4 Homeownership

Entering 2009, foreclosures were at a record high, price declines were keeping many would-be buyers on the sidelines, and tighter underwriting standards were preventing many of those ready to buy from qualifying for mortgages. Ongoing job losses and sagging prices threatened to push foreclosures higher even as federal interventions began to take effect. While the long-term fallout from dramatically lower house prices remains to be seen, restoring normalcy to the for-sale housing and mortgage markets will clearly take time.

Changing Supply–Demand Balance

The national homeownership rate slid from its peak in 2004 to 67.3 percent in the first quarter of 2009, erasing all of the gains since 2000 **(Table A-4).** Although the total number of households rose by 3.2 million between 2005 and 2008, only 1.0 million homeowners were added on net. The declining ownership rate thus signifies that a smaller share of people were choosing to own homes while many others were being forced from the market, either through foreclosures or tighter lending standards.

With the number of owners leveling off and the supply of for-sale homes soaring, the homeowner vacancy rate hit a recordbreaking 2.8 percent last year. Rates in small condominium buildings were especially high. Indeed, owner vacancy rates in two- to four-unit buildings were more than three times—and in five- to nine-unit buildings more than five times—the single-family vacancy rate **(Figure 17).** Many owners of these vacant condominiums are low-income and minority households living in center cities.

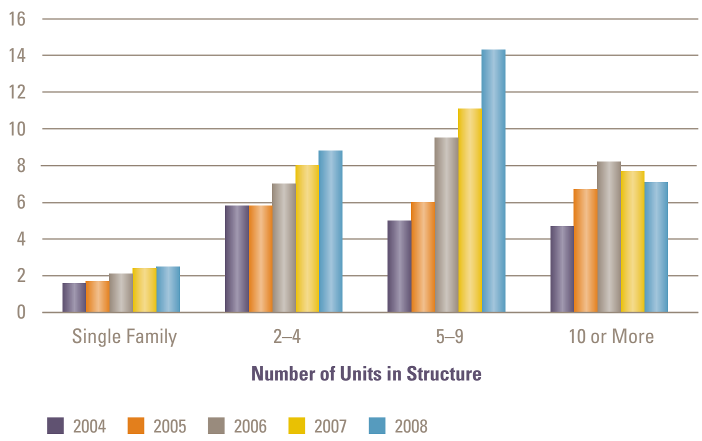
Owner vacancy rates for newer homes have also surged. Even in the best of times, newer homes tend to have higher vacancy rates than older homes because some are completed and ready for occupancy before owners move in. But it is nonetheless striking that the vacancy rate for homes built since 2000 jumped by almost four percentage points to 9.7 percent in just two years. Rates on newer homes have soared for at least two reasons. First, overbuilding occurred primarily in areas where new construction was most intense. Second, speculators likely focused on buying new homes because they could lock in low prices and wait several months before closing on the sale and then flipping the property.

Meanwhile, owner vacancy rates for older homes have remained at a lower level and have not risen nearly as much. Among units built before 1990, vacancy rates have remained in the 1.5–2.3 percent range since 2000.

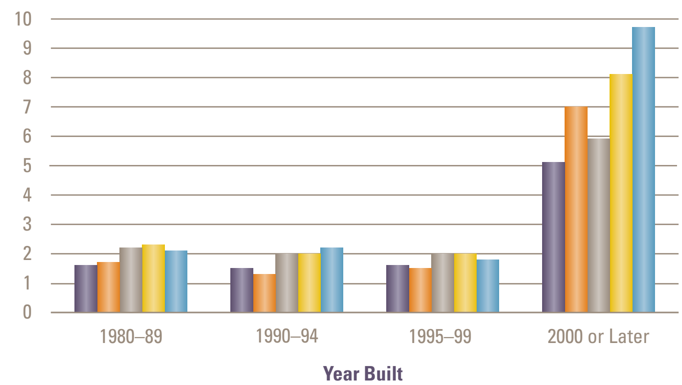
Figure 17

Owner Vacancy Rates Have Risen Dramatically In Small Multifamily Buildings …

Homeowner Vacancy Rate (Percent)



… And in Newer Units



Source: US Census Bureau, Housing Vacancy Survey.

