



Homeownership

Falling home prices, stringent credit standards, and stubbornly high inventories of vacant homes roiled homeownership markets throughout 2007 and into 2008. Homeowners whose mortgage interest rates have reset or who have lost their jobs are especially hard hit. With home prices down, many of these owners cannot sell or refinance to get out of unmanageable loans. But even those able to pay their mortgages and under no pressure to sell are feeling the spillover effects from the foreclosure crisis on home prices and credit markets. The only silver lining is that lower prices and slightly lower mortgage interest rates are easing affordability for first-time buyers still able to qualify for loans.

Cycling Demand

Despite all the attention that subprime and so-called affordability loans have gotten for fueling the housing boom, the national homeownership rate had already peaked by the time these products took off in 2004. Indeed, the homeownership rate began to retreat in 2005 and 2006 and then dropped more sharply in 2007, to 67.8 percent in the fourth quarter. Thus, it appears that these mortgage innovations did less to lift homeownership than to enable homebuyers to chase prices higher, investors to borrow money to speculate, and owners to borrow against home equity.

What sparked the decade-long homeownership boom was instead the improved affordability brought by lower interest rates and flat home prices in the wake of the 1990–1991 recession. That downturn was quickly followed by the longest economic expansion since World War II and unusually strong, broad-based income growth. During this period, Congress and regulators also leaned on financial institutions to step up lending in low-income and minority neighborhoods. Equally important, widespread adoption of automated underwriting tools in the latter part of the 1990s allowed many more borrowers to qualify for prime loans while adding little to credit risk.

From 1994 to 2001, the national homeownership rate surged by 3.8 percentage points, and rose even more among minorities and younger households (**Figure 18**). Innovations in prime mortgage lending contributed to larger homeownership rate advances among blacks (up 5.9 points), Hispanics (up 6.1 points), and households under 35 years old (up 3.9 points). After the 2001 recession but before house prices and lending practices went wild, the national homeownership rate climbed another 1.2 percentage points to a peak of 69.0 percent. In the three years since, homeownership rates have fallen back for most groups, including a nearly 2.0-point drop among black households and a 1.4-point drop among young households (**Table A-5**).

Once the current turmoil passes, the full benefits of automated underwriting tools in the prime mortgage market will once again provide a favorable climate for homeownership growth. With more prudent underwriting and less risky products, subprime lending may well reassert itself as a viable business—although one unlikely to serve as many borrowers as it did at its peak when more reckless practices were tolerated.

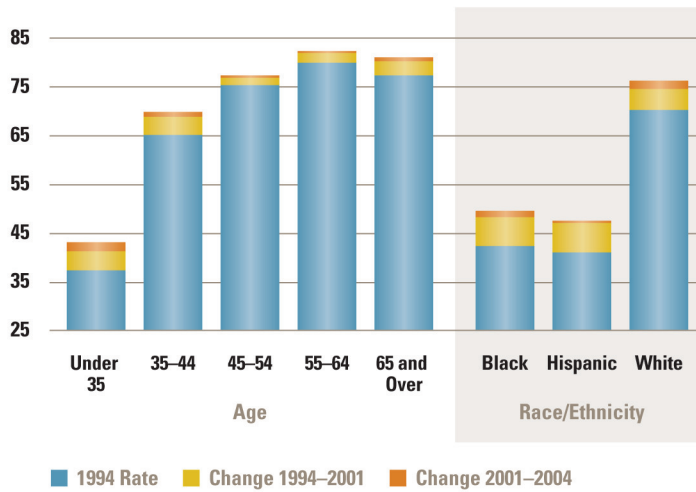
Lending Pullback

Mortgage originations plunged in 2007 as house prices fell, credit standards tightened, and mortgage interest rates stayed within a narrow range. According to Inside Mortgage Finance, total loan originations were down by 18 percent last year to \$2.43 trillion, with purchase originations alone declining by 23 percent to \$1.17

Figure 18

Younger and Minority Households Saw the Largest Increases in Homeownership Rates

Homeownership Rate (Percent)



Notes: White and black householders are non-Hispanic. Hispanic householders can be of any race.
Source: US Census Bureau, Housing Vacancy Survey.

trillion. The largest reductions were in loans designed to lower initial payments. By the end of 2007, the shares of loan originations with adjustable rates or with interest-only (deferring principal payments) or payment-option (requiring minimum payments even lower than accrued interest) features had all declined (Figure 19).

