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Only a Private Housing Finance Market Can Produce Stability

By Peter J. Wallison

In the last half-century, US government backing for the housing finance market has consistently produced cycles of boom and bust. The reason is clear: only sound underwriting standards can produce a mortgage market with defaults of less than 1 percent, but the government has repeatedly encouraged the loosening or abandonment of standards. The affordable housing goals established for Fannie Mae and Freddie Mac were only the most recent and extensive iteration of this policy, and they fostered a massive housing bubble, a mortgage meltdown, and ultimately the financial crisis of 2008. True to form, a recent proposal by the government's principal financial regulators has subverted the Dodd-Frank Act's half-hearted attempt to reestablish underwriting standards and sets the stage for a return to the policies that caused the crisis. As long as government continues to control the housing finance market, continued instability and cycles of boom and bust are inevitable.

A stable housing finance system—one without repeated cycles of boom and bust—is a goal that both left and the right claim for their policies.

When the Protect American Taxpayers and Homeowners (PATH) Act was introduced in the US House of Representatives earlier this year, its Republican sponsors argued that it would produce a more stable system of housing finance by eliminating Fannie Mae and Freddie Mac over a five-year period and creating an almost entirely private housing finance market for the future. The only exception to this gradual privatization of the housing finance market would be a new structure for the Federal Housing Administration (FHA), which would henceforth be an independent not-for-profit corporation, focused entirely on low-income first-home buyers but carrying an explicit government guarantee for at least a portion of its insurance.

Advocates on the left cite the same desire for market stability as one of the reasons they support a government-backed system of housing finance, which they see as assuring a steady flow of credit to housing, limiting the formation of credit bubbles, and promoting consumer-friendly loans that limit defaults.[1]

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History since the Great Depression era shows that—whether employed by the government or the private sector—reasonable underwriting standards are the key to sustained market stability. Indeed, when government has sought to stabilize the housing market, it has adopted and maintained these standards, reducing defaults and creating a long period of stability. Since the late 1950s, however, the government has repeatedly intervened in the housing finance market, stimulating the growth of credit

Key points in this *Outlook*:

- Since the late 1950s, the government has repeatedly stimulated the growth of credit bubbles by reducing home mortgage underwriting standards and providing credit in already overheated housing markets.
- A recent government proposal to lower the standards for a high-quality mortgage perpetuates the same weak lending standards that led to the 2008 financial crisis.
- As long as the government controls the housing finance market, we can expect destructive cycles of boom and bust to continue.

bubbles and mortgage defaults by reducing underwriting standards. The result has been continuing cycles of boom and bust, culminating in the 2008 financial crisis.

Indeed, it appears that the activist view of government's role in the economy, together with the normal inclinations of a democratic government, will lead to continued cyclicality and instability in the future. Even after the mortgage meltdown of 2008, the government, the political left has made evident its desire to "open the credit box" by reducing underwriting standards. This will once again put in place all of the fundamental causes of the recent crisis.

Government and Housing Finance, 1930s to 1960s

The government's direct involvement with the housing finance market began in 1934 with the establishment of the FHA during the Great Depression. To stabilize the chaotic market of the time, the FHA was authorized to insure mortgages up to 100 percent and began its operations with underwriting standards that included a minimum down payment of 20 percent and a maximum loan term of 20 years.

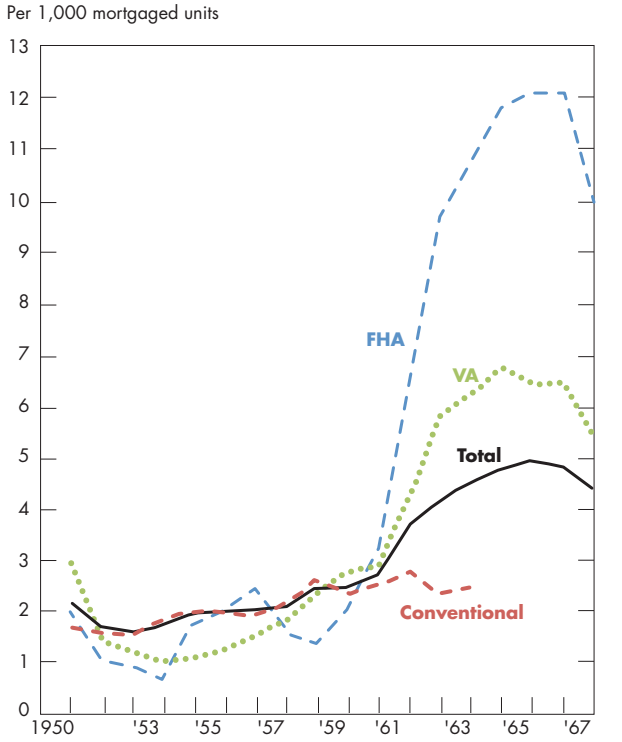
A 1936 FHA underwriting manual shows that FHA underwriters also wanted to see a good or excellent credit record and a relatively low debt-to-income ratio that took into account the borrower's residual income (remaining income after outstanding debts).[2]

Because of these strict underwriting standards, the FHA's record for the next 20 years—through the Great Depression, World War II, and the postwar housing boom—was exemplary: defaults on FHA mortgages remained well under 1 percent.

