

Silent Mortgages – A Critical Tool for Helping Families Rebuild Homes Damaged or Destroyed by Hurricanes Katrina, Rita, or Wilma

by Jeffrey Lubell¹

One of the many challenges posed by the devastating trio of hurricanes in the Fall of 2005 – Katrina, Rita and Wilma – is how to help families that suffered large uninsured losses to rebuild their homes. While the federal government has two programs designed to provide rebuilding assistance to impacted families – small grants from the Federal Emergency Management Agency and home repair/replacement loans from the Small Business Administration – neither is adequate to fully meet the need. “Silent mortgages” provide a third option that could help tens of thousands of families to rebuild who would not otherwise have been able to do so, while conserving scarce government funds to meet the full range of rebuilding needs.

What are Silent Mortgages and how can they help families rebuild their homes?

Silent mortgages are mortgages in which no payments of principal or interest are due until the home is sold (or the homeowners pass away). Silent mortgages could provide the funds needed to repair or rebuild the homes of tens of thousands families whose homes were damaged or destroyed by the hurricanes, but who lack adequate property and/or flood insurance to pay for the damage. Silent mortgages are being used successfully (on a smaller scale) in affordable housing programs around the country; they are also similar, in certain respects, to reverse mortgages.

Why do we need Silent Mortgages?

Silent mortgages address a need that is not met by the two principal forms of assistance currently available from the federal government:

SBA Rebuilding Loans. The Small Business Administration (SBA) is authorized to provide home repair/rebuilding loans at both subsidized and market rates of interest. However, according to the New York Times (*The Poor Need Not Apply*, Editorial, December 21, 2005), some 82 percent of the families whose home rebuilding loan applications have been processed by the SBA have been rejected on the grounds that their incomes are too low or their credit scores are inadequate. Because the expected payoff of a silent mortgage is based on the sale of the home, rather than the family’s income, silent mortgages could be extended to many families that would not qualify for a standard private market mortgage or a SBA rebuilding loan.

FEMA grants. The Federal Emergency Management Agency (FEMA) is authorized to provide grants to families that cannot qualify for a SBA rebuilding loan, but the grants are generally capped at \$5,200 for home repairs and \$10,500 for home replacement. Both amounts are inadequate to cover the full costs of home repair and replacement. While it would theoretically be possible to expand FEMA’s grant program to provide much higher levels of rebuilding grants, that would be far more expensive than an equivalent amount of rebuilding assistance provided in the form of Silent Mortgages.

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While the federal government has provided states with Community Development Block Grants that could be used to provide grants to allow affected homeowners to rebuild their homes, such funds are in short supply. Using silent mortgages, rather than grants, to help families rebuild their homes would allow states to stretch their grant dollars further to meet additional, critical, rebuilding needs.

Who would be good candidates for Silent Mortgages?

While silent mortgages would benefit many different types of households, they would be particularly effective for helping the *elderly on fixed incomes*. This is because large shares of the elderly have little or no preexisting mortgage debt on their property, making them good candidates for silent mortgages; at the same time, many of these households have incomes that are too low to afford regular payments of principal and interest on a standard mortgage, even at reduced interest rates.

Here's a little more background on the types of situations in which silent mortgages would be most effective:

Because silent mortgages are loans, rather than grants, it is important that they be structured in such a way as to make it reasonably likely they will be repaid. This means that, as a general rule, the combined amount of the silent mortgage and any other preexisting mortgage on the property should not exceed the expected value of the rebuilt home.²

There are three main scenarios that would satisfy this condition, and thus be good circumstances in which to utilize silent mortgages:

1. A household owns its property free and clear. In other words, there is no preexisting mortgage.
2. A household has only a modest level of debt on the property (say, debt that is less than 20 percent of the expected value of the rebuilt property), so that, even with complete rebuilding of the home, the total amount of the silent mortgage and preexisting debt would be less than the expected value of the rebuilt home.
3. A household has a more significant debt load, but the property is not completely destroyed, so that the combined cost of a silent mortgage to repair the existing home and the preexisting debt remains less than the expected value of the rebuilt home.

