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Freddie and Fannie Reject Debt Relief

By **SHAILA DEWAN**

Home values have fallen so much in Arizona that almost half the people with mortgages there owe more than their homes are worth. So when federal money became available to help stem the tide of foreclosures, the state flagged that group for help.

If banks would forgive some of a homeowners' mortgage debt, the state said it would pay half, up to $50,000 of a $100,000 loan reduction. Despite the generous terms, most banks balked.

Only three homeowners have been approved for debt reduction since the program began in September 2010. A major obstacle has been that the two largest mortgage guarantors, Fannie Mae and Freddie Mac, will not participate — in Arizona or elsewhere. No loans are eligible for the state's program if they were bought and held or securitized by the two companies, which are now under government control and guarantee more than 70 percent of the country's home loans.

"It is extremely difficult for the principal reduction program to be successful" when Fannie and Freddie opt out, said Shaun Rieve, a spokesman for the Arizona Department of Housing.

The companies' policy against debt forgiveness, or principal reduction, has blocked widespread use of what many have come to believe is an indispensable tool for fixing the housing problem. The state attorneys general have been insisting that debt forgiveness be a part of the multibillion-dollar

settlement they are negotiating with big banks over faulty mortgage practices.

Smaller investors and companies that service home loans have stepped up debt forgiveness as well.

Not so Edward J. DeMarco, who as acting director of the Federal Housing Finance Agency oversees Fannie and Freddie. Even though he recently signaled that he might make it easier for homeowners to refinance into more favorable loans, he has held his ground on debt relief. Fannie and Freddie say reducing the principal is bad for business, and as a result bad for taxpayers.

Critics counter that banks and investors have benefited from the government response to the housing collapse while borrowers have largely been left to sink. Last week the inspector general of the Federal Housing Finance Agency said that Freddie Mac had not pursued Bank of America aggressively for compensation for bad loans, despite warnings from a senior staff member.

“It’s sinful, is the word I would use, that they won’t do this,” said John Taylor, president of the National Community Reinvestment Corporation, referring to debt forgiveness. “And the only reason they won’t is they don’t want to realize the red ink that’s already on their books.” They are delaying taking inevitable losses on shaky loans.

White House officials say that although taxpayers essentially own Fannie and Freddie, the administration lacks authority to require Mr. DeMarco to comply with its policies, which encourage principal reduction through a handful of programs. The Federal Housing Administration and the Veterans Administration do not allow principal reduction on their loans either.

Large lenders have long resisted debt forgiveness because of fears that it creates a moral hazard, meaning it could encourage borrowers to take out risky loans in the future because the consequences would not be so bad, or to default to qualify for principal reduction. They argue that other types of loan modifications achieve the same goal.

Proponents of debt forgiveness argue that the failure to reduce debt is hurting the economy, postponing inevitable losses and costing more in the long run. While 28 percent of all loans that are

modified go into default again within a year, loan modifications involving principal reduction are more successful. In the latest sign that debt forgiveness might make financial sense to some on the lender side, the nation's second-largest mortgage insurance company, PMI Group, has found a way around Fannie and Freddie's policy. PMI, which shares the credit risk in many Fannie and Freddie loans, will pay some underwater homeowners, those who owe more than their home is worth, if they make prompt payments for several years, a de facto principal reduction.

While the company would not disclose what percentage of the principal was covered, a spokesman for the Loan Value Group, which administers the program for PMI, said that on average it was 5 to 7 percent of the loan amount but could be as much as 30 percent.

Fannie and Freddie's rejection of principal reduction may simply be postponing losses that will occur anyway. Sharon Wells, a retired real estate agent who lives on Social Security, said the modification by Chase Bank of her Fannie Mae mortgage led to an increase in the principal rather than a reduction, even though she already owed about 30 percent more than her home, near Phoenix, was worth.

Ms. Wells, 66, said she had heart trouble and had outlived her doctor's prognosis, so there was virtually no chance that she would live to pay off the new 40-year term, or that the house would regain its previous value before her death, meaning the lenders would ultimately take the loss anyway. She had been preparing to sell her home and downsize when the market crashed.

"The logical, pragmatic thing, the thing that would have helped this country the most, would have been to write this loan down to a realistic number so we could have the normal buying and selling of homes," she said.

But Fannie and Freddie maintain that deciding who merits principal reduction raises concerns about fairness. They argue that if future lenders believe there is a chance that borrowers will not have to repay the entire amount, they will price that risk into their loans, raising costs for everyone. The companies say making monthly payments affordable is achieved equally well by forbearance, which

allows part of the principal to be subtracted from the calculation of payments and instead tacked on to the end of the mortgage. “We’re not sure what is gained by giving up the right to collect that principal after the forbearance period ends and the borrower has regained financial footing,” said Brad German, a spokesman for Freddie Mac.

But proponents of debt forgiveness say that forbearance does little to increase a borrower’s willingness to pay.

“The banks are trying to shoehorn an affordability fix into a negative equity problem,” said Frank Pallotta, a managing partner of the Loan Value Group, which runs the homeowner incentive program used by PMI. “About 35 percent of all defaults are at least in part strategic,” he said, meaning that even if a financial mishap like job loss is behind a homeowner’s decision to stop paying, being underwater is a factor.

About one in five homeowners with a mortgage is underwater, and the total amount of negative equity is estimated at $700 billion to $800 billion. While many of those borrowers are coping with self-inflicted wounds, the problem is not limited to subprime loans.

Among mortgages backed by Fannie and Freddie, a vast majority of which are prime, the percentage of underwater homeowners is virtually the same as the percentage among all mortgages. The scope of the problem has led to calls for an across-the-board write-down, a solution that is expensive, impractical and unnecessary, says Mark Zandi, an economist at Moody’s Analytics.

“I don’t think the problem is as deep as people think,” Mr. Zandi said. Just enough principal reduction is needed to shrink the share of foreclosed homes on the market, which would allow prices to rise, he said. Homeowners would be less likely to default if prices were increasing, he added. Servicers providing principal reduction have devised ways to limit moral hazard. In Arizona, the program was restricted to homeowners with moderate incomes who had resisted taking out equity loans in the boom. Ocwen Loan Servicing, whose loan modifications top the national average, intensively evaluates the homeowner’s budget before determining if principal reduction would result in a net gain for the

investor, who otherwise might face a steeper loss in foreclosure.

After a successful trial program, Ocwen, based in Atlanta, has also begun offering shared appreciation plans, in which part of a borrower's principal is forgiven, but if the home is eventually sold at a profit, the owner must share that profit with the lender.

As for moral hazard, Steve Bailey, chief servicing officer at PennyMac, a California company that bought shaky loans, said that failure to cut principal was to blame, not the other way around.

"A loan that is modified and left at 200 percent loan-to-value invites the moral hazard," he said. "You're telling a person that they need to live in this house that's severely underwater, paying more for housing than they need to, and looking around their neighborhood at homes that have gone through foreclosure and are available for much less."

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