The New Mortgage Plan

In Arizona on Wednesday, President Obama rolled out a plan designed to reduce foreclosures.

The multipronged plan has several moving parts. Since it could have an impact on both your personal finances — and you're investing strategy — I want to give you some straight talk on it.

First, let's start with some background...

As you know, many of the mortgages we take out aren't held in the portfolios of the banks we got them from. They're bundled into bonds called Mortgage Backed Securities (MBS), which are owned by investors — pension funds, bond funds, foreign central banks, and so on.

A separate group of companies, called loan servicers, are responsible for collecting our monthly mortgage payments. They then remit principal and interest payments on those MBS to the bondholders, collecting a fee for their work.

Now here's the thing: When borrowers start missing payments, those servicers have to take steps to minimize losses for the loan investors. Sometimes, the best strategy is to move a loan straight to foreclosure. Sometimes, modification works best.

Loan "mods" can be structured in any number of ways. For instance,

- The borrower's interest rate and payment can be reduced.
- If the borrower has an Adjustable Rate Mortgage that's about to adjust higher, the rate can be frozen at the "start" rate instead.
- The loan term can be extended — turning a 30-year mortgage into a 40-year one.
- The monthly payments already missed can be added to the loan's principal, and the loan re-amortized, making it more likely the borrower will catch up.
- Or the actual loan principal can be reduced.

The Nitty-Gritty of the Obama Modification Program

With that intro out of the way, let's delve into the Obama plan.

The first major component of the plan is *designed to encourage loan modifications through government subsidies and payments — payments that go to mortgage servicers, borrowers, and investors.*

As part of the plan, servicers will screen their portfolios for borrowers whose monthly payments consume a high percentage of their gross monthly income. Anyone who's spending more than 38% of their income on their mortgage will be eligible for a break.

Specifically, loan servicers and investors will eat the cost of getting the borrower's payment down to that debt-to-income ratio threshold. Then the government will jump in and subsidize the cost of cutting the ratio even further to 31%. Servicers will generally use interest rate reductions and term extensions to get the payments lower.

Borrowers don't have to be delinquent already to qualify, a departure from previous modification programs. But they have to be owner-occupants. No second home owners or investors need apply. The loans also can't be too large. They have to be for less than the current Fannie Mae and Freddie Mac conforming loan limits — $417,000 nationally, and up to $729,750 in specific areas designated "high cost."

The rate relief isn't permanent, either. Borrowers will only get cheaper rates for five years, after which time their rate will gradually revert to a level in line with the market. And in no circumstance will the servicers be allowed to cut a borrower's rate below 2%.

You might be wondering: Yeah, so what? Loan modifications have been going on for several months, and it hasn't had much impact.

That's true. The difference now is that the government is going to subsidize them in an attempt to make them more aggressive and more widespread.

Specifically, servicers will get a $1,000 upfront fee for each modification they put in place. They also stand to collect fees of up to $1,000 every year for three years if the borrower can stay current on his loan.

That's not the only money flowing from Washington...

- Servicers also get an incentive payment of $500 if they modify loans BEFORE borrowers miss payments.
- Mortgage investors get $1,500 for that, too.
- Borrowers who stay put in their homes and make payments on their modified loans, rather than walk away, can collect $1,000 a year for five years in principal reduction payments.

Finally, the Treasury Department and FDIC will establish a $10 billion insurance fund. The fund will distribute payments to mortgage investors if home prices keep falling.

The idea is to encourage more servicers and investors to allow modifications, rather than move straight to foreclosure out of fear home prices will keep dropping.

Fannie Mae and Freddie Mac Ramp Up Their Refinance Role

There's another major component to this plan designed to help borrowers, whose homes have lost value, refinance...

Currently, Fannie Mae and Freddie Mac generally can't buy or guarantee loans that are made at a loan-to-value ratio of 80% or more. In other words, you have to have at least 20% equity in your home to qualify. But falling home prices have eroded the equity of millions of borrowers; making many of them ineligible to refinance despite the fact mortgage rates are relatively low.

Enter the Obama plan.

It will permit Fannie and Freddie to refinance mortgages they already hold — or that they put into MBS — as long as the new loans (including any fees) don't amount to more than 105% of the current value of the underlying homes.

Borrowers can participate in this program if they have a second mortgage, but only if the second mortgage lender agrees to stay in second position. The refi loans will feature fixed rates with terms of 15 or 30 years, with no prepayment or balloon payments. Applications will be accepted after March 4, when technical details of the program are hammered out.

To help Fannie and Freddie ramp up their mortgage market role, the Treasury Department will double the amount of money it has committed to inject into the two companies — to as much as $400 billion from $200 billion. The two firms will also be allowed to increase the size of their retained loan portfolios to $900 billion from $850 billion.

There are a few other miscellaneous components to this plan as well...

For starters, from here on out all banks receiving Financial Stability Plan (the new name for TARP) aid will be forced to implement a uniform loan modification program. The government will seek to apply any modification program to FHA and VA loans, in addition to conventional loans owned or guaranteed by Fannie and Freddie.

Meanwhile, the Obama administration will back legislative efforts to allow bankruptcy judges to cram down mortgage balances. Specifically, the administration wants any legislation to allow judges to treat the portion of a mortgage amount that exceeds the current value of the borrower's home as unsecured debt. Courts routinely slash unsecured debt loads as part of the bankruptcy process.

