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Monthly condensed analyses of crucial real estate and economic issues offered by the UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. Here, Stephen Oliner, resident scholar at the American Enterprise Institute and senior fellow at the UCLA Ziman Center for Real Estate, explodes the myth that only people with excellent credit can secure a home mortgage today.

The Myth that Mortgage Credit is Really Tight

By Stephen Oliner, senior fellow, UCLA Ziman Center for Real Estate

"I've been surprised that housing hasn't recovered more robustly than it has. In part, I think it reflects very tight credit ... for any borrower that doesn't have really pristine credit ..."

- Fed Chair Janet Yellen, FOMC Press Conference, December 17, 2014

The claim that mortgage credit is very tight for all but pristine borrowers has been repeated so often by respected policymakers and economists that it is now taken as fact. When Janet Yellen says that mortgage credit is hard to come by — as she did at all of her FOMC press conferences last year — people listen. The drumbeat about tight mortgage credit has continued this year, with commentary to that effect in the Fed's Monetary Policy Report to Congress and the Administration's Economic Report of the President. Economists outside the government regularly offer the same assessment.

This characterization of today's mortgage market, however, is misleading. The truth is that most people with a steady job and an average (or worse) credit score can get a mortgage. Many borrowers taking out home-purchase loans these days have less than perfect credit. The federal government has been more than willing to guarantee higher-risk mortgages, and it's been doing a lot of business with lenders that originate the loans and then pass the credit risk to taxpayers.

"The default rate on these FHA loans, while relatively low in today's benign environment of solid job growth and rising home prices, would increase substantially in an ordinary recession and would skyrocket if we have another financial meltdown."

Since the financial crisis, the federal government has nearly monopolized home mortgage lending in the United States. Even now, more than six years after the crisis began, 80 percent of the mortgage loans originated to purchase homes have a federal

government guarantee. That's an astounding statistic in a supposedly free-market economy like the United States. The upshot is that the standards imposed by the various guarantee programs largely determine the availability of mortgage credit.

Virtually all of the federal guarantees are provided by Fannie Mae, Freddie Mac, the Federal Housing Administration (FHA), or the Department of Veterans Affairs (VA). Fannie and Freddie — the government-sponsored enterprises that have been under federal conservatorship since September 2008 — are the largest players in the nation's mortgage finance system. The FHA, an agency within the Department of Housing and Urban Development, focuses on supporting borrowers deemed to be underserved in the mortgage market, while the VA program exclusively serves veterans.

The guarantee programs differ widely in terms of credit standards, with Fannie and Freddie at the top, the VA in the middle, and the FHA at the bottom. Although Fannie and Freddie have been loosening their standards lately under pressure from their regulator (the Federal Housing Finance Agency), most of the loans they guarantee continue to be solidly underwritten. Indeed, the median credit score for borrowers with home purchase loans guaranteed by Fannie or Freddie exceeds 750, well above the median score for all individuals in the United States. Those who assert that mortgage credit is tight usually cite this statistic.

But many borrowers have been financing their home purchases with loans guaranteed by the FHA, VA, or the smaller programs for borrowers in rural areas or Native Americans. Taken together, these programs currently account for 40 percent of home purchase loans with a government guarantee. FHA alone has a 25 percent share of government guaranteed home purchase loans.

A few statistics about FHA loans are sufficient to dispel the myth that only pristine borrowers can get a mortgage. In recent months, the median credit score for borrowers who took out an FHA-guaranteed home purchase loan was 673. About two-thirds of all individuals in the U.S. have a higher credit score than that. FHA's credit standards are loose as well for two other primary determinants of loan risk: the size of the down payment and the monthly payment burden. The median FHA borrower makes a down payment of less than five percent. If the borrower were to turn around and sell the home, the agent's commission and other costs would exceed five percent. Hence, the median borrower is effectively underwater on day one. Second, many FHA-guaranteed loans have onerous monthly payments relative to the borrowers' income. In fact, the payment-to-income ratio for more than four in ten FHA borrowers exceeds the ability-to-repay limit that was set in the recent Qualified Mortgage rule. This is a not a picture of tight credit.

The default rate on these FHA loans, while relatively low in today's benign environment of solid job growth and rising home prices, would increase substantially in an ordinary recession and would skyrocket if we have another financial meltdown. To gauge the vulnerability of recently originated mortgage loans, AEI's International Center on Housing Risk publishes every month the results of a rigorous stress test, the National Mortgage Risk Index (NMRI). The NMRI uses the default experience of loans originated in 2007 to estimate how recent loans would perform if hit with a shock akin to the 2008-09 financial crisis. The index shows that nearly 25 percent of recent FHA loan borrowers would default in that scenario. This would be exceptionally harmful, not just to the borrowers, but also to the neighborhoods in which they live and to the taxpayers who would have to make good on the FHA's loan guarantees.

The misleading narrative about tight mortgage credit has prompted calls from many quarters to "open up the credit box." But the FHA is already operating, in effect, as a large subprime lender. Extending even riskier mortgages would not turn out well. History shows that prudent underwriting is the only way to ensure a stable housing finance system and sustainable homeownership. We forget this basic lesson at our peril.

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