



HOMEOWNERSHIP TRENDS

After 12 successive years of increases, the national homeownership rate slipped to 68.9 percent last year. This small dip reflects in part the sharp swing in renter households, whose numbers fell by a half-million in 2004 and then surged by more than a half-million in 2005. Even so, the number of homeowners increased by nearly one million last year as solid job gains and rapid house price appreciation brought buyers to the market.

Buoyed by demand for investment properties and second homes, home sales hit a new peak before softening in the latter part of the year. As sales slowed in many areas, the months' supply of homes on the market increased. Although not yet creating a buyer's market in most places, the backlog was enough to slow the rate of house price appreciation in a slim majority of metropolitan areas in the second half of 2005.

LASTING GAINS

While topping out nationally, homeownership rates in some regions and among some groups continued to rise last year (Table A-5). Thanks in part to underwriting systems that relieve downpayment constraints and new mortgage products that lower initial monthly payments, homeownership rates increased modestly in the Northeast and West as buyers rushed to take part in hot markets. In fact, the homeownership rate of households under the age of 40—the group most likely to be deterred by higher interest rates and house prices—edged up 0.1 percentage point.

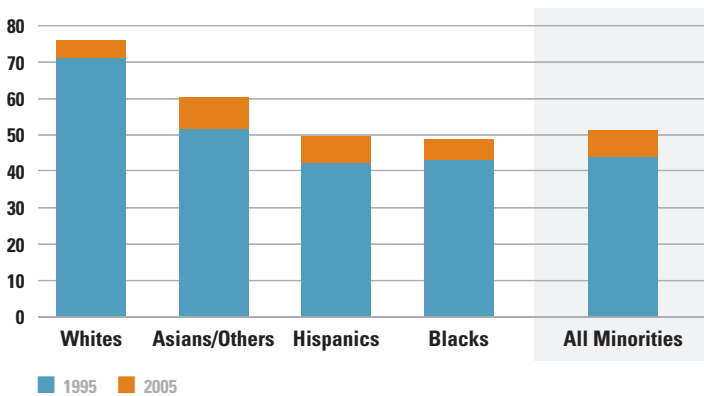
More importantly, the boom that began in 1993 puts households in their 20s and 30s (the echo boomers and the baby-bust generation) on a distinctly higher homeownership trajectory than previous generations. While homeownership rates have gone up across the board, younger and minority households have made the largest percentage-point gains.

Accounting for nearly two-thirds of household growth in 1995–2005, minorities contributed 49 percent of the 12.5 million rise in homeowners over the decade. But even with these strong numerical gains, increases in homeownership rates of minorities barely exceeded those of whites. As a result, the gap between white and minority rates remains near 25 percentage points (Figure 19).

In large measure, the stubbornly wide homeownership gap reflects the rapid growth in young minority households. Because young households have lower homeownership rates than older households, they bring down the overall rate for minorities. Part of the disparity in rates also reflects the fact

Figure 19 **Despite Gains, the White-Minority Homeownership Gap Remains Wide**

Homeownership Rate (Percent)



Notes: Whites, blacks and Asians/others are non-Hispanic. Hispanics may be of any race. Asians/others include Pacific Islanders, Aleuts and Native Americans.
Source: Table A-5.

that minorities continue to lag whites in average income. Indeed, the lower average incomes and ages of minorities together account for about 15 percentage points of the gap in the homeownership rates.

SECOND-HOME DEMAND

While available statistics provide inconsistent estimates, ownership of second homes is clearly on the rise. The Housing Vacancy Survey puts the growth in second homes between 1995 and 2005 at 22 percent—a 1.2 million increase in just ten years. The American Housing Survey places the rise

in second-home ownership at a smaller but still substantial 620,000 over the ten years between 1993 and 2003.

Similarly, the shares of homeowners in all age groups who reported owning a seasonal/vacation home or timeshare were also up in the Survey of Consumer Finances (Figure 20). The increases reported in second-home shares, however, are concentrated entirely among fractional timeshare owners for all age groups except those now in their 60s.

