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HOW WASHINGTON WILL RESPOND TO SUBPRIME MEDIA FRENZY

According to housing experts, lenders will foreclose on up to 2 million of the nation's 80 million homeowners before the current housing crisis abates. A disproportionate share of those suffering foreclosure will be subprime borrowers – many of them minorities or elderly. They closed adjustable rate mortgages with low initial interest rates in 2004 and 2005 that are now resetting at much higher levels that they cannot afford to pay.

Subprime borrowers are not alone when they ask, "What happened – and what's next?" Investors wonder if the collapse of the subprime market will lead to sharply falling home prices as foreclosed properties glut the market, triggering a collapse in consumer confidence and a recession. Industry analysts wonder what the crisis means for mortgage lenders, private mortgage insurers, and the owners of subprime mortgage-backed securities. In newspapers across the country, journalists and editors worry that the "subprime meltdown" will spread.

Consumer advocates claim that many of those threatened with losing their homes are victims of predatory mortgage brokers and lenders who took advantage of unsophisticated consumers to earn high fees and ongoing returns while shoving all of the risk that the Federal Reserve would boost interest rates onto their gullible customers. Restive Democratic leaders, like Presidential contenders Hillary Clinton and Senate Banking Committee Chairman Christopher Dodd, are publicly weighing how to help distraught borrowers from losing their homes and how to prevent abusive loans from being issued.

Subprime lenders and investors see things differently. They point out that generous underwriting standards and low downpayments worked to the advantage of millions of borrowers who never would have qualified in the past. Indeed, 69 percent of Americans now own their own homes, an all time record, compared to 64 percent in 1995, because of these liberal rules. During 2002-6, subprime borrowers gained windfalls as home prices soared, giving them eye popping returns and entry to the middle class. It is only when home prices finally flattened or fell and interest rates rose that critics started calling them names. Even in today's stagnant market, 87 percent of subprime borrowers are current on their mortgages and enjoying homeownership. Subprime lenders warn that if Congress goes too far, higher-risk borrowers will encounter new obstacles, built with the intent of helping the disadvantaged but operating as barriers to homeownership.

Subprime lending is claiming many victims. What will the politicians do?

Nationwide, The Subprime Market Weakness is No Big Deal

From a global perspective, subprime market's weakness is of minor consequence. Even if a wave of subprime foreclosures hit, the market can handle it. According to the National Association of Realtors, 3.748 million existing homes were on the market in February 2007,

including homes that were in foreclosure. The mean price of existing houses sold last month was $260,100, giving this inventory a mark-to-market value of $975 billion. This week's homebuilders' report found that another 546,000 new homes also were up for sale at a median value of $260,000, making this inventory worth at least $142 billion since the mean average new home price is higher than the median price. Thus, more than $1,117 billion of residential properties are on the market.

As the box to the right shows, the national residential real estate market is fifty times larger than the expected value of foreclosed property created by defaulting subprime borrowers. In the worst hit states – Ohio, Michigan, and Indiana – statewide averages will be around 4 percent of added inventory, compared to the 2 percent national average calculated in the box. In a few pockets in the country, where aggressive mortgage brokers were most active, an above average number of subprime foreclosures could add 10 percent to the value of residential inventory on the market.

Subprime foreclosures will have little impact on a $1 trillion-plus market

Subprime mortgage outstanding balances represent 13 percent of the $10 trillion total market, or $1.3 trillion. John Reich, Director of the Office of Thrift Supervision , told Congress on Tuesday that the foreclosure rate on subprime mortgage rose from 2.48 percent in December 2005's normal market to 3.63 in December 2006, when rate shock and stagnating home prices were obvious to all. The Mortgage Bankers Association recently reported a 4.5 percent foreclosure rate. These data points provide reference points for gauging market impact of the "subprime crisis."

First, assume that foreclosed subprime borrowers have negligible home equity. During "normal times," 2.48 percent of the $1.3 trillion in outstanding subprime balances would be in foreclosure, implying a market value of $32 billion in foreclosed subprime property on the national market. Today's foreclosure rate, 4.5 percent, implies that $59 billion in subprime property is on the market – $27 billion more than "normal." This "excess" $27 billion means that $1,090 billion of real estate would be for sale, instead of $1,117 billion. The subprime crisis adds a little than 2 percent to the value of housing inventory for sale. Who thinks the housing market will collapse because 102 homes are for sale in an area instead of 100?

