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Analysis: Mortgage probe may open new path for housing relief

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By Aruna Viswanatha and Rick Rothacker

(Reuters) - A controversial weapon could be deployed soon in the U.S. fight against the housing crisis as states and top banks near a deal in their dispute over mortgage abuses -- cutting the mortgage debt owed by homeowners.

Five major banks could be required to commit roughly $15 billion to reduce principal balances for struggling homeowners and modify loans in other ways under a proposed deal to settle allegations linked to the "robo-signing" scandal.

That amount would be part of broader sanctions that could total $25 billion, small change for the giants of Wall Street but potentially sowing the seed for a new approach to tackling the housing crisis.

Settlement talks continue with the banks, state attorneys general and some federal agencies over foreclosure shortcuts and other abuses. A deal could be struck within a month, according to people familiar with the matter.

Much of the exact language has yet to be hashed out but it could provide for the first broad use of principal writedowns, something economists and housing advocates say is a drastic but needed step to help set right the housing market.

Investors and the government-controlled mortgage finance giants Fannie Mae and Freddie Mac -- which own around half of all U.S. mortgages -- have long resisted the idea.

There are concerns it could encourage some borrowers to stop paying in order to qualify for a reduction in their overall mortgage.

Fannie and Freddie's regulator has been wary of allowing principal reductions, doing so would lower the value of the assets held by the taxpayer-supported firms.

More broadly, public anger over the possibility of bailouts for homeowners who got out of their depth in debt is seen as one of the origins of the conservative Tea Party movement.

Given the political sensitivity, the Obama administration has so far trodden carefully to help homeowners. It wants to let more borrowers refinance to lower interest rates and stretch out the terms of loans to reduce monthly payments.

Some officials at the Federal Reserve say the central bank should buy more mortgage debt to bring down borrowing rates.

But those efforts do little to address the underlying problem, that many borrowers owe more than their homes are worth.

Under a potential settlement, the five banks -- Bank of America, JPMorgan Chase, Citigroup, Wells Fargo, and Ally Financial -- would have to meet dollar targets to reduce principal for underwater borrowers.

"I think it will be a step in the right direction," said Ira Rheingold, executive director of the National Association of Consumer Advocates. "The AGs hope this could work as a pilot program, and show how principal reduction could work."

To be sure, the reductions will have limited impact. The deal is unlikely to touch mortgages held by Fannie and Freddie. And according to a back-of-the-envelope calculation, $15 billion in reduction at $50,000 per borrower could reach around 300,000 borrowers, a fraction of the 11 million underwater homeowners.

But a deal may prompt banks to expand the limited principal reduction programs that they have so far directed toward only the riskiest loans in their portfolios.

The settlement could lay the groundwork for a broader program, if Fannie and Freddie are swayed to test it out themselves as an alternative to the costly process of foreclosing on struggling borrowers.

"Fifteen billion (dollars) is a drop in the bucket, but here might well be the very opportunity to conduct an experiment," said Ken H. Johnson, a professor at Florida International University's business school.

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One model could be the 2008 settlement between Countrywide, the mortgage lender bought by Bank of America in that year, and state attorneys general. It provided a framework for loan modifications that became the basis for the administration's Home Affordable Modification Program which has so far had only a modest impact.

That deal set up the now widely used "waterfall" approach to trying to lower a borrower's monthly payment through a series of steps that include reducing the interest rate, extending the term of the loan and deferring some principal.

The states are hopeful a settlement on foreclosure abuses could have a similar ripple effect.

Not all states are satisfied with Bank of America's compliance with the 2008 settlement, presaging some concerns that could arise in any new settlement. Nevada and Arizona sued the bank saying it did not honor its obligations and engaged in "deceptive" practices in dealing with distressed borrowers.

Shum Preston, a spokesman for the California attorney general, also said that his office continues to receive complaints from Countrywide borrowers.

But Massachusetts, which last year extracted an additional commitment from Bank of America to reduce around $3 billion in principal on some of its riskiest loans across the country, said the bank had been complying with the settlement.

A spokesman for the attorney general's office in the state, Brad Puffer, said around 2,600 residents have received loan modifications under the settlement, saving some $125 million in mortgage payments, including both principal reductions and other types of modifications.

Bank of America said it had extended 49,000 offers to reduce principal for underwater borrowers nationwide, forgiving almost $3 billion in principal payments, since the agreement.

That settlement, and a similar one by Wells Fargo, were directed at the riskiest loans, leaving largely untouched more traditional mortgages that still deep underwater due to cratering home prices.

Wells says it has provided $4 billion in principal reduction as part of 96,000 modifications completed since the Wachovia acquisition. In addition, since 2010, Wells has participated in a HAMP principal reduction program.

"We're never been here before so we can't look to past experience," said Johnson, the business school professor, "with the added complexity of what foreclosures do to market pricing, some form of principal reduction may be the answer."

(Reporting by Aruna Viswanatha in Washington D.C. and Rick Rothacker in Charlotte, North Carolina; Editing by Tim Dobbyn)
