Twelve Things You Need to Know About the Housing Market

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It was six years ago this week that the Federal Housing Finance Agency (FHFA) placed Fannie Mae and Freddie Mac into conservatorships. Since then, the US housing system has made significant progress, yet critical challenges and much work remain. To frame a discussion of housing policy, we outline key points regarding the state of housing today, and the issues at the core of determining future policy direction.

The Housing Market Today: A Brief Progress Report

The Macro View: Housing Markets Are Recovering

1. **Market conditions have improved over the past several years.** While the damage from the housing crisis has been substantial, we are finally seeing a sustained market recovery. House prices, as measured by FHFA, have recovered more than 50 percent of their decline since 2007. Mortgage delinquency rates, as measured by the Mortgage Bankers Association, have fallen from a peak of more than 10 percent to about 6 percent, their lowest level since 2007. Financing continues to be affordable. Mortgage rates recorded by Freddie Mac are nearly half a percentage point lower than a year ago, and remain near record lows.

2. **But the housing recovery is not complete.** Despite recent increases, house prices today are where they were in the summer of 2005, and mortgage delinquency rates remain stubbornly high relative to historic norms for this point in the business cycle. And the degree of recovery varies by local market. Many potential homeowners believe they may not qualify for a mortgage, or they are just not prepared to re-enter the housing market.

Credit Standards Have Improved

3. **Improved underwriting is a good thing.** The housing crisis was marked by a substantial deterioration in underwriting standards, but they have clearly improved in recent years. Lenders and borrowers alike had excessive confidence in rising home prices, and this led to higher-risk lending. The restoration of more prudent underwriting dramatically lowers the risk of a recurrence of the past crisis.

4. **Some argue that underwriting has become *too* tight, but other factors may be at play.** With house prices rising in most markets since 2011, and mortgage delinquencies and unemployment declining, it would be reasonable to expect greater home purchase activity. Offsetting the positive economic news, however, are other factors that persist and remain difficult to evaluate. These factors make potential homeowners reluctant to enter the market and cause lenders to add additional requirements, referred to as credit overlays, to their standard underwriting requirements.

a. Families remain cautious on home purchases, given stagnant real income growth for many households. Potential homebuyers are pausing as well, from the combination of losses in retirement savings, the need to repay other consumer debt, and uncertainty over the strength of the jobs market and the future path of house prices. The millennial generation appears to be starting families and settling into a long-term career paths at a slower rate than did prior generations, which reduces their demand for homeownership at this time.

b. Cautious behavior by lenders affects the housing market. Some of this caution is the unintended consequence of policy actions. For example, new laws and regulations, and their attendant costs and risks, are still being digested by market participants. In addition, the government continues to enforce penalties for past violations. While much of this activity is necessary and appropriate, it may distract from new lending activity and make lenders more cautious. Separately, operational and other risk management shortcomings at many institutions are still being addressed by regulators and the firms themselves.

Critical Structural Changes Are Under Way

5. **The crisis showed that numerous structural improvements were needed in housing—and such improvements have been under way for several years.** Poor data, misuse of specialty mortgage products, lagging technologies, weak servicing standards, and an inadequate securitization infrastructure became evident during the financial crisis. A multi-year effort to fix and rebuild this infrastructure has been quietly under way, with notable improvements already in place. The mortgage industry has been working since 2010 to overhaul mortgage data standards and the supporting technology. New data standards have emerged and are in use, with more on the way. These standards should improve risk management while lowering origination costs and barriers to entry.

   During the crisis, many specialty products, such as interest-only loans appropriate for a limited group of borrowers, were instead sold much more broadly. These have been removed from retail shelves. Trial-and-error has led to more consistent and robust mortgage servicing standards, even while the process of improvement has been painful for many families seeking loan modifications. While these structural changes attract less public attention than the big policy questions, they are essential for ensuring a liquid and resilient housing finance system.

6. **Structural improvements will take several more years.** A new securitization infrastructure has been in development for more than two years. This ongoing work should be a cornerstone for the future secondary mortgage market. Other structural improvements will include updated quality assurance (rep and warrant) systems for the Federal Housing Administration, Fannie and Freddie, revamped private mortgage insurance eligibility standards, and completion and implementation of remaining Dodd-Frank rulemakings.