But actual second-home shares are likely higher than these numbers suggest because the survey does not ask about properties owned for occasional use (other than of a seasonal/vacation nature). Many owners have second homes that they use mostly on weekends or for work reasons. Indeed, only 56 percent of all second homes reported in the Housing Vacancy Survey are for seasonal use.

Home equity growth and lower interest rates are certainly part of the explanation for the surge in second-home ownership. The trend toward later retirement as well as increases in other sources of household wealth—including stocks, bonds and inheritances—have also helped. Moreover, the tax law changes of 1997, which excluded realized capital gains from the sale of homes of up to \$500,000, reduced the incentive for sellers to reinvest in more expensive primary residences. Many households likely applied some of this cash to second-home purchases.

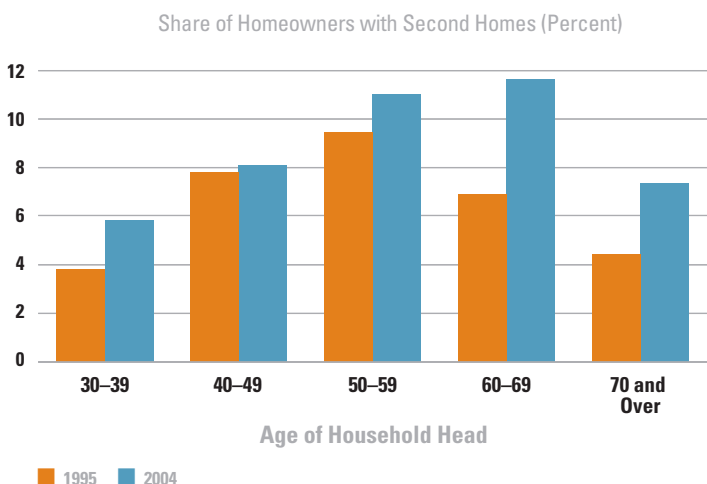
Looking ahead, the number of second homes should continue to increase even if age-specific second-home ownership rates do not. The movement of the baby boomers into their 50s and 60s—the ages when households are the most likely to own additional homes—helps to ensure healthy growth in second-home ownership between now and 2015.

ERODING AFFORDABILITY

House prices continued their dazzling ascent in 2005, climbing well ahead of household income and general price inflation (Figure 21). Until the end of 2003, falling interest rates offset escalating prices to keep homebuying affordable in many metropolitan areas. But with both short- and long-term rates climbing thereafter, the monthly mortgage payment on a typical home with a 30-year fixed-rate loan increased by \$104 to \$1,165 in 2005, while that with a one-year adjustable loan rose by \$148 to \$998. For buyers who could not cover the higher downpayment and instead rolled the difference into the mortgage, monthly payments on fixed-rate loans were up by \$115 last year.

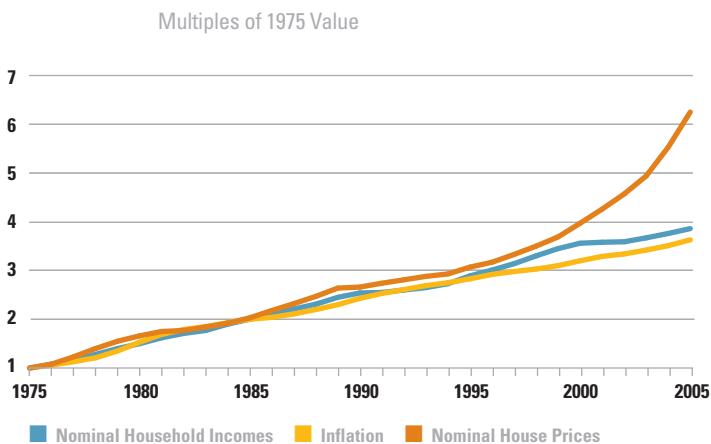
In the nation's hottest housing markets, the erosion of affordability has been much more dramatic. In Phoenix, for example, monthly payments on a median-priced home jumped from \$930 in 2003 to \$1,017 in 2004 and to \$1,316 in 2005—

Figure 20 Increasing Shares of Households of All Ages Own Second Homes



Note: Second homes include fractional ownership in timeshares and vacation properties.
Source: Table A-10.

