4 HOMEOWNERSHIP

The national homeownership rate slipped again in 2009 as foreclosures set new records and tighter underwriting standards restricted the pool of potential buyers able to qualify for loans. While house price declines and a federal tax credit drew first-time homebuyers into the market, those same price declines also left millions of current owners unable to sell their homes without incurring losses. Meanwhile, loan performance continued to erode and foreclosures mounted as unemployment soared.

FALLING HOMEOWNERSHIP RATES

After sliding in 2007 and 2008, the number of homeowners held about steady in 2009 as gains in first-time buyers offset losses caused by foreclosures. But more rapid growth in the number of renters than owners drove the national homeownership rate down to 67.4 percent last year—fully 1.6 percentage points below the 2004 peak **(Figure 18).**

Homeownership rates slipped in all four regions of the country and in more than three-fifths of the states. The largest drop occurred in the Midwest, where the homeownership rate stood 2.8 percentage points below its 2004 peak, at 71.0 percent. The Northeast posted the smallest decline—1.2 percentage points—from its high, holding at 64.0 percent **(Table A-4).** Homeownership rates in three-quarters of the states are below 2004 levels, and rates in nearly half of the states are below 1999 levels.

The dip in homeownership has affected households of all incomes, although low-income families were hit particularly hard. This group had previously achieved gains that far exceeded what demographic trends alone might have produced. From 1995 to 2005, homeownership rates among households in the bottom income quartile rose 6 percentage points (albeit from a low base), while rates for higher-income households were up only 4 percentage points. From 2005 to 2009, however, homeownership rates for low-income households fell almost twice as much as those for higher-income households on a percentage-point basis. As a result, the overall gain in homeownership for low-income households over the full 14-year period barely exceeded that for higher-income households.

AFFORDABILITY GAINS

The bright spots on the homeownership front last year were the dramatic increase in affordability and the growth in first-time buyers it produced. For households able to avoid unemployment, meet tighter underwriting standards, and put more money down, payments for a newly purchased median-priced home were more affordable in 2009 than they had been in years.

Near the height of the housing boom, mortgage payments on a median-priced home peaked at 32.7 percent of median household income. By the first quarter of 2009, the share had retreated to just 19.6 percent of median income. After edging higher in mid-2009, payment-to-income ratios hit a new low of 18.9 percent in the first quarter of 2010 as interest rates eased and the median home price fell back from modest summertime gains.

The median home price dropped from $227,100 in the second quarter of 2006 to $166,100 in the first quarter of 2009, while rates on 30-year fixed-rate mortgages slipped from 6.6 percent to 5.0 percent. As a result, monthly payments for a median-priced home with a 90-percent mortgage fell by more than a third, from $1,300 to $800. The improvement in affordability was widespread. By 2010, more than 80 percent of metropolitan areas reported payment-to-income ratios below 1990s levels **(Table W-2).** If mortgage interest rates were to increase 100 basis points, however, the share of metros that would still be more affordable would fall to 70 percent **(Figure 19).** Home prices in more than 85 percent of metro areas were also down last year, with more than one-quarter posting new lows in the first quarter of 2010.

FIRST-TIME HOMEBUYER SURGE

The first-time buyer share of home sales typically decreases during expansions and increases during recessions. In hot housing markets, the share declines as first-time buyers are priced out and current homeowners take advantage of rising prices to trade up. When markets are weak, overall sales activity is depressed and current owners tend to stay in place.

According to the National Association of Realtors®, the first-time homebuyer share climbed in both 2007 and 2008, and then surged in 2009. First-time purchasers rose from 36 percent of all homebuyers in 2006 to about 45 percent in 2009. The increase in share added roughly 306,000 sales in 2008–9. Without this gain, existing home sales for the year would have fallen by 63,000.

An important catalyst for the jump in first-time homebuyers in 2009, however, was the first-time homebuyer tax credit program. Various estimates place the impact of the tax credit on either pulling demand forward or releasing pent-up demand at 200,000–400,000 additional buyers—similar to last year's increase in first-time sales.

