Insight

How Not to Blow Up the Housing Market

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Executive Summary

- A challenging housing market has Congress and the federal agencies searching for ways to provide the nation with housing relief.
- Historically, government intervention in housing markets has been characterized by failure more often than success; federal efforts to alleviate the housing crunch by creating new demand-side subsidies will only increase housing costs for all Americans, harming those they intend to help.
- In the worst-case scenario, intervention in the housing market could undo the efforts of the Federal Reserve to tame inflation, increasing the risks of recession.

Introduction

Despite welcome economic indicators that house prices and other key housing costs may be at least peaking, if not falling, the housing market remains a significant pain point for American consumers. Median house prices reached a new record high in June. The sale of new single-family homes has decreased forty percent since January. The rental market is particularly hot, with asking rents increasing 23 percent nationwide as compared with 2019.

When considering the economic stresses the housing market presents, Congress, the White House, and the federal agencies will of course be tempted to use the powers they have (and some they do not) to try to give relief to American consumers. Regrettably, however, government intervention in the housing market has historically done more harm than good. Housing finance was at the center of the 2008 financial crisis that visited substantial economic stress on Americans and spurred dramatic government intervention. Yet more than a decade later, the central actors in the crisis and response – Fannie Mae, Freddie Mac, and the Federal Housing Finance Administration (FHFA) – remain essentially unchanged.

Before Congress and the administration consider further intervention in the housing market, they must first seek to do no harm.

Before That, a Note on the Fed

It is important to note that decreasing demand for housing is precisely what the Federal Reserve has set out to achieve in its battle against inflation. High prices are the most effective way to achieve this. “Shelter,” or housing, is one of the components of the Consumer Price Index (CPI) that tracks the average change over time in prices paid by consumers for a “basket” of goods. The shelter component of the CPI represents one-third of the index and has exhibited an uninterrupted rise in inflation, from 1.6 percent in January 2021 to 5.7 percent in July, with no signs yet of peaking. For the Fed to reduce overall inflation, decreasing the shelter component of the CPI is the single most effective measure to bring down prices across the whole economy, and the Fed has done this by raising the federal funds rate. This causes all other interest rates to rise, including mortgage rates. Higher mortgage rates mean higher house prices, which decrease demand. Decreased housing demand results in fewer people buying housing, or spending capital on housing-related costs, which slows the increase of the shelter component of the CPI.

Higher rates make debt more expensive, which has implications for home purchasing and home construction. Over time, however, house prices will fall in reaction to decreased housing demand. With that in mind, Congress and the federal agencies would do well to consider what they might do (or, more appropriately, *not* do) to prevent an overstressed housing market from blowing up or undoing the efforts the Fed has undertaken to cool the economy.

Increasing Housing Demand

Demand-Side Subsidies

At its core, the stress in the U.S. housing market is caused by supply, not demand. Housing supply is constrained by a dearth of new construction resulting from low labor availability, the high cost of materials, and restrictive local regulations. Existing homes are not returning to the market at typical rates as economic stresses, the low mortgage rate environment, and the unknowns of listing a home in the backdrop of a global pandemic caused homeowners to delay or cancel their plans to list. Housing inventory, while on track to rise, is at historic lows. The total inventory of homes available for sale fell 26 percent in January 2021 year-over-year. At its lowest point, the Federal Reserve Bank of St. Louis estimated that there remained only three and a half months of total housing inventory – in other words, it would be only three and a half months without construction until there would be no homes available in the United States. Housing permits and starts, which have barely recovered from the 2007–2008 financial crisis,

There are very few policy levers that Congress can on to increase housing supply, and even fewer that will operate in a short timeframe. Demand-side subsidies, which in their immediacy continue to prove attractive to legislators, will only increase the population of potential homeowners chasing the same small number of available houses, further increasing prices.

Equity Initiatives

A classic example of demand-side subsidies includes the June announcement by the FHFA of new equitable housing plans for Fannie Mae and Freddie Mac. That there is a clear need for racial equity in homeownership rates is not in question – the gap between Black and White homeownership rates is greater now than in the 1960s when it was legal to deny someone a home based on the color of their skin. But these new housing plans raise a number of difficult questions. When the vast majority of federal initiatives amount simply to demand-side subsidies, home prices will necessarily rise and housing will become even more unaffordable to exactly the communities the FHFA is seeking to serve.

Not only do these programs run the risk of being directly counterproductive, they raise uncomfortable questions about the FHFA itself. Why under the FHFA's purview have homeownership rates declined, precisely, and why does the FHFA think the answer entails crafting new plans rather than reviewing the success of the overly complex constellation of existing programs seeking to address these issues? The federal government currently provides appropriated funding through more than 30 programs within the Department of Housing and Urban Development, tax credits and deductions for both corporations and individuals, housing programs for veterans through the Department of Veterans Affairs, rural housing programs through the Department of Agriculture, and mortgage insurance programs through the Federal Housing Administration and government corporation Ginnie Mae.

