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US government keeps interfering in $26 trillion housing market

Adam Creighton

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The biggest market in the US, real estate, makes a mockery of the country's reputation as a bastion of free enterprise. The level of government interference in the $US26 trillion ($34 trillion) US housing market, worth 40 per cent more than it was five years ago, continues to rise automatically and with little scrutiny.

The toxic subprime loans that spread around the world stoking the 2008 financial crisis have evaporated. But in their place a new socialisation of mortgage risk has emerged, underpinning surging house prices and increased borrowing. Prices in Denver, Seattle and Portland are rising at Sydney-style double-digit annual pace, while US house prices overall have been rising about 5 per cent a year since 2012. Texas house prices are already 20 per cent above their 2006 peak.

"Our nationalised home lending system is an economics-free zone," says Edward Pinto, a scholar at the American Enterprise Institute with 42 years in the industry.

"It's a frog in a pan on slow boil: we have the unseemly situation of low-capital government entities competing with each other to underwrite risky loans. This will continue until it can't, which could be 12 or 15 years away."

To foreigners, the US housing market is odd indeed. Forget about main street banks taking in deposits and making loans, as in Australia, where the big four have about 85 per cent of the market.

Chastened by billions in fines and tougher regulations, the US banks have almost vacated the field and now originate fewer than one-fifth of new home loans.

Quicken Loans, a Detroit finance company, for instance, is about to overtake banking giant Wells Fargo as the biggest US home lender.

Already more than 60 per cent of the $US10 trillion in US mortgages outstanding are directly or indirectly insured by the US government, or a smattering of New Deal and 1960s-era agencies with varying degrees of government ownership and control.

These loans are packaged up and sold to investors, such as large pension and mutual funds, all around the world. And this share is growing, with about 90 per cent of new loans guaranteed by these agencies — up from about 80 per cent a decade ago.

“The vast majority of mortgage risk is now directly borne by US taxpayers with basically no capital standing behind it,” says Mark Calabria, a financial regulation expert at the Cato Institute.

Even the US Federal Reserve is helping prop up demand. It holds $US1.7 trillion in mortgage-backed securities. While the quantitative easing programs that instigated the build-up have finished for now, the Fed still buys about one-quarter of new mortgages issued to maintain its existing stock.

Investors wouldn’t be so keen if credit quality mattered to them. But it doesn’t. These loans are insured or guaranteed by one of Fannie Mae, Freddie Mac or Ginnie Mae. As long as they conform to increasingly generous limits laid down by regulation, these agencies will guarantee — for a fee of less than 0.7 percentage points, which ultimately is passed on to the borrower — interest payments and principal.

“Most of the benefit doesn’t go to bring in more borrowers, a large portion of it goes to higher prices for the sellers,” says Pinto. The system doesn’t appear to have helped home ownership much, though. The US home ownership rate has steadily fallen from 69 per cent in 2004 to 63 per cent, the lowest level since the 60s. This is far below Australia’s rate, which has fallen a little below 70 per cent in recent years.

Nevertheless, borrowers believe they are getting an excellent deal. US households can borrow for 30 years fixed at 3.5 per cent, which is less than many sovereign governments have to pay. More than 80 per cent of mortgages outstanding are of this type, a feature extending back to the 30s when congress first stipulated the duration of loans that Fannie Mae would insure.

“Even if the Fed jacked up the funds rate 100 basis points (1 per cent) between now and (the end of) 2017, it would still be dirt cheap,” says Frank Nothaft, chief economist at CoreLogic. And there’s no penalty for borrowers, who tend to hold their mortgages for about eight years on average, for repaying early if interest rates fall or they want to sell and move.

Christopher Whalen, research director at Kroll Bond Rating agency, says foreign central banks’ negative interest rate programs have drawn money to US real estate too, bidding house prices up further. “Housing is an asset class that’s not easy to mess with from a policy perspective,” he says. Indeed, politics, and specifically the need to encourage home ownership and maintain prices, has motivated the recent increase in government involvement.

Intended to be temporary, the agencies’ loan limits were relaxed significantly in the wake of the financial crisis, but they remain high and are about $US625,000 in many parts of the US.

“A more cynical interpretation is that people like (congress members) Barney Frank and Nancy Pelosi wanted to see more of the housing markets in their own districts (California and Boston) covered,” says Calabria. Not surprisingly, the average loan to valuation ratio has crept up from 80 per cent to 86 per cent since the financial crisis. While US banks have roughly doubled their capital levels (albeit from not very much) to more than $US1.1 trillion since the financial crisis,

Fannie and Freddie and the Federal Housing Authority — which insures the loans that Ginnie Mae packages up and sells — have little meaningful capital. If swathes of loans default, taxpayers will be picking up the tab.

Some parts of the housing system have improved since the crisis. Douglas Duncan, chief economist at Fannie Mae, points out that underwriting standards have improved dramatically. "It's definitely stricter now, average credit scores much higher, the ability for a borrower to get a loan has been reduced," he says, noting default rates had fallen to below 1 per cent.

"Subprime gone, no-doc is gone; that means income, employment and cash reserves are verified, the three critical elements," says Nothaft. "Yes there's more high loan-to-value lending, but if house prices continue to rise and job growth remains strong that's a big risk mitigator," he adds.

The value of derivatives related to mortgages, which tend to amplify and spread risk, has slumped too since its peak in 2008. But subsidies are no less lethal simply because they can't be easily quantified in a budget. *The Economist* recently estimated the subsidy was the equivalent of $US150bn a year or a little less than 1 per cent of US gross domestic product.

Certainly, the policies have ensured house prices are higher than they otherwise would be, a dubious benefit for younger households locked out of the market.

Whatever the amount, the incentives in the housing system aren't aligned for financial stability. Fannie and Freddie are government-chartered entities with private shareholders. Their premiums don't vary with the credit risk of the borrower, which naturally encourage riskier borrowers overall.

In theory, the US government doesn't stand behind their guarantees, although the financial crisis showed that it did in practice, which is what matters for incentives. Fannie Mae and Freddie Mac are the epitome of the "heads we win, tails taxpayers lose" philosophy that has become entrenched in the financial system.

A sharp fall in house prices or burst of delinquency wouldn't prompt a financial crisis immediately. The US government has deep pockets, with the ability ultimately to increase taxation or even print money. But the loss of billions would provoke outrage and fuel another costly process of regulation that could make the regulatory architecture worse.