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Fannie Mae Official Details Plans on Low-Down-Payment Mortgages

By Peter Eavis
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Fannie Mae's low-down-payment mortgages are part of a wider effort to increase the flow of housing credit.Credit Larry Downing/Reuters

Seeking to bring more people into the housing market, the government said last month that it planned to expand the availability of mortgages with low down payments.

On Thursday, the chief executive of Fannie Mae, the largest government mortgage entity, provided some crucial details on what the program would look like.

In an interview, the executive, Timothy J. Mayopoulos, said that he expected Fannie's low-down-payment mortgages to cost the borrower less than similar loans available under certain other government programs. But he also said that Fannie's loans would require private mortgage insurance on top of the down payment, a stipulation that might, in theory, limit the size of the program.

Even as the government is moving ahead with the changes, some housing analysts had concerns, contending that the program could lead to higher defaults.

Fannie Mae and Freddie Mac, another large government-backed entity that guarantees mortgages, are regulated by the Federal Housing Finance Agency. Under its director, Melvin L. Watt, the agency has recently taken steps that aim to ease the flow of housing credit. Since the financial crisis of 2008, some 80 percent of mortgages have had some form of taxpayer guarantee. In other words, banks still make mortgages, but they turn around and sell most of them to bond investors with a government backstop attached.

Most of that backstop comes from Fannie and Freddie, which typically only guarantee mortgage amounts that are equivalent to around 80 percent of the value of the underlying house. As a result, borrowers who take out loans backed by Fannie and Freddie often have to have the cash to make a down payment of some 20 percent of the value of the house. But thousands of potential borrowers struggle to amass the savings to make a down payment of that proportion, and they, therefore, fail to qualify for loans backed by Fannie and Freddie.

As part of a wider effort to increase the flow of housing credit, Mr. Watt said last month that he wanted Fannie and Freddie to back loans with down payments as low as 3 percent of the value of the home. He called that effort a “much needed piece to the broader access to credit puzzle.”

Mr. Watt, however, seemed to tamp down expectations about the down payment efforts, saying they were narrower initiatives than other things that the housing finance agency was doing to prompt more mortgage lending. The biggest measure was a relaxation of the terms under which the government can make banks take back soured mortgages.

Right now, borrowers can apply for low-down-payment loans that are backed by another arm of the government, the Federal Housing Administration, which backstopped nearly 14 percent of mortgages made this year, according to data from Inside Mortgage Finance. But F.H.A. loans typically cost borrowers substantially more than loans backed by Fannie and Freddie. Asked if Fannie’s low-down-payment loans would be cheaper than those backed by the F.H.A., Mr. Mayopoulos, said, “In many cases it will be.”

Fannie’s charter prevents it from backing loan amounts that exceed 80 percent of the value of the house, which is why borrowers may have to make a 20 percent down payment. Fannie will, however, guarantee a loan if private mortgage insurance effectively makes up the portion of the 20 percent that the borrower has not covered with a down payment.

The big question is whether private mortgage insurers have the desire to take on this business. A down payment of 3 percent would, in theory, leave the insurer taking a substantial amount of the risk if the borrower defaults. But Mr. Mayopoulos said, “Everything I am hearing from private mortgage insurers is that they have capital to put to work and they are expressing to us that they have an appetite to do that.”

Timothy J. Mayopoulos, chief executive of Fannie Mae, at a House panel in 2009.Credit Alex Brandon/Associated Press

The push for low-down-payment loans will no doubt intensify the debate over how far to go in making mortgage credit more available.

Many studies show that borrowers who make down payments of at least 20 percent usually have much lower default rates. As down payments fall, lending gets riskier.

“You can make low-down-payment loans to people with high credit and high-down-payment loans to people with low credit,” said Mark A. Calabria of the Cato Institute, a libertarian-leaning research group. “It’s when you mix the two that you start to see skyrocketing default rates.”

And the advantage of a higher down payment is that it reduces the risk that, in a house price slump, borrowers get trapped in mortgages that are worth far more than the fallen value of their homes. A borrower who puts down 3 percent is almost immediately “under water” after the transaction costs of the purchase. Any slight decline in house values would then hurt. And falling prices may soon become a reality. Interest rates are expected to start rising next year, which may weigh on the housing market. “I just worry that we will be getting people into low equity loans at just about the time that they are going to need that equity,” Mr. Calabria said.

But some housing specialists contend that factors other than size of down payment, like a borrower’s credit score, can also help explain who keeps paying a mortgage.

In an analysis this week, the Urban Institute compared loans with down payments of 3 percent to 5 percent with those with down payments of 5 percent to 10 percent. The loans with smaller down payments had lower default rates than the other mortgages when the credit scores of the borrowers were higher. “Borrower’s credit is a stronger indicator of default risk than down payment size with these loans,” the institute’s Housing Finance Policy Center wrote.

Mr. Mayopoulos said that Fannie would look at a range of borrower characteristics in its low-down-payment program. These would include income levels and how much cash borrowers had in their bank accounts.

Both entities suffered huge losses in the housing crisis after guaranteeing and buying large amounts of mortgages that later defaulted. In 2008, the government bailed out Fannie and Freddie, ending their run as full-fledged private companies. Congress has introduced legislation that would replace Fannie and Freddie with a scaled-back taxpayer backstop, but those efforts have stalled.

Fannie had a low-down-payment program but ended it last year, while Freddie canceled its effort in 2011. Fannie decided to stop its program after the F.H.A. increased the fees it charges for its guarantee. The fear was that the market would then direct poorer quality low-down-payment loans mainly to Fannie’s program. Mr. Mayopoulos said that he did not think this would happen once Fannie’s new program was up and running. “We know we won’t be the only provider in the marketplace,” he said, “And we will be able to monitor what’s going on.”