Mortgage Market Reversals

After years of record-setting originations, proliferation of new products, and tolerance of lax underwriting, mortgage lending did an about-face in 2007 and 2008. According to Freddie Mac estimates, originations fell by 33 percent in real terms in 2008 alone and by 62 percent from the 2003 level **(Figure 18).** Non-prime lending (including subprime and near-prime loans) went from a flood to a trickle before the spigot was effectively shut off in mid-year. Originations of non-prime loans with so-called affordability features—such as interest-only or payment-option loans—also plunged, falling from almost 20 percent of originations in 2005 to less than 2 percent in 2008.

The drop-off was particularly sharp in states and metropolitan areas where these loans were especially popular. For example, the share of loans with affordability features originated in San Francisco, San Jose, and San Diego exceeded 50 percent during the peak of the housing boom but sank to less than 5 percent by mid-2008.

Similarly, "piggyback" loans went from more than a third of all home purchase loans in 2006 to just a few percent by the end of 2008. These second mortgages, taken out at the time of purchase to cover all or part of a 20 percent downpayment, allow borrowers to avoid paying mortgage insurance and to qualify for a better conforming interest rate on their first mortgages. While of potential benefit to homebuyers, these loans increase the risks to investors because the combined loan-to-value ratios are higher than the 80 percent of the first loan.

Stung by the horrible performance of subprime mortgage pools, investors have essentially stopped buying any mortgage-backed securities that are not guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae. While buyers might be willing to purchase these privately issued securities at low enough prices, most sellers have yet to offer deep discounts. Meanwhile, buyers remain concerned about the disproportionate share of seriously delinquent loans in these private label securities **(Figure 19).**

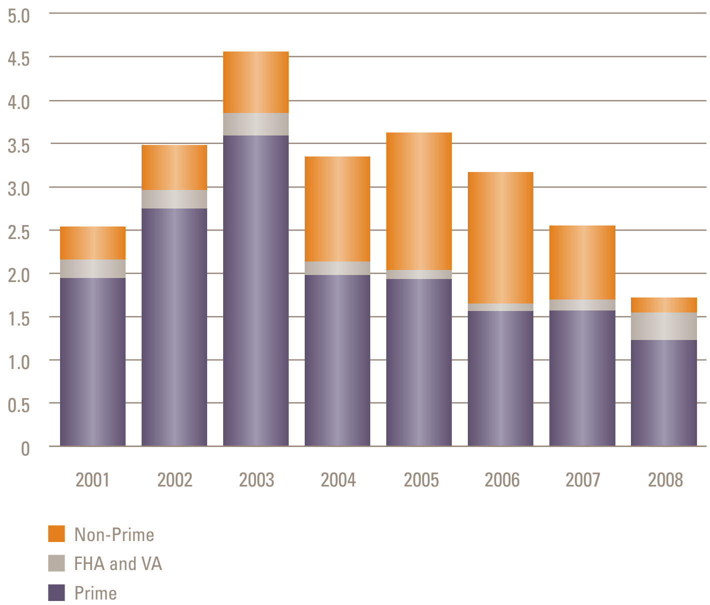
Apart from FHA-insured loans, low downpayment loans have been shelved along with loans requiring only limited income verification. First American LoanPerformance reports that the share of non-prime loans with more than 100 percent financing fell from 15 percent in 2006 to 1 percent in mid-2008, while the share requiring little or no income documentation shrank from 45 percent in 2006 to 19 percent at the end of last year.

Fannie Mae and Freddie Mac, operating under federal conservatorship, now dominate the market along with government-owned FHA and Ginnie Mae. Between 2006 and 2008, the Fannie and Freddie share of new mortgage-backed security issuances soared from 40 percent to 74 percent, while the Ginnie Mae share jumped from 4 percent to 22 percent. Meanwhile, FHA and VA

Figure 18

Non-Prime Lending Has Collapsed, Shrinking the Pool of Potential Homebuyers

Volume of Single-Family Loans Originated (Trillions of 2008 dollars)



Notes: Single-family properties may have 1–4 units. Dollar values are adjusted for inflation by the CPI-U for All Items. Non-prime loans include subprime, Alt-A, and home equity loans/lines.
Source: Freddie Mac, Office of the Chief Economist.

more than quadrupled their real volume of loan originations last year, lifting their market share from 7 percent in the fourth quarter of 2007 to 34 percent in the fourth quarter of 2008.