DISMAL LOAN PERFORMANCE

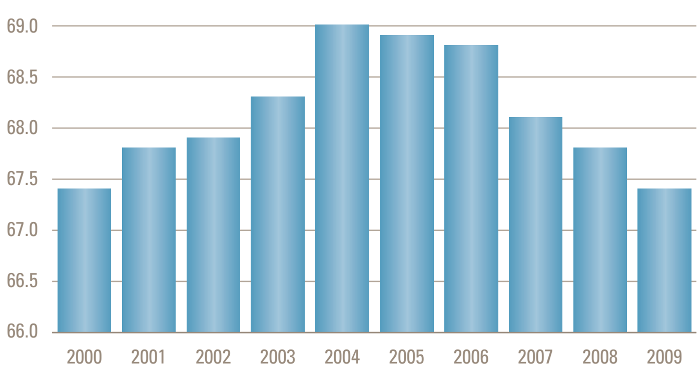
When combined with heavy job losses, the same lower home prices that drew first-time homebuyers into the market contributed to stunningly poor mortgage loan performance. The number of loans more than 90 days delinquent or in foreclosure was high and climbing in early 2010. According to the Mortgage Bankers Association, the shares of severely delinquent loans in the first quarter of 2010 ranged from 5.1 percent of prime fixed-rate mortgages to a whopping 42.5 percent of subprime adjustable-rate mortgages **(Figure 20).**

With such high delinquency rates, foreclosures have continued to rise. Rates for subprime mortgages remain especially high not only because of a 370,000 increase in the current inventory of loans in foreclosure, but also because of the 1.5

FIGURE 18

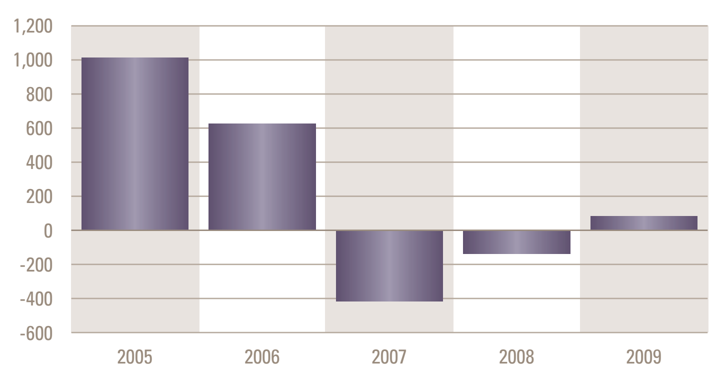
Although Homeownership Rates Peaked in 2004 …

Homeownership Rate (Percent)



… The Number of Homeowners Continued to Rise through 2006

Annual Change in Homeowner Households (Thousands)

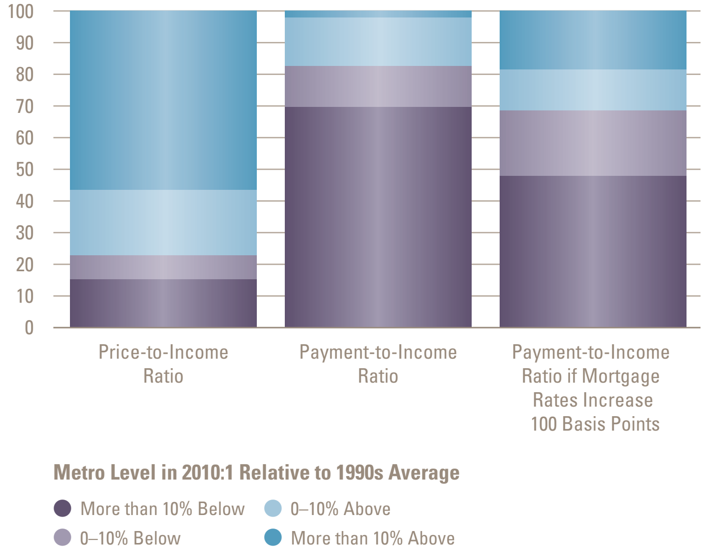


Source: US Census Bureau, Housing Vacancy Survey.

FIGURE 19

While Many Areas Have Become More Affordable for First-Time Homebuyers, Higher Interest Rates Could Cut into Gains

Share of Metropolitan Areas (Percent)



