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Principal Reduction: Is Debt Forgiveness Fair?

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Few topics have sparked more debate among housing market watchers than mortgage principal reduction. Its proponents tout debt forgiveness as one of the surest ways to counteract the housing slump. Its critics label it a handout that would cost taxpayers and spur further defaults.

The arguments for and against are only going to get hotter. In 2010, principal reduction was included in just 11 percent of those mortgage modifications without government guarantees. But by the fourth quarter of 2011, the number had jumped to 40 percent, according to a report by mortgage research firm Amherst Securities Group. And it's likely to rise still further: The "robo-signing" settlement reached in February requires the country's five major mortgage servicers to perform at least $10 billion in write-downs, mostly on loans that they own, to atone for illegal foreclosures.

Now principal reduction is nipping at the heels of Fannie Mae and Freddie Mac. Many consumer advocates and policymakers are calling for the twin mortgage guarantors to adopt the loss-mitigation tactic, but so far the mortgage giants' conservator, the Federal Housing Finance Agency, has resisted.

Simmering beneath the surface of data-driven arguments both for and against principal reduction burns a more profound question, one that no doubt colors how most people view the proposed method:

Is principal reduction fair?

The question isn't just academic to borrowers like Doreen Thomas, a 78-year-old widow who has lived in her Maplewood, N.J., home since 1999.

Thomas (pictured above) receives $604 a month from Social Security, but with a $1,444 monthly mortgage payment, she's looking at eventual default. At this point, she has used up her savings and no longer can rely on assistance from her daughter, who has her own children to support.

Thomas has tried off-and-on for three years to acquire a loan modification. Recently, she said, Wells Fargo rejected her latest application.

"The little help I used to get, I don't know how much longer I will get it," Thomas said. "But then, something else might turn up. I do a lot of praying."

The Specter of 'Moral Hazard'

If she does stop paying her mortgage, she may then be eligible for principal reduction, which often requires that homeowners be in default to qualify. That raises the "moral hazard" objection: If Thomas stops paying, then other homeowners might do likewise in order to receive the same aid, said Mark Calabria, director of Financial Regulation Studies at the conservative Cato Institute.

FHFA acting director Edward DeMarco has said that this is one reason why he has resisted allowing Fannie Mae and Freddie Mac to use principal reduction.

"A key risk in principal forgiveness targeted at delinquent borrowers is the incentive created for some portion of these current borrowers to cease paying in search of a principal forgiveness modification," DeMarco said at a speech at the Brookings Institution in April.

All forms of mortgage modification, not just principal reduction, carry some of the same risk, but critics say that principal reduction offers more of an incentive for a homeowner to strategically default. Calabria points out that principal reduction, unlike a break on an interest rate, offers a lasting reward in the form of increased home equity. And, he added, debt forgiveness also puts a homeowner closer to having a home value that exceeds his or her loan, which makes it much easier for a borrower to sell.

Whether or not you buy into the argument of moral hazard often depends on whom you hold responsible for the housing bust. Kathleen Day, a spokesperson for the Center for Responsible Lending, puts it on the lenders.

"It's the banks that were bailed out," she said. "It is they who incurred the moral hazards.... They got to keep all their executive pay, so they privatized the gain, but when it came time to bail out, they socialized the risk."

Five years into the housing crisis, Day said, there is no evidence that principal reduction, which has been used by some lenders, has spurred many homeowners to default: "It was a bogus argument, and it is a bogus argument."

The Blame Game

Thomas Martin, president of America's Watchdog, a consumer advocacy group, believes too-big-to-fail lenders acted on a moral hazard, knowing that the U.S. government would bail them out if the music stopped -- as, of course, it did.

That rash approach to business, along with some lenders' tendency to lure borrowers into loans that they could not afford, justifies debt forgiveness in the minds of many -- regardless whether it costs lenders money.

"The ignition point was bank fraud on a scale never seen before," Martin said. "Should those guys pay? I mean, yeah!"

But what about those homeowners who didn't know when to stop in their drive to buy bigger or better, or who didn't seriously weigh the risks of buying a home to begin with?

Should You Pay for Your Neighbor to Stay?

The question of whether lenders should reduce principal on some distressed mortgages grows even more fraught in the case of write-downs performed under government-sponsored programs like the Home Affordable Modification Program.

Taxpayers fund HAMP, which subsidizes modifications on distressed mortgages. So when a lender performs a HAMP modification, taxpayers are footing some of the bill.

"It's picking winners and losers," Calabria said. "It's implicitly transferring income from one party to another."

Even in the case of principal reductions performed by lenders without HAMP subsidies, the cost may reach everyday Americans. Investors, such as pension funds, who own packaged loans (mortgage-backed securities) take a hit. "It's a wash," Calabria said. "You're redistributing income instead of creating it."

Fannie and Freddie in a Fix

Lawmakers, government officials and consumer advocates continue to pressure the FHFA -- which has controlled Fannie and Freddie since the government bailed them out in 2008 -- to approve principal reductions.

Previous FHFA studies found that principal reduction would end up costing taxpayers billions of dollars. However, a recent analysis upended that conclusion. It found that, even after accounting for the cost of HAMP subsidies paid by taxpayers, a debt-forgiveness program would save the public $1 billion, The Wall Street Journal reported.

Nonetheless, FHFA Acting Director DeMarco announced today that taxpayer-owned Fannie and Freddie, which back 60 percent of U.S. mortgages, still wouldn't approve a principal-reduction program. He said that the potential costs of a debt-forgiveness program outweighed its potential benefits, mentioning specifically the possibility that such a program could create a moral hazard where homeowners would default just to qualify for principal forgiveness.

In such a scenario, questions of fairness would surely come back into play. "Somebody has got to pay the taxes for it," Calabria said. "It's taking from a hand and giving to another."

principle reduction Mark Ritter

An Ethical Dilemma, Even for Those Who Benefit

Even some of those who have benefitted from principal reduction feel the conflict.

Mark Ritter (pictured above with his wife) stopped paying his mortgage in early 2011, after he was forced to quit his job in order to care for his wife, who suffered from a form of Alzheimer's that made her visually disabled. After sliding into delinquency, he struggled for almost a year to get his lender to lower the 10 percent interest rate on his mortgage.

But his persistence paid off: After persevering through countless paperwork headaches, Ritter, with the help of free counseling services offered by NeighborWorks HomeOwnership Center, finally prevailed. He said that his lender reduced his rate to 2.0 percent, and promised that he would receive $18,000 in principal reduction if he keeps up on his payments.

The end result, he said, has made him feel "wonderful." Nonetheless, even he isn't sure if he fully agrees with the modification technique that has helped make it possible for him to hold onto his home.

"From one point of view, I don't know," Ritter said. "I don't know if it is justified because you agreed to pay a certain amount.

"On the other hand, the exorbitant interest -- the fact that I paid already going on $50,000 interest to the financial institutions -- maybe an $18,000 reduction isn't a huge deal to them."

Thomas, despite her financial situation, doesn't want others to help pay off something that she made a promise to pay herself.

"I don't agree with it," she said. "Yes, [lenders] should help. But only through interest rate."