



# Refinancing At-Risk Homeowners

## An Analysis of Today's Proposed Changes to the Home Affordable Refinancing Program

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### Introduction

Our nation's slowing economic recovery prompted policymakers to consider ways to shore up consumer demand and get our economy moving again. One central focus of these efforts was to find ways to improve the weak housing markets, where hundreds of thousands of foreclosed homes are keeping home values down and depressing household wealth, thus complicating efforts to generate demand and create jobs.

The Obama administration already had in place an important program that had the potential to strengthen the housing market, stimulate the economy, and increase employment. To combat the foreclosure crisis, the administration created the Home Affordable Refinance Program, or HARP for short, shortly after President Barack Obama took office. HARP was designed to allow current, but underwater, homeowners to refinance at historically low mortgage rates, a simple and eminently sensible idea since many homeowners would ordinarily not be able to do so simply because their home values had dropped, a common occurrence given that national home prices have fallen by more than a third since their 2006 highs.

Alas, HARP did not have the anticipated effect because a number of barriers to refinancing under this program, including program requirements established by the nation's two leading mortgage finance companies, Fannie Mae and Freddie Mac—currently in government conservatorship, limited the take-up of this program. Fewer at-risk homeowners turned to HARP than were expected.

Today, the Federal Housing Finance Agency, with Fannie Mae and Freddie Mac and in conjunction with the White House, the Department of the Treasury, and the Department of Housing and Urban Development, announced welcome changes to HARP to reduce the barriers to participation in order to “attract more eligible borrowers who can benefit from refinancing their mortgage.” While the details of the changes to

HARP are not yet fully spelled out, if implemented correctly, a revamped HARP could make a meaningful contribution to strengthening the housing market and the broader economy.

This issue brief examines the causes of the low participation in this program and analyzes today's announced changes to HARP. We also describe how a more effective HARP, while no panacea to the problems in the housing market, can play a role in strengthening the housing market and advancing economic recovery and job creation.

### What is the Home Affordable Refinance Program?

On February 18, 2009, President Obama proposed a series of major initiatives meant to address the housing and foreclosure crisis. One of the major programs announced at this time was the Home Affordable Refinance Program, or HARP, which is designed to lower the mortgage rates for homeowners who are still current on their mortgages but are at risk of becoming delinquent because the value of their property has dropped. Under current underwriting guidelines, many underwater homeowners with relatively high interest rates are unable to refinance into the historically low rates available today because their “loan-to-value ratio”—the outstanding amount of their loan as compared to the current market value of their home—is too high to qualify for a refinancing.

HARP is meant to allow these homeowners, particularly those who are “underwater,” owing more on their mortgage than their home is worth, to refinance into the current historically low rates, so long as their loans are held or guaranteed by Fannie or Freddie.

Here is how HARP currently works. First, a borrower must check to see if his loan is a Fannie Mae or Freddie Mac conforming loan, meaning one of the two housing finance giants can purchase the loan from a lender. If it is, then the homeowner is required to have an independent appraisal of the value of his home done to verify that the current loan-to-value ratio on his mortgage is less than 125 percent. If the borrower's mortgage meets the loan-to-value requirements, then the borrower is eligible for the HARP program, and can shop around for lenders to see who will offer the best pricing on a HARP refinancing loan.

Finally, after the borrower's income and other details are confirmed, the borrower closes on the refinanced mortgage, receiving a mortgage at the current low rates available to everyone else. The basic idea behind HARP was to provide access to the current lower mortgage rates to homeowners who were still current on their monthly payments but who were being shut out of refinancing options—not through any fault of their own but merely because their home prices had dropped in value.

Unfortunately, HARP did not have the effect it was meant to as just under 900,000 HARP refinancings occurred since the program's implementation in March 2009. This compares to President Obama's original estimate of 4-5 million HARP refinancings. Moreover, only

7 percent of mortgages refinanced through HARP are for borrowers who are more than 5 percent underwater (meaning that they have mortgages that are worth more than the value of the home itself), suggesting that HARP isn't really working effectively in targeting borrowers who are most in need of its help.

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### So, why was there such low take-up of the program?

At a high level, HARP did not work as well as it should have because it was not particularly appealing to home mortgage borrowers and lenders. On the borrower side, HARP was unattractive because the upfront costs are high compared to the lower payments offered by refinancing. To be able to participate, borrowers have to pay for an appraisal before they even know if they're eligible for a HARP refinancing. If they qualify, they must pay relatively high closing costs, including the purchase of new title insurance.

