The Hard Road Ahead for Housing

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Highlights:

• The housing sector has come a long way, but has a long way to go.
• Mortgage underwriting standards have reverted to much more conservative norms, and housing policy is very much in a state of flux.
• The result: renting is on the increase, and may enjoy renewed popularity for some time.

Over time, I’ve discovered that just about everyone thinks they know what’s going on in the real estate market. Impressions can be formed from a variety of observations: fourteen “for sale” signs in four blocks, ground being broken for a new subdivision, or the latest Zillow reading on what houses in the neighborhood are worth. It’s almost impossible to fight accumulated anecdotes like these with hard facts.

It’s also sometimes hard to fight hard facts with harder facts, but that is what I’ll endeavor to do in the coming paragraphs. There are certainly many signs that residential real estate conditions are improving, but I just cannot get that optimistic about the US housing market.

Asha did a nice job of covering the most recent housing numbers in one of her daily reports. To be sure, sales and construction have come a long way since bottoming in 2009. Affordability (which combines mortgage rate and pricing conditions) is near all-time highs, and prospective buyers are taking notice.
The growing body of positive readings has led some forecasters to estimate housing starts of over 1 million units next year, which would represent another 30% increase from the current pace.

When viewed from the demand side, though, this seems like a very optimistic projection. There may well be a number of buyers who would like to own a home, but affording it and financing it are another question.

Mortgage credit conditions remain much more restrictive than they were six years ago. While terms for commercial and credit card loans have eased in the past year, home lending standards remain very tight.

Reflecting this, the average credit score associated with new home loans sold to the Federal Agencies (Freddie Mac and Fannie Mae) has risen to around 760, from around 720 in 2006. Further, the average down payment on homes, which stood at less than 5% six years ago, is moving back to the 10% or 20% standard which was once typical.

It’s very challenging for many borrowers to meet these standards. Certainly those who are un- or underemployed will struggle to gain access to credit, and other families working to deleverage may choose to defer a home purchase.

Getting a down payment together is much harder than it used to be. Equity in an existing home had been a leading source of down payment on a new one, but the correction in house prices has drained this reservoir for many families. With nearly one in four homes “underwater” relative to the mortgage on the property, sellers are much less likely to turn around and become purchasers. Saving from scratch takes a long time, given low saving rates and low rates of return on some asset classes. There is broad community of prospective home buyers who could get a mortgage in 2006, but cannot today.
In the past, lenders might have been tempted to get just a little more aggressive in the hope of generating additional volume. But major mortgage underwriters are still spending considerable time and expense working through the backlog of foreclosures and lawsuits stemming from loans made during the boom.

As well, regulation surrounding mortgage lending is very much in a state of flux. The newly-formed Consumer Financial Protection Bureau (CFPB) is updating the types of disclosures borrowers must be provided, and is outlining the terms under which a borrower might claim damages from a lender for being misled. Firms that securitize their new mortgages for sale to investors will eventually have to retain a residual interest; this “skin in the game” requirement has yet to be finalized. Given the uncertainties in rulemaking, lenders are understandably cautious about underwriting.

Housing optimists have pointed to the pent up demand created by family formations since the financial crisis. (In this context, family formation refers to newly independent adults, not the arrival of children.) Unfortunately, the cohort which has emerged from college in the past five years is facing a weak job market and very high levels of student debt.

Congress attempted to ameliorate these challenges with a first-time homebuyer credit in 2009, and the Federal Housing Authority (FHA) continues programs which require smaller down payments. But these efforts are limited in scale and/or time.

More broadly, our country is overdue for a renewed conversation around housing policy. For decades, Government Sponsored Enterprises (GSEs) like Freddie Mac and Fannie Mae had the dual mandate of promoting home ownership and promoting healthy secondary markets for home loans. Being quasi-private companies, they were also expected to provide attractive returns to shareholders.
Elements of this mission ultimately proved irreconcilable, and the stress endured by the GSEs will be very costly to American taxpayers. Very little has been done to help define the future for Freddie and Fannie, which creates another layer of uncertainty around the housing sector. The secondary market for “jumbo” loans, needed to finance homes whose prices exceed GSE limits, has been closed for four years.

And so, absent a major policy intervention, renting will be an increasingly popular strategy. An important fraction of recent home sales find investors as the buyers; many of them plan to turn around and rent the properties.

The accepted wisdom for much of the past twenty years was that neighborhoods of home owners had lower crime rates, higher achievement rates, and stronger commitments to community. But if the owners cannot afford their homes, the potential for default and transiency threaten the realization of those lofty ideals. So while many are hoping for a much more robust housing recovery, we might be better off in the long run if the repair is more gradual.

That will be bad news for me. On arriving at the bank, my boss told me that one of my central objectives was to get his home’s value back to its 2006 level. My best hope might hacking into Zillow and temporarily improving its depiction of the property...otherwise, it’s been nice working with you.