The Successes and Shortcomings of the
Homeowner Affordability Modification Program

Testimony to the Subcommittee on Housing and Community Opportunity of the
Financial Services Committee of the U.S. House of Representatives

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Dean Baker, Co-Director
Center for Economic and Policy Research
1611 Connecticut Ave., NW
Washington, DC 20009
202-293-5380, 114
baker@cepr.net

Thank you, Chairwoman Waters, for giving me the opportunity to present my views to the subcommittee on the success of the Homeowner Affordability Modification Program (HAMP) and prospects for the recently proposed modifications to the program. I will begin my comments with a brief discussion of the state of the housing market. An understanding of this market is essential for assessing the merits of any mortgage modification program. Against this backdrop, I will provide an assessment of the extent to which HAMP has succeeded to date and the likely differences that the Home Affordable Foreclosure Alternatives Program (HAFA) will make for homeowners.

It is important to recognize the central role that the housing bubble has played in the mortgage crisis. While the proliferation of deceptive mortgages and the soaring unemployment rate of the last two years would have created problems for homeowners in any environment, the reason that we face a mortgage crisis, with millions of homeowners facing the loss of their home every year, is that we had a bubble in the housing market that is now in the process of deflating.

In many former bubble markets home prices are now down by more than 30 percent from their bubble peaks in the years 2005-2007. In some markets the declines exceed 50 percent. In these markets, even homeowners who got a traditional 30-year fixed rate mortgage are likely to be facing difficulties. Almost anyone who bought their home near the peak of the bubble will be underwater on their mortgage, owing more than the value of their home. This means that they have no equity to draw on to get them through a spell of unemployment or other serious economic setback.

Being underwater also means that homeowners have relatively little at stake in keeping their homes. Since they lack equity they will in many cases find it more attractive to default on a mortgage and seek rental housing than to continue to make payments on their mortgage. The fact that such a huge number of mortgages are underwater guarantees that there will be millions of homeowners facing default and foreclosure.

Unfortunately for struggling homeowners, home prices in most markets will almost certainly have further to fall in order to return to long-term trend levels. The Case-Shiller 10-City index is still almost 50 percent higher, after adjusting for inflation, than it was in June of 1996, before the bubble began to send house prices upward. This run-up in house prices followed a full century in which nationwide house prices had just tracked the overall rate of inflation. While the 10-City index is not fully representative, even the broader House Price Index (HPI) produced by the Federal Housing Finance Agency still shows a real increase in house prices of 30.8 percent since the second quarter of 1996.[1]

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[1] This calculation chains the rise in the quarterly index from the second quarter of 1996 until the fourth quarter of 2007 with the rise in the monthly index from the fourth quarter of 2007. In addition to differences in geographical coverage, there are also methodological differences between the Case-Shiller index and the HPI. The most important difference is the exclusion of the non-conforming mortgages from the HPI. This exclusion likely caused the HPI to understate the increase in house prices prior to the peak of the bubble and to understate the decline in the years since the peak.

These rises indicate that house prices nationwide still have considerably further to fall before returning to trend levels.

In this respect, it is important to note that there were three important supports for the market put in place in 2009 that will be removed over the course of this year. Probably the most important support was the Federal Reserve Board's purchase of $1.25 trillion of mortgage-backed securities as part of its policy of "quantitative easing." This policy pushed mortgage rates to their lowest level in more than 50 years, with the 30-year fixed rate bottoming out at close to 4.7 percent last summer. This program was phased out as of March 31, 2010. Mortgage interest rates have already risen to 5.2 percent and are almost certain to increase more in the absence of further intervention. It is quite likely that the 30-year rate will soon cross 5.5 percent, and some economists have projected year-end rates as high as 6.0 percent.

At 6.0 percent, a monthly payment will be 15.6 percent higher than with a 4.7 percent mortgage. This means that, other factors being equal, the same household in the higher interest rate environment only could afford a home that costs 15.6 percent less. This will be an important factor putting downward pressure on prices.

The second major housing support put in place in 2009 was the first-time homebuyers tax credit. The $8,000 credit is just under 5 percent of the median price for an existing home. The credit was originally scheduled to expire at the end of November of last year. It was extended and expanded to include some current homeowners. But this new credit is scheduled to expire at the end of April. The end of this credit will pull out an important support for the market.[2]

The third important source of support for the housing market was the Federal Housing Authority (FHA), which insured 30 percent of purchase mortgages in 2009. This was a huge expansion of the FHA's role in the market, which had contracted to just 2.0 percent at the peak of the subprime boom in 2006. One consequence of such a rapid expansion in the context of declining home prices and high unemployment was large losses on its loans. As a result, the FHA has fallen below its minimum capital requirements and is now cutting back on its involvement in the market.

