

Our Titanic Crisis: An Economic Rescue Plan

by Bertram Horowitz, Inc.

Our current financial crisis has wreaked havoc on the credit markets, the stock market and the entire economy. We must remember that the root cause of this crisis is the collapse of the residential housing market, which has been further exacerbated by the continuing downward housing spiral. Most of the \$700 billion in TARP rescue funds have been deployed as capital infusions into banks and financial institutions in an attempt to address our economic crisis at the institutional and trading level. This alone will not rescue the economy. **A comprehensive solution must directly address the residential housing market catastrophe.**

Establish "Federal Home Mortgage Insurance Company"

A solution to the financial crisis would be the creation of a Federal Home Mortgage Insurance Company (FHMIC). Just as the FDIC was created to encourage and safeguard individual bank deposits, the FHMIC would retain the private banking mechanism for home mortgages and insure bank mortgages to homeowners. **Banks and lending institutions would then have an incentive to refinance and issue mortgages since the FHMIC would insure mortgages against default.** FHMIC would be a nonprofit insurer designed to serve as a catalyst to stimulate and support the residential housing market, which would: help financially distressed homeowners refinance or modify their mortgages and stay in their homes; provide incentive for lending institutions to grant new loans; and facilitate the gradual rise in prices in the housing market. The FHMIC could be structured to be self-supporting and would be essential to the rescue of the economy.

FHMIC Guarantees Against Mortgage Credit Default Risk

The root of the housing crisis is that mortgages were granted without regard to traditional mortgage underwriting standards, and this resulted in the current subprime mortgage crisis. **It is imperative that lenders return to more traditional mortgage underwriting criteria when**

evaluating a homeowner's eligibility for a refinance, modification or new mortgage. The FHMIC would provide mortgage insurance to the banks for primary residence mortgage loans that meet modified traditional mortgage underwriting standards. Traditional mortgage underwriting standards include: no more than 80 percent mortgage loan to appraised value; no more than 28 percent of income devoted to housing expenses; full income verification; and good credit history.

FHMIC would require that the distressed homeowner be required to pledge additional assets such that the pledged assets plus the current assessed value of the home is, at least, 5 percent greater than the amount to be refinanced. In return, the homeowner's monthly payment is reduced to as low as the original monthly payment. Upon meeting FHMIC mortgage insurance underwriting criteria, the lending institution would receive FHMIC mortgage insurance, which guarantees against credit default risk. Mortgage insurance premium is passed through to the homeowner and is paid in the future (e.g., when the home is sold). **FHMIC would be the underlying insurance mechanism employed to address the residential housing crisis.**

Dire Case: Home Underwater, Skyrocketed Monthly Payments

Most difficult to address is the case of a homeowner whose house is "underwater" (i.e., worth less than the outstanding mortgage) and where the homeowner's monthly payment has skyrocketed. FHMIC would facilitate efforts for such homeowners to keep their home while largely retaining the general principle of traditional underwriting standards. Consider the following representative cases:

1. 2005—homeowner purchases house in Stockton, Calif., for \$500,000 and receives an interest-only mortgage of \$500,000 at an initial "teaser" ARM interest rate of 4 percent resulting in a monthly mortgage payment of \$1,667.

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2. 2008—interest has adjusted upward to 8 percent, resulting in a monthly mortgage payment of \$3,333 and the current appraised value of house has fallen to \$300,000. The house is now \$200,000 “underwater.”
3. Homeowner faces loss of home with the original lending institution left holding a non-performing mortgage in default. There is great temptation for the homeowner to simply walk away from his house and face foreclosure and/or bankruptcy. As this sort of dire situation has played itself out over millions of homes, it is magnified upward through the banking system, our credit and stock markets, and through the entire economy.
7. Assuming the homeowner meets all FHMIC underwriting criteria, the FHMIC grants mortgage insurance to the lending institution, and the homeowner is offered a new \$500,000 mortgage loan under terms the homeowner can now afford.
8. The homeowners accept the new terms and the original \$500,000 loan is satisfied. The homeowners’ monthly payment is returned to \$1,667 computed at the original 4 percent interest rate. Assuming the prevailing interest rate is 5 percent, the imputed difference in the monthly payment of \$417 (and interest on lost interest) is added to the outstanding principal. When the loan is satisfied, the homeowner is required to pay the bank’s mortgage insurance premium for obtaining FHMIC insurance on the mortgage. At any point throughout the loan, the homeowner could pay off a portion of the loan, which would lower their final mortgage insurance premium as well as the outstanding principal. As housing prices rise, pledged collateral may be released back to the homeowner as the loan-to-assessed value ratio decreases.

FHMIC Facilitates Solution...

