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Fannie-Freddie Regulator's 3% Down Loans Draw Jeers

By Clea Benson
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Mel Watt, director of the Federal Housing Finance Agency, has set off a political tempest.

The cause: 3-percent down mortgages.

Watt, who oversees Fannie Mae and Freddie Mac, unveiled his plan in late October to allow the companies to back mortgages with down payments as low as 3 percent. Republican lawmakers and some industry executives are lambasting the change as an irresponsible opening of the credit floodgates.

The blowback shows the pressure Watt faces in his effort to expand homeownership six years after defaults on subprime loans set off the financial crisis. Watt said low down-payment loans are a safe way to help families with healthy incomes and meager savings buy homes. Jeb Hensarling, chairman of the House Financial Services Committee, said Watt's plan is a return to the policies that caused the housing crash.

Watt's proposal is "an invitation by government for industry to return to slipshod and dangerous practices that caused the mortgage meltdown in the first place and wrecked our economy," Hensarling said in a statement last week. The initiative "must be rejected."

Fannie Mae (FNMA) and Freddie Mac, which purchase about two-thirds of new home loans and package them into bonds, currently allow down payments as low as 5 percent. Fannie Mae accepted 3 percent down as recently as last November before increasing the requirement as part of a tightening of its underwriting standards. Taxpayers bailed out the two companies in 2008.

'Narrow Effort'

Watt, 69, told bankers in Las Vegas that the return to 3 percent down is a "narrow effort" to bring more Americans, especially minorities, into the housing market. Watt said his plan will help those who "experienced record loss of wealth during the financial crisis as a result of abusive mortgage products, the economic downturn, and other factors."

The U.S. homeownership rate has fallen to 64.4 percent from 69.2 percent in 2004 as blacks, Hispanics and first-time buyers struggle to get loans. Lenders have tightened standards after paying tens of billions of dollars in settlements of mortgage-related lawsuits for underwriting errors.

Douglas Yearley, chief executive officer of homebuilder Toll Brothers Inc. (TOL), called Watt's proposal "a really dumb"idea during a conference in late October.

Peter Wallison, a fellow at the American Enterprise Institute and former Treasury official during Ronald Reagan's presidency, wrote a Nov. 4 article criticizing the decision that was published in newspapers such as the Wall Street Journal and the Palm Beach Post.

Taxpayer Bill

"Since the taxpayers are still standing behind Fannie and Freddie, it's clear who will have to pay the bill when these mortgages default in the future," Wallison wrote.

Fannie Mae CEO Timothy J. Mayopoulos, responding to critics, told reporters that mortgage rules enacted as part of the 2010 Dodd-Frank act ensure the safety of 3 percent down loans. They will still have to conform to the qualified mortgage rule, which offers lenders protection from legal liability only if borrowers spend no more than 43 percent of their income on debt. The rule also penalizes lenders for risky features such as balloon payments or interest-only payments.

During a Nov. 7 speech in New Orleans, Watt pointed out that borrowers will need to meet extra requirements, such as debt counseling or stronger credit histories, than are needed for loans with larger down payments.

"The guidelines for these loans will be targeted in their scope and will include standards that support safety and soundness," he said.

Negligible Risk

Laurie Goodman, director of the Housing Finance Policy Center at the Urban Institute in Washington, said Watt's move is an important first step in expanding credit. A study of Fannie Mae data by Goodman and other researchers found that credit scores had more bearing than the size of the down payment on whether borrowers defaulted.

The study concluded that allowing loans with down payments between 3 percent and 5 percent is likely to have a "negligible" effect on mortgage risk. These loans made up only about 1 percent of Fannie Mae originations when they were previously allowed.

Private mortgage insurers support the 3-percent down loans, said Rohit Gupta, chief executive officer of Genworth Mortgage Insurance and co-chair of U.S. Mortgage Insurers. Borrowers are required to obtain insurance when they put less than 20 percent of the purchase price down on Fannie Mae and Freddie Mac loans.

"Fully documented, low down-payment loans with the right credit score and right debt-to-income ratio have performed in this cycle," Gupta said. "We have empirical data that those loans can be insured."

Camel's Nose

Most lenders will welcome the loans as well, said Dave Stevens, CEO of the Mortgage Bankers Association in Washington.

"These loans will be underwritten more conservatively and will likely come with higher mortgage insurance costs," Stevens said. "History has shown that these loans, when properly underwritten, perform well."

Mark Calabria at the Cato Institute said there's no guarantee that lending will be confined to borrowers with the highest credit scores on the scale set by the Fair Isaac Corp. (FICO), or FICO.

"This is just the camel's nose under the tent," said Calabria, a former congressional staff member. "You start with low down payments for high-FICO borrowers, which you can do safely, and it erodes over time. It's disingenuous or naive to say it's going to remain with high-FICO borrowers."

Cut Principal

While Watt fends off these criticisms, he's also under pressure from consumer groups, which are calling on him to ease credit even further. The National Community Reinvestment Coalition and the Center for American Progress are urging him to cut the principal on loans for troubled borrowers, and increase lending in inner-city neighborhoods.

"Is there a nice way to say, he's damned if he does and he's damned if he doesn't?" said Issac Boltansky, an analyst at Compass Point Research & Trading LLC in Washington.

Watt, a former Democratic congressman who took over the job at FHFA in January, probably will have to defend his proposal again this week when he testifies before the Senate Banking Committee.

While the FHFA director hopes to win supporters, he does have the authority to offer the loans without congressional approval. Fannie Mae and Freddie Mac are now finalizing details of who will be eligible for the loans and how they will be priced.

Background Noise

"The backlash shows the political contours of the issue are going to remain complicated," said Boltansky of Compass Point. The criticism "will just be background noise to the administrative actions, because they're going to proceed no matter what."