The Impact of the HOPE for Homeowners Program Rule

Alastair W. McFarlane ★ U.S. Department of Housing and Urban Development, Office of Policy Development and Research; e-mail: *alastair.w.mcfarlane@hud.gov*

Edward Szymanoski U.S. Department of Housing and Urban Development, Office of Policy Development and Research; e-mail: *edward.j.szymanoski @hud.gov*

Kurt G. Usowski U.S. Department of Housing and Urban Development, Office of Policy Development and Research; e-mail: *kurt.g.usowski@hud.gov*

★ Corresponding author

U.S. Department of Housing and Urban Development Working Paper # REP 08-04; October 2008

1. Overview of HOPE for Homeowners Program

The Housing and Economic Recovery Act of 2008 (HERA) established the temporary HOPE for Homeowners Program. The Program allows homeowners to avoid foreclosure, using the Federal Housing Administration (FHA) insurance program structure already in-place at the Department of Housing and Urban Development. Under the Program, certain borrowers facing difficulties with their mortgages will be eligible to refinance into FHA-insured mortgages. The Program was implemented on October 1, 2008 and will last through September 30, 2011. FHA will insure up to $300 billion in new loans. Borrowers will pay FHA an upfront mortgage insurance premium of 3 percent of the original insured mortgage amount and an annual premium of 1.5 percent of the outstanding balance thereafter.[1]

Participation in the Program is voluntary and so there must be agreement of all involved parties: the senior mortgage holder, all junior mortgage holders, and the homeowner. Mortgage lenders that might otherwise pursue foreclosure on a loan may find that they can minimize their losses by assisting the homeowner to refinance into a new mortgage loan insured by FHA under the Program.[2]

HERA sets both general and specific requirements for affected parties. Senior mortgage holders are required to accept, as payment-in-full, no more than 90 percent of the current appraised value of the property (87 percent after payment of the upfront premium to FHA). Subordinate mortgage holders must write-off the entire amount due to them, in exchange for a share of future property-value appreciation. To qualify, borrowers' debt-to-income ratio on their

[1] For more information on the rule, please see the FHA website on the program (http://portal.hud.gov/portal/page?_pageid=73,7601299&_dad=portal&_schema=PORTAL) as well as the regulation itself (Docket No. B-2009-F-01).

[2] While the Program is to be administered by HUD and FHA, a statutorily created Board of Directors (consisting of HUD, Treasury, the Federal Deposit Insurance Corporation and the Federal Reserve), is charged with establishing the program's standards and policies, and for providing program oversight.

prior mortgage must be at least 31 percent. The homeowner must agree to pay HUD a portion of the property equity created in the new mortgage (defined as the difference between the appraised value and the initial balance of the new mortgage) and 50 percent of any future property value appreciation. HUD would then pay the subordinate mortgage holders from that 50-percent share.[3,] Positive profits (if any) earned by the FHA from the program through the premiums and appreciation-sharing provisions will be used to pay down the national debt. Net losses arising from the cost of providing the credit-guarantee will be paid for by the Treasury, but may be reimbursed by Fannie Mae and Freddie Mac to an extent described in Section 1338(b) of HERA.

2. Cost-benefit Analysis

The economic impacts of the rule stem largely from Congressional mandates, as the final rule adheres closely to the prescriptive language of the statute. The expected net benefits of Hope for Homeownership are substantial. We estimate that with only 10,000 participants annually, the Program will generate from $62 million to $355 million of net benefits to society. However, program participation could be as high as 100,000 annually, with commensurately higher benefits.[4]

Benefits. The benefit of the Act that this rule implements is to prevent foreclosures, for which there are economic costs. The Joint Economic Committee of the U.S. Congress (April 2007) estimates the costs per foreclosure at almost $80,000. The foreclosed upon household pays moving costs, legal fees, and administrative charges of $7,200 (Moreno, 1995). Lenders also bear significant costs in terms of legal fees. A study from the Federal Reserve Bank of Chicago reported that lenders alone can lose $50,000 per foreclosure (Hatcher, 2006). The $50,000 loss is estimated for a $210,000 property. Standard and Poor's describes these costs as consisting of loss on loan/property, property maintenance, appraisal, legal fees, lost revenue, insurance, marketing, and clean-up. Of these costs, the primary cost to lenders is the cash loss on property sale.