After falling by 2.7 percent in 2006, national housing prices may continue to decline in 2007 and 2008, even if subprime weakness is a material cause. One market signal suggests this is likely. The residential housing futures market run by the Chicago Mercantile Exchange projects prices will fall by 3.0 percent between May 2007 and February 2008. All of this may be part of a natural market correction and profit taking; the Federal Reserve reports that household real estate assets rose in value from $13.7 trillion to $20.6 trillion, a 50 percent increase, between 2002 and 2006.

Congress' First Response: Let's Hold Hearings

It will take Congress time to fashion a solution, and it will be based on how bad the problem becomes. CAN does not share the views of the alarmists and believes that there is only modest danger that Congress will overreact by drying up credit to the housing market.

As they seek solutions, Congressional Democrats will evaluate the Bush Administration's proposal to modernize HUD's FHA program to out-compete subprime lenders on price. If they accept Bush's proposal, then private mortgage insurers such as **MGIC**, **PMI**, and **Radian** will lose. Subprime lenders such as **HSBC**, **Countrywide**, **Washington Mutual**, **CitiMortgage**, and **Wells Fargo** – who hoped to gain market share and fatter margins as weaker subprime lenders go out of business – may find they must compete instead against Uncle Sam, who isn't interested in making a profit. Democrats have rejected many Bush legislative proposals, but House Democrats approved his FHA expansion ideas unanimously on a July 25, 2006 House floor vote. The overall vote was 415 to 7. Last year, then Senate Banking Committee Chairman Richard Shelby (R-AL) asked for more time to study the bill, with the expectation that a compromise bill would become law this Congress. It looks likely that this expectation will be realized.

A Creative Non-Response from Senator Dodd

Senate Banking Committee Chairman Christopher Dodd has been visible on the subprime issue, as any presidential candidate with legislative jurisdiction should be. Dodd wants to be seen as helping currently endangered subprime borrowers avoid tragedy and also to be the author of legislation that prevents future tragedies by reining in predatory lenders. He must surely know that the subprime foreclosure problem is not really unusual from an historic perspective, even as he tries to use the media's focus on it to his advantage. After all, the subprime mortgage foreclosure rate hit 9 percent, twice today's average, just 7 years ago.

The Senator has decided to call for an "all parties conference" of banks, mortgage-backed securities holders, distressed borrowers, regulators and consumer advocates. He will task them to "come up with a solution." His tactic will work politically for a reason the public will not understand. Faced with the expensive prospect of having to foreclose, oftentimes lenders will prefer a less costly way of working out problems, restructuring loans by writing off principal, lowering interest rates, and granting grace periods. On some occasions, they will arrange "pre-sales" which allow delinquent borrowers to leave without impairing their credit ratings. Without a "national conference," lenders likely will restructure two-thirds of delinquent subprime loans on a one-on-one basis. Dodd plans to claim credit for these consumer-friendly workouts. Politicians have not changed much over the centuries. Egyptian pharoahs used to take credit for the sun rising.

Do not expect lenders, or the owners of mortgage-backed securities based on subprime instruments including investment banks and foreign creditors, to get relief from Washington. They will be the ones providing the relief to subprime borrowers in workouts.

Two Congressional Responses Worth Watching: FHA and Predatory Lending Reforms

In the near future, Congress is likely to consider reviving the near-moribund FHA program. Currently, only $400 billion in federally-insured FHA loans are outstanding, representing 4 percent of the $10 trillion national total. Historically, FHA has insured 10 percent or more of the mortgage market, targeting first-time home buyers who can not put more than 5 percent down. Another name for traditional FHA customer is subprime borrower.

With the support of the Bush Administration, House Republicans passed a bill raising FHA-insured loan limits in three ways. In "high cost areas" such as California, FHA could insure 100 percent of the Freddie Mac limit which is now $417,000, compared to 87 percent now, or $362,790. In "low cost areas," FHA could insure up to 65 percent of Freddie's national limit or $271,050, compared to 48 percent now, or $200,160. In intermediate areas where most homes are located, FHA could insure up to the median price in the area, up from 95 percent of the median price now.

