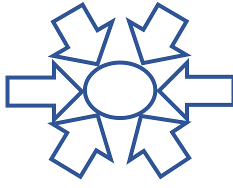

GSE Activity Report

Monday, January 23, 2023

The Fed's Heavy Hand on Equitable Housing

Summary

Under Director Thompson, FHFA's top policy priority is equitable housing. However, a ground-breaking study from Fed staff shows that FHFA is swimming upstream when the Fed raises rates. Combined with our own research showing that ultra-low rates also accelerate inequitable housing, the best FHFA can do to help lenders reach LMI borrowers is tread water – better than sinking, but still hard work getting pretty much nowhere.

Impact

After 2008 and even to this day of seemingly-high rates, the Fed set rates that are negative in real terms even when inflation was completely quiescent. As we have detailed elsewhere and much data show, ultra-low rates spur sometimes-frenzied home buying and mortgage refinancing by existing homeowners and wealthier households. This spurs rapid house-price appreciation that undermines unaffordability even as it ensures that anyone attempting to set aside savings for a down payment falls ever farther behind market prices.

In some ways, rising rates enhance equality – if not housing-market profitability – by virtue of cooling refis and, at least in theory, allowing lower-income households to gain a bit of wealth accumulation that enhances the odds of home ownership once a down payment has been accrued. We say in theory because rising rates now remain negative in real terms and, as the Fed study shows, rate hikes adversely affect DTI ratios and thus the ability of lower-income households to qualify for a mortgage even as their ability to save for a downpayment remains fruitless. And, of course, improved equality wrought solely by disadvantaging the middle class is pyrrhic in terms of improved social welfare.

Specifically, the study uses the period around FOMC rate-hike announcements to see what happens to LMI borrower capacity. Without paying attention also to inflation or broader macroeconomic trends, the paper finds that a rate hike of one percentage point reduces the share of home-purchase mortgages to LMI borrowers by 7.5%; low-income borrowers are down and out 16% in this scenario. First-time homebuyers capacity to buy is also down about four percent. These shocks last for at least a year after the 1 pp rise and thus are surely more acute for multi percentage-point rates hikes over a longer period of time – i.e., now.

Speaking of pyrrhic victories, rate hikes also reduce inequality by virtue of their adverse impact on financial-asset prices. Market pullbacks resulting from higher rates adversely affect wealth for those in the financial market. However, eliminating inequality by virtue of pain for those who have substantial

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wealth in financial assets is thus not meaningfully offset by improvements to LMI households. LMI-household DTIs impede mortgage eligibility in the absence of acute house-price declines which of course have significant market and macroeconomic impact. Further, even if the upper class's market pain were meaningfully offset by LMI home-ownership opportunity, wealth accumulation via home equity takes years and often has more than a few bumps along the way.

Outlook

In short, the FHFA can only do so much. The significant upfront pricing drops for LMI-related loans announced last week may help offset rate rises, but this is likely to be marginal at best because the Fed's rate hikes have been so sharp and so fast and underlying macroeconomic challenges are so acute. It is possible that disproportionate wage gains for LMI and minority workers may increase mortgage affordability in ways not captured by this study, but that remains to be seen in the current, volatile environment. It's also unlikely given all the ground these households have to make up in terms of lost savings and still-high housing prices.

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