



Discussion of “Efficient Credit Policies in a  
Housing Debt Crisis”  
by Janice Eberly and Arvind Krishnamurthy

By Deborah Lucas

MIT and NBER

# Findings and analysis

- Simple optimizing model to analyze policy interventions to reduce foreclosures and stimulate spending after an adverse income shock
- Main conclusions:
  - Lower payments are more important effective than principal reductions for liquidity-constrained consumers
  - Writing down mortgage debt is advantageous for lenders, but they may wait to do that longer than is socially optimal
  - A well-designed mortgage contract would automatically reduce payments and debt during recessions

# Findings and analysis

- Main conclusions:
  - **Lower payments are more important effective than principal reductions for liquidity-constrained consumers**
    - Theoretically robust and borne out empirically (e.g., Fuster and Willen)
  - **Writing down mortgage debt is advantageous for lenders, but they may wait to do that longer than is socially optimal**
    - Not persuaded. Literature suggests low strategic defaults and lenders don't do this
    - Simple model unlikely to capture complex factors and incentives affecting default
  - **A well-designed mortgage contract would automatically reduce payments and debt during recessions**
    - Likely to be expensive if sold at market prices because of put in bad economic states
    - This effectively was available to policymakers during crisis but wasn't exploited
    - But it also might have helped considerably in this most recent crisis...

# Why wasn't there a more aggressive policy response?

- Many policymakers agreed that getting cash to households is the most effective stimulus
  - Hence passage of the American Recovery and Reinvestment Act (ARRA).
- Governmental-controlled entities had regulatory discretion over a large portion of the mortgage market (FHA, VA, Fannie, Freddie).
- Administrative rule changes could have allowed significant reductions in payments at a very low cost to the government
  - Much more bang-for-buck than ARRA.
- Neither the Administration nor Congress acted to make those low-cost changes, although serious proposals were put forward to do so.

## “An Evaluation of Large-Scale Mortgage Refinancing Programs”

- CBO working paper by Deborah Lucas, Damien Moore and Mitchell Remy
- **Idea:** Relax income and loan-to-value restrictions for borrowers who wish to refinance and whose mortgages are currently insured by Fannie, Freddie, or FHA
- Even modest version of program analyzed would have had **significant benefits:**
  - Allowed 2.9 million mortgages to be refinanced (many more than HARP or HAMP)
  - Averted 111,000 foreclosures
  - Saved the GSEs and FHA \$3.9 billion on credit exposure from guarantees
- **Costs** would have included:
  - Portfolio losses to GSEs, Treasury and the Federal Reserve of \$4.5 billion (net cost \$.6 billion)
  - Costs to non-federal investors of \$13 to \$15 billion; a wealth transfer to borrowers