In the 1930s, the conventional market consisted primarily of lending by banks and savings and loan (S&L) associations (or similar institutions known as building and loans), which were intended to take local deposits and funnel them into home mortgages. Insured S&Ls were regulated by the Federal Home Loan Bank Board (Bank Board), established in 1932. Before and after World War II, conventional mortgages constituted about two-thirds of the housing finance market. This market was also stable, with defaults under 1 percent, primarily because the Bank Board kept down payments at 40 percent in the 1930s and no less than 20 percent in the postwar period.[3]

However, when the US economy went into recession in 1957, Congress—to stimulate housing demand—reduced the FHA's down payment requirement to 3 percent in steps between 1957 and 1961. This was the first time that Congress had used underwriting standards for purposes other than assuring the quality of mortgages or the safety and soundness of financial institutions. Now, to stimulate economic growth, Congress was manipulating the conditions under which a mortgage would be granted. An important line had been crossed.

FIGURE 1
POSTWAR FORECLOSURE RATES



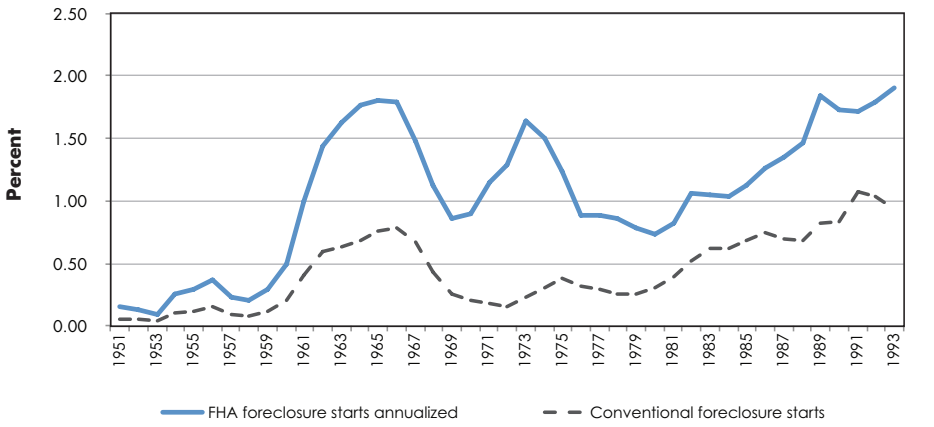
Source: John P. Herzog and James Earley, *Home Mortgage Delinquency and Foreclosure* (Cambridge, MA: National Bureau of Economic Research, 1970), 26, www.nber.org/chapters/c3294.pdf.

The results are clear in figure 1. By the late 1960s, foreclosures were 16 times higher for FHA mortgages than they had been in 1953. The chart also shows that conventional mortgage foreclosures remained relatively stable, primarily because the average loan-to-value (LTV) ratio of conventional loans at the time was much lower than for FHA mortgages. Between 1959 and 1967, the average LTV ratios of outstanding FHA loans ranged between 91 and 92.9 percent, while the LTV ratios of outstanding conventional loans ranged between 71.1 and 76.1 percent.[4] Nevertheless, although conventional mortgages were about two-thirds of all US mortgages in the 1960s, the homeownership rate in the US was approximately 64 percent, where it remained for the next 30 years.

It seems reasonable, then, to attribute the difference in foreclosure rates between the conventional and FHA markets to the fact that FHA underwriting standards could be

easily manipulated by Congress—which was seeking to boost the housing market in the recession of the late 1950s and early 1960s—while the Bank Board was concerned about the safety and soundness of the S&Ls under its jurisdiction.

FIGURE 2
FHA AND CONVENTIONAL FORECLOSURE STARTS, 1951–93



Source: Peter J. Elmer and Steven A. Seelig, "The Rising Long-Term Trend of Single-Family Mortgage Foreclosure Rates," FDIC Working Paper 98-2, 1998, www.fdic.gov/bank/analytical/working/98-2.pdf; and Mortgage Bankers Association.

Reduced Standards, 1960s to Early 1990s

Although government mortgage insurance encouraged banks and other lenders to make mortgage loans that met the FHA's standards, limited resources often reduced the number of loans that could be made by the banks, S&Ls, and other institutional lenders that were the primary sources of mortgage credit at the time. Once a mortgage was closed, the lender frequently had to hold the loan indefinitely because there was no active secondary market, reducing the lender's ability to make additional mortgage loans. To address this problem, Congress authorized the creation of Fannie Mae as a government agency in 1938. Its role was to buy government-guaranteed or insured mortgages from lenders, thus freeing them for additional mortgage lending.

When Fannie was partially privatized in 1968, its new congressional charter specified that it was to acquire mortgages "of such quality, type, and class as to meet, generally, the purchase standards imposed by private institutional investors." The same language was inserted in Freddie's charter when it was privatized in 1970.

In the same 1970 legislation, both companies—now called government-sponsored enterprises (GSEs)—were authorized for the first time to enter the conventional market. The charter language quoted above was obviously a direction from Congress to acquire only high-quality loans—known as prime loans—and Fannie and Freddie continued to follow the traditional underwriting standards of the conventional market as they acquired conventional mortgages after 1970. Despite seven recessions between 1953 and 1991, foreclosures on conventional mortgages remained consistently below 1 percent and were far more stable than FHA foreclosure rates during much of this period (figure 2).