Figure 21 House Price Appreciation Has Diverged Sharply from Income Growth and General Price Inflation

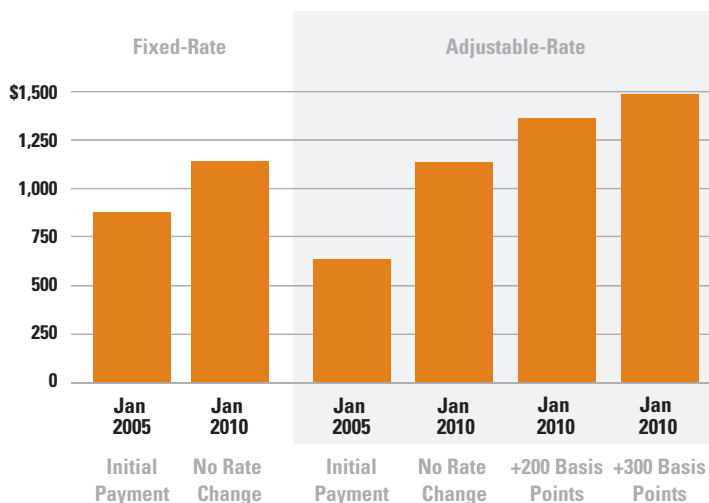


Sources: Freddie Mac Conventional Mortgage Home Price Index; Bureau of Labor Statistics, CPI-UX for All Items; Moody's Economy.com Median Household Income Estimates.

Figure 22

Rising Interest Rates May Compound Payment Shocks for Borrowers with Adjustable Interest-Only Mortgages

Monthly Mortgage Payments



Notes: Assumes interest-only period of five years and teaser rate of one year on adjustable loans. Calculations are based on loan amount of \$180,180 (90% of the 2004 median sales price in 2005 dollars). Interest rates include a .125 percentage-point premium to account for interest-only feature. Sources: National Association of Realtors, Existing Single-Family Home Prices; Freddie Mac, Conventional Mortgage Home Price Index and Primary Mortgage Market Survey.

even for homebuyers who were able to cover the increasingly large ten percent downpayment.

Responding to these pressures, growing shares of borrowers turned to adjustable-rate mortgages. After nearly doubling to 35 percent in 2004, the adjustable-rate share of conventional mortgage originations fell only slightly to 31 percent in 2005 (Table A-3).

Normally, it takes large spreads to encourage borrowers to forgo the protection of fixed-rate mortgages. Yet for part of 2004 and most of 2005, there was almost no difference between fully indexed adjustable rates and fixed rates. Under these conditions, the main appeal of adjustable mortgages is the lower teaser rate offered in the first year or two of the loan. The discounts started at about 0.4 percentage point in 2004, ended the year at about 1.5 percentage points, and inched up to about 2.0 percentage points for the rest of 2005.

Adjustables are also gaining share because they now feature longer initial fixed rates, allowing borrowers to match the lock-in period to the length of time they plan to stay in their homes. Accordingly, the most popular adjustable loans are “hybrids” with a fixed-rate period of five years. Only about a third of adjustable originations in 2005 had an initial term of one year, down from nearly half in 1999.

Over the course of 2005, fully indexed interest rates on adjustable mortgages increased by about 1.6 percentage points. When added to the expiration of the initial 1.5 percentage-point discount, some adjustable-rate borrowers had to face much higher payments early in 2006. Many lenders do, however, cap the single-year adjustment so that not all borrowers were hit by the full increase.

