Recovering Housing Market Solves Principal Reduction Dilemma

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Senate Republicans are drawing a bead on Rep. Mel Watt (D-NC), President Obama's pick to take over as Director of the Federal Housing Finance Agency (FHFA). A key reason is that Watt supports principal reduction, which is anathema to the GOP.

It would be a shame, however, if Watt's confirmation were scuttled over a dispute that has been overtaken by events. U.S. housing markets have come roaring back to life, and while that's great news, it has probably closed the window for principal reduction.

During the depths of the housing crisis, many progressives called for reducing the mortgages of homeowners who are "underwater," meaning they owe more than their house is worth. Conservatives bitterly opposed principal reduction, saying it would reward irresponsible borrowers and expropriate the property of legitimate lenders.

FHFA Director Ed DeMarco, the man Watt has been nominated to replace, resolutely resisted pressure from the Obama administration and Congressional Democrats to use principal reduction remedies on mortgages backed by the two Government Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac

Recently, the White House announced a two-year extension of their central housing modification program, Home Affordable Modification Program (HAMP). The program differs from the Administrations similarly titled refinancing initiative, Home Affordable Refinancing Program (HARP) in that it allows underwater homeowners structural changes to their loans whereas HARP just lowers the interest rate.

According to a memo circulated by Compass Point Research and Trading," The extension of the HAMP gives the Obama Administration the necessary optionality to push for principal reduction on GSE-backed mortgages through the HAMP if there is a change in leadership at the Federal Housing Finance Agency (FHFA)."

Compass Point goes on to point out," While it is important to note Rep. Watt has softened his position on principal reduction since being nominated, we still believe that Rep. Watt would embrace principal reduction on GSE-backed mortgages through HAMP if he were to be confirmed."

House Financial Services Committee Chairman Jeb Hensarling (R-Texas), strongly opposed the HAMP extension issuing a statement saying, "HAMP is a costly and abject failure that takes money from hardworking taxpayers, bails out banks that made bad loans, and forces Americans who struggle to pay their own mortgages to also pay their neighbor's."[1]

Housing Market Leads Recovery

When the bubble burst in 2007–2008, housing prices took a sickening dive, wiping out $7 trillion in home equity and triggering a wave of defaults. But while the federal government bailed out the banks and other financial institutions, it didn't throw underwater homeowners much of a lifeline.

True, the Obama administration's HARP program cut interest rates on underwater loans, but that wasn't enough to keep many homeowners from being dragged under by "negative equity." That's why many progressives took up the cause of principal reduction. PPI endorsed a variation on this theme—a two-year pilot program for "shared appreciation" in which lenders could buy a share of a homeowners' loan balance, and gain in the upside when housing prices recovered.

That was then. Now, however, housing markets are rebounding vigorously, a bright spot in an uneven recovery. In many regions, home prices are rising sharply, lifting millions of homeowners above water and giving a boost to home construction. Politically speaking, the window for principal reduction has probably closed.

Not so, say advocates, including the U.S. Treasury Department. They note that more than 10 million homeowners are still underwater, albeit 1.7 million less than at the end of 2011.[2] With the possible departure of FHFA Chief Ed DeMarco, a staunch opponent of principal reduction, the agency can reverse course and start offering people a chance to cut their loan balances as well as interest rates. In truth, however, this isn't the time for a political donnybrook over principal reduction. Here's why:

1. **Housing markets are on fire.** The housing market is enjoying sustained momentum alongside record highs in the stock market, and is finally leading the broader recovery. According to the Case-Schiller index, prices appreciated 10.2% in March, above analysts' expectations.[3] Housing analytics firm Core Logic calculates that a price jump of 5% would be enough to lift another 1.8 million homeowners above water.[4]

Meanwhile, Fannie Mae and Freddie Mac (GSEs) are hauling in bales of cash. Consequently, Fannie has been able to pay off about $95 billion and Freddie about $37 billion of the approximately $182 billion[5] they received from a taxpayer bailout. That means the mortgage giants may be able to exit federal conservatorship years ahead of schedule. And unless the Fed abandons quantitative easing, interest rates are expected to remain relatively low for the next few years.

