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President's Homeownership Proposals Should Be Sent Back to the Drawing Board

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As has been the case over the past several years, the President's newly released budgetary policies addressing homeownership—now combined with efforts to contain the damage caused by the collapse of the subprime mortgage market—are somewhat disconnected from the financial market factors and the lender/borrower behavior that contributed to the mortgage and housing market collapse now underway. On the one hand, the President's budget proposes to spend $215 million on several borrower/owner counseling programs to help keep troubled homeowners in their homes and out of foreclosure, while on the other hand it proposes to further loosen Federal Housing Administration (FHA) mortgage lending underwriting standards in ways that discourage households from adopting financially responsible savings and borrowing practices. Combining the two conflicting components, the overall tilt of the proposal is toward financial irresponsibility.

A better approach would be to encourage a return to more traditional underwriting practices that require borrowers to have an equity stake in their homes. The federal government should also link any mortgage assistance to an end to onerous local land use regulations that have caused much of the home price inflation in recent years.

A Nation in Debt. As for the counseling plans, the presumption is that it will help borrowers overcome instances of innumeracy that led some to commit to monthly spending and debt service obligations exceeding their monthly income. Such counseling would also advise them of the importance of paying their bills on time and teach them to prioritize spending obligations and choices, i.e., meeting the monthly mortgage payment should take precedence over the acquisition of a big screen TV. Such a focus may be timely. Macroeconomic data reveal that earlier in this decade, American consumers engaged in a massive, collective shift from accumulating assets through savings to accumulating debt through borrowing, thereby leaving them with little or no degree of freedom to deal with even minor financial setbacks.

Although analysts are still learning about the many factors that contributed to the subprime problems, a growing body of evidence suggests that a great many households engaged in a degree of risky financial behavior that is without precedent in the nation's economic history. For starters, at some point in the early part of this decade, households on average stopped saving money and instead embarked on a debt-fueled binge of consumer spending, including the acquisition of homes that many could not otherwise afford in the absence of excessive debt.

From 1970 to 1989, each year Americans saved more than 9 percent of their personal income. In the 1990s, the savings rate fell by almost half to a little

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over 5 percent, and since 2000 it has averaged 1.6 percent. In 2005 and 2006, the savings rate fell below 1 percent. Because these savings rates also include contributions to 401(k) plans and other retirement savings programs—which represent funds unavailable for current spending purposes—the "discretionary" household savings rate, including money that could be used for a downpayment on a house or for an unexpected expenditure, would have been substantially negative in recent years.

With the nation awash in easy credit, and with many mortgage lenders willing to provide subprime mortgage loans and/or risky second mortgages that obviated the need for any downpayment, households had little incentive to save and began to spend more than they earned. At the same time, car loans, credit card debt, and equity lines of credit became available on similarly generous terms, further undermining incentives to save while enhancing a household's ability to spend.

Rewarding Irresponsible Behavior. Under the circumstances, the most appropriate federal response would be to propose policies aimed at restoring personal responsibility and financial independence. Instead, the Administration seems intent on enlarging the share of the mortgage market that it controls by way of the Federal Housing Administration (FHA) mortgage insurance program, and doing so by offering more attractive credit terms similar to the underwriting deficiencies heretofore limited to the subprime market. HUD's fiscal year (FY) 2009 budget request reads as follows:

> Eliminate the current statutory 3 percent minimum downpayment, reducing a significant barrier to homeownership. FHA's existing downpayment requirement does not meet the demands of today's market place, in which most first-time homebuyers put down 2 percent or less. Reform would enable the FHA to offer a greater variety of downpayment options.[1]

This is not the first time the Administration has proposed legislation to reduce the downpayment required on FHA mortgages. The American Dream Downpayment Act—passed in late 2003—provided $200 million per year in taxpayer-funded downpayment grants to eligible FHA borrowers.[2] The President's FY 2009 budget request seeks another $50 million for the program and proposes ending the 3 percent requirement. At the same time that these reductions in FHA underwriting standards are being proposed, FHA (in 2007-III) experienced a default rate of 13.52 percent, compared to 3.25 percent for prime mortgages and 16.68 percent for subprime loans.[3] Under the circumstances, any further diminution in FHA credit standards could boost FHA default rates to that experienced by subprime loans. Given the consequences of the turmoil in the subprime market, a proposal emulating some of its diminished underwriting standards would be the wrong way to go.

