# Table of Contents

- **Introduction** .................................................................................................................................................. 3
- **The American Dream** .................................................................................................................................... 4
- **Benefits of Home Ownership** ........................................................................................................................ 7
- **Economic Bubbles** ......................................................................................................................................... 9
- **Financial Institution Failures** .......................................................................................................................... 14
- **Effects on the Housing Market and Beyond** ............................................................................................... 16
- **Housing and Economic Recovery Act of 2008** ............................................................................................ 17
- **2008 Presidential Election** .......................................................................................................................... 20
- **Geithner Plan** .............................................................................................................................................. 21
- **American Recovery and Reinvestment Act of 2009** ................................................................................... 23
- **Current Foreclosure Environment** .............................................................................................................. 27
- **Effects of Foreclosure** ................................................................................................................................... 30
- **Making Home Affordable Program** ............................................................................................................. 31
- **Home Affordable Refinance** .......................................................................................................................... 32
- **Home Affordable Modification** .................................................................................................................... 34
- **Strengthening Fannie Mae and Freddie Mac** ............................................................................................... 39
- **Home Affordable Plan Analysis** ................................................................................................................... 39
- **Conclusion** ................................................................................................................................................... 46

- **Guide to Acronyms** ..................................................................................................................................... 51
- **Bibliography** ................................................................................................................................................ 52
Introduction

The boom environment experienced by the real estate and mortgage industry a few years ago seems like a distant memory in light of constant press about slow home sales, the rising rate of foreclosures, and bank failures. In this paper, I examine the American Dream and how this ambiguous ideal has contributed to the real estate boom, and the more recent factors that led to this boom and bust. I also research the policies created by the federal government to address the rising rate of foreclosures, and analyze the most recent policy of President Obama’s Making Home Affordable Plan.

Working as an on-site sales manager for a national homebuilder from 2003 to 2008, I was in the middle of the brewing storm. I enjoyed selling homes to first time homebuyers that were thrilled to have the opportunity to purchase a home of their own. I pre-qualified potential buyers for mortgages that had poor credit, bankruptcy in their past, but did not want to miss out on the real estate boom; many of whom eventually were approved for a loan. I sold condominiums to active adult customers that had large homes to sell but were willing to purchase their next home before even putting their current residence on the market because they were concerned the home would sell too fast, before they had another place to move.

The current foreclosure crisis the United States is experiencing today affects people of all walks of life and its impacts are far-reaching. While it is distressing to hear about families and children losing their homes, the effects of foreclosures expand to neighbors, communities, local businesses, financial institutions, and more. The problems created by the foreclosure crisis have damaged the national economy and contributed to a global financial crunch.
The American Dream

What is the American Dream? Is it the certain unalienable rights defined in the Declaration of Independence of life, liberty, and the pursuit of happiness? Is it being able to express one’s views, religious or otherwise, without the fear of persecution? Does equality of opportunity summarize this compelling dream? Many scholars agree that the term was popularized by a 1931 book by James Truslow Adams, *The Epic of America*. In this book, Adams serves up a one-sided account of the nation’s history from the landing of Christopher Columbus forward, and developed a concept of “that American dream of a better, richer, and happier live for all our citizens of every rank.”¹ He made it very clear that this dream was not simply the pursuit of financial gain, noting that “It is not a dream of motor cars and high wages merely, but a dream of social order in which each man and each woman shall be able to attain to the fullest stature of which they are innately capable, and be recognized by others for what they are, regardless of the fortuitous circumstances of birth or position.”² In a recent Vanity Fair article titled “Rethinking the American Dream,” author David Kamp remarks Adams saw “that life in the United States offered personal liberties and opportunities to a degree unmatched by any country in history – a circumstance that still remains true today.” Kamp further states that “this invigorating sense of possibility, though it is too often taken for granted, is the great gift of Americanness.”³

Less than 80 years after James Truslow Adams articulated the grand concept of the American Dream, the idealistic notion has evolved to one that centers on financial gain, conspicuous consumption, and the often referred to catchphrase of “Keeping up with the Joneses.” It is naïve to think, though, that the importance of material wealth is a 20th century construct. In a Forbes magazine series on the American Dream, Jim Cullen affirmed that “the American Dream in any formation has never been a zero-

1 (Adams, 1931)
2 (Adams, 1931)
3 (Kamp, 2009)
sum game – the goal has always been to end up with more than you started with.\textsuperscript{4} For many Americans, achieving the goal of owning a home is a sign of success and a tangible demonstration of wealth, regardless of whether said home is surrounded by an actual white picket fence. In the 1920s, President Hoover called homeownership a pillar of family life.

Two decades later, in 1944, the Serviceman’s Readjustment Act, better known as the GI Bill, further promoted home ownership by enabling millions of veterans to become homeowners. Prior to the passage of this bill, home ownership was a privilege for the affluent, as purchasing a home required a large down payment. The GI bill allowed veterans to borrow the appraised value of the home without a down payment, encouraging veterans to become homeowners, which subsequently caused an expansion in the middle class and growth of suburbs. A number of books have been written about the G.I. Bill and its impact on the United States, including a book appropriately titled “Over Here: How the G.I. Bill Transformed the American Dream” written by Edward Humes in 2006. This bill spurred Bill Levitt, founder of now infamous Levittown, to construct simple homes in Long Island, New York that he initially sold only to World War II veterans. The impact on new home construction was enormous: in 1944, the amount of housing starts numbered 144,000 but reached close to 1.7 million in 1950.\textsuperscript{5} It was during this postwar boom that the rate of home ownership skyrocketed, and, along with owning cars, televisions and other material possessions, became the fundamental goal of the American Dream.

\textsuperscript{4} (Cullen, 2007)
\textsuperscript{5} (Jackson, 1987)
Economist John Kenneth Galbraith was troubled by the developing display of affluence among society, and criticized this way of life in his 1958 book *The Affluent Society*. He argued that Americans were so busy pursuing an unsustainable degree of affluence that they had lost a sense of their priorities, replacing public sector needs of parks, schools, and other societal necessities in exchange for personal loans and installment purchases. In the 40th anniversary edition, he reaffirmed his diagnosis made when the book was originally written:

“The government does spend money readily... on what has come to be called corporate welfare. Otherwise there is still persistent and powerful pressure for restraint on public outlay. In consequence, we are now more than ever affluent in our private consumption; the inadequacy
of our schools, libraries, public recreation facilities, health care, even law enforcement, is a matter of daily comment.”

Ironically enough, in the same year Galbraith’s book was written, 1958, Bank of America released the BankAmericard in Fresno, California. The card introduced an innovative feature for the time – revolving credit. In 1976, the BankAmericard changed its name to Visa, and is currently the most widely used credit card in the world. Visa accounts for over 50% of all credit card transactions worldwide with more than one billion issued cards.\(^7\) Consumer credit increased from $2.6 billion in 1945 to $45 billion in 1960, then more than doubling to $105 billion by 1970.\(^8\) The amount of revolving consumer credit as of February 2009 has reached a whopping $955.7 billion.\(^9\) Instead of pursuing the American Dream by working hard and managing expectations, Americans could send back one of many credit card pre-approvals received in the mail and money was theirs. Money was free and people were happy to use it. Availability of credit was supplied not just for consumer purchases, but also for home loans, which further enabled Americans to become homeowners.

**Benefits of Home Ownership**

Homeownership was encouraged for many reasons. The economy benefits from homeownership: in 2005, 16% of the total economic activity was directly attributed to the housing sector with household real estate holdings accounting for $20.7 trillion. After subtracting mortgage debt, net household real estate equity amounted to $10.9 trillion.\(^{10}\) Social benefits include educational achievement, civic participation including voting and volunteerism, ability to pay for health care and better health outcomes, and reduced crime and domestic violence rates. Increasing home ownership in

\(^6\) (Galbraith, 1998)
\(^7\) (Marples, 2008)
\(^8\) (Kamp, 2009)
\(^9\) (Federal Reserve Statistical Release, 2009)
\(^{10}\) (NAR Research Division, 2006)
distressed areas stabilizes populations, and creates stakeholders of revitalization, building wealth in low income households. Home owners also enjoy less measurable benefits, such the freedom to have pets, paint walls, make upgrades, and enjoy the pride of owning a home. A 1996 study found that homeowners have a heightened sense of well-being: when compared to renters, homeowners are happier, have higher self-esteem, rate themselves higher in physical health, score lower on a scale of depression, and are more likely to believe that they can do things as well as anyone else.\(^{11}\) President George W. Bush echoed the importance of homeownership when he said “there’s no greater American value than owning something, owning your own home and having the opportunity to do so.”\(^{12}\)

The federal government strongly supported homeownership as a way to encourage construction activity and spur the economy, creating wealth for homeowners that would then help to further boost the economy. Fannie Mae and Freddie Mac were established to further help citizens attain the goal of owning a home. The Federal National Mortgage Association (FNMA), better known as Fannie Mae, was created in 1938 by President Franklin D. Roosevelt, with the initial purpose of purchasing FHA-issued mortgages, to allow the FHA to issue more loans and create more homeowners. Four decades later, in 1968, Fannie Mae became a privately owned company and expanded its role to purchase non-FHA mortgages. The 1968 Charter Act also gave Fannie Mae the authority to issue mortgage-backed securities. To avoid a monopolization of the secondary market, through the Emergency Home Finance Act of 1970, Congress created the Federal Home Loan Mortgage Corporation (FHLMC), more commonly referred to as Freddie Mac. Both government sponsored entities (GSEs) continue to operate under a federal charter and work in the secondary mortgage market to provide funds to mortgage bankers and lenders to enable home loan lending in two primary ways: purchasing mortgages loans from lenders and issuing mortgage backed securities from pools of loans. During the time period from 2004 – 2006, the

\(^{11}\) (Weber, 1996)
\(^{12}\) (Eaves, 2007)
two entities purchased a total of $434 billion in securities backed by subprime loans, creating the market for more such loans to be originated.\textsuperscript{13}

**Economic Bubbles**

The rate of homeownership was increasing, more homes were being constructed, and prices were rising. However these increases were could not continue over the long term and supply and demand would soon catch up with each other, causing an severe crash in the market.