Changing the Formula

Such a challenging time for the housing market would not represent the safest testing ground for Congress or the federal agencies to experiment with sweeping changes to how the market operates.

Foreclosure Requirements

California, New York, and New Jersey all have active bills that would alter foreclosure rules in their states. While legislation that would discourage institutional or out-of-state investors from purchasing foreclosed properties may help keep homes and commercial buildings in the hands of residents, the bills still represent economic protectionism. Investment that may revitalize communities will be directed elsewhere, driving up competition and prices where it is directed.

Medical Debt

The Office for Management and Budget (OMB) recently directed federal agencies to ignore existing medical debt to the fullest extent possible when making lending decisions. This of course will include the FHFA and is likely to apply to the GSEs at the very least by association (although not originators of loans themselves, the GSEs effectively set market standards for loan originators by determining which loans they will buy, with which characteristics, and under which circumstances). Reducing the amount of data available to lenders decreases the quality of lending decisions the agencies make and will not by itself improve consumer creditworthiness; in fact, it far more likely to dothe opposite as it may cause Americans to end up even further in debt due to purposefully withheld information.

Model Changes

The FHFA is past due for a decision on its review of alternative credit scoring models. The vast majority of the industry (and federal agencies) has used the FICO Classic scoring model for the last 20 years. Any change to this approach would be costly to the GSEs and private lenders, and those costs would quickly be passed on to consumers.

Increasing Housing Risk

The United States does not have a functioning private secondary mortgage market and has a wildly distorted primary market because of Fannie Mae and Freddie Mac. If Congress seeks a healthy and functioning housing market that benefits all participants, then it must continue its efforts to reform the GSEs. But the Biden Administration has reversed these gains, decreasing the amount of capital the GSEs are required to hold and once again allowing them to purchase the riskiest mortgages. GSE reform is absolutely necessary for the long-term health of the housing market, but the process will be slow, costly, and likely involve a temporary increase in housing prices. Short of the reform the market needs, however, Congress and the FHFA must commit to not increasing the footprint of the GSEs in the housing market.

Pilots

The FHFA has repeatedly and consistently engaged in mission creep via the mechanism of new pilot programs. These pilots expand the products offered and decrease underwriting standards at the GSEs. While this gets more people into houses, it does nothing to expand housing inventory, and thereby acts as another demand-side subsidy, increasing the costs of housing for everyone. In July, 10 members of the House wrote to FHFA Director Sandra Thompson, noting "The Enterprises have a history of venturing into new activities and product offerings that go well beyond their congressionally approved roles in the secondary market. The FHFA must do more to ensure there is appropriate transparency regarding any new products or activities that the Enterprises undertake and that these activities do not displace private firms or crowd out private capital."

The FHFA must undertake to finalize the long-overdue rulemaking on Prior Approval of Enterprise Products, a requirement of the Housing and Economic Recovery Act of 2008 that still has not been brought into law nearly 15 years later.

Capital

Fourteen years after the GSEs were brought into conservatorship, they remain undercapitalized. The GSEs enjoy all the opportunities of both private entities and government agencies without the regulation or supervision of either. Former FHFA Director Mark Calabria took a series of extremely important steps along the path to GSE reform, not least of which was halving the GSEs' combined leverage ratio (down to a still mind-boggling 500-1). These efforts not been continued, and what's more, this administration's FHFA has made the baffling decision to return risk to the GSEs by allowing them to make more toxic loans and hold less capital against that risk.

The Federal Housing Administration (FHA) has significantly expanded its role since the financial crisis and, with the GSEs, guarantees over $7 trillion in mortgage-related debt to the borrowers least able to repay. The FHA's book of mortgages is considered so toxic that even Ginnie Mae, the Government National Mortgage Association, has proposed a 250 percent risk weight on gross mortgage service rights (MSRs) that make up the majority of the FHA's business. Former FHFA Director Calabria has warned that the FHA is setting the market up for failure with its poor underwriting standards, the risk of which could topple the housing market.

Conclusions

Even in the best of times it can be difficult to parse the wide variety of economic indicators. Depending on interpretation, the housing market is either boiling or has already collapsed. The economy writ large is either strong or in a recession. Against this backdrop, the Fed is attempting to engineer a "soft landing," decreasing inflation without triggering significant economic collapse. Part of this effort necessarily involves intentionally making the housing market more hostile for a time, as noted by Fed Chair Jerome Powell. While there is little Congress and the federal agencies can do to improve housing supply in the short term, they could do much in haste and good intentions that would further muddy the economic waters. At worst, further demand-side subsidies would undo the Fed's efforts, increasing the pain of inflation, the risks of recession, and the length of economic recovery.