Double Trouble: How Fannie Mae and Freddie Mac are Helping and Hurting the New York City Residential Mortgage Market

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This is part of a series of CHPC briefings examining current issues of importance to the NYC housing and community development industries.

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Citizens Housing & Planning Council recently convened a meeting of practitioners from the housing industry to discuss the state of the residential retail mortgage market and its impact on the housing market. The discussion was led by Dan Levitan, a founding partner of the Home Mortgage Acceptance Corp. (HMAC), currently Managing Director at The Manhattan Mortgage Company (MMC) and Lisa Ryell, Managing Director at MMC.

The global recession is well underway, fueled in large part by the U.S. mortgage market collapse in 2007. Fannie Mae and Freddie Mac, which were placed into conservatorship in September 2008, and which have received $96 billion from the Treasury to ensure their financial solvency, may be unintentionally impeding recovery of the residential mortgage market in New York City.

Their regulatory standards prescribe the kinds of loans that lenders can make - the three largest being Wells Fargo, Bank of America, and JPMorgan Chase - and those standards have tightened in recent months. This tightening of standards will likely result in fewer fraudulent loan transactions, a relief for consumer protection advocates. However, it also constricts the housing market by preventing prospective middle-income individuals from purchasing and results in higher rates and fees for those who do qualify. Condominium lending regulations are particularly onerous, and may be further weakening the housing market in New York City.

New Regulations

Fannie and Freddie play a critical role in maintaining the stability of the residential mortgage market. By purchasing mortgage loans from lenders at a premium, they inject lenders with the liquidity they need to keep lending. Fannie and Freddie decline to purchase loans that deviate from their strict regulatory standards, ensuring that all lenders adhere to them as well. Residential lending terms have become stricter, and loans underwritten by Fannie and Freddie generally do not exceed $730,000; loans above that amount are riskier and are deemed "jumbo loans." Portfolio lenders, institutions that lend their own money, are not concerned about selling their loans on the secondary market and so operate with comparatively relaxed lending standards and have emerged to fill the lending gap for jumbo loans.

Fannie Mae and Freddie Mac developed a new category of loans in 2007 to address the complete collapse in jumbo loan lending. Previously, the "conforming loan limit" (i.e., the maximum loan amount that Fannie Mae would qualify for purchase) was $417,000. When the market collapsed in 2007, lenders panicked and financing for jumbo loans ceased. In response, Fannie Mae and Freddie Mac developed a mid-range category of loans. Now, loans of $417,000 and less are conforming; $417,000 to $625,000 ($730,000 in high cost areas such as NYC) are agency jumbo/ high balance; and $730,000 and up are

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jumbo non-conforming, generally lent by small portfolio lenders with no desire to sell.

An article in the New York Times this summer described the mortgage market as shaped like a barbell: borrowers at the very ends of the income spectrum (very low-income and very high-income) are able to obtain mortgages; borrowers with incomes up to $250,000 have access to loans guaranteed by the Federal Housing Administration (FHA), while the affluent can obtain loans from portfolio lenders. For those borrowers in the mid-range of incomes, mortgages are harder to come by.

Fannie Mae's new condo guidelines may be stifling condo demand during this delicate period of housing recovery. Prior to 1999, with 20% down, a bank would conduct a limited project review – i.e., lend to a purchaser with little to no information on the condominium association and/or the building. Now, for an established condominium (i.e., one in existence for two years or longer), a building is eligible for limited project review only if 90% of the units in the building are either sold or in contract for purchase. If not, Fannie Mae undertakes an excruciating review of the building's health. The condominium association must submit a budget for the coming year showing a line item for replacement reserves. Condo associations are reluctant to disclose this and almost never have a budget for replacement reserves, which would require increasing common charges. However, the FHA recently promulgated relaxed lending standards which may jumpstart the NYC condo market. Taking effect on December 7, 2009, the new rules lower the FHA's pre-sale requirements for new condo buildings from 50-75% to 30%. The FHA will also guarantee loans for 50% of a condo's units if the project meets strict underwriting standards

In addition, under the new regulations, a project can't be more than 20% commercial, but, as all developers know, ground-floor retail is often the financial crux of a new residential building. Financing is so tenuous that mortgage brokers are now insisting that potential purchasers have financing contingency clauses in their purchase contracts, allowing them to terminate the contract if they can't obtain financing by a certain date - a prudent provision in any residential contract.