Economist Charles Kindleberger defined five stages of a bubble:

1. An event triggers considerable opportunities for profit; often a technical innovation.
2. Cheap money pours into the market.
3. “Euphoria” – investors pile into the market because they do not want to miss out, regardless of the intrinsic value of what they are buying.
4. Bust and panic selling.
5. “Revulsion” – investors abandon the market and prices sink to unusually cheap levels.\textsuperscript{14}

While home ownership has been considered by most to be an essential component of the American Dream, policies over the past decade helped to spur the economy and encourage more people to pursue the dream of owning a home. Major events that led to the current housing bubble are the tech bubble bust and the September 11\textsuperscript{th} terrorist attacks. The dot-com bubble began from Silicon Valley, California around 1995 and tech start-ups were the rage. Companies in the internet sector and related fields were fueled by venture capitalists and initial public offerings that enabled the start-ups to grow at warp speeds with the number one goal being to create market share, often at the expense of the bottom line. Unfortunately, the massive growth was unsustainable. On March 10, 2000, Nasdaq

\textsuperscript{13} (Leonnig, 2008)
\textsuperscript{14} (Cooper, 2002)
peaked at 5048.62 – its highest finish ever. The bottom hit on October 2, 2002 when the index fell to 1141.11. Exactly nine years after the peak, on March 10, 2009, Nasdaq closed at 1358.28.

The US economy was still experiencing the tech bubble crash when it was struck by the terrorist attacks of September 11th, 2001. The US was feeling the effects of a recession evidenced by declines in Gross Domestic Product, personal income, and sales volume, among other indicators. In an effort to spur economic growth, Federal Reserve chairman Alan Greenspan lowered the federal funds rate to 1%, which is considered virtually zero in the lending world. Interest rates were at their lowest in forty years, and many people realized that mortgage money was the cheapest source of equity available.

Rate Comparison 1972 - 2008

Source: Federal Reserve Statistical Release H.15, Selected Interest Rates

15 (Goldberg, 2005)
16 (Twin, 2009)
17 (National Bureau of Economic Research, 2003)
The influx of cheap money, coupled with the regulatory mandate from Congress, spawned the lowering of lending standards and proliferation of subprime and adjustable-rate mortgages. Homeowners tapped out the equity in their homes, using cash-out refinance as an ATM machine to fuel spending for expenses not necessarily associated with home ownership, such as vacations, cars and other such purchases. In many areas across the country, particularly in California, Florida, and Nevada homes were appreciating at such spectacular rates that people decided investing in real estate was a sure thing. Speculators entered the market causing condo sales to skyrocket. Lending standards went out the window - buyers were approved for mortgages without documenting their incomes, often called “liar loans.” Adjustable rate loans were offered with an initial teaser rate that adjusted shortly after closing, causing monthly payments to double or triple. Interest only mortgages were exactly that – borrowers made payments based only on the interest, assuming that equity would be created in their home from appreciation and when the borrower was ready to sell the house, it would not matter that none of the principal had been paid down. Another program was option ARMs, which allowed buyers to make a minimum payment that did not even cover the interest, resulting in negative amortization where the borrower owed more than the original principal on the loan.

Such programs sound absurd, but the intent behind them was solid. NINA (no income, no assets) or liar loans were geared toward self-employed borrowers, who did have the income to justify their home purchase but did not want to provide the lengthy documentation that was needed for traditional programs. Adjustable rate mortgages could be helpful for people in a situation where the homeowner planned to stay in the home for a short time period before selling, or when their income was going to change. Perhaps a stay at home parent was planning to enter the workforce soon, but the borrowers could not show the income at the time of loan origination but had full faith their household income would increase. Option ARMs were helpful to people who earned incomes based on commission only, meaning the amount of their wages could fluctuate wildly from paycheck to paycheck. The problems
came when these programs were abused. Many people that were approved for these loans were never in a position to be able to afford the homes they were purchasing. In 2006, shortly before the burst of the housing bubble, homes were selling for 5.2 times a person’s disposable income, compared to the historical ratio of four times disposable income.\(^\text{18}\)

While the proliferation of subprime and exotic loans kept the home buying frenzy going, Fannie Mae and Freddie Mac fed the cycle by purchasing more loans. Mortgages have been bought and sold on the secondary market for decades. Asset backed securities are investment vehicles that package assets with predictable and similar cash flows into a bundle, and the money from the mortgage payments on the assets in the bundle is used to pay investors a coupon. The real estate serves as collateral for the investment. These securities enable an investor to acquire a diverse portfolio with one coupon payment.

With the expansion of real estate, a new type of asset backed security was being created with subprime mortgage loans. While these types of loans were placed into different risk classes, the riskier bundles had higher coupon rates since they carried a higher risk of default. Because lenders now had an avenue to sell this risky debt, they had incentive to originate risky loans. Often the loan officers and mortgage brokers received higher commissions on subprime loans. They charged more upfront fees than conventional mortgages because of the higher risk. As long as home prices kept appreciating, the wheels kept turning and fueling the machine. The rate of homeownership peaked at 69.2% in 2004.

\(^\text{18}\) (Ahrens, 2008)
The pace of home sales and appreciation could not continue. In 2006, the signs began to show that the housing market was beginning to cool. New home sales slowed; correspondingly so did median sale prices. Interest rates were on the rise, and the adjustable rate mortgages of the previous year or two were beginning to reset. Default rates began rising. Asset backed securities and the investments that had spawned from them were no longer so desirable. Lenders, who could easily sell their loans months before, no longer had eager buyers. Many of these lenders subsequently went out of business. Institutional funds faced margin and collateral calls from banks, and had to sell other assets to raise cash. Trouble in the mortgage industry carried over to other financial institutions that invested heavily in mortgages.
Financial Institution Failures

The Federal Deposit Insurance Corporation is an independent agency of the federal government, created in 1933 after the thousands of bank failures during the Great Depression. The purpose of the FDIC is to promote “public confidence in the US financial system by insuring deposits in banks and financial institutions for at least $250,000; by identifying, monitoring and addressing risks to the deposit insurance funds; and by limiting the effect on the economy and financial system when a bank or thrift institution fails.” Since October 2000, the FDIC website has kept a list of banks failures and assistance transactions. Year to date, as of March 27, 2009, twenty-one US banks have failed. In comparison, for all of 2008, 24 banks failed. This is in stark contrast to the number of bank failures in 2005 and 2006, during which time there were zero bank failures. If the rate of failures so far in 2009 continues, it can be

19 (Federal Deposit Insurance Corporation, 2008)
estimated that 84 banks will fail this year. While the estimated number of bank failures is not expected to come close to the 747 banks that failed during the savings & loan crisis of the 1980s and 1990s, the banks failing now are larger and more complex.\textsuperscript{20}

Financial giants were caught with huge exposures to bad debt from overvalued commercial mortgage backed securities. In March of 2008, investment bank Bear Stearns was purchased by JPMorgan Chase for the low price of approximately $2 per share, or about $236 million. The sale price seems even more absurdly low when one considers that the value of the company headquarters building in New York was $1 billion.\textsuperscript{21} However, after outcry from angry shareholders, the purchase price was increased to $1.1 billion, or $10 per share. Bear Stearns was on the verge of collapse, due to investors pulling their money out, leaving the firm without liquidity. The federal government stepped in to extend JPMorgan Chase a $30 billion credit line for the purchase. The government wanted to avoid the complicated legal process that would have been involved with tens of billions of dollars in assets and the devastating effects to US investments that could have followed if Bear Stearns went bankrupt. A few months later in September 2008, Lehman Brothers, a leading US investment bank, filed for bankruptcy. With $639 billion in assets and $619 billion in debt, Lehman’s bankruptcy filing was the largest in history.\textsuperscript{22} At the same time as the Lehman collapse, Merrill Lynch, the world’s largest retail stock brokerage, was sold to Bank of America for $50 billion, after worries about their liquidity.

