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Fannie, Freddie to Cut Mortgage Balances for Thousands of Homeowners

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Thousands of homeowners will be eligible to have their mortgage balances cut under a plan approved by the federal regulator of mortgage-finance companies Fannie Mae and Freddie Mac, according to people familiar with the matter.

The plan approved by the Federal Housing Finance Agency marks the first time that Fannie and Freddie will reduce mortgage balances on a large scale for struggling homeowners since the housing crisis erupted. But it doesn't go as far as some housing advocates wanted.

Fewer than 50,000 "underwater" homeowners, who owe more than their homes are worth and are already behind in their mortgage payments, will likely be eligible, people familiar with the matter said.

Fannie and Freddie—which don't make mortgages but rather buy them from lenders and wrap them into guaranteed securities—would also forgive principal only in cases where they determine the companies would lose less money with that option than foreclosure or other foreclosure-prevention methods. In addition, the new program will likely be limited to mortgages whose outstanding principal balance is under a certain dollar amount, people familiar with the matter said.

Because of the plan's restrictions, it won't have a significant impact on the national housing market, said Moody's Analytics chief economist Mark Zandi.

Still "it makes economic sense to do for everyone involved. It will keep some stressed homeowners in their homes, reduce losses to Fannie, Freddie and thus taxpayers, and could if focused, buoy some hard pressed neighborhoods," Mr. Zandi said.

The plan could be announced within the next few weeks, the people said.

About 4.3 million borrowers were underwater as of the end of 2015, according to real-estate data firm CoreLogic, down from 12 million in 2009. Not all those loans are backed by Fannie and Freddie.

In the past, policy makers have explicitly rejected reducing the principal of mortgages backed by Fannie and Freddie, which were bailed out during the 2008 financial crisis and put into a so-called conservatorship under the direction of the FHFA.

Conservatives and others have long worried that any program involving principal reduction would signal to homeowners that such steps might be used in future crises.

“Is the role of Fannie and Freddie to make sure your house doesn’t decline in value? I don’t remember seeing that in the charter,” said Mark Calabria, director of financial regulation studies at the libertarian Cato Institute.

On the other hand, supporters of principal reduction say the tool is effective in getting some delinquent homeowners to start paying their mortgages again, which in the long-term can save taxpayers money. Some advocates say that the benefits can flow to the rest of the community, as the homeowner becomes more likely to spend to maintain their home.

“Homeowners behave differently when they feel like a glorified renter versus when they feel like they’re an owner,” said Julia Gordon, executive vice president of the National Community Stabilization Trust, a nonprofit that works in neighborhood revitalization.

Principal reduction at Fannie and Freddie has been debated for years. The Obama administration’s signature foreclosure prevention program—the Home Affordable Modification Program—encouraged mortgage servicers to reduce principal in some instances.

But the FHFA is independent of the administration and has been slow to roll out a program. Edward DeMarco, FHFA director from September 2009 until January 2014, wouldn’t use that option, citing the risk to taxpayers.

Mr. DeMarco, now a fellow at the Milken Institute, on Monday said the FHFA’s research in 2012 indicated lowering a borrower’s monthly payment mattered most to avoiding foreclosure and that other methods of modifying loans were more effective than principal reduction. Most underwater borrowers still paid their mortgages and “we didn’t want to create an incentive for them not to be current,” Mr. DeMarco said.

Some left-leaning housing advocates hoped that Mr. DeMarco’s successor, former Democratic Congressman Melvin Watt, would move quickly on a broad principal-reduction program. Instead, Mr. Watt took a slower, more-measured approach, frustrating some advocates and lawmakers.

“It has been six years since Congress created FHFA, and in all that time, your agency has never, not once, permitted a family to reduce its principal,” said Sen. Elizabeth Warren (D., Mass.) in a hearing with Mr. Watt in November 2014. Mr. Watt at the time said that the agency would come up with a plan soon.

Since then, the potential impact of a principal-forgiveness plan has greatly diminished, not just because of foreclosures but also because of rising home values.