If the loss to a lender from foreclosure is $50,000, the gain to the lender from participating in the program will be less than $50,000. To enter the Program the lender must accept, as payment-in-full, an amount equal to no more than 87 percent of the current property value. In the case of our example property, currently valued at 210,000, that would be $183,330. In the typical situation where the senior mortgage lender had an 80 percent loan on the property, but local property values have declined by 25 percent, then the original property value would have been $280,000, and the amount of outstanding indebtedness owed would be $224,000, for a property currently valued at $210,000. The loss incurred by the first lien holder from the requirements of the program would then be $40,670 ($224,000 less $183,330). Thus, the gain from participating in the program is the $50,000 loss in foreclosure, less the $40,670 cost of program participation, for a net benefit to the lender of $9,330.

The benefits to the lender from participating could be greater than $9,330. It is possible

[3] After the Hope for Homeowners Program was launched, the TARP legislation (Emergency Economic Stabilization Act of 2008. Public Law No: 110-343) modified some if its provisions. Specifically, the TARP authorizes the Board to consider loan to value ratios higher than 90 percent and to make direct payments to junior lien holders to provide greater incentives for these lien holders to release their liens.

[4] Note that the estimates presented in this article are slightly different than the ones in the original Regulatory Impact Analysis, written before the submission of the final rule. First, we are using the credit-subsidy estimates made by the Board and approved by OMB . These estimates were not finalized at the writing of our initial analysis. Second, we adopt assumptions concerning the program foreclosure rates consistent with the final estimates. Third, our thinking concerning the benefits of participation to lenders has evolved, resulting in a slightly lower estimate of the expected losss to lenders in the event of a foreclosure of one of the new FHA loans.

that the loss of property value ($210,000 before foreclosure) via foreclosure in target areas of the program will be substantially more than the $50,000 estimate provided in the Federal Reserve study. In a distressed market, the loss of value on the property could be substantially higher. Vacant homes in distressed neighborhoods are also more likely to suffer vandalism, forcing the lender to incur property-rehabilitation expenses. Thus, the final loss to the lender from foreclosure could exceed the $50,000 estimate provided. If the lender loss from foreclosure were $75,000, the lender benefit from program participation y in this example would be about $35,000.

Foreclosures resulting in long-term vacancies have a negative impact on the value of neighboring properties by reducing the physical appearance of the neighborhood, attracting crime, and by depressing the local economy. The Joint Committee cites an estimate of $1,508 by Immergluck and Smith (2006) of the negative externality of a single foreclosure on nearby properties. In addition, the local government loses from a foreclosure through lost taxes from the foreclosed property, unpaid utility bills, property upkeep, and a shrinking tax base as home prices decrease. The Joint Committee uses an estimate of $19,227 of the average cost per foreclosure to local governments from a study by Apgar and Duda (2005).

HUD's estimate of the average gross economic benefits of averting foreclosure is $37,265. However, this benefit will not be realized for every household assisted. Some households will default on their new FHA loan and eventually lose their homes in foreclosure even after the loan write-down. Although the program maintains FHA's requirement that new loans be based on a family's long-term ability to repay the mortgage, some foreclosure is experienced on all types of FHA loans.

The first lien lenders will retain their full benefit of $9,330 per loan sent through the Program because these benefits are not affected by foreclosures on the new loans. However, the lenders who originate the new FHA-insured loans at the written-down amounts will bear losses of about $3780 on each insured loan which ultimately goes to foreclosure, because FHA-insured lenders typically absorb some of the foreclosure costs estimated to be 2 percent of the unpaid balance. Thus, the net benefit to lenders as a group would fall from $9,330 to $8,574 per participant if 20 percent of the participants eventually end up in a foreclosure. The net benefit to lenders as a group falls to $7,818 if 40 percent of participants fail.

The expected benefit per refinancing for other categories (cost avoided for homeowners, local governments, and neighboring properties) is equal to our estimated benefit multiplied by the probability that a property does not go to foreclosure after the write-down.