Last but not least, the Hope for Homeowners plan — which has been a total dud, resulting in only a handful of loans — will be modified. The FHA will cut fees that borrowers have to pay and loosen standards so that borrowers with higher debt burdens can qualify, among other steps.

This Plan

The Administration hopes these efforts will help 7 million to 9 million families either restructure their loans or refinance them. It will also prevent house prices from declining an additional $6,000 (above and beyond the declines they're already experiencing).

There are those who think those projections are *way* too optimistic — and this is why.

First, as I mentioned earlier, the modification plan only applies to owner occupied homes with loans less than the conforming loan limit. Some 40% of existing homes sold during the peak of the bubble — 2005 — were purchased as second homes or investment properties, according to the National Association of Realtors. Those borrowers won't get any relief. Neither will "jumbo" borrowers who have larger loans — loans that are experiencing their own delinquency surge.

I understand why those loans are being excluded. Politicians don't want to be perceived as bailing out speculators or rich people. But it also limits the plan's impact as any foreclosures in those parts of the mortgage market won't be mitigated by this plan.

Second, home prices in the hardest-hit housing markets (where foreclosures are most prevalent) have plunged. They've dropped so much, in fact, that even the more generous 105% LTV refinance standard won't help many borrowers.

Just look at what's going on in our own backyard, Detroit, Michigan, suburbs. Let's say you bought a median priced home in the Detroit suburbs market in December 2005, around the peak. It would have cost you $408,200, according to figures from the Michigan Association of Realtors.

Now let's be generous and assume you put 10% down, rather than financed the whole shebang (which many people did). You would have had to come up $40,820 and finance $367,380 — leaving you with a mortgage with an initial loan-to-value ratio of 90%. Thirty-year fixed rates averaged about 6.3% at the time, so your principal and interest payment would have come to $2,274.

But in the three years since then, home prices have plunged — to just $246,000 as of December 2008. In other words, your home has lost $162,000 in value, or 39.7%. During that same three-year period, you would have only paid your mortgage principal down to $353,739 (less than $14,000).

Bottom line: Thanks to the plunge in home prices, and the slow payoff of loan principal you get with a traditional 30-year mortgage, ***your loan-to-value ratio shot up from 90% to a mind-boggling 144%!*** That means the new Fannie and Freddie LTV cap of 105% doesn't mean anything. You still can't refinance.

Moreover, that $5,000 principal pay down subsidy you might get as part of the plan pales in comparison to the $162,000 decline in value you've suffered.

And here's something else to think on: If you assume prices instantly stop falling, turn around, and then climb 5% per year from their December 2008 level in this example, guess how long it would take to get back to even (your original purchase price)?

Give up? How about more than 10 years — sometime in 2019!

You could do this same exercise for many of the horror story markets in California, Arizona, Nevada, Florida, Ohio, and elsewhere. With borrowers so deeply underwater, the new refinance standards — as generous as they are — won't help. Nor will the small incentive payment encourage many borrowers to stay put.

Result: We're going to see tons of "walk always" and "jingle mail" — homeowners abandoning their homes and mailing their keys to their lenders — despite the plan.

That brings me to the biggest complaint analyst have about this plan: ***It still doesn't attack the principal reduction issue head on.*** Multiple studies and analyses I've read confirm that reductions in borrower loan balances increase the success rate on modifications. It deals with the "I'm hopelessly underwater so why should I keep making payments, even if they're cheaper" problem.

Yet lenders are fighting that approach tooth and nail, and principal reductions are NOT a central part of this plan. Instead, loan term extensions and rate reductions will be the main technique used to reduce payments to the 38% and 31% thresholds.

Unless and until principal reductions move front and center, redefault rates on modifications will remain extremely high analyst say. That means many of today's modifications will be tomorrow's foreclosures.

What It All Means to You...

Bottom line, the Obama plan could help you if you're a borrower at risk of defaulting on your loan — or if you're already heading toward foreclosure. The plan won't fully be in place until early March. But you may want to go ahead and contact your loan servicers now to discuss your options.

The servicers should also be able to tell you if your loan is owned or guaranteed by Fannie Mae or Freddie Mac. If you got a conventional, plain vanilla 30-year fixed mortgage, chances are you're in that category. That would make you eligible to refinance under the new, more generous collateral value standards, but only if you fit in the 80% to 105% LTV bracket.

And what if you're an investor? Does this mean it's safe to wade into housing and banking stocks? No, not in my opinion.

Like every other program before it, it will help *some* borrowers and *some* lenders avoid *some* foreclosures. But it won't be a cure all. And it won't have a significant impact on home prices. I expect them to continue to fall this year and into 2010, given the very large overhang of property on the market and rising unemployment.

Lastly, I have to question whether preventing foreclosures is a good idea in the first place. Maybe it sounds callous. But foreclosures are the market's way of moving overpriced homes saddled with too much debt into the hands of new, more stable owners. These new buyers can pay drastically-reduced prices, which allow them to buy with traditional 30-year fixed-rate loans instead of all the scary financing that was popular between 2004 and 2007.

In sum ... delaying and dragging out the downturn by artificially propping up home prices arguably works *against* the market healing.

Until next time,

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