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Ed DeMarco could hasten end to foreclosure crisis by allowing debt forgiveness


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To forgive or not to forgive — that is the question. Everyone is waiting for Ed DeMarco — director of the Federal Housing Finance Agency, which oversees Fannie Mae and Freddie Mac in their government conservatorship — to rule one way or the other.

Whether DeMarco allows forgiveness of some mortgage debt owed by American homeowners won't make or break the housing market. But answering yes would help end the foreclosure crisis more quickly and boost the economy.

DeMarco's reluctance to say yes is understandable. This is a politically charged issue. The tea party was born out of the disgust many Americans felt early in the financial crisis upon learning that the federal government was even contemplating reducing the principal on some troubled mortgages.

Proponents of that idea argued that although it might cost the taxpayers something, it would ultimately be far cheaper than letting the housing market sink and drag down the U.S. economy. Detractors argued that forgiveness was unfair to the vast majority of homeowners who were diligently making their mortgage payments on time. Principal reduction would also create moral hazard, encouraging many homeowners to quit paying their mortgages in order to have their own loans reduced.

The Obama administration recently put the issue back on the policy agenda, when it tripled the monetary incentives under its loan modification program to Fannie and Freddie for principal reductions. For every dollar Fannie and Freddie take off a home mortgage, taxpayers will pay up to 63 cents, using money from the $700 billion TARP fund originally appropriated to help struggling financial institutions.

This makes it tougher for DeMarco to say no. With taxpayers taking on so much of the financial burden of principal reductions, Fannie and Freddie could end up making money. As conservator of the agencies, DeMarco has said his first responsibility is keeping them solvent with a minimum of help from the U.S. Treasury. Fannie and Freddie have already received almost $200 billion, by far the most costly taxpayer bailout of the recent financial crisis.

Yet despite the administration's offer, DeMarco could still say no. He argues that principal forgiveness isn't as effective as principal forbearance, something Fannie and Freddie have been doing for a long time. In a forbearance, the homeowner pays interest and principal on a smaller mortgage, at least for a time, but still owes the full amount. The lower monthly payment helps with affordability, giving stressed homeowners a break. But because they are still on the hook for the full mortgage, others are less likely to intentionally default to receive it.

Adding principal reduction to Fannie's and Freddie's loan mitigation efforts would also be costly to administer. Indeed, everything Fannie and Freddie do is difficult and expensive.

Perhaps there is a middle ground: forbearance that evolves into forgiveness if the homeowner earns it. In an "earned mortgage," the homeowner receives forbearance and immediately pays on a smaller mortgage to help with affordability. He then earns forgiveness as the amount owed is reduced proportionately over time, as long as he stays current.

As an example, consider an underwater homeowner who owes $150,000 on a home worth $100,000. With a 5 percent mortgage rate, his monthly payment is just over $1,000. With an earned mortgage, the bank forebears on $25,000 of the mortgage amount, saving the homeowner more than $100 per month. The homeowner still owes $150,000, but this is reduced by $5,000 a year, or $25,000 over five years. If the homeowner goes delinquent for more than two months during those five years, he owes the entire $150,000. If the homeowner wants to move before five years, his mortgage would be reduced pro rata. Under most scenarios, he would still be underwater, and would go through a short sale. It is possible that the home could appreciate enough so that with the mortgage reduction he would pocket a gain. But this seems unlikely.

An earned mortgage seems well suited for homeowners who are deeply underwater but fighting hard to keep their homes. An estimated 6.5 million homeowners are underwater more than 30 percent, and most have never been more than two months late on their mortgage (see chart). This is a key threshold for default. Even a small financial reversal, such as a roof leak or a busted air-conditioning unit, could discourage these homeowners from holding on. Forbearance would provide them with some relief , but an earned mortgage would offer a real financial hook — making it possible to get back above water and avoid default.

Moral hazard is much less a problem with an earned mortgage. Because a homeowner must earn forgiveness, and even then is unlikely to be above water soon, the program is much less subject to abuse. Also worth noting is that banks have forgiven principal on mortgage loans they own for some time, with good success. Moral hazard has not increased and default rates are low compared with other types of mortgage modifications.

There are signs that the housing crash is almost over. Home sales and construction are rising and prices are more stable.

It is premature, however, to conclude that the problem is behind us. Millions of homes are stuck in foreclosure; as these go to foreclosure and short sales, the market's fragile stability is threatened.

Policymakers don't need to do a lot to prevent that, but they should take the opportunities they have to help. Forgiveness won't come easy for the FHFA and its agencies, but if it helps even a few hundred thousand homeowners, it is the right thing to do. Say yes.

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http://www.washingtonpost.com/realestate/ed-demarco-could-hasten-end-to-foreclosure-crisis-by-allowing-debt-forgiveness/2012/05/10/gIQAdKn6FU_story_1.html