Fixing the Home Financing Market: HARP 2.0 Analysis, Observations and Comparisons

Executive Summary

The U.S. housing market has been on a decline for the past five years, and the resulting financial crisis has engulfed the entire global economy. To tackle the vicious circle of falling home prices and foreclosures, the U.S. government launched various programs aimed at reducing mortgage defaults through a reduction of payments and short sale. While the low interest rate regime and the correspondingly low mortgage rates make it more conducive for homeowners to refinance their mortgages, steadily declining home values have made most borrowers ineligible for such programs. The Home Affordable Refinance Program (HARP) 1.0, launched in 2009, did cater to underwater homeowners, but not to a significant extent (e.g., loan-to-value ratios were limited to 125%). Additionally, high refinance charges, and low lender and insurer participation, reduced the potential relief HARP 1.0 could offer.

In November 2011, a revamped version of HARP, HARP 2.0, was launched. HARP 2.0 caters to significantly underwater homeowners. It features lower refinance charges, greater government support for lenders, minimal appraisal and underwriting requirements, and a simpler and faster process. The combination of these HARP 2.0 features, low target interest rates, signs of stability in the housing market and other supporting initiatives such as an extension of payroll tax cuts could turn out to have the biggest impact a government program has had on the housing market. Per initial estimates, HARP 2.0 has the potential to add $350 billion to the mortgage originations market over the next two years, thus providing refinance relief to about two million borrowers.

While HARP 2.0 does not address distressed borrowers (who are addressed by other programs) and shadow inventory segments, nevertheless it is focused on market shortcomings that previous programs were unable to solve. This paper addresses the attributes and implementation of HARP 2.0.

Background

The U.S. Housing Market Decline

The U.S. housing market started off the millennium strongly, buoyed in particular by the low interest rate regime set by the U.S. Federal Reserve (the Fed) to boost the economy after the bursting of the dot-com bubble. New home sales increased at an annual rate of 6.43% over the period 2000 to 2005 (see Appendix, Figure A2). Construction activity followed step, with new for-sale homes rising at an annual rate of 7.46% during the same period (see Appendix, Figure A3). Along with low interest rates (and the corresponding low mortgage rates), the housing tax policy (capital gains exclusion of $250,000/$500,000 for individuals/couples once in two years on the sale of a home) and deregulation in financial markets (allowing investment and commercial banks to

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merge, use of adjustable rate mortgages, lower control on interest rates set by banks, etc.) fueled investments in the real estate and mortgage securitization markets.

However, the interest rates were kept low for a prolonged time. Low interest rates, high home prices, and "flipping" (reselling homes to make a profit) effectively created an almost risk-free environment for lenders because risky or defaulted loans could be paid back by flipping homes. Lenders began financing subprime and no-doc (no income verification) mortgages. By 2006, the mortgage rates rose to 6.66% from a low of 4.65% in 2003 (see Appendix, Figure A1). This decreased housing demand and increased the monthly payments for adjustable rate mortgages. The resulting foreclosures increased supply, further lowering housing prices. With increasing defaults, the securitization market backed by these mortgages collapsed, which led to the financial crisis in 2007. The housing market has been in decline ever since.

Government Programs to Stabilize the Housing Market

To help homeowners avoid foreclosure and meet their mortgage obligations, and to stabilize the housing market, the U.S. government introduced numerous programs beginning with the Housing and Economic Recovery Act (HERA) of 2008's HOPE for Homeowners. Figure 1 (next page) summarizes these programs along with their effectiveness in stemming the decline in the U.S. housing market.

From the summary in Figure 1 it is apparent that various government programs have had limited success in reducing loan defaults and foreclosures, and have been unable to address all distressed homeowners. Further, none of the programs evaluated in the chart target severely distressed borrowers.

With the prevailing low interest rates, refinance is perceived as one of the primary ways of reviving the housing markets. Figure 2 (see page 4) tracks HARP refinance volumes and compares it to the total refinance volumes observed since the program's inception. The refinance volumes under HARP have been dismal, with only about one-quarter of the initial target of three million to four million refinances achieved as of October 2011. After a promising start, HARP refinance volumes have been on the decline of late, in absolute numbers as well as in comparison to the total refinance volume.

