
FRBSF WEEKLY LETTER

November 29, 1985

Fannie Mae's New Standards

Effective October 15, 1985, the Federal National Mortgage Association (FNMA, or "Fannie Mae") adopted tighter underwriting standards for the low down-payment mortgages it purchases. These new standards affect nearly all aspects of the underwriting process, including credit evaluation and property appraisal. Because FNMA is the nation's largest investor in home mortgages, many observers worry that these new standards will make housing considerably less affordable and housing activity consequently more sluggish.

This *Letter* argues that, in the near-term, the impact of FNMA's actions will depend on the extent to which others in the housing finance industry adopt equally restrictive standards. Considering current mortgage market conditions, a widespread move towards even tighter standards is unlikely. Moreover, even if underwriting standards were to become more restrictive, the impact of such a change would be short-lived since house prices and household borrowing patterns would adapt to the new mortgage market conditions.

Tighter standards

The rapid appreciation in house prices of the mid- to late 1970s tended to insulate investments in home mortgages from default risk. The growing equity produced by rapid price appreciation reduced homeowners' defaults on mortgage loans and protected lenders from loss by providing a sufficiently large cushion to absorb foreclosure costs in the rare event of default. Underwriting standards for home mortgages reflected the lenders' perception of low default risk, making low down payment (alternatively, high loan-to-value, LTV) mortgages easier for borrowers to obtain. Beginning in the early 1980s, however, the rate of housing price appreciation slowed considerably, leaving homeowners with highly leveraged investments and lenders with greater exposure to default risk. Two back-to-back recessions pushed defaults and losses on home mortgage loans to postwar highs.

According to FNMA's analysis of its portfolio of defaulted loans, high LTV mortgages (those with

LTV ratios of 90 percent or more) posed the greatest threat, with a default rate five times that of 80 percent (and lower) LTV mortgages. Others in the housing finance industry also experienced an increase in the riskiness of high LTV mortgages, particularly adjustable rate mortgages. Consequently, the housing finance industry has moved to tighten underwriting standards on these loans within the last year or so. In general, the changes require both higher borrower income to qualify for a high LTV loan and a stronger equity position in the property securing the loan. Appraisal practices have been tightened to account for below-market financing and other seller-provided concessions that inflate the sales price and hence the borrower's stated equity position.

Private mortgage insurers (MIs) were among the first to adopt these new standards. MIs insure the first 25 percent of the value of most high LTV mortgages and, therefore, incurred substantial losses when the real estate market began to sour. Other investors soon followed as losses on foreclosures exceeded their private mortgage insurance coverage.

In one sense, then, FNMA's newly adopted underwriting standards continue an already established trend. However, FNMA's new standards also "leapfrog" the industry in some ways. For example, with respect to borrower income qualifications, FNMA's new standards are significantly more stringent than those of the Federal Home Loan Mortgage Corporation (FHLMC, or "Freddie Mac," another major purchaser of home mortgages) and the MIs. FNMA now requires that, for a high LTV mortgage, a borrower's payment-to-income ratio generally not exceed 25 percent for housing expenses alone and 33 percent for housing and other debt-service expenses. By contrast, the industry's standards are now 28 and 36 percent, respectively. Thus, FNMA's new standards require income approximately 12 percent higher to qualify for a 95 percent LTV mortgage at current rates.

Also, FNMA's new standards for appraisals are more stringent in at least one respect. Like the rest

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of the industry, FNMA now requires that the appraised value of a home to qualify for high LTV mortgages exclude the value of seller/builder concessions and contributions in excess of three percent of the property's value. However, FNMA's new definition of "contributions" is more comprehensive than that of the industry as a whole. As a result, the appraised value of properties that secure loans FNMA is planning to purchase likely will be lower, making 95 percent financing on the actual purchase price harder to obtain from FNMA than from others in the industry.

Mortgage credit availability

FNMA's new standards represent a significant diminution in its willingness to supply funds to the mortgage market. Based on a survey of its larger members, the National Association of Homebuilders (NAHB) estimates that if FNMA's standards had been the industry norm earlier this year, one-half to two-thirds of the homebuyers that sought high LTV mortgages would have been unable to obtain the same amount of credit under the new as under the old standards. Whether such a curtailment of mortgage credit will occur now that FNMA's standards are in effect, however, will depend on the extent to which the rest of the industry adopts FNMA's tighter standards.

