Opening the Credit Box

by
Jim Parrott and Mark Zandi

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Prepared by

Moody's Analytics

Urban Institute

Table of Contents

Opening the Credit Box 2
How tight is the credit box? 3
Mortgage credit and full employment 5
What is behind the tight credit box? 5
Hangover from the Great Recession 5
Costly nonperforming loans 6
Refi focus 6
Put-back risk 6
Judgment calls 7
Changed circumstances 7
Foot faults 7
Interpreting the rules 7
Policy response 8
Conclusions 8
About the Authors 10

Opening the Credit Box

The continued recovery of the U.S. housing market is key to the recovery of the broader economy. Unless and until housing makes a broad-based and sustained comeback, the nation will not return to full employment and robust economic health.

Fortunately, housing has recently posted some hopeful numbers. Housing starts have nearly doubled since their nadir during the Great Recession, rising from 500,000 to 900,000 units (annualized), and prices are up 15% from only two years ago. That resurgence has in turn helped fuel much of our recent economic growth. But this momentum faces worrisome headwinds.

The recent turn in the housing market has been powered in part by strong demand from investors who have been buying up distressed properties at a voracious rate, driven by low house prices and strong rental demand. However, with fewer remaining distressed properties, rising house prices, and easing rental demand, investor demand has begun to wane.

For the housing recovery to maintain its momentum, first-time and trade-up homebuyers must fill the void left by investors. The recent rise in interest rates complicates this transition, as 30-year, fixed mortgage rates have jumped from a historic low below 3.5% a year ago to above 4.5% today. Although mortgage rates are still low by historical standards, when combined with higher house prices they make single-family housing no longer as affordable as it was just a few months ago. This is a problem especially for first-time buyers, who tend to have lower credit scores and little savings for down payments.

Potential homebuyers are also grappling with exceedingly tight mortgage credit conditions. All but those with the most pristine balance sheets find it difficult to obtain loans. The average credit score on loans to purchase homes this year is over 750, some 50 points higher than the average credit score, and 50 points higher than the average among those who took loans for home purchases a decade ago, before the housing bubble.

A range of mutually reinforcing factors is driving this constriction of credit. First, lenders have reassessed how much risk they are willing to take on, in part because they were burned badly in the crisis and in part because they have come to recognize a range of costs associated with riskier lending not fully appreciated before: the increased cost of servicing distressed borrowers; the reputational and legal risks associated with servicing significant numbers of delinquent or defaulting loans; and a similar range of risks associated with originating loans that subsequently default, to name but a few.

Another factor keeping credit tight is the amount of industry resources devoted to refinancing, a booming business in recent years whose revenues have allowed lenders to remain conservative in their purchase origination business. While rising interest rates and a cooling refinance market change these economics, it remains an open question whether lenders will pivot from refinancing to a more aggressive approach to the purchase market.

Finally, deep uncertainty about when and why Fannie Mae, Freddie Mac, and the Federal Housing Administration will force lenders to take back credit risk for underwriting mistakes exacerbates all the other factors already mentioned. When a lender makes a loan to be purchased or insured by one of these institutions, which together cover 85% of the purchase market, they do so with the understanding that they will not bear the cost of any subsequent default. However, the government retains the right to put the cost of a defaulting loan back on the lender if it is later determined that the lender did not follow the rules in making the loan. This allows Fannie, Freddie and the FHA to enforce their underwriting guidelines and thus better manage their risk.

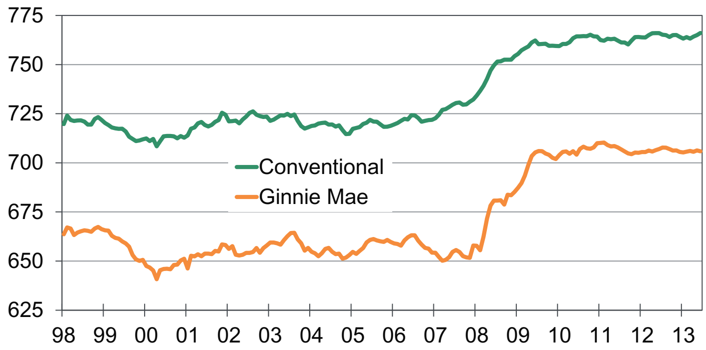
In recent years, these institutions have been much more aggressive about putting defaulting loans back to lenders. This aggressiveness, combined with lender uncertainty about the rules they are supposed to follow to avoid put-backs, has led them to discount the credit-risk protection they receive from the institutions. Lenders are only willing to make loans intended for purchase by Fannie or Freddie or insurance by the FHA if there is little prospect of default, so that they do not expose themselves unwittingly to the risk that they will bear the cost.

These factors, together with a host of uncertainties about where forward-looking rules and reforms will land—from the definition of qualified residential mortgage to the reform of Fannie, Freddie and FHA—are keeping lending tight, which is in turn depressing demand and holding back not only the housing market but also the broader economic recovery. If left unaddressed, the problem could become a binding constraint with serious consequences for long-term economic growth, particularly as the nation's demographics change and fewer people fit neatly into the current credit box.