One week before the Lehman Brothers collapse and Merrill Lynch buyout, the Treasury Department announced that government-sponsored entities (GSEs) Fannie Mae and Freddie Mac would operate in a government conservatorship to be administered by the Federal Housing Finance Agency. The strength of these two agencies is crucial to maintaining stability and liquidity in the housing and mortgage markets, as Fannie Mae and Freddie Mac together own or guarantee an enormous share of

\textsuperscript{20} (Joffe-Walt, 2009)  
\textsuperscript{21} (Godoy, 2008)  
\textsuperscript{22} (Mamudi, 2008)
newly issued mortgages. While the lending capacity in the market overall was decreasing, Fannie and Freddie were increasing their combined share. A 2008 Washington Post article reported that Fannie and Freddie typically finance about 40% of the nation’s mortgages\textsuperscript{23}, but a Congressional Research Report issued in September 2008 revealed that Fannie and Freddie had purchased 80% of all new home mortgages in 2008 through June 30\textsuperscript{th}\textsuperscript{24}.

The agencies were in critical condition with continued decline likely, but they were too big to be allowed to fail. Without the support of the secondary market, lenders would have to keep loans on their books, which would cause mortgage loans to become costlier and harder to obtain. The interest of the US treasury in this conservatorship is to protect holders of GSE debt, which includes many large investment companies and foreign governments. James Lockhart is the new director of the Finance agency, and will control and direct operations of the company, having the powers formerly held by shareholders, directors and officers. The conservatorship will have the power to collect all money due and preserve the assets and property of the company. In return, the Treasury will receive $2 billion in preferred stock that will pay a 10% dividend. One billion will come from each entity and the additional $1 billion will come from the purchase of additional stock by the conservatorship.

**Effects on the Housing Market and Beyond**

The impacts on the housing market have been severe. Home prices and property values across the country have dramatically declined and Americans are nervous about buying a home because they fear prices will continue to drop. Net home sales dropped 72% from January 2006 to September 2008.\textsuperscript{25} Existing home inventory peaked during the summer of 2008 with 4.6 million units and 11 months’ supply, and has since decreased slightly as of the end of March 2009, with 3.74 million homes available.

\textsuperscript{23} (Leonnig, 2008)
\textsuperscript{24} (Jickling, 2008)
\textsuperscript{25} (Fix Housing First, 2009)
for sale.\textsuperscript{26} From March 2008 to March 2009, existing home sales decreased 7.1\%, new home sales declined by 30.6\%, and housing starts fell 48.4\%.\textsuperscript{27} Most experts agree that housing inventory needs to be reduced before prices will stabilize, with some estimating that reaching a 7 -- 8 months' supply will be an indicator of price stabilization.

Many major economic indicators have taken a turn for the worse during this crisis -- unemployment is on the rise, retail sales are down, and gross domestic product growth has decreased. Consumer confidence has dropped 60.55\% from March 2008 to March 2009.\textsuperscript{28} People are not secure in their personal financial situations and have cut back on spending. Fear about job loss is evident as some companies, including automobile manufacturers and homebuilders, have created unique return and/or reimbursement policies for buyers who may lose their jobs after purchasing the product. Involuntary Unemployment Insurance (IUI) programs, such as DreamKeeper, are protection programs that cover mortgage payments in the event of job loss.\textsuperscript{29} The federal government has recognized the turmoil in the economy, and passed legislation to help combat these problems.

**Housing and Economic Recovery Act of 2008**

The Housing and Economic Recovery Act (HERA) was signed by President Bush on July 30, 2008. It was evident that government intervention was necessary to mitigate the housing crisis that was developing and spreading. Major components include providing $300 billion for FHA guarantees, strengthening Fannie Mae and Freddie Mac, and establishing the Federal Housing Finance Agency.

The three hundred billion dollar guarantee was designed to enable 400,000 borrowers (a figure estimated by the government) in danger of losing their homes to refinance into more affordable

\textsuperscript{26} (Yun, 2009)
\textsuperscript{27} (National Association of Realtors, 2009)
\textsuperscript{28} (National Association of Realtors, 2009)
\textsuperscript{29} (Association for Homeowners Across America, 2009)
government insured loans through the Hope for Homeowners Act. The Hope program, which began on October 1, 2008 and was to run through September 30, 2011, offered government insurance to lenders who voluntarily reduced mortgages for at-risk homeowners to at least 90% of the property’s value. Only borrowers with an owner occupied, principal residence were eligible – loans for investors and second homes were excluded. Current mortgage payments need to be 31% or higher of the borrower’s total monthly income, and the borrower must be able to certify that they have not intentionally defaulted on their existing mortgage, did not obtain their mortgage fraudulently, and have not been convicted of fraud. To apply, homeowners would need to contact an FHA approved lender, who would determine the size of the loan that the borrower would be able to repay. If the current lender agrees to write down the amount of the existing mortgage, the FHA lender will pay off the discounted existing mortgage. While the program would seem to be helpful to families in danger of losing their homes, the program is completely voluntary for all participants. Investors and lenders must take big losses to participate. Lenders must waive penalties or fees and help pay for origination and closing costs. For the government to recoup its investment over the long run, the FHA would receive 50% of any future profits in the home.

The Hope Act also addressed the issue of lender abuses, which was one of many factors being charged with responsibility for the subprime fallout. Under the Safe Mortgage Licensing Act, existing state run mortgage origination licensing and registration would be strengthened. The law established a nationwide loan originator licensing and registration system to set minimum standards for all residential mortgage brokers and lenders with the purpose or preventing fraud and requiring education for brokers and lenders.

Tax benefits for homeowners and governments were strengthened by this housing stimulus. A refundable first time homebuyer credit was created, which worked like an interest free loan to be paid
back over fifteen years. The amount of the credit was $7,500, which would be deducted from the homeowner’s tax liability for the year the home was purchased. In subsequent years, the loan would be paid back through the homeowner’s federal taxes in increments of $500 per year. Couples using the standard deduction received an additional $1,000 deduction for property taxes, or $500 for individuals. States benefited by receiving $11 billion of tax-exempt bond authority for use to refinance subprime loans, make loans to first time buyers, and finance the building of affordable housing. An additional four billion dollars was provided for communities to use for neighborhood stabilization funds to purchase foreclosed homes, in an effort to stabilize the market.

The GSE conservatorship for Fannie Mae and Freddie Mac that went into effect on September 7, 2008 was authorized by HERA. A trust fund was also developed that would be financed by a percentage of the profits from the GSEs. In the first years, the fund would be used to cover costs of any defaulted loans in the FHA foreclosure program, with the ultimate goal of the fund to be used for development of affordable housing. Modernization measures were also included. These measures contained provisions for increasing loan limits, increasing the down payment requirement for FHA loans to 3.5% and placing a one year moratorium on the use of risk based pricing.

While many of the benefits of HERA are immeasurable, the impact, or lack thereof, of the Hope for Homeowners program is evident. The program was estimated to benefit 400,000 homeowners on the brink of losing their homes. As of February 2009, only 451 applications had been received and a disappointing total of 25 loans had been closed. Critics point out that borrowers may choose not to participate due to the high fees and high interest rates offered, combined with the requirement they must split any future profits with the government. Lenders must lose money by reducing the principal owed on the loan, with the only benefit being the possible avoidance of foreclosure.

30 (Naylor, 2009)
2008 Presidential Election

The most important issue of the 2008 presidential election was the economy, fueled by the severe financial crisis the US faced in September. According to a CNN poll, 57% of those surveyed cited the economy as the issue that would be “most important to you when you decide how to vote for president.”

The War in Iraq and Health Care tied for second most important, each receiving 13% of respondents choosing either issue as most significant. Commenting about government intervention in the financial crisis, Yale endowment manager David Swenson said “the government has done it with an extreme degree of inconsistency. You almost have to be trying to do things in an incoherent and inconsistent way to end up with the huge range of ways they have come up with to address these problems.”

This 2008 election was the first in fifty years in which neither party had an incumbent president or vice president on the ticket. The Democratic Party boasted Hilary Clinton, wife of former president Bill Clinton, as the favorite to win the nomination. Another senator putting his hat in the ring was freshman Illinois Senator Barack Obama, notable for a few reasons: he gave the keynote address at the 2004 Democratic National Convention, was the only African-American in the Senate, and the only presidential candidate on record for opposing the war in Iraq before it began. The Republican party claimed three significant nominees: Arizona Senator John McCain, well known for his military history as a naval aviator, having spent over five years as a Prisoner of War in Vietnam; former New York Mayor Rudy Giuliani, known for his leadership in the wake of the September 11th terrorist attacks, and Arkansas Governor Mike Huckabee, a self-proclaimed “evangelical leader” proud of his experience as a pastor, having been

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31 (Issues - Election Center 2008)
32 (Zingales, 2009)
33 (Presidential Election of 2008)
the youngest president of the Arkansas Baptist State Convention. These candidates took part in the most lengthy president campaign in U.S. history, spanning 21 months.

Senator Barack Obama won 349 electoral votes and 52% of the popular vote. Many called the outcome a “mandate” against the previous administration’s policies. Some hailed the historic significance of the results, citing the importance of electing the nation’s first African-American President. Regardless of what side of the issue people stood, most political observers agreed that President Obama would be facing a long and difficult road ahead. President Obama acknowledged this in his inaugural speech, telling a crowd estimated to be well over 200,000, that “the road ahead will be long. Our climb will be steep. We may not get there in one year or even one term...”