While poor loan performance and tighter underwriting standards were likely responsible for the drop in the shares of interest-only and payment-option originations, it was the narrower difference between discounted adjustable and fixed interest rates that brought down adjustable-rate loan originations starting in 2004. With the performance of subprime adjustable loans eroding in 2006-2007, total ARM originations declined even further as lenders reduced initial discounts on one-year adjustables from a peak of 2.3 percentage points early in the year to just 0.5 percentage point at the end.

The pullback in subprime adjustable lending has made it more difficult for distressed owners to avoid foreclosure by refinancing. This is particularly true in low-income and minority neighborhoods as well as in some Southern states where subprime lending was concentrated. Most subprime loans are considered high cost, with interest rates at least three percentage points above those on Treasuries of comparable maturities. In 2006, more than 40 percent of loans on one- to four-unit properties originated in low-income census tracts were high cost, as were 45 percent of such loans originated in low-income minority communities. By comparison, high-cost loans accounted for only 23 percent of originations in middle-income white areas and 15 percent in high-income white areas.

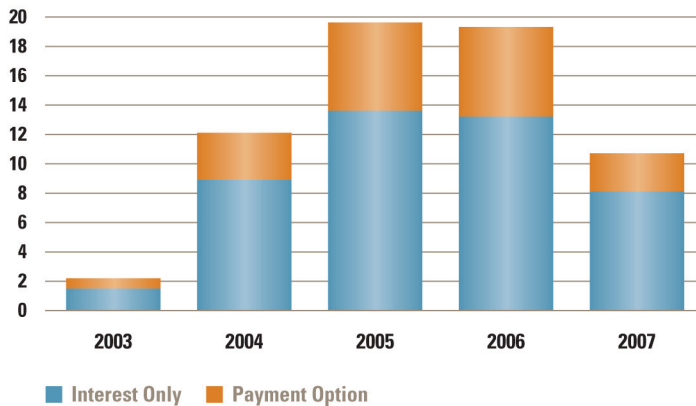
This does not mean, however, that the fallout from subprime loans is confined largely to low-income and minority neighborhoods. Fully

Figure 19

Loans with Affordability Features and Adjustable Rates Have Lost Significant Market Share

Share of Loan Originations (Percent)

Affordability Products



Notes: Loans with affordability features are interest-only or payment-option products. Shares are based on the number of originations of prime and subprime loans.
Sources: First American CoreLogic, LoanPerformance data; Federal Housing Finance Board, Monthly Interest Rate Survey.

Adjustable-Rate Loans

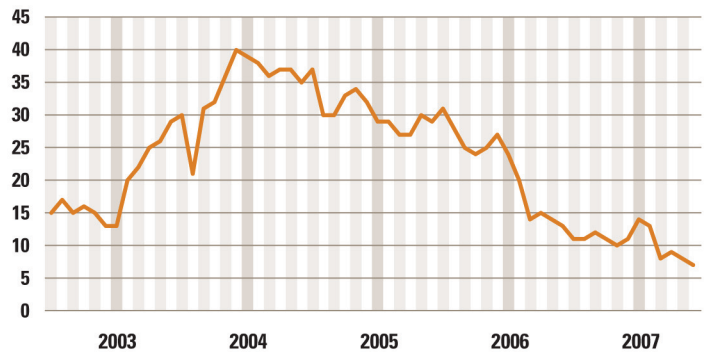
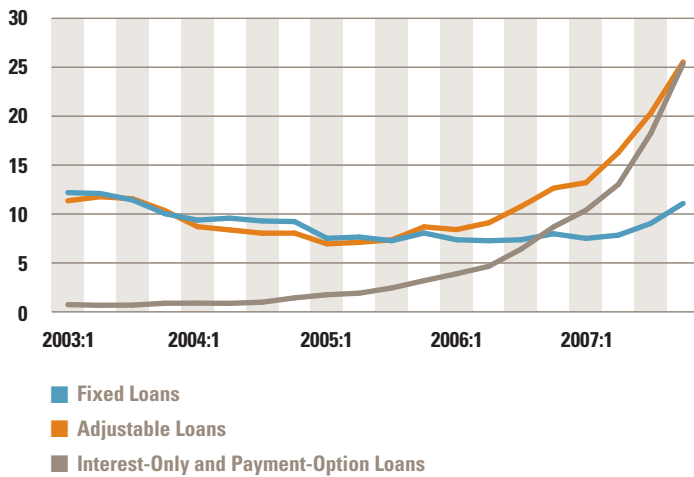