Mortgage brokers in NYC must now also contend with a new regulatory scheme governing appraisals: the Home Value Code of Conduct (HVCC), which was adopted by Fannie Mae and governs all loans originated (applied for) on or after May 1, 2009 in all states. The HVCC was supposed to inject integrity into the home appraisal process, but it instead appears to be diluting the quality and accuracy of appraisals, and artificially deflating sales values of homes across the country.

Under the HVCC, a broker can't order an appraisal directly; brokers must contact a lender's third party appraisal management company to order one. The appraisal management company has a list of all licensed appraisers, and puts the job out to bid; the winning bidder is the appraiser who agrees to the lowest fee and the smallest percentage of that fee – the other portion of the fee going to the bank.

Additionally, quality in appraisers varies wildly; mortgage brokers speak anecdotally of appraisers making egregious mistakes in comparable properties and appraisers lacking English fluency. A prospective homebuyer who obtains his own appraisal, however, will be prevented from using it with his lending institution by the HVCC's transportability rules. The HVCC does allow a lender/third party to strike an appraiser from its list for incompetence, but lenders are reluctant to strike less qualified appraisers who offer profitable fee splitting arrangements. Mortgage brokers are dismayed at the restrictiveness and poor quality control of the new regulations.

The HVCC has proven to be so detrimental to appraisal quality that the National Association of Mortgage Brokers has circulated an

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online petition lobbying the House Financial Services Committee to repeal the HVCC. The Committee has responded by adding an HVCC sunset provision to H.R. 3126, the Consumer Financial Protection Agency Act of 2009, which is expected to pass in the House shortly. The sunset provision calls for the director of the Consumer Financial Protection Agency, provided it's created, to promulgate a new set of appraisal standards.

Fannie Mae has also set forth new rules regarding the borrower's credit score. Previously, if the borrower had a score of 620 and above, they qualified for a loan without any negative consequences. Now, a credit score of 620-679 will qualify for an interest rate .375% to .5000% higher than market; a credit score of 680-700 will qualify for a rate .125% to .250% higher than market, and a score of 720 and above with a market interest rate. Fannie Mae also penalizes borrowers of loans for 2-4 family homes by imposing a surcharge, the theory being that the lender assumes more risk if the borrower is relying on rent from a second unit to pay the mortgage. This is an old battle for New York City, where density is desired and the rental market is the mainstream.

Consequences

Less favorable sources of funding are now being utilized as a last resort. FHA's 234(c) condominium insurance plan insures condominium loans for 30 years; this program is often combined with subsidies. The program is unpopular in New York because it cannot be used where a condominium association's founding documents place legal restrictions on conveyance of the condo unit, such as a right of first refusal for the condo association. Many developers are now using this source of financing out of desperation; it enables them to provide financing with 3-5% down and low credit scores.

Seemingly well-qualified buildings are now being declined under the new regulations. For example, Freddie declined to qualify a 100% owner-occupied building on 73rd and Broadway where the developer retained a small interest in a portion of the sub-basement. In another instance, Fannie Mae declined to qualify a loan with seemingly impeccable credentials. A partner at a large law firm in Manhattan sought to change a jumbo loan to a new conforming loan with a lower rate, at a 44% loan to value ratio and a debt service to income ratio of 12%. The building was an established condominium with 850 units, 85% of which were sold and owner-occupied, but the sponsor retained 15% of the units as free market rentals, with no incentive for the sponsor to sell. Fannie Mae deemed the building too risky because the building was not moving toward full ownership (it had been 5 years since the sponsor had sold a unit), and declined to qualify the building. A decrease in value is the unfortunate consequence of Fannie Mae's refusal to qualify a building for loan purchase. Moreover, if Fannie Mae declines to qualify a building, purchasers of units in that building must uniformly turn to portfolio lenders, whose rates could never approximate those under Fannie Mae's standards.

The consequences for the affordable housing community are two-fold. First, until residential mortgage lending approaches normal levels, lending for middle-income borrowers will be a low priority. Second, a functional mortgage market is necessary for the capital and cross-subsidies necessary to drive affordable housing development. The future of the residential mortgage market depends on whether the federal government focuses on inflation or unemployment in the coming months. If the government focuses on raising the employment rate, they must also focus on spending continuously to keep interest rates low. If, instead, the government focuses on combating inflation, interest rates must rise. Either policy will have a significant impact on New York City's housing market, and CHPC will be watching for developments in the coming months.

This brief, written by Stefanie Marazzi, William R. Ginsberg Practitioner Fellow, was adapted from a discussion led by Dan Levitan and Lisa Ryell on October 21, 2009 at CHPC's office.
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