According to the latest estimates by CoreLogic, there are still about 10.7 million underwater mortgages and an additional 2.4 million mortgage borrowers have less than 5% equity in their homes. Negative/close to negative equity has led to a situation in which HARP 1.0 is being rendered less effective due to risk avoidance from mortgage insurers, second lien holders and originators. These risk avoidance aspects include second lien holders not agreeing to re-subordinate behind a new mortgage, insurers not agreeing to transfer the private mortgage insurance (PMI) policies to new mortgages and lenders imposing overlays on government eligibility guidelines.

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The Federal Housing Finance Agency (FHFA) recently launched a revamped version of the HARP program, dubbed HARP 2.0, which widens the net to include refinancing to accommodate more insufficient and negative equity borrowers and thereby hopes to improve refinance volumes.

HARP 2.0: Program Details and Analysis

HARP 2.0 was launched by FHFA on November 15, 2011 to boost refinance volumes and enable more homeowners, even those who are significantly underwater (LTV>125%), to benefit from persistently low interest rates.

Key Features

The key features of HARP 2.0 are highlighted in Figure 3 (see page 5). The key changes in the program are removal of underwater limits, simplified appraisal and underwriting norms, as well as reduced guarantee fees — which will make more homeowners eligible for refinance under HARP.

Guidelines

The HARP 2.0 guidelines are detailed in Figure 4 (see page 6).

HARP 2.0 is Beneficial for Borrowers, Servicers, Lenders and Investors

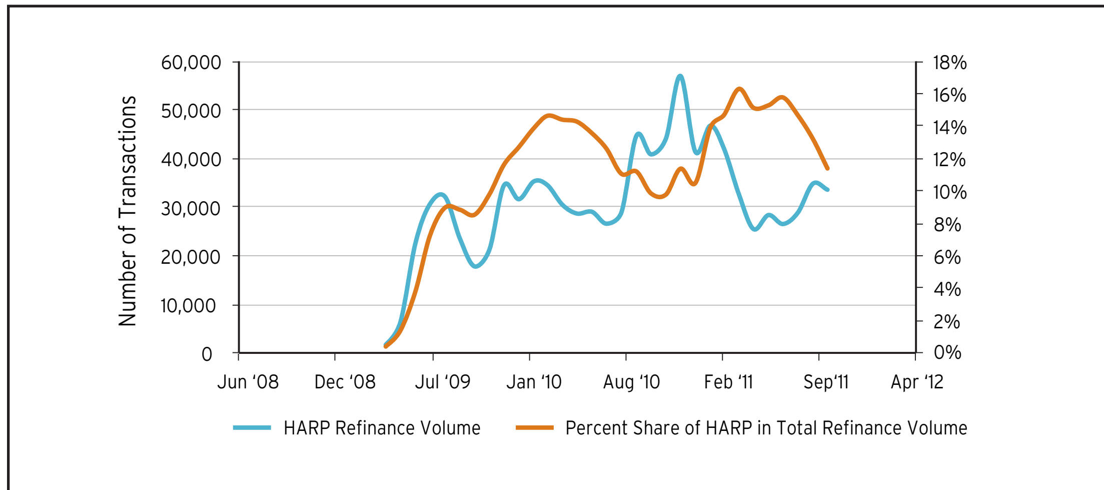
HARP 2.0 fills a crucial gap (targeting severely underwater borrowers), and has the potential to benefit borrowers, lenders and investors alike.

