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Subject: Legacy Loans Program

The PPIP should be extended to include a TALF-like program for *newly-originated* Jumbo mortgages accumulated into a securitization. This would solve the problem that the FED is causing through its agency asset purchasing program. See American Banker article below.

Viewpoint: Two Steps to Stop Bleeding in Housing

American Banker | Wednesday, February 25, 2009

By Bill Hilliard

On Feb. 16, President Obama announced that the Treasury Department would add $200 billion to the Federal Reserve Board's $500 billion program to purchase mortgage-backed securities. This idea seems smart on the surface, but careful study reveals the opposite.

As currently structured, the Fed's spending has accelerated the housing downturn and added fuel to a recessionary spiral. The president can mandate simple changes to the Fed's program to correct this problem.

We have two home mortgage markets in the United States. The first is called the “agency” market. It consists of mortgage loans either purchased or insured by government-run agencies including the Federal Housing Administration, Fannie Mae, Freddie Mac, and others. These agencies connect Main Street—the residential mortgage market—to Wall Street—dealers and investors—by supporting a secondary market for loans. For 2009, the loan limit ceiling for agency mortgages is $417,000 for most of the country.

The second mortgage market is called the “non-agency” market. It consists of mortgage loans not eligible for U.S. government purchase or insurance. This non-agency market includes all so-called “jumbo loans”, which are loans for larger amounts than are permitted within the agency loan limits for a specific location.

Nonagency loan volume in the first nine months of last year fell 70% from a year earlier. They now make up less than 10% of the market. A paucity of nonagency lending compresses housing prices, creating a recessionary spiral in every urban market nationwide.

Until last year homebuyers could qualify for much more credit in relation to their incomes than is currently available.

For example, HUD estimates the median household income in Chicago in 2008 is $71,600. Families meeting this criterion comprise Chicago's middle-class. Using pre-crisis debt-to-income ratios, middle-class households with $71,600 of annual income qualified for approximately $496,000 in non-agency mortgage financing. Depending on their down payment, these families could purchase homes valued anywhere from $550,000 to as high as $620,000. These buyers were not reckless speculators. They were simply middle-class households purchasing family homes in conventional urban neighborhoods.

Today, subsequent homebuyers with the same qualifications are hard-pressed to obtain a loan exceeding $417,000. New buyers with 10-20% down can only pay between $460,000 and $525,000. As a result, home values have compressed for existing Chicago homeowners. Much or all of their home equity has been lost. Although the absolute amount of compression varies from house to house, and from city to city, the effect is similar for homes nationwide. As middle-class housing wealth is crushed, families cut their discretionary spending. This leads to business closings and layoffs, and in turn, to an increase in foreclosures. There is a vicious deflationary cycle occurring in some of the nation's formerly vibrant commercial centers.

Two things are needed to stop deflationary housing compression. Credit must be restored to all qualified middle-class homeowners purchasing or refinancing a primary residence, and a new form of mortgage contract is needed to entice secondary buyers to return to the nonagency market.

Increasing credit availability is easy. When Congress set the formula for agency loan limits, they granted Alaska and Hawaii limits 150% higher than the highest limits approved elsewhere in the United States; the government-run agencies can purchase and insure loans of up to $1,094,625 (though in practice, the agencies have limited loans to $793,750 or less). That limit should be extended to all agency mortgages nationwide. It would restore credit availability to Main Street immediately, without costing taxpayers a single dime.

Moreover, this policy would not inflate home prices in lower-priced communities any more than it has inflated Honolulu's $610,000 median price. A higher agency loan limit would simply ensure that credit is available to all qualified middle-class homebuyers, and that home prices do not overcorrect as an unintended result of an arbitrary loan limit.

Changing loan limits is not enough. We must also replace today's standard mortgage contract with one that compensates lenders adequately for holding large loans in portfolio while not penalizing borrowers with toxic terms or excessive interest.

The new loan type needed is not really new at all. It is called a shared appreciation mortgage. These loans are often used in commercial mortgage financings. Also, Congress adopted a SAM format for the Hope for Homeowners program it rolled out last year to refinance borrowers in default.

SAMs provide borrowers with a low, fixed-rate payment over the 30- or 40-year life of the loan. As compensation for this safety feature, lenders earn a risk premium on the back end by sharing in a piece of the home's appreciation. The lender's one-time, tax-deductible shared appreciation fee is paid by the borrower only out of profits received, if any, when the home is sold.

Essentially, the lender is a bondholder earning principal plus interest, as well as a real estate investor earning profits from the underlying property appreciation. Since residential real estate values increase by an average of 1.5% over inflation in the long run (and in the short run, borrowers try not to sell their homes at a loss), it is likely that the real estate profits would provide adequate compensation to reignite the jumbo mortgage market.

If all jumbo mortgages employed a SAM format, the loan premiums should drop back to the 0.25%-0.5% levels seen in the past. Over time these premiums may disappear altogether, because of the inherent real estate option value within the SAM.

Mr. Obama should immediately lift the loan limits for agency loans nationwide to $1,094,625.

In addition, he should adapt the FHA's Hope for Homeowners SAM format for all agency-supported loans exceeding today's $417,000 limit — not just for mortgage workout loans. Only a SAM format can provide lenders and investors with a compelling return to compensate them for holding jumbo mortgage securities in their portfolios, while concurrently providing homeowners with lower payments that are both fixed and affordable.

As part of the New Deal, the FHA launched a lending program adopting the 30-year amortizing loan format. This program was so successful that portfolio lenders followed suit, and secondary markets developed thereafter. It is time to reinvent the standard mortgage format once again.

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Best Regards,

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