Bloomberg

U.S. Housing Recovery Stymied by Government

By Kathleen M. Howley - Jul 6, 2011

Sue Stamper, a business owner in Sacramento, California, wants to buy a home. After mortgage-financiers Fannie Mae and Freddie Mac imposed the strictest loan standards in more than a decade, she doesn't qualify.

Pam Crawford of Lyon Real Estate is trying to sell a three- bedroom bungalow on Sacramento's east side for $179,000, a third less than what it went for in 2004. She hasn't found a buyer even after cutting the asking price by $10,000 two weeks ago.

The two women, who haven't met, illustrate the deadlock crippling the U.S. housing market five years into the crash: While a record share of Americans want to buy homes, U.S. policies, often working at cross-purposes, are making it more difficult. Government-controlled Fannie Mae and Freddie Mac have boosted standards so high that some people previously considered prime borrowers no longer qualify. That's limiting a real estate rebound that also has been damped by a state attorneys general probe into foreclosure practices and an Obama administration loan-modification program that has fallen short of expectations.

"It's very important for a robust recovery that we get the right credit standards," said Joseph Stiglitz, a Nobel-prize winning economist and professor at Columbia University in New York. "Giving out unsupportable mortgages was a disaster, and now the danger is overreacting and making the standards excessively high."

Incentives, Bond Purchases

Fannie Mae and Freddie Mac, seized by the U.S. during the closing months of the Bush administration in 2008, have tightened more than a dozen mortgage qualifications since then, including those for down payments and credit scores. The restrictions come after the government handed out $16.2 billion in homebuyer tax credits to pump up demand and the Federal Reserve bought more than $1 trillion of mortgage bonds to lower borrowing costs.

The Fed on June 22 lowered its estimate for 2011 economic growth to a range of 2.7 percent to 2.9 percent from the 3.1 percent to 3.3 percent it projected in April, citing the residential real estate market as a factor. Housing is "a big reason that the current recovery is less vigorous than we would like," Chairman Ben S. Bernanke said in a speech last month.

"The government is working at cross-purposes," said Doug Bandow, a senior fellow at the Cato Institute, a libertarian policy-research center in Washington. "There's been a desperate attempt to reinflate housing by throwing money at the problem. The worst time to tighten lending is after doing that."

Lending for mortgages to buy homes probably will drop to $432 billion this year from $473 billion in 2010, according to a forecast last month by the Mortgage Bankers Association in Washington. In January, the trade group predicted a rise to $616 billion, which would have been the first increase since 2005. The association now forecasts the gain will be in 2012.

Fannie, Freddie Standards

Banks tend to follow Fannie Mae's and Freddie Mac's requirements for lending because they set the standards for loans they guarantee, purchase and package into bonds. The companies, along with the Federal Housing Administration, back about 90 percent of loan originations.

Nine out of 10 mortgages bought by Fannie Mae in the first quarter were held by borrowers with credit scores higher than 700, according to regulatory filings. In 2003, the share was 68 percent. Credit scores, developed by Fair Isaac Corp., range from 300 to 850.

Higher loan requirements have displaced about one-third of people who might have gotten mortgages in the years before a collapse in credit quality led to the subprime crisis, Bernanke said at a June 22 news conference. That's an "important problem," he said.

Screening Out

"We screen out about 30 percent of the people who call looking for a mortgage, usually because of their credit scores," said Michael D'Alonzo, president of Creative Mortgage Group in Maple Glen, Pennsylvania, and head of the National Association of Mortgage Brokers in Plano, Texas. "A lot of people don't even try, because they've heard horror stories of how hard it is to get a loan."

Home sales tumbled in three of the past four months even with properties at their most affordable level in a generation, according to the National Association of Realtors. Real estate prices in 20 U.S. cities fell 4 percent in April from a year earlier, the biggest decline since 2009, the S&P/Case-Shiller index showed last week. Pending home sales, a measure of signed contracts, rose 8.2 percent in May, not enough to erase the prior month's 11 percent drop, the Realtors said June 29.

Americans are still interested in buying residences, a sign that tighter loan standards are limiting sales. In May, 5.5 percent of people said they wanted to purchase a home, a record, according to the Conference Board, a New York research firm.

Sales Decline

Government efforts to bolster housing so far have had hefty price tags and mixed results. While the homebuyer tax credit of 2009 and 2010 initially increased transactions, sales dropped to a record low in July, three months after it ended.

The credit cost $16.2 billion in lost tax revenue, data from the Government Accountability Office in Washington show. It resulted in 1 million sales that wouldn't otherwise have occurred, according to an estimate by the Realtors association.

"Most of the sales affected by the tax credit were most certainly a change of the time of the purchase, not a change in the decision to buy," said the Cato Institute's Bandow.

The most successful program was the Fed's drive to lower interest rates by purchasing bonds, starting with $1.25 trillion of mortgage-backed securities in 2009 and 2010, said Mark Zandi, chief economist at Moody's Analytics Inc. The average rate for a U.S. 30-year fixed loan fell to 4.17 percent in November, the lowest in records dating to 1971, according to Freddie Mac.

