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FHFA Announces Principal Reduction: Why the Numbers Are So Small and Why It Still Matters

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The Federal Housing Finance Agency (FHFA) announced on April 14 that Fannie Mae and Freddie Mac (the government-sponsored enterprises, or GSEs) would offer principal reduction to a targeted group of underwater borrowers. Given the careful design of the program and the rapidly declining number of borrowers who would be well served by such help, the near-term impact of the step will be minimal. The step is nonetheless important as it represents a break from the long-held position of the GSEs to decline offering such relief under any circumstances. In this note, we describe the program, its likely impact over the near term, and why it matters over the long term.

To qualify for the new program, borrowers must meet the following criteria:

- The property must be owner-occupied.
- The borrower must be at least 90 days delinquent as of March 1, 2016.
- The borrower must have an unpaid principal balance of no more than $250,000.
- The borrower must have a mark-to-market loan-to-value ratio (LTV) of more than 115 percent after capitalization of arrearages, as of the date the borrower is evaluated for the modification.

Servicers will solicit borrowers who may be eligible through summer and fall 2016. Those found eligible will be offered a loan modification in which the principal balance of their loan will be written down by 30 percent or to 115 percent LTV, whichever is less. To receive the benefit, the borrower must make three consecutive payments under the new terms of the loan. Borrowers must be enrolled in the program by December 31, 2016.

FHFA estimates that approximately 33,000 GSE borrowers will be eligible for principal reduction under this program. To minimize the servicers' expense of implementing a program for so few borrowers and maximize borrower participation, the GSEs are providing servicers with a list of likely eligible borrowers and are offering the principal reduction through a streamlined modification program that the servicers already use. Under this new program, principal is forgiven rather than simply forborne as under the current program. Assuming a 9.5 percent take-up rate, which is that of the streamlined modification program already in place, 3,155 borrowers would benefit. If the take-up rate of the new program is double the existing one, 6,310 would benefit.

Why so few borrowers will benefit

Why will only a few thousand of the more than three million underwater borrowers nationwide benefit from this program? While we don't have the tools to replicate the FHFA's numbers precisely, we do have enough to provide a general understanding of the relative order of magnitude.

In table 1, we size the eligible universe. As of the end of 2015, slightly more than 400,000 GSE borrowers were more than 90 days delinquent (table 1A). Of these, approximately 14.39 percent, or 58,787, were at least 5 percent underwater, and 9.25 percent, or 37,759, were at least 15 percent underwater (table 1B). Our algorithm does not take into account arrearages, so the 105 percent LTV cut-off is likely most comparable to the 115 percent cut-off in FHFA's calculations. We also use different home price indices than those used in the FHFA calculations, but they are indicative. Limiting loans by owner-occupancy and balances of less than $250,000 brings us down further, to 42,309 loans. While not exactly the 33,000 estimate of FHFA, it is close enough to give a sense of how they got there.

TABLE 1A

Seriously Delinquent (SDQ) Loans

Fannie Mae	267,174
Freddie Mac	141,255
Total	**408,429**

TABLE 1B

Underwater SDQ Loans

Category	MTMLTV	Share (%)	Number
Underwater	≥100	18.00	73,514
5 percent underwater	≥105	14.39	58,787
10 percent underwater	≥110	11.53	47,086
15 percent underwater	≥115	9.25	37,759

Note: MTMLTV=mark-to-market loan-to-value ratio.

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TABLE 1C

Owner-Occupied Underwater SDQ Loans

Category	Owner-Occupied	Owner-Occupied and Size ≤$250,000
Underwater	65,860	52,908
5 percent underwater	52,667	42,309
10 percent underwater	42,184	33,888
15 percent underwater	33,828	27,176

Notes: Owner-occupied loans make up 89.58 percent of the market, and owner-occupied loans less than $250,000 make up 71.97 percent of the market. The FHFA estimated that the latter group consists of 33,000 borrowers.