# “An Evaluation of Large-Scale Mortgage Refinancing Programs”

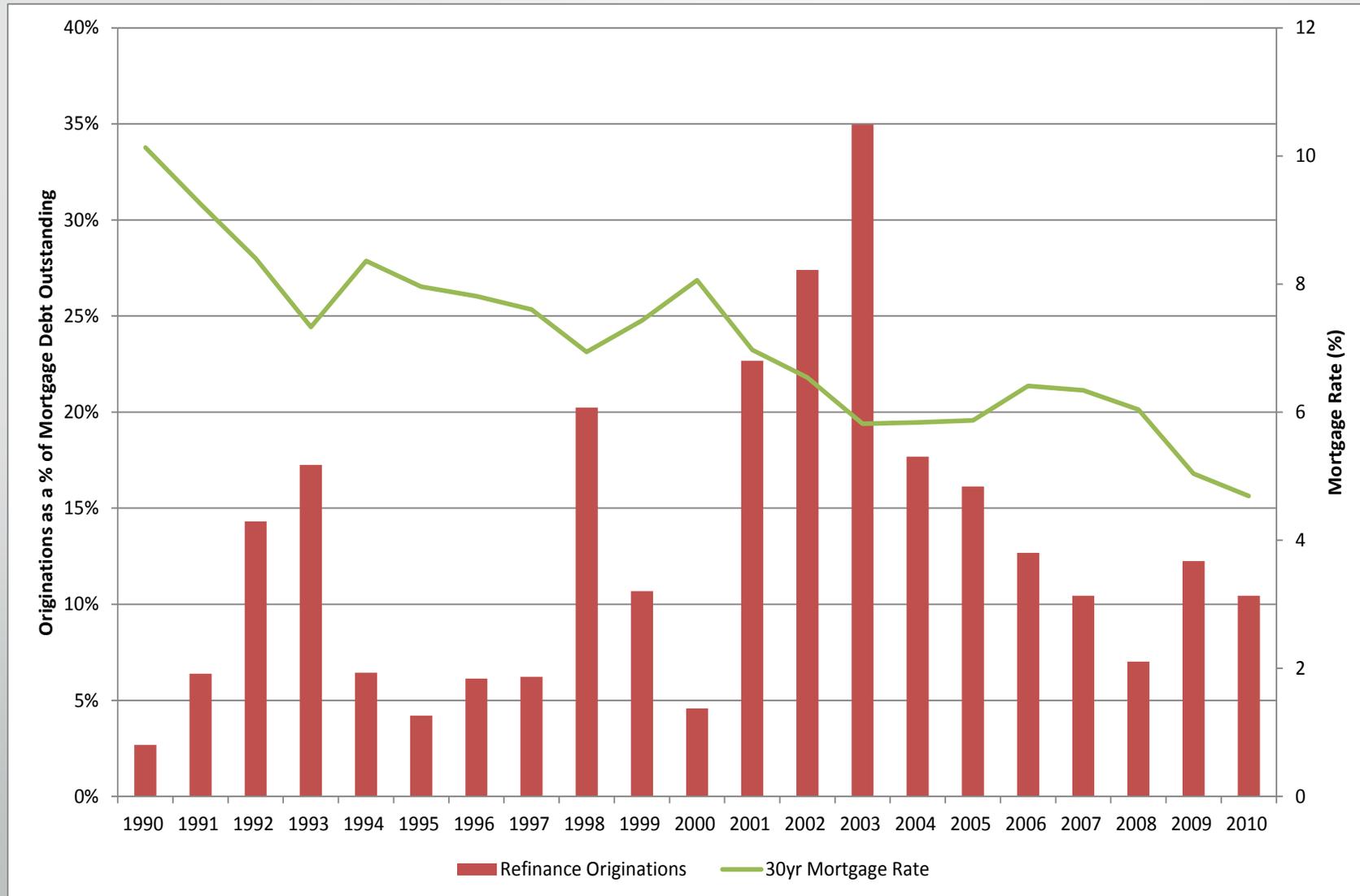
- Observations
  - Refinancing lowers payment amount by lowering interest rate and by re-amortization over a new 30-year period
    - Reamortization has a large effect too for seasons mortgages
  - Estimates of costs and savings based on CBO model of default and prepayment calibrated with historical data from the GSEs and FHA, starting in 2012Q1, looking at universe of outstanding loans that were potentially eligible
  - Scale of program uptake would have depended among other things on fees and documentation requirements. Assumed a small fee reduction via interest rate reduction.
  - Significant assistance to homeowners and stimulus without principal reduction or below-market rates so at low cost to the government
  - More liberal than HARP and FHA Streamlined Refinance because eliminated LTV and income restrictions. Similar to several proposed bills.
  - Liberalization captured in model by looking at predicted change in prepayment when assumed FICO scores are raised to 780 and LTV lowered to 50%.

