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U.S. Foreclosure Settlement Muddies Outlook for Mortgage Relief

Story tools

April 14 (Bloomberg) -- The foreclosure-abuse settlements announced yesterday by federal regulators may make it harder for state attorneys general and the Obama administration to force banks to reduce loan balances for more troubled U.S. homeowners.

The 14 largest U.S. mortgage servicers, including JPMorgan Chase & Co. and Wells Fargo & Co., agreed to review all foreclosed loans from 2009 and 2010, and pay back losses in cases that were mishandled. They also will improve procedures by hiring staff, upgrading document-tracking systems and assigning a single point of contact for each borrower.

While the attorneys general proposed many similar terms last month, banking regulators didn't include any requirements for lowering mortgage debt. That may hinder Iowa Attorney General Thomas J. Miller as he leads a group of state officials working with the administration to require lenders to evaluate loan cuts for some borrowers whose homes are worth less than their mortgages.

“I have always been pretty skeptical about the ability of principal reductions to get you much,” said Mark A. Calabria, director of financial-regulation studies at the Cato Institute, a public-policy research group in Washington. “I think we will look back and say this was the death knell.”

The settlements, which include yet-to-be determined monetary penalties, also prohibit banks from seizing homes for which borrowers have negotiated a trial or permanent loan modification. The attorneys general proposal goes a step further, freezing the foreclosure process even while borrowers are being evaluated for workouts.

Divided Views

The agreements stem from reviews of the mortgage-servicing industry by the Office of the Comptroller of the Currency, the Federal Reserve, the Office of Thrift Supervision and the Federal Deposit Insurance Corp. The banks didn't admit or deny regulators' findings.

The loan-reduction rules are the most divisive part of Miller's bid to get servicers to settle with all 50 states on allegations of abusive foreclosure practices. In the past month, at least seven state attorneys general rejected the proposal, and Brian T. Moynihan, chief executive officer of Bank of America Corp., said widespread principal cuts were bad policy.

Miller has pushed for such relief as one of the best ways to bolster the housing market by reducing foreclosures, which drive down property values for homeowners who continue to pay their mortgages.

HAMP's Shortcomings

The Treasury Department's main foreclosure-prevention program, which lowers monthly payments, has resulted in about 600,000 permanent loan modifications, short of its goal of up to 4 million. The Home Affordable Modification Program, also known as HAMP, doesn't require loan cuts.

Federal regulators said the decision to craft their own deal doesn't preclude what they call a global settlement with banks that could also include the state attorneys general and Obama administration.

Officials from Justice Department, the Department of Housing and Urban Development and 10 state attorneys general met yesterday for a second time with banks to negotiate a broader settlement, Associate U.S. Attorney General Tom Perrelli told reporters. The group is discussing potential fines and whether servicers should be required to reduce the principal on some home loans.

The agreements “will not limit our pursuit of remedies and reforms,” Iowa's Miller said yesterday in a statement. HUD Secretary Shaun Donovan said the deals support their broader effort.

Rewarding Default

“The Obama administration and the state attorneys general are committed to ensuring the banks are held accountable in a way that helps to strengthen the housing market and helps American families stay in their homes,” he said yesterday in a statement.

Opponents of mandatory loan writedowns, including the Office of the Comptroller of the Currency and dissenting attorneys general, say they reward borrowers for failing to meet their obligations and could cause additional defaults as homeowners stop making payments so they can qualify for help.

“There's very little incentive for the banks to accept any deal that's going to require them to forgive significant amounts of principal for underwater borrowers,” said Jaret Seiberg, a financial-policy analyst for Washington Research Group, a Washington-based unit of broker MF Global Holdings Ltd. “It's one of those slippery slopes where once you start, you don't know where you'll end.”

Case Against Writedowns

The Office of the Comptroller of the Currency, the primary overseer of national banks, supports giving lenders the option to cut borrowers' debt, Bryan Hubbard, a spokesman for the regulator in Washington, said in an e-mail.

Mandatory reductions don't make sense because contracts with some investors who own bonds backed by mortgages don't permit them, and it isn't fair to make servicers or investors absorb losses from declining property values that would ordinarily be borne by homeowners, he said.

“Principal reduction results in immediate and permanent loss to servicers/investors with no potential for recovery if property values rise or the borrower's financial condition improves,” he wrote.

The federal settlements come as the U.S. housing market remains under pressure from unemployment of almost 9 percent. A record 2.9 million properties received foreclosure filings in 2010, according to RealtyTrac Inc., a data firm in Irvine, California. Sales of existing homes fell 9.6 percent in February, and distressed properties accounted for 39 percent of deals, data from the Chicago-based National Association of Realtors show.

Case for Writedowns

About 27 percent of U.S. mortgage holders were underwater at the end of last year, according to Zillow Inc. of Seattle, a real estate information company.