Because elderly homeowners tend to be more likely than other homeowners to have paid off their mortgages, and thus be free of any preexisting home mortgages, silent mortgages would be particularly useful for this population.

² There are a number of different approaches that could be taken to valuing the rebuilt home. As discussed in more detail in our separate paper on "Silent Mortgage Design Issues," we recommend that the rebuilt home be valued at: the pre-hurricane land value plus the estimated replacement costs of the improvements after rebuilding/repair.

How many families could benefit from Silent Mortgages?

While it is difficult to provide a precise estimate, our rough estimate is that silent mortgages could be appropriate for at least half of all families with large, uninsured losses – roughly 125,000 to 150,000 households – and maybe more. The basis for this estimate is detailed in Appendix A.

What are the principal benefits of Silent Mortgages?

Silent mortgages:

- Provide a mechanism for helping property owners rebuild their homes when they might not otherwise have been able to do so.
- Provide a less-expensive alternative to grants for helping homeowners rebuild their homes, allowing states and localities to extend scarce grant funds to meet other critical rebuilding needs.
- Give property owners with large uninsured losses the means to hold onto their properties long enough for property values to rebound, helping to preserve much of the equity that they had accumulated prior to the hurricanes, which may represent their principal or only source of assets. Without an ability to rebuild through silent mortgages, many impacted families might feel compelled to sell their properties quickly, at bargain-basement prices, wiping out their pre-hurricane asset base. A growing body of evidence indicates that assets are critical to families' long-term financial well-being.
- Help property owners that are unable to afford regular payments on a rebuilding loan to avoid bankruptcy and destitution. Many elderly homeowners, for example, had paid off their initial mortgages and planned to retire in their homes. In addition to being unable to afford a standard rebuilding loan, such families may be unable to afford to rent a home at market rates. Silent mortgages will help meet their shelter needs.
- Provide an incentive for families to return to devastated areas and rebuild their homes, contributing to economic recovery and community redevelopment.

What are the principal risks or other drawbacks of Silent Mortgages?

As with any other policy option, silent mortgages are not without drawbacks and potential risks:

- Because silent mortgages are loans, rather than grants, they will need to be repaid – in all likelihood through the sale of the home. This means that, while silent mortgages can provide a medium-term solution for sheltering families, they do not represent a permanent transfer of wealth to homeowners and do not fully restore homeowners to the position they were in before the hurricane. On the other hand, as noted above, they *do* allow families to return to their communities and rebuild their homes, and they *do* maximize the chances that families recover the pre-hurricane value of their land. They may also provide families with an opportunity to build assets through appreciation.

- If properties *depreciate* in value, rather than stay stable or appreciate, it may not be possible to fully recover the principal balance of all silent mortgages. This risk is mitigated by the possibility that not all neighborhoods will be rebuilt. In such a case, developable land would be in short supply, contributing to the likely increase in property values over time in those neighborhoods that do end up being rebuilt.
- Some families with silent mortgages could fail to keep up their properties. This risk could be mitigated by requiring home repair courses; structuring the transaction so that families can share in any home price appreciation, and thus have an incentive to keep up the home; and/or requiring families to repay some or all of the shortfall in the event their property has fallen into disrepair. Periodic home inspections could also be used to verify that families are adequately keeping up their properties.
- While significantly less expensive than outright grants, silent mortgages nevertheless have a cost. A cost estimate is currently being prepared.

What rebuilding needs are not addressed by Silent Mortgages?

While silent mortgages would meet a huge unmet need for rebuilding assistance, they are not intended to meet all possible rebuilding needs. Specifically, at least the following rebuilding tools are needed *in addition* to silent mortgages:

- A Land Bank or Redevelopment Authority to acquire, assemble, clear, and parcel out land for redevelopment. If structured appropriately, such an entity could allow families that choose not to rebuild their homes with an outlet to safely sell their property, with the potential to recapture some or all of their pre-hurricane equity, helping to maximize their future financial well-being. This could be done either by providing for the purchase of properties at pre-hurricane land values, or by offering families a share of property value increases that occur between the times of purchase and redevelopment.