Easing mortgage lending standards so that more creditworthy borrowers can obtain the loans needed to purchase homes is thus not only important to the current recovery, but also critically important to the economy's long-term health. Policymakers must rise to the challenge by reducing the uncertainty that is driving lenders to tighten the credit box, applying the same focus and sense of urgency that they applied to opening up refinancing through the Home Affordable Refinance Program: the problem is similar, but the stakes much higher. To be clear, the objective is not, and should not be, a return to the recklessly loose standards of the bubble years, but to strike a sensible balance between risk management and access to credit. Today's market has overcorrected, and it is hurting the nation's recovery.

Chart 1: Mortgage Lenders Want Higher Credit Scores

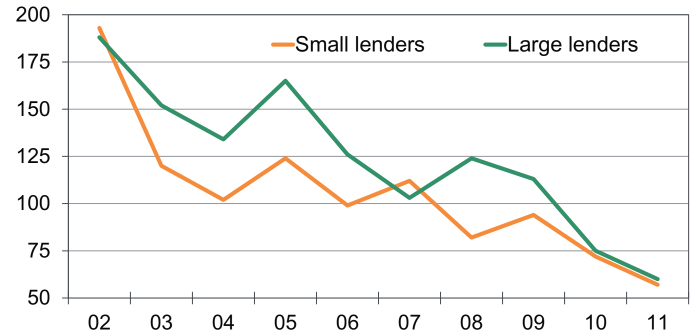
Avg credit score for purchase loans at origination



Sources: CoreLogic, Moody's Analytics

Chart 2: More Underwriting Diligence

Avg monthly number of applications per underwriter



Sources: Mortgage Bankers Association/Stratmor Peer Group Survey, Moody's Analytics

How tight is the credit box?

Mortgage lending is tight by historical standards. It is of course tight by the standards of the housing bubble, but also by the standards in place before the bubble a decade ago when mortgage lending was more staid and generally much less risky.[1]

Tight mortgage underwriting is most evident in the high credit scores lenders require from households receiving a loan to purchase a home. The average score of households receiving purchase mortgage loans from Fannie Mae and Freddie Mac rose to a new high of 766 in June (see Chart 1). A decade ago, prior to the housing bubble, average credit scores were some 50 points lower. Current FHA borrowers have an average credit score above 700, also about 50 points higher than in more normal times.

Lending to households with lower credit scores has also fallen sharply. Only 10% of purchase loan borrowers earlier this year had scores below 660, and virtually no one had scores below 620. Prior to the housing bubble, typically closer to one-fifth of borrowers had sub-660 scores.[2]

For context, less than one-third of Americans have scores above 766, and one-third have scores below 660. The average credit score for all Americans is 700.

The recent tightening in underwriting through higher credit scores is even more stringent than the data suggest, as the same score represents a lower credit risk today than it has in recent history. Households with high scores today earned them during a tough economic period with high unemployment, weak stock prices, and declining house values. In contrast, households had a much easier time obtaining high credit scores in the late 1990s and the early 2000s, when unemployment was low and stock and house prices were posting record highs.

As one would expect, the credit scores lenders will accept for a mortgage loan determines the size of the pool of eligible borrowers. Every 10-point reduction in the required average credit score increases the pool of potential mortgage borrowers by just over 2.5%.[3] Thus, if the average acceptable credit score declined 50 points, putting it back to where it was before the housing bubble, then the pool of potential mortgage borrowers would increase by 12.5% or more than 12.5 million households. Even if only half of these potential borrowers were to become homeowners, the impact would be significant.

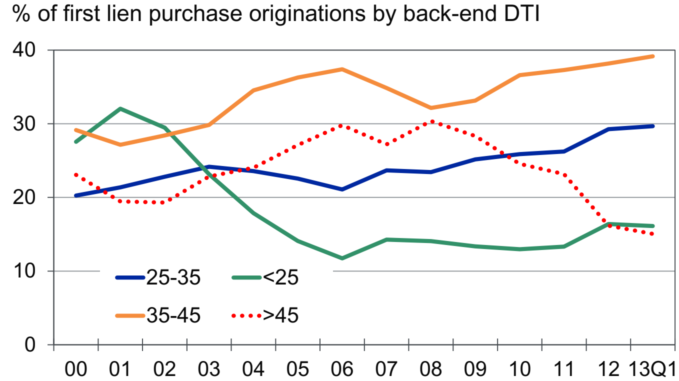
The tight underwriting environment has virtually eliminated access to all but plain-vanilla, long-term, fixed-rate loans. While this is arguably appropriate in many cases—few miss "alt-A," subprime, interest-only or negative-amortization loans—even adjustable-rate mortgages have fallen off dramatically.[4] If Fannie and Freddie are taking any risk, it is by making more loans to investors, who account for one-tenth of the two finance agencies' originations this year, a larger than normal share.