Government Support Programs

Program and Duration	Salient Features	Performance	Assessment
HOPE for Homeowners July 2008 to September 2011	**Premise:** Write down of principal balance to 93% of current home value and reduction of the mortgage payments thereby. **Target segment:** Struggling and upside-down borrowers who had mortgage payments worth more than 31% of the gross monthly income, and were facing possible foreclosure. **Eligibility criteria:** • The original mortgage is dated on or before January 1, 2008. • The homeowner did not default on the original loan intentionally. • The homeowner is not invested in multiple home loans. • All information on the original mortgage is true (including income sources and job details). • The homeowner has not been convicted of fraud.	As of February 2009, only 451 applications had been received and 25 loans finalized, far short of the expected figure of 400,000.	The program failed because of high fees, high interest rates, the need for a reduction in principal on the part of the lender, and the requirement that the federal government receive 50% of any appreciation in value of the house.
Home Affordable Modification Program (HAMP) March 2009 to December 2012	**Premise:** Reduction in mortgage payments through a combination of rate reduction, term extension and principal forbearance such that debt-to-income ratio (DTI) is reduced to 31%. **Target segment:** Borrowers who are facing financial hardship and are delinquent or in danger of becoming delinquent. Eligibility criteria: • Owner occupied and mortgage obtained on or before January 1, 2009. • The homeowner has a mortgage payment that is more than 31% of his/her monthly gross (pre-tax) income. • Up to $729,750 is owed on the home. • The homeowner has a financial hardship and is either delinquent or in danger of falling behind. • The homeowner has sufficient, documented income to support the modified payment. • Homeowner must not have been convicted within the last 10 years of felony larceny, theft, fraud or forgery, money laundering or tax evasion, in connection with a mortgage or real estate transaction.	As of October 2011, the following statistics were reported: • Trial modification offers (cumulative): 1.95 million. • Active trial modifications: 85,060. • Permanent modifications started: 883,076. • Active permanent modifications: 735,464.	HAMP was a big disappointment because of servicers' inefficiencies in offering HAMP and the re-default by many borrowers who were issued HAMP modifications. With the program due to expire by December 2012, only 735,464 homeowners are currently in permanent modifications and 85,060 are under trial modifications. These numbers are well short of initial promises to lower mortgage payments for 3 million to 4 million borrowers. This program too did not offer incentives to significantly help underwater borrowers.
Home Affordable Refinance Program (HARP) 1.0 March 2009 to June 2012	**Premise:** Reduction in mortgage payments through refinance to lower interest rates. **Target segment:** Borrowers current on mortgages but with fallen home values (LTVs from 80% to 125%). **Eligibility criteria:** • Mortgage must be owned or guaranteed by Fannie Mae or Freddie Mac (no FHA, VA, USDA or jumbo loans permitted). • Borrower must be current and have not been more than 30 days late on a mortgage payment in the last 12 months. • The loan-to-value (LTV) ratio on the first mortgage can't exceed 105% (raised to 125% on July 1, 2009). • Borrower must exhibit the ability to make the new payments which must also improve the long-term outlook of the mortgage. • No limit on the combined loan-to-value (CLTV) ratio for second mortgages as long as the second mortgage lender is willing to re-subordinate its loan to the new first mortgage.	Fannie Mae and Freddie Mac refinanced nearly 962,100 loans through HARP program as of October 2011.	The refinanced loans are much lower than the estimated figure of 3 million to 4 million. Lender conservativeness and lack of appropriate incentives and provisions led to limited success of this program.
Home Affordable Foreclosure Alternatives (HAFA) April 2010 to December 2012	**Premise:** Foreclosure avoidance through short sale or deed-in-lieu. **Target Segment:** Borrowers who are underwater on their mortgages and have been denied a modification via HAMP. **Eligibility criteria:** • Borrower lives in the home or has lived there within the last 12 months. • Borrower has a documented financial hardship. • Borrower has not purchased a new house within the last 12 months. • The first mortgage is less than $729,750. • The mortgage was obtained on or before January 1, 2009. • Borrower must not have been convicted within the last 10 years of felony larceny, theft, fraud, forgery, money laundering or tax evasion in connection with a mortgage or real estate transaction.	• All HAFA Agreements Started: 34,605. • HAFA Agreements Active: 8,818. • HAFA Transactions Completed: 20,701. • Completed Transactions – Short Sale: 20,110. • Completed Transactions – Deed-in-Lieu: 591.	Limited success as HAFA was not able to address problems of borrowers residing in owner occupied properties.

Figure 1

HARP Performance



Source: FHFA – Foreclosure Prevention & Refinance Reports
Figure 2

With the revised guidelines, HARP is now more inclusive for underwater borrowers. As compared to HARP 1.0, HARP 2.0 does not have any underwater limits. This means that borrowers with more than 125% LTV, disadvantaged so far, can benefit from this program. Also, vacation homes and investment properties, now included in the purview, will add to the refinance volumes. The revised payment history guideline, allowing at the most one late payment in the last seven to 12 months, would also increase the number of homeowners eligible for HARP and will further incentivize borrowers to stay/become current on their mortgages. HARP 2.0 waives the need for appraisal and underwriting for many homeowners, partly enabled through the proposed use of automated valuation models (AVMs).