Lower interest rates and relaxed loan-to-value standards at Fannie Mae and Freddie Mac sparked a wave of refinancing in the first quarter of 2009, indicating that private primary market activity can ramp up quickly. But before the market for loans lacking implicit or explicit federal guarantees can revive, investors must be willing to purchase these loans—or the securities they back—without such large risk premia. By the time these private label markets do come back, it is likely that the federal government will have taken actions to prevent another collapse.

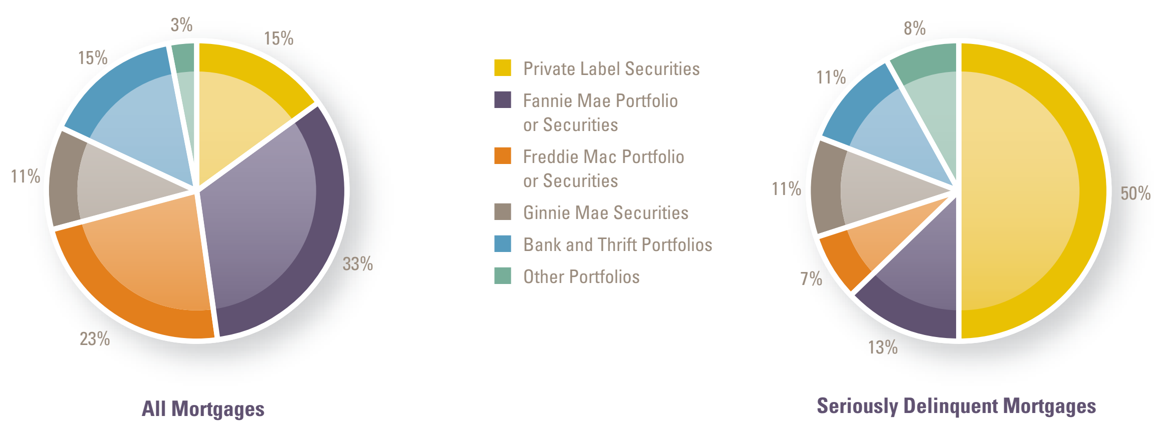
Affordability and Mortgage Underwriting

Affordability measures typically use the prevailing 30-year fixed mortgage interest rate and assume a 10 percent downpayment to translate home prices into monthly payments **(Table A-1).** Under these assumptions, real monthly payments on a median priced house in 2008 were 20 percent below the 2006 peak **(Table W-6).** As a share of median owner income, monthly payments fell five percentage points to 20.1 percent. With interest rates still sliding, affordability improved even more in the first quarter of 2009.

But these standard measures exaggerate the change in affordability. From 2004 through 2007, homebuyers were able to chase

Figure 19

Seriously Delinquent Mortgages Are So Far Concentrated Among Private Label Securities

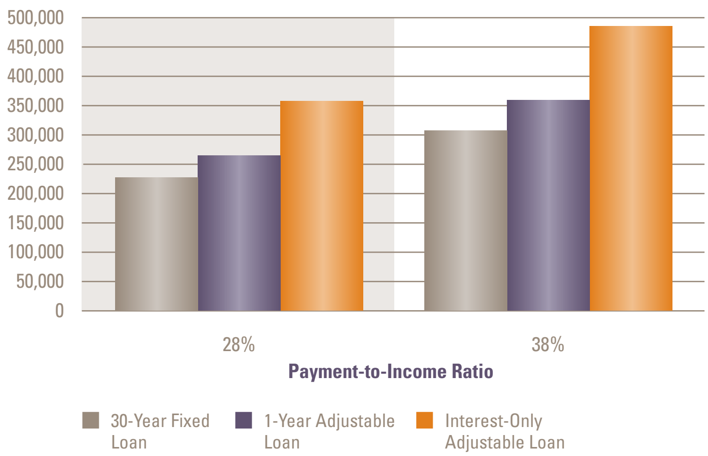


Notes: Data are as of December 2008. Seriously delinquent loans are at least 90 days delinquent or in foreclosure. Private label securities are mortgage securities not securitized by Freddie Mac, Fannie Mae, or Ginnie Mae.
Source: Freddie Mac, Office of the Chief Economist.