The tighter lending is also evident in lenders' substantially greater due diligence. Lenders are appropriately looking over the loans they originate with much more care. According to an annual Mortgage Bankers Association survey, the typical loan underwriter works on 50 applications per month (see Chart 2). This compares with almost 200 applications a decade ago.

Underwriting does not appear overly tight in terms of debt-to-income or loan-to-value ratios. Forty percent of purchase borrowers have a back-end debt-to-income ratio between 35% and 45%, compared with less than 30% of borrowers prior to the bubble.[5] And while only 15% of purchase borrowers today have a back-end DTI above 45%—fewer than before the crisis—that is appropriate, since 45% is an unmanageably high ratio for most borrowers (see Chart 3).

Chart 3: Mortgage Borrowers Have High DTI Ratios

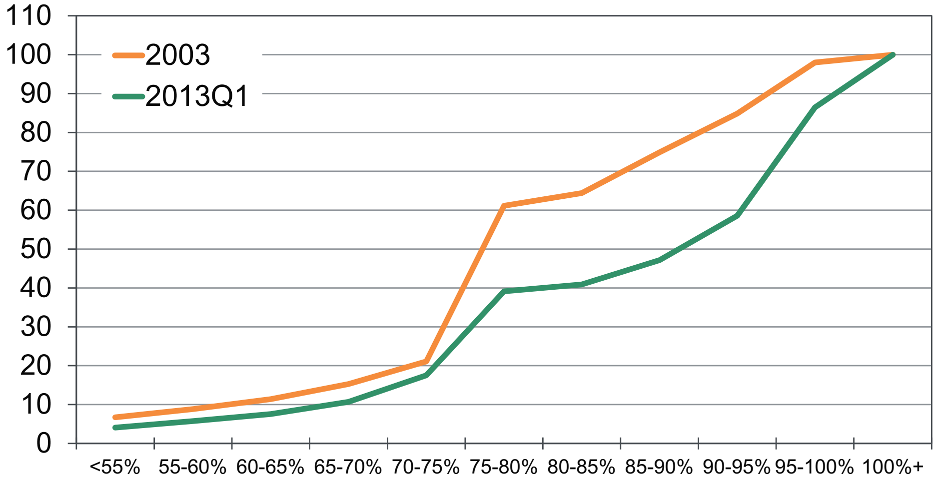
% of first lien purchase originations by back-end DTI



Sources: CoreLogic, Moody's Analytics

Chart 4: Lenders Are Accepting Higher LTV Ratios

Cumulative distribution of LTVs for purchase originations, %



Sources: CoreLogic, Moody's Analytics

Nor do loan-to-value ratios appear to be overly restrictive relative to historical standards. The average purchase loan today has an LTV of 85% to 90%, compared with 75% to 80% prior to the bubble (see Chart 4). This high range of average LTVs is partly because so much homeowner equity was wiped out during the housing crisis and partly because of the high share of high-LTV lending by the FHA. The numbers may be a bit overstated given a trend in conservative appraisals, but likely only somewhat.

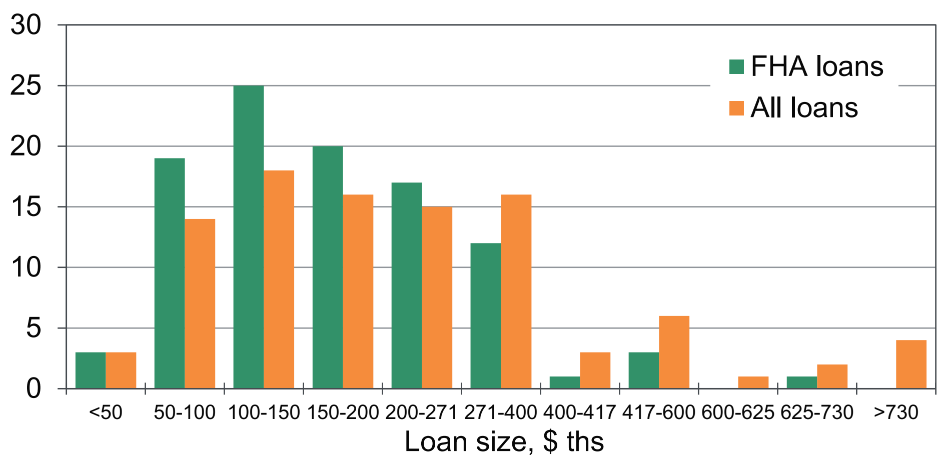
Some impending moves by Fannie and Freddie and possibly the FHA will tighten the credit box further. Fannie Mae has announced that it is increasing the down payments required for loans that it supports from 3% to 5%, and the Federal Housing Finance Agency has also said the maximum size of Fannie- and Freddie-backed loans will fall. The latter puts pressure on FHA to follow suit so that it does not take on increasing market share as the government-sponsored enterprises pull back. Although none of these steps is likely to have a significant impact on its own—indications are that the initial drop in loan limits will be incremental—together they will exert additional pressure on access to credit, particularly if policymakers take steps to reduce the government's footprint before we see a rebound in the still-dormant private-label securitization (PLS) market.