HARP 2.0 fills a crucial gap (targeting severely underwater borrowers), and has the potential to benefit borrowers, lenders and investors alike.

For lenders, implementing HARP 2.0 will require few changes to existing loan origination and fulfillment systems and processes, more so for lenders who have already implemented HARP 1.0. Thus, the refinance process will now be simpler, faster and easier to implement for lenders, which can lead to a rapid growth in refinance volumes. This is unlike HAMP implementation for mortgage servicing, which has been a nightmare for most servicers due to antiquated and disparate technology and processes. Luckily for originators, the technology alignment on the originations side is light years ahead of servicing. Most of the HARP changes will be easily accommodated through product and pricing changes and some alterations to core originations systems.

Lenders can realize significant benefits by offering this program. Freddie Mac and Fannie Mae have extended greater support to this program by waiving the reps and warranties requirements imposed on lenders. The losses on any bad loans made under HARP 2.0 will be borne by Freddie and Fannie. According to CoreLogic, with nearly two million homeowners expected to qualify for HARP 2.0, the program will create an additional $350 billion in the originations market over the next two years ($175,000 average loan amount). Lenders who show greater flexibility and quick rollout of HARP 2.0 stand to gain from this. The potential originations market will also help banks use their excess capacity, which had been held back due to the depressed housing and job market, a lower willingness to take lending risks and hence reduced refinance volumes. With the backing of government-sponsored enterprises (GSEs), lenders and servicers can use HARP 2.0 to lower monthly borrower payments and thereby avoid potential defaults, thus improving their loan portfolio quality. Greater lender participation will help the broader economy and stem any further declines in home prices.

HARP 2.0 Features

Scale and Scope	• Expected to benefit two million additional home owners. • Refinancing for homes that are underwater and can't obtain a traditional refinance or are ineligible under HARP 1.0. • Only homes with loans guaranteed by Fannie Mae or Freddie Mac before May 31, 2009 are eligible.
Participating Entities	• Federal Housing Finance Agency (FHFA), which released the HARP 2.0 program and oversees Fannie Mae and Freddie Mac. • Fannie Mae and Freddie Mac – the GSEs. • Bank of America, Wells Fargo, Chase, US Bank and Citi may be some of the participating lenders; lender participation is voluntary.
Timelines	• The program guidelines were released to lenders on November 15, 2011. • HARP 2.0 refinancing applications are being accepted beginning December 1, 2011. • Deadline for application for a refinance under HARP extended to December 31, 2013.
Eligibility Requirements	• Mortgage must be owned or guaranteed by either Freddie Mac or Fannie Mae. • Current mortgage must have been closed on or before May 31, 2009. • Should not have completed a HARP refinance since June 1, 2009. • Must be current on the home loan. • Cannot have made a late payment within the past six months and more than one late payment in the last 7 to 12 months. • Loan-to-value ratio must be greater than 80%. • Loan must fall under the current conforming loan limits.
Key Changes from HARP 1.0	• No underwater limits: Borrowers will now be able to refinance regardless of how far their homes have fallen in value. Previous loan-to-value limits were set at 125%. • Eliminating appraisals and underwriting: Most homeowners will not have to get an appraisal or have their loan underwritten, making their refinance process smoother and faster. • Modified fees: Certain risk-based fees for borrowers who refi into shorter-term loans have either been eliminated or modified. • Relaxation of guidelines relating to reps and warranties and being current on home loan.

Note: A conforming loan is one that falls at or below the maximum financeable amount allowed by the FHFA. In general, the maximum amount financed is $417,000. However, in high-cost areas defined by the FHFA, the maximum amount is $625,500.

Figure 3

The waiver of mortgage insurance (MI) for those mortgages which do not have an MI will be beneficial for homeowners who have seen a significant increase in their LTVs. A homeowner now also has multiple refinance options to select from, provided that he/she qualifies for the same. Risk-based fees (or loan-level price adjustments) for homeowners who refinance into shorter-term loans have either been eliminated or modified, and this encourages homeowners to opt for lower term fixed-rate mortgages so they can more quickly build equity in their homes. These aspects, along with simpler and faster processing, make HARP 2.0 much more attractive to homeowners looking to refinance.