Figure 20

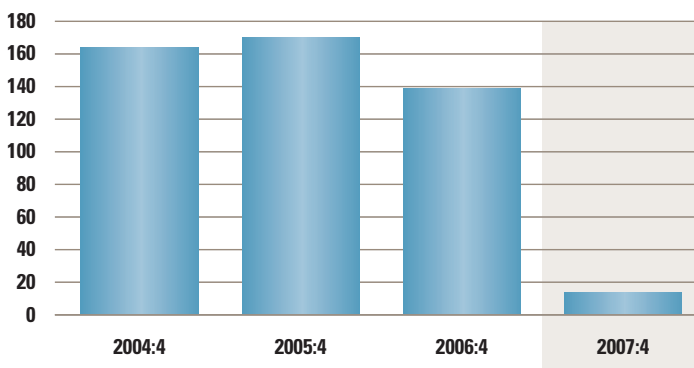
Skyrocketing Subprime Delinquencies ...

60+ Day Delinquency Rates (Percent)



... Caused the Collapse of Subprime Credit Originations

Subprime Mortgage Originations (Billions of 2007 dollars)



Notes: Subprime loans are defined by lenders and are primarily 2/28 ARMs. Interest-only and payment-option delinquency rates are averages of monthly data. Delinquency rates are the share of loans serviced that are at least 60 days past due or in foreclosure.

Sources: First American CoreLogic, LoanPerformance data; Mortgage Bankers Association, National Delinquency Survey; Inside Mortgage Finance, *2008 Mortgage Market Statistical Annual* adjusted for inflation by the CPI-U for All Items.

57 percent of high-cost loans in 2006 were originated outside such areas. While more diffuse, some of these markets are also seeing pockets of distressed properties.

The markets most exposed to the cutback in loans with interest-only and payment-option features are the country's most expensive. Indeed, a simple measure of affordability—the ratio of median home price to median income—alone accounts for almost 70 percent of the variation in the metro share of these products at the 2006 peak. Furthermore, the areas with the highest shares of these affordability products in 2006 saw the largest declines in 2007. For example, loans with affordability features accounted for more than

half of all loans originated in San Diego, San Jose, and Santa Cruz in 2006 but less than a third in 2007. States with high 2006 shares and large 2007 declines include Nevada (from 41 percent to 25 percent), Arizona (29 percent to 18 percent), Florida (25 percent to 13 percent), and Washington, DC (26 percent to 15 percent).

As they continued their exit from markets in 2007, housing investors also contributed to the drop in mortgage lending. First American CoreLogic's LoanPerformance data indicate that the investor share of all non-prime loan originations (including subprime, Alt-A, and non-conforming loans) peaked at 12.2 percent in the first quarter of 2006, before falling back to 8.7 percent in the third quarter of 2007 (Table W-8). The dollar volume of all non-prime investor loans plunged by two-thirds over this period, and of just subprime investor loans by a whopping seven-eighths. According to the Mortgage Bankers Association, loans to absentee owners also accounted for almost one in five loans entering foreclosure in that quarter. Shares in states with distressed economies (such as Ohio and Michigan) or with widespread speculation (such as Nevada and Colorado) were even higher.