While it may be too soon to say anything definitive, FNMA's action probably does not presage a general move toward even tighter standards. FNMA apparently has a stronger incentive than the industry as a whole to adopt a cautious posture. Although the entire industry has experienced an increase in problem and defaulted loans as well as an erosion in its capital base, according to FNMA's chairman, David Maxwell, FNMA's experience in this regard is particularly troublesome as a result of its decision to follow a countercyclical policy during the steep recession in 1981-82. During that time, FNMA purchased a large number of conventional loans that other investors considered too risky. The large increase (from 3,000 in March 1984 to 7,800 in June 1985) in FNMA's portfolio of properties acquired through foreclosure is associated almost entirely with loans purchased in 1981-82. By contrast, FHLMC has not had loan losses of the same magnitude as FNMA's, and will, therefore, not need to adopt more stringent underwriting standards, according to one analyst.

The relatively stringent underwriting standards adopted by FNMA will probably induce borrowers to seek funds from other sources. For example, a number of homebuilders apparently have already shifted business to FHLMC and the Federal Housing Administration which insures mortgages that are pooled and sold by the Government National Mortgage Association. Of course, since many private suppliers of mortgage credit cannot obtain funds as cheaply as can FNMA with its status as a federal agency, the price of mortgage credit may have to rise to induce those other suppliers to shift additional resources to mortgage lending. The requisite increase in the price of mortgage credit likely will not be large, though, since the existence of federal deposit insurance enables insured depository institutions to obtain funds relatively cheaply. Moreover, FHLMC's status as a federal agency should enable it to expand its operations easily. Many analysts, in fact, expect FHLMC to capture a large share of the business that otherwise would have gone to FNMA.

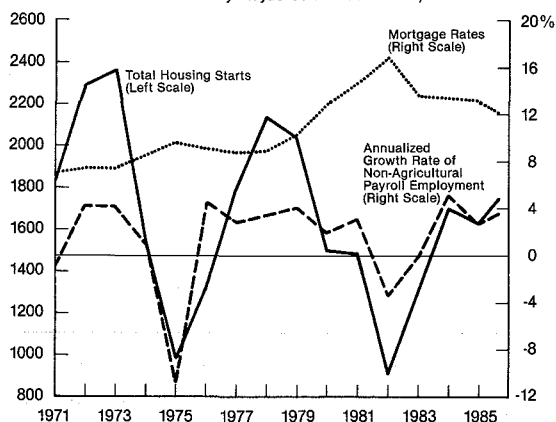
Empirical evidence tends to support the view that FNMA's actions will have only a limited impact. A study by Jaffee and Rosen in 1979 found that the then-record level of new mortgage commitments by FNMA and other federal agencies reduced mortgage rates only six basis points in the late 1970s. Thus, a curtailment of FNMA's activity should not produce much of an impact in the opposite direction. One can expect, at most, only a modest rise in mortgage rates and a small reduction in the total quantity of mortgage credit.

Impact on housing

Because FNMA's actions are not likely to reduce the overall supply of mortgage credit significantly, it also is unlikely that they will have a major effect on overall housing activity. This view assumes, of course, that mortgage loan demand and housing activity are not highly sensitive to the small rise in mortgage rates that may be required to bring about shifts in the market shares of various mortgage market participants now that FNMA's new standards are in effect. There is a considerable body of empirical work to support this assumption. Studies by Meltzer, Hess and Rosen all suggest that the price of housing adjusts to changes in financing terms, leaving overall housing activity unchanged.

HOUSING, EMPLOYMENT GROWTH AND MORTGAGE RATES

(Annual Data in Thousands, Seasonally Adjusted Annual Rates)



The housing market's apparent insensitivity to selectively tighter underwriting standards within the past year also suggests that housing activity is not highly sensitive to modest changes in mortgage credit availability. Instead, much of the slower-than-anticipated pace of housing activity within the last year can be explained by factors such as lower inflation expectations (including lower expectations of housing price appreciation) and the economy's generally sluggish performance.