It is more difficult to estimate the take-up rate given its dependence on behavioral variables that are difficult to predict. That said, we assume that the take-up rate for a program in which borrowers will have their principal forgiven will be considerably higher than an otherwise identical program in which its repayment would merely be delayed, simply because it is a much more attractive offer. The publicity around the announcement and the requirement that servicers identify and solicit those who could qualify should also drive up the take-up rate. However, many eligible borrowers are severely delinquent and have declined the help offered to date, which suggests that a significant number will remain nonresponsive to outreach. Given these factors, we estimate that the take-up rate could be as much as twice that of the comparable forbearance program, or 19 percent, although it is unlikely to be much higher. Whether it can reach this level depends on how aggressively consumer groups that work closely with distressed borrowers supplement the servicers' outreach so that borrowers understand the attractiveness of the option and the limited time frame in which to accept it. Given FHFA's eligibility numbers, a 19 percent take-up rate would imply a total of around 6,300 principal reduction modifications.

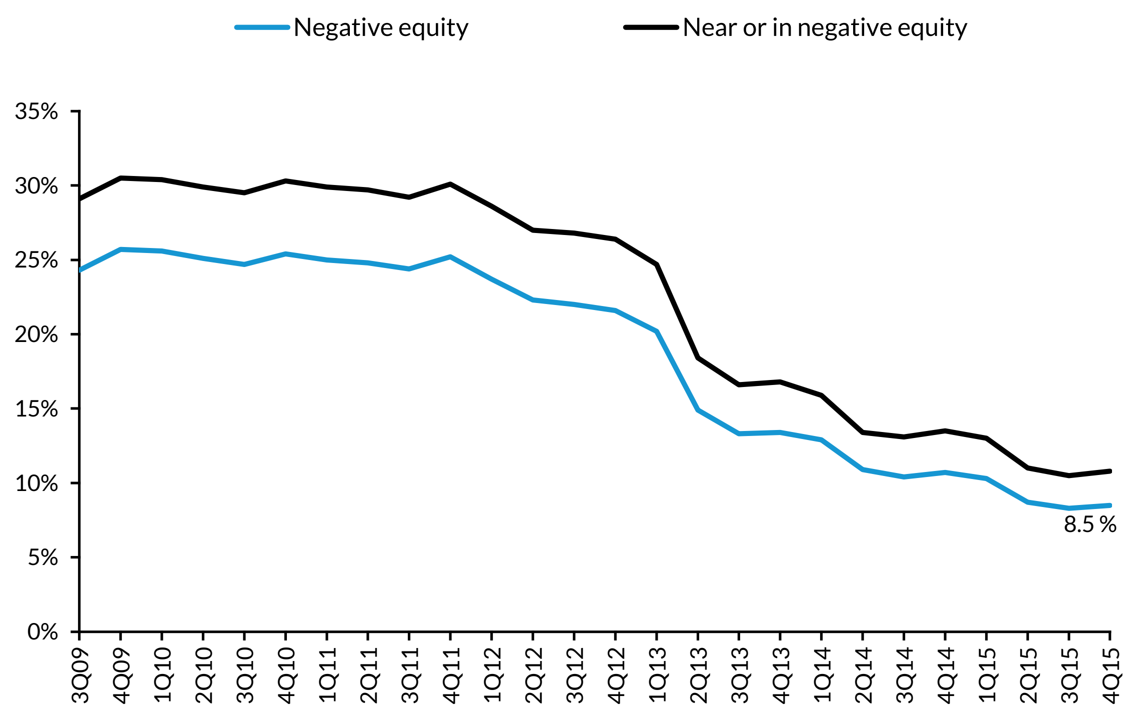
The modest numbers are driven by an improving economy, not an overly conservative program

To meaningfully increase the number of borrowers who would benefit from this program, the FHFA would have to adjust one or more of the three most binding criteria: participants are severely delinquent; participants were severely delinquent as of March 2016; and participants are at least 15 percent underwater. It is difficult to see which of those constraints could be reasonably loosened. Borrowers who are not severely delinquent have not signaled the need for assistance; borrowers who are only barely underwater are likely to be brought back above water soon with even a modest continuation of home price appreciation; and if the FHFA were to remove the date restriction, it might provide incentives to borrowers who can afford to pay their mortgages to stop paying to receive the benefit.

