Trump Adm. Moves to Reduce Chances for Real Estate Meltdown

"What a terrible thing to do to American homeowners," Senator Chuck Schumer (D-N.Y.) said in reaction to the Trump administration's reversal of a last-minute action by outgoing Obama administration on the FHA home mortgage insurance rate.

"In one of his first acts as president, President Trump made it harder for Americans to afford a mortgage by reversing a recent decision by the Department of Housing and Urban Development to reduce annual insurance premiums that many borrowers pay," Schumer complained.

William E. Brown, president of the National Association of Realtors (NAR), was also upset at the Trump administration's action. "According to our estimates, roughly 750,000 to 850,000 home buyers will face higher costs and 30,000 to 40,000 new home buyers will be left on the sidelines in 2017 without the cut," he insisted..

California Association of Realtors President Geoff McIntosh chimed in, arguing that the new administration's move will "negatively" impact home buyers in California "more than any other state."

In perhaps the most amazing reaction of all, *The Intercept* even argued that in one of the first official acts of his presidency, Donald Trump had increased taxes on a million middle-class homebuyers!

Just what did Trump do to elicit these hostile reactions?

On January 20, the very day he became president, his administration suspended, indefinitely, a policy announced by the Obama Department of Housing and Urban Development (HUD) on January 9, that would have gone into effect yesterday, January 27. What the Obama administration attempted to do was to cut the mortgage insurance premium by one-quarter of one percent set by the Federal Home Administration (FHA), used by many potential home buyers.

FHA insurance is a federal government program which subsidizes real estate transactions, financed by home loans. The beneficiaries include not only some home buyers, but also banks and those in the real estate industry, such as real estate agents and home builders. It makes loans cheaper, and reduces the risks to lenders who choose to make loans to borrowers who are greater risks.

Bloomberg explained the way it works: "The FHA sells insurance to protect against defaults and doesn't issue mortgages. It is a popular program among first-time home buyers because it allows borrowers to make a down payment of as low as 3.5 percent with a credit score of 580, on a scale of 300 to 850."

When a lender makes a home loan, he wants the borrowers to invest some of their own money into the property — known as a "down payment." That way, borrowers are less likely to "walk away" from the home, and leave lending institutions unable to recoup their loan. The higher the down payment, the better, in the view of the lenders.

But, of course, many would-be home buyers simply do not have enough money to make that down payment, and this is where the FHA insurance comes in. If the borrower defaults, then the insurance will cover the lender. This system discourages those who wish to purchase a home from saving enough money to make a larger down payment, but instead encourages them spend money now. Combined with the deliberate government monetary policy of keeping interest rates lower, this is, in effect, a subsidy for borrowers. If the FHA needs a bailout — as happened in 2013 — the taxpayer ultimately is on the hook.

In the end, these government subsidies create more demand than one would actually have with a free market in lending. This higher demand, of course, causes more homes to be built, and more loans to be made, than would otherwise be the case. Since this increased demand comes from more marginal borrowers, the end result is predictable: more defaults.

It is also questionable whether this artificial reduction in interest rates and in mortgage insurance is really beneficial to the potential home buyer. After all, without the artificial increase in demand, home prices would be lower. When these misguided government policies drive up prices of homes, the predictable solution by those in government is to call for more subsidies, which only drive the prices up even more. And the cycle continues.

Not surprisingly, mortgage lenders, who stand to make more loans under such a system, support the subsidies of mortgage insurance by the FHA. Home builders, who have more customers, think it's grand. Real estate agents sell more houses, and happily pocket more commissions.

The classic essay "That Which is Seen, and That Which is Not Seen," by the 19th century French philosopher Frédéric Bastiat, explains masterfully why such activities continue. Everyone can see the benefits to home buyers, lenders, home builders, and real estate agents. But the money to support such government programs come from taxpayers, which means money is being taken from their pockets and transferred to those who benefit from such programs. What is "not seen" is those who would have benefitted from the taxpayer using his money to buy something else, rather than having it sucked away by the government.

And, as history as shown, these real estate booms eventually come to an end, and there are a large number of defaults, such as in the 2008 financial meltdown. The 1927 bust in the Florida real estate market contributed to the onset of the Great Depression, in another historical example. When these inevitable "busts" occur, then those who benefitted during the "boom" often reap the whirlwind, and we see banks close, home builders scaling back and laying off construction workers, and home owners who are stuck with houses that are now glutting the market. And real estate agents wonder where all the home seekers went.

Secretary of Housing and Urban Development nominee Secretary Ben Carson stated that outgoing Secretary Julian Castro did not ask him for his opinion before he took the rate-cut action. Responding to a question from Senator Pat Toomey (R-Penn.), Carson said, "I, too, was surprised to see something of this nature done on the way out the door, which of course has a profound effect. If confirmed, I am going to work with the FHA administrator and other financial experts to really examine that policy."

The Trump administration's move is actually a baby step in the right direction. Instead of the government policy of driving down interest rates and punishing savers, the government should allow the free market to determine the interest rate. As individuals are able to expect more money in their bank accounts from higher interest rates, we can anticipate more Americans to save. As more money capital is thus formed, this natural increase in the supply of money will lower interest rates. Those wishing to buy a home will save money for a longer period of time before they buy.

Even under a free market, there will still be loans made to borrowers who wind up defaulting. But without government subsidies, we can confidently predict that the number of defaulters will be far fewer. We will not experience the “boom” that comes from such unwise loans; but the good news is that we will not have the horrific “busts” we have seen in this industry, either.

William E. Brown of the National Association of Realtors, however, argues that “without the cut,” 750,000 to 850,000 home buyers will “face higher costs and 30,000 to 40,000 new home buyers will be left on the sidelines in 2017.” Under his reasoning, why not cut the mortgage insurance premium even more than the outgoing Obama administration? After all, no matter where one sets the mortgage insurance premium, there will always be some would-be home purchasers left out.

Instead, under the policy advocated by Brown and politicians such as Chuck Schumer, more and more people will take out risky loans, and prices of homes will soar even higher, with the result that people such as Brown and Schumer will call for even more subsidies to “help” these poor folks who cannot afford homes in a real estate market with ever-rising prices.

Like the dog chasing its tail, there is no end to it all.

As Ed Pinto, a resident fellow at the American Enterprise Institute, commented, Trump administration’s action in stopping the premium cut “is actually good news for first-time buyers.” He argued that cutting the mortgage insurance premium in a seller’s market only increases the demand for FHA loans and causes an increase in the price of homes — leaving many would-be home purchasers “on the sidelines.”

The policy winds up hurting the very people it supposedly is designed to help — not unusual for a government program.