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HARP Strikes A Sour Chord

Around 11 million homeowners, about 25% of all homeowners, owe more debt on their homes than the homes are worth, hence the term “underwater mortgage”. Most were victims of the housing bubble (2004-2008) fueled by easy financing that artificially inflated prices while people were buying houses, or borrowing against their existing homes. The interest rate on these mortgages in most instances is in excess of 6.5% but the homeowners do not qualify for refinancing at current interest rates as low as 4%. This means the homeowner is paying hundreds of dollars and in some instances thousands of dollars more each month than he would otherwise pay if he could refinance at current rates.



Image via Wikipedia

Lenders may have already written off a portion of these loans for financial or tax reasons, but the borrower is still treated as owing the entire amount with monthly payments still due per the terms of the mortgage, including payments on amounts the lender may have treated as a loss. Every month the lenders get the borrowers to make payments on the underwater loans, the lenders receive a windfall of interest payments well in excess of current market interest rates. Lenders actually prefer to keep the homeowner captive to the terms of the mortgage and debt in excess of home value. Imagine how much is being paid on underwater mortgages each month to the satisfaction of the lenders. Every month a homeowner writes a check on an underwater mortgage is another victory for the lender.

It is in this environment the lender plays on the homeowner’s fears and takes advantage of his moral predisposition to pay what he owes. It is obvious that if most people stopped paying on their underwater mortgages lenders would no

longer have the luxury of letting the homeowners twist in the wind. Of course, this will not happen because most people fear the stigma of foreclosure and bankruptcy and do not want to be among the first to default in what may not be a mass movement. So most borrowers will act the way lenders are counting on already.

If the President and Congress really want to help these homeowners, a program much broader than HARP (Home Affordable Refinance Program) should be established. For example, legislation could provide for a new subset of a Chapter 11 or 13 bankruptcy for underwater mortgages only, but without the stigma of the B(ankruptcy) word. Under this program underwater mortgages would be modified based on the fair market value of the home, and the net worth and income of the homeowner.

Continuing with this example, homeowners that meet the following criteria would be eligible to participate: (1) home value less than 85% of the mortgage, (2) annual PITI (principal, interest, property taxes and insurance) greater than 30% of homeowner's adjusted income (mostly cash income less taxes and other specified permitted expenses), and (3) an adjusted net worth (e.g., excluding certain assets that would be exempted in a conventional bankruptcy) less than 25% of the mortgage amount. If the home value is at least 75% of the mortgage the interest rate would be reduced (not below current market rates) and principal amortization would be deferred (not beyond the original mortgage term) so that PITI would be no more than 30% of adjusted income. If the value of the home is less than 75% of the debt the principal amount of the debt would be reduced so that the home value is not less than 75% of the reduced mortgage. The reduction of debt would be further limited so as not to increase the homeowners adjusted net worth in excess of 25% of the reduced mortgage. The interest rate reduction and deferral of principal amortization discussed above would also apply to the reduced mortgage so PITI is no more than 30% of adjusted income. In situations where a mortgage cannot be modified as discussed above because 30% of adjusted income cannot support payments on a modify mortgage, the program would allow for a short sale with the borrower no longer liable for all or part of the remaining loan balance. Most important, this program would allow the borrower to immediately reduce PITI payments to no more than 30% of adjusted income until the debt restructuring is completed thereby discouraging lender procrastination. The establishment of the program itself may make lenders more willing to work with homeowners outside the program.

This program would not create a windfall for the borrower. Borrowers with substantial income or substantial net worth will still be expected to honor their loan obligations or pursue existing alternatives. However, I suspect such legislation would not be popular with lenders, parties who provided guaranties related to securitized debt, Freddie Mac and Fannie Mae. But like the pig in the python, it is time for our economy to digest the underwater mortgage problem.