A targeted program to lower principal for struggling homeowners can help shrink the overhang of foreclosures, said Cristian de Ritis, a director at Moody's Analytics Inc., an economics-research firm in West Chester, Pennsylvania. Borrowers who have loan balances in line with their home values have an incentive to keep paying and a cushion if they lose a job or face other financial setbacks.

About 200,000 to 500,000 mortgage holders could qualify for a writedown and stay current on payments as long as changes are implemented within the next six months, de Ritis said. Standard & Poor's, the New York-based ratings company, said in a Feb. 7 report that trimming mortgage balances is the “most effective” and “least frequent” modification. Less than 3 percent of workouts include writedowns.

“If the program is delayed, it will have less of an impact as many distressed borrowers will have already lost their homes,” de Ritis said.

Fixing System

The attorneys general and federal regulators began separate probes of the industry late last year amid allegations of shoddy practices such as robo-signing, or using workers with little or no training to sign thousands of documents filed in support of foreclosures without reading them. The investigations were broadened to include all aspects of the servicing business.

“Our enforcement actions are intended to fix what is broken, identify and compensate borrowers who suffered financial harm and ensure a fair and orderly mortgage-servicing process going forward,” John Walsh, acting comptroller of the currency, said yesterday in a statement.

The regulators deal with servicers is a victory for banks that shows how their political muscle has been strengthened after atrophying during the financial crisis. Servicers may now be less inclined to agree to a deal with the states including mortgage relief.

‘Moral Hazard'

“The regulators' settlement lets the banks' defenders say that anything else is piling on,” said Peter Swire, a law professor at Ohio State University in Columbus, Ohio, who was an adviser on housing issues to President Barack Obama until August.

Regulators are too cozy with the banks they oversee, said Paul Leonard, director of the California office for the Center for Responsible Lending, which seeks to protect homeownership and family wealth. He said banks are in no position to argue that bailing out troubled borrowers creates a “moral hazard” that will encourage other homeowners to seek handouts.

“Banks are ignoring the hypocrisy of having accepted billions of dollars of federal bailouts when they wouldn't have survived without such federal largesse,” Leonard said.

More than 1.8 million homes are projected to be taken this year in foreclosures, short sales and voluntary dispossessions known as deeds in lieu, according to Moody's Analytics. Borrowers lost 1.67 million homes in 2010, the research firm said.

Writedown Challenge

Paul Willen, an economist with the Boston Federal Reserve, said the danger of offering a program for loan cuts is that lenders will be inundated with applications from borrowers, most of whom don't need them, slowing the already clogged foreclosure pipeline. The inherent challenge with writedowns is identifying which borrowers are sufficiently discouraged by their equity position to stop making payments, Willen said.

“We do not see broad-based principal reduction as a sound policy decision for America,” Bank of America's Moynihan said April 12 in prepared remarks to state attorneys general in the company's hometown of Charlotte, North Carolina. “It's hard to see how we could justify reducing principal for many delinquent customers who represent a small portion of borrowers, but not for the vast majority of our customers who have stayed current on their loans.”

Credit Rating ‘Ding'

Lenders can avoid moral hazard issues by adding “frictions” to the program so that “those who don't need principal reductions are not envious of those who receive it,” Laurie Goodman, senior managing director at Amherst Securities Group LP in New York, said in a March 24 report. The borrower could be forced to share any future appreciation with the lender or face a credit-rating “ding” by accepting the modification, she wrote.

Miller's 50-state coalition began to fracture last month when a 27-page list of proposed settlement terms leaked and at least seven Republicans attorneys general, including Florida's Pam Bondi and Virginia's Kenneth Cuccinelli, came out against it. New York Attorney General Eric Schneiderman said April 11 that a settlement shouldn't preclude individual states from investigating servicers.

“The term sheet's principal reduction proposals may actually foster an unintended ‘moral hazard' that rewards those who simply choose not to pay their mortgage -- because they can simply take advantage of lenders' obligation to honor virtually automatic principal writedowns,” according to a March 22 letter to Miller signed by the attorneys general of Virginia, Texas, Florida and South Carolina.

One Tool

Prentiss Cox, a University of Minnesota law professor and former assistant state attorney general, said the attorneys general don't need all 50 states onboard to be successful. If a reasonable number of states are represented, banks might see the terms as a de facto national standard, he said.

“When you have federal regulators like the OCC captive to the industry they regulate, it's critical that the AGs use the law-enforcement function to create rules that are more balanced in favor of consumers,” Cox said.

While Miller hasn't disclosed the size of the potential penalties servicers may face, the group could seek $20 billion, two people briefed on the talks said in February.

Geoff Greenwood, a spokesman for Miller, said writedowns are just “one tool in the toolbox.”

“He favors doing so only in appropriate circumstances where the homeowner simply cannot afford the payment,” Greenwood said. “And he would want to ensure that it's structured in a way to prevent strategic default.”

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