Many of the purchasers who received FHA-backed mortgages will be unable to otherwise obtain financing and therefore will be excluded from the market. If the FHA were to reduce its market share by 10 percentage points, and half of the excluded homebuyers were unable to get other financing, this would imply a reduction of 5 percent in the number of potential homebuyers. This could have a substantial impact on home prices.

[2] Some states also have first-time homebuyers credits, most notably California. California's credits are capped at $10,000, but the state has appropriated only $200 million for its credits. This sum will be exhausted long before the end of 2010.

Other factors suggesting further declines in home prices include a continuation of record housing vacancy rates. In the fourth quarter of 2009, the most recent data available, the Census Bureau reported that 10.9 percent of all housing units were vacant year-round. This is more than 50 percent higher than the vacancy rates that would ordinarily be observed. The high vacancy rates are also leading to falling rents, with the rental components in the consumer price index falling for the first time since they were created. All of these factors suggest that further home price declines are very likely. Indeed, the HPI, after rising somewhat in summer and fall of 2009, fell 2.6 percent from November of 2009 to January of 2010, the most recent month for which data are available.

This backdrop of falling house prices is essential for understanding the extent to which HAMP and the HAFA are actually helping homeowners. The presumption of many participants in this debate is that it is desirable to always keep people in their homes as homeowners. This is not necessarily true. In many cases, families will face far higher housing costs as owners than they would if they were renting a comparable unit. This means that they are draining away income from other potential uses, such as providing food, clothes, education, and even proper upkeep of the home.

Higher monthly housing costs can perhaps be justified if families are accumulating equity in a home. However, if the price of the home is still falling, then it is unlikely that the homeowner will be able to accumulate equity. In such situations, even if homeowners receive the benefit of a modification, they are likely to still find themselves underwater when they do end up selling their home. This means that they could still face a strike on their credit record from a short sale and will have wasted all the excess money paid on a mortgage during their years of homeownership.

Unfortunately, none of the HAMP criteria involve assessing the housing market in which a home is located by considering the ratio of home prices to annual rents. A high ratio of price to rent means that the family could save money by renting a comparable unit. I recently did an analysis comparing ownership costs with rental costs with Hye Jin Rho.[3] We found that in several cities, homeowners who bought near the peak of the bubble could save more than $1,000 per month by renting a comparable home, even assuming a low-cost mortgage. This huge gap between ownership and rental costs suggests that homeowners may still be paying far more in housing costs than necessary, even if they received the benefit of a modification through HAMP.

Furthermore, the existence of a high price-to-rent ratio suggests the likelihood that the bubble has not fully deflated in a specific market. This increases the probability that the home price will fall further, leaving the homeowner in a situation where they will

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[3] Baker, Dean and Hye Jin Rho, 2009, "The Gains from Right to Rent," Washington, DC: Center for Economic and Policy Research, available at http://www.cepr.net/index.php/publications/reports/gains-right-to-rent/. The calculations in this study compare housing costs for a home at 75 percent of the median house price with the fair market rent estimated by the Department of Housing and Urban Development for a two-bedroom apartment.

eventually have to sell their home for less than the outstanding principal on the mortgage.[4]

Since the HAMP fails to consider price-to-rent ratios, it is likely that many of the modifications have taken place in markets that are still bubble-inflated. It is difficult to see how keeping families in a situation in which they are paying more in housing costs than necessary, and in which they likely will never accumulate any equity, is helping them. In these situations, the money paid out through the HAMP programs is helping banks, not homeowners.

Of course the vast majority of delinquent homeowners facing foreclosure have not received permanent modifications through HAMP. The most recent data show that less than 200,000 homeowners have gotten permanent modifications. This is in a context in which close to 1.5 million families a year are leaving their homes through foreclosure or forced sales. In this context, the HAFA program seems more likely to provide a benefit to homeowners, although the cost per homeowner to the public could be substantial.

