Homebuyer, Be Warned

Mortgage rates figure to rise under the administration's housing proposals, with good reason.

By Jim Tankersley

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Fannie Mae and other government-sponsored enterprises currently guarantee more than 95 percent of mortgages.

wants to make buying a house more expensive. That's the most important take-away from the housing finance proposals that administration officials released officially today—both for prospective homebuyers and the economy at large.

The proposals from the Treasury and Housing and Urban Development departments are aimed at weaning the still-depressed housing market from its overwhelming dependence on government-guaranteed mortgages. In particular, the administration offers three options to phase out Fannie Mae and Freddie Mac, the giant mortgage firms that have been buying or guaranteeing the vast bulk of new home loans ever since the financial crisis three years ago.

Those options range from an essentially full government guarantee of home lending to no guarantee at all (outside of support for the poor from the Federal Housing Administration). Each of those options would push most mortgage rates higher, and for a simple reason: the government would be forcing lenders to take on some or all of the risk on loans that they make. And the lenders, of course, would pass on that cost to homebuyers.

Put another way, the federal government has been backstopping more than 95 percent of new home loans since it took control of Fannie and Freddie back in September 2008. That's an incredibly valuable insurance policy, and lenders are getting it at a big discount. It's a small wonder that banks want to keep some version of Frannie's protection.

But the administration's options would put more of the risk back on lenders, who would, in turn, charge homebuyers a higher price for taking that risk.

"Under all of the options, mortgage rates are likely to go up," said Mark A. Calabria, director of financial regulation studies at the free-market Cato Institute. "I don't really see that as a bad thing, since (mortgage rates) bear little relationship to fundamentals right now."

Some homebuyers will feel the effects of the administration's plans right away. The proposals include lowering the total value of homes eligible for a government-backed mortgage from $729,000 to $625,500. The administration also wants to raise the FHA's annual insurance premium by 25 basis points—a quarter of a percentage point—and force anyone receiving a Fannie- or Freddie-backed loan to make a 10-percent down payment.

Longer term, how much borrowing costs go up will depend on how much risk Congress shifts from the government to the market. It's a complicated equation, in part because it's historically difficult to put much daylight between government and the housing market.

In the late 1980s, when he was the chief economist for Freddie Mac, Robert Van Order calculated that roughly 90 percent of U.S. mortgages carried some form of government backstop—either through the FHA, Government Sponsored Enterprises like Fannie and Freddie, or FDIC insurance for banks.

Van Order now chairs the George Washington University School of Business Center for Real Estate and Urban Analysis, where he just released a paper arguing that the FHA has now taken on more risk than it can likely bear. But in an interview, Van Order said it was hard for the government to extract itself. If Fannie and Freddie drop out of the market, he predicted, banks insured by FDIC would fill the void.

"It's not like this is new," Van Order said. "So you have to ask the question, if you change one institution, where will the risk go?"

Further muddling the issue are complaints, from both ends of the ideological spectrum, that the administration's housing plans lack detail and leave some risks unaddressed.

Conservatives worry the proposals don't address capital requirements for banks that over-incentivize riskier loans. Liberal home-affordability advocates worry that anything less than a full government guarantee could effectively price poorer buyers out of the market.

"You'll end up with two separate but not equal lending markets," with the FHA serving the poorest buyers and private firms serving everyone else, said Sarah Rosen Wartell, executive vice president for the liberal Center for American Progress. She and John Taylor, president and CEO of the National Community Reinvestment Coalition, fear those markets will suppress economic mobility.

"There are a lot of reasons, good reasons, why Americans for generations have become homeowners," Taylor said. "It is the ticket to the middle class. And it appears that ticket is going to become more expensive for a lot of (low- and middle-income) buyers."

Just how expensive is up to Congress—and the answer could take a while. Analysts expect the housing debate to stretch for months or years. The administration's reform plans would take even longer to fully execute: five to seven years, Treasury Secretary Timothy Geithner estimated today.

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