# Summary costs and benefits of large-scale refinancing program

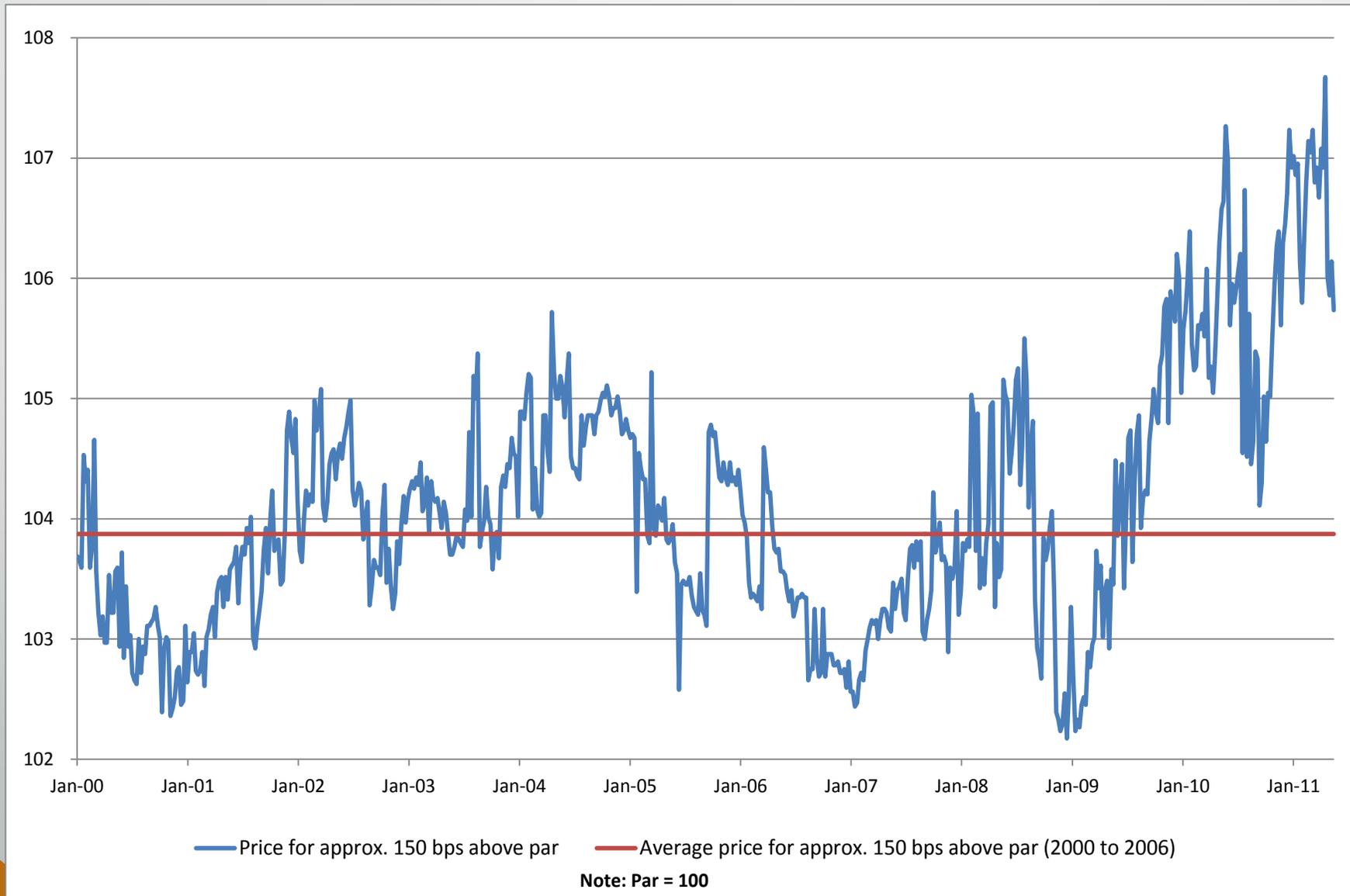
Table 4. Incremental Refinancing and Components of Federal Fair-Value Cost

<b>Category</b>	<b>Amount (\$ billions)</b>
Volume of incremental refinancing from program	\$428
Percentage of outstanding 30-year and 15-year MBSs	10%
Number of incremental loans refinanced	2.9 million
Number of defaults averted	111,000
First-year gross cash savings from reduced mortgage payments	\$7.4
Reduction in subsidy cost on GSE guarantees <sup>a</sup>	\$2.5
Reduction in subsidy cost on FHA guarantees <sup>a</sup>	\$1.4
Lost portfolio value to GSEs	(\$1.8)
Lost portfolio value to Federal Reserve	(\$2.4)
Lost portfolio value to Treasury	(\$0.3)
<b>Total federal gain / (loss)</b>	<b>(\$0.6)</b>
<sup>a</sup> Reduction in subsidy costs for the GSEs and FHA are net of lost put-back option value.	