For a sense of the impact that a more aggressive contraction in the government's support of the market would have, consider a reduction in the current limit of $625,000 in high-cost states to the $417,000 limit available in the rest of the country. If in place this year, close to 7% of purchase originations would not have been able to get a GSE loan. Lowering the limit further to $400,000 would affect an additional 3% of purchase originations (see Chart 5). Of course, a much higher share of originations would be affected in regions with high house prices such as California, the Northeast Corridor, and parts of Florida and Illinois.

Reducing Fannie and Freddie's outsize role in the mortgage market is ultimately desirable, but will significantly tighten the credit box and impair the housing and economic recoveries if private mortgage lenders are not able to fill the void when that contraction occurs. It is encouraging that bank lenders who originate jumbo loans are stepping up their lending, especially in strong housing markets such as the Bay Area of California. But they still appear cautious about making higher-LTV loans, raising questions about how prepared they are to provide the broader liquidity needed as the government pulls back. Only one-fifth of purchase loans originated so far this year with a balance of $417,000 to $625,000 had a greater than 80% LTV. How the government's moves affect access to credit for the segments of the population on the other side of their withdrawal will ultimately depend on whether there is a PLS market in place to fill in the void. But it will clearly be important for policymakers to ensure that as they curb government lending they shrink its market share, not the size of the market.

Chart 5: How Important Are Lower Loan Limits

Share of purchase loan originations by loan size, %, 2013 ytd



Sources: Mortgage Bankers Association, Moody's Analytics

Mortgage credit and full employment

The availability of mortgage credit is critical to the housing market's recovery and, given housing's central role in the economy, to the broader recovery. If credit remains tight as investor demand fades and mortgage rates rise, it could choke off housing's budding revival. And more home sales, housing construction, and house price growth is necessary to create the additional jobs needed to return to full employment.

Investors have been instrumental to housing's turnaround. Low prices, especially for distressed properties, combined with strong rental demand and rising rents, have made single-family housing an attractive investment. Investors have been particularly active in the distressed housing markets in Arizona, California, Florida and Nevada, accounting for as much as two-thirds of existing-home sales in early 2012. Nationwide, investors accounted for almost one-third of sales last year, up from closer to one-tenth of sales a decade ago.

Access to mortgage credit has not been an issue for most investors. Many have been institutional investors with significant financial resources, and the bulk of their purchases have been made with cash. Fannie, Freddie and the FHA also have lending programs to help qualified investors obtain mortgages to facilitate the sale of distressed properties.

Housing investor demand has peaked, however, as it is no longer as easy to obtain such a good return buying a distressed property, fixing it up, and renting it out. Prices for distressed properties have risen as the number of properties in REO falls. Fannie, Freddie, the FHA, bank lenders and PLS pools currently have just over 300,000 homes in REO, half the number at its peak in 2010. There are still close to 1.5 million loans somewhere in the foreclosure process and 1.2 million more that are seriously delinquent and likely to end up there. Many of these properties have been vacant a long time, however, and will be costly to renovate. Rental prices have also moderated as the supply of single-family homes for rent has ballooned.

With investor demand waning, the housing recovery will gather strength only if there is more demand from first-time and trade-up homebuyers. Coming out of the crisis, however, demand from first-timers has remained notably soft, accounting for no more than one-third of home sales, compared with closer to one-half of sales in more normal times. First-timers are generally younger households in their 30s, a group that has been hit particularly hard by the tough economy. Job growth has been slow, and most new jobs are lower-paying. Add to this a significant aggregate student debt load, and younger households face challenges maintaining the high credit scores and down payments needed to obtain mortgage loans.

Access to mortgage credit has also become more challenging with the recent increase in mortgage rates. Rates on long-term, fixed-rate loans are still low but have risen more than a percentage point since the start of 2013. For the typical first-time buyer this will add about $150 to a monthly mortgage payment, significantly reducing affordability. In early 2012, a first-timer earning the median income could purchase an existing home priced at 140% of the median. That ratio is closer to 100% today. It is still affordable compared with most other times, but the reduction in affordability means that several million first-timers who could have purchased a home just a few months ago no longer can.[6]

The impact of tight credit conditions on housing demand and the broader economy is evident from simulations of the Moody's Analytics U.S. structural economic model. In the model, existing- and new-home sales are determined by household formations, real after-tax household income growth, the user cost of housing, and mortgage credit standards. Mortgage credit standards are measured by a combination of the average credit score, back-end debt-to-income ratio, loan-to-value ratio, and adjustable-rate mortgage share for first mortgage purchase loan originations.[7]

When the Moody's macro model was run under the assumption that lenders lower the average credit score necessary to obtain a purchase mortgage loan by 50 points—consistent with the scores lenders have accepted in more normal times—the annual pace of new- and existing-home sales rose by nearly 450,000 units. The model suggests this increase would occur four to six quarters after the change in scores.[8] The rise in home sales in turn would support 275,000 more single-family housing starts per year, and raise house prices nearly 4%.