Together, Silent Mortgages and a Land Bank or Redevelopment Authority could provide displaced homeowners with a range of options for dealing with their properties. They could choose either to utilize Silent Mortgages to rebuild their properties, or to sell their properties to the Land Bank or Redevelopment Authority.

- A mechanism for addressing the situation of families with both large uninsured losses and large amounts of outstanding mortgage debt. This problem is particularly acute in areas in which flood insurance was not required by the federal flood insurance program. As noted above, this problem cannot be solved through silent mortgages.
- A mix of housing subsidies to ensure that the redeveloped communities are affordable to families at different income levels.

Who would issue Silent Mortgages?

There are two main approaches for structuring silent mortgages:

Direct loan. One option would be for the government to issue silent mortgages as a direct loan – for example, from a state or local housing finance agency;

Private funds, backed by government guarantee. An alternative approach would be for private lenders to issue silent mortgages, backed by a 100% government guarantee. Under this approach, in addition to the guarantee, a mechanism would need to be established to compensate lenders for the deferred interest on the funds extended. (For options, see our separate paper on “Silent Mortgage Design Issues.”)

In the event that a state or locality chooses to fund silent mortgages with funds under its control, such as Community Development Block Grant funds, either approach could be used. In the event that the federal government chooses to fund the silent mortgages directly, however, we believe the most feasible approach would be rely on private lenders to make silent mortgages backed by a 100% loan guarantee from the Federal Housing Administration (FHA).

How much could families borrow?

We recommend that the silent mortgage cover the costs of repairing/rebuilding either: (a) a home of the quality of the one that was destroyed or damaged by the hurricane or (b) a modest-sized home of decent quality, whichever is higher. We further recommend capping the maximum loan amount at \$200,000, the current maximum for a SBA rebuilding loan.

Would the loans carry any interest payments?

Yes, but the interest would generally be deferred until the time of sale. For reasons explained more fully in our separate paper on “Silent Mortgage Design Issues,” we recommend that interest be calculated as three-quarters of the amount of any home price appreciation.³ Basing interest on home price appreciation helps to preserve families’ pre-hurricane equity. Allowing families to retain one-quarter of the home price appreciation ensures they have a financial incentive to maintain their homes.

Because this formula will not always be sufficient to fully compensate lenders for the deferred interest on the principal balance of silent mortgages, a government subsidy will be needed to cover any shortfall. Options and precedents are discussed in the separate Design Issues paper.

Would families be required to make monthly payments?

Families with silent mortgages will be required to pay their own property taxes and property and flood insurance. As silent mortgages are principally intended to meet the needs of families that cannot afford to make monthly payments on even a subsidized mortgage, however, we

³ Under our recommendation, home price appreciation would be calculated as the difference between (a) the sale price of the home (less transaction costs) and (b) the baseline value of the rebuilt home, calculated at the time of the silent mortgage as: pre-hurricane land value plus the plus the estimated replacement costs of property improvements after rebuilding/repair.

recommend that additional monthly payments *not* be required of most families. As explained in more detail in our separate paper on “Silent Mortgage Design Issues,” if additional monthly payments are to be required, they ought to be limited to families with comparatively higher incomes.

Who would be eligible for Silent Mortgages?

While silent mortgages are needed most for families that cannot qualify for a reasonably priced rebuilding loan from the SBA or a private lender, it would be inequitable to limit eligibility to these families alone. We thus recommend that eligibility be open to all families with large uninsured losses related to one of the hurricanes, but that the terms of the mortgage be varied such that families with higher incomes assume greater responsibility for the full costs.

Would Silent Mortgages be time-limited?

As discussed in more detail in our separate Design Issues paper, silent mortgages could be designed either with or without a fixed time limit for repayment.

- Communities that choose to use CDBG or other government funds to directly issue silent mortgages as an alternative to outright grants may be comfortable allowing families to occupy their homes indefinitely, or may wish to extend this option to certain categories of families, such as the elderly.
- On the other hand, if the expected source of capital is private funds, based on a government guarantee, lenders are likely to desire a fixed time-horizon, after which the loan will either need to be refinanced or repaid through the sale of the home.