Government Policies and Economy Are Conducive for HARP 2.0

The U.S. government aims to keep interest rates near zero at least until mid-2013 and may extend this policy further if deemed necessary to support economic growth. This will help keep mortgage rates down and enable borrowing/refinancing at lower rates, thus supporting the housing market revival.

Consumer spending is one of the most significant drivers of the U.S. economy, accounting for nearly 70% of the gross domestic product (GDP). Given the poor job market and the slow GDP growth forecast, the recent legislation to extend payroll tax cuts by two months (and maybe more in the coming months) allows consumers greater spending flexibility and aims to boost the GDP. This can have a positive impact on the housing market as well, with more homeowner savings available to pay their mortgages.

Meanwhile, the U.S. housing market is showing some signs of stability. As seen in Appendix, Figure A6, the House Price Index (HPI) from March to October 2011 has remained more or

HARP 2.0 Guidelines

Guideline	Details
Loans Covered	Most loans owned by Fannie Mae and Freddie Mac will be eligible for a HARP 2.0 refinance. Loans that are not subprime and those that allow negative amortization, such as Option ARMS.
Liens Covered	The program is for the first lien only. All subordinate/junior liens must be re-subordinated to the new first mortgage.
LTV Guidelines	All caps on LTV for HARP refinance eligibility have been removed. Some limits come into play based on whether the borrower refinances under HARP with the new loan being an FRM or an ARM. The guidelines are stated below: • No maximum LTV for FRMs with terms up to 30 years. • 105% for FRMs with terms greater than 30 years and up to 40 years. • 105% LTV for ARMs with initial fixed periods greater than or equal to five years and terms up to 40 years (as permitted by the ARM plan) or ARMs with terms longer than 30 years.
Mortgage Insurance	• If the current loan has mortgage insurance, mortgage insurance will also be required on the new mortgage. Otherwise, it won't be required. • Loans that currently have lender-paid mortgage insurance (LPMI) are ineligible.
Documentary Requirements	• No income and asset documentation will be needed in most cases. This could change by lender based on their overlays. • But if the payment increases by more than 20% or funds must be brought in to the closing for some reason or another, borrower must re-qualify for the new loan under the following rules: Borrower must have a credit score of at least 620 and debt-to-income ratio cannot exceed 45%. Also, lenders are required to verify income and assets.
Loan Level Price Adjustment (LLPA) Guidelines	The fees are 0% on FRMs of 20 years or fewer, and 0.75% for FRMs of more than 20 years and for all ARMs.
Coverage for Second/ Investment Homes	Second/vacation homes and investment/rental properties are eligible for HARP 2.0 provided that they meet the eligibility guidelines.
Reps and Warranties	• HARP 2.0 is shifting responsibility for certain "reps and warranties" – defined as lender obligations when a loan goes bad– from the banks to the government. With less liability for the "bad loans" they make, a greater number of banks are expected to participate in HARP. • The relief on reps and warranties is backed in part by use of AVMs (Automated Valuation Models) by Freddie and Fannie (Fannie's AVM system won't be ready until March 2012).
Others	• The waiting period to refinance after a bankruptcy and for reestablishment of credit has been lifted. • The borrower must receive a benefit in the form of either a reduced monthly mortgage payment or a more stable loan product, such as refinancing an ARM into an FRM.

Figure 4

less stable. Hence, this may be the right time for borrowers to refinance without worrying about a significant future reduction in their home values.

