

Tight Credit Conditions Continue to Constrain the Housing Recovery

By Jordan Rappaport and Paul Willen*

The expansion of Federal Housing Administration lending has let households with imperfect credit or the inability to make a large down payment maintain access to mortgage borrowing. Rather than excluding such households, lenders have been applying strict underwriting conditions on all borrowers. Clarifying what constitutes approved lending may help relax credit conditions with minimal increase in risk.

The housing recovery continues to struggle to gain traction. While single-family home prices have rebounded strongly over the past two years and the pickup in sales in May offers some cause for optimism, single-family construction and trend sales remain sluggish. Correspondingly, originations of mortgages to purchase a home fell in the first quarter to their lowest level since early 2011.

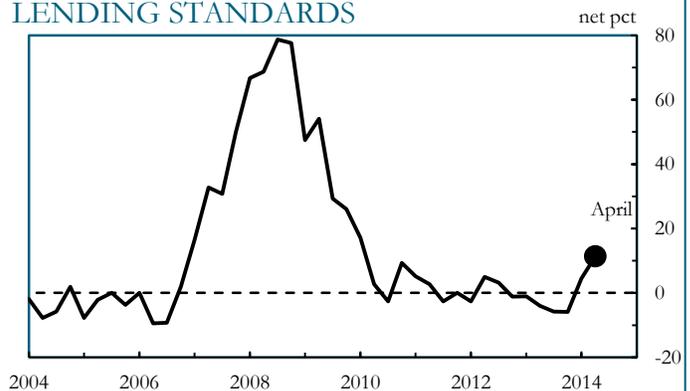
Credit conditions have been a key factor constraining the recovery. With the onset of the housing crisis, banks and other lenders significantly tightened their criteria for making mortgage loans. Most visibly, they stopped making “subprime” loans to households with especially poor credit histories. Households with FICO credit scores below 620—a score that might be triggered, for example, by being 90 days late on a loan payment—essentially lost any access to mortgage borrowing. And lenders no longer allowed borrowers to take out a “piggyback” second mortgage to make a down payment.

This tightening of mortgage credit is reflected in the Senior Loan Officer Opinion Survey (first chart). Each quarter the Federal Reserve asks a large number of banks whether they have tightened, loosened, or left unchanged their standards for mortgage lending. The percentage of banks reporting they had tightened standards minus the percentage reporting they had loosened standards remained high, quarter by quarter, from early 2007 through early 2010. Since then, there has been almost no offsetting loosening.

Notwithstanding the tightening of standards, households with imperfect credit histories or that were unable to make a large down payment continued to have access to mortgage borrowing. Rather than doing so in the “conforming” market, which consists of mortgages that can be purchased by Fannie Mae and Freddie Mac, they instead took out mortgages guaranteed by the Federal Housing Administration (FHA). FHA lending has traditionally focused on helping low- and moderate-income households purchase a first house. Hence it allows for some credit impairments and requires only a modest down payment.

Beginning in 2007, FHA lending grew rapidly. It accelerated in 2009 after Congress authorized the FHA to more explicitly target a broader set of households. To do so, the FHA increased the maximum loan it would guarantee to \$730,000. Single-family purchase mortgages guaranteed by the FHA grew from 300,000 in 2006

BANKS TIGHTENING MORTGAGE LENDING STANDARDS



Sources: Federal Reserve, Haver Analytics.

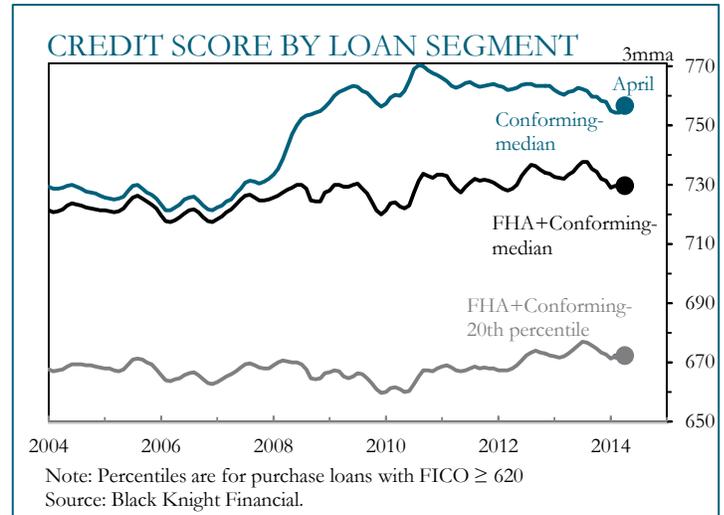
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to 1.1 million in 2010. Over these years, originations of all other types of purchase mortgages plunged. Correspondingly, the FHA share of single-family purchase originations jumped from 5 percent to 44 percent.

The success of FHA lending in maintaining access to credit is borne out by credit scores on newly originated purchase mortgages. From early 2007 to mid-2010, the median FICO score on a conforming mortgage increased by almost 50 points (second chart, blue line). But the median FICO score for the combination of conforming and FHA-guaranteed mortgages increased only 10 points (black line). Over this same interval, the 20th percentile FICO score for combined purchase originations—a better measure of access to mortgage borrowing—was unchanged (gray line).



The jump in FHA lending similarly maintained access to credit for households unable to afford a large down payment. FHA-guaranteed purchase loans typically require a down payment of 3.5 percent. For the combination of conforming and FHA purchase mortgages, the share of households making a down payment of 5 percent or less—net of any secondary liens—has remained comparable to what prevailed during the housing boom and higher than what prevailed previous to it. Consistent with this, the share of lending in the combined segments to purchase a house in a low- or moderate-income community is actually higher today than during the housing boom.

Rather than cutting off access to mortgage credit for a subset of households, ongoing credit tightness more likely takes the form of strict underwriting procedures applied to all households. Lenders require conservative appraisals, meticulous documentation, and the curing of even the slightest questions of title. To the extent that these standards constitute sound lending practices, adhering to them is a positive development. But the level of vigilance suggests that regulatory uncertainty may also be playing a role.

Since the housing crisis, the FHA, the Federal Housing Finance Agency, the Consumer Financial Protection Bureau, and other government and private organizations have been continually developing a new regulatory framework. Lenders fear that departures from the evolving standards will result in considerable costs, including the forced buyback of loans sold to Fannie and Freddie and the rescinding of FHA mortgage guarantees. The associated uncertainty has caused lenders to act as if strict interpretations of possible restrictive future standards will apply.

In addition to tight credit, the housing recovery faces a number of challenges. Weak income growth, increases in student debt, and rising home prices are each putting downward pressure on purchase demand. Clarifying what constitutes approved lending may help to overcome these challenges.

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