Still, with short-term interest rates expected to climb again in 2006, a growing number of adjustable-rate borrowers will likely see their payments go up. The Mortgage Bankers Association estimates that adjustable-rate loans now amount to about 25 percent of total mortgage debt outstanding. The interest rate on about a quarter of this debt has or will reset by the end of 2006. Fortunately, the vast majority of homeowners—including the 75 percent of mortgage debt holders with fixed-rate loans, plus the nearly one-third without mortgages—will be unaffected by these changes.

MORTGAGE PRODUCT INNOVATION

To help buyers qualify for mortgages, increasing numbers of lenders now offer a variety of products that lower borrowers’ initial monthly payments. For example, interest-only loans defer principal payments for a set number of years. Payment-option loans defer a portion of the interest payments and roll the difference into the principal. Low-documentation loans let borrowers with erratic or hard-to-document resources provide limited details about their income and assets.

Despite the novelty of these products, many consumers have been attracted by their flexibility. LoanPerformance estimates that, from almost zero in 2003, interest-only loans accounted for 20 percent of all mortgage originations, 37 percent of adjustable-rate loan originations, and five percent of fixed-rate loan originations in the second half of 2005. At the same time, payment-option mortgages reached 10 percent of originations by year end, and low documentation loans 12 percent in the second half of 2005. Although they amount to only a small share of all homeowners, about three million borrowers have interest-only adjustables and one million have payment-option first mortgages.

While all homeowners with interest-only loans must begin to pay principal at the end of the agreed-upon period, those with adjustable loans may also get hit with higher interest rates when the initial fixed-rate period ends. Together, these effects can drive monthly payments up sharply (Figure 22). Most interest-only adjustable loans do, however, have interest-only periods of at least five years, allowing time for a borrower’s income to increase or the household to move before the principal payments come due. Indeed, about one in eight homebuyers relocate within three years of buying their homes, and one in three relocate

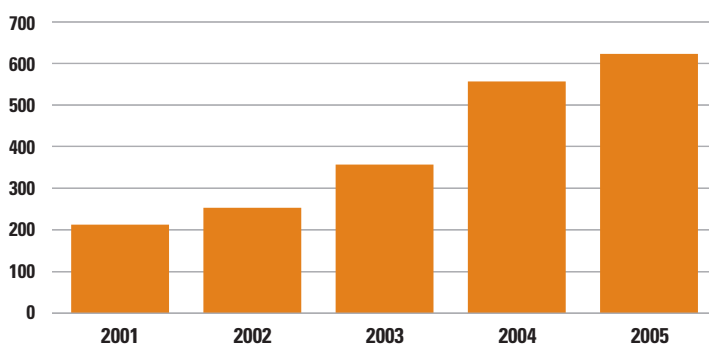
within five years. Some home loans also have fixed-rate and interest-only periods whose termination dates do not coincide, thereby preventing both rate adjustments from occurring at the same time.

SUBPRIME LENDING GROWTH

Along with the market for innovative loan products, the volume of subprime loans has grown dramatically from just \$210 billion in 2001 to \$625 billion in 2005 in real terms (Figure 23). Last year's total represents 20 percent of the dollar value of loan originations and about seven percent of mortgage debt outstanding (Table A-9).

Figure 23 Subprime Lending Has Surged

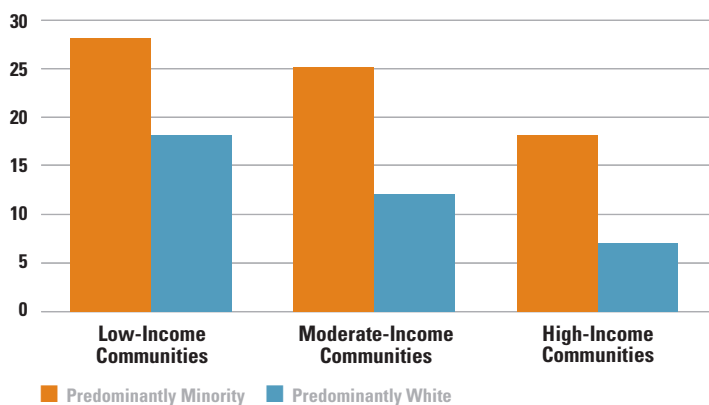
Subprime Originations (Billions of 2005 dollars)



Notes: All dollar values are adjusted for inflation by the CPI-UX for All Items.
Source: Table A-9.