Are there any precedents for Silent Mortgages?

Yes. Silent mortgages are similar (though not identical) to two existing products: silent seconds and reverse mortgages:

- Silent seconds are government-funded second mortgages that do not require any repayment of principal or interest until the sale of a home. One of several types of “soft” second mortgage financing being utilized in affordable housing programs nationwide, silent seconds are being used with increasing frequency in high cost markets, such as California, to help families purchase their first home.
- Reverse mortgages provide elderly homeowners with funds (either in a lump sum or through an annuity) extended based on the value of the home.

Both products are similar to silent mortgages in that the source of repayment is the sale of the home, rather than the income of the homeowner. While the silent mortgages we propose here will likely need to be extended against a larger proportion of a home’s value than these preexisting products, we believe that extension is justified by the strong public interest in meeting the needs of families and communities impacted by the hurricanes.

Will Silent Mortgages enable families to rebuild in neighborhoods the government decides should not be rebuilt?

No. Silent mortgages are only a financing mechanism. They do not determine which neighborhoods ought to be rebuilt or what the building standards or insurance requirements ought to be. Those questions need to be worked out before families are issued silent mortgages to rebuild.

Where can I get more information on Silent Mortgages?

For more information, see our separate paper on “Silent Mortgage Design Issues” or contact Jeffrey Lubell at jlubell@nhc.org.

Appendix A – Rough Estimate of Number of Families that Could Benefit from Silent Mortgages

While it is difficult to give a precise estimate of the number of families that could benefit from silent mortgages, our rough estimate is that silent mortgages could be appropriate for at least half of all families with large, uninsured losses – roughly 125,000 to 150,000 households. This estimate is based on the following observations:

Total Population Seeking Aid. According to a New York Times report in late December, the SBA has received 276,000 applications for rebuilding loans. (*The Poor Need Not Apply*, Editorial, December 21, 2005.) Assuming some applications have not yet been filed, but that some very modest number of these applications are for small sums that could be met through the FEMA grant program (FEMA nevertheless requires families to apply first to the SBA), it seems reasonable to estimate the total population of families with large uninsured losses that are seeking assistance at roughly 250,000 to 300,000.⁴

Proportion of Households with Little or No Debt. As noted in the body of the analysis, silent mortgages are most appropriate for families with little or no preexisting home debt. (They would also work for families with larger debt loads but less than total destruction of their homes, but we have no way of estimating how many families fall into this category.)

- In 2004, some 140,000 (43.4%) of the 323,000 homeowners in the New Orleans Metropolitan Area owned their home free and clear and another 27,900 (8.6%) had debt with a loan to value ratio of less than 20%.⁵ Assuming these proportions are similar for the impacted areas as a whole, roughly half of all homeowners have little or no debt on their property and thus could be good candidates for silent mortgages if they suffered large uninsured losses.
- Families with large, *uninsured* losses are more likely to have little or no home debt than the typical homeowner because property insurance is generally required as a condition of receiving a mortgage, as is flood insurance (at least in those areas in which flood insurance was mandated by the federal flood insurance program).
- While the exact demographics of families with large uninsured losses are not known, it appears likely that they have somewhat lower incomes than the average homeowner. In the New Orleans Metropolitan area, the percentage of families with no or low home debt in 2004 was *considerably higher than average* among families with incomes below the poverty line (63.8% owned their homes free and clear and 8.2% had loan to value ratios of less than 20%). This is probably because poor homeowners are more likely to be elderly than non-poor homeowners, and thus to have paid off their mortgages.

In light of these data points, a conservative assumption would be that at least half of all households with large uninsured losses could be good candidates for silent mortgages.

⁴ This analysis does not consider families with large uninsured losses that have chosen *not* to apply to the SBA for assistance as there appears to be no basis for deriving that estimate and such families are less likely to apply for silent mortgages than those that have already applied to the SBA.

⁵ 2004 American Housing Survey for New Orleans MSA.