Figure 20

Innovative Mortgage Products and Relaxed Underwriting Vastly Increased Purchasing Power During the Boom

Maximum Qualifying Mortgage in 2005 (Current dollars)



Note: Maximum qualifying mortgage is the amount of financing available to a hypothetical homebuyer with the median 2005 homeowner income of $57,000.
Source: JCHS calculations based on 2005 Freddie Mac Primary Mortgage Market Survey and US Census Bureau, Current Population Survey.

prices higher without adding to their initial monthly payments by taking advantage of various affordability products. In fact, more than one-third of borrowers took out adjustable-rate (ARM) loans in 2004 **(Table A-3),** while nearly one-fifth took out interest-only or payment-option loans in 2005. Instead of reducing their payments as a share of income, though, most borrowers used the loans to keep up with rising prices—especially in markets with rapid appreciation and heavy speculation. In California and Nevada, for example, more than 40 percent of loans originated in 2005–6 had payment-option or interest-only features.

The impact on purchasing power was profound. In 2005, a household with the median owner income of about $57,000 and spending 28 percent of income on mortgage principal and interest could qualify for a 30-year, fixed-rate loan of $225,000. But if the same household took out an adjustable-rate loan with a discounted interest rate, the maximum loan amount increased to $263,000 **(Figure 20).** Adding an interest-only feature to that ARM and qualifying the household based on the initial interest-only payments raised the potential loan to $356,000. And under the common practice at the time of allowing the borrower to spend 38 percent of income on mortgage costs, the amount the household could borrow with an interest-only ARM jumped to some $482,000.

After regulatory guidance issued in 2006 pushed the industry back towards tighter, more uniform standards, interest-only and even some adjustable-rate loans became hard to get. By mid-2007, teaser discounts on adjustable-rate mortgages began to shrink and the spread between fully indexed fixed- and adjustable-rate loans hit zero and then turned negative. As a result, households can no longer use these loan features to leverage their incomes to buy ever more expensive homes. With a 2008 median owner income of about $64,000 and prevailing interest rates through April 2009, a household spending 28 percent of income could qualify for a 30-year, fixed rate loan of just $277,000.

This means that only a limited pool of households can take advantage of today's soft home prices. Current homeowners do not benefit from lower prices if their own homes are also worth less, and first-time buyers must overcome higher hurdles to qualify for mortgages. Indeed, the renewal of strict underwriting standards has turned back the clock on credit access for first-time homebuyers by about 15 years, restoring the income and wealth constraints that were so much a focus of national housing policy in the 1990s.

For many potential buyers, amassing the downpayment is the main obstacle. In 2004, the Census Bureau estimated that of all renters who could not afford to buy a modestly priced home, 97 percent reported a cash problem such as excessive debt or insufficient funds for a downpayment, while 78 percent reported insufficient income to qualify for a mortgage. Some 75 percent had both cash and income-related constraints. And with the drastic erosion of household wealth, fewer first-time buyers will be able to turn to family members for assistance. Creating incentives to save for the downpayment will therefore be critical to enable first-time buyers to purchase homes even at today's lower prices.

Soaring Foreclosures

At the end of 2008, first-lien loans in foreclosure stood at 3.3 percent of all loans—an increase of 62 percent in one year. The share of loans at least 60 days past due rose by almost two percentage points, to 4.8 percent, in just the last half of 2008. Unless new federal initiatives result in many more loan workouts, foreclosure filings will likely continue to rise through the first half of 2009.

With foreclosure filings up and home sales down, more and more homes are being sold for less than the purchase price or for less than the outstanding mortgage balance. Zillow.com estimates that the share of homes sold for a loss—many of which were foreclosed properties—climbed from 10 percent of existing home sales at the end of 2006 to 22 percent at the end of 2007, and to 42 percent at the end of 2008.

For much of this decade, the highest foreclosure rates were concentrated in the economically distressed states of Ohio, Michigan, Indiana, and Illinois. But last year, that distinction passed to four other states that had seen severe overbuilding, intense housing speculation, and heavy reliance on risky loan products. Indeed, foreclosure rates in California, Arizona, Nevada, and Florida surged from less than 0.9 percent at the start of 2007 to 5.9 percent by the end of 2008 **(Figure 21).** During that quarter, the number of foreclosed loans topped 660,000 in these four states alone, accounting for a stunning 61 percent of the growth in foreclosures nationwide.