The accompanying chart shows that major swings in housing activity are closely correlated with changes in employment growth. While it is difficult to determine the exact nature of the causal relationship between the two, a number of economists have theorized that housing demand is influenced by uncertainty about the level of future income. In other words, when employment growth declines, as it has lately, households become more uncertain about their ability to make large purchases of durable goods, such as housing.

This analysis suggests that the changes in financing terms that have occurred within the last year have not been the determining factor in explaining the slower-than-expected pace of housing activity. Likewise, small changes in mortgage rates and mortgage credit availability brought about by FNMA's actions should not have much impact on housing activity. However, if the supply of mortgage credit were sharply curtailed, as would happen if all lenders were to tighten their underwriting standards in line with those of FNMA, the resulting decline in housing demand could be sub-

stantial in the short-run, particularly since approximately 300,000 high LTV mortgages are written each year. Borrowers with high LTV mortgages would need to increase their down payments and/or reduce the value of the homes they purchase. Since, in the short-run, households' ability to generate larger down payments is fairly constrained, housing demand probably would fall significantly and cause a drop in housing starts and prices.

In the long-run, however, the impact of generally tighter underwriting standards on the number of housing units built is likely to be minor since household borrowing and consumption patterns eventually would adjust to changes in the supply of mortgage credit and the price of housing. Several studies (including a study by Pozdena in the Fall 1980 issue of this Bank's *Economic Review*) have found that, over the long-run, so-called "affordability" constraints such as would be created by the wide-scale adoption of FNMA's new standards are not binding because the burden of a reduced supply of mortgage credit does not fall solely on housing. The ready availability of high LTV mortgages until recently has induced households to take on a greater share of mortgage debt than they otherwise would have. In many instances, this debt has been used to finance a wide variety of consumption expenditures in addition to housing purchases. As a result, a contraction in mortgage credit availability will lead, in the long-run, to adjustments in households' overall consumption and borrowing decisions as well as in housing investments.

Conclusion

The tighter underwriting standards on high LTV mortgages that already have been adopted by the housing finance industry apparently have had almost no measurable effect on housing overall. Likewise, FNMA's new standards should have very little effect. Where FNMA's requirements are more stringent than the rest of the industry, borrowers and lenders will tend to shift business away from FNMA. It is only in the unlikely event that others are compelled by increasing default risk or deteriorating financial conditions to adopt even tighter underwriting standards that the availability of mortgage credit and housing demand will be much affected by FNMA's new standards.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding	Change from	Change from 11/7/84	
	11/6/85	10/30/85	Dollar	Percent ⁷
Loans, Leases and Investments ^{1 2}	197,311	560	10,692	5.7
Loans and Leases ^{1 6}	178,382	485	10,326	6.1
Commercial and Industrial	51,126	486	— 1,112	— 2.1
Real estate	65,447	94	4,008	6.5
Loans to Individuals	37,845	— 31	7,242	23.6
Leases	5,395	— 11	324	6.3
U.S. Treasury and Agency Securities ²	11,778	108	172	1.4
Other Securities ²	7,151	— 33	195	2.8
Total Deposits	201,516	2,251	9,433	4.9
Demand Deposits	48,957	1,408	3,736	8.2
Demand Deposits Adjusted ³	33,168	685	3,564	12.0
Other Transaction Balances ⁴	14,614	779	1,874	14.7
Total Non-Transaction Balances ⁶	137,944	63	3,821	2.8
Money Market Deposit Accounts—Total	45,574	85	6,356	16.2
Time Deposits in Amounts of \$100,000 or more	38,552	77	— 2,460	— 5.9
Other Liabilities for Borrowed Money ⁵	24,833	1,412	2,196	9.7
Two Week Averages of Daily Figures	Period ended 11/4/85	Period ended 10/21/85		
Reserve Position, All Reporting Banks				
Excess Reserves (+)/Deficiency (—)	25	52		
Borrowings	17	54		
Net free reserves (+)/Net borrowed(—)	8	— 2		

¹ Includes loss reserves, unearned income, excludes interbank loans

² Excludes trading account securities

³ Excludes U.S. government and depository institution deposits and cash items

⁴ ATS, NOW, Super NOW and savings accounts with telephone transfers

⁵ Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources

⁶ Includes items not shown separately

⁷ Annualized percent change