Costs. The cost to the taxpayer of the program is the subsidy paid to FHA to cover the cost of the credit guarantee not covered by program revenues.[5] The subsidy is the difference between the present value of the cost to the FHA and the future stream of revenues. It is only in scenarios with high program foreclosure rates that positive costs of assistance could be expected. The Board estimates that, as long as the program foreclosure rate is below 34 percent, the credit subsidy rate would be negative. A negative rate implies that the program would generate net budget receipts in present value terms. The possibility of net receipts even under a high-program-foreclosure-rate scenario is due to the very large revenue streams built into this program. The Act mandates that FHA charge an upfront premium that is twice its normal charge, and an annual premium three times its normal charge; that the homeowner agree to pay to FHA a significant portion of the property equity created at the time of the program refinance, and to share half of all property appreciation with FHA. Gains by the FHA from the program's credit guarantee would

[5] The figure of $300 billion, which is the amount available through mid-2011 to insure new FHA-issued mortgages to qualified homeowners, is not the cost to taxpayers. First, participation in the Program is voluntary and so the total cost of the Program is uncertain. Second, the average cost of assistance is not the up-front cash required to purchase the loan but the subsidy required to the FHA to breakeven on the deal.

go to the Treasury and would ultimately be used to pay down the national debt, while losses would be ultimately reimbursed by Fannie Mae and Freddie Mac to the extent described under Section 1338(b).

If the program foreclosure rate were 40 percent, the Board estimates a positive subsidy rate of 10 percent or $18,300 per loan. If the program foreclosure rate were 20 percent, the Board estimates a negative subsidy of 2.5 percent or $4,580.[6]

Expected Economic Benefits per Refinancing

Category of Benefit	Estimated Benefits Per Foreclosure Prevented	Expected Benefits per Refinancing at Program Foreclosure Rate of 20%	Expected Benefits per Refinancing at Program Foreclosure Rate of 40%
Homeowner	$7,200	$5,760	$4,320
Lender	$9,330	$8,574	$7,818
Local Government	$19,227	$15,382	$11,536
Neighboring Home Value	$1,508	$1,206	$905
Total Costs of Foreclosure	**$37,265**	$30,922	$24,579
Subsidy to FHA		-$4,583	$18,333
Net Benefit to Public		$35,505	$6,246

Net Benefits. The net benefit of the program to society is equal to the gross benefits of the avoiding foreclosures less the cost to the public of providing those benefits. At a high program foreclosure rate of 40 percent, which was assumed by the Board, the expected benefits per household assisted would be $24,579. Even if the program costs are extremely high, at $18,333 per household, there will be net economic benefits of $6,246. At a lower program foreclosure rate, the expected benefits of preventing a foreclosure would be higher and the cost would be lower, thus the net benefit would be higher as the program foreclosure-rate is lower. In the lower foreclosure rate scenario of 20 percent, the expected benefits are greater at $30,922 and the FHA receives an average profit of $4,583 per loan. Since this negative subsidy will be contributed to the Treasury, it can be considered a transfer to the taxpayer. The net benefit of the Program to the public under a foreclosure rate of 20 percent is thus $35,505.[7]

Aggregate Impact The level of participation in the program is a major unknown. The Board estimates that up to 400,000 participants may be in a position to utilize the program over its three-year life. In a slightly less optimistic scenario of 100,000 participants annually, the gross benefits could be as high as $3.1 billion and the net benefits to the tax payer could be even greater at $3.6 billion.

There are many reasons to suspect that annual program participation will be less than 100,000. Lenders may not find sufficient incentives to participate, even compared to the costs of foreclosure. The lender must be willing to assume a 10 percent loss if it allows mortgage holders to refinance. Foreclosure and Hope for Homeowners are not the only alternatives facing a lender.

---

[6] The estimates of the credit subsidy estimates is very sensitive to assumptions concerning the path of future housing prices. The Board's estimates, used here, are based on an allowance for an immediate price decline of 5 percent due to appraisal error, a significant price decline over the next three years, and t a return to a long-run annual growth trend of 3.4 percent. Using the same model, but assuming no initial drop due to appraisal error, the same decline over the next two years, and an eventual long-run growth rate of 3.0 percent yields a positive subsidy of 2 percent at the 40 percent program foreclosure rate, and a negative subsidy of 9 percent, at the 20 percent program foreclosure rate.