Moreover, borrowers whose property values have dropped to the point where their outstanding loan balances are more than 105 percent of the value of their homes—a loan-to-value ratio of 105—are subject to “loan-level price adjustments,” which significantly increase the rates borrowers must pay. As Federal Reserve Board Governor Elizabeth Duke described, loan-level price adjustments are essentially “upfront fees that are added to the refinancing costs of loans that are judged to have higher risk characteristics, such as high loan-to-value ratios.” These loan-level price adjustments can significantly increase the fees that borrowers ultimately pay.

In short, underwater borrowers seeking to do a HARP refinance must shell out hundreds of dollars for an appraisal just to see if they qualify for HARP. And then if they do qualify, they can expect to pay potentially thousands more in closing costs—for a loan that may be priced much higher than the 4.25 percent rates that are available right now.

There was also a marked lack of enthusiasm for HARP on the lender side. Many lenders are not participating in HARP, and of those who do many will only refinance mortgages with loan-to-value ratios below 105. In other words, lenders are not offering HARP refinances for those homeowners who need them the most—those with mortgages that are larger than the value of their homes.

One reason why lenders are reluctant to participate in HARP is related to the representations and warranties they are required to make (for example, that the borrower's income and employment status are accurately stated, or that the property value is as listed) on loans they have sold to Fannie Mae and Freddie Mac. If a loan goes into default in the first six months after refinancing, then Fannie and Freddie typically ask the lender to prove that the reps and warranties it made on the loan were valid or else take the loan back. Lenders have been hesitant to refinance existing loans into HARP and make new reps and warranties on high loan-to-value loans.

## Proposed changes to HARP

Today, the Federal Housing Finance Agency—the conservator of Fannie Mae and Freddie Mac—announced several changes to HARP. These changes are designed to increase the effectiveness of the program by increasing participation of both borrowers and lenders.

First, FHFA announced it would reduce the upfront burden for borrowers seeking HARP refinances by eliminating standard appraisal requirements where possible. Appraisals are generally considered necessary to establish the loan-to-value ratio of the mortgage being refinanced, which for a number of technical reasons is important for how a HARP loan is financed. But the high costs of appraisals alongside the requirement that an appraisal must be done simply to determine eligibility, have made this a major barrier to HARP's success.

To ease these appraisal burdens, FHFA will now allow borrowers to use the home price-valuation models already utilized by Fannie and Freddie, which are generally fairly accurate, as a proxy for appraisals. But these so-called Automated Valuation Models are not available everywhere. The Obama administration is reportedly exploring how to expand the availability of the model and we look forward to further details for how it intends to do so.

FHFA should also explore other ways to reduce the barrier posed by the appraisal requirements for those without access to these models. One option might be to have the appraisal cost incorporated into the overall principal being refinanced, so that instead of paying hundreds of dollars upfront a borrower would simply pay a couple of dollars more each payment (which is more than offset by the lower rate). At the very least Fannie and Freddie should make these valuations available to homeowners considering HARP so that they can know before paying for an appraisal whether they have a chance of qualifying.

We also encourage FHFA to consider additional options to lower the upfront cost of participation to homeowners. FHFA, for example, could ease the title insurance requirement, which is typically the most expensive component of closing on a refinance. Title insurance provides certainty that the home is free of any legal claims against its ownership, and is a necessary part of mortgage lending because it effectively protects the holder or guarantor of the loan (in this case, the federal government) from legal claims against title. That being said, given that many of the properties in question have recently undergone a title search at the time of the home's original purchase, there may be ways that FHFA can reduce the costs of this title insurance requirement while still protecting itself from risk. A more limited title search may be appropriate for certain categories of loans and borrowers. We believe there are reasonable workarounds that may be possible, if FHFA is willing to go this route.

Second, FHFA supposedly will waive loan-level price adjustments, which increase the interest rates for borrowers with higher loan-to-value ratios. These loan-level price adjustments are meant to reflect the increased risk of default that higher loan-to-value ratios can bring. But given that Fannie and Freddie already own the credit risk on HARP-eligible

mortgages, waiving these loan-level price adjustments makes sense. The reason, as Federal Reserve Board Governor Elizabeth Duke noted, a HARP refinancing “can actually reduce risk because it reduces payments and thus makes default less likely.”

