The Daily Dish

Moving and Shaking at the FHFA

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Housing markets are about to get really interesting. Residential housing prices rose 20 percent last year, and rents were up a comparable amount as well. As the Fed raises rates, one can expect mortgage interest rates to climb (as they already have), too. But as a second whammy, the Fed will begin to downsize its balance sheet, which in practice means unloading tens of billions of dollars in mortgage-backed securities each month. The undisguised intent is to cool off the residential market – this is one of the key transmission mechanisms for monetary policy – although the additional demand for rentals makes the impact on rents a real issue.

There is considerable chatter about whether the Fed can maneuver to a "soft landing," or whether the outcome is a recession in the years to come. The highly cynical and watchers of history (Eakinomics considers itself both) note that, eight out of nine times the Fed has attempted this, its actions have triggered a recession. Given those odds, these are hardly the circumstances in which to subject mortgage finance to new uncertainties or costs. Nevertheless, on Tuesday the White House released a fact sheet on its efforts to "ease the burden of medical debt." As part of the effort: "The Biden-Harris Administration is providing guidance to all agencies to eliminate medical debt as a factor for underwriting in credit programs, whenever possible and consistent with law." This includes a directive that "the Office of Management and Budget (OMB) will be issuing new guidance to agencies to, whenever possible and consistent with law, eliminate medical debt as a factor for underwriting in credit programs, or reduce its impact."

Which brings us to the mortgage market. Every mortgage that Fannie Mae or Freddie Mac purchases must come with a credit score. And those scores have been under scrutiny. The fact sheet notes that "FHFA [Federal Housing Finance Agency] is reviewing the credit models that Fannie Mae and Freddie Mac use and looking at ways to ensure that measures of creditworthiness are accurate, reliable, and predictive." Indeed, in 2018, FHFA issued a proposed rule on the "Validation and Approval of Credit Score Models by Fannie Mae and Freddie Mac" in response to a congressional directive in the Credit Score Competition Act. Fannie Mae and Freddie Mac have been testing the traditional credit score from the Fair Isaac Corporation (FICO) (the approach employed by the FHFA since 2003), along with alternatives. At present, they have certified the soundness of the traditional approach.

At this point, the reader is entitled to wonder: "Where is this going? Aren't they just going to keep doing the same thing? After all, it works and this is the wrong time to shake things up." And Eakinomics would be entitled to think (and <u>is</u> thinking): "Shame on you, reader! This is the federal government we are talking about."

That's right, we are going to do this the hard way. FHFA has announced that it is considering four options:

1. Keep the current practice of requiring one score for each borrower in evaluating loans;
2. Require that lenders provide borrowers' scores for all approved score models on every loan;
3. Allow lenders to choose any one of the approved score models in submitting a loan to Fannie and Freddie; or
4. Create a primary and secondary score model for each borrower, and whichever qualifies the

loan for purchase “wins.”

Word on the street is that FHFA will announce this week and that it is leaning toward option (3). This option would allow lenders to cherry-pick the score model that is most likely to qualify for purchase (and which meshes nicely with the administration’s goal of ignoring medical debt). The bad news is that this could cost (according to FHFA, no less) up to $600 million and take about two years to implement. Yes, those would be the same two years during which the Fed is trying to engineer its soft landing, against the background of one of the most challenging housing markets in recent history!

But never mind the specifics. The real problem here is that the FHFA has simply invented a new process and is imposing it on the mortgage industry without any opportunity for feedback. If it wanted to come up with an alternative to a certified, single score, it should propose a rule implementing (2), (3), or (4), request and consider public comments, and then issue a final rule based on that feedback. A more normal rulemaking process would eliminate a lot of uncertainty, minimize the adjustment costs, and impose the least stress on the residential housing finance industry.

The FHFA should announce a proposal, not a decision. Especially right now.