Housing largely affects the broader economy through construction and the wealth effects of rising house prices on consumer spending. Thus, in the simulation, the increase in housing construction and house prices lifts real GDP by 0.7%, adds 600,000 jobs and reduces unemployment by 0.4 percentage point. This is approximately one-fourth of the gap between the current unemployment rate of 7.3% and the estimated full-employment rate of 5.7%.[9] Normalizing credit scores will not by itself get the economy back to full employment, but it would go a long way and, at the very least, cushion the negative fallout from rising interest rates.[10]

What is behind the tight credit box?

Identifying the factors that are keeping lenders so cautious is key to opening the tight mortgage credit box. A painful hangover from the Great Recession, a reassessment of some of the costs involved in mortgage lending, the diversion of resources to refinancing, and regulatory uncertainty are all important parts of the explanation.

Hangover from the Great Recession

It is useful to begin any consideration of the credit environment by recalling what we have come through over the past five years. The crisis in the housing market wiped out trillions of dollars in homeowner and institutional wealth, put millions of Americans into foreclosure, brought scores of financial institutions to their knees, and led the nation to the brink of fiscal disaster. The crisis was driven in large part by loose lending, as everyone involved— homeowners, lenders and investors—took on too much risk and paid dearly for it.

It should be no surprise, then, that market participants are now being conservative about taking on credit risk. While the impact of this broad conservatism is impossible to quantify, it is important to keep in mind, as it hangs over credit-risk decisions made all through the housing finance system, lowering the industry's risk tolerance generally and exacerbating each of the other causes discussed below.

Costly nonperforming loans

One of the more acute lessons that lenders have learned in the crisis is how expensive and risky it is to service large numbers of nonperforming loans. Servicing borrowers who call with questions about how to hold on to their home when they can no longer pay their bills is altogether different than servicing someone who simply mails in a check each month. A lender spends on average eight times more money servicing a nonperforming loan than one that is performing.[11]

Heading into 2008, most lenders' servicing models were designed to handle relatively small numbers of defaulting borrowers. As the numbers rose, lenders had to build new systems to handle a completely different kind of servicing business, in which more time was spent managing complicated relationships with economically distressed customers. Many institutions were slow and clumsy in adapting, which led to more defaults than necessary and a wave of legal action and bruising publicity that continues to this day.

As a result of the experience, lenders now anticipate greater servicing cost and legal and reputational risk should those loans go into default. The larger projected costs in turn make these loans less attractive to offer, because lenders are reluctant to charge higher fees to make up the difference, given the legal and optical risks of charging significantly different rates to this group of borrowers.

Refi focus

Another reason for lenders' tight underwriting is their recent focus on mortgage refinancing. In 2012, rates fell below 4% for the first time in 50 years, and the administration's efforts to expand refinancing through improvements to HARP and the QRM FHA's streamlined refi program began to bear fruit: Refinancing volume surged to $1.2 trillion, up one-third from the prior year.[12] Although this boom has been important to the broader economy, putting more money into the pockets of millions of families and in turn their local economies, some of it has come at the expense of purchase originations.

Rather than simply expanding their resources to meet the surging demand for refinancing, lenders chose to divert at least some of the needed resources from elsewhere, including their purchase origination business. They also managed the surge by increasing margins on their refinancing business, expanding their average margin per loan sixfold from the first quarter of 2011 to the second quarter of 2012.[13] In a more competitive environment, market pressures would have kept these margins down, but in the consolidated lending industry that emerged from the crisis, lenders have been able to use higher margins to manage demand while maintaining more than adequate revenues to make up for the opportunity cost of tighter originations.

The net effect of these measures was to put the entire lending industry in a strong position to limit new lending to lower risk borrowers. As we will discuss below, however, this dynamic is changing as interest rates rise and refinancing eases.

Put-back risk

The final factor keeping underwriting tight is in many ways the most important, because unlike the others, it is within the control of policymakers.

When lenders originate loans that are guaranteed by Fannie Mae or Freddie Mac or insured by the FHA, they make a set of commitments, called "reps and warranties" in the industry, affirming that they have complied with the underwriting guidelines established by the government guarantors. If it is later determined that the loan did not comply with these reps and warranties, the guarantors can put the credit risk back to the lender. With Fannie and Freddie, this means forcing the lender to buy back the loan; with the FHA, it means forcing the lender to indemnify the agency for any insurance claim made on the loan.

This protection of course makes sense. Fannie, Freddie and the FHA agree to assume the credit risk of a given loan based on the understanding that the loan meets certain characteristics, including the borrower's credit score, the value of the collateral, and so forth. Having some confidence in those characteristics is important in determining not only whether they should or even can back the loan, but also how to price the loan to cover their risk. Without confidence in those characteristics, the agencies would be unable to manage their risk adequately.

