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GSE Reform: FHFA Should Not Pursue Mortgage Principal Reduction Alternatives

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Should the Federal Housing Finance Agency (FHFA) expand home mortgage modification policy to include principal reduction alternatives (PRAs)? For the past five years, the FHFA has maintained a consistent stance that implementing a PRA policy would come at a high cost to taxpayers with little benefit overall to homeowners. On the other hand, the Federal Housing Administration (FHA)—under the regulatory and policy guidance of the Department of Housing and Urban Development—has expanded its PRAs since 2010.

Until Congress finally resolves the important reform issues surrounding Fannie Mae and Freddie Mac and government guarantees in the U.S. housing market, the FHFA should not begin any new mortgage modification programs, specifically any PRA programs.

FHFA Says "No" to Principal Reduction Policy. The FHFA is responsible for the safety and fiscal oversight of the two giant housing government-sponsored enterprises, Fannie Mae and Freddie Mac. The FHFA was put in place in 2008 to manage Fannie and Freddie until Congress could decide the fate of Fannie and Freddie.

During these past five years, there have been consistent calls for the FHFA to allow Fannie and Freddie to assist "underwater" mortgage holders in various ways. (Underwater mortgage holders are those borrowers owing more on their mortgage than the value of the home).

To be sure, the FHFA *has* implemented various mortgage assistance programs to lower the monthly payments for underwater mortgage holders. These mechanisms effectively use some combination of term structure lengthening, interest rate reduction, and "principal forbearance" to bring monthly mortgage payments down to an affordable level (generally to 31 percent of gross monthly income).[1]

Still, the FHFA has also firmly maintained that it would not expand these assistance programs to include PRAs to mortgages in Fannie and Freddie's portfolios. A PRA plan allows homeowners to modify the terms of their mortgage by reducing the principal amount of the loan. For instance, if a homeowner's mortgage principal is $150,000, a PRA plan may allow that amount to be reduced by 10 percent, meaning the lender would now be able to charge interest on only $135,000 for the remainder of the loan's term. Thus, by government decree, a portion of the loan would be eliminated.

In a 2012 report, the FHFA outlined the primary concerns for taxpayers and homeowners if the agency were to expand its mortgage modification assistance to include PRAs. The FHFA is concerned mainly with the longer-term moral hazard risk of PRAs versus current FHFA modification programs that do not allow the borrower to simply walk away from a portion of the loan.[2]

The FHFA should continue its zero tolerance position toward any PRA because:

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- Principal reduction (as opposed to principal forbearance, which the FHFA currently allows Fannie and Freddie to pursue) would disrupt the initial financial contract between borrowers and lenders. Implementing such a policy would create a moral hazard in the mortgage market by fundamentally distorting the incentives for PRA-eligible borrowers who are currently making timely mortgage payments.

- The Congressional Budget Office (CBO) estimates that, even under the most generous PRA—which would forgive principal to 90 percent of a home's current value (i.e., a 90 percent loan-to-value ratio)—total default rates would decrease less than 8 percentage points.[3] This change is small given the fact that an estimated 221,000 borrowers would effectively have a portion of their mortgage loans eliminated.

- The FHFA estimates that the operational costs for supporting and executing the policy range between $70 million and $90 million just for Fannie Mae and Freddie Mac with a time frame of over one year.[4]

Mixing Principal Reduction Policy with FHFA's "Duty to Serve." The implementation of FHFA-led PRAs would likely create broad incentives for many borrowers to become eligible. Under similar FHA plans, for instance, borrowers are informed that they are eligible for principal forgiveness if they simply *demonstrate hardship*.[5] This would likely be broadly defined as any borrower who owes more than the value of his or her home (i.e., with a loan-to-value above 100 percent) even if he or she is making current payments on the mortgage.