Geithner Plan

President Obama has already begun making significant steps toward economic recovery. On January 26, 2009 he appointed Timothy Geithner as the 75th Secretary of the Treasury Department. Prior to his nomination, Geithner worked as the President of the Federal Reserve Bank of New York and served as a permanent member of the Federal Open Market Committee. With the US financial crisis at the forefront of not just the national, but global economy, Secretary Geithner quickly settled into his new role, and delivered a plan to rescue the troubled banking system on February 10, 2009. In his speech, he asserted that restarting the economy and creating jobs requires jumpstarting economic demand for goods and services, which is a goal of the American Reinvestment and Recovery Act. He also emphasized the use of the Financial Stability Plan to ensure that businesses with good ideas have credit to grow and expand, and working families can get affordable loans to meet their economic needs, all to power an economic recovery. He remarked that plan should address the issues that are plaguing the lending environment: uncertainty, troubled assets, and capital constraints of financial institutions and

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34 (Obama: 'This is your victory' )
frozen secondary markets that have been the source for about half of lending for everything, ranging from small business to car loans. Secretary Geithner emphasized that the financial stability plan will “institute a new era of accountability, transparency and conditions on the financial institutions receiving funds.” The plan is broken down into six parts:

1. Financial Stability Trust
2. Public Private Investment Fund
3. Consumer & Business Lending Initiative
4. New Era of Transparency, Accountability, Monitoring and Conditions
5. Housing Support and Foreclosure Prevention
6. Small Business and Community Lending Initiative

The fifth component of this plan aims to help drive down mortgage rates by having the Federal Reserve purchase up to $600 billion in GSE mortgage backed securities and mortgage debt. There is bipartisan agreement that helping prevent foreclosures and restricting mortgages will help slow the downward spiral harming financial institutions and the overall economy. Fifty billion dollars of TARP (Troubled Assets Relief Program) money will be committed to preventing “avoidable” foreclosures of owner occupied middle class homes by helping to reduce monthly payments. All financial stability plan recipients will be required to participate in foreclosure mitigation plans. Loan modification guidelines will be established for government and private programs to bring order and consistency. Finally, in order to enable loan modifications for a greater number of distressed homeowners, more flexibility will be built into Hope for Homeowners and the FHA.

In his announcement, Geithner criticized the previous administration, commenting that “policy was always behind the curve, always chasing the escalating crisis. The emergency actions meant to

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35 (US Department of Treasury, 2009)
provide confidence and reassurance too often added to public anxiety and to investor uncertainty.”

However, his plan was vague and short on details. In response to the plan announcement, investors flocked to Treasury bonds and the Dow Jones industrial average dropped 4.6% on the day of his speech. Despite Geithner’s harsh remarks about the policies of the Bush administration, many of the policies he offered were tweaks to previous Treasury Secretary Henry Paulson’s strategy. There were some novel elements to his plan, including creating an entity with public and private money to buy bad assets from banks, creating a stress test of the nation’s banks, and using $50 billion to prevent foreclosures. It is unclear how the public private partnership for cleansing toxic assets will work, and Robert Brusca of FAO Economics remarked that “Fannie Mae and Freddie Mac failed precisely because of their public-private identity crisis.”

The American Bankers Association approved of the plan, with ABA President Edward Yingling responding that it is “a comprehensive, yet flexible plan that can restore confidence in the markets. We are pleased they took the time to address the stress in the financial markets in a coordinated way.”

American Recovery and Reinvestment Act of 2009

Shortly after Secretary Geithner’s announcement, the American Recovery and Reinvestment Act of 2009 was signed. The Act passed in the House of Representatives on February 13, 2009 by a vote of 246 to 184 and was passed in the Senate later the same day by a vote of 60 – 38. President Obama signed the $780 billion package on February 17th. Thirty-five percent of the bill is devoted to tax cuts with the rest for spending that will occur in 2009 and 2010.

There are a number of provisions in the Act that are provided to help the recovery of the housing and mortgage markets. A homebuyer tax credit of $8,000 is provided for first-time buyers who

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36 (Irwin, 2009)
37 (Lever, 2009)
38 (Lever, 2009)
39 (Lever, 2009)
purchase a principal residence between January 1 and December 1, 2009 and unlike the previous $7,500 tax credit, this one does not require repayment. The credit will be claimed on the homebuyer’s tax return to reduce their liability, with any unused portion being refunded in the form of a check. The 2008 FHA and Fannie/Freddie loan limits have been reinstated, which were the greater of 125% of the 2008 local area median home price or $271,050 for FHA and $417,000 for Fannie/Freddie. There is an overall cap of $729,750, but language included in the bill gives the HUD Secretary the discretion to increase the loan limit for a sub-area (smaller than a county), if needed. High cost areas like New York, San Francisco, and Washington D.C. are among the 73 counties in the country that will be eligible for the highest limit. Previously high cost limits were capped at $625,500. The National Association of Realtors considers these limits to be a victory for homeowners, buyers, and realtors.

FHA focuses on safer loans, primarily 30 year fixed rate mortgages. FHA loans help borrowers avoid the risks associated with exotic subprime mortgages which have contributed to rising default and foreclosure rates. Sources of conventional mortgage credit have sunk, so FHA has been filling the void for many borrowers. From September to December 2008, FHA facilitated $97 billion of mortgage activity in the housing market; $35 billion of which was through FHA refinancing products. FHA also offers a reverse mortgage product, known as HECM or home equity conversation mortgage, which also has a new national limit of $625,500 increased from $417,000. Reverse mortgages allow homeowners 62 and older borrow against the value of their homes without selling them or having to make monthly repayments. The borrower can acquire the funds through a lump sum payment, monthly payment, or line of credit with no repayment required as long as the homeowner lives in the house. The loan is eventually repaid when the homeowner passes away or sells the home. While costly, the advantage to using a reverse mortgage is the cash flow that it provides to homeowners to help supplement their retirement income and help keep these homeowners in their homes.

40 (Sullivan, 2009)
The Act provides two billion dollars to combat the negative effects of foreclosures. This funding will be used for the Neighborhood Stabilization Program, which is a program created by HERA to provide grants through the Community Development Block Grant to address problems that can be created when whole neighborhoods are devastated by foreclosures.

Affordable housing items are also addressed. Existing U.S. Department of Agriculture (USDA) rural housing programs will receive $500 million. The Rural Housing Service provides a guaranteed loan program and direct housing loan program for those meeting the eligibility criteria. The additional funding is reported to be able to provide for an additional 192,000 homeowners. To facilitate low income housing, states will be allowed to trade in a portion of their 2009 low income housing tax credits for treasury grants to finance construction or acquisition and rehabilitation of low income housing. Another tool to help local jurisdictions promote investment is that tax exempt interest earned on specified state and local bonds issued during 2009 and 2010 will not be subject to the alternative minimum tax.

Additional items considered to support housing include allowances for energy efficiency and infrastructure improvements. Six billion dollars will be available in energy efficiency and conservation grants for energy audits, retrofits and financial incentives. Through 2010, homeowners of existing housing stock will be able to claim a 30% tax credit for purchases of new furnaces, windows, and insulation. Other provisions include $5 billion allocated to modernize the nation’s electricity grid, $5 billion for weatherization assistance for low income households, and $2 billion for federally assisted housing (section 8) efficiency efforts. Transportation investments will be enabled with $46.7 billion and $7.2 billion in grants will be available to promote broadband deployment in unserved and underserved areas. The National Association of Realtors supports the broadband expansion efforts because a 2006
report from the Commerce Department showed that property values are 6% higher in communities where broadband is available.\textsuperscript{41}

Housing and Urban Development projects received $13.6 billion in the Recovery Act, over $10 million of which was allocated within one week of the bill signing. Seventy-five percent of the funding has been allocated to formula based programs which do not require applications from grantees, making it possible to distribute so quickly. HUD has broken down the programs receiving funds into three categories: (1) investments promoting energy efficiency and green jobs; (2) supporting shovel-ready projects and assisted housing improvements; and (3) promoting stable communities and families hit hardest by the economic crisis.

Approximately $3.5 billion will support energy efficiency and green building. Over three thousand public housing agencies will split $3 billion going to the public housing capital fund, which will be used for energy efficient modernization and large scale improvements to public housing development. The Native American Housing Block Grant will receive $255 million which tribal entities will use for energy efficient modernization and renovation of housing. Local efforts to eliminate lead from lower income homes will receive $100 million, which will also go toward stimulating private sector investment in lead hazard control.

$4.25 billion has been dedicated to support low income housing. State Housing Financing Agencies will receive $2.25 billion for tax credit assistance to kick start production of affordable rental housing projects that rely on low income tax credits. Two billion dollars will be used for project-based rental assistance, providing twelve month funding for Section 8 project based housing contracts.

The final component of HUD spending will go toward promoting stable communities. Twelve hundred state and local government will share $1 billion from the Community Development Block Grant

\textsuperscript{41} (American Recovery and Reinvestment Act of 2009)
Program. These jurisdictions can use the funds to target their own community development priorities. Most use these funds to rehabilitate affordable housing and improve key public facilities. The Homelessness Prevention Fund will receive $1.5 billion, which will be used to help state and local governments rapidly re-house homeless people and families who enter shelters. These funds will also be used to expand efforts to prevent homelessness for those experiencing a sudden economic crisis.