The modest numbers are less a function of an overly conservative program than of an improving economy. The number of underwater borrowers and seriously delinquent loans are both down sharply in recent years. According to CoreLogic, the number of underwater borrowers has declined from 25 percent in 2011 to 8.5 percent in 2015 (figure 1). This is primarily because of increasing home prices.

FIGURE 1

Negative Equity Share

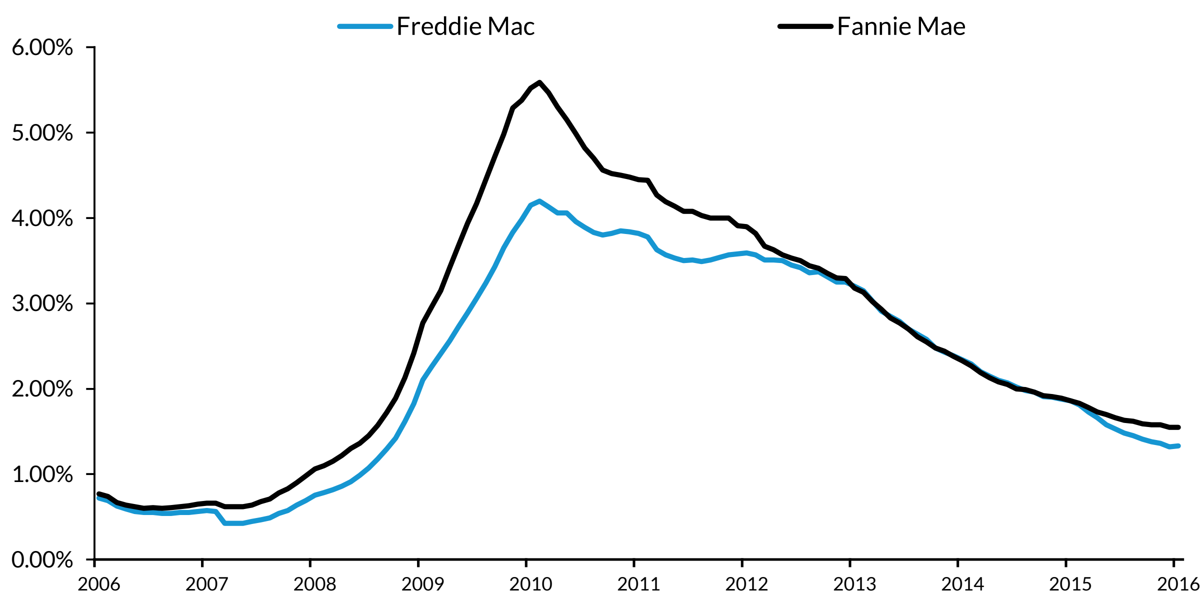


Sources: CoreLogic and Urban Institute.
Note: CoreLogic negative equity rate is the percentage of all residential properties with a mortgage in negative equity. Loans with negative equity refer to loans above 100 percent LTV. Loans near negative equity refer to loans above 95 percent LTV.

The number of seriously delinquent loans has fallen just as dramatically: at Fannie, they have declined from a peak of 5.59 percent in February 2010 to 1.55 percent in January 2016; at Freddie, they have fallen over the same period from 4.2 percent to 1.3 percent (figure 2). This drop has been driven by liquidations and loan modifications that have brought borrowers current. Since the third quarter of 2007, Hope Now numbers indicate there have been 7.92 million liquidations and 7.73 million modifications.

FIGURE 2

Serious Delinquency Rates on GSE Loans



Sources: Fannie Mae, Freddie Mac, MBA Delinquency Survey, and Urban Institute.
Note: Serious delinquency is defined as 90 days or more past due or in the foreclosure process.

Why the program still matters

Despite the relatively small number of borrowers who will benefit, this program is important because it ends the prohibition on principal reduction long maintained by the GSEs. During the throes of the crisis, the GSEs' refusal to reduce principal stymied efforts by policymakers and industry participants to ease the growing pressure exerted on the fragile market by a rising tide of negative equity. By ending the prohibition, this move finally avails future policymakers of a critical tool to address the needs of distressed borrowers in a distressed market the next time we face that challenge.