Subprime Turmoil

While mortgage performance in general has been slipping since mid-2006, delinquencies in the subprime market are particularly high—especially among riskier adjustable-rate, interest-only, and payment-option mortgages (Figure 20). While each lender has its own rules of thumb to define subprime, these loans are made primarily to borrowers with past credit problems. Because of their abysmal performance, subprime loans fell from 20 percent of originations in 2005–2006 to just 3.1 percent in the fourth quarter of 2007 (Table A-6). The real dollar volume plummeted from \$139 billion in the fourth quarter of 2006 to \$14 billion at the end of last year. So far in 2008, the volume of subprime lending has likely dropped further.

The roots of the crisis lie in the unusually tight housing markets, historically low interest rates, and investor demand for high returns in the first half of this decade. This was also a period of unprecedented global economic growth, and capital was pouring into the United States. American homebuyers took advantage of the low interest rates these conditions produced to snap up properties. But with markets tight and multiple bidding situations common, home prices started to climb much faster than incomes. Even subprime loans, which predictably perform worse than prime loans, were seen as safe enough investments because home values were appreciating so quickly.

In their search for ever-higher returns, investors borrowed short-term money from banks to purchase securities backed by subprime mortgages. By leveraging their investments, they hoped to boost their profits but exposed themselves to refinance risk each time they had to roll over their debt. Meanwhile, the cash flows associated with mortgage payments were sliced up and in some cases pooled with nonresidential loans, obscuring how deterioration in loan performance would affect many bond issues.

At the same time, lenders enabled buyers to chase prices higher by offering products that lowered initial mortgage payments but exposed borrowers to the risk of payment shocks when their interest rates reset. Lenders also took on additional risk by requiring small downpayments, even though modest home price declines could wipe out an owner's equity. On top of this, lenders were all too willing to relax income-reporting requirements to draw self-employed and other hard-to-qualify borrowers into the market. These borrowers were willing to pay slightly higher interest rates or fees in return for not having to verify their incomes. With payment-option, low-downpayment, and no-income-verification loans readily available, housing investors had access to low-cost, highly leveraged capital as never before. Lenders layered risks on top of risks without considering the potential consequences for performance, while mortgage investors continued to buy up staggering volumes of these loans.

But by 2005, higher borrowing costs and skyrocketing home prices were slowing homebuyer demand in some markets. With the underlying indexes on adjustable-rate loans increasing by three percentage points, mortgage rates rose just as many subprime loans began to hit their reset dates. At that point, borrowers with these loans started to see their monthly mortgage costs go up.

In 2006 and 2007, the inventory of vacant homes for sale ballooned and prices fell, eliminating the protection afforded by strong appreciation and boosting the share of distressed borrowers. Making

matters worse, several metropolitan areas in the Midwest were in recession and tighter credit standards prevented borrowers from refinancing out of their troubles. Charges of unfair and deceptive practices were also leveled against many lenders. Defaults on subprime loans within six to eighteen months of origination—even before most resets hit—increased with each successive vintage from 2003 to 2007 (**Figure 21**).

The speed and severity of the erosion in subprime loan performance had disastrous impacts on credit availability and liquidity. Stung by losses and uncertain about how much worse performance would become, mortgage investors stopped buying new originations and tried to sell their positions in existing loans in a market with little demand. Once sought-after mortgage securities suddenly dropped sharply in value. Lenders lost confidence in some investment funds and mortgage companies, and demanded repayment of their short-term borrowings. With no other lenders stepping up, many investment funds collapsed and mortgage companies went under.

These troubles not only shuttered the subprime market but also badly crippled the prime and near-prime (Alt-A) markets. In particular, the interest-rate differential between prime mortgages that can and cannot be sold to Fannie Mae and Freddie Mac widened dramatically. In addition, loans requiring no documentation and very low downpayments all but disappeared by late 2007.