In recent years, Fannie, Freddie and the FHA have each become more aggressive about exercising their right to put the credit risk of loans back to lenders. In 2011 and 2012, for instance, Fannie and Freddie together required lenders to buy back $43 billion in loans, an 80% increase over the prior two years. Early indications are that both institutions have been even more aggressive through the first half of this year.[14] Some of this increase was to be expected given the dramatic rise in defaults over the period, as the government guarantors have a greater interest in putting loans back if they go into default. But at least some of the increase can be attributed to an increasingly aggressive posture regarding what constitutes sufficient grounds for a put-back.

This aggressive turn is not itself a problem. Under normal circumstances, lenders could adapt to changing regulatory conditions by improving their quality control or raising prices to reflect increased risk. The problem is that Fannie, Freddie and the FHA have stepped up their put-backs in ways that lenders cannot address adequately through better underwriting or pricing. This includes disagreements over judgment calls made by lenders or their agents; changes in circumstances occurring after the underwriting process has been completed; small mistakes that bear little relation to either the credit risk or the subsequent default; and inconsistent interpretations of the rules.

This has forced lenders to manage their risk by reducing the risk of default. In other words, because they cannot confidently minimize or price for the kind of underwriting decisions that Fannie, Freddie or the FHA may penalize them for, they are simply not lending to borrowers who might go into default.

Judgment calls

There are a number of steps in the underwriting of a loan in which the lender or their agent must exercise relatively broad judgment in complying with Fannie, Freddie and FHA guidelines. For instance, the lender must determine whether a prospective borrower has the intent to occupy the property for which they are seeking the loan. Their agent also must determine which properties are appropriate comparative sales (comps) for an appraisal. The underwriting process is replete with judgment calls like these, when the guidelines mandate a process to be followed but not a specific outcome to be reached.

For many of these calls, the government guarantor reserves the right to disagree with the judgment call made by the lender. When a borrower with a guaranteed loan defaults, the government guarantor may reappraise the house using different comps. If this results in a lower appraisal and a revised LTV that no longer qualifies for the terms that the government guarantor originally offered the lender, the government guarantor may put that loan back. Similarly, the government guarantor may review the loan file of a defaulting borrower and find that subsequent to the closing of the loan that borrower began to use the property as a second home. Now disagreeing with the lender's initial judgment that the borrower intended to use the house as a primary residence, the government guarantor may put that loan back.

In both instances, the lender follows the guidelines provided, but the government guarantor disagrees with a judgment call made and the lender finds itself stuck with a cost that it had assumed it was protected against.

Changed circumstances

Time elapses between when a loan is underwritten by a lender and when it is purchased or guaranteed by Fannie, Freddie or the FHA. Occasionally, circumstances change during that period, rendering a loan that was in compliance at the time of underwriting defective at the time the government guarantor takes on the risk.

For instance, the borrower may have taken a pay cut or assumed more debt, sending their debt-to-income ratio above the level needed to qualify for the loan to be guaranteed under the terms agreed to by the government guarantor. If that borrower subsequently defaults, the government guarantor may put the loan back to the lender.

Again, the lender follows all of the relevant underwriting guidelines but finds itself stuck with a cost that it had assumed it had protected itself against.

Foot faults

The typical loan file is several hundred pages long and contains thousands of pieces of information, ranging from matters that bear directly on the credit risk of the borrower, like his or her salary, to those that are more clerical in nature, such as the spelling of his or her name. Given the sheer volume of information, it is difficult for lenders to eliminate the risk of mistakes in the production of such a loan file.

Fannie, Freddie and the FHA nonetheless retain the right to put a loan back for virtually any mistake, however small or unrelated to the borrower's credit risk. For instance, if a government guarantor finds in the file of a defaulting borrower that a page in the deed of trust is unreadable, it may put the loan back to the lender even if the deed itself is without issue. Lenders are largely unable to control for this risk.

Interpreting the rules

Several different entities have the authority to enforce the reps and warranties that lenders make to the FHA. There is the regional Homeownership Center, which determines if a lender has made a mistake sufficient to trigger indemnification for any losses on the loan. There are four HOCs, each with a separate team charged with making these calls. There is also the FHA's inspector general, which may review the lender's underwriting to determine whether a mistake has been made sufficient to trigger a claim under the False Claims Act. If in the IG's judgment it has, then they refer the matter to the Department of Justice, which must decide whether to pursue treble damages triggered under the statute.

Currently there is no standard for interpreting or enforcing these rules, which means that there are multiple sets of decision-makers applying multiple interpretations, which may or may not line up with one another. Just because one HOC has ruled one way in one region does not mean that another will rule the same way in another region, or that the FHA's IG will agree and choose not to send the matter to the DOJ for further review. This interpretive uncertainty magnifies the uncertainty generated by each of the factors mentioned above.

