a borrower refinances, the remaining amount of principal that is owed is returned to the mortgage holder, requiring the mortgage holder to reinvest at a time when rates are low.

However, the gains to borrowers and the losses to investors in mass refinancing may not necessarily be zero-sum.³² If borrowers spend more domestically of an additional dollar than investors would have spent of the same dollar, then refinancing would increase aggregate spending and support the economic recovery.³³ In addition, a significant percentage of mortgage-backed securities (MBS) are held by foreign investors and the federal government.³⁴ Reducing the investment income to those holders of MBS is unlikely to have a large negative impact on consumer spending in the United States. In analyzing both of these potential channels for

(...continued)

one year. See Congressional Budget Office, available at <http://www.cbo.gov/sites/default/files/cbofiles/attachments/s3085.pdf>.

²⁸ RealtyTrac, "U.S. Foreclosure Activity Increases 9 Percent in May," press release, June 11, 2012, at <http://www.realtytrac.com/content/foreclosure-market-report/may-2012-us-foreclosure-market-report-7238>.

²⁹ See Testimony of the Honorable Phillip L. Swagel, in U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *State of the Housing Market: Removing Barriers to Economic Recovery*, hearing, 112th Cong., 2nd sess., February 9, 2012.

³⁰ See Testimony of Dr. Mark Zandi, chief economist of Moody's Analytics, in U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *The Responsible Homeowner Refinancing Act of 2012*, hearing, 112th Cong., 2nd sess., May 24, 2012.

³¹ Zandi calculates the \$7.3 billion by multiplying the total number of borrowers who would refinance (2.9 million) by the average mortgage balance (\$140,000) and the average rate reduction (1.8%).

³² See Joseph Tracy and Joshua Wright, *Why Mortgage Refinancing Is Not a Zero-Sum Game*, Federal Reserve Bank of New York, January 11, 2012, at <http://libertystreeteconomics.newyorkfed.org/>.

³³ For more on the spending decisions across income levels, see Karen E. Dynan, Jonathan Skinner, and Stephen P. Zeldes, *Do the Rich Save More?*, Federal Reserve Board, November 2000, at <http://www.federalreserve.gov/>.

³⁴ Approximately 30% of GSE MBS are held by foreign investors, the Federal Reserve, and the GSEs. The Federal Reserve System, *Flow of Funds Accounts of the United States*, Fourth Quarter 2011, Table L. 210, at <http://www.federalreserve.gov>.

stimulus, the Federal Reserve Bank of New York estimates that every dollar that a borrower's monthly payment is reduced by a refinancing would generate nearly 50 cents of additional spending.³⁵

Some argue that it is unfair to target economic stimulus through a relatively small number of homeowners who happen to meet certain eligibility criteria.³⁶ They suggest that if fiscal stimulus policies are implemented, they should have a broader base and not exist within the framework of housing policy.

Financial Sector

Mass refinancing might cause the GSEs to lose investment income from the mortgages they hold in their portfolio but gain from the reduced likelihood of default. In its cost estimate of S. 3085, CBO expected the GSEs would realize net savings of approximately \$500 million in FY2013 as a result of S. 3085.³⁷ A large-scale refinancing of GSE MBS would also reduce investment income for the Federal Reserve, which CBO estimates holds about \$850 billion in GSE MBS. CBO found that the Federal Reserve would experience revenue losses of "about \$500 million over the 2013-2022 period, with most of that impact falling in the next four years."³⁸ The amount expected to be lost by the Federal Reserve is similar to the amount expected to be gained by the GSEs.

A large-scale refinancing of GSE MBS would not only reduce income for large institutional investors like the GSEs and the Federal Reserve, but would also reduce returns to mutual funds and individuals' savings in public and private pension funds, which hold approximately 18.6% of agency MBS. The Investment Company Institute (ICI), the national association of U.S. investment companies, estimates that 62% of mutual-fund-owning households had annual incomes of less than \$100,000 in 2011.³⁹ However, the value of the MBSs held by investors already factors in prepayment risk, and, some argue, investors have benefited from the "barriers" that are limiting refinances.⁴⁰ Others express concern that further intervention now could cause investors to expect the government to intervene again in the future, causing future interest rates for borrowers to rise.⁴¹

³⁵ See Joseph Tracy and Joshua Wright, *Why Mortgage Refinancing Is Not a Zero-Sum Game*, Federal Reserve Bank of New York, January 11, 2012, at <http://libertystreeteconomics.newyorkfed.org>.

³⁶ Testimony of the Honorable Phillip L. Swagel, in U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *State of the Housing Market: Removing Barriers to Economic Recovery*, hearing, 112th Cong., 2nd sess., February 9, 2012.

³⁷ Congressional Budget Office, available at <http://www.cbo.gov/sites/default/files/cbofiles/attachments/s3085.pdf>.

³⁸ *Ibid.*

³⁹ Investment Company Institute, *Profile of Mutual Fund Shareholders, 2011*, February 2012, p. 105, at http://www.ici.org/pdf/rpt_12_profiles.pdf.

⁴⁰ The potential barriers to refinancing have limited prepayments, allowing investors to earn higher returns than may be expected in the current low interest rate environment. Testimony of Dr. Mark Zandi, chief economist of Moody's Analytics, in U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *The Responsible Homeowner Refinancing Act of 2012*, hearing, 112th Cong., 2nd sess., May 24, 2012.

⁴¹ For a summary of this concern and potential policy options, see Alan Boyce, Glenn Hubbard, and Chris Mayer et al., *Streamlined Refinancings for up to 14 Million Borrowers*, January 18, 2012, <http://www4.gsb.columbia.edu/>.

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