**Current Foreclosure Environment**

An article posted by Freddie Mac in March 2009 announced that out of 55.0 million mortgages outstanding, 3.46 million are considered seriously delinquent, meaning the loan is either 90 days or more in arrears, or already in foreclosure.\(^4^2\) An estimated total of six million families are already facing foreclosure or are expected to face foreclosure over the next few years, with many more struggling to make payments. Between December 2006 and December 2007, the rate of foreclosure increased 79%, but the actual rate was only 1.033% of mortgaged homes. In the top 100 housing markets, the rate of foreclosure was slightly higher at 1.38%. Bethesda, Maryland saw foreclosures rise by a seemingly astounding 1,288%, but the total foreclosure rate was only 0.682%.\(^4^3\) In the areas with the highest percentage rise in foreclosures, the actual amount was relatively small. The three areas with the highest rates of foreclosures were Detroit, Michigan at 4.92%; Stockton, California with 4.87%; and Las Vegas, Nevada having 4.23% of homes in foreclosure. The average rate of foreclosure for the top 100 metropolitan areas was 1.38%.\(^4^4\) There were 3,157,806 foreclosure filings nationwide, which refers to default notices, auction sale notices, and bank repossessions on 2,330,482 US properties in 2008, representing an 81% increase from 2007 and 225% increase from 2006.\(^4^5\)

\(^4^2\) (Freddie Mac, 2009)  
\(^4^3\) (Burns, 2009)  
\(^4^4\) (Burns, 2009)  
\(^4^5\) (RealtyTrac, 2009)
While these statistics may sound low, the actual numbers are overwhelming. At the current pace, 2,900 families are losing their homes each day. Using a median home price of $190,000, the value of homes entering into foreclosure equals $551,000,000 per day. To put the number of people affected in perspective, in the year following Hurricane Katrina, the population of New Orleans declined by approximately 229,000 according to the Census Bureau. More Americans are losing their homes to foreclosure each month than the total number of people that left New Orleans after Katrina. It is estimated that in the next few years, one in nine residential borrowers is likely to undergo foreclosure.

Even responsible families who have been consistently making their mortgage payments have seen property values fall and are unable to refinance to today’s lower mortgage rates. There is risk that

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46 (Congressional Oversight Panel, 2009)
47 (Congressional Oversight Panel, 2009)
The escalation of lenders foreclosing will push home prices even lower, further reducing the value of household savings, making it even more difficult for families to refinance because of the diminished equity in their homes. According to First American CoreLogic, one out of five homeowners owns a home worth less than its mortgage. The Conventional Mortgage Home Price Index (CMHPI) purchase-only series registered a 17.9% annualized decline in US housing prices during the fourth quarter of 2008. Over the four quarters of the year, home sale prices fell an average of 9.5% in the series, which accounts for the largest annual decrease in the 39 year history of the index. Locally, while the Baltimore/Towson area experienced a decline of 5.84% in 2008, the price appreciation over the past five years was 48.87%. In response to the fourth quarter price declines of 2008, Vice President and Chief Economist of Freddie Mac, Fred Nothaft noted that “while historically low interest rates on long-term fixed rate mortgages helped the housing market, demand for homes was weakened by rising unemployment, wealth declines from declining stock market valuations, and general lack of consumer confidence.”

The foreclosure crisis has no class or income boundaries. Many families do not fit into the stereotypes and do not have subprime loans. People sunk money into real estate, assuming it was a safe investment, and recent history showed this was not necessarily a foolish decision; not since the Great Depression has there been a sustained drop in housing prices. October 2008 was the first time the number of prime mortgages in delinquency exceeded the number of subprime loans in danger of default. Despite this seemingly alarming statistic, the total number of prime mortgages exceeds those being subprime, and in 2007, 11.7% of subprime mortgages entered into foreclosure compared to only 1.3% of prime loans.

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48 (Cohen, 2009)  
49 (Freddie Mac, 2009)  
50 (MSN Money, 2009)  
51 (Freddie Mac, 2009)  
52 (Cohen, 2009)  
53 (US Census Bureau, 2009)
Effects of Foreclosure

While foreclosures can be devastating for the families who lose their homes, the negative effects are far reaching. Aside from the emotional and financial loss to families who have experienced foreclosures, there are additional, or spillover, effects. These are often referred to as negative externalities and include lowering nearby property values, reducing the local property tax base, increasing blight and crime, disrupting social ties, and more. Some studies have shown that foreclosure on a home reduces prices of nearby homes by as much as nine percent.\(^{54}\) Foreclosures are sold at a significant discount, which affects appraisals of nearby properties. Appraisals are partially based on sales of comparable properties in the area. Furthermore, an increase in the supply of available properties can lower values of homes, particularly in areas with stable housing demand. Foreclosures also depress commercial real estate prices throughout the neighborhood. Top concerns of major US city leaders are housing and neighborhood vitality, rising crime rates, and reduced commercial activity. Owners with delinquent mortgages often do not have the means to properly maintain and/or upgrade their homes, causing deterioration in the condition of the home, and when the house is vacated it can attract vandalism and crime. Mark Wiseman, director of the Cuyahoga County Foreclosure Prevention Program in Cleveland, Ohio says that in the inner city, it takes a mere 72 hours for a house to be looted after it is vacant.\(^{55}\) When a house is abandoned, people will dump garbage in the yard, break windows, steal doors and appliances, and other destructive actions.

It is more effective to prevent initial foreclosures in a neighborhood from happening because they have more severe price-depressing effects than subsequent foreclosures. Foreclosure prevention and mitigation efforts need to go beyond the physical home and be more comprehensive to protect the

\(^{54}\) (U.S. Department of the Treasury, 2009)  
\(^{55}\) (Christie, 2007)
vitality of local communities. However, these prevention programs are resource intensive and community organizations can quickly become overwhelmed by requests for assistance.

Foreclosures are costly to many parties involved. In 1997, the FHA reported average foreclosure losses of $28,000; the Veterans’ Administration reported losses of $10,600; and private insurer United Guaranty Corporation reported an average loss of $17,300 on its foreclosed loans.\(^56\) Loan servicers lose the servicing fee that is paid for each mortgage they are monitoring for every loan that goes to foreclosure. In addition to lost property tax revenue, local governments can also lose tax revenues from surrounding properties as values decline and may incur costs if they have to maintain and dispose of the property. Mortgage insurers lose the portion of the outstanding debt and resale costs that the sale of the property does not cover. Homeowners’ associations’ funds get drained trying to keep up with the foreclosed homes, and other homeowners may be asked to make up the difference. A 2009 report from the Congressional Oversight Panel cites that, after accounting for costs of the foreclosure and the lower prices that foreclosure auctions bring, the lender will lose an average of $60,000 per foreclosure. The same report estimated that a single foreclosure can cost a city over $34,000.\(^57\) Foreclosures hurt capital markets, causing a decline in the market value of mortgage-backed securities and can ultimately impair the solvency of the financial institutions that invested in them.

**Making Home Affordable Program**

Shortly after President Obama signed the American Recovery and Reinvestment Act, he revealed his Homeowner Affordability and Stability Plan. The President made the announcement on February 18, 2009 in Phoenix, Arizona – one of the most heavily affected areas of the housing crisis. The purpose of the $275 billion plan is to support a recovery in the housing market and ensure that workers can continue paying their mortgages. The plan will offer assistance to seven to nine million homeowners

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\(^{56}\) (McCarthy, Van Zandt, & Rohe, 2001)

\(^{57}\) (Congressional Oversight Panel, 2009)
to help make their mortgages more affordable and prevent the “destructive impact of foreclosures on families, communities, and the national economy.” Homeowners are broken down into two different groups by the plan: the first is the segment of homeowners can afford their payments, but own homes that are worth less than what they owe on their mortgages; while the second group of homeowners are those borrowers who cannot afford their mortgages, have fallen behind on their payments and, without intervention, will eventually be foreclosed upon. The first group of homeowners can take advantage of a refinancing program, while the second group of homeowners will be helped by a loan modification program. The third component of the plan will be to strengthen confidence in Fannie Mae and Freddie Mac through a number of initiatives. Detailed guidelines for these programs were laid out by the Treasury Department on March 4, 2009.

**Home Affordable Refinance**

The Home Affordable Refinance Program will provide low cost refinancing for responsible homeowners suffering from falling home prices. This first group, composed of over ten million homeowners, may choose to walk away from their homes rather than continue to make payments on an investment that may never pay off. President Obama’s plan seeks to help these borrowers refinance into a lower interest rate loan. Borrowers that owe more than 80% of the value of their home have a hard time finding a lender that will refinance their home, so millions of homeowners with solid credit that have made their payments on time cannot take advance of the low interest rates on the market today. Borrowers that currently hold adjustable rate mortgages would be able to refinance into a more stable fixed rate loan. Only 15 or 30 year fixed loans are allowed. Prepayment penalties, balloon payments, and cash-out refinances are prohibited. Homeowners with a second mortgage can qualify to refinance as long as the first mortgage is less than 105% of the property value, but the program will not

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58 (U.S. Department of the Treasury, 2009)
change the terms of the second loan. The refinance program hopes to help four to five million of these homeowners who took out loans owned or guaranteed by Fannie or Freddie. Borrowers must be an owner occupant of a one- to four-unit residence, current on their mortgage, have sufficient stable income, and will need to contact their loan servicers to find out if they qualify. Because Fannie Mae and Freddie Mac already hold the risk for these loans, the refinanced loans should lower the risk of the loan for the GSEs while also benefiting the borrower as they will be able to take advantage of a lower monthly payment and/or more stable payments over time. Documentation requirements should not be burdensome, as the lender already has information from their original application on file and in some cases, an appraisal is not required. The homeowner will be required to pay lender points and other fees to complete the transaction. Borrowers that owe more than 105% of the value of their home will not qualify for this program. All refinances must be closed by the program expiration date of June 10, 2010.