The Scope and Capacity for Refinance Remains Huge

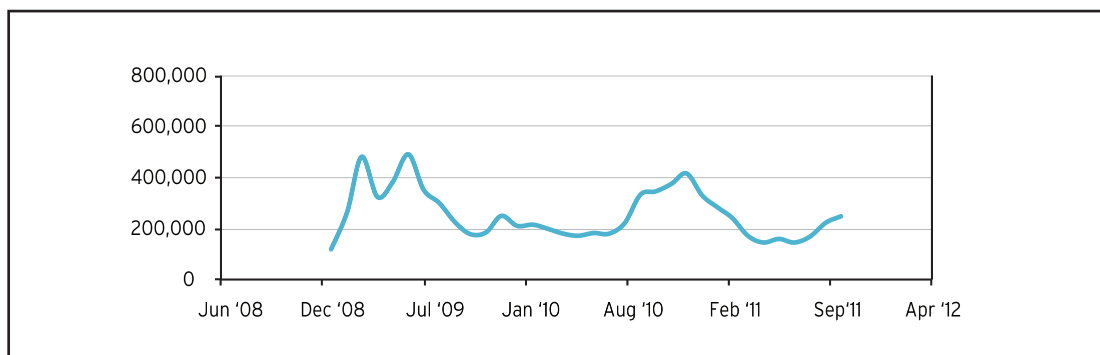
Traditional refinance has seen low activity in the last few years due to historically low mortgage rates (see Appendix, Figure A1) and the risk-aversion of lenders in an uncertain economic environment. This has led to a surplus capacity with the banks, which can now be put to use on the back of greater government support.

As seen in Figure 5, refinance activity has been falling, with a year-on-year decline of 29% as of October 2011. However, the pace picked up in the three months ending last October. With nearly 10.7 million homeowners still under water, and a slow housing market recovery, refinance activity has strong growth potential.

Issues and Challenges Can Impede HARP 2.0's Success

HARP 2.0 refinancing will not significantly reduce the level of insufficient and negative equity. This is because the program offers only the potential of lower payments but doesn't reduce principal, so borrowers will continue to hold mortgages that are significantly higher than the values of their homes. HARP 2.0 is specifically targeted at severely underwater borrowers and does not address the larger issues of high home inventories and depressed home prices.

Total Refinance Volume



Source: FHFA — Foreclosure Prevention & Refinance Reports
Figure 5

Loans with lender-paid mortgage insurance (LPMI) are not eligible for HARP 2.0. Additionally, though HARP 2.0 allows refinance for LTV ratios more than 125%, the criteria for being current on payments will not cover the hardest hit homeowners (those who have defaulted on more than one payment in the last year) unless they improve their payment history in the coming year. This may limit the number of homeowners eligible for refinance.

As the short-term payroll tax cuts are proposed to be funded through an increase in the guarantee fees (G-Fees) charged by the government-sponsored enterprises (GSEs) from lenders, lenders may pass on the charge to borrowers, thus rendering the impact of payroll tax cuts on the housing market ineffective.

Insurers such as the AIG-owned United Guaranty have opposed reps and warranties waivers as they feel that the risk of any fraudulently written or bad loans will have to be borne by all insurers along with the GSEs and taxpayers. Without the support of all the entities involved, the program cannot succeed.

Conclusion

Though HARP 2.0 does not target distressed borrowers and shadow inventory, based on our analysis it has the potential to be more successful compared to HARP 1.0, and therefore could lead to large refinance volumes. In our view, lenders and servicers and underwater homeowners stand to benefit from this program and hence should grab this opportunity. By reducing the monthly payments for underwater homeowners and building equity faster, HARP 2.0 will control the rate at which new distressed assets hit the market, thereby offering significantly better uplift to the housing market with lesser effort as compared with HAMP and HARP 1.0.

In recent developments, in December 2011 Fannie Mae updated its seller guide to reflect the changes announced as part of HARP 2.0. Fannie surprisingly eliminated the requirement that the lender determine if the borrower has a reasonable ability to repay the mortgage. Thus, for Refi Plus[1] the lender will no longer be required to determine the borrower's reasonable ability to repay the mortgage. This indicates that the GSEs are much more willing to provide lenders with reps and warrants relief than previously anticipated. This change may entice lenders further to participate in HARP 2.0. This also shows that the complete picture of HARP 2.0 is still emerging and the effectiveness of the program depends on the final shape that this program takes.