Better Than Nothing

"Some of the government's efforts to stimulate the housing market have been more successful than others, but it's hard to imagine what would have happened if it had done nothing," said Zandi, based in West Chester, Pennsylvania.

Bernanke has signaled that some of the blame for the housing morass may be on the government's foreclosure-prevention plan, the Home Affordable Modification Program, or HAMP.

"I'd like to see further effort to modify loans where appropriate, and, where not appropriate, to speed the process of foreclosure and disposition of the foreclosed homes in order to clear the market," he said.

HAMP has fallen short of expectations. When President Barack Obama announced the program in 2009, he set a goal of 3 million to 4 million modifications by the end of 2012. Of the 1.6 million trial plans started since then, 608,615 have turned into permanent modifications.

Higher Foreclosures

"We've managed to keep a lot of people in their homes and alleviated a lot of suffering," said Timothy Massad, acting assistant secretary for the Treasury Department's Office of Financial Stability. Without the government programs, "you would have had a higher rate of foreclosures and foreclosures are not in anybody's interest," he said.

In some cases, modifications have only prolonged the pain by giving second chances to people who later end up in default, said Arizona Attorney General Tom Horne, a Republican. About a third of new foreclosures are loans that have defaulted after modifications or the borrowers caught up on payments, according to Lender Processing Services Inc. (LPS)

"I'd like to see government get out of the real estate business entirely," said Horne. "The market can find its way all on its own."

2.2 Million Homes

There were 2.2 million properties in foreclosure in May, according to Lender Processing, a Jacksonville, Florida-based company that provides loan-servicing software. Another 1.9 million mortgages were delinquent more than 90 days, the point at which foreclosure proceedings typically start.

Lenders are delaying home seizures as all 50 state attorneys general investigate the industry's foreclosure practices. The probe, begun late last year, follows 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.

Horne declined to comment on the investigation. Iowa Attorney General Tom Miller, the Democrat leading negotiations for the states, said last month that officials are making progress in the talks. He didn't return phone calls seeking comment.

Bank seizures and notices of default or auction dropped in May to the lowest level in almost four years, according to RealtyTrac Inc., a real estate data company in Irvine, California. Delays in working through the inventory may postpone a recovery by preventing home prices from reaching a bottom.

"The only way out is to let the market take the hit and then move on," said Cato's Bandow.

Increased Restrictions

For prospective buyers, Fannie Mae and Freddie Mac mortgage-qualification rules have been changed to include lower debt limits, bigger down payments and restrictions on the financing of condominiums, along with the higher credit scores.

“We don’t believe the pendulum has swung too far given the changed landscape of mortgage risk,” said Doug Duvall, a spokesman for Freddie Mac in McLean, Virginia.

Fannie Mae has implemented “the right standards to help stabilize the housing market,” said Amy Bonitatibus, a spokeswoman for the Washington-based company.

The FHA, with down-payment requirements as low as 3.5 percent, has also been raising the average credit score for its mortgages. The average credit score for FHA loans to purchase homes was 701 in April, up from 669 three years earlier, according to government data. The loans now account for about a third of new mortgages, five times the size of its 2007 share, according to the Department of Housing and Urban Development.

Tax Dollars

Stricter standards are necessary to reduce risk for the government and, ultimately, the taxpayers, said Frank Pallotta, managing partner of Loan Value Group, a mortgage-consulting firm in Rumson, New Jersey. The U.S. rescued Fannie Mae and Freddie Mac from insolvency after they had invested in subprime securities as a way to meet their Congressional mandate to support affordable housing.

“It’s kept some people out of the game, but in this market, with falling prices, you don’t want everyone in the game,” Pallotta said. “It’s our tax dollars on the line.”

By the time borrowers get to their local banks, the standards may be even higher, said Mark Goldman, a loan broker with C2 Financial Corp. in San Diego. Lenders want to prevent mortgages from being returned by Freddie or Fannie, so they exceed the rules -- a safety cushion called an overlay.

Little Tolerance

“Lenders are scared, so they’re going to have overlays,” Goldman said. “What you get, as a result, is the most conservative underwriting in 20 years.”

Stamper, in Sacramento, knows that. She missed some credit card payments after a car crash with an uninsured driver last year, and the financial history she described as “near perfect” took a hit. The so-called risk premium fees Fannie Mae and Freddie Mac charge for credit scores under the mid-700s, which can add 3 percentage points to rates, put her dream of buying a home out of reach.

"Clearly the market was too easy during the housing boom," said David Berson, the former chief economist of Fannie Mae who now holds that position for PMI Group Inc. (PMI) in Walnut Creek, California. "It is almost certainly too tight now."

To contact the reporter on this story: Kathleen M. Howley in Boston at kmhowley@bloomberg.net.

To contact the editor responsible for this story: Kara Wetzel at kwetzel@bloomberg.net.