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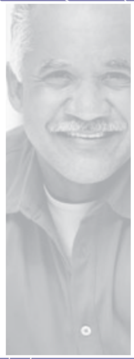
Homeownership



As housing markets peaked in 2005 and cooled over 2006, the impact on homebuying and homeownership was immediate. With concerns over the impending correction curtailing demand and affordability pressures mounting, both the national homeownership rate and the net growth in the number of homeowners fell for the second consecutive year.

SOFTENING MARKETS

After weakening in 2005, the conditions that had promoted outsized gains in homeownership eroded further in 2006. Interest rates, while still low, were a full percentage point higher in mid-2006 than a year earlier, raising the mortgage payments on newly purchased homes. In addition, house price appreciation slowed in most areas, taking the sense of urgency out of the market.

Affordability had in fact begun to erode in some markets as early as 2003, as soaring house prices outpaced the benefits of low interest rates **(Figure 17)**. By the first half of last year, nearly all markets felt the crunch. Although mortgage rates receded from 6.76 percent in July 2006 to 6.14 percent in December and price appreciation slowed dramatically, uncertainty about the direction of rates and prices kept potential homebuyers at bay.

The subsequent retreat in homebuying left new home sales down 18 percent from the record 2005 level, and existing home sales down 8 percent. Caught unaware, suppliers were unable to respond quickly enough to the large drop-off in demand. Home builders had to complete houses under contract even as buyers started to cancel orders. Meanwhile, sellers of existing homes kept their properties on the market, holding out for the prices they still believed they could get. As a result, the supply of both new and existing homes for sale rose sharply in the last quarter of 2006 and continued to climb in early 2007.

Motivated sellers in many markets finally started to reduce their prices. Home builders led the charge with concessions, discounted mortgages, and other offers. But most sellers not forced to move continued to hold out, creating a lag before areawide prices started to respond to eroding market conditions. Prices are therefore likely to remain soft for a time in most places even if the economy continues to expand.

MIXED REGIONAL CONDITIONS

Despite the gloomy national picture, both production and homebuying were up in some metropolitan areas in 2006. Nominal median house prices increased at least 10 percent for the year in 23 of the 149 metros evaluated, including Los Angeles, Orlando, and Tampa. Although declining in many of these markets, nominal prices in half of them were still higher in the fourth quarter of 2006 than a year earlier.

At the same time, though, nominal median house prices fell for the year in 34 of the covered metropolitan areas. In most cases, these areas had either distressed economies or especially heavy speculative activity that had left them vulnerable to further trouble. Only a handful of metros—mostly in the Midwest—posted price declines of three percent or more, and just three showed a drop of more than five percent.

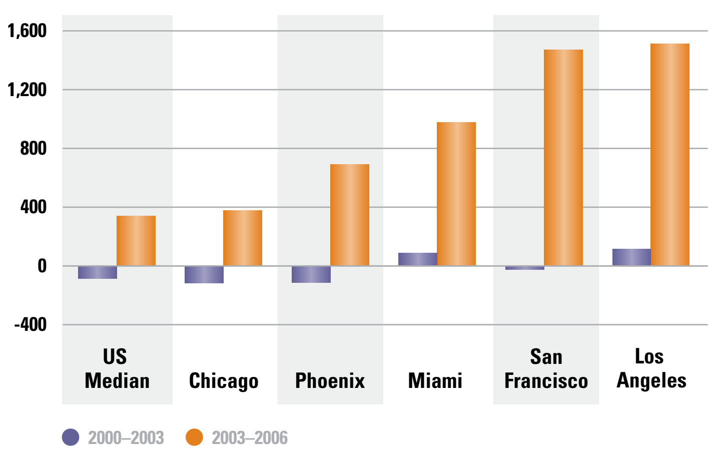
Meanwhile, price softness in some areas appears to reflect overbuilt markets and a fall-off in speculative activity. With the end of rapid price appreciation, the share of prime investor loans dropped by more than five percentage points in markets such as Phoenix, Sarasota, and Reno **(Figure 18).** In large markets such as Las Vegas, Washington, DC, and Riverside, CA, the retreat in investor demand translated into 4,000 fewer loans in a single year, and into more than 10,000 fewer loans in Phoenix.

In many smaller locations, the absolute decline was far more modest but the percentage drop was staggering **(Table W-4).** In Merced, CA, for example, investor loans plummeted by 70 percent. Second-home demand, which had accounted for over 30 percent of prime purchase loans in 2005 in resort areas like Atlantic City, Myrtle Beach, Naples, and Fort Myers, fell by as much as half.

With higher interest rates offsetting even the largest price declines, affordability remained an obstacle for first-time homebuyers. In Detroit, where prices fell the most, the mortgage payment for a median-priced house bought in 2006 was still $30 more a month in real terms than for one purchased in 2005. In Los Angeles, where prices continued to rise at double-digit rates, the monthly mortgage payment for a newly purchased home shot up $590 in just one year and $1,500 over three years.

FIGURE 17 **Affordability Eroded in Both Rapidly And Slowly Appreciating Housing Markets After 2003**

Change in Real Monthly Mortgage Cost for a Median-Priced Home (Dollars)



Note: Monthly mortgage costs are for a newly purchased home, assuming a 30-year fixed-rate mortgage and a 10% downpayment.
Source: National Association of Realtors® 2006 Median Existing Single-Family House Price, adjusted by the Freddie Mac Conventional Mortgage Home Price Index and the Bureau of Labor Statistics CPI-UX for All Items.

MORTGAGE PRODUCT EXPANSION

As house prices escalated over the past few years, mortgage lenders introduced more and more products designed to lower initial monthly payments but carrying higher risks of future upward adjustment. The Mortgage Bankers Association reports that adjustable-rate mortgages (ARMs) grew from 13 percent of all originations (prime and non-prime purchases and refinances) in mid-2003 to 35 percent in mid-2005.

To compete for customers, lenders also offered deep discounts on some adjustable products. Average discounts in the prime market thus rose from just 0.14 percentage point in January 2003, to 1.52 percentage points in January 2005, to 2.34 percentage points in January 2007.

When the discounts expire, payments on recently originated adjustable loans will rise not only by the discounted percentage points, but also by any increase in the indexes to which the loan rates are tied. Fully indexed adjustable rates climbed from about four percent in 2003 to almost eight percent in the second half of 2006. Some borrowers with adjustable-rate mortgages will, however, be able to refinance to fixed-rate mortgages before their payments reset. Indeed, 14 percent of refinances in the fourth quarter of 2006 involved switching from an adjustable- to a fixed-rate loan.