Figure 2 also shows that the conventional market began to deteriorate somewhat in the late 1980s. The cause in this case was likely to have been Fannie's temporary abandonment, between 1981 and 1984, of the traditional prime mortgage standards it had previously been following. The high market interest rates of the inflationary late 1970s had created serious problems for Fannie. Its portfolio of conventional and government-insured mortgages consisted of long-term fixed-rate loans, which were yielding substantially less than Fannie's cost of funds. Freddie was less affected by interest rate conditions because it had already begun to securitize substantial amounts of its loans in the 1970s. Investors in Freddie's mortgage-backed securities were taking the interest rate risks that were causing Fannie's losses.

To avoid insolvency during this period, Fannie reduced its underwriting standards so that it could obtain upfront fee payments for acquiring riskier subprime and other low-quality mortgages. This mitigated its interest rate problem but resulted in serious credit losses between 1981 and 1984.[5] Accordingly, in 1985, Fannie completely revised its underwriting procedures, returning to the traditional standards that it had used through most of the 1970s: a down payment of 10 to 20 percent, a good to excellent credit record (FICO scores, which are now commonly used, were not in wide use at this time), and a debt-to-income ratio of no more than 38 percent.

A study of the Atlanta area by the Government Accountability Office in 1990 showed that these standards were being applied there by both Fannie and Freddie.[6] Sim-

ilarly, a random study of Fannie's portfolio in 1992 also showed that the mortgages acquired after the 1985 reforms went into effect were again showing default rates less than 1 percent.[7]

The importance of reasonable underwriting standards was demonstrated recently in a data set released by Freddie in March 2013, consisting of 15 million 30-year, fixed-rate, fully documented loans. These mortgages represented 53 percent of all the loans Freddie acquired between 1999 and 2011. The 47 percent not disclosed were mortgages of lower quality, such as adjustable-rate mortgages (ARMs) or loans Freddie had acquired under special programs to meet the affordable housing (AH) goals, which I will describe later in this *Outlook*. Accordingly, the 53 percent were Freddie's best loans, probably the best in the market at the time they were acquired, since the GSEs could outbid any private investor for the loans they wanted.

TABLE 1
DEFAULT RATES ON FREDDIE MAC'S 1999 PURCHASE-MONEY COHORT THROUGH 2012

Loan Type	Default Rate	Default Rate as a Multiple of Prime Default Rate
A. Prime (>660 FICO, <=90% LTV, <=38% DTI)	0.55%	1
B. Nonprime (missing at least one element of the prime loan triad)		
1. DTI>38%, but prime-level down payments and FICOs	0.98%	1.8
2. LTV>90%, but prime-level FICOs and DTIs	2.24%	4.1
3. Weighted average of all nonprime (number of loans missing at least one element of the prime loan triad)	3.01%	5.5
4. DTI>38%, with nonprime down payments and/or FICOs	4.25%	7.7
5. FICO<660, but prime-level down payments and DTIs	4.32%	7.9
6. LTV>90%, with nonprime FICOs and/or DTIs	5.26%	9.6
7. FICO<660, with nonprime down payments and/or DTIs	7.00%	12.7

Note: All loans are fully documented 30-year fixed-rate home purchase loans acquired by Freddie Mac in 1999.
Source: Author's compilation based on Freddie data set.

Table 1, based on the Freddie data set, shows the difference in default rates between prime traditional purchase-money mortgages—that is, mortgages with FICO scores of more than 660, down payments of at least 10 percent, and debt-to-income ratios of at least 38 percent—and purchase-money mortgages in the data set's 1999 cohort that do not meet one or more of these traditional standards. The default rates among the mortgages Freddie did not disclose were likely much higher.

The Conventional Market, 1992–2008

The year 1992 was the end of one era and the beginning of another. In that year, at the urging of community activists who complained that the GSEs' underwriting standards were excluding many low- and moderate-income borrowers from homeownership, Congress adopted the ironically named Federal Housing Enterprises Safety and Soundness Act.[8] This legislation established the first prudential regulator for Fannie and Freddie—a chronically weak one—and authorized the Department of Housing and Urban Development (HUD) to establish and increase the so-called affordable housing goals (AH goals). These required Fannie and Freddie to buy an increasing quota of mortgages that were made to low- and moderate-income (LMI) borrowers (borrowers at or below the median income in their communities). Although the initial quota of 30 percent was not difficult to meet, Congress authorized the Department of Housing and Urban Development (HUD) to increase it and cleared the way for far more ambitious requirements by suggesting in the same legislation that down payments could be reduced below 5 percent without seriously impairing mortgage quality. Through the AH goals, the government for the first time had a way to control the underwriting standards in the conventional market.

In succeeding years, HUD raised the LMI goals, with many intermediate steps, to 42 percent in 1996, 50 percent in 2000, and 56 percent in 2008. HUD also increased subordinate goals for loans to very-low-income borrowers and minorities in geographic areas designated as "underserved." Table 2 shows the gradual increase in the goals and subgoals by the year each new goal or subgoal went into effect.

Finding borrowers who were goals-eligible became more and more difficult as the quota increased, and especially when it reached and then exceeded 50 percent. So they could meet the quota in each year, the GSEs were compelled to reduce their underwriting standards.