The Foreclosure Crisis

With borrowers defaulting in record numbers and lenders unable to restructure the loans, the number and share of homes entering foreclosure skyrocketed to their highest levels since recordkeeping began in 1974. According to Mortgage Bankers Association counts covering about 80 percent of loans, the number of loans in foreclosure more than doubled from an average of 455,000 annually in 2002–2006 to nearly 940,000 in the fourth quarter of 2007. Meanwhile, the share of loans in foreclosure jumped from less than 1.0 percent in the fourth quarter of 2005 to more than 2.0 percent by the end of last year, and the share entering foreclosure rose from 0.4 percent to 0.9 percent.

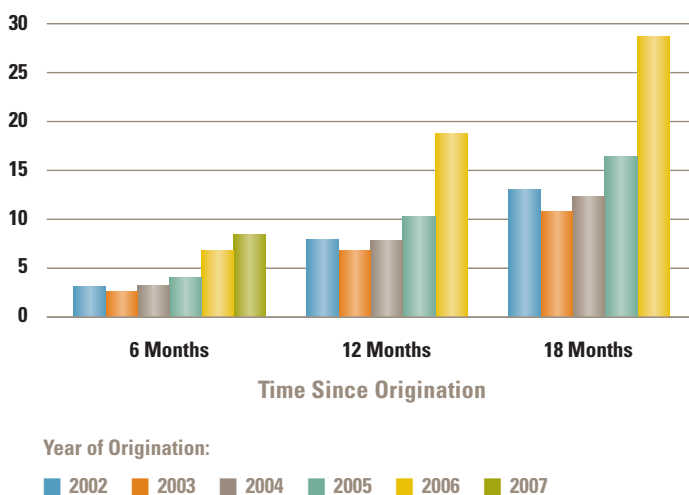
Subprime loans are largely the culprit. The foreclosure rate on subprime loans soared from 4.5 percent in the fourth quarter of 2006 to 8.7 percent a year later. Over the same period, the foreclosure rate for adjustable-rate subprime loans more than doubled from 5.6 percent to 13.4 percent, while that for fixed-rate subprime loans nudged up from 3.2 percent to 3.8 percent. Although the rate for prime loans also increased, it remained under 1.0 percent.

As troubling as the foreclosure crisis is on the national stage, conditions in the economically depressed Midwest are even worse. In the fourth quarter of 2007, Ohio had the country's highest foreclosure rate of 3.9 percent—equivalent to 1 in 25 loans—followed closely by Michigan and Indiana (**Table W-9**). In other states with high foreclosure rates, the main driver was not a faltering economy but rather high subprime loan shares or sharp price declines following heavy speculation.

Figure 21

Delinquency Rates on Recent Adjustable Subprime Loans Soared Even Before Resets

60+ Day Delinquency Rates (Percent)



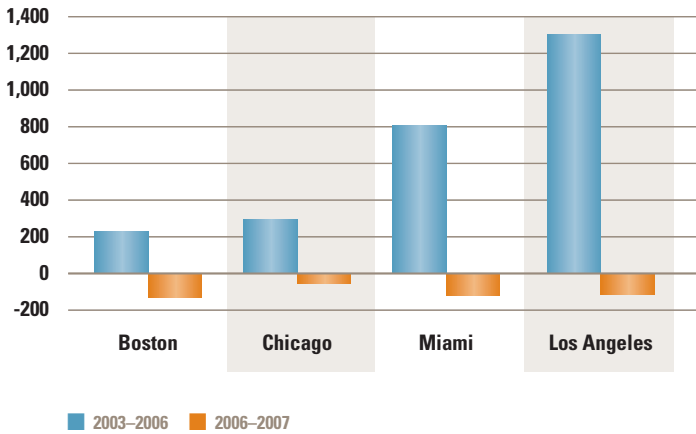
Notes: Subprime loans are defined by lenders and are primarily 2/28 ARMs. Delinquency rates are the share of loans serviced that are at least 60 days past due or in foreclosure.

Source: First American CoreLogic, LoanPerformance data.