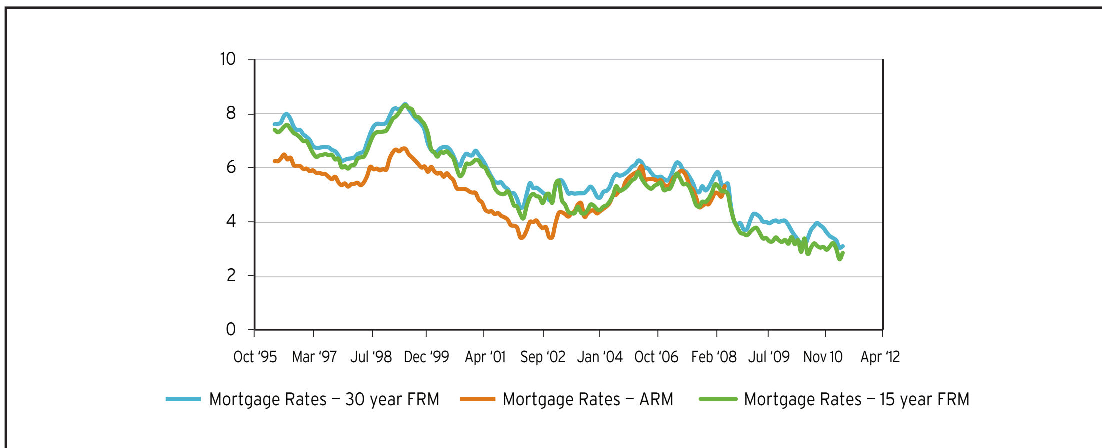
Appendix

The U.S. Housing Market

As covered in the background section, the U.S. housing market witnessed a boom period in the early part of the millennium powered by low interest rates, favorable housing tax policies and financial deregulation. However, these circumstances promoted risk-taking among lenders who began financing sub-prime and no-doc mortgages and flipped homes to realize abnormal profits. An increase in mortgage rates by 2006 triggered defaults on sub-prime mortgages and increased foreclosures. Housing prices began to fall and the corresponding decline in the value of mortgage securities led to the fall of many financial institutions that had invested in them. This ultimately led to the financial crisis in the United States and impacted other economies the world over.

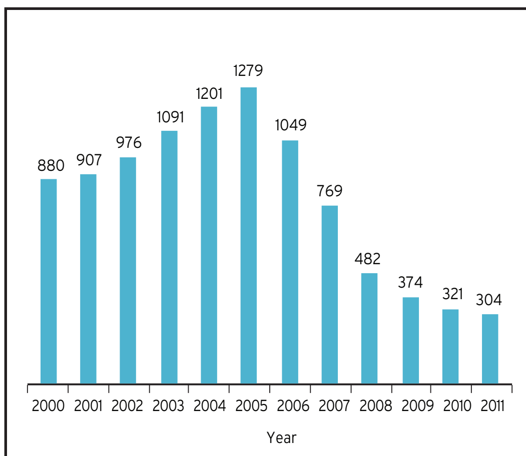
Figure A1 shows the rates for 15-year and 30-year fixed rate mortgages (FRMs), and adjustable rate mortgages (ARMs). This chart shows the relative low levels to which ARM rates dropped as compared to FRMs between 2003 and 2005, leading to more buyers and investors flocking to ARMs. With a subsequent increase in Fed interest rates, ARMs went up steeply and matched FRMs in 2005.

Historical Mortgage Rates (%)



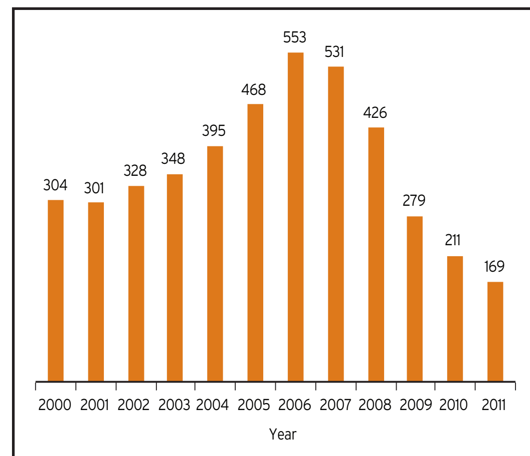
Source: FHFA – Historical Mortgage Rate Summary Tables
Figure A1

New Home Sales (in thousands of units)



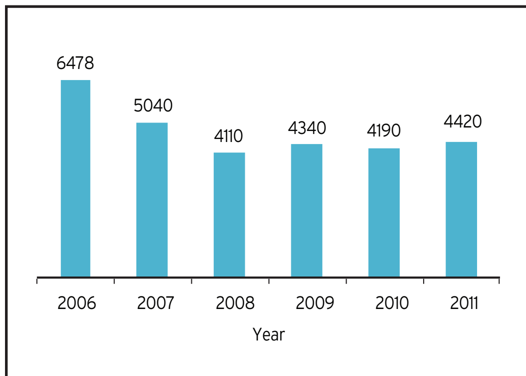
Source: Census and National Association of Home Builders (NAHB)
Figure A2