What we need more than anything else, of course, is jobs. People who don't have them can't pay their mortgages on time or save for a down payment. More people working means fewer delinquencies, decreasing defaults and more first-time homebuyers to keep the housing market churning.

2. **The President's main response to the housing crisis—HARP—is working.** FHFA recently expanded the program to the end of 2015. Many of the estimated 2 million homeowners that still qualify for the program will be able to refinance as more families see the value of their homes continue to rapidly rise.

   HARP got off to a rocky start as the program launched, mostly under the weighty expectations set by the Administration itself. But it has gradually turned into a success story, with 2.4 million borrowers who have refinanced and locked in generationally low interest rates.[6]

3. **It's time to bring private investors back—not scare them off.** The government's intervention saved the housing markets, but its mortgage lending footprint is too large—covering over 90% of all new mortgages. It's tough for private lenders to compete with the GSEs. Mortgage giants have a price advantage because they have a government guarantee, which makes their costs extremely low. A big push now for principal reduction would confront private investors with the risk of government-imposed losses, which is hardly an environment that emboldens them to return to housing markets.

4. **It's not time to increase homeowner's tax burden.** "The Mortgage Debt Relief Act of 2007" was passed by Congress to allow the amount of principal forgiveness on a primary residence to be excluded from taxable income. Normally, if a homeowner had $50,000 reduced on the balance of their mortgage, then that $50,000 would be included in their taxable income that year. Homeowners in the 25% tax bracket would see their tax bills rise by $12,500.

   But an extension to the law is set to expire at the end of 2013, effectively front-loading the tax burden of principal reduction. It's hard to see this Congress extending it again.

5. **The "outs" will resent the "ins."** The most difficult question surrounding principal reduction is who should qualify for it? Essentially, un-

derwater borrowers who have fallen behind on their payments would qualify while underwater borrowers who have kept up their payments would qualify for the HARP program, lowering their rate but not their loan balance. Administration opponents would no doubt successfully call it yet another bailout (and technically it is—remember Rick Santelli's rabid rant over bailing out troubled homeowners—the moment effectively gave birth to the modern Tea Party.)

Conclusion

Rather than fight over emergency measures, lawmakers ought to focus on shoring up the fundamentals of our fast-recovering housing market. It's imperative to make sure the FHA regains its solvency, so low-income, minorities and first time homebuyers have the opportunity to achieve the American dream. Congress needs to graduate the GSEs from conservatorship and decide their future so the market can begin to draw in private investors and reduce taxpayer exposure.

These are necessary priorities that will keep a broad rise in the market stable, which only helps serve everyone.

Endnotes

[1] United States, Congress, The House of Representatives, The Committee of Financial Services, "Chairman Hensarling Opposes Obama Administration Decision to Extend Failed HAMP", 113th Congress, May 30, 2013. http://financialservices.house.gov/news/documentsingle.aspx?DocumentID=335875

[2] Julie Schmidt, "Rising Prices Buoy Up Some Underwater Homeowners", *USA Today,* March 19, 2012, Available at: http://www.usatoday.com/story/money/business/2013/03/19/rising-home-prices-reduce-underwater-borrowers/1997729/.

[3] Mark Lieberman, "Case-Shiller Indices Show Strongest Gain Since 2006", *DSNews.com, May 28, 2013,* Available at: http://www.dsnews.com/articles/case-shiller-indices-show-strongest-gain-since-2006-2013-05-28.

[4] Prashant Gopal, "U.S. 'Underwater' Homeowners Regain Equity as Prices Rise", *Bloomberg*, March 19, 2013, Available at: http://www.bloomberg.com/news/2013-03-19/u-s-underwater-homeowners-regain-equity-as-prices-rise.html.

[5] Carey Vanderborg, "Fannie Mae to Make $59.4B Dividend Payment to US Government", *International Business Times*, May 9, 2013, Available at: http://www.ibtimes.com/fannie-mae-make-594b-dividend-payment-us-government-1249205#.

[6] Scott E. Reckard, "Federal Refi Programs for Underwater Homeowners Hits Its Stride", *LA Times*, April 26, 2013, Available at: http://articles.latimes.com/2013/apr/26/business/la-fi-harp-refinance-20130427.

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