More significantly, FHA would be allowed to compete very aggressively with subprime lenders by offering to insure loans inexpensively when borrowers put down very little, or no, money. FHA would have to do this compete in a world where more than 70 percent of first-time homebuyers put down less than 2 percent in 2006. When testifying before Congress on March 15, 2007, Brian Montgomery, Assistant Secretary of Housing, asserted: "If granted, FHA's new legislative authority would save homeowners a lot of money, because FHA's loan product would carry a lower interest rate than a non-prime loan. … For example, if FHA charged a 3 percent upfront insurance premium for a $225,000 loan to a credit-impaired borrower versus that same borrower obtaining a subprime loan with an interest rate 3 percent above par, the borrower would pay over $300 more in monthly mortgage payments with the subprime loan and over $137,000 more over the life of the loan."

Subprime mortgage originators and private mortgage insurers beware; FHA may well get from Congress the powers it needs to win back the 10 percent market share it lost to subprime lenders during the past decade.

Predatory Lending Rules May be Expanded

House Banking Chairman Barney Frank (D-MA) has made it clear he will pass a bill to toughen predatory lending laws. While he will conduct his own review, a recent Bush Administration Task Force and the ideas of consumer advocates will play an important role in shaping his bill. He is joining the chorus of Democratic critics questioning how much attention regulators have paid to enforcing the Home Equity Preservation Act, better known as HOEPA. HOEPA has several anti-predatory lending provisions for mortgages that tapped established home equity, either through a refinancing or loans offered to homeowners who owned homes free and clear. It established national interest rate and fee thresholds defining predatory lending.

In 2005, HUD and Treasury formed a predatory lending task force that found mortgage originators, brokers as well as lenders, were continuing the abusive practices known as "loan flipping" and "loan packing." They would offer repeated refinancings to borrowers, charging new fees with every transaction, funding these fees by increasing the loan amounts. In some instances, borrowers incurred prepayment penalties if they repaid their current loans, thereby making the cost of such refinancings even higher. The task force also identified predatory practices in loans made to homeowners having limited incomes, such as retirees, approved solely on the basis of equity, disregarding borrowers' abilities to pay. These loans did not trigger HOEPA through high fees or interest rates, yet were defined as predatory because of risk they pose to the unsophisticated.

The Center for Responsible Lending (CRL) takes consumer advocacy beyond the recommendations of the HUD/Treasury task force. It wants federal laws to:

- Establish that every borrower has the means to repay his/her loan – without resorting to selling the property or refinancing under pressure
- Ensure that all parties operate in good faith; CRL singles out mortgage brokers, who walk away from closings with incentive checks in their pockets, facing no consequences if the loans goes bad
- Curtail "steering" – the practice of recommending a more costly loan than a borrower's credit profile justifies – by requiring objective pricing standards; CRL advocates heavier reliance on automated underwriting programs over more subjective internal criteria
- Continue to curtail abusive prepayment penalties
- Help subprime borrowers who are in danger of losing their homes, with credit counseling, restructuring in the aftermath of unexpected repairs or short-term income disruptions, as well as flexible forebearance and workout plans.

Predatory Actions Bring Out the Lawyers, too

All lenders – prime or subprime – may feel the effect of another reform favored by regulators and consumer advocates, who want an end to federal preemption of state laws. Currently, HOEPA provides a national standard that prevails even if state lawmakers try to impose stricter anti-predatory rules. So far, the courts have backed federal preemption. A pending Supreme Court case may give consumer advocates the opportunity they have been waiting for. The Supreme Court is scheduled to rule on *Watters v. Wachovia Bank* within the next few weeks. In this case, Wachovia Bank opened mortgage offices in Michigan and did not adhere to the state's licensing requirements for mortgage companies, arguing that the mortgage subsidiary of a national bank was subject only to federal guidelines. The courts have sided with Wachovia all the way to the Supreme Court, but the outcome of this case is hardly certain. Three justices – Kennedy, Souter and Breyer – lean toward Wachovia's support, and three justices – Roberts, Stevens and Bader Ginsburg – appear to side with Michigan. One justice, Thomas, has recused himself. Alito and Scalia will determine whether this case becomes a clear win for one side or the other, or a tie that encourages future lawsuits challenging federal regulatory preemption. If Wachovia loses, stricter state predatory lending laws suddenly could apply retroactively to millions of loans, opening up the prospect of class action laws suits against subprime lenders.

Between Congress and the Supreme Court, Washington is making its own contribution to the subprime meltdown. The subprime media frenzy may be overblown, but the political risk is high if you are exposed companies that assist subprime borrowers.

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