An estimated $500 billion in mortgage debt is underwater,\(^{59}\) and bailing out all of these homeowners would be expensive. It is tough to know which of the underwater homeowners are willing to walk away. These borrowers could choose to walk away from their homes and rent a similar home in the same town and reduce their living expenses dramatically. Some people will have no choice but to default in spite of the availability of the refinance plan, due to a need to move, starting a new job, getting married, or other life changes. Borrowers facing these situations may default because they will not be able to sell their house for enough money to allow them to pay off their mortgage, even though there are certainly disadvantages to defaulting. These would include damaging credit scores, the emotional distress of leaving their homes, and other headaches that come along with moving. Others will continue to make payments because they think it’s the right thing to do.

\(^{59}\) (Leonhardt, Economic Scene - A Bailout Aimed at the Most Afflicted Homeowners, 2009)
Economists from the Federal Reserve Bank of Boston reviewed a similar problem in the Boston area that began two decades ago. From early 1989 until late 1991, prices in the Boston area fell 15% and did not return to their 1989 peak until 1997. Of the homeowners who were underwater at the end of 1991, only 6.4% were foreclosed upon, with most of the foreclosures involving those that could not make their monthly payments due to the recession New England was experiencing at the time. Only one to two percent of the homeowners that were financially able to make their payments walked away from their homes. This example could argue against any government intervention to aid individuals that owe more than their home’s value, but the Fed counters that being underwater is a “necessary but not a sufficient condition for foreclosure.” Additionally, reasoning can be made that the psychology of the current bust is different from the Boston example, as prices in some areas have fallen almost 50% from their 2006 peak.

**Home Affordable Modification**

The Home Affordable Modification program, at cost of $75 billion, will prevent foreclosures and aims to help three to four million at-risk homeowners stay in their homes. This part of the plan is intended to reach responsible homeowners struggling to afford their payments because of the current recession but cannot sell their homes for what their mortgage is worth because prices have fallen. The program focuses on homeowners already in default or at risk of being in default, often suffering from serious hardship, decreases in income, increases in expenses, payment shock, high debt to income, and other indications of distress. Some households have been the victims of predatory lending, watching their payments rise to 40 or 50 percent or more of their monthly income, particularly if they hold subprime or exotic loans with exploding terms and hidden fees.

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60 (Leonhardt, Economic Scene - A Bailout Aimed at the Most Afflicted Homeowners, 2009)
The program has strict eligibility requirements. Delinquency is not required for borrowers to be eligible, as loans modifications are more likely to be successful if they are made before the borrower misses a payment. As with the refinance program, only owner occupied homes are eligible, and loans must have been originated before January 1, 2009 and cannot exceed the conforming loan limit of $729,750. Every potentially eligible borrower who calls or writes in to their loan servicers in reference to a modification must be screened for hardship. A servicer can determine whether a borrower is at risk for imminent default, for reasons such as upcoming jumps in mortgage payments or significant reductions in income. However, participating servicers and lenders are not required to modify a loan if there is reasonable evidence indicated the borrower submitting false or misleading information when the loan was originated.

Borrowers with high debt (having a total debt to income ratio 55% or greater) can qualify, but they must agree to complete HUD-certified consumer debt counseling. There is no cost to borrowers to participate in the program, but it is expected that fraudulent organizations will originate schemes to charge for counseling or loan modifications. HUD will make funding available for non-profit counseling agencies to improve outreach and communication, particularly in area hardest hit by foreclosures and vacancies.

Even if the homeowner is in bankruptcy court, they may still be eligible. The program will allow judicial modifications of home mortgages during bankruptcy when the borrower has no other options. A mechanism will allow borrowers who file for bankruptcy to implement a responsible payment plan to pay the debts they are able to pay. If borrowers are unable to obtain an affordable loan modification, a bankruptcy judge could reduce the amount of the outstanding principal balance of the residence to current fair market value – a practice that has been done with vacation homes and investment
properties. Efforts to promote lenders to voluntarily modify mortgages have been unsuccessful, but the prospect of losing control to a bankruptcy judge may make lenders more eager to participate.

Financial Stability Plan recipients are required to use the Treasury guidelines for loan modification. Lenders will have to reduce monthly payments to a specified affordability level, which cannot be more than 38% of the borrower’s gross income. The monthly payment is defined to include principal, interest, taxes, insurances, and HOA or condo fees. The program will then match further reductions in monthly payment dollar for dollar to reduce the payment to 31% of borrower’s income. To reach this target level of affordability, interest payments will be reduced to as low as 2%. If payments calculated at 2% interest are still higher that the target level, then lenders will extend the term of amortization up to forty years. If the target level still has not been met, then the lender will forbear principal at zero interest until the payment is reduced to 31% target. Lenders can also shrink payments by reducing the principal amount, with the program still sharing the costs of the reduction up to the amount the lender would have received for an interest rate reduction, given that the payment meets the 31% target. The modified payments will be kept in place for five years, after which the interest rate can be stepped up by 1% per year to the conforming loan survey rate in place at the time of the modification. The rate will be capped for the life of the loan. Loans modifications under this program can be made until December 12, 2012, with a loan eligible to be modified one time only.

Loans that meet certain conditions are required to be modified. Servicers must meet a Net Present Value (NPV) test on each loan at risk of imminent default or at least 60 days delinquent and compare cash flows with and without modification. If the NPV of the expected cash flow is greater in the modification scenario, the servicer must modify the loan (assuming no contract prohibitions exist). The Treasury guidelines define the parameters of the NPV test, including acceptable discount rates, property valuation methodologies, home price appreciation assumptions, foreclosure costs and timelines, and
borrower cure and re-default assumptions. If the NPV test is negative and a modification is not pursued, the lender must seek other foreclosure alternatives, such as a deed-in-lieu or short sale. To determine the home’s value, servicers make use a Broker Price Opinion (BPO), GSE automated valuation model (AVM), or other specified means.

Incentives are available for lenders and borrowers that successfully complete a loan modification that reduces the monthly payment by at least six percent. Servicers will receive an upfront fee of up to $1,000 for each eligible modification meeting the guidelines, and “pay for success” fees of $1,000 per year for three years as long as the borrower continues to stay in the home and make payments. The annual pay for success payments will be the lesser of $1,000 or half the reduction in the borrower’s annualized monthly payment. Similar incentives will be provided for servicers that modify FHA, VA, or USDA loans or refinance loans according to Hope for Homeowners or other similar FHA programs. Since modifications are more successful before the borrower has defaulted, mortgage holders will receive an incentive of $1,500 and servicers will receive $500 for modifications made while the borrower is still current on their payments. Participation is not required by second lien holders, but the program will include incentives to extinguish second loans modified under the program, as doing so will reduce the overall debt of the borrower and should improve loan performance. Servicers can receive an additional $250 for obtaining a release of a valid second lien, after extinguishing the junior lien according to a specified Treasury schedule. To encourage homeowners to stay current on their mortgage, they are can receive a “pay for success” payment of up to $1,000 for five years that goes toward reducing their principal balance. No incentive payments will be made to any participant unless the modification lasts for at least three months. Incentives are also available to servicers that pursue alternatives to foreclosure, such as short sales or taking of deeds in lieu of foreclosure as a way to encourage families and servicers to avoid the costly foreclosure process and minimize the damage to financial institutions, borrowers, and communities. Servicers can receive a $500 payment and can make
reimbursable payments up to $1,000 to extinguish other liens. Borrowers can receive up to $1,500 in relocation expenses, in an effort to reduce vacancy and neighborhood decline. No participants will receive any incentive payments until the loan servicer has entered into the program agreement with the Treasury’s financial officer.

A lack of common standards throughout the industry has limited the use of loan modifications, despite the reality that modifications are likely to reduce foreclosure and raise the value of securities owned by investors. Servicers tend to avoid pursuing loan modifications due to worry of lawsuits from shareholders disturbed that loans were modified without consent from the owners of mortgage backed securities who invested in the loan. A goal of the newly released guidelines for sustainable modifications is to “bring order and consistency to foreclosure mitigation.” The US Treasury will establish and insurance fund of up to $10 billion to discourage lenders, servicers, and investors from opting to foreclose on mortgages that could be viable now, in fear that prices will fall further. The government will provide investors with the security to complete more modifications by assuring that their losses are partially offset if prices continue to decline. Mortgage holders would also be provided with an additional payment on each modified loan that is linked to declines in the home price index.