All these gray areas create a sizable risk blind-spot for lenders. They know that it is there, but they do not know quite what is in it. This means they cannot protect against it through better underwriting or increased pricing and must do so instead by not lending to borrowers who have more than a very low risk of default. In essence, lenders are discounting the value of the insurance they have purchased from the government, lending to only those borrowers to whose credit risk the lender is comfortable remaining exposed.

This may not appear to be a bad thing. Lenders are retaining some skin-in-the-game, thus allowing less credit risk into the system, which in turn means less exposure for the taxpayer. The objective in risk management, however, is not to eliminate risk altogether but to strike the right balance between risk and return, which here is access to credit. Put differently, our policymaking goal here is not to stop lending, which is what it would take to eliminate altogether the credit risk to the taxpayer, but to make sure that lending strikes an appropriate balance between providing broad access to mortgage credit and not taking on too much credit risk.

In defining the credit criteria, a borrower must meet to qualify for a government-guaranteed loan, policymakers have attempted to strike that balance. But those decisions are being undermined in their implementation. In part because of the uncertainty generated by the enforcement of underwriting rules, the credit box defined by the policymakers has been rendered irrelevant by a much tighter one defined by the lenders. Thus an enormous number of borrowers who policymakers have decided should have access to government-backed credit do not.

Policy response

Fortunately, some of the factors behind the tight credit conditions are receding. The nightmare of the Great Recession is fading and, with the refinancing boom losing steam, lenders are turning their attention back to originating more purchase loans.

Policymakers can further help open the credit box by resolving lenders' uncertainty over put-back risk. The timing would be especially propitious as lenders consider how to respond to the weakening in refinancing activity. As mortgage rates rise and the refinancing boom that has driven bank revenues for several years subsides, lenders face a critical question. Do they pivot to purchase originations, redirecting resources to a more aggressive origination business? Or do they accept lower revenues and downsize their lending operations? Down one path we see the tightness in credit finally easing; down the other we see it calcify and threaten to become a long-term feature of the market. Announcements earlier this month that two of the nation's largest lenders, Wells Fargo and Bank of America, will lay off thousands of employees suggest that we may be taking our first steps down the second path.

The question, then, is what policymakers can do to alter this course by addressing the one factor directly within their control: the uncertainty generated by put-back risk. There are unfortunately no easy answers on how to do this since the rules that have generated the uncertainty are important in helping the government guarantors manage their risk and are complex in part because the credit risk involved is complex.

The answer is not simplicity, but clarity. Fannie, Freddie and the FHA need to work with lenders to identify the sources of uncertainty. Where do judgment calls, changes in circumstance post-underwriting, foot faults, or conflicting interpretations leave lenders unable to protect against their risk by better underwriting? The objective needs to be creating and enforcing rules in a way that leads to better underwriting and quality control, not less lending.

There is a model for addressing this challenge. Back in late 2010, policymakers were growing frustrated by the underwriting overlays that lenders were putting in place in their lending through HARP. Although Fannie and Freddie were committed to guaranteeing these loans, a lack of clarity about when and why they might put such a loan back to lenders made lenders reticent to make them except to a small subset of those borrowers who actually qualified for the program.

To address the problem, policymakers in the administration and at the FHFA brought Fannie, Freddie and the lenders together so that those making and implementing the rules could understand the sources of lender uncertainty, and lenders could better understand the intent behind the rules at issue. Through a long, and at times painstaking, process, the parties gradually came up with solutions that allowed policymakers to maintain the protection they needed against excessive credit risk, but provided the certainty lenders needed to lend through the program with more confidence. As a result, refinancing through this program took off, helping millions more borrowers reduce their monthly payments by thousands of dollars, providing a much-needed and timely stimulus to the economy.

We need the same kind of effort here. The problem is almost identical, yet the stakes are much higher. To its credit, the FHFA has introduced a helpful framework for addressing some of the lenders' concerns, and more recently the FHA has begun to engage lenders to understand the issues involved in their lending. Yet to date, both processes have been slow and incremental.[15] Given the complex questions involved and the reticence of each agency to give up discretion over credit risk management, this is understandable. However, given the importance to the housing market and the broader economy of expanding access to borrowers whom policymakers have deemed creditworthy, the agencies must embrace the challenge with a good deal more urgency. They should put into place a process with clear objectives and an aggressive timeline for resolution, making it a priority on the order of their efforts to address the problems that plagued HARP.

Conclusions

Although the economy has come a long way since the recession, the recovery has been lackluster. There are many reasons, but first among them has been the slow turnaround in the housing market. In the wake of every other recession since World War II, housing has been key to jump-starting growth. In this one, largely because of the role that housing played in the crisis, it has not been able to provide the same critical stimulus.

The recent housing revival is thus encouraging. Home sales, residential construction and house prices are all rising again. And while this has yet to support the job growth needed to push us into full recovery, indications are that it will if housing continues to gain momentum. However, this will only happen if there is stronger demand from first-time homebuyers. And we will not see the demand needed among this group if access to mortgage credit remains as tight as it is today.