[7] Under the alternative housing-price scenario of lower short-run price depreciation, the net benefit to the public of this rule per refinancing would be $47,400 for a program foreclosure rate of 20 percent and $20,900 for a program foreclosure rate of 40 percent.

The lender also has the option of proposing a work-out plan of its own design to the borrower.[8]

Some features of the program could discourage homeowners from participating. For example, the homeowner must sign agreements to pay unknown amounts of money to HUD in the future. While unknown, they might be substantial in dollar terms. For every refinancing, the senior mortgage holder must reach an agreement with the homeowner as well as the junior mortgage holder and the new FHA lender, and do so relatively quickly. The burden of negotiating among four parties, and doing so quickly, may lead to the failure of some efforts to effect a workout.

If the annual level of participation proves to be 10,000, then the gross benefits are $309 million annually and the net benefits to the public are $355 million annually at a 20 percent program foreclosure rate. The gross benefits are $246 million annually and the net benefits to the public are $62 million annually at a 40 percent Program foreclosure rate. Over the three years of the Program and discounted at 7 percent this adds up to a net benefit of $175 at a 40 percent foreclosure rate and $997 million at a 20 percent foreclosure rate.[9]

Aggregate Annual Benefits of Program (in millions)

Participants	**Gross benefits**	**Benefits Net of FHA Subsidy**	**Gross benefits**	**Benefits Net of FHA Subsidy**
	At 20% Program Foreclosure Rate		*At 40% Program Foreclosure Rate*	
5,000	$155	$178	$123	$31
10,000	$309	$355	$246	$62
25,000	$773	$888	$614	$156
50,000	$1,546	$1,775	$1,229	$312
100,000	$3,092	$3,551	$2,458	$625

References

Apgar, William C. and Mark Duda, "Collateral Damage: The Municipal Impact of Today's Mortgage Foreclosure Boom," National Multi-Housing Council, May 11, 2005)

Board of Directors of the Hope for Homeowners Program. Hope for Homeowners Program: Final Regulations, Docket No. B-2009-F-01.

Federal Housing Administration, U.S. Department of Housing and Urban Development. (2008). Hope for Homeowners. http://portal.hud.gov/portal/page?_pageid=73,7601299&_dad=portal&_schema=PORTAL

Hatcher, Desiree , "Foreclosure Alternatives: A Case for Preserving Homeownership," *Profitwise News and Views,* Chicago Federal Reserve Bank, February 2006

Immergluck D. and Smith G. (2006). The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values. *Housing Policy Debate*, Volume 17, Issue 1.

[8] There are reasons that a high participation rate may come to fruition despite some of the barriers discussed. For example, Bank of America Corp. has agreed to settle claims brought by state attorneys general regarding certain risky loans originated by Countrywide Financial Corp. Under the terms of the deal, which involves up to 390,000 loans, Bank of America will first try to refinance borrowers into FHA loans under the Hope for Homeowners program (Simon, Wall Street Journal, October 6, 2008).

[9] Under the alternative housing price scenario of lower shirt-run depreciation, the aggregate net benefits would be $474 million for a program foreclosure rate of 20 percent and $209 million for a program foreclosure rate of 40 percent. Over the three years of the Program and discounted at 7 percent this adds up to a net benefit of $587 million at a 40 percent foreclosure rate and $1.3 billion at a 20 percent foreclosure rate.

Joint Economic Committee, Sheltering Neighborhoods from the Subprime Foreclosure Storm (April 11, 2007)

Ruth, Simon. (October 6, 2008) “Bank of America Settlement Worth Over $8 Billion,” Wall Street Journal, P. A3.

Standard and Poor’s, :“The Anatomy Of Loss Severity Assumptions in U.S. Subprime RMBS,” (May 7, 2008), http://www2.standardandpoors.com/portal/site/sp/en/us/page.article/4,5,5,1,1204835910066.html