

## Bailing Out Underwater Mortgages



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### Summary

The ongoing mortgage crisis has produced profound changes in the economic conditions of American families and destabilized global financial markets. Millions of homeowners are currently “underwater” on their mortgages – that is, they owe more on their mortgages than their homes are worth. The federal government has taken unprecedented steps to intervene in the crisis, both to reduce family hardship and to curb insolvency among financial institutions. The nearly trillion-dollar federal policy response to the crisis represents the broadest economic intervention since the Great Depression. Yet as mortgage delinquencies and home foreclosures continue to rise, there is growing public concern that these interventions were insufficient and the end of the crisis is nowhere in sight.

### What are underwater mortgages, and why are they a public policy concern?

Underwater homeowners are of particular concern because they are more likely to default on their mortgages. First, households with mortgages worth more than their homes are unable to refinance their way out of the high-cost mortgages they can no longer afford. Second, even households who could afford to continue paying their mortgage may choose to strategically default, and walk away from their homes when there is no equity left to preserve (Geanakoplos and Koniak 2009; Foote et al. 2008). Some economists project that housing prices will continue to fall in 2010, increasing mortgage defaults by pushing more homeowners underwater and deepening the negative equity position for those already underwater (Christie 2010).

At a micro level, mortgage defaults and home foreclosures exacerbate financial hardships for families, result in residential displacement and community instability, depress local housing prices, and increase the need for social services. At a macro level, mortgage defaults reduce solvency among financial institutions, constrain the availability of credit, and slow economic growth. The federal government now has the unenviable task of designing policies to keep underwater mortgages from undermining economic recovery.

### The underwater mortgage crisis: How did it happen, and where are we now?

In the first half of the last decade, homeownership opportunities expanded quickly for several reasons: low interest rates, rapid housing price appreciation, expansionary mortgage policies, growth in the secondary mortgage market, and improved access to credit among traditionally underserved borrowers. Housing prices then declined after peaking

in mid-2006, triggering a wave of defaults among borrowers. By the end of 2009, American households had lost \$7 trillion in real estate wealth, 13.6 percent of all U.S. mortgages were in a state of delinquency, and nearly 1 in 20 borrowers – more than 5 million households – were 90+ days delinquent and at risk of foreclosure (Office of the Comptroller of the Currency and Office of Thrift Supervision [OCC and OTS] 2010; Streitfeld 2010).

Historically, homeowners have faced foreclosure because they experienced an income shock, such as job loss, which rendered them unable to continue making monthly mortgage payments. What makes this housing crisis unique is that the unprecedented foreclosure rates are driven by a more complicated mechanism. Through mid-2006, both rapid expansion in the subprime mortgage market and declines in bank underwriting standards made mortgages accessible to many borrowers with weak credit histories and insufficient (or unverified) income and assets (Bhardwaj and Sengupta 2008). Additionally, the new availability of mortgage products – such as interest-only loans and 80/20 loans with no down payment combined with rapid housing price appreciation to encourage increased debt among borrowers hoping to refinance into lower cost mortgages, once the home had appreciated sufficiently or interest rates had dropped (Edmiston and Zalneraitis 2007).

These mortgage market trends made borrowers particularly vulnerable to interest rate increases and declining housing prices. In mid-2006, as housing prices began to decline amid rising interest rates and credit markets tightened, homeowners found themselves unable to refinance out of high-cost mortgages, especially if their home was now worth less than their mortgage. The inability to refinance was particularly problematic for homeowners with variable-rate and interest-only mortgages, who could no longer afford the monthly payment after the mortgage reset at a higher rate.

A sizable portion of mortgage defaults are among underwater homeowners, and, as real estate prices continue to fall, homeowners are further underwater than ever. By the end of 2006 approximately 7 percent of homeowners were underwater (Calculated Risk 2007); the figure reached 15-20 percent by 2008 (Bernanke 2008; Hagerty and Simon 2008). The most recent estimates of underwater mortgages are staggering: Some claim that 11 million (one in five) U.S. households with mortgages are currently underwater (*eCredit Daily* 2010; Streitfeld 2010), while

others place the estimate as high as one in four (First American CoreLogic 2010; *The Economist* 2010).

The problem is even worse among households that purchased homes in the last five years, with 29 percent (nearly one in three households) underwater (Hagerty and Simon 2008). Among subprime borrowers who purchased a home in 2007, an estimated 37 percent were in a negative equity position by mid-2009 (U.S. GAO 2009). And by the third quarter of 2009, 12.5 percent of borrowers (more than 10 million homeowners) were underwater by more than 20 percent, with nearly half underwater by more than 50 percent (Bernard 2010).