Unfortunately, the proposed FHA reforms would reward bad decision-making beyond the household level. Also rewarded would be communities that have engaged in counterproductive planning, exclusionary zoning and smart growth practices, and have abused the property rights of their citizens in order to limit community access to those with substantial wealth and income. As a consequence of the land shortages caused by these practices, home prices have soared in many communities. The budget request for HUD reads:

> Increase and simplify FHA's loan limits. FHA's loan limit in high cost areas like California and the Northeast would rise from 87 to 100 percent of the Government Sponsored Enterprise (GSE) conforming loan limit.[4]

California, of course, is the least affordable market in the nation, largely because of four decades of abusive zoning practices and smart growth strategies designed to limit development. As a conse-

1. U.S. Department of Housing and Urban Development, "Fiscal Year 2009 Budget Summary," p. 2, at *www.hud.gov/about/budget/fy09/fy09budget.pdf*.
2. See Ronald D. Utt, "American Dream Downpayment Act: Fiscally Irresponsible and Redundant to Existing Homeownership Programs," Heritage Foundation *WebMemo* No. 378, December 5, 2003, at *www.heritage.org/Research/Budget/wm378.cfm.*
3. Mortgage Bankers Association, National Delinquency Survey, Q307, data as of September 30, 2007.
4. U.S. Department of Housing and Urban Development, "Fiscal Year 2009 Budget Summary," p. 2.

quence, the median priced home in Los Angeles ($588,000)[5] is equal to 11.5 times the income of the median household in the area, compared to just 2.8 times the median income in Atlanta where property rights abuses are much less severe. Indeed, a recently published housing affordability survey of the United States, the United Kingdom, Ireland, New Zealand, and Australia found that five of the least affordable housing markets were in California.[6] Some California metropolitan areas have experienced significant subprime usage and mortgage default rates because many middle-income households were forced to take on heavy debt loads to achieve the American dream of homeownership. Because of the heavy regulation it imposes on land use practices, California's homeownership rate was 60.2 percent in 2006, compared to 68.8 nationwide; only two other states in the nation (Hawaii and New York) had a lower homeownership rate.[7]

In effect, the President is proposing to substantially expand the scope and intrusion of the federal government into the nation's mortgage market for no other reason than to accommodate the home price inflation induced by decades of property rights abuses in a dozen or so metropolitan areas. A better solution, and one consistent with the market principles espoused by this Administration, would be to link the availability of any concessions in federal mortgage programs with substantive deregulation of land use practices in high-cost areas.

Conclusion. While the President is to be commended for attempting to address the many problems caused by the subprime turmoil, a better approach would be to link the availability of federal mortgage assistance to meaningful land use deregulation and to recreate a mortgage market that encourages individual financial responsibility, as opposed to the incentives for profligacy embodied in current practices.

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5. National Association of Realtors, Median Sales Price of Existing Single Family Homes for Metropolitan Areas, 2007.III, available at *www.realtor.org/Research.nsf/files/MSAPRICESF.pdf/$FILE/MSAPRICESF.pdf.*
6. Wendell Cox and Hugh Pavletich, "4th Annual Demographia International Housing Affordability Survey: 2008," available at *www.demographia.com.*
7. U.S. Census Bureau, "Housing Vacancies and Homeownership (CPS/HVS)," Annual Statistics: 2006, Table 13, at *www.census.gov/hhes/www/housing/hvs/annual06/ann06t13.html.*