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Mel Watt's plan to loosen mortgage credit will shape housing finance for years

By Joseph Lawler

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Despite being a new officeholder of a relatively obscure federal agency, Mel Watt drew a strong reaction for his speech Tuesday by signaling that the federal government will increase its role in helping more Americans buy houses.

For now, credit standards for home loans remain tight. But Watt's speech also sketched out a greater long-term role for the bailed-out mortgage businesses Fannie Mae and Freddie Mac.

For Republicans, it was the moment they had feared when, for months, they blocked President Obama's nomination of the former North Carolina Democratic congressman to his current post as director of the Federal Housing Finance Agency. As the conservator -- the government steward -- for Fannie and Freddie, the FHFA has massive influence over the mortgage market.

Watt began his speech noting “certain changes in focus” from the plans laid out by his fiscally conservative predecessor Ed DeMarco, and then outlined a number of plans to loosen the terms that Fannie and Freddie require for the loans they insure. The two government-sponsored enterprises buy loans from lenders and package them into insured securities, with the purpose of increasing liquidity in the mortgage markets.

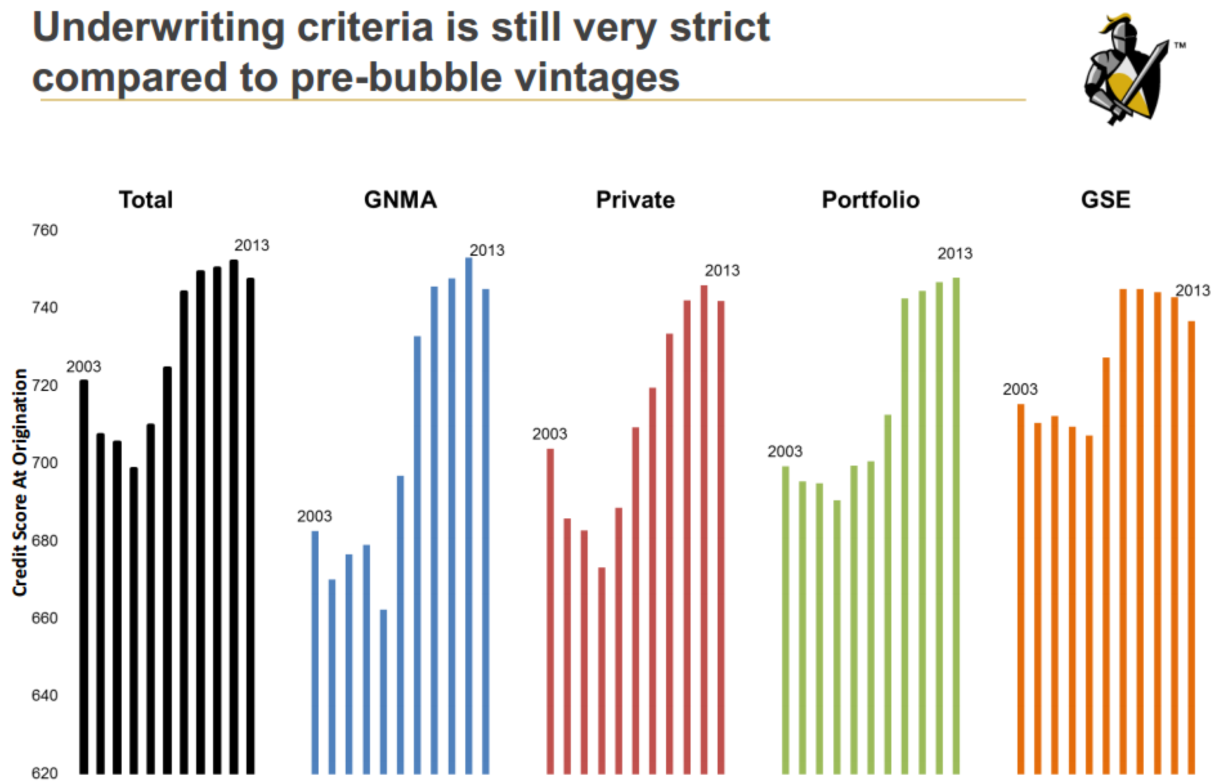
The immediate reaction to Watt’s speech was to raise concerns that his actions would inflate a new housing bubble, and it drew strong condemnations from right-of-center analysts, such as the Cato Institute’s Mark Calabria:

Americans may understandably be concerned about the standards Fannie and Freddie require for the loans they guarantee — the two did receive $188 billion in bailout funds after risking trillions on bad loans.