Looking to the Future: Policy Issues and Considerations

The American Dream and Public Policy: A Challenge of Setting Clear and Achievable Goals

7. **Homeownership remains firmly rooted in the American Dream.** Owning one's own home remains a key component of economic and personal freedom. Public policy promotes homeownership in the widespread, nonpartisan belief that homeownership promotes the well-being of families, and stability and cohesion in local communities. Despite the losses from recent experience, surveys indicate that homeownership remains a goal for most Americans.

8. **Housing is primarily a consumption good, not an investment.** Many people speak of homeownership as an essential means of building wealth for lower- and middle-income Americans. Yet long-term returns from housing significantly lag financial investments, such as stocks and bonds. Moreover, efforts over the past 50 years to subsidize homeownership have not produced a meaningful, sustained increase in homeownership rates; and families lost trillions of dollars in housing wealth during the crisis. In the wake of years of substantial government policy intervention in the working of housing markets, the people most damaged have been the intended beneficiaries of those policies. This is not an indictment of the well-intentioned goals of policymakers, but it should invite a willingness to think about those goals and how public policy is used to promote them.

9. **Public policy faces multiple competing objectives when it comes to homeownership.** Housing policy faces the perennial challenge of protecting taxpayers, reducing government costs, and limiting government involvement in the marketplace, while still subsidizing and incentivizing affordable homeownership opportunities and ensuring adequate rental housing. Beyond these trade-offs, though, are additional tensions between policies that promote homeownership and other societal goals.

   For example, policies encouraging homeownership that result in sprawl may conflict with environmental goals, both with regard to commuting to work centers and the natural resources used to build and maintain large houses on large lots. And policies that promote taking on large debt with 30-year repayment terms often reduce the wealth-building opportunity of homeownership, since those terms can also reduce retirement savings and increase financial risk. Families should be able to make informed choices, based on their preferences and resources, but policy initiatives that encourage debt over equity, or that favor homeowners who would own a home in the absence of subsidies, should be reconsidered. Recognizing competing policy goals, and then trying to reconcile them, is a significant challenge.

10. **A focus on homeownership may distract from critical housing issues for the poor and elderly.** Roughly one-third of American households live in rental housing, yet policy debates appear to lend much less than one-third of their attention to rental housing issues. The social welfare issues of housing for the poor and elderly, and the related issues of homelessness, have a compelling moral claim for public attention. Setting national housing policy priorities must include appropriate consideration for society’s truly needy. A question worth asking is whether housing subsidies that now go to upper-income families could be redirected to support affordable rental and homeownership opportunities.

The Legislative Outlook Is Hopeful, but Delay Increases Risk

11. **A policy foundation for the future is beginning to emerge.** Last year the Hensarling and Corker-Warner bills got the ball rolling, and this year the Johnson-Crapo, Waters, and Delaney bills have been added to the mix. While the various proposals have important differences, they share key similarities: winding down Fannie Mae and Freddie Mac, building a common securitization infrastructure, and drawing private capital back into the marketplace while reducing taxpayer involvement. We should build on these similarities, making them the cornerstone features of final legislation.

12. **Six years is long enough.** The country has political differences regarding the role of government in housing. But another election cycle or two is unlikely to change that. The ongoing conservatorships continue to distort markets and place taxpayers at risk. And legislation is not just about the conservatorships—updating the mission and structure of the FHA is also central to framing the country’s future housing policy.

The Challenge Ahead: Rebuilding the Country's Housing Finance System

In view of the mammoth failure of the old system, I suggest we use a measure of skepticism when considering the argument that "new" means "risky," or that we cannot do better than what we had. Often it turns out that the individuals who argue for preserving the status quo are actually protecting an existing interest, either business or political.

A free economy depends upon a free and vibrant financial system to allocate scarce capital. As a country, our collective belief has been in the power of independent decisions by those providing capital to pursue outcomes that promote growth and increase national wealth. We also have a long tradition of taking steps as a government to account for externalities when market forces alone cannot account for public benefits or costs to the national economy

This is our time, as a country, to consider all of these issues as legislators develop a new framework for housing finance. We have had a great failure in the old housing finance system. Millions of families have been harmed, losing trillions of dollars in personal wealth. Private capital is sitting on the sidelines, waiting for government to act. We can't take the risk of waiting longer. We must replace the system with something better.