As early as 1995, the GSEs were buying mortgages with 3 percent down payments, and by 2000 they were accepting loans with no down payments. They were

TABLE 2
INCREASES IN HUD'S AFFORDABLE HOUSING GOALS BY YEAR OF IMPLEMENTATION

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Low & Moderate Housing Goals	40%	42%	42%	42%	42%	50%	50%	50%	50%	52%	53%	55%	56%
Fannie Actual	45%	45%	44%	46%	50%	51%	52%	52%	53%	55%	57%	56%	54%
Freddie Actual	41%	43%	43%	46%	50%	53%	50%	51%	52%	54%	56%	56%	51%
Special Affordable Goal	12%	14%	14%	14%	14%	20%	20%	20%	20%	22%	23%	25%	27%
Fannie Actual	15%	17%	15%	18%	19%	22%	21%	21%	24%	24%	28%	27%	26%
Freddie Actual	14%	15%	16%	18%	21%	23%	20%	21%	23%	26%	26%	26%	23%
Underserved Goal	21%	24%	24%	24%	24%	31%	31%	31%	31%	37%	38%	38%	39%
Fannie Actual	25%	29%	27%	27%	31%	33%	33%	32%	32%	41%	43%	43%	39%
Freddie Actual	28%	26%	26%	27%	29%	32%	31%	33%	34%	43%	44%	43%	38%

Source: Federal Housing Finance Agency.

also compromising other underwriting standards, such as borrower credit scores, to find the subprime and other nontraditional mortgages they needed. In 2001, following a 1996 study by the Federal Reserve that showed the significant predictive power of the FICO score, bank regulators declared that any loan with a FICO score of 660 or less must be recorded by a bank as a subprime loan, and hence a risky investment, no matter its other characteristics.[9] When Fannie filed its first 10-K report in 2002, it revealed that in 2000 14 percent of its single-family loans already had FICO scores of 660 or less, with 16 percent in 2001 and 17 percent in 2002. These loans, then, were subprime.[10]

As table 2 shows, Fannie and Freddie met the goals each year, but for the most part by only a few percentage points. It is apparent that they were struggling. As Freddie noted in a 2007 financial report:

> Declining market conditions and regulatory changes during 2007 have made meeting our affordable housing goals and subgoals *even more challenging than in previous years*. The increased difficulty we are experiencing has been driven by a combination of factors, including the decreased affordability of single-family homes that began in 2005; deteriorating conditions in the mortgage credit markets, particularly with respect to *greatly reduced origination of subprime mortgages*; and increases in the levels of subgoals.[11] [emphasis added]

Fannie made a similar point about the AH goals in a statement in the 2006 10-K report it filed with the US Securities and Exchange Commission (SEC):

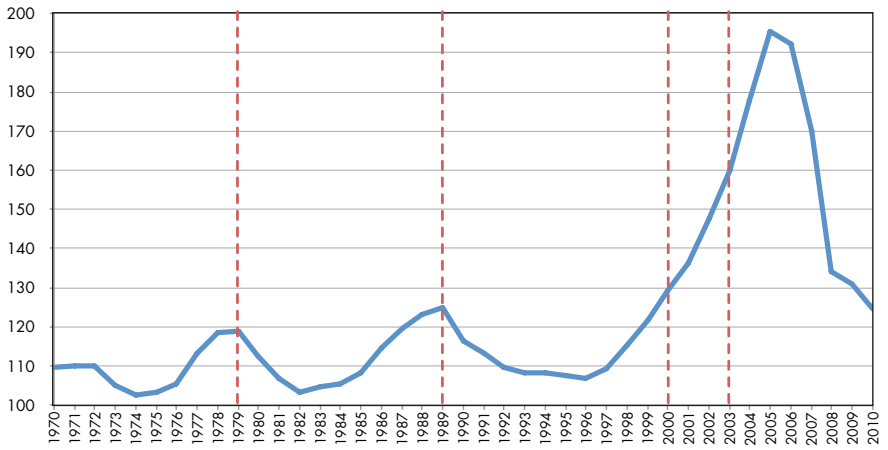
> [W]e have made, and continue to make, significant adjustments to our mortgage loan sourcing and purchase strategies in an effort to meet HUD's increased housing goals and new subgoals. These strategies include entering into some purchase and securitization transactions with *lower expected economic returns than our typical transactions*. We have also relaxed some of our underwriting criteria to obtain goals-qualifying mortgage loans and increased our investments in higher-risk mortgage loan products that are more likely to serve the borrowers targeted by HUD's goals and subgoals, *which could increase our credit losses*.[12] [emphasis added]

To meet the ever-increasing goals, Fannie and Freddie had to reduce their underwriting standards. In fact, that was explicitly HUD's purpose, as this statement by the department—one among many—makes clear:

> Millions of Americans with less than perfect credit or who cannot meet some of the tougher underwriting requirements of the prime market for reasons such as inadequate income documentation, limited downpayment or cash reserves, or the desire to take more cash out in a refinancing than conventional loans allow, rely on subprime lenders for access to mortgage financing. *If the GSEs reach deeper into the subprime market, more borrowers will benefit from the advantages that greater stability and standardization create*.[13] [emphasis added]

Yes, you read that correctly; HUD was suggesting that borrowers with "less than perfect credit" should also have the opportunity to do cash-out refinancing of their homes, and if the GSEs could be induced to buy those mortgages, the world would be a better and fairer place. Obviously, at this point (2004) HUD had given up any pretense of concern about mortgage quality; it was solely pursuing a social policy.

FIGURE 3
CASE-SHILLER HOME PRICE INDEX 1970–2010



Source: Online data from *Irrational Exuberance*, by Robert Shiller (www.econ.yale.edu/~shiller/data.htm).