Fannie Mae and Freddie Mac are responsible for monitoring the programs. Measures such as documentation and audit requirements will be central to the program, to prevent and detect fraud. Freddie Mac will be responsible for auditing compliance. Participating servicers will have to report data on the loan modifications, including borrower and property characteristics, and outcomes. This data will be pooled so that the government and the private sector can measure the success of the program and make adjustments if needed. The Treasury will meet quarterly with the FDIC, Federal Reserve, HUD and FHFA to ensure the program is continuing on the track to meeting goals. While lenders are not required

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61 (U.S. Department of the Treasury, 2009)
to participate, it is expected that the substantial incentives offered by the government will encourage them to do so.

The plan does not apply only to conventional mortgages. Legislation will be pursued to enable FHA to reduce fees paid by borrowers, increase flexibility for lenders to refinance trouble loans, and permit borrowers with high debt loads to qualify. Servicers will be encouraged to consider refinancing borrowers into the improved Hope for Homeowners Program when feasible, including incentives as previously mentioned. HUD will award $2 billion in competitive neighborhood stabilization program grants for innovative programs that reduce foreclosure, and spend $1.5 billion to provide renter assistance to reduce homelessness and help families avoid having to enter shelters.

**Strengthening Fannie Mae and Freddie Mac**

The final component of Obama's housing plan is to support low mortgage rates by strengthening confidence in Freddie Mac and Fannie Mae. In 2008, through HERA, Congress increased funding to the GSEs to ensure the strength and security of the mortgage market, but the current plan goes further. The Treasury is increasing its preferred stock purchase agreements to $200 billion each, doubling the original level of $100 billion each. The Treasury will continue to support GSE mortgage backed securities to promote stability and liquidity of the marketplace, and will increase the size of their retained mortgage portfolios by $50 billion to $900 billion total.

**Home Affordable Plan Analysis**

The cost of the plan is estimated by some, including Bloomberg, to reach $275 billion. The true cost of the plan ultimately depends on whether it succeeds in stopping the decline of home prices. In spite of whether critics agree that the plan is the best way to solve this crisis, most agree that limiting foreclosures and putting a floor under plummeting home prices is critical to the nation's economic
recovery. Limiting foreclosures will help the housing recovery by slowing the growth of inventory on the market due to foreclosures. Lowering the unsold inventory will then help stabilize home prices and values. Inducing financially healthy homeowners to come to the market will only further help to reduce unsold inventory. In February 2009, there were 3.8 million existing homes on the market, equal to 9.7 months of inventory at the current sales pace. Additional “shadow inventory” is not counted in this numbers, which Rick Sharga, Senior Vice President for RealtyTrac, estimates that lenders are holding between “600,000 and 700,000 residential properties that are not on the Multiple Listing Service.”

The housing plan clearly will not help everyone. Homeowners who are massively underwater, owing more than 105% of their homes value, will not be helped. Homeowners who are truly in trouble, in places like Florida, California, Arizona and Nevada where prices have dropped 30% or more, will not qualify. For people who owe so much more than their home is worth, an affordable payment might not be enough incentive to keep them in their homes. A California lawyer, Peter Fredman, launched a website to help borrowers decide whether continuing to make payments on their mortgage or dump their home, called payorgo.com. The headline on the website reveals the “Walk Away From Your Mortgage Calculator,” which claims to help the homeowner decide whether it is in their economic interest to walk away. Experts say that foreclosure activity has been artificially suppressed due to government moratoriums or voluntary lender halts, but insist that many of these homes will eventually be foreclosed upon. It is expected that delinquency rates on non-agency mortgages will increase, since the plan hopes to take the somewhat viable non-agency mortgages and refinance them into agency loans. The resulting non-agency loans will be the mortgages with no hope. The plan will help neighborhoods where people pay their mortgages, whose home values would decline further as nearby homes are foreclosed upon.

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62 (Doler, 2009)
63 (Law Office of Peter Fredman, 2009)
The Making Home Affordable plan mentions the existence of second loans, but makes no effort to factor these additional mortgages into the equation. Depending on the situation, this could help or hurt the homeowners.

<table>
<thead>
<tr>
<th>Homeowner A</th>
<th>Homeowner B</th>
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<tbody>
<tr>
<td>Sales Price: $500,000</td>
<td>Sales Price $500,000</td>
</tr>
<tr>
<td>Existing Primary Loan Balance: $395,000</td>
<td>Existing Primary Loan Balance: $468,000</td>
</tr>
<tr>
<td>Existing Second Loan Balance: $72,000</td>
<td>No Second Mortgage, Owner Pays PMI</td>
</tr>
<tr>
<td>Current Home Value: $380,000</td>
<td>Current Home Value: $380,000</td>
</tr>
<tr>
<td>LTV of Primary Mortgage: 104%</td>
<td>LTV of Primary Mortgage: 123%</td>
</tr>
</tbody>
</table>

Despite the fact these homeowners both own homes with the same decrease in value, only one homeowner can be helped by the refinance program because of the difference in loan-to-value of the first mortgage. Alternately, homeowners that do not meet the 80% minimum LTV with their first mortgage, even if their combined loans exceed 100% of the value, cannot qualify for the refinance program. This will hurt the many homeowners that tapped out the equity in their home to finance home improvements, their children’s college tuitions, etc. These borrowers could also be severely underwater, but they do not fit the eligibility requirements that would enable them to refinance into a lower interest rate. Many of these second loan programs include potentially dangerous variable rates and balloon payments.

Appraisals are critical to these refinancing and modification programs. The value of the home must be determined before further action can follow. The validity of the appraisals is an enormously important component of the plan. Automated Value Models (AVM) are computer programs that use equations to calculate property values, with inputs of demographics, property characteristics, sales
prices and price trends. Using this valuation method undoubtedly saves time and money and AVMs are praised for lacking human error and bias, but a key weakness is that there is no physical inspection of the property. Details about the condition of the property, level of updates, curb appeal, and other less objective items are not factored into AVMs. The effectiveness in using this valuation method in falling markets is questionable as the calculated value could be artificially high. Using higher values will hurt homeowners that could be excluded from the refinance program because their loan to value will not meet the minimum threshold required for eligibility.

A second method of determining value allowed by the plan is the use of a Broker Price Opinion (BPO). This method involves a real estate agent determining the property value, as opposed to the use of a more expensive, licensed appraiser. BPOs are sometimes referred to as comparative market analyses, and are considered to be an informal estimate of market value based on comparable sales in the neighborhood. The argument against BPOs is that the agents often have minimal or no appraisal training and are not subject to regulatory oversight. Critics also claim that BPOs often result in artificially low values that will enable the property to sell quickly, which then damages subsequent valuations because the original property becomes a comparable for future use. Using artificially low values can also hurt homeowners wanting to take advantage of the refinance program, because the resulting loan to value using the low value may cause the homeowner to exceed the maximum loan to value of 105%.

Freddie Mac, the Federal Finance Housing Agency and the New York State Attorney General created an agreement in March 2008 to improve the independence and accuracy of the appraisal process, called The Home Valuation Code of Conduct (HVCC).64 This code prohibits lenders and third parties from influencing appraisal results, sets conditions for the lender’s use of an in-house or affiliate  

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64 (Freddie Mac, 2009)
appraisal, requires lenders to a randomly selected sample of appraisal reports and valuations, and includes other rules and requirements.

The loan modification program addresses the immediate issue of making payments more affordable but does not combat the issue of house depreciation. Borrowers should be able remain in their homes with their newly lowered monthly payments, but they may face the same problem with increasing payments as borrowers with adjustable rate loans. Payments will be stepped up every year by a 1% increase in the interest rate, and assuming a borrower’s income situation stays the same, it is possible that in a matter of time, the mortgage payment becomes unaffordable and the homeowner is once again in distress. Even if the homeowner is able to continue to make payments once the payment has adjusted after five years to the market rate, what happens if they still owe more than their home is worth? At that point, they would be in the situation of homeowners that currently have the option of the refinance program – where it may not make sense for them to continue making payments on a losing proposition and they could make the decision to walk away from their home.

Critics claim that some homeowners have an easy come, easy go mentality. Many loans were made with $0 down payment, like renting. When people have no personal investment in the home, it makes walking away easier. Lenders complain that many struggling borrowers do not respond to outreach efforts and when they do, are unrealistic about what can be accomplished. Homeowners now have to face the “stark reality of financial insecurity after a prolonged era of fiscal euphoria.” Neighbors get angry when they see nearby homes in foreclosure sell at a deep discount, and watch their home value and equity disappear while their mortgage payment stays the same. Lenders need to get back to the basics of qualifying borrowers. The tightening of mortgage guidelines that has evolved over

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(Cone, 2009)
the past two years is necessary. The move to strengthen homebuyer counseling programs is essential, as potential homebuyers need to understand the enormous responsibility that comes with owning a home.

Americans need to realize that home ownership is not appropriate for everyone. The government needs to stop treating renters like second-class citizens and include support for rentals beyond public housing for low-income families. While there are many benefits to home ownership, there are also benefits to renting a home. Some people are simply not in a secure financial position to own a home and need to learn how to budget their money and consistently meet their current obligations before taking on a significant mortgage payment. Workers that are subject to recurring relocation may not benefit from owning a home, in the event they will need to move every few years. Maintenance is an important part of owning a home, and renters are able to leave that critical responsibility to their landlords. A family moving to a new area may want to rent a home prior to purchasing so that they can take the time to find a residence that meets their needs instead of quickly jumping into a home that may not be the best fit for them.