Figure 22

Slightly Lower Mortgage Costs Did Little to Ease the Run-Up in Affordability Problems in Many Areas in 2007

Change in Monthly Mortgage Costs (2007 dollars)



Notes: Costs are based on a median-priced home purchased with a 10% downpayment and a 30-year fixed-rate mortgage. Prices are adjusted for inflation by the CPI-U for All Items.
Sources: National Association of Realtors®, Median Sales Price of Existing Single-Family Homes; Federal Housing Finance Board, Fixed Rate Contract Interest Rate for All Homes.

For households, the consequences of foreclosures go beyond wiping out equity and even losing the roof over their heads. The implications for their credit scores and long-term financial well-being can be disastrous. For lenders, foreclosures also mean significant losses. In 2002, TowerGroup estimated that the foreclosure process for a single property cost \$59,000 and took an average of 18 months. These costs are no doubt higher today in markets where lenders cannot sell the properties for enough to recoup their losses. Moreover, foreclosures impose economic and social costs on the neighborhood and larger community, depriving municipalities of tax revenue and driving down prices of nearby homes.

States were among the first to react to the mounting foreclosure crisis. Ohio introduced one of the more sweeping prevention strategies that included partnering with loan servicers to reach out to borrowers at risk, providing counseling, conducting loan workouts, and offering education on how to avoid such situations in the future. Massachusetts, Pennsylvania, and North Carolina have enacted similar programs, while other states have stepped up regulation of lenders and strengthened anti-predatory lending rules.

On the federal side, the Treasury Department and the Federal Reserve led efforts to persuade lenders to restructure loans and write down mortgage balances, to eliminate some credit market uncertainty by providing guidance on underwriting standards and enforcement of lending practices, and to recommend regulatory changes that will help prevent a recurrence of today's conditions. The Federal Housing Administration, Fannie Mae, and Freddie Mac

have also been tapped to help refinance mortgages. Congress is now looking at legislation to target predatory lending. Finally, community, lender, and government groups have created a handful of programs to help borrowers facing default and interest-rate resets.

Modest Affordability Relief

Even with widespread price declines, affordability for would-be homeowners has not improved significantly (Figure 22). Assuming a 10-percent downpayment and a 30-year fixed-rate loan, the real monthly mortgage costs for principal and interest on a median-priced single-family home bought in 2007 was only \$76 lower, and the downpayment \$1,000 lower, than on a home bought in 2006. In 45 of 138 NAR-covered metros, real mortgage costs were marginally lower for a house bought in 2007 than for one bought in 2005. In just 17 metros (primarily in the Midwest), costs were lower last year than in 2003 when interest rates were at their bottom.

At current interest rates, the national median price would have to fall another 12 percent from the end of 2007 to bring the monthly payments on a newly purchased median-priced home to 2003 levels. In 40 metros, prices would have to drop by more than 25 percent. Even if interest rates were to come down by a full percentage point, the national median home price would still have to decline by 2 percent—and by more than 25 percent in 18 metro areas—to reduce mortgage costs to 2003 levels. Of course, only first-time buyers still able to qualify for a loan can take full advantage of the improved affordability brought on by lower house prices. Most repeat buyers must sell their homes at discounts similar to those on the homes that they buy.

The Outlook

With subprime mortgage troubles hanging over the market, the near-term outlook for homeownership is grim. Late in 2007, First American CoreLogic estimated that interest rates on \$314 billion of subprime debt would reset this year. Fortunately, fully indexed rates on one-year adjustable loans have fallen by 3.0 percentage points since early 2007, which may spare some borrowers with resets from default. In addition, the federal government is working on a range of initiatives to blunt the impact of subprime interest-rate resets.

The wave of foreclosures will take months to process and the number of homes entering foreclosure could continue to rise even if the volume of loans with resets drops from last year's level. Job losses and falling home prices are now adding to foreclosure risks. Meanwhile, mortgage credit will remain tight and larger risk premiums will offset much of the decline in short-term rates.

While changes in the age and family composition of US households favor homeownership over the next five to ten years, market conditions will overwhelm any positive lift from these demographic drivers at least in the short term. How long homebuying will take to recover from the bust remains uncertain.