## Negative equity and mortgage default

Homeowners with negative equity are more likely to default on their mortgages – even in the absence of financial hardship – because mortgage repayment does not increase home equity. Although there are no systematic data on the proportion of underwater mortgages in default, there is compelling evidence that the two are strongly related. A recent study by First American CoreLogic (2010) finds that homeowners default on their primary residential mortgages at the same rate as investors in rental properties, that is, once their homes are underwater by 25 percent or more, or the mortgage balance is \$70,000 higher than the property value. An estimated 5-10 million homeowners have reached this threshold (Bernard 2010; Streitfeld 2010). Consultants at Oliver Wyman recently estimated that nearly 17 percent of homeowners who defaulted in 2008 chose to do so because their homes were underwater, rather than because of financial hardship (Streitfeld 2010).

Underwater mortgages in default resolve through one of three ways:

- *Mortgage cure* (becoming current on the mortgage through repayment or loan renegotiation),
- *Short sale* (selling an underwater home in default at a loss, in some cases with the lender's consent to forgive the difference between the sale price and the mortgage amount), and
- *Foreclosure* (property repossession by the lender).

In the case of short sale and foreclosure, borrowers with other assets may be held liable for loan amounts not covered by the short sale or foreclosure. Short sale figures are one indicator of the pervasiveness of underwater mortgages in default. In January

2010, 15.9 percent of all home purchases resulted from short sales (Hoak 2010). Current estimates from real estate Website, Zillow.com, report that between 28.5 and 33 percent of homes sell at a loss, though loss sales are not always short sales (Zillow.com 2010; Haviv 2010).

## Who is underwater?

Homeowners relying either on subprime or reduced documentation mortgages (called “Alt-A,” for “Alternative-A paper”) are heavily exposed to mortgage defaults and negative equity. The U.S. Government Accountability Office provides the following estimates of underwater mortgage status:

- 63 and 57 percent of subprime and Alt-A borrowers, respectively,
- 80 percent of nonprime borrowers with variable payment mortgages, which include interest-only loans, and
- 75 percent of nonprime borrowers with short-term hybrid adjustable rate mortgages (U.S. GAO 2009).

A recent Massachusetts-based study found that homeowners who purchased condominiums and multi-family dwellings – often used as investment income properties – are more likely to be underwater and in default, in comparison to the overall borrower population. The same study also found that negative equity disproportionately affects low- and moderate-income borrowers, who may have purchased homes beyond what they could afford (Foote, Gerardi, and Willen 2008).

Underwater mortgages are also concentrated geographically in real estate markets that experienced the highest appreciation rates during the housing boom. As of the fourth quarter of 2009, 70 percent of properties with mortgages were underwater in Nevada, followed by 51 percent in Arizona, 48 percent in Florida, 39 percent in Michigan, and 35 percent in California (First American CoreLogic 2010).

## The federal policy response

In large part, the federal policy response to the mortgage crisis has aimed at stabilizing the financial sector. As such, the Emergency Economic Stabilization Act of 2008 (the “Wall Street Bailout”) and subsequent creation of the Troubled Asset Relief Program (TARP) – which authorizes and oversees the federal government’s purchase of up to \$700 billion in illiquid

mortgage-backed securities – have done little to curb mortgage delinquencies.

The Obama Administration’s \$275 billion Home Affordable Modification Program (HAMP) is a more direct intervention, aimed at reducing foreclosures by providing incentives to lenders to make more affordable modifications to mortgages. The HAMP program has drawn criticism for its stringent eligibility restrictions; narrow reach, with some estimating the program assists fewer than 4 percent of borrowers who are more than 60 days delinquent; lengthy processing time; evidence of disparate impact, with white HAMP-eligible borrowers more likely to receive loan modifications than minority HAMP-eligible borrowers; and re-default rates of more than 50 percent among loans modified through HAMP and other loan servicer programs (Daly 2010; OCC and OTS 2010; National Community Reinvestment Coalition 2010).

In a recent *New York Times* op-ed, John Geanakoplos and Susan Koniak (2009) argue that the federal government’s efforts to curtail foreclosures won’t work for underwater borrowers, who will continue to default on their mortgages as long as the principal balance is higher than the value of their home. They claim that bailing out underwater mortgages *by forgiving loan principal* is a less costly, more effective alternative to loan modification programs.

There is a growing realization among federal policymakers, mortgage lenders, and servicers, as well as underwater borrowers themselves, that existing loan modification programs are insufficient and only more drastic measures will stem the surge in mortgage defaults. Yet questions remain about how best to solve the problem, and whether taxpayers will be able to stomach the cost of additional loan modification programs. In late March 2010, Bank of America announced the nation’s first major principal forgiveness program, aimed at borrowers who are more than 20 percent underwater (Harney 2010). That same week, the Treasury Department announced that up to \$14 billion in TARP funds would help to write down principal on underwater mortgages backed by the Federal Housing Administration (Kilgore 2010). Whether these new programs are effective – or induce moral hazard by creating additional incentives for borrowers to default, as some critics warn – remains to be seen.

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