Instead of suffering the burden of home loss (#3), FHMIC provides an insurance mechanism to progress toward a solution:

4. Lending institutions and service providers are required to contact homeowner and advise eligibility to refinance or modify his current mortgage with the same or another lending institution. Qualifying criteria and a new application form would be included as well as availability of counseling services from the FHMIC regarding refinance options.
5. Homeowner applies for refinance or modification. In order to meet the loan-to-value requirements, the homeowner must pledge, as collateral, additional assets in non-borrowed funds totaling, at least, \$225,000 (special legislation would be enacted to also permit assets from retirement plans and anticipated inheritance to be held in trust until the value of the home increases) in addition to the \$300,000 in collateral from the current appraised value of the home.
6. Homeowner’s application is reviewed to determine whether it qualifies for refinance or modification of current mortgage using modified traditional underwriting standard criteria as required by FHMIC. Since

the \$300,000 appraised value plus the \$225,000 pledged assets equal \$525,000 and this is, at least, 5 percent greater than the \$500,000 outstanding mortgage balance, the modified FHMIC loan-to-value criterion has been met.

A Comprehensive Plan: Fairness and Benefits to All Parties

This plan is intended to balance equities between all parties. It is worthwhile to consider the benefits to various parties from each of their perspectives:

Distressed homeowner—retains ownership of home and stays in community; monthly payments returned to original low monthly payment; retains ownership of pledged assets that may be released back to homeowner at later date; pays for benefits received at time of loan satisfaction.

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Secure homeowner—fewer homes dumped onto the market at rock-bottom foreclosure prices—decline in home values reversed because of decreased supply; recognizes that distressed homeowner neighbor is not being bailed out “for free.”

Prospective homeowner—the existence of FHMIC mortgage insurance encourages lending institutions to grant low interest mortgages to new home purchasers.

Lending institution—incentive to lend because of FHMIC mortgage insurance; investment is largely protected by FHMIC mortgage insurance (a 10 percent deductible is recommended so the lending institution assumes some risk); roughly 5 percent rate of return on largely government-backed mortgage assets.

Taxpayer—FHMIC is a sound, non-profit, self-supporting insurer with strict underwriting standards; FHMIC could be initially capitalized with some of the TARP funds designated to address potential foreclosures; perceives FHMIC as housing analog to FDIC for bank deposit insurance; overall economic health of country enhanced.

As with all properly priced insurance policies, the insurance premium is commensurate with the risk: the greater the risk of default, the higher the mortgage insurance premium. In addition to mortgage insurance premium, FHMIC could marshal additional assets from bailout funds as well as other parties who may be responsible for the subprime crisis including appraisers, credit rating agencies, fraudulent applicants, predatory lenders and predatory mortgage brokers.

This plan would not prevent all foreclosures as many homeowners would still be unable to meet even modified underwriting mortgage standards, and FHMIC would deem such homeowners' mortgages to be “uninsurable.” Lending institutions would still be encouraged to directly renegotiate mortgage workout terms with homeowners who not qualify for FHMIC mortgage insurance.

Why This Plan?

Unlike typical insurance, a unique characteristic of FHMIC insurance is that it actually acts to prevent losses. We are only at the beginning of a looming foreclosure crisis. The financial markets have, in effect, responded to a projection of future foreclosures on a massive scale. The proposed FHMIC intervenes and significantly reduces the otherwise anticipated foreclosure catastrophe. Addressing individual residential homeowners' distressed mortgages becomes the engine that propels the rescue solution upward to the banks, the financial institutions and finally through our entire economy here and, potentially, abroad. The continued downward economic spiral would be reversed: more homeowners would remain in their homes with affordable loans; financial markets would recognize that the problem is effectively mitigated; housing values would rise and the market value of mortgage-backed securities would increase; lending institutions would unlock credit; balance sheets would be cleaned up; and employment would rise. The contagion spread by the subprime crisis would be reversed as the solution spread through the economy.

FHMIC would provide a catalyst for banks and lending institutions to rescue sinking homeowners and avert catastrophic consequences. We have a choice. We can settle for watching our economic Titanic sink and a large segment of its homeowner passengers perish while we concentrate on saving financial institutions...OR... **we can intervene in a meaningful way and provide incentive to the lending institutions to throw the sinking homeowners a lifeline and save both the financial institutions and the individual residential homeowners. In the process, we will have stabilized and improved the entire economy through “trickle-up economics.”**

This essay offers an opinion regarding a proposed solution to our current financial crisis and is intended only as a general discussion. Bertram Horowitz, Inc. Actuarial and Risk Consultants, would be pleased to provide additional details.

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Bertram Horowitz, president of Bertram Horowitz, Inc., Actuarial and Risk Consultants, has 30 years of experience in insurance regulation and has been involved in innovative solutions to insurance and regulatory financial crises. As a financial actuary with a regulatory specialty, Bertram Horowitz's career has been largely devoted to appropriate implementation of government regulations, consideration of the economic consequences of government policy and the development of innovative solutions. Mr. Horowitz is the former special deputy superintendent and financial actuary for the New York State Insurance Department. Bertram Horowitz, Inc., Actuarial and Risk Consultants, was founded in 1986 and specializes in assisting governments with the administration of their laws and policies.

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