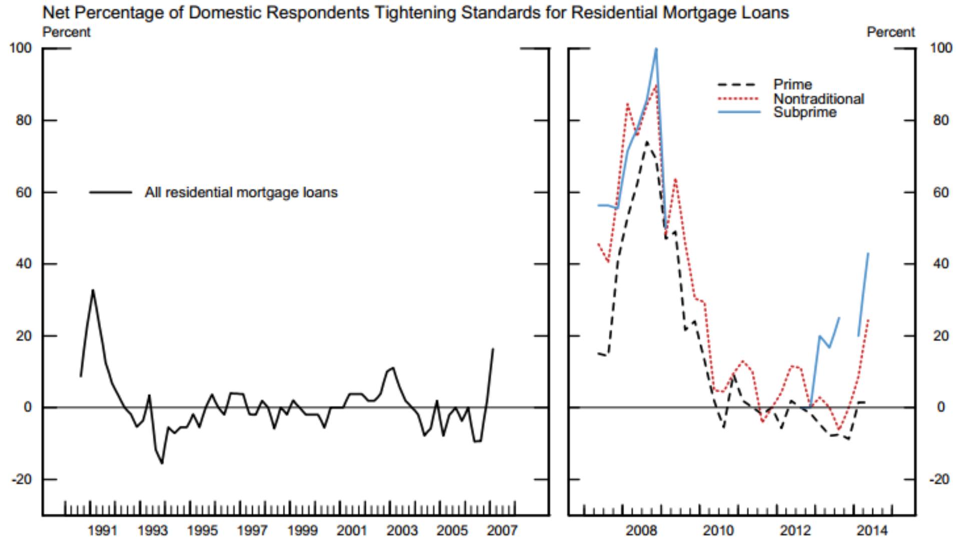
The background, though, is that mortgage credit remains tight.

That's partly because the FHFA, under DeMarco, took steps to tighten the terms required by Fannie and Freddie, including by raising the fees the two GSEs charge to guarantee loans. The GSEs are dominant in the secondary mortgage market, backing roughly two-thirds of new loans in recent years.

This chart from Black Knight Financial Services, an industry data company, shows that both the GSEs and the overall market are requiring higher average credit scores for loans than they did before the housing bubble began inflating:

