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HOPE NOW: One Step to Resolve the Subprime Mortgage Crisis

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With the economy struggling for growth under the combined weight of the housing and mortgage crises, Treasury Secretary Henry Paulson's "HOPE NOW"—a negotiated voluntary agreement with mortgage lenders, investors, and others—is a far better way to deal with the hundreds of billions of dollars worth of subprime mortgages than heavy-handed legislation, which is likely to come into effect too late to do borrowers much good.¹ The simple fact is that housing and some of the financial markets are a mess, and the current bad news only hints at the dangers that may lie ahead. The longer this situation continues without effective action, the more likely it is that consumer and market confidence will continue to erode and that additional areas of the economy will weaken. Any government response should be temporary and carefully crafted to address today's problems without a permanent increase in the federal government's role that could undermine the housing market over the long term.

This is not the time or place to lay blame, although there is plenty of that to go around—from irresponsible, naïve, or undereducated borrowers to sloppy, unscrupulous, or predatory lenders. The immediate issue is what, if anything, can be done through new policies to prevent these problems from snowballing. This is a time for appropriate and effective policy solutions, but not a regulatory or legislative overreaction that would have harmful consequences.

The Administration's Proposals. In short, Secretary Paulson worked with both lenders and inves-

tors to facilitate a voluntary program under which subprime mortgages that are about to reset from a low initial interest rate to a higher one would be frozen at the current lower rate for a period of time, perhaps five to seven years. Such an agreement would allow workers who can afford their mortgages today, but would not be able to pay the higher mortgage rates that will go into effect otherwise, to avoid immediate foreclosure. It would grant them valuable time to proceed in a more orderly way to refinance their mortgages, improve their finances, or sell their homes.

The limited steps in HOPE NOW have the potential to help restore stability to financial markets and reduce the chance of further weakening of the economy. Without steps to mitigate damages, many loans will likely be forced into foreclosure, causing even greater uncertainty in the markets. Foreclosure is both time consuming and expensive and hurts both the borrower and the mortgage holder. Moreover, the foreclosure of one property in a neighborhood tends to hurt the value of nearby homes. As property values decline, additional loans and securitized mortgages will be seen as riskier and more likely to lose value. Also, as homes go into foreclosure and

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downward pressure is placed on housing prices, local housing markets tend to freeze up as buyers and sellers grow unusually uncertain about reasonable values. Thus, Paulson's approach is one that should help calm and stabilize the markets without permanently increasing the federal government's role in housing markets.

The mortgage market has changed and evolved in recent years, with many new types of products taking a large proportion of recent loans. Those mortgages have been combined with others into billions of dollars worth of mortgage-backed securities and sold into the secondary market. The risk that these now-troubled securities could continue to add to the financial markets is something that should not be discounted. A number of major financial institutions have already written down billions of dollars of these securities, and some analysts are worried about widespread damage. For example, the state investment pool in Florida, which had invested in these securities, was temporarily closed to withdrawals recently after a "run" on the fund by anxious municipalities trying to protect their money.²

Thus, the negotiations leading up to the agreement announced by Secretary Paulson were even more difficult because the lenders who originated mortgages often no longer own them. This means that the agreement also had to be in the interest of investors and allowable under the terms of the securitization agreement. In fact, although people with loans where the interest rates freeze will pay less interest than they would otherwise, the lost income to lenders and investors will be much less than if the loan had defaulted. This agreement is not a bailout; rather, it is a time-out that will give much-needed breathing room to the markets.

Secretary Paulson's actions will not help everyone. Homeowners who either have already defaulted or cannot afford their mortgage payments even at the lower initial interest rate will be in the same fix that

they are now. The sad fact is that there is little that can be done for these borrowers. Similarly, those who can afford both their current mortgage payment and the higher payment after the interest rate resets will not be affected, because they do not need this assistance.

In addition to the HOPE NOW plan—which can be implemented administratively—the President is also urging Congress to enact a mixed bag of legislation in five areas related to mortgage lending. These include:

1. The President's FHA modernization legislation, which includes a troubling provision to reduce FHA down-payment requirements below their already low level;
2. Changing the tax code to exempt from taxable income the amount of any mortgage forgiveness;³
3. Allowing states to issue tax-exempt bonds to refinance existing mortgage loans, thereby using an inefficient tax concession to subsidize some borrowers;
4. Spending \$170 million to expand loan counseling to troubled borrowers, a service that should be financed by the lenders who will be the chief beneficiary of the proposal; and
5. An important package of changes to the federal regulation of Freddie Mac and Fannie Mae.

Of the five proposals, the most important is improving the regulation of Fannie Mae and Freddie Mac. The others range from potentially useful to harmful.

Principles for Policy Changes. Secretary Paulson's voluntary, negotiated agreement is a proper response to an increasingly serious situation. It is far preferable to the calls by some presidential candidates and legislators for a government-imposed solution that ignores both property rights and contracts. Any action to address the mortgage crisis should measure up to four key principles to ensure

1. See Ronald D. Utt, "H.R. 3915 Would Impose New Burdens and Limits on Moderate Income Borrowers," Heritage Foundation *WebMemo* No. 1703 November 14, 2007, at www.heritage.org/Research/Economy/wm1703.cfm.

2. Craig Karmin, "Florida Fund Is Drained of \$1.2 Billion, Future of State Pool Unclear as Investors Continue to Retreat," *The Wall Street Journal*, December 7, 2007.

3. See JD Foster, "The Subprime Mortgage Crunch: Providing Tax Relief for Ex-Homeowners," Heritage Foundation *WebMemo* No. 1603, September 10, 2007, at www.heritage.org/Research/Taxes/wm1603.cfm.

that it does not, in the long run, undermine the financial and housing markets:

- **Respect for Private Property:** A negotiated interest rate freeze does not unilaterally abrogate private contracts. Instead of imposing a solution or allowing bankruptcy judges to unilaterally rewrite contracts, a voluntary freeze should result in a mutually beneficial solution that prevents greater damage to the economy. This agreement would not set a dangerous precedent that would allow unilateral federal revisions to contracts in the future; legislative proposals to unilaterally impose interest rate changes would.
- **No New Housing Subsidies:** Lenders and investors will take small losses now in order to avoid larger losses in the future. A key factor is that the losses will be taken by those who own the mortgages. This is far preferable to spending billions of taxpayer dollars on the problem.
- **No New Permanent Government Role:** A negotiated freeze on interest rates avoids an increased role for state, local, or federal government agencies. The solution lies with the private sector, which has the greatest interest in resolving the problem.

- **Temporary and Limited Measures:** Any solution to respond to rising problems in the subprime mortgage market must be carefully targeted, temporary, and limited to dealing with the immediate problem. It should not become a vehicle for expanding housing programs or pushing other agendas.⁴

Conclusion. Secretary Paulson's HOPE NOW is the right approach to begin restoring stability to financial markets. By acting as an honest broker, Paulson has orchestrated a solution in which lenders and investors will suffer modest costs today in order to prevent enormous costs if mortgages by the thousands go into foreclosure. A voluntary agreement is far superior to either doing nothing and letting the economy suffer additional damage or allowing the government to alter thousands of private contracts. It is also far superior to heavy-handed regulatory responses. Any government response should be targeted and limited to dealing with the immediate problem, not a vehicle for expanding housing programs or pushing other agendas.

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4. See Ronald D. Utt and David C. John, "The Subprime Mortgage Situation: Bailout Not the Right Solution," Heritage Foundation *WebMemo* No. 1604, September 10, 2007, at www.heritage.org/Research/Economy/wm1604.cfm.