The new easy-credit terms that the GSEs were using to meet the AH goals spread far beyond the low-income borrowers that the loosened standards were intended to help. Once Fannie and Freddie reduced their underwriting standards, many borrowers who could have afforded prime mortgages sought out the easier terms so that they could buy larger homes with smaller down payments. Thus, home buyers above the median income were adding leverage, and loans to them were decreasing in quality. In many cases, these homeowners were withdrawing cash from the equity in their homes through cash-out refinancing as interest rates declined in the mid-2000s. By 2007, 37 percent of loans with down payments of 3 percent went to borrowers with incomes *above* the median.[14]

As result of the gradual deterioration in loan quality over the preceding 16 years, by 2008, 56 percent of all mortgages in the United States—32 million loans—were subprime or otherwise low-quality loans.[15] Of these, 76 percent were on the books of government agencies or institutions that were controlled by government policies, with the GSEs holding or guaranteeing about two-thirds. This shows incontrovertibly that government policies had created the demand for these risky loans.

The Great Housing Bubble, 1997–2007

With all the new buyers entering the market because of the AH goals, housing prices began to rise. By 2000, the developing bubble was already larger than any bubble in US history, but HUD—continuing to increase the AH goals—kept new money pouring into the overheated market. The bubble kept rising until 2007, when—at nine times larger than any previous bubble—it finally topped out and housing prices began to fall.

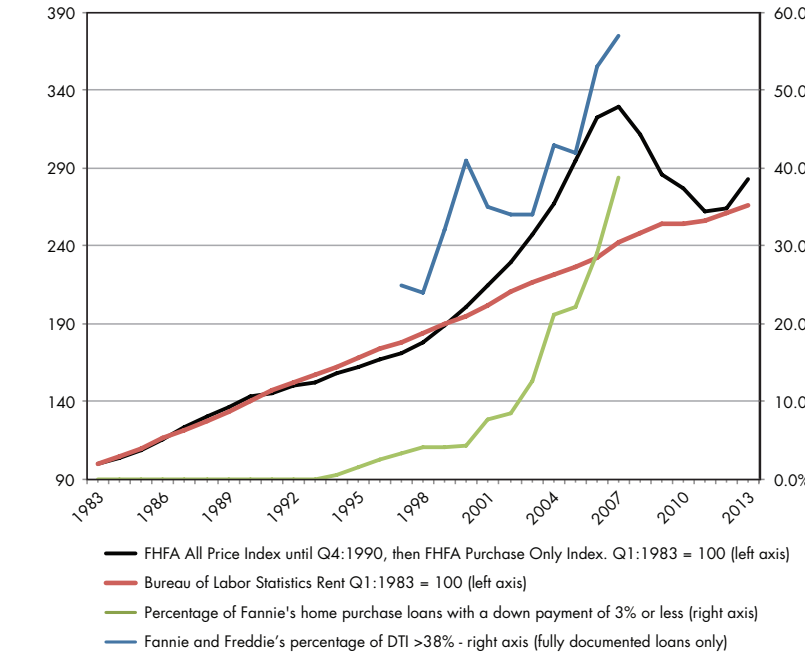
The vertical lines in figure 3 show the previous postwar bubbles, the size of the bubble in 2000—and its size in 2003, when commentators who blame the bubble on the Fed's monetary policy usually say that interest rates were kept too low. At that point, the bubble was already three times as large as any previous bubble. The Fed's monetary policy may have accelerated the growth of the bubble after 2003, but before 2003, and thus before the Fed's low-interest monetary policy took effect, the bubble had already reached an unprecedented size.

Figure 4 shows the relationship between nontraditional mortgages and the growth of 1997–2007 bubble. Nontraditional mortgages take many forms, including mortgages to borrowers with FICO credit scores of 660 or below, mortgages with low or no documentation, and interest-only mortgages. In figure 4, the nontraditional mortgages are loans with 3 percent down payments and debt-to-income ratios greater than 38 percent. The chart makes clear that as mortgage underwriting standards declined the bubble continued to grow. This is to be expected; as borrowers were able to gain additional leverage through lower down payments they could pay more for homes they wanted, accelerating the bubble.

Housing bubbles tend to suppress delinquencies and defaults while they are growing. This is because, as prices rise, it becomes possible for borrowers in financial trouble to refinance their loans or sell their homes for more than

FIGURE 4

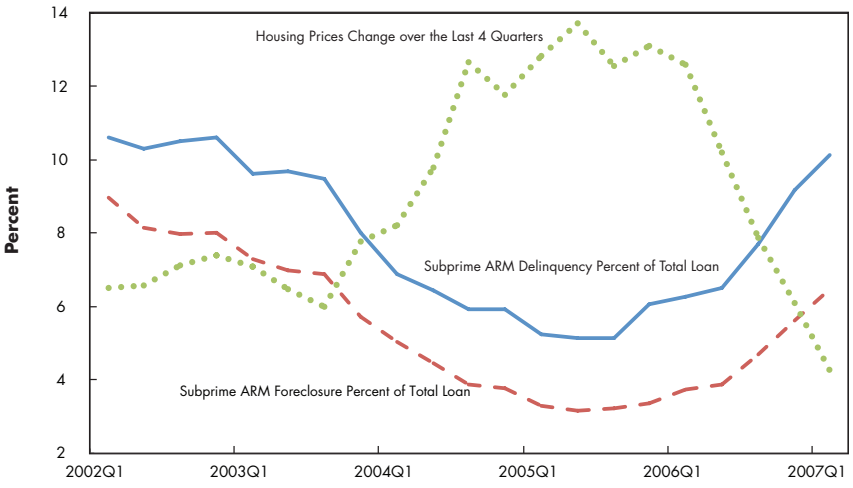
NONTRADITIONAL MORTGAGES FED THE GROWTH OF THE HOUSING BUBBLE



Source: Various indices as detailed in the graph.