Figure 24 High-Cost Loans Are More Common In Low-Income Minority Communities

High-Cost Loan Share (Percent)



Notes: Loans are for home purchase only. High-cost loans are defined as having an Annual Percentage Rate more than 3.0 points above that on Treasury Bonds of comparable maturities. Low-/moderate-/high-income communities have under 80%/80-120%/over 120% of area median income. Predominantly minority communities are at least 50% minority. Predominantly white communities are at least 90% non-Hispanic white.
Source: JCHS tabulations of 2004 Home Mortgage Disclosure Act data.

Subprime lending has helped millions of Americans with blemished credit histories buy homes or tap into their housing wealth at a time when strong price appreciation has lifted their home equity. In fact, LoanPerformance reports that almost six million homeowners now have subprime first-lien mortgages. Without the sudden expansion of subprime lending, most of these homeowners would have been denied access to credit.

But subprime loans typically have special terms and higher rates to cover the higher expected default rates. At six percent in the fourth quarter of 2005, the share of subprime loans at least 60 days delinquent or in foreclosure was seven times that of prime loans. Moreover, the concentration of subprime loans in low-income minority neighborhoods puts some of these communities at risk of widespread foreclosures (Figure 24).

MOUNTING FHA RISK

Prime and subprime lenders are now competing successfully for borrowers that previously qualified only for FHA-insured loans. As a result, FHA is losing much of its traditional base of first-time and minority homebuyers to lenders able to offer better deals. The net effect is that FHA currently holds a significantly smaller market share that is made up of riskier loans. Today, delinquency rates on FHA loans exceed those on subprime loans (Figure 25).

Unlike subprime lenders that engage in risk-based pricing, FHA charges a single average price and imposes a flat 1.5 percentage-point upfront premium for mortgage insurance, as well as a 0.5 percentage-point recurring premium. Although FHA continues to take in more in premiums than it pays out in claims, concerns are mounting about the stability of this 70 year-old insurance program. Moreover, the pressures on FHA's credit quality are probably here to stay, given the ability of both prime and subprime lenders to use automated underwriting and risk-rating technology to compete on price for less risky borrowers in FHA's traditional markets.

Still, FHA remains a critical resource in many underserved areas and may again be called upon to stabilize housing markets in the event of a sharp regional downturn. Indeed, when the oil boom went bust and the savings and loan industry collapsed in Texas in the 1980s, FHA became the insurer of last resort and staved off a potentially harsher correction in the state.

HOME EQUITY GAINS

Having significant home equity is the best protection against foreclosure because homeowners can sell at a profit if they cannot cover their mortgage payments. Even with the massive cash-outs over the past several years, home equity still amounts to about 56 percent of the aggregate value of primary

residences. At last measure in 2004, escalating home prices had shored up the wealth of most homeowners, with 94 percent having equity of 10 percent or more and 87 percent having equity of 20 percent or more. Only three percent of homeowners had equity stakes of less than five percent (Figure 26). Nevertheless, some seven percent of non-elderly low-income homeowners have such small equity stakes.

With homeownership the cornerstone of household wealth in America, the wealth gap between owners and renters is enormous (Table W-11). Among those under age 40 with incomes in the \$20,000–50,000 range, owners have ten times the median

net wealth of renters. Fully half of their \$45,640 net wealth is in the form of home equity. Among households in their 40s and 50s with incomes in that same range, the discrepancy is even bigger—\$88,000 versus \$6,430—with home equity again contributing half of owners' wealth.