New for Sale Homes (in thousands of units)



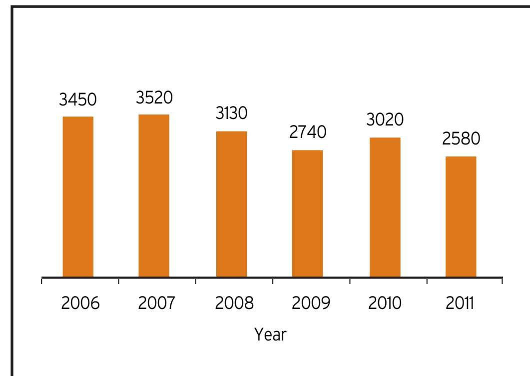
Source: Census and National Association of Home Builders (NAHB)
Figure A3

Existing home sales (in thousands of units)



Source: NAHB and National Association of Realtors
Figure A4

Existing home inventory (thousands of units)



Source: National Association of Home Builders (NAHB)
Figure A5

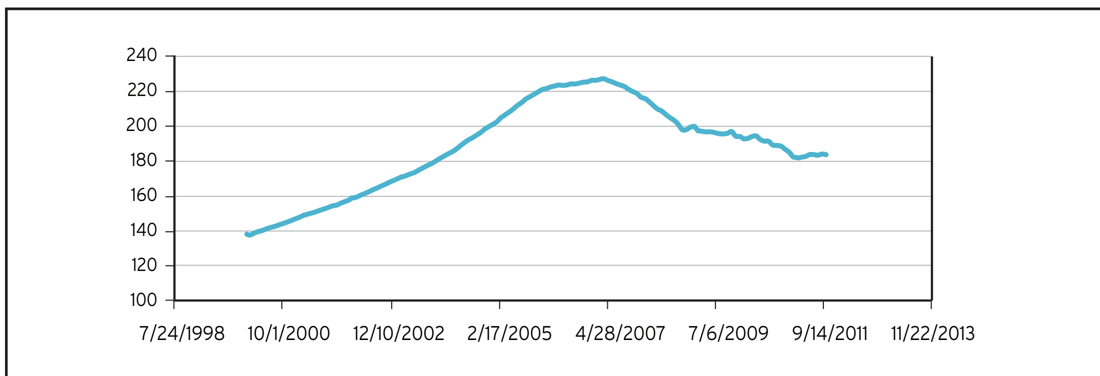
Figure A2 shows the new home sales figures from 2000 to 2011 (latest as of November 2011). New home sales rose from 0.9 million units in 2000 to a peak of 1.3 million units in 2005. Home sales declined steeply thereafter to just 0.3 million units in 2011. Figure A3 shows that new for sale homes followed a similar trend, albeit with a lag of a year which is attributable to the reaction time needed for new home construction to match the trend in new home sales.

The data on existing home sales shows that sales in this segment, after peaking at about 7 million units in 2005, have declined since then, with the activity picking up slightly in the last two years (see Figure A4). The huge inventory of existing homes for sale, as shown in Figure A5, further highlights the depressed state of the U.S. housing market since 2006.

The overall indicator of the U.S. housing market performance, the house price index (HPI), is shown in Figure A6. U.S. home prices had increased steadily in the early part of the last decade, rising to a peak of 154.65% of the January 2001 prices in April 2007. However, prices declined rapidly thereafter, bringing many homeowners underwater (owing more on homes than their worth).

The decline in housing prices lowered the equity of mortgage borrowers, and with high interest rates and a weakening job market, many borrowers began to default on their mortgage payments and foreclosures accelerated. This led to a vicious cycle in which falling property prices led to more foreclosures, which in turn led to more borrowers defaulting on their loans.

House Price Index



Source: FHFA - House Price Index History
Figure A6

Footnote

[1] Refi Plus (also known as Fannie Mae Refinance Plus and FNMA Refi Plus) is the HARP or Home Affordable Refinance Program offered through Fannie Mae.

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