The Daily Dish

The Housing Market Pendulum

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Eakinomics: The Housing Market Pendulum

At the root of the U.S. mortgage market meltdown, and a great contributor to the global financial crisis, was poor mortgage origination. Trillions of dollars of mortgage lending was targeted on borrowers who did not meet normal qualifying standards, proved unable to make payments, went into arrears on their mortgage payments, and often defaulted. As corollaries, the valuations of houses plunged — harming even those who had no mortgage debt; Fannie Mae, Freddie Mac and the Federal Housing Administration were liable for billions in payments because they guaranteed the underlying mortgages; and financial institutions with heavy concentrations of housing market exposure either failed (e.g., Bear Stearns) or were bailed out by the taxpayers (e.g., Fannie and Freddie).

It was a mess, clearly, and one not hard to avoid. The dollars to buy a house come from two sources: equity investment by the buyer (i.e., the down payment) and dollars lent to the purchaser (i.e., the mortgage). The more money that the homeowner puts down, (a) the more of their own financial livelihood is at risk, giving them incentives to make good decisions on the house they buy and how much they pay for it, (b) the less their incentives to default on their mortgage loan and lose their equity, and (c) the smaller the mortgage interest and repayment of principal each month, lessening the likelihood of running into a cash-flow crunch. The converse is also true, as the less money down, the weaker are the financial incentives, the more likely borrowers are to default, and the greater the potential stress of carrying the mortgage. So, the major lesson learned from the crisis was to support high-quality origination.

Or so we thought. Enter the 2017 version of financial magic: crowdfunding the down payment. As explained by CNBC "CMG Financial, a mortgage lender, just launched HomeFundMe, the first online platform that allows borrowers to crowdfund the down payment on a home purchase without fees and with the backing of mortgage giants Fannie Mae and Freddie Mac." Let me get this straight. I don't have a dime for my down payment, so I get it from HomeFundMe, pay no fees, get a guarantee from Fannie Mae or Freddie Mac (naturally) and all will be fine.

Or as explained in the article: "'What we're doing today is we're trying to test and learn a variety of solutions because the preferences for today's homebuyers have changed significantly, and there is no silver bullet to solving a problem that's as hard as how do you find a down payment,' said Jonathan Lawless of Fannie Mae." (Yes, actually, there is: get a job and save your money.)

Ok, I've been a little unfair. The crowdfunded dollars are technically gifts, just as parents (for example) often give first-time homebuyers help on their down payment. But it is unclear if they are required to actually put the funds down or not. Also, the recipient must undergo financial counseling, which could improve decisions somewhat. And the whole thing could be moot because who wants to give money anonymously to help someone default on their mortgage?

But the basic lesson is that financial markets love innovation and are prone to amnesia, so not all innovation constitutes progress. That's fine if you are playing with private sector money. But Fannie and Freddie are playing with the taxpayers’ money, and this is another reminder of why wholesale housing finance reform is necessary.