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Will Looser Credit Jump-Start Housing Market or Overheat It?

by Kate Berry
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Regulators' recent moves to encourage lenders to relax standards have reignited a contentious debate over whether looser credit will revitalize the housing market or set it up for another disaster.

Some experts say the changes by the Federal Housing Finance Agency and the Federal Housing Administration will help the housing recovery that lost traction a year ago, when interest rates jumped and mortgage applications collapsed. Others say lending to weak borrowers will drive up home prices in the short term but lead to more foreclosures down the road.

Still others say the changes will make little difference either way.

"We simply don't have enough qualified homebuyers even with mortgage rates getting as low as 3.25%," says Logan Mohtashami, a senior loan officer at AMC Lending in Irvine, Calif. "We're coming off a debt-asset bubble and deleveraging of mortgage debt is still going on. How much more risk do regulators want lenders to take?"

Lending standards are already quite liberal, Mohtashami contends. Far from restricting credit, he argues, lenders have been making loans to borrowers with low credit scores, low down payments and high debt loads since the housing crash (through FHA, for example). In that light, the changes announced by new FHFA Director Mel Watt and FHA Commissioner Carol Galante amount to tweaks on the margins.

"It won't do anything for demand," Mohtashami says. "An economy with low wage jobs cannot fuel a housing market that has seen home prices rise 40%."

Watt, in his first major announcement as head of the FHFA, the regulator and conservator of Fannie Mae and Freddie Mac, moved to reduce the risk to lenders of having to buy back defective loans. The aim is to embolden lenders to remove so-called credit overlays - FICO score requirements of 680 or so that are used to screen out borrowers with a higher probability of default. Starting in July, the government-sponsored enterprises will allow lenders to "cure" loans that have nitpicky defects, rather than making them repurchase the assets. The FHA is advancing a similar quality assurance plan meant to ease lenders' fears of having to indemnify the agency for losses on loans to riskier borrowers.

Those changes, combined with the recent dip in mortgage rates and easy comparisons with home sales a year ago, could spark a rebound in lending in the second half, some lenders and analysts say. A drop in rates "is a big plus, particularly in the context of the opening of the credit box," says Mark Zandi, chief economist at Moody's Analytics. "We're counting on it because the housing recovery is so vital to the economy."

Indeed, housing's doldrums are now threatening to derail a full economic expansion, sparking ominous comments from Federal Reserve Chairwoman Janet Yellen and Treasury Secretary Jack Lew. Single-family originations fell 27% in the fourth quarter to $293 billion, according to the Mortgage Bankers Association, and many lenders suffered another 30% drop or more in the first quarter.

Zandi, who is leading the charge for looser credit, has long claimed the pendulum has swung too far. Easing up on mortgage buybacks and urging lenders to eliminate credit overlays will go a long way toward a normalized market, he says.

"There are a lot of creditworthy borrowers who cannot get credit and so it's very reasonable to ease underwriting standards, mostly by lowering FICO scores," Zandi says. "If housing doesn't pick up, then we'll be stuck in a slow-growth economy."

But with unemployment still high and wage growth persistently weak, some critics say policymakers are setting the stage for another housing recession.

Despite rising home prices, many homeowners are still living in the aftermath of the financial crisis.

Six and a half million or so borrowers are underwater, owing more than the value of their mortgage, according to CoreLogic. Another 10 million have insufficient equity to sell their homes and buy another. Another 3 million homeowners are in some stage of delinquency, which is 50% higher than the current inventory of homes for sale. Cash buyers make up 30% of homebuyers, up from 10% in a normal market, and have been the major driver of home price
increases.

Ed Pinto, a fellow at the American Enterprise Institute and longtime critic of government intervention in the housing market, called the changes the regulatory agencies announced last week "the official launch of subprime 2.0."

Without lender overlays, the FHA's minimum requirements of a 3.5% down payment and 43% debt-to-income level and no set credit score are a recipe for default, he says.

"We have a curious policy of taking the most vulnerable potential homeowners with the most volatile income streams, and urging them to buy homes in the most price-volatile neighborhoods, and then wonder why they don't gain wealth," says Pinto.

Some housing experts argue this time around is different.

The Dodd-Frank Act and other reforms enacted in the wake of the financial crisis eliminated the egregious loan products that pushed many borrowers into foreclosure. Loans with teaser rates, balloon features, and negative amortization do not meet the "qualified mortgage" requirements of the Consumer Financial Protection Bureau. In addition, all lenders are required to assess a borrower's ability to repay a loan.

"There is abundant data that shows standard loans, even to low-FICO borrowers, did extremely well through the crisis," says Mike Calhoun, the president of the Center for Responsible Lending, an advocacy group in Durham, N.C. "Product type was the overwhelming determinant of default rates."

Dick Bove, vice president of equity research at Rafferty Capital, sees a political impetus for the Obama Administration to relax credit standards.

Democrats desperately need strong GDP growth of at least 4% heading into the midterm elections if they are to have a shot at wrestling control of the House away from Republicans, he says. Meanwhile, the QM rule that went into effect in January has prevented first time homebuyers and many minorities from qualifying for home loans.

"We heard very clearly from Yellen and Lew that we need housing," Bove says. "These guys want the House of Representatives and they're not going to get it if the economy and housing are not strong. So they have to change the rules and come up with a mechanism for allowing low-income people to buy houses."

Even if lenders do relax some credit requirements, it will take some time for the changes to take hold. Mortgage executives are hardly rushing to their boards of directors suggesting they lend to borrowers with weak credit or that loan repurchases are a thing of the past.

"The largest banks have felt so bruised by buybacks that a move in their direction doesn't really take back the bitterness of their past treatment," says Jim Vogel, head of agency debt research at FTN Financial in Memphis, Tenn.

Internal data from lenders shows overall demand is soft, Mohtashami says.

"We're in year six [of the post-crisis era] and if you're in the business, you knew that we never had the goods but they always blamed tight lending," he says. "It is so frustrating."