A Proposal to Help Distressed Homeowners

by Chris Foote, Jeff Fuhrer, Eileen Mauskopf, and Paul Willen

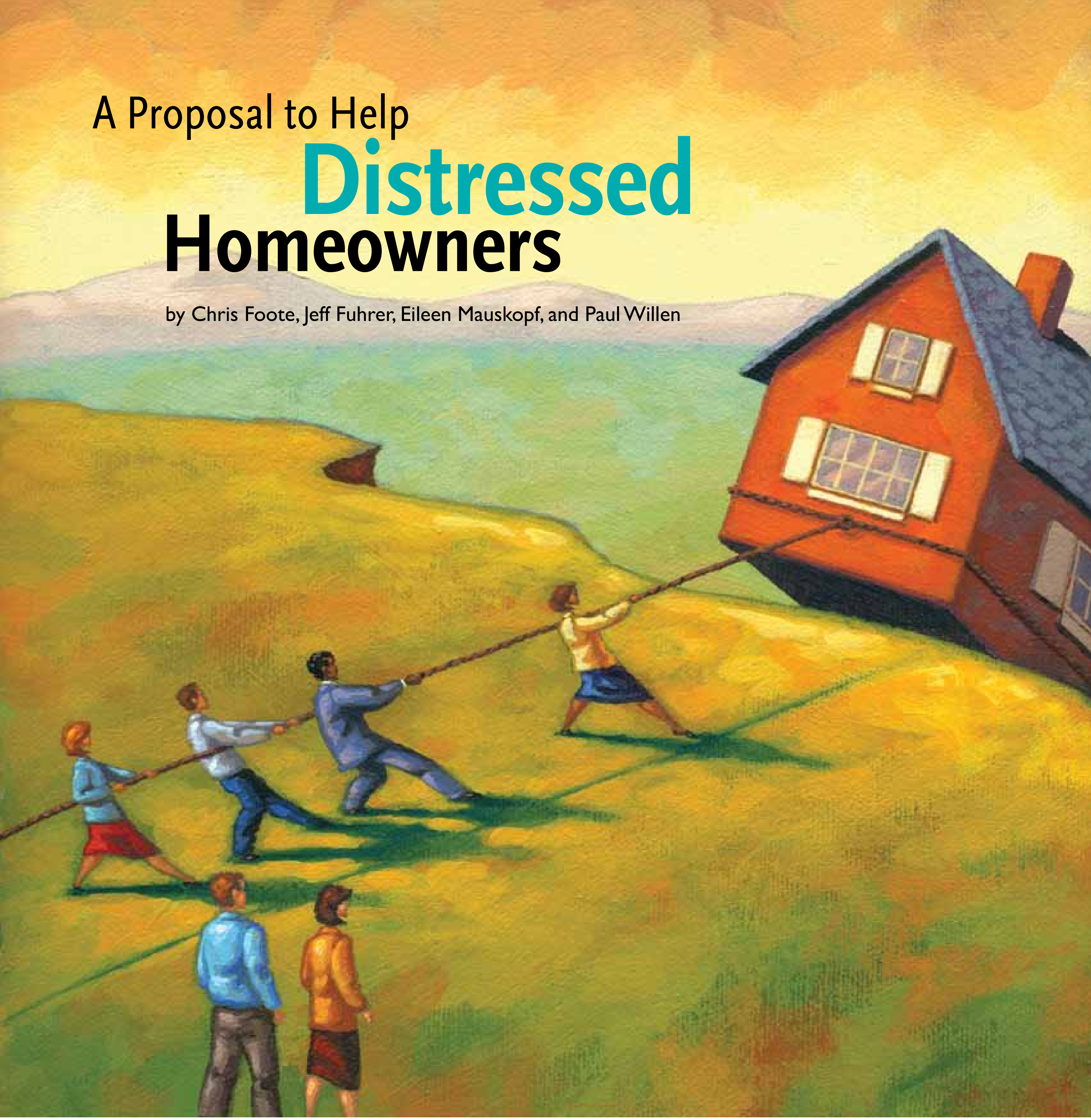

Illustration: Eric Westbrook

Homeowners who have previously been up-to-date on their mortgage often stumble after a significant income disruption. That is especially true if they have negative equity—in other words, if they owe more on the mortgage than their home is worth.