The often heard argument against renting is that a renter is throwing their money away. That statement is simply not true – a renter is paying a fee for a place to live. Anyone else, homeowner or not, pays a fee for a service such as a haircut or oil change. The upfront costs of renting are significantly less than purchasing a home, with renting often requiring only a security deposit in addition to first and last month’s rent while purchasing a home requires payment of lender and title fees, government transfer and recording taxes, and a down payment. Renting provides greater flexibility because moving can be immediate, instead of taking months to sell and complete closing on a home. The costs of moving are much less, as selling a home often requires the paying for the service of real estate agent and closing costs. Renters do not have to pay homeowners or condominium association fees, property taxes and
special assessments are the responsibility of the landlord, and often some utilities are included in the rental payment.

Unfortunately, in many areas outside expensive urban areas such as New York and San Francisco, our society attaches a stigma to renting, and some people feel ashamed of being renters instead of homeowners. Perhaps in light of the problems we are facing from too many people buying homes, we can hope for a cultural shift in thinking that owning a home is an essential component of the American Dream. Sadly, I do not think this is a realistic possibility to assume that our culture will change drastically for the long term as a result of this crisis.
Conclusion

I personally have felt the effects of this crisis. My home, which I purchased in 2005, has had a decrease of over $100,000 in value. Many of my neighbors, who purchased in my community at higher sales prices, have seen their values decrease more than $250,000. For over five years, as I mentioned earlier in this paper, I worked for a national homebuilder. They have felt the impact through recurring downsizing. My position with the company was terminated in one of these waves in December 2008. Working in new home sales, I also witnessed hopeful homeowners insist that they could afford to buy a home when they had a past history of not making payments on other debts they incurred, income that did not justify their purchase, and other factors that caused me to believe purchasing a home was not in their best interest. However, my personal opinion was not what mattered; what did matter was whether a lender would approve their application for a mortgage; and often times it was approved. I even gave my old washer and dryer to one of our purchasers, only to find that the police had been called to her home to remove squatters. Less than one year after closing on her first home, she walked away and let it go into foreclosure because she was unable to make the payments. I cannot completely blame the homeowner – a lender told her she could afford a home. Did she lack the education to make an informed decision? Did she submit fraudulent information in her loan application? Should the lender have approved her loan? Should her $0 down payment loan been made available to any borrower?

Ironically enough, the week of April 3, 2009 I received a letter from JPMorgan Chase bank, holder of my home equity line of credit, informing me that I was no longer able to draw on my home equity line. While I did not find fault with that, I was shocked by one sentence: “With home values falling in many parts of the country, we’ve used a proven valuation method to estimate your home’s value at $531,000.” I find their “proven valuation method” to be extremely faulty considering that the local

66 (JPMorgan Chase, 2009)
taxing authority, the City of Baltimore, recently reduced the assessed value of my home from $522,740 to $420,570. Based on recent sales in the area, I would be completely unrealistic if I expected to sell my home for a price anywhere near the appraised value determined by Chase, who states they “have confidence that our valuation method for your property is accurate.” The statement that they are confident in their valuation is frightening.

It is difficult to determine where the blame lies. Some homeowners were extravagant and purchased homes beyond their means; some signed documents they did not understand or were steered into more expensive mortgages; and others were misled about refinancing to a lower rate only to find out later they received a teaser rate. Government policies intended to spur the economy ultimately led to lender abuses. Seeking profitable investments, the financial industry encouraged risky lending to continue, and for awhile, the economy as a whole benefitted.

The magnitude of the foreclosure crisis is enormous. The rising rate of foreclosures is not an independent problem, but one component of the overwhelming financial crisis Americans are currently experiencing. The list of guilty parties is lengthy: the federal government, Fannie Mae, Freddie Mac, financial institutions, investors, lenders, mortgage brokers, home buyers, and more. So many organizations and individuals played a role in creating the black cloud the country is trying to move through, and many more Americans are feeling its effects. The basic economic adage that “there is no such thing as a free lunch” has always rung true, but the investors who earned enormous returns from mortgage backed securities, lenders and homebuilders who raked in record profits, and homebuyers who were able to receive loans with little or no money down despite poor credit history that were too caught up in the unrealistically optimistic assumption that prices would continue to rise and fuel the economy have been brought back down to reality. Millions of Americans have been the victims of job
loss, seen their retirement savings drop, watched the value of their home plummet, and even lost their homes over the past few years.

While there may be further discussion about how solid President Obama’s plan is, the requirements and guidelines appear to have been carefully thought out. I fear that banks will use their proven valuation methods to deny help to many homeowners that should be considered eligible. Lenders may slow their processing of applications in hopes that the longer they wait, the more bailout money they will receive. Perhaps financial institutions are remembering the Resolution Trust Corporation that arose from the savings and loan crisis of the 1980s and expecting that the government will ultimately do more to bail out banks. Why should the banks take part of the losses when the government may take on all the losses if they just wait a little longer?

Assuming that four million homeowners will be helped by the refinance plan, using a median sales price of $190,000, the total value of homes being assisted by this program is $760 billion. The costs of President Obama’s plan are enormous. The amount of revenue that will be lost from the decrease of loan interest is staggering; in one year, lenders could lose over $5 billion in interest payments.

<table>
<thead>
<tr>
<th>Current Scenario</th>
<th>Refinance Scenario</th>
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<td>$938.97</td>
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</table>

Cost to Lender:

- Monthly Payment Difference: $140.23
- Annual Payment Difference: $1,682.71
- Total Loss in 1 Year for 3 million loans: $5,048,126,624.50

For the loan modification plan, the government estimates that three to four million homeowners will be helped, at a cost of $75 billion. Assuming three million loans are modified, the cost for each modification comes to $25,000. While the government is sharing the loss with the lenders, the amount of revenue
lost from reduced interest payments is far higher than in the refinance example. However, the loss taken due to the lower interest rate to the lender is far less than the loss that would be incurred due to a foreclosure.

Mortgage lending was once considered the safest of all investments because of the well-researched decision making that documented the ability of the borrower to pay. Innovations in the mortgage industry, such as automated underwriting, risk-based pricing and stratified securitization supported the development of flexible and affordable opportunities for home ownership to those with poorer credit ratings and less savings for down payment. These riskier subprime loans, which were often made with larger upfront fees and higher interest rates, are foreclosed upon at a higher rate. Subprime lenders increased their lending from $90 billion in 1996 to $375 billion in 2003. The primary incentive for mortgage brokers is to close the deal, so they may be less concerned with long term performance of the loan. The mortgage origination system is not structured so that buyers to get the best terms for which they qualify, as higher risk loans charge higher fees. Moral hazard is a condition that exists when an individual or organization takes more risk or acts less carefully than it normally would because it does not have to bear the consequences of the results. This may have caused some lenders to steer borrowers to high prices mortgages when they could qualify for better terms and market high risk loans to people whose incomes could not cover ever repaying the loan.

The significance of the foreclosure crisis spreads far beyond the housing and mortgage industries. The crisis in the housing industry has led to bank failures, job loss, falling home values, decreased property tax revenue, a global credit crunch, and more. The government has recognized that intervention is necessary as there are still many homes projected to foreclose in the near future, many more homeowners that owe more than their home is worth, and more banks that will fail unless something is done to help distressed homeowners, bailout banks and encourage banks to lend.
The American Dream of homeownership is not one that should be dismissed as a response to the current financial crisis. Despite the fact that many Americans have lost and will continue to lose their homes does not mean that home ownership has lost its luster. There are benefits to owning a home that exceed purely financial motives, and these are not entirely measurable or tangible. Thousands of years of history proves that people will always seek the opportunity to stake their claim and find a place of their own, and that desire is not going to fade away. However, the environment of conspicuous consumption and “free” credit needs to be adjusted, and changes are already evident. In today’s world, many families are reevaluating what is truly important and examining their needs versus wants. Unfortunately a conflict continues to exist between the financial needs and abilities of families and the desire of the federal government to encourage consumer spending as a way to spur the economy.

While critics may claim the Obama plan is too costly, or see foreclosure mitigation as a way of saving deserving homeowners and rewarding irresponsible ones, the alternatives are to directly bail out investors, or do nothing and let the severe repercussions continue. With all the negative press surrounding corporate bailouts in the financial, insurance and automobile industries, why not do something to help the families that have been striving to create their American Dream?
Guide to Acronyms

ARM – Adjustable Rate Mortgage
AVM – Automated Valuation Model
BPO – Broker Price Opinion
CDBG – Community Development Block Grants
COP – Congressional Oversight Panel
FDIC – Federal Deposit Insurance Corporation
FHA – Federal Housing Administration
FHFA – Federal Housing Finance Agency
FHLMC – Federal Home Loan Mortgage Corporation (Freddie Mac)
FNMA – Federal National Mortgage Association (Fannie Mae)
GSE – Government Sponsored Entities (Fannie Mae and Freddie Mac)
HERA – Housing and Economic Recovery Act of 2008
HOA – Homeowners’ Association
HUD – Department of Housing and Urban Development
HVCC – Home Valuation Code of Conduct
NAR – National Association of Realtors
TARP – Trouble Assets Relief Program
USDA – United States Department of Agriculture
VA – Veterans’ Administration
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