OPINION

# Wallison: Get Ready for the Next Housing Bubble

*Mel Watt is a long-time champion of mortgage quotas for affordable housing. Here we go again.*

By PETER J. WALLISON

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By banning filibusters of most executive-branch and judicial nominations, the Democrats have done historic damage to the Senate. This will have long-term consequences for the nation, but the most significant initial fallout will likely be the confirmation of Rep. Mel Watt (D., N.C.) to head the Federal Housing Finance Agency, which regulates mortgage giants Fannie Mae and Freddie Mac.

Since these two government-sponsored enterprises became insolvent in September 2008, FHFA has also been their conservator, with the power to control their operations and policies. Mr. Watt is a good man, but he is a man of the left, and he will use his control of Fannie and Freddie to return to the policies that brought on the mortgage meltdown in 2007 and the financial crisis in 2008.

Just before the crisis, 58% of all U.S. mortgages—32 million loans—were subprime or otherwise weak. Of these, 24 million, or 76%, were on the books of government agencies, primarily Fannie Mae and Freddie Mac. This shows incontrovertibly that the government itself was the source of the demand for these low-quality loans.

The U.S. had once been known for the high quality of its mortgage loans, but this began to change once Congress enacted affordable-housing goals in 1992. Under that legislation, Fannie and Freddie—which were then, as now, the standard-setters for the mortgage market—were required by the Department of Housing and Urban Development to purchase an increasing quota of loans to borrowers at or below the median income where they lived.

As HUD increased this quota between 1992 and 2008, Fannie and Freddie were forced to reduce their underwriting standards—accepting loans with 3% down payments in 1995 and 0% down in 2000—in order to find eligible borrowers. Mortgage financing is a competitive business, and as Fannie and Freddie's underwriting standards deteriorated, they spread to the wider market.

Borrowers who could afford down payments of 10% or more were happy to take loans with 3% or nothing

Rep. Mel Watt (D., N.C.), left, is President Obama?s choice to head the Federal Housing Finance Agency, which controls mortgage giants Fannie Mae and Freddie Mac. *Bloomberg*

down and buy larger homes. The increased borrower leverage and the sheer number of new borrowers fed an enormous housing price bubble between 1997 and 2007. When the bubble collapsed in 2007 and 2008, an unprecedented number of mortgage defaults drove down housing values 30% to 40%—and drove Fannie and Freddie into insolvency.

A government bailout of more than $180 billion enabled Fannie and Freddie to continue operating after September 2008 under FHFA's acting director, Edward DeMarco. A nonpolitical civil servant, Mr. DeMarco has seen it as his duty to protect taxpayers from another bailout. To this end, he has increased the underwriting standards that Fannie and Freddie employ before they acquire a loan, raised the fees they get for guaranteeing mortgage-backed securities, and limited the scope of the affordable-housing goals. The two enterprises are now profitable and able gradually to repay the government.

Mr. DeMarco's actions have aroused the opposition of the left. Critics complain that his underwriting standards are too high, meaning that many low-income borrowers will not be able to buy homes. This is the same argument community activists made when they pressed Congress to adopt the affordable-housing goals. Today, the idea underlying the goals goes by a new term—"opening the credit box." But the objective is the same: reduce underwriting standards so borrowers who have poor credit records and don't have down payments will be able to buy homes.

This is exceptionally bad policy. Even Barney Frank, the principal backer of the affordable-housing goals for much of his career in Congress, admitted in 2010 that "it was a great mistake to push lower-income people into housing they couldn't afford and couldn't really handle once they had it."

The only way to maintain a stable housing market is by requiring reasonable underwriting standards. This means a down payment of at least 10%, a FICO credit score above 660, and a debt-to-income ratio, after the mortgage is closed, of no more than 38%. When those standards were generally in force between 1970 and 1992, mortgage defaults in the U.S. were under 1% and the national homeownership rate was 64%—about where it is today after all the foreclosures in recent years.

Unfortunately, Mr. DeMarco's underwriting standards will almost certainly change, and for the worse, once Mr. Watt is in charge of the Federal Housing Finance Agency. The stage has already been set. The Consumer Financial Protection Bureau (CFBP), an agency created by the Dodd-Frank Act, has outlined a minimum quality mortgage that will permit a borrower to get a loan with a 3% down payment and a FICO credit score well below 660. Under Dodd-Frank, a lender could be subject to severe penalties if it turns out that the borrower cannot repay the loan—but the CFPB's rule protects the lender against liability if Fannie and Freddie's automated underwriting systems approve the loan.

Enter Mr. Watt. The North Carolina congressman is a consistent, long-time supporter of affordable-housing quotas. He joined Barney Frank in 2003 to block the Bush administration's attempt that year to increase government oversight of Fannie and Freddie. And in 2007 he cosponsored legislation that would have pushed the two GSEs even deeper into the subprime mess. One can be sure that there will be many low-quality mortgages approved by Fannie and Freddie on his watch.

In August, the six financial regulatory agencies that Dodd-Frank directed to define a high-quality mortgage (the Federal Reserve, Comptroller of the Currency, Federal Deposit Insurance Corporation, Securities and Exchange Commission, FHFA and HUD) reported that they're quite happy with the CFPB's minimum-quality loan. Despite the mandate in Dodd-Frank, they decided not to propose a high-quality mortgage.

The six agencies reported that mortgages that met the CFPB's low standards between 2005 and 2008 had a default rate of 23%. Incredibly, they were still OK with that. Why? We are "concerned," they said, "about the prospect of imposing further constraints on mortgage credit availability at this time, especially as such constraints might disproportionately affect groups that have historically been disadvantaged in the mortgage market, such as lower-income, minority, or first-time home buyers."

As we gaze into the open credit box the financial regulators have set before us, is there any doubt where the housing market is headed?

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