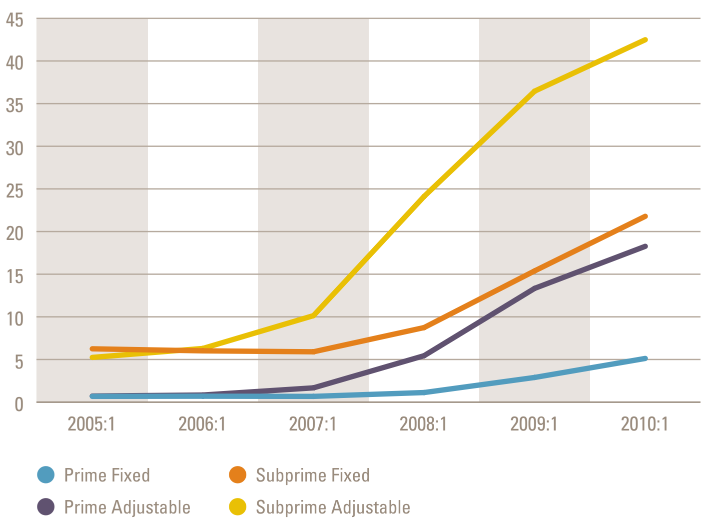
Notes: Areas are the 87 metros with quarterly data available for 1989–99 and 2009. Payments are based on a 10% downpayment and a 30-year fixed-rate mortgage (5.0% in 2010:1). Ratios use median household income.

Source: JCHS calculations based on data from Freddie Mac, the National Association of Realtors®, and Moody's Economy.com.

FIGURE 20

Serious Delinquencies Have Climbed to New Heights

Share of Loans at Least 90 Days Past Due or in Foreclosure (Percent)



Source: Mortgage Bankers Association, National Delinquency Survey.

million drop in the number of subprime loans being serviced between the first quarter of 2007 and the first quarter of 2010. This huge decline reflects the fact that so many subprime loans have already been extinguished through foreclosures and short sales (sold for less than the amount owed on the mortgage), and that no new loans are being originated.

Despite a much higher incidence of serious delinquencies and foreclosures among subprime loans, most problem mortgages are now prime loans. During this cycle, record home price declines and heavy job losses have left prime loan performance orders of magnitude worse than in previous cycles. Indeed, serious delinquency rates for prime conventional loans typically remain well below 2 percent even during downturns, but were 7.1 percent in the first quarter of 2010. Among prime loans that Freddie Mac owns, a recent survey found that 58 percent of delinquent borrowers cited unemployment or curtailment of income as the reason for their payment problems. Running a distant second is excessive financial obligations (16 percent), and third is illness or death (11 percent).

Delinquencies and foreclosures have been highly concentrated by state. California and Florida alone account for more than a quarter of loans at least 90 days delinquent, plus more than a third of loans in foreclosure **(Table A-6).** Serious delinquency rates are highest in Florida (20.6 percent), Nevada (19.6 percent), Arizona (12.8 percent), and California (12.1 percent), and lowest in North Dakota (2.3 percent), Alaska (3.0 percent), and South Dakota (3.5 percent). In the states with the highest incidence of delinquencies, foreclosures will likely weigh on home price gains.

Delinquencies are also highly concentrated in pockets within metros. Among loans originated to homeowners in 2006 and more than 90 days delinquent, some 10 percent are located within just 1 percent of zip codes. Fully two-thirds of seriously delinquent loans are found in only 25 percent of zip codes. Delinquencies have been especially high in low-income minority neighborhoods, where high-cost lending was concentrated during the housing boom **(Figure 21).** While many distressed areas are in inner cities, some of the hardest-hit communities are found in the rural areas and outlying suburbs of California and Florida.

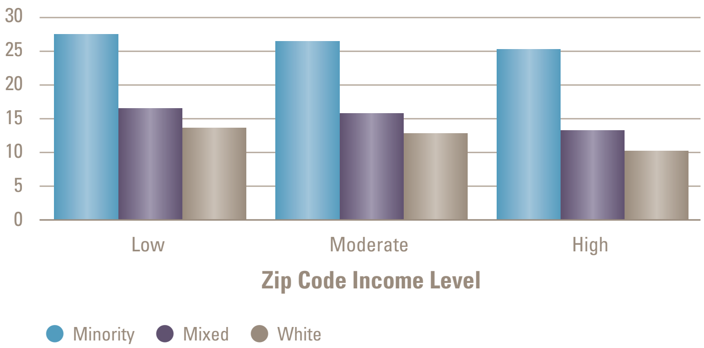
THE FORECLOSURE CRISIS

Since the first signs of a spike in defaults in early 2007 through the first quarter of 2010, servicers covering 85 percent of mortgage loans report that 6.1 million foreclosure notices have been issued on first-lien loans. Furthermore, the number of loans in the foreclosure process stood at 2.1 million in the first quarter—nearly quadruple the number just three years earlier.