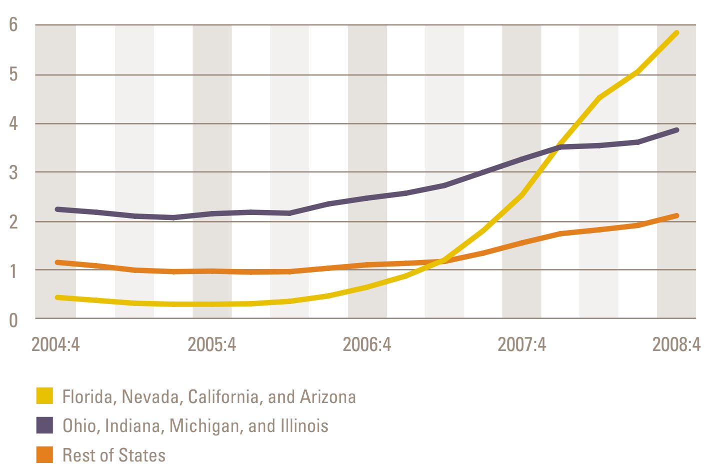
Managing the Crisis

With the notable exception of the first-time homebuyer tax credit and efforts to keep low-cost credit flowing, federal attempts to stabilize housing markets have focused on preventing foreclosures. Early programs hinging on voluntary efforts, however, failed to stem the surge in foreclosed properties. In early 2009, the new administration introduced a new program requiring that all lenders receiving federal Financial Stability Plan assistance write down the mortgage payments of borrowers to 31 percent of their incomes, with the federal government picking up part of the cost. To encourage support, the plan provides such generous incentives as $1,000 per year to servicers on still-performing loans and up to $1,000 per year to homeowners who make their payments on time. The program hopes to reach 3–4 million distressed homeowners.

Figure 21

Foreclosures Are Highest in States with Once-Booming Housing Markets

Foreclosure Rates (Percent)



Note: Foreclosure rates are calculated as the sum of loans in foreclosure by state groups divided by total loans serviced in those groups.
Source: Mortgage Bankers Association, National Delinquency Survey.

Unfortunately, borrowers that benefit from meaningful loan modifications may well default again. The Office of Thrift Supervision's fourth-quarter 2008 report indicates that, of the loan modifications made by national banks and federal thrifts that lowered payments by 10 percent or more, one-fifth were at least 60 days delinquent within six months of modification.

Meanwhile, several states and municipalities have come up with their own programs. According to the Pew Center on the States, 34 states had adopted foreclosure prevention laws by the end of 2008. Nine had either instituted a moratorium or increased the number of days before a notice of default must be issued, allowing borrowers and lenders more time to find alternatives. Although the moratoria were intended to forestall the problem in anticipation of federal initiatives, evidence suggests that they may have also driven up mortgage costs and driven down credit availability.

The Outlook

The homebuying market will continue to struggle until the foreclosure crisis comes to an end. Although new federal efforts may prevent millions of families from losing their homes, mounting job losses will likely keep foreclosures at elevated levels. At the same time, falling prices are keeping potential buyers on hold while locking millions of potential sellers in their current homes.

Tighter underwriting standards also present higher credit, income, and wealth hurdles to homeownership. While downpayment requirements may ease when lenders sense that home prices have reached bottom, stricter caps on mortgage payment-to-income ratios and thorough verification of income will likely remain in place for some time. Credit standards will probably be the last to loosen, given the abysmal performance of subprime loans. When borrowers with tarnished credit histories are able to get loans again, they will likely face careful underwriting and only be offered standard products.

How households respond when home prices stop falling and the economy improves will determine whether and when the home-ownership rate turns up again. In the near term, demographic forces favor the rental over the for-sale market. Bargain pricing could, however, lure many to buy homes even if credit remains relatively tight. Among the other difficult challenges that lie ahead are jumpstarting mortgage lending that lacks federal guarantees, moving Fannie Mae and Freddie Mac out of conservatorship, and modifying regulations to avoid a repeat of the market meltdown.