FIGURE 5

THE EFFECT OF RISING HOME PRICES ON MORTGAGE DEFAULTS



Source: John B. Taylor, *Getting Off Track* (Hoover Institution Press, 2009), 12.

the principal amount of the mortgage. Under these conditions, potential investors in mortgages or mortgage-backed securities receive a strong affirmative signal; they see high-yielding mortgages—loans that reflect the riskiness of lending to a borrower with a weak credit history—without the expected number of delinquencies and defaults. They come to think that "this time it's different": that the risks of investing in subprime or other weak mortgages are not as great as they had thought (figure 5).

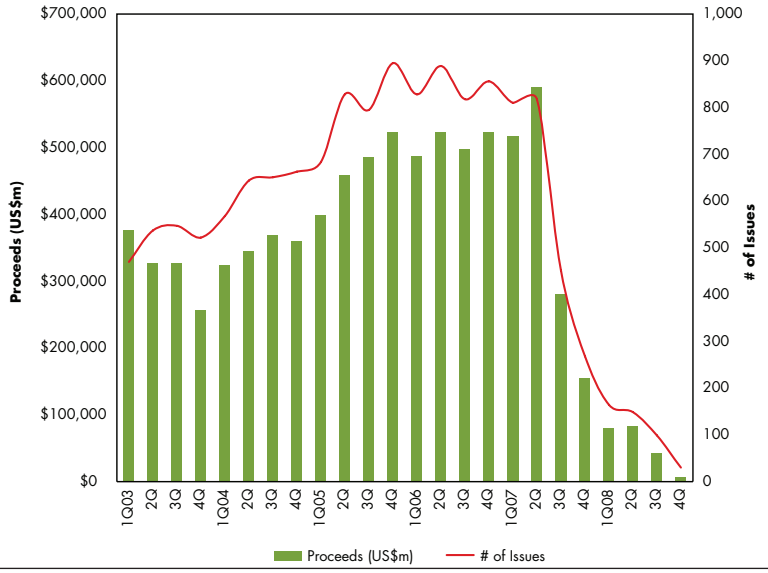
Housing bubbles are also procyclical. When they are growing, they feed on themselves as buyers bid up prices so they will not lose a home they want. Appraisals, based on comparable homes, keep pace with rising prices. And loans keep pace with appraisals, until prices get so high that buyers cannot afford them no matter how lenient the terms of the mortgage.

But when bubbles begin to deflate, the process reverses. It then becomes impossible to refinance or sell a house where the mortgage is higher than its appraised value. Financial losses cause creditors to pull back and tighten lending standards, recessions frequently occur, and would-be purchasers cannot get financing. Sadly, many are likely to have lost their jobs in the recession but cannot move where jobs are more plentiful because their mortgages are underwater. In these circumstances, many homeowners are tempted to simply walk away from the mortgage, knowing that in most states the lender has recourse only to the home itself.

With the largest housing bubble in history deflating in 2007, and with more than half of all mortgages made to borrowers who had weak credit or little equity in their homes, the number of delinquencies and defaults in 2008 was unprecedented. One immediate effect was the collapse of the market for private mortgage-backed securities (PMBS) that were held by banks and other financial institutions in the United States and around the world.

Investors, shocked by the sheer number of mortgage defaults that seemed to be underway, fled the market for these securities, causing a sharp drop in market values. Figure 6 shows the collapse of the PMBS market, beginning in 2007. What little PMBS market activity that there was in

FIGURE 6
COLLAPSE OF THE MARKET FOR PRIVATE MORTGAGE-BACKED SECURITIES



Source: Thompson Reuters, *Debt Capital Markets Review*, Fourth Quarter 2008, http://thomsonreuters.com/products_services/financial/league_tables/debt_equity/.

2007 and 2008 probably came from purchases by Fannie and Freddie, which received AH goals credit for purchasing PMBS that were backed by subprime and other low-quality mortgages.

This had a disastrous effect on financial institutions. Since 1994, they had been required to use mark-to-market accounting in setting the balance sheet value of their assets and, in some cases, their operating results. The absence of a market for the PMBS they held meant that many of these institutions had to write down the value of their PMBS assets to the distress values that prevailed in the market at the time. This reduced their capital positions and made them appear unstable and perhaps insolvent. In many cases, the mark-to-market rules also inflicted significant operating losses, which also contributed to investor anxiety and fear.

In this environment, the bankruptcy of Lehman Brothers in September 200 produced a full-scale investor panic, causing financial institutions to hoard cash and refuse to lend to one another, even overnight. This was the financial crisis. The ill-chosen remedy was the Dodd-Frank Act, which has drastically lengthened the period of recovery.