The proposal effectively gives money to servicers and first and second mortgage holders for allowing homeowners to make a short sale or to be released from their mortgage commitment without a strike against their credit record. The plan provides up to $2,000 to first lien holders to pay up to $6,000 to second lien holders to release the homeowner from their obligations.[5] It also provides up to $1,500 to servicers for their time in working out this arrangement. The proposal also gives homeowners up to $3,000 in relocation assistance.

This formula implies a potential cost of up to $6,500 for each homeowner who benefits from the program, with a division of $3,000 per homeowner and $3,500 for the investors and servicers. In effect, taxpayers will be paying the investors and servicers up to $3,500 to release each homeowner from their obligations without a strike on their credit record. In most cases, the cost is likely to be somewhat less than this amount, but even if the payments to the first lien holder average only half the maximum, the government will still be paying servicers and investors $2,500 per homeowner to prevent them from having a strike on their credit record.[6] Nonetheless, this is still likely a more realistic formula for helping homeowners in most cases than modifications through the HAMP program.

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[4] The nationwide average for the ratio of home prices to annual rent would be in the neighborhood of 15 to 1, however there have been long-term divergences, especially in markets where they are rent controls or other restrictions on raising rents.

[5] The payment to the first lien holder is on a 1 to 3 basis for the payments made to the second lien holder in a short sale.

[6] It is also worth examining whether the second lien holders are likely to unduly profit from this arrangement. In principle, this plan allows them to get a return of up to 6 cents per dollar. Second liens on homes where the first mortgage was underwater have often sold at much lower prices.

As a less costly and more effective alternative, Congress could attempt to increase the bargaining power and security of homeowners by temporarily changing the rules on foreclosure to allow homeowners to remain in their homes as renters for a substantial period (e.g. 5-10 years) following a foreclosure. During this time homeowners would pay the market rent for the home as determined by an independent assessment.[7]

This proposal would have the benefit of immediately providing housing security to families facing foreclosure without forcing them to go through a lengthy review process. (The right can be restricted to only apply to some homeowners, such as those who bought a home for less than the median price in an area, so as to ensure that it is not benefiting wealthy homeowners who used bad judgment in paying too much for a home.)

This Right to Rent plan also would not require any taxpayer dollars. It only temporarily changes the rules on foreclosure, based on the extraordinary conditions in the housing market that occurred during the bubble years . Lenders can still foreclose and take possession on a home when the homeowner has defaulted on a mortgage, however, they will potentially have to accept the homeowner as tenant for a substantial period of time.

This immediately gives the homeowner security in their home. They will be allowed to stay there for a substantial period of time, allowing their children to stay in their schools and families to prepare for and plan their future moves. Right to Rent also would make foreclosure much less attractive to investors, since they would potentially have tenants for a substantial period of time. This gives investors more incentive to modify loans on their own, without the involvement of the government.

Right to Rent also would provide the right incentive to lenders in future market frenzies. If lenders realize that rules on foreclosure can be changed to their disadvantage in such cases, then they will likely be more cautious when they see extraordinary run-ups in home prices in the future. This is exactly the sort of rational behavior from investors that the government should want to encourage.

Conclusion

To date, the various loan modification programs that have been put forward, including HAMP, have offered limited benefit to homeowners in large part because there has been little interest in considering the underlying dynamics of the housing market. As it stands, we are in a bubble market that is in the process of deflating, but which almost certainly has another 10-20 percent to decline. This means that most homeowners who purchased their homes near the peak of the market are unlikely to ever see any equity in their home. In addition, even they are likely to be paying more in ownership costs than they would to

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[7] This "Right to Rent" proposal is outlined in Baker, Dean, 2009. "The Right to Rent Plan," Washington, DC: Center for Economic and Policy Research, available at http://www.cepr.net/index.php/publications/reports/the-right-to-rent-plan/.

rent a comparable home, even if they were to benefit from a modification and receive a lower cost mortgage.

The HAFA program is a step forward in recognizing that many homeowners will be better off giving up their home, although a substantial portion of HAFA's costs are essentially payments to investors and servicers to prevent homeowners from getting a strike on their credit record. A much more efficient approach would be Right to Rent legislation that would temporarily change the rules on foreclosure to allow homeowners to stay in their homes, paying the market rent for a substantial period of time following foreclosure. By incentivizing lenders to negotiate, Right to Rent would immediately benefit all homeowners facing foreclosure. Finally, Right to Rent could be implemented at no cost to taxpayers and would require no new bureaucracy.