The reasons for the tight credit box are complex and the solutions to opening it are not easy, but policymakers have the tools needed to make a meaningful difference. If they use them, the housing market and the broader economy are poised to finally turn the corner to full recovery.

(Endnotes)

1 Identifying a time when mortgage lending standards were neither too tight nor too easy is difficult. Arguably a good benchmark was the early 2000s, after the tightening in standards that occurred following the technology bust. Mortgage credit quality was good, and egregious lending had not yet produced the housing bubble of the mid-2000s.

2 A subprime mortgage loan is generally deemed to have a credit score below 620.

3 This is based on data from credit bureau Equifax.

4 In 2006 at the height of the housing bubble, over one-fifth of Fannie and Freddie loans were alt-A, 15% were interest-only loans, and there were even a meaningful number of negative-amortization and subprime loans. http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2013/q22013_credit_summary.pdf

5 A household's back-end debt-to-income ratio includes all debts, not just mortgage debt, which is used to calculate the front-end DTI.

6 In the 25 years between 1985 and 2010, on average, the typical first-time homebuyer could purchase an existing home priced at 80% of the median at prevailing mortgage rates.

7 Principal component techniques are used to combine these different underwriting criteria into a single measure of underwriting standards. The ARM share is a proxy for lenders' use of loan type to reach a broader group of potential borrowers, especially as fixed rates increase.

8 This assumes that there is no change in monetary policy in response to the stronger housing market and economy. Although this would not be realistic in an economy already operating at full employment, it is realistic in the current context with the Federal Reserve still engaged in quantitative easing.

9 There is significant debate over the full-employment unemployment rate. The CBO and Federal Reserve estimate the full-employment unemployment rate at closer to 5.5%.

10 Using the Moody's macro model, reducing average credit scores by 50 points lifts housing activity enough to offset the impact of an approximately 2-percentage point increase in fixed mortgage rates.

11 According to the Mortgage Bankers Association, the average cost of servicing a performing loan is $164 compared with $1,350 for servicing a non-performing loan.

12 HARP is designed to allow refinancing for borrowers with GSE-backed loans who had been paying their bills on time but had insufficient equity in their homes to refinance through normal channels.

13 According to MBA's Quarterly Mortgage Bankers Performance Report for the third quarter of 2012, the average margin per loan rose from $346 to $2,152 during this period.

14 These figures are based on Fannie and Freddie's SEC filings for 2010-2012. Their fillings for this year show the largest quarter in history with claims of over $13 billion. These figures are consistent with FDIC call report data that show that between 2008 and June of 2013, first lien repurchases and indemnifications for depository institutions have risen to over $100 billion.

15 In September 2012, the FHFA released a framework in which lenders would be released from most reps and warranties on a loan for which a borrower has made all of their payments for 36 months, and directed the GSEs to build a more robust front-end quality control process. The purpose of the latter was to help lenders identify defects earlier, so that they could adjust their loan manufacturing process in real time to minimize defects. Consistent with this directive, Freddie recently announced new programs intended to spot all defects within 120 days of purchase. While these are steps in the right direction, a significant level of uncertainty remains around both, hampering their effectiveness.

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About the Authors

Jim Parrott

Jim is a senior fellow at the Urban Institute. Earlier this year he left the White House, where he spent several years as a senior advisor at the National Economic Council (NEC). There he led the team of advisors charged with counseling the cabinet and president on housing issues. He was on point for developing the administration's major housing policy positions, articulating and defending those positions with Congress, the press and public, and counseling White House leadership on related communications and legislative strategy. Prior to his time with the NEC, Jim was Counsel to Secretary Donovan at the Department of Housing and Urban Development. He advised the secretary on policy, legislative and communications issues, represented the secretary and the administration with Congress, the press and public, and represented HUD on the team of senior advisors that he later led from the White House. He has a J.D. from Columbia University School of Law, an M.A. from the University of Washington, and a B.A. from the University of North Carolina.

Mark Zandi

Mark is chief economist of Moody's Analytics, where he directs economic research. Moody's Analytics, a subsidiary of Moody's Corp., is a leading provider of economic research, data and analytical tools. He is a cofounder of Economy.com, which Moody's purchased in 2005. He is on the board of directors of MGIC, the nation's largest private mortgage insurance company, and The Reinvestment Fund, a large CDFI that makes investments in disadvantaged neighborhoods. He is the author of Paying the Price: Ending the Great Recession and Beginning a New American Century, which provides an assessment of the monetary and fiscal policy response to the Great Recession. His other book, Financial Shock: A 360º Look at the Subprime Mortgage Implosion, and How to Avoid the Next Financial Crisis, is described by the New York Times as the "clearest guide" to the financial crisis. He earned his B.S. from the Wharton School at the University of Pennsylvania and his PhD at the University of Pennsylvania. He lives with his wife and three children in the suburbs of Philadelphia.

Moody's Analytics

Urban Institute