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Housing Finance: FHA and Lessons Learned from Fannie Mae and Freddie Mac

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Congress passed a combined spending proposal (H.R. 2112) that includes an increase in the limits on mortgages held by the Federal Housing Administration (FHA), though Fannie Mae and Freddie Mac are left untouched.

A forthcoming study by The Heritage Foundation demonstrates how federal intervention in the housing market by Fannie and Freddie over the past 10 years slightly increased home prices. In addition, the Heritage analysis shows that home prices are influenced not by mortgage interest rates and down payments—which are subsidized in mortgages sold to Fannie and Freddie—but by household assets, personal income, and effective tax rates. Therefore, liquidating these government-sponsored enterprises (GSEs) would slightly lower housing prices. At the same time, liquidation would re-establish market forces and return clarity to pricing mechanisms, which would increase stability and return the housing market into equilibrium.

How the GSEs Affect Home Prices. Heritage's analysis of the effects of Fannie and Freddie's subsidized interest rates and low down payment requirements on median single-family home prices (using quarterly data that reaches back over 30 years) demonstrate that:

- Conventional mortgage interest rates have a small negative impact on home prices.
- Other things being equal, an increase in the mortgage interest rate leads to a slight decrease in home prices. For example, a 25-basis-point increase in the interest rate, as discussed in an economic study by Scott Frame and Lawrence J. White,[1] yields housing prices that are 2.25 percent lower than they would be otherwise.
- Down payments are associated with lower home prices when property tax rates are included. Based on our results, a 25-basis-point increase in down payments leads to housing prices that are 1.5 percent lower than they would be otherwise. However, the association between down payments and home prices is not robust because in four other model specifications the relationship is statistically insignificant.
- Contrary to the expectations of policymakers, Fannie Mae and Freddie Mac's policy since 1996 of easing requirements for homeownership was associated with a rise in housing prices, though the effect was relatively small. Results overall indicate that home prices are mainly influenced by household assets, personal income, and tax treatment of the households.

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- Lastly, government intervention in the market leads to huge inefficiencies. Low interest rates from monetary stimulus may temporarily benefit those borrowers who refinance existing mortgages at lower interest rates, but market distortion and asymmetric information between GSEs and consumers may bring that benefit to a rude halt.

Lawmakers should heed these results. After at least a decade of policy mismanagement, they continue to double down on these previous mistakes. Recently enacted into law, the latest terrible policy idea is enabling the FHA to insure mortgages of up to $729,750 instead of the current ceiling of $625,000.[2] Though the law does not call for an increase in the limits on mortgages held by Fannie and Freddie, it increases the role of the FHA in housing markets and, thus, may produce harmful effects for society as a whole.

Rather than continue with erroneous government solutions, the federal government should avoid increasing subsidies. Allocating a federal subsidy to a government agency like the FHA would likely have similar adverse effects to prior subsidies by Fannie and Freddie in the form of lower interest rates and lower down payment requirements.

The Federal Housing Administration. The FHA is responsible for insuring mortgage loans in the housing market. The problem is that it is currently leveraged at 300 to one, with only $2.6 billion in its reserves to cover its $1.1 trillion in liabilities.[3] Moreover, there is a 50 percent chance that it will need a bailout from the U.S. Treasury.[4] Given that the minimum down payment for an FHA loan is only 3.5 percent, this law will likely enhance the possibility of further foreclosures, since most borrowers will have little equity in their homes. Yet Congress somehow thinks that it is a good idea to enable the FHA to become even more overextended, ensuring that taxpayers are strapped with more financial obligations if it requires a future bailout.

Expanding FHA subsidies could have adverse long-term effects for the housing market and the economy as a whole. At the expense of stimulating the demand side in the short term, further subsidization could create another bubble in the medium and long terms.

The Roles of Fannie Mae and Freddie Mac. Whatever the underlying causes of the bubble, it is evident that excessive expansion in credit to the housing sector fueled by financial institutions—most notably Fannie Mae and Freddie Mac—increased demand for real estate and caused housing prices to overheat, distorting the natural market equilibrium.

Likewise, the currently proposed bill offers substantial expansion in credit into the housing market through the FHA. Just as Fannie and Freddie's credit expansion distorted the market, FHA's mortgage limit increase would likely create similar distortions. In addition, Fannie and Freddie were originally established to develop a secondary mortgage market to increase homeownership among underprivileged groups and underserved areas. However, over the years, they became involved in profiteering and mortgage-backed securities. There is no reason to believe that the FHA would not engage in similar misconduct.

Moving Forward. The fact that GSEs distort the market, inflate economic bubbles, and create general economic disequilibrium should provide guidance going forward. It is disheartening that

1. See W. Scott Frame and Lawrence J. White, "Fussing and Fuming over Fannie and Freddie: How Much Smoke, How Much Fire?," Federal Reserve Bank of Atlanta, October 2004, pp. 7–8, at *http://www.frbatlanta.org/filelegacydocs/wp0426.pdf* (October 25, 2011).
2. Associated Press, "Hill Bargainers Agree to Boost Size of FHA-Backed Mortgages but Not Fannie's, Freddie's," *The Washington Post*, November 15, 2011, at *http://www.washingtonpost.com/business/hill-bargainers-agree-to-boost-size-of-fha-backed-mortgages-but-not-fannies-freddies/2011/11/15/gIQAVlYbPN_story.html* (November 16, 2011).
3. Annie Lowrey, "F.H.A. Audit Sees Possible Bailout Need," *The New York Times*, November 15, 2011, at *http://www.nytimes.com/2011/11/16/business/economy/auditor-says-fha-could-need-bailout.html?_r=3* (November 16, 2011).
4. U.S. Department of Housing and Urban Development, *Quarterly Report to Congress FY 2011 Q3*, September 30, 2011, at *http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/rtc/fhartcqtrly* (November 16, 2011).

Congress passed a law that only further extends the reach of government, which has leveled much economic damage thus far.

An economically sound policy is to phase out GSEs and replace them with a private-sector housing finance system, which would eliminate distortions in the housing market and empower people to pursue homeownership according to market forces. In turn, this would create a stationary development trend in the housing market. Congress has to learn from past defeated policies.

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