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In his State of the Union[1] speech, President Obama laid out a new program to assist homeowners by enabling mass refinancing to the current very low level of mortgage rates. The Administration claims that tens of millions of families may benefit by this program with an average savings of around $3,000 per year. The cost of the program is estimated by the Administration to be between $5 and $10 billion and is proposed to be covered by a tax on major banks.

This appears to be at least the third attempt to jump start large scale refinances. In 2010 the HARP (Home Affordable Refinance Plan) was launched with a prediction that it would enable refinancing for five million borrowers that were otherwise unable to refinance. There were many obstacles and fewer than one million families were able to successfully refinance. Then, in late 2011 the eligibility rules were eased in HARP II. And now we have HARP III.

Why is it proving difficult to achieve substantial refinances? There appear to be several reasons. One is simply that the plans, in particular HARP I and to a lesser extent HARP II, had eligibility criteria that sharply reduced the universe. These criteria included no delinquencies in the past six months, current loan-to-value above 80% and (in the case of HARP I) below 125%, origination of the underlying loan before 2009, etc. Second, the GSEs (Government Sponsored Enterprises, Freddie Mac and Fannie Mae) have applied substantial fee and rate add-ons that sharply reduced the benefit from refinance. Third, underwriting standards including documentation are very strict. Fourth, there are significant operational issues with mortgage servicers who are swamped with delinquent loans, foreclosures in process, and attempting to deal with multiple government refinance or modification programs.

Streamlined Program

To address some of these obstacles, professors at the Columbia Business School[1] have proposed a simple yet comprehensive plan. This plan would allow any homeowner with a GSE mortgage to refinance his or her mortgage with a new mortgage at a fixed rate of 4.00% or below. The only requirement is that the homeowner be current on his or her current mortgage for at least three months. The underwriting process would be streamlined (and lenders on the new loans indemnified against “rep and warranty” violations), with no required appraisal or income verification.

The professors argue that lowering payments through mortgage finance is an important channel through which monetary policy is intended to assist the economy in difficult times. Yet today, thanks to various frictions including high GSE fees and falling home prices, this refinance channel has been effectively closed. Their proposal would reinstate the mortgage refinance channel.

Who would be the winners if this proposal comes to fruition? Clearly, qualifying homeowners would benefit. The professors estimate that 14 million homeowners would achieve an average payment reduction of $2,600 per year. This is effectively a very large, and permanent, tax cut. Economists generally believe that the stimulative effect of permanent tax cuts is much greater than the effect of temporary tax cuts (like the payroll tax holiday currently in place).

The GSEs would benefit from large up-front fees from the new originations and the credit risk of these mortgages would be lower than the ones they replace. On the flip side, the GSEs hold large quantities of securities currently valued at premiums to par, and the price of these securities would fall. The professors estimate that the net effects on the GSEs would be positive.

Mortgage lenders and title companies would benefit from the new business.

Taxpayers would benefit from reduced liabilities for the GSEs and improved housing market conditions and economic activity.

Who would bear the costs? The primary bearers of the costs would be holders of mortgage-backed securities. Assuming that investors simply replaced the securities that paid off with MBS constructed from the newly created loans, then the investors yield would decline from 5-6% to something around 3%. Also, large mortgage servicers would incur declines in the value of their mortgage servicing rights.

Companies involved in mortgage lending would benefit while mortgage investors and servicers would lose. The large banks are heavily involved in each of these activities and the net effect for each bank would depend on the ratio of new loans generated to existing loans paid off.

Background

The ability to prepay a mortgage loan is a valuable option held by the mortgagor. Normally, when market interest rates fall dramatically, we would expect to see a huge surge of refinances as mortgagors take out a new lower rate loan and pay off the higher rate existing loan. But this process has been severely hampered in the current cycle thanks to falling housing prices and tighter loan underwriting.

The consequence has been a bonanza for owners of mortgage backed securities (MBS) that are insured or guaranteed by the Federal Housing Administration or by Freddie Mac or Fannie Mae. The prices of such securities have skyrocketed due in large part to the refinance obstacles. Across the universe of agency MBS the average premium is seven points (that is, the average price is 107). If the ability to refinance were not constrained, the average premium would be cut in half.

Effectively, the Columbia plan will cause MBS to trade more or less like they would have absent the frictions currently impairing the refinance process.

Policy

There is a lot of debate about whether offering mortgage customers a call (prepayment) option is good policy. While highly valuable to the mortgagor, this call can create volatility in interest rates and requires extensive hedging by mortgage originators and investors. Irrespective of the arguments pro and con regarding offering the call option as a standard feature of mortgage loans, the fact is that most mortgages today have this call option and mortgage investors bought MBS knowing this call was in place.

The professors at Columbia argue that the mortgagor should own an additional option – the ability to repurchase his or her loan at a discount if interest rates rise or if credit quality worsens. Companies that issue marketable debt generally have this ability, why not homeowners as well? The effect would be to enable homeowners to build equity more rapidly and possibly reduce both interest rate risk and credit risk. It would reduce the effect of mortgage "lock in" where a borrower is reluctant to move if he holds a low rate mortgage during a period of high or rising interest rates. The ability to buy back your mortgage at a discount would increase labor mobility and economic efficiency. So far as I am aware, this ability to repurchase your mortgage at a market discount is only currently available in the Danish mortgage market.

It seems to be working pretty well in Denmark. The Danish mortgage market is well established and highly stable. Indeed, housing prices in Denmark rose further and fell faster than they did in the US during the housing boom and bust, yet delinquencies and foreclosures in Denmark remained very low. It seems to me we ought to give the Danish model some further study.

[1]Barack Obama, State of the Union Speech, January 2012.

[2]Alan Boyce, Glenn Hubbard, Chris Mayer, and James Witkin, "Streamlined Refinancings for up to 14 Million Borrowers ", Columbia University, 2012.