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Sharing the Pain and Gain in the Housing Market

How Fannie Mae and Freddie Mac Can Prevent Foreclosures and Protect Taxpayers by Combining Principal Reductions with "Shared Appreciation"

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Introduction and summary

More than five years into what is arguably the worst foreclosure crisis in American history, millions of families are still at serious risk of losing their homes. Nearly one in four homeowners is "underwater," meaning they owe more on their mortgage than their home is worth,[1] and more than 7 million homes are still in the foreclosure pipeline, according to analysis from Morgan Stanley.[2] In fact, some analysts predict we're only halfway through the crisis.[3]

The big question before lenders, investors, and policymakers today is how to avoid another wave of costly and economy-crushing foreclosures. There are several ways to lower an at-risk borrower's monthly payments and increase the chance of repayment: refinancing to today's historically low interest rates, extending the loan's terms, modifying the interest rate, deferring payments, or lowering the amount the borrower actually owes on the loan—so-called "principal reduction." In most cases the lender or mortgage investor responsible for the loan considers all of these options when deciding which intervention is best for the specific borrower.

That is, unless the loan is owned or guaranteed by Fannie Mae or Freddie Mac, the country's two biggest mortgage finance companies. Fannie and Freddie have yet to embrace one option—principal reduction—as a viable foreclosure mitigation tool.

In fact the two mortgage giants, which are now operating under government conservatorship, are forbidden from lowering principal on any mortgages they own or guarantee by their regulator, the Federal Housing Finance Agency, or FHFA. That's the case despite a growing consensus among economists, investors, academics, and consumer advocates that principal reduction is often the most cost-effective way to avoid unnecessary foreclosure for certain groups of borrowers.

Principal reductions are particularly effective for deeply underwater borrowers that are facing long-term economic hardships, such as a permanent reduction in wages or long-term increases in unavoidable spending. These families are at high risk of default and often cannot see the long-term upside from making expensive

monthly payments into a bad investment. With more equity in their home, these borrowers would be more likely to stick it out in tough economic times by making deep cuts to savings or other areas of spending.

These are homeowners worth helping. Foreclosure is often the worst-case scenario for everyone involved, but especially for underwater borrowers who boast close ties to their communities and prefer to stay in their homes. These kinds of homeowners consider the administrative fees, consequences for their future credit, and other costs of foreclosure. So, too, do the lenders or investors, who often have to shell out tens of thousands of dollars in legal fees, foregone interest, and losses on the property. And each foreclosure in the neighborhood decreases the value of everyone else's home, which is a drag on the local housing market.

Reducing principal is the only way to rebuild an underwater borrower's equity while permanently lowering monthly mortgage payments. That's one reason why almost one in five modifications of private loans held in bank portfolios involves some principal reduction, according to one survey.[4] But FHFA is not convinced principal reduction is ever the best option for Fannie or Freddie.

To be fair that position may make sense if the goal of the agency is to protect the short-term interests of Fannie and Freddie. Principal reductions require the lender to take a hit on their books today in order to save more money tomorrow by reducing defaults and foreclosures. In the case of Fannie and Freddie, that may mean billions of more dollars in temporary support from taxpayers, who have already invested $150 billion in the companies since 2008.[5]

But it's important to realize that over the long run, the goverment-sponsored enterprises are projected to lose even more money if they don't act today. And more than three years into the conservatorship, with no clear path for the federal government to wind down its control of Fannie and Freddie anytime soon, we need to start thinking long term. It's time for Fannie, Freddie, and FHFA to give their stance on principal reduction another thought. This report explains why Fannie, Freddie, and FHFA should embrace a targeted principal-reduction program for certain deeply underwater loans it owns or guarantees. This is not a matter of charity, though more struggling homeowners would likely be able to stay in their home as a result. At its core, principal reduction is good business.

Indeed, we already know that principal reductions are beneficial to Fannie and Freddie in the long term. FHFA's own analysis shows that reducing principal on all

deeply underwater borrowers would save the government-sponsored enterprises and the taxpayers supporting them approximately $20 billion over the life of those loans relative to not doing anything.[6] A carefully designed principal-reduction program—one that limits the long-term risks borne by Fannie and Freddie and focuses on borrowers that actually need a reduction—makes the business case even stronger.

To maximize returns to Fannie and Freddie, we propose a pilot program that reduces principal—often by as little as 5 percent or 10 percent—without creating skewed incentives for borrowers. Through so-called "shared appreciation" modifications, Fannie or Freddie agrees to write down a portion of the principal on deeply underwater loans in exchange for a portion of the future appreciation on the home. The borrower has a reason to keep paying, while the lender benefits when home prices eventually stabilize and rebound.

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Since the borrower has to give up a meaningful share of future home price appreciation, basically establishing a cost for program participation, the shared appreciation modification is not particularly attractive to borrowers that don't need it. And by phasing in the principal reduction—say, over the course of three years contingent on meeting every monthly payment—the borrower has additional incentive to stay current on their mortgage. Both of these program rules deter borrowers from defaulting on their loan just to get a reduction in principal, what some critics call the "moral hazard" problem.

That said, we fully understand that principal reductions should not be available to everyone. As is the case with any loan modification, the principal reduction must be in the best interest of both the borrower and the lender, or in many cases the mortgage investor that owns the loan. This consideration must be done on a loan-by-loan basis.

At this point, we don't have enough data to determine when exactly principal reduction is the best option for Fannie and Freddie compared to other modifications such as interest rate modifications or principal deferral. Indeed, that's the main reason for a targeted pilot. For now we recommend Fannie and Freddie focus on borrowers that are most likely to benefit from a reduction, specifically borrowers that:

- Have a mortgage that's worth at least 115 percent of the home's current value
- Are either delinquent on their mortgage payments or at imminent risk of default
- Face a long-term economic hardship, such as a nontemporary decrease in income or a permanent increase in unavoidable spending

- Do not have private mortgage insurance or a second lien, such as a home equity loan

To be sure, we believe that principal reduction could be the best modification option for Fannie- or Freddie-backed borrowers that do not meet all of these criteria. But we propose that the pilot focus on this core group to test the model.

We also recommend that the shared appreciation pilot operate through the Home Affordable Modification Program, or HAMP. The Obama administration recently announced new incentives for Fannie and Freddie to write down principal through HAMP, which should help the companies keep more underwater borrowers in their homes, according to our analysis.

But before we go further into the details of our proposal, let's take a closer look at the negative equity crisis facing millions of American families today, many of which have loans backed by Fannie Mae or Freddie Mac.

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