Thus, between 1992 and 2008, yet another government intervention in the housing finance market triggered instability, but in this case the intervention was so pervasive and went on for so long that it caused more than simply a decline in housing prices and a large number of mortgage defaults; instead, by weakening the financial institutions that normally hold mortgages and mortgage-backed securities, it caused a global financial crisis.

Can This Pattern Be Changed?

As long as government remains in charge of housing finance policy, we can have little hope that anything will stop the repeating cycles of housing boom and bust that characterized the half-century between the late 1950s and 2008.

It is in the nature of democratic government to provide benefits to its citizens. We see this every day in how difficult it is for Congress to cut discretionary spending of any kind or to trim out-of-control entitlements. Moreover, once established, government programs keep growing over time. Social Security was enacted in 1935. Initially, it provided benefits to retired workers, but it was expanded in 1939 to cover their dependents and survivors and, later, to cover disabilities. Still later, Social Security benefits were tied to inflation and wages. Medicare and Medicaid were later extended to other groups, and on and on. This is not to say that these programs were not justifiable on some grounds. The point is the pattern: once established, these programs continued to expand.

A good part of the current opposition to Obamacare, for example, comes from those who recognize its problematic potential for unchecked growth. Whatever the system is today, say its opponents, it will be larger, more expensive, more intrusive, and more destructive of individual choice in the future. If we look at the history of other government programs, that can hardly be denied.

The housing finance system itself is an excellent example of continual benefits expansion. Because Fannie and Freddie were in effect subsidized by their government backing before 1992, the US housing finance system provided mortgages to the middle class at a somewhat lower cost than to other individuals. The middle class were the principal beneficiaries because the GSEs could not buy mortgages larger than a certain size, essentially limiting the benefits of a GSE mortgage to middle-class home buyers. And given the GSEs' underwriting standards, only middle-class home buyers who had saved for a down payment and

maintained good credit were able to get mortgages at the lower rate that the GSEs were able to provide.

In 1992, as I have noted, Congress required that the benefits of a GSE mortgage be shared with low- and moderate-income borrowers through the so-called AH goals. Then, in 2008, Congress increased the conforming loan limit for high-cost areas of the country so that the benefit of a GSE mortgage could be extended to people buying $1 million homes.

Indeed, even now, the government is doing it again—proposing the virtual elimination of underwriting standards in the future. The Dodd-Frank Act authorized the Consumer Financial Protection Bureau (CFPB) to outline the terms of a minimum-quality loan, the Qualified Mortgage (QM). The act also directed the federal financial and housing regulators to outline the terms of a high-quality mortgage, called the Qualified Residential Mortgage (QRM). The CFPB proposed the QM in January 2013 to general approval in the housing industry (a bad sign). The QM prohibited a number of low-quality mortgages, such as loans that do not amortize or that involve high borrower costs, but its most important element was a legal obligation placed on the lender to assure that the borrower had the ability to repay the loan at the time the mortgage was agreed to.

It is important to point out that establishing the borrower's ability to repay when he or she contracts for a mortgage is not even close to a complete underwriting standard. Underwriting is the process of determining not only whether a borrower can repay but also whether he or she will repay. History has shown that borrowers' credit ratings (which show their willingness or propensity to pay) and down payments (which show their commitment to the home and thus the mortgage) are far more important indicators of a loan's quality than the fact that a borrower has a job and an income at a particular point in time. A mortgage with no down payment and a credit score of 660 or less would qualify under the QM standard, but a glance at table 1 will show that the default propensity of loans with these characteristics is almost 13 times higher than those that have 10 percent down payments and FICO scores above 660.

In contrast, Dodd-Frank intended the QRM to be a loan of such high quality that sponsors of securitizations would not be required to retain any of the risks of mortgage pools containing solely QRMs. The Fed, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the SEC, the FHFA, and HUD were the six financial regulators that were required under Dodd-Frank to develop the terms of the QRM, and they initially outlined their proposal in 2011. This produced an outcry from the housing industry (another bad sign) because the proposal contained a requirement for a 20 percent down payment. A down payment that high, many in the industry argued, would mean that large numbers of people would not be able to buy homes. Forgotten was the fact that the homeownership rate was approximately 64 percent for the 30 years before the AH goals were adopted, and for much of that period the traditional conventional mortgage required a down payment of that size.

Nevertheless, the regulators went back to the drawing board and, in August 2013, reproposed a QRM that is virtually identical to the QM, the minimum mortgage standard. Underwriting standards such as a FICO score and a down payment were abandoned, even though the regulators admitted in their proposal that mortgages meeting the QM standard had a default rate of 23 percent between 2005 and 2008.[16] Needless to say, a market in which defaults could reach 23 percent would not be stable. But the agencies did away with significant underwriting standards because, they stated, they were "concerned about the prospect of imposing further constraints on mortgage credit availability at this time, especially as such constraints might disproportionately affect groups that have historically been disadvantaged in the mortgage market, such as lower-income, minority, or first-time home buyers."[17]

This is the same rationale that underlay the destructive affordable housing goals. The events of 2008 had taught the agencies nothing. Once again, the government is on the way to adopting policies that will enable more people to buy homes. By some lights, that may be good social policy. It is certainly good short-term politics; it will please the realtors and homebuilders, as well as a large number of voters who will not see the downside until they lose their homes in the next turn of the cycle.

However, if what we are after is a stable housing market—avoiding future financial crises and protecting the taxpayers—the current direction is certainly the wrong direction. It will simply continue the instability that has plagued the mortgage market since the government first began to manipulate mortgage underwriting standards in the late 1950s.

