

Moody's Questions Feasibility of Fannie Mae's Strategic Default Policy

*Carrie Bay
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Last month, Fannie Mae announced new policy changes intended to deter financially competent homeowners from walking away from their mortgage obligation by imposing stiffer penalties for strategic default – a phenomenon that has become increasingly more common as home prices have plummeted and more and more borrowers find that they owe more on their mortgage than the home is worth.

The GSE says borrowers who intentionally default when they had the capacity to pay or those who do not complete a workout alternative in good faith will be ineligible for a new Fannie Mae-backed mortgage for a period of seven years from the date of foreclosure.

Fannie Mae says the policy change is designed to encourage borrowers to work with their servicers and pursue alternatives to foreclosure. While a bold attempt at preventing unnecessary foreclosures, the analysts at Moody's Investors Service argue that the GSE may encounter snags ahead since figuring out who to penalize for strategically walking away will be a significant challenge and implementing the policy could be difficult.

Previously, the GSE barred homeowners who'd been foreclosed on from obtaining a new mortgage for five years. However, Fannie Mae's new policy extends the foreclosure-waiting period to seven years unless the borrower can prove that they faced extenuating circumstances when they defaulted on the loan.

For borrowers who can prove hardship or document that they attempted to contact their servicer to obtain a loan workout, the waiting period could be reduced to as little as three years. For borrowers who attempt to "gracefully exit" their mortgage obligation by means of a short sale or a deed in lieu may only have to wait two years to obtain a new Fannie Mae mortgage.

Moody's says Fannie Mae's latest step may increase awareness of the strategic default issue and deter some borrowers who might be contemplating such a move, but there are definite hurdles to implementing such a policy.

In the first place, the ratings agency's analysts argue that there is no consensus on the precise definition of strategic default. Credit reports contain information on whether a borrower has defaulted but not why. In addition, income data are typically not reported by the credit bureaus and would have to be obtained from employer or tax records to determine whether a defaulting homeowner had the ability to continue payments or was forced into foreclosure by financial circumstances.

Even with access to all this information, Moody's says it may prove to be difficult to determine whether a borrower merely chose to renege on a mortgage obligation or acted in anticipation of a potential job loss or some other disruption to income. Some cases may be clear, but Moody's says the majority are likely to require costly review, and could be contested by borrowers in court. Further complicating the process, such reviews would have to be conducted retrospectively, several years after an initial foreclosure, when the borrower applied for a new loan, the analysts noted in recent commentary.

They says the policy's effectiveness in deterring default will also depend on how other players in the housing market respond to Fannie's initiative. If strategic defaulters can still obtain loans from Freddie Mac, the Federal Housing Administration (FHA), or private lenders sooner than seven years after a foreclosure, Fannie's crackdown will have little impact, Moody's contends.

According to the firm's analysts, without universal agreement about the penalties for strategic default, Fannie Mae's policy could actually reignite private subprime lending since strategic defaulters who are locked out of government loans, but have income, could give rise to an attractive niche market.

Fannie Mae also said it will pursue deficiency judgments against strategic defaulters more aggressively in cases where it has the legal authority to do so. Moody's says this tactic is likely to be a more effective tool for discouraging walk-aways than the extended waiting period for a new mortgage.