Given that approximately 80 percent of underwater borrowers in Fannie and Freddie's combined portfolios uphold their mortgages and continue paying in the system, PRAs could increase default rates.[6] For instance, many of these borrowers may respond to the change in incentives by electing to "strategically default" simply to attain the new government subsidy.

Furthermore, because of new regulatory principles such as the "duty to serve," the FHFA could be required to direct Fannie and Freddie—or any government-backed institution that replaces them—to implement PRAs to ensure that everyone has "access to affordable credit."[7] The requirements to do so would be publicized and likely lead to an increase in demand for a principal reduction take-up that may not be fully accounted for in the prediction models.

Leaving aside this fact, Fannie Mae has estimated that it would have to forgive almost $73 billion of principal if all of the responsible borrowers—those who have remained current on their mortgages—choose to become delinquent and qualify for any FHFA-led PRA.[8] These amounts represent only Fan-

1. The FHFA should be given credit *for not expanding* its loan modification programs to include PRAs, but the loan modification programs it has pursued have hardly been harmless. Some of the modifications it has set for borrowers—and taxpayers backing the modification—are still less than desirable. For example, to ensure that the loan modification effectively reduces the new monthly payment to an affordable level (31 percent of gross monthly income), the FHFA has lengthened term structures on loans up to 40 years in some cases. While there may be concurrent interest rate reduction on the same loan modification, the FHFA has supported loan modifications that put a borrower into an even longer loan than the 30-year mortgage and effectively ensuring more interest payments (in total) for the borrower over the life of the loan. Federal Housing Finance Agency, "Review of Options for Underwater Borrowers and Principal Forgiveness," July 31, 2012, p. 8, http://www.fhfa.gov/webfiles/24108/PF_FHFApaper73112.pdf (accessed November 27, 2013).
2. Ibid., pp. 12–15.
3. Congressional Budget Office, "Options for Principal Forgiveness in Mortgages Involving Fannie Mae and Freddie Mac," May 2013, p. 43, http://www.cbo.gov/sites/default/files/cbofiles/attachments/44114_WorkingPaper-OptionsPrincipalForgivenesl.pdf (accessed November 27, 2013).
4. FHFA, "Review of Options Available for Underwater Borrowers and Principal Forgiveness," pp. 14–15.
5. Ibid., p. 13.
6. Ibid., p. 3.
7. See Norbert J. Michel and John L. Ligon, "GSE Reform: Affordable Housing Goals and the 'Duty' to Provide Mortgage Financing," Heritage Foundation *Issue Brief* No. 4083, November 12, 2013, http://www.heritage.org/research/reports/2013/11/affordable-housing-goals-and-the-duty-to-provide-mortgage-financing.
8. Fannie Mae, "Fannie Mae's Analysis Regarding Principal Forgiveness and Treasury's HAMP Principal Reduction Alternative (HAMP PRA) Program," p. 13, http://www.fhfa.gov/webfiles/24107/pf_fanniemae73112.pdf (accessed December 3, 2013).

nie's loans, but the cost would certainly be higher once the eligibility standards are made public.

Implications for the Housing Finance System. If borrowers do not expect a positive change in their employment and permanent income, then any principal reduction policy would likely have even less impact on the economy and housing markets than the CBO predicts. The CBO recently estimated that even under the most generous FHFA-led PRA, the U.S. economy may grow less than 0.1 percent, with virtually no change to the real demand for housing.[9]

More importantly, FHFA-led PRAs would likely have longer-term negative implications for the housing finance system. The introduction of such a program would likely signal to markets that mortgage contracts are riskier than expected and less secure. Private lenders may in turn choose to reduce mortgage credit availability.

Zero Tolerance. Until Congress finally resolves the important reform issues surrounding Fannie Mae and Freddie Mac and ending government guarantees in the U.S. housing market, the FHFA should continue a zero-tolerance stance on principal reduction policy.

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9. CBO, "Options for Principal Forgiveness in Mortgages Involving Fannie Mae and Freddie Mac," p. 22