Conclusions

All this allows several conclusions.

First, reasonable underwriting standards—such as those that kept the homeownership rate at 64 percent for 30 years—reduce mortgage defaults and thus have the potential to create a stable housing finance market.

Second, far from taming the tendencies toward asset bubbles in housing, as the left claims, the government's policies consistently promote bubbles by reducing down payments, increasing borrower leverage, and artificially increasing housing demand.

Third, instead of "consumer-friendly" loans that reduce defaults, government policies that reduce or eliminate underwriting standards tend to bring into the market people whose credit position is weak and unstable. As Barney Frank—long a supporter of the AH goals—noted in 2010, "[I]t was a great mistake to push lower-income people into housing they couldn't afford and couldn't really handle once they had it."[18] Yet, by eliminating the QRM in order to assist borrowers who cannot meet reasonable underwriting standards, the government is proposing to do the same thing again.

Finally, and perhaps most important, it seems clear that powerful political incentives will relentlessly push the government—if it has the power to do so—into loosening mortgage underwriting standards: this step is costless at first, satisfies powerful interest groups, can be credibly presented as a source of economic growth, and provides a short-term benefit to large numbers of voters. For politicians, the combination is irresistible. Yet the long-term result, as shown again and again over the last half-century—with increasing severity—is instability and even financial crisis.

Given this reality, a privately operated housing finance system is the only structure with the potential to create a stable market. In a future *Outlook*, I will discuss how, even within the context of Dodd-Frank, a private financing system can tame the housing market's recurrent cycles of boom and bust.

Notes

1. See, for example, David Min, "How Government Guarantees in Housing Finance Promote Stability," UC Irvine School of Law Research Paper No. 2012-73, 2012, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2153886.

2. "Rating of Borrower" (part II, section 3), in *FHA Underwriting Manual*, February 1936 edition

3. John P. Herzog and James Earley, *Home Mortgage Delinquency and Foreclosure* (Cambridge, MA: National Bureau of Economic Research, 1970), 12, www.nber.org/chapters/c3294.pdf.

4. Ibid., 10, table 2.

5. Department of Housing and Urban Development, Office of Policy Development and Research, *1986 Report to Congress on the Federal National Mortgage Association*, 1986, 6. See also Timothy Howard, *The Mortgage Wars* (New York: McGraw-Hill Education, 2013), 25–29.

6. Government Accountability Office, *Secondary Mortgage Market: Information on Underwriting and Home Loans in the Atlanta Area*, Report to Congressional Requesters, November 1990, www.gao.gov/products/RCED-91-2.

7. Fannie Mae, "Serious Delinquencies by Demographic Characteristic," March 1992. (Document in author's files.)

8. *Housing and Community Development Act of 1992*, Public Law 102-550, 106 Stat. 3672, H.R. 5334, (October 28, 1992), Title XIII.

9. Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Board, Office of Thrift Supervision, "Expanded Guidance for Subprime Lending Programs," January 31, 2001, www.occ.gov/news-issuances/bulletins/2001/bulletin-2001-6.html and www.occ.gov/news-issuances/bulletins/2001/bulletin-2001-6a.pdf.

10. Fannie Mae, 2002 Form 10-K, March 31, 2003, 85, http://phx.corporate-ir.net/phoenix.zhtml?c=108360&p=irol-secAnnual &control_SelectGroup=Annual%20Filings.

11. Freddie Mac, *Financial Report for the Three and Nine Months Ended September 30, 2007*, November 20, 2007, 8, www.freddiemac.com/investors/infostat/pdf/supplement_112007.pdf.

12. Fannie Mae, 2006 Form 10-K, 146, www.fanniemae.com/resources/file/ir/pdf/proxy-statements/form10k_081607.pdf.

13. US Department of Housing and Urban Development, "Regulation of Fannie Mae and Freddie Mac: Final Rule," *Federal Register* 69, no. 211 (November 2, 2004): 63581, http://gpo.gov/fdsys/pkg/FR-2004-11-02/pdf/04-24101.pdf.

14. US Department of Housing and Urban Development, *Profiles of GSE Mortgage Purchases in 2005–2007*, 2007, table 10a-2007, www.huduser.org/datasets/GSE/profiles_05-07.pdf.

15. The data on subprime and other nontraditional mortgages (NTMs) used in this *Outlook* were developed by my AEI colleague Edward Pinto. In his initial analysis, in 2010, he found approximately 26.5 million subprime and other NTMs in the US financial system. In 2011, the SEC sued some of the top officers of Fannie and Freddie for failing to disclose that the GSEs were acquiring large numbers of NTMs. In connection with the suit, the SEC identified approximately 1.3 additional nonprime loans that had not been previously reported, bringing the total to just under 28 million. The Freddie data set, and a similar data set disclosed by Fannie, showed that the GSEs were exposed to an additional 3.5 million NTMs, bring the total to more than 31 million.

16. US Department of the Treasury et al., "Credit Risk Retention" (Reproposal), August 2013, 258, www.federalreserve.gov/newsevents/press/bcreg/bcreg20130828a1.pdf.

17. Ibid., 263.

18. Larry Kudlow, "Barney Frank Comes Home to the Facts," Real Clear Politics, August 21, 2010, www.realclearpolitics.com/articles/2010/08/21/barney_frank_comes_home_to_the_facts_106844.html.