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Government to Deploy Broader Mortgage Aid

By NICK TIMIRAOS

The Obama administration on Tuesday will launch its most ambitious effort at reducing mortgage balances for homeowners who owe more than their homes are worth.

Officials say between 500,000 and 1.5 million so-called underwater loans could be modified through the program, the first initiative to target homeowners who are current on their mortgage payments but are at risk of default because they have no equity in their homes. Some experts are warning, however, that the same knots that tied up prior initiatives could do so again.

Under the new "short refinance" program, banks and other creditors that write down mortgages to less than the value of the property can essentially hand off the reduced loan to the government. The process involves refinancing borrowers into loans backed by the Federal Housing Administration.

While the program puts taxpayers at risk—officials estimate one in five loans in the program could default—the government has set aside \$14 billion previously earmarked for housing aid from the Troubled Asset Relief Program to cover losses.

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The new program, which was announced in March, is starting as the housing market shows signs of renewed trouble and as the Obama administration's signature Home Affordable Modification Program, or HAMP, falls short of

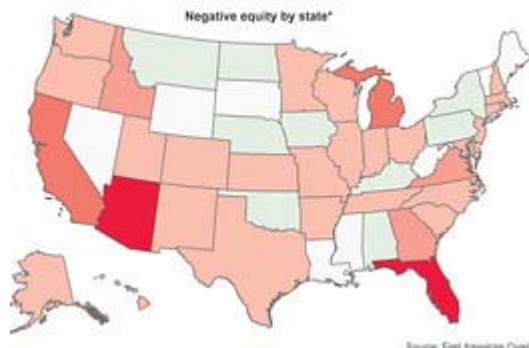
its goals of helping three million homeowners. Half of the 1.3 million borrowers that enrolled in temporary loan modifications have fallen out of HAMP because they didn't qualify. Only one-third has received permanent modifications.

The initiative also comes as mortgage rates fall to their lowest levels in more than 50 years. Average rates on 30-year fixed-rate loans dropped to 4.43% last week, down from 4.55% during

the previous week, according to a survey published Wednesday by the Mortgage Bankers Association.

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One of the biggest dangers facing the housing market is the glut of underwater homeowners who could default if their personal finances or home prices worsen. About 11 million borrowers, or 23% households with a mortgage, were underwater as of June 30, according to CoreLogic Inc.

The White House hopes to reach borrowers like Irene Gerloff, 62 years old, who was turned down for a loan modification because she can't afford her payments. While she owes \$292,000 on her two-bedroom condominium in La Habra, Calif., the property is probably worth less than \$200,000.

She is worried about what happens in five years, when her "interest-only" loan begins requiring much larger payments. "If things don't improve between now and 2015, I'm going to have to let this house go," said Ms. Gerloff, a secretary.

But not every homeowner who is underwater can participate. The bank or investors that own the loan must be willing to write down its value.

The administration's plan doesn't target loans held by Fannie Mae and Freddie Mac, which own or guarantee half of the \$10 trillion in U.S. first-mortgage debt, to avoid inflicting big upfront losses.

Instead, officials hope to reach more loans that were bundled by Wall Street firms and sold to investors as mortgage-backed securities. For more than a year, many of those investors, which include hedge funds and pension funds, have been clamoring for such a program because they have already had to mark down the value of their holdings.

"It'll take some really crappy loans out of the marketplace...and replace them with much higher-quality" mortgages, said Scott Simon, a managing director at Pacific Management Investment Co.

But that could be hard to do because mortgage servicers, which handle loan payments and decide which loans should be modified, are overwhelmed. And some borrowers might be discouraged from taking part because receiving a principal reduction will show up on their credit score.

Moreover, investors may not be able to participate as hoped because certain contracts that govern mortgage securitizations say modifications can only proceed if there is an "imminent" risk that the borrower would default.

Reducing balances for borrowers who are current could open mortgage servicers to lawsuits from investors that hold the riskiest slices of bonds. Those investors would be wiped out if balances are greatly reduced. For that reason, "lenders are going to be especially reluctant to do short

refinances on folks who are current," says Alan White, an assistant professor at Valparaiso University in Indiana.

Officials stress the new program isn't going to be a panacea. But they say that it should give servicers flexibility to modify current loans, and that they are "cautiously optimistic."



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Zully Bravo, left, and Alfredo Gonzalez met with a mortgage negotiator in Palm Beach, Fla., late last month.

"We've heard a lot of positive feedback from servicers and from investment groups to be able to write down" loans, said Vicki Bott, a senior FHA official.

Analysts say that the program is most likely to succeed on loans that banks already own in their portfolios. It could also provide investors with a vehicle for getting rid of loans that have been modified and are current again. "It's going to be a 'take out' for modified loans," said Laurie Goodman, a senior managing director at mortgage-bond trader Amherst Securities Group LP in New York.

The program must resolve a stubborn problem that has hindered every other modification program: how to deal with second mortgages. The program says second liens must be reduced so that the total mortgage debt is less than 115% of the home's current value. The government will make partial payments for banks to reduce those loans, but banks have been very reluctant to write down seconds that are current.

Investors that hold first mortgages are leery of writing down their loans without extinguishing the second because junior-liens are in a first-loss position. On a loan that has a second behind it and is heavily upside-down, "do I take the write-down and effectively pay off the second? I don't think so. That second is worthless," said Vincent Fiorillo, portfolio manager at Doubleline Capital, a Los Angeles-based fixed-income manager.

He said the program could work for loans without seconds, though he says it's possible many borrowers will still have too much debt to qualify for an FHA-backed loan.

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