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Can home loan modification through the 60/40 Plan really save the housing sector?

In a recent article in the Federal Reserve Bank of St. Louis Review, Manuel Santos, a professor at the University of Miami, claims to offer a simple solution to "save the housing sector." Called the "60/40 Plan," his proposal is the centerpiece of a business called 60/40 The Plan Inc. Santos's article is, in our opinion, written less like an academic article and more like promotional material.

The developer of the 60/40 Plan, Gustavo Diaz, is seeking a patent for the proposal. Unfortunately for the stressed mortgage market, his idea is simply a specific variant of a long-standing mortgage-servicing practice known as "principal forbearance." In general, principal forbearance occurs when the mortgage lender grants a temporary reduction of a borrower's monthly mortgage payment, often reducing the payment by a significant fraction, with the stipulation that the borrower repay this benefit, with interest, at a later date.

Principal forbearance is a loss-mitigation tool that mortgage lenders and servicers have been using for decades. In fact, Fannie Mae and Freddie Mac are currently using this technique as a loss mitigation tool and alternative to principal forgiveness (which Federal Housing Finance Agency Acting Director Edward DeMarco discussed here). Private mortgage lenders have also widely used principal forbearance, especially in the first few years of the recent foreclosure crisis.

As articulated in Diaz's 60/40 Plan, principal forbearance simply splits a distressed borrower's current principal balance into two parts: a 60 percent share that will fully amortize over 30 years and be subject to interest payments at market rates, and a 40 percent share that is treated as a zero-interest balloon loan due at the time of sale.

Of course, in practice, the optimal shares and other terms of a principal forbearance program should be, and often are in practice, based on a given household's financial situation. One size does not fit all. Professor Santos advocates the 60/40 Plan in large part because it is, in the language of economists, "incentive compatible." What this means is that borrowers who need assistance with their mortgage payments will find the program helpful and borrowers who do not need assistance will not find the program very appealing and thus will have little incentive to pretend to be a borrower in need of help in order to qualify for the program.

He writes: "It is important to understand that the 60/40 Plan builds on financial postulates and incentive compatible mechanisms that can be firmly implemented. It is designed as a first-best contract between the homeowner and the lender by holding onto some basic principles of incentive theory."

We agree completely with this sentiment. In fact, one of us wrote an article almost five years ago that advocated a policy of principal forbearance over principal forgiveness for exactly these reasons. Thus, the 60/40 Plan is not a novel concept, as Professor Santos seems to believe. But even more problematic, principal forbearance, as we have come to realize over the past few years, is not a panacea for the housing market for several reasons. First, it is really only helpful and appealing to borrowers that have temporary cash-flow problems who do not wish to move. This is because under the 60/40 Plan and principal forbearance in general, a borrower remains in a position of negative equity, which makes it virtually impossible to sell, since the borrower would need to come up with the amount of negative equity in cash to repay the entire principal balance of the mortgage at closing. For example, in the numerical example that Professor Santos works through to illustrate how the 60/40 Plan would work in practice, the borrower remains in a position of negative equity for 15 years. Thus, if a cash-strapped borrower needs to move immediately, or even a few years down the road, default (or re-default) is very likely.

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Second, carrying 40 percent of the mortgage at a zero (or below market) interest rate imposes significant costs on the lender or investor. (These costs are viewed as being offset by savings from avoiding foreclosure.) Nevertheless, principal forbearance is not always going to be a positive net-present-value proposition; this depends on the share being protected (40 percent is quite high), the amortization schedule (30 years is very long), the discount rate, and the re-default rate. Indeed, Professor Santos seemingly assumes no re-default despite the fact that under the plan a borrower would remain in negative equity for a very long time, as we discussed above.

Third, most distressed mortgages are not held by depository institutions as whole loans. Fannie Mae and Freddie Mac have been able to selectively employ principal forbearance because they make investors whole in terms of the original promised principal and interest payments. This is not true for private-label securitizations, and there have been ongoing disagreements between investors and servicers as to optimal loss-mitigation strategies. (And there is no reason to think this proposal would not be similarly controversial.) The 60/40 Plan also seemingly ignores the significant complications posed by existing second liens and mortgage insurance policies.

Finally, Professor Santos claims that the 40 percent zero-coupon balloon shares —typically nonrecourse loans to severely distressed homeowners—will have a deep secondary market to pull liquidity back into the housing market. This seems far-fetched given that these assets have little or no yield and will have high default rates with no recourse. However, reading further, it appears that the proposal assumes a Federal Deposit Insurance Corporation (FDIC) insurance wrap for these assets to facilitate their sale. The cost of this insurance would likely be expensive and require a controversial new program, with premiums expected to cover losses or a congressional appropriation. However, it also ignores the fact that FDIC-insured depository institutions only hold about 25 percent of all mortgages.

Principal forbearance can be a useful loss-mitigation tool, although its value depends on economic circumstances. The 60/40 Plan that Professor Santos advocates is an example of principal forbearance and not a novel concept. Moreover, the 60/40 Plan does not consider a number of important institutional factors that have hampered loss-mitigation activities since the onset of the mortgage foreclosure crisis. Simply put, the 60/40 Plan will not save the housing market.

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