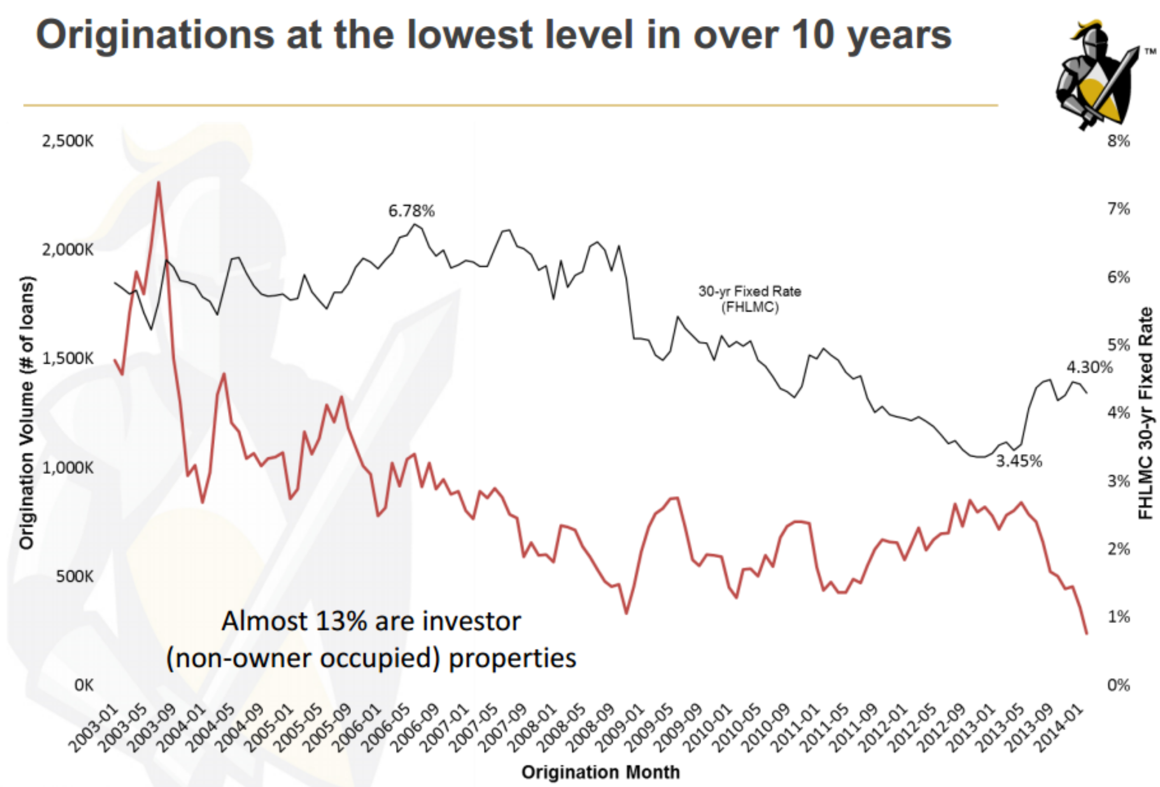


The Federal Reserve's survey of loan officers shows that they tightened terms for mortgages drastically during the crisis, and haven't significantly eased them since (and even have been tightening conditions again recently):



Note: For data starting in 2007:Q2, changes in standards for prime, nontraditional, and subprime mortgage loans are reported separately. Series are not reported when the number of respondents is three or fewer.

The bottom line, and what likely motivated Watt to begin easing the FHFA's terms, is that amid rising mortgage interest rates, mortgage originations, including refinancings, are at the lowest level in more than 10 years, according to Black Knight:



It's against that background that some policymakers -- not just industry groups and affordable housing advocates -- have said that a loosening of credit standards might be necessary for a stronger housing recovery. Former Federal Reserve Chairman Ben Bernanke warned in late 2012 that “the pendulum has swung too far” towards stringent underwriting standards in the wake of the crisis, and that "overly tight lending standards may now be preventing creditworthy borrowers from buying homes, thereby slowing the revival in housing and impeding the economic recovery.”

But Watt’s decisions will not just shape the short-term availability of mortgage credit. They also will play a critical role in shaping the housing finance system for years.

DeMarco had explicitly favored tightening the GSEs’ lending terms to shrink their market footprint and bring private capital into the secondary market for mortgages. By reversing course, Watt plans for Fannie and Freddie to maintain their market share — which in turn will lessen the pressure on Congress to wind down the two companies and reform the market.

Some analysts welcome the change. The Urban Institute's Jim Parrott, formerly an Obama administration economic adviser, wrote in response to Watt's speech that the private market is not currently capable of taking over market share from the GSEs, and that by limiting Fannie and Freddie's presence, the FHFA simply would deny creditworthy borrowers the chance to own a house.

“Watt has signaled that he will turn from focusing on the enterprises as institutions in intentional decline to institutions that should be better prepared to form the core of our system for years to come," Parrott wrote in praise of Watt's decisions.

But Douglas Holtz-Eakin, the president of the right-leaning American Action Forum and a former Congressional Budget Office director, is skeptical of the changes Watt has planned. “This is sort of a re-creation of the worst aspects of their conduct,” Holtz-Eakin warned, referring to the troubled history of Fannie and Freddie as companies competing for market share heading into the crisis.

“What it says,” Holtz-Eakin said of Watt’s comments on Fannie and Freddie, “is that these are agencies of the government that we can use for policy purposes,” rather than assets under the FHFA’s management for conservation. "Those are two different views.”

If the Obama administration determines that lending standards are too tight, Holtz-Eakin said, it should review restrictive rules promulgated by the Consumer Financial Protection Bureau and other federal financial agencies, rather than respond with an ad-hoc policy undertaken through the GSEs.

For his part, Watt said that his plan "allows us to meet our mandates of upholding safety and soundness and ensuring broad market liquidity." With reform legislation in both the Senate and House apparently stalled for the near future, the health of the housing market depends in large part on Watt's judgment.