With job losses generating more mortgage delinquencies, policymakers might consider whether foreclosure-prevention efforts should help homeowners with payments for a while. We propose a government payment-sharing arrangement that would work with the homeowner's existing mortgage and significantly reduce monthly payments while the homeowner is unemployed. We believe a payment-sharing plan stands a better chance of preventing foreclosures than longer-term but less significant payment reductions achieved through loan modification.[1] More broadly, payment sharing could not only benefit participating homeowners, but also could protect the housing industry from escalating foreclosures and could stabilize financial markets and the economy.

In our view, previous plans based on long-term loan modifications, have been stymied because (a) contrary to the common wisdom, lenders and mortgage servicers will not always find a modification to be in their best interest, and (b) extant plans are generally unable to offer modifications to those who become unemployed.[2]

The payment-sharing plan we propose has neither of those drawbacks. It could take the form of either a loan or a grant. In both versions, the homeowner would have to provide proof of job loss—or other significant income disruption—and proof of the home's negative equity.

Plan Features

Negative equity does not by itself lead to default unless the amount is extremely high.[3] Owners with negative equity who have not suffered adverse life events (for example, job loss, divorce, or illness) generally stay current on their mortgages.[4] Negative equity is, however, a necessary condition for default.[5] Borrowers who have positive equity usually can sell or refinance. The reason that foreclosures are rising today is that falling housing prices have increased the prevalence of negative equity at the same time that unemployment is rising—the so-called *double-trigger* effect.

The reason that foreclosures are rising today is that falling housing prices have increased the prevalence of negative equity at the same time that unemployment is rising.

The best way to prevent foreclosures right now is by the government offering borrowers who have experienced income disruption some temporary but significant assistance. The two versions of our proposal have five features in common. First, the government pays a significant share of the household's current mortgage payment (25 percent and up) directly to the mortgage servicer. Second, the government's share of the mortgage payment is equal to the percentage decline in family earned income. Third, proof of a recent and significant income disruption is required. Fourth, the assistance ends upon resumption of the borrower's normal income stream—or after two years. Fifth, the plan caps the maximum government payment (say, at $1,500 monthly).[6]

Addressing Challenges

The most difficult design challenge is to avoid attracting homeowners who don't need help and inadvertently letting them game the system (a phenomenon called *moral hazard*). Eligible homeowners would have to prove that their equity is either essentially zero or negative. In the loan version, program participants would pay an interest rate reflecting the elevated risk the government is assuming. And the grant version would explicitly exclude homeowners having enough income (or wealth) to continue making mortgage payments despite negative equity.

The Loan Version

In the loan version, the government's payments accrue to a loan balance to be repaid with interest at a future date. Government payments end when the homeowner's income stream has been restored, or after two years, whichever is sooner. Because the household's mortgage payments may rise (for example, with an adjustable-rate mortgage), the government's payment is capped at a predetermined amount. When borrowers stop receiving government payments, they begin repaying them. They have five years to do so. If the home is sold for more than the value of the mortgage balance, the government has first claim on any remaining equity, up to the value of the loan balance, including accrued interest.

If after the payment-assistance period, the homeowner still cannot afford the monthly payment on the original mortgage, the foreclosure process may begin. The government might then seek loan repayment as it would for education loans—for example, by placing liens on future income.

The Grant Version

In the grant version, the government would provide at least 25 percent of the monthly mortgage payment for up to two years without requiring repayment. Homeowners whose adjusted gross income (average income in the two years prior to income disruption) exceeds a to be specified multiple of median family income in 2008 would not be eligible, a useful if imperfect means of excluding very high-income homeowners who likely have accumulated significant wealth to self-insure against temporary income loss.

Advantages and Disadvantages

The plan provides a significant but temporary reduction in the homeowner's payment during the period of income loss—an advantage over loan-modification programs, which do not always lower payments sufficiently and sometimes even raise them—by adding missed payments to the outstanding loan balance.