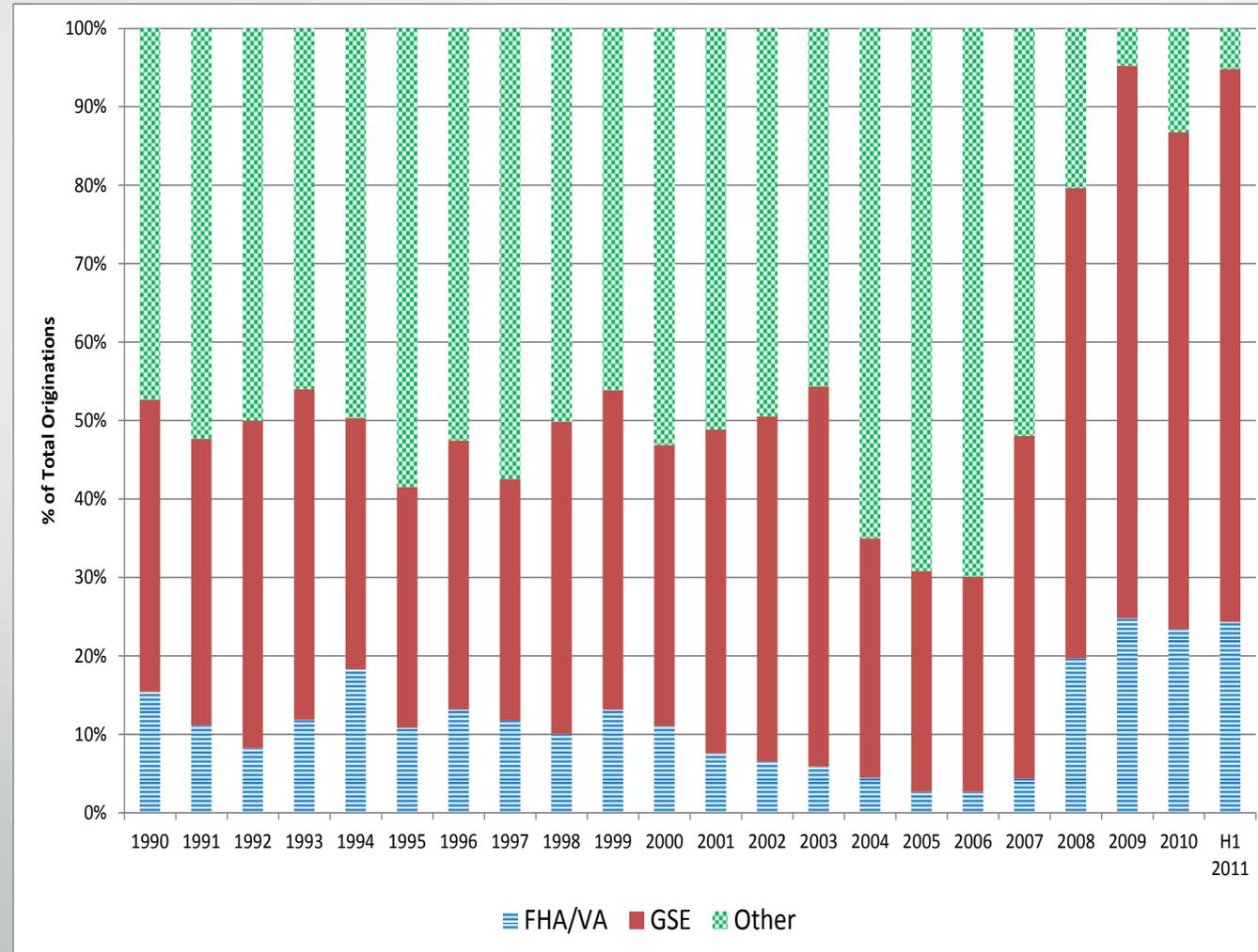
# Refinancing activity in response to interest rate reductions was muted in the post-2007 period



# With refinancing blocked, mortgage investors experienced unprecedented gains



# More than half of outstanding mortgages were government-backed and could potentially have benefited from rule changes to facilitate refinancing



## Concluding thoughts

- Analysis in paper is very useful in thinking through how mortgage design and policy could be modified to more effectively accommodate income shocks
- Automatic adjustments to rates and payments as suggested in proposed new mortgage design would have avoided impediments to such adjustments in current system, even though prepayment options gets you part way there
- Experience with proposals for large-scale refinancing suggest off-setting effects on investors that may mitigate benefits, including higher original rates and capital losses when crisis hits that lowers lending and spending.
- Thank you!