FIGURE 21

Even Controlling for Income, Minority Neighborhoods Have Been Especially Hard Hit by Troubled Loans

Average Share of 2006 Loan Originations Ever More than 90 Days Delinquent through 2009 (Percent)



Notes: Data include all zip codes with at least 100 mortgage originations for owner occupants in 2006. Incomes in low/moderate/high zip codes are less than 80%/80–120%/more than 120% of the median household income for each state. Minority/mixed/white zip codes were more than 50%/10–50%/less than 10% minority in 2000.

Sources: First American CoreLogic; US Census Bureau, 2000 Decennial Census.

Once a loan enters foreclosure, it is rarely cured. While some homes are sold short, the vast majority is auctioned off. In the two states where auction sales are not required, title is conveyed to the lender. Either way, a flood of homes is coming on to the market at depressed prices as lenders try to shed properties they have had to take back.

With so many millions of families facing the loss of their homes, the federal government has stepped in with two major foreclosure prevention programs: the Home Affordable Refinancing Program (HARP) and the Home Affordable Modification Program (HAMP). Both initiatives provide significant mortgage payment relief. HARP allows qualified borrowers (loans purchased or guaranteed by Fannie Mae or Freddie Mac) to refinance into lower interest-rate or fixed-rate loans for up to 125 percent of the home value. The average reduction in borrowers' monthly payments is $150. Through March 2010, however, HARP had completed only 291,600 refinancings.

Under HAMP, in contrast, loan modifications can push interest rates as low as 2 percent—or more recently, reduce the total amount owed—to reduce the borrower's mortgage payments to 31 percent of monthly income for five years. HAMP modifications have cut participants' monthly mortgage payments by $500 on average, lowering median payments for participants from $1,419 to $849. Through April 2010, HAMP has made 1.2 million trial modifications that typically last 90 days. Of these, 299,092 have been successfully converted to "permanent" modifications, which after five years gradually convert to fixed payments at a capped interest rate for the remaining term of the loan. With a 2012 goal of 3–4 million modifications, the program has so far provided relief to more than 1 million homeowners and helped to slow the pace of loans entering foreclosure.

While the jury is still out on how many foreclosures HAMP will permanently avert, there is reason to believe that many loan modifications will fail. Indeed, government data on mortgages modified by banks and thrifts since January 1, 2008 indicate that even borrowers with substantially lower payments re-default at high rates. After just six months, fully one-quarter of those with payment reductions of at least 20 percent were again 60 or more days delinquent. The re-default rate for HAMP-modified loans is likely to be high as well.

OPPOSING MARKET FORCES

Homeownership markets are being tugged in different directions. On the one hand, lower prices have made homes more affordable. On the other, tighter underwriting standards have made qualifying for a mortgage much more difficult. Lenders have reduced maximum debt-payment-to-income ratios and are now demanding larger downpayments and higher credit scores.

Stricter underwriting can limit the pool of potential homebuyers. For example, using the 38-percent-of-income standard commonly allowed during the housing boom, about 17.8 million renters had incomes in 2008 that would have qualified them for a 30-year fixed-rate mortgage on the median-priced home. At a more stringent 28-percent standard, however, only 12.5 million renters would have qualified. Such a large swing in the payment-to-income requirement for loans means that home prices would have to drop more than 26 percent for households qualifying at 38 percent to still be able to purchase homes at the 28-percent-of-income standard.

While lower prices imply smaller downpayments, lenders now require a higher fixed percentage of the purchase price **(Table A-3).** This has brought back the wealth constraints that were largely eliminated in the early half of the 2000s when very low- and no-downpayment loans were widely available for the first time. From 2003 to 2007, the share of recent homebuyers making no downpayments rose from 9 percent to 15 percent, with the first-time buyer share putting no money down nearly doubling from 13.5 percent to 26.0 percent.

Higher credit score cutoffs shrink the pool of eligible buyers regardless of how affordable housing becomes. According to a recent study by Barclays Capital, 87 percent of the home purchase loans owned or guaranteed by Fannie Mae and Freddie Mac were made to borrowers with FICO scores above 750 and original loan-to-value ratios below 75 percent **(Figure 22).** Only 2 percent of their mortgages that were originated in 2006 met such standards.

With Fannie and Freddie looking for higher-quality loans and subprime lending virtually eliminated in 2008–9, borrowers with lower credit scores flocked to alternative nonprime products such as USDA-guaranteed rural loans and FHA-insured loans. Indeed, according to First American CoreLogic, the FHA share of the home purchase market ballooned from just 6.6 percent in 2007 to 30.1 percent in 2008 and then climbed to 56.4 percent in 2009. But as loan losses mounted, FHA also reduced the flow of credit to lower-scoring borrowers, doubling the share of originations to applicants with scores above 680 between 2007 and 2009.