For lenders, servicers, and second-lien holders, the plan contains a more realistic recognition of their incentives and no pressure to do mortgage modifications. Even if foreclosure cannot be avoided when the government aid terminates, the housing market is likely to have recovered enough that disposal of the property will garner a higher price.

On the downside, the plan probably cannot stop homeowners who have extreme negative equity—say, 40 percent or greater—from defaulting when government aid ends. Indeed, the plan may merely delay foreclosure without any guarantee of economic or social benefit. Another concern is that the borrowers who should get help may choose to default rather than pursue a government loan. Meanwhile, the grant version raises the potential for moral hazard.

Finally, administering the program does require some cooperation from mortgage servicers—for example, giving applicants their outstanding loan balances and some home-price information. If the government chose to offer payment for such assistance, that would add cost.

Estimating Costs

The cost of the grant version is easier to estimate than the cost of the loan version. The civilian labor force is about 155 million persons. With the unemployment rate at 9.4 percent in July 2009 and continuing high, more than 14 million workers will be unemployed. An upper bound on the share of unemployed persons who are likely to be homeowners is the national homeownership rate of about 68 percent. That suggests 9.5 million unemployed homeowners.[7] A very high upper bound on the share of unemployed homeowners likely to have negative equity is 35 percent, which implies that about 3 million persons would be eligible for the program. According to nationwide data on individual mortgages, the average mortgage balance of those who are 60-plus days delinquent is approximately $200,000, with an average interest rate of 7.7 percent.[8]

Assuming a 30-year amortization schedule, the average yearly payment is $17,111. If the government pays 50 percent of the yearly cost on average, then the cost of providing help to 3 million homeowners is about $25 billion annually, perhaps $50 billion overall.[9] That amount is lower than the costs of other foreclosure prevention plans.

The loan version's cost would be smaller. Indeed, if all participants paid back their government loans, the program would cost virtually nothing in present value. Some borrowers, however, will default, and the government may therefore incur unrecovered costs. It is hard to estimate the degree of default, but the number is likely lower than in existing programs.

Although no program for preventing foreclosures is perfect, we believe that ours has the best chance of success because it addresses two of the leading causes of current foreclosures in a way that other plans cannot. Policymakers may decide the plan needs tweaking, but the spillover effects of escalating foreclosures call for urgency.

Chris Foote, Jeff Fuhrer, *and* **Paul Willen** *are research economists at the Federal Reserve Bank of Boston.* **Eileen Mauskopf** *is a research economist at the Board of Governors of the Federal Reserve System.*

Endnotes

[1] The views and recommendations expressed here do not represent an official position of the Boston Fed, the Board of Governors, or the Federal Reserve System.

[2] See Manuel Adelino, Kristopher Gerardi, and Paul Willen, "Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization," Federal Reserve Bank of Boston Public Policy Discussion Paper P09-4 (2009).

[3] Our proposals do not address defaults arising only from dramatically reduced equity positions.

[4] See Christopher Foote, Kristopher S. Gerardi, and Paul Willen, "Negative Equity and Foreclosure: Theory and Evidence," *Journal of Urban Economics* 64, no. 2 (2008): 234-245, which finds that more than 90 percent of Massachusetts owners with negative equity at the end of 1991 avoided foreclosure over the next three years.

[5] By negative equity we mean that the value of the home after paying the transaction costs for refinancing or selling is less than the outstanding balance of the mortgage.

[6] This cap is based on data suggesting that the average loan balance on seriously delinquent loans is about $200,000 with an average interest rate of about 7.7 percent.

[7] The number of houses/mortgages involved would be smaller if both spouses lost their jobs.

[8] The interest rate estimate of 7.7 percent is the average interest rate on loans that are currently 60 or 90-plus days delinquent, according to a Lender Processing Services Inc. loan-level dataset. The FDIC estimates an outstanding balance of seriously delinquent loans of $200,000—close to average the balance we find in LPS data.

[9] A $500 payment for each of 3 million loans would increase the cost by $1.5 billion.