THE OUTLOOK

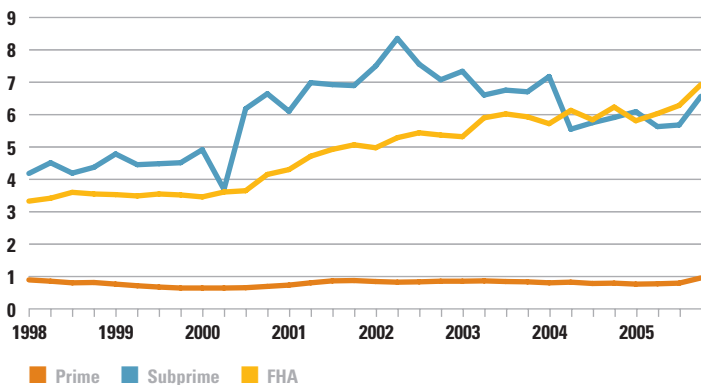
The gains of the last ten years have lifted homeownership growth to a higher trajectory. Remaining on this path depends on whether the recent conditions that have strongly favored homeownership can continue.

A major reason for the recent climb in homeownership is that house price appreciation has been unusually strong over the past five years. In addition, long-term interest rates have remained at historic lows even as short-term rates have returned to more normal levels. If the economy picks up steam, interest rates are likely to increase and the growing share of households with adjustable-rate mortgages will find themselves with rising payments. Interest-only borrowers who do not sell their homes or refinance before principal payments come due will also get hit by much higher payments. Already though, an increasing number of borrowers have refinanced their adjustable loans.

If the economy instead stumbles and job growth falters, a larger number of subprime borrowers will be at greater risk. At the same time, however, the lower interest rates that usually accompany such slowdowns would help adjustable-rate borrowers and create opportunities for other homeowners to refinance their loans on more favorable terms. ■

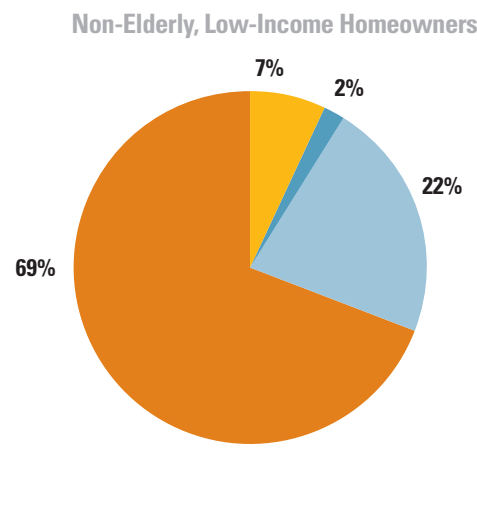
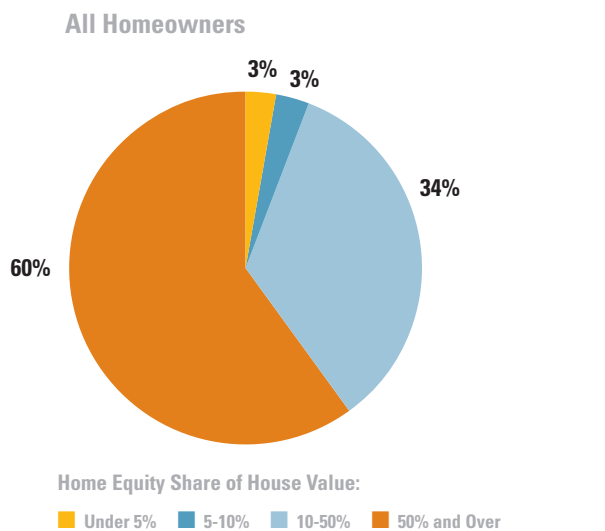
Figure 25 Delinquency Rates for FHA Loans Now Exceed Those for Subprime Loans

Share of Loans at Least 60 Days Delinquent Or in Foreclosure (Percent)



Source: Mortgage Bankers Association.

Figure 26 Most Homeowners Have Significant Equity Stakes



Notes: Non-elderly are under age 65. Low-income homeowners are in the bottom fourth of all households sorted by pre-tax income.
Source: JCHS tabulations of the 2004 Survey of Consumer Finances.