Meanwhile, the federal stimulus package increased funds for a USDA-guaranteed mortgage program from $6 billion to $12 billion, but the strength of demand is likely to exhaust these resources well before the end of the fiscal year. Until damaged credit histories have time to heal or businesses find more sustainable ways to lend to people with lower credit scores, the shortage of loans available to these buyers will hinder the housing market recovery.

THE OUTLOOK

Plunging home prices have left millions of owners underwater on their mortgages. For about 4.9 million of these households, home prices would have to rebound by more than 25 percent before their homes are worth as much as the amount they owe. Many owners will therefore be unable to change residences without facing losses. This is likely to be a drag on the repeat sales market in 2010 and perhaps beyond.

For the millions of owners who have already lost their homes to foreclosure, their lives have been uprooted and their credit scores will take years to fully recover. Even if they want to get back into the ownership market, they will have a difficult time doing so because credit for subprime borrowers is currently unavailable. When subprime credit markets unfreeze, these individuals will have to pay a premium on their mortgage interest rates to be able to buy other homes.

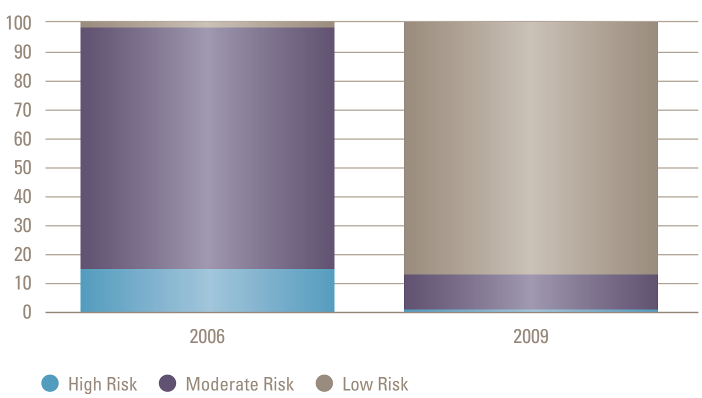
At the same time, falling home prices and low interest rates have been an unambiguous boon for first-time homebuyers. After the surge in home prices in 2004–6, followed by the severe recession and credit crisis in 2007–9, there is pent-up demand in the market. The return of meaningful income, wealth, and credit constraints may, however, limit the ability of some potential first-time buyers to qualify for loans.

In the longer term, it is unclear how much the sharp house price cycle will influence household decisions to own or rent. Yet it remains true that buyers who purchase homes at or near price bottoms with leverage stand to gain if real house price appreciation returns to its long-term pace slightly above real income growth.

FIGURE 22

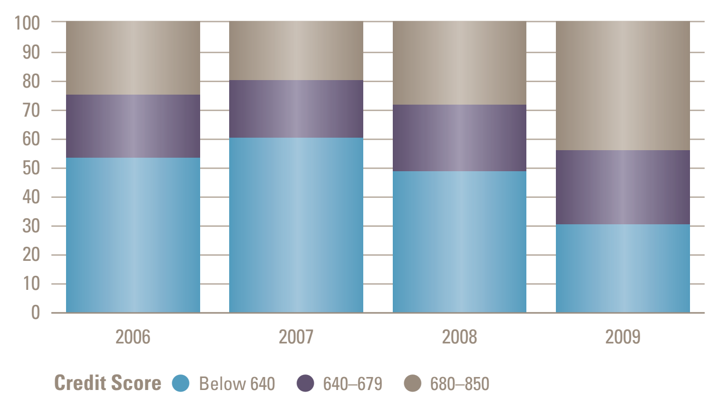
Fannie Mae and Freddie Mac Have Tightened Their Underwriting Standards ...

Share of Originations Guaranteed by Freddie and Fannie (Percent)



... And FHA Has Restricted Access to Borrowers with Poor Credit Scores

Share of FHA-Insured Mortgages by Dollar Volume (Percent)



Notes: High (low) risk loans are to borrowers with credit scores under 690 (above 750) and have loan-to-value ratios above 85% (below 75%). FHA data exclude records with no credit score information.

Sources: Barclays Capital, *GSEs: Back to the Future, US Interest Rates Strategy, 2009*; US Department of Housing and Urban Development.