Third, to encourage the participation of lenders, FHFA announced that it will ease the requirements for lenders to make new representations and warranties on HARP refinances. The details have not been released. But one way that this can be done is by allowing the payment history of an existing loan to be grafted onto the new HARP loan. In this scenario, the fact that a loan has been current over its lifetime would be taken into account in considering the representations and warranties being made on the new HARP loan.

One detail that FHFA did provide was this—in exchange for reducing lender representation and warranties, FHFA will offer new risk-based fees that can be reduced if borrowers refinance into shorter-duration mortgages. The take-up rate of this new change to the HARP program and its ultimate impact will depend on how well these fees are designed.

Yet it remains unclear how many households can afford to increase their monthly mortgage payments by refinancing into shorter-maturity mortgages. We are hopeful that FHFA will structure these fees in a way that does not block the participation of otherwise eligible borrowers.

There are also other ways to encourage the participation of lenders—ways we urge FHFA to explore. Lenders could be required to publicly report the number of HARP loans they have provided, thus creating some public pressure. A similar approach was tried with the Home Affordable Modification Program—the companion mortgage relief program of the Obama administration—with limited success.

A more aggressive approach might be to establish actual numerical targets for HARP refinancing that must be met by mortgage-servicing companies of Fannie and Freddie loans. Mortgage-servicing companies collect mortgage payments from homeowners with mortgages purchased by Fannie and Freddie (and before the housing crisis for private financial institutions that packaged and sold them as mortgage-backed securities). Certain considerations should be taken into account in designing such requirements, including that servicers may be restricted from soliciting loans for refinancing, but generally speaking servicers should face pressure to implement HARP underwriting and accept HARP refinance applications. With the top four mortgage servicing companies run by Bank of America Corp., Citigroup Inc., JP Morgan Chase & Co., and Wells Fargo & Co.—responsible for more than half of all mortgage servicing—a little bit of motivation could go a long way toward increasing participation.

We also encourage FHFA to better advertise HARP to the 4 million to 5 million borrowers who are eligible. Whether through presidential remarks, the print media, the Internet websites of Fannie, Freddie, and the Federal Housing Finance Agency, or other

avenues, the opportunities for HARP refinancing should be made known to underwater homeowners. Increasing homeowner applications for HARP refinances will be an important part of increasing the overall take-up of the program.

Finally, FHFA will allow borrowers with loan-to-value ratios in excess of 125 percent to participate in the program. That is, borrowers with deeply underwater mortgage will be able to refinance their mortgage through HARP. This is an important step in expanding the program to those who need the most help. Mortgages with loan-to-value ratios in excess of 125 percent are not eligible to be packaged into so-called Real Estate Mortgage Investment Conduits, which means that they cannot be pooled into mortgage-backed securities.

Thus, in expanding the program to borrowers with loan-to-value ratios in excess of 125 percent, Fannie Mae and Freddie Mac are implicitly committing to holding the loans in portfolio. Details for how they will do so were not provided in today's announcement and we await further information to be released next year.

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## Potential benefits of proposed changes

The details of the proposed changes have not yet been fully spelled out. But if correctly operationalized, a revamped HARP could bring several benefits. Specifically, the changes could help reduce the number of mortgage defaults and contribute to stabilizing housing markets by allowing struggling homeowners who are current on their mortgages to take advantage of historically low interest rates to lower their monthly payments. The federal government is already on the hook for mortgages backed by Fannie and Freddie, so lower payments reduces the risk of default and taxpayer loss. Fewer foreclosures, in turn, will help stabilize home values and improve the value of the mortgages held or guaranteed by Fannie and Freddie and thus reduce taxpayer exposure.

Since the larger economic recovery is inextricably tied to stabilizing the housing market, a retuned HARP should also contribute to the broader economic outlook by putting more money into the pockets of struggling homeowners who are likely to spend it. With interest rates on 30-year fixed-rate mortgages near 4 percent, refinancing will mean more disposable income for households and greater spending power. This, combined with a more stable housing market, should help a bit to increase economic activity and job growth.

That being said, the details of the changes have not yet been fully spelled out. We at the Center for American Progress welcome changes that are intended to reduce the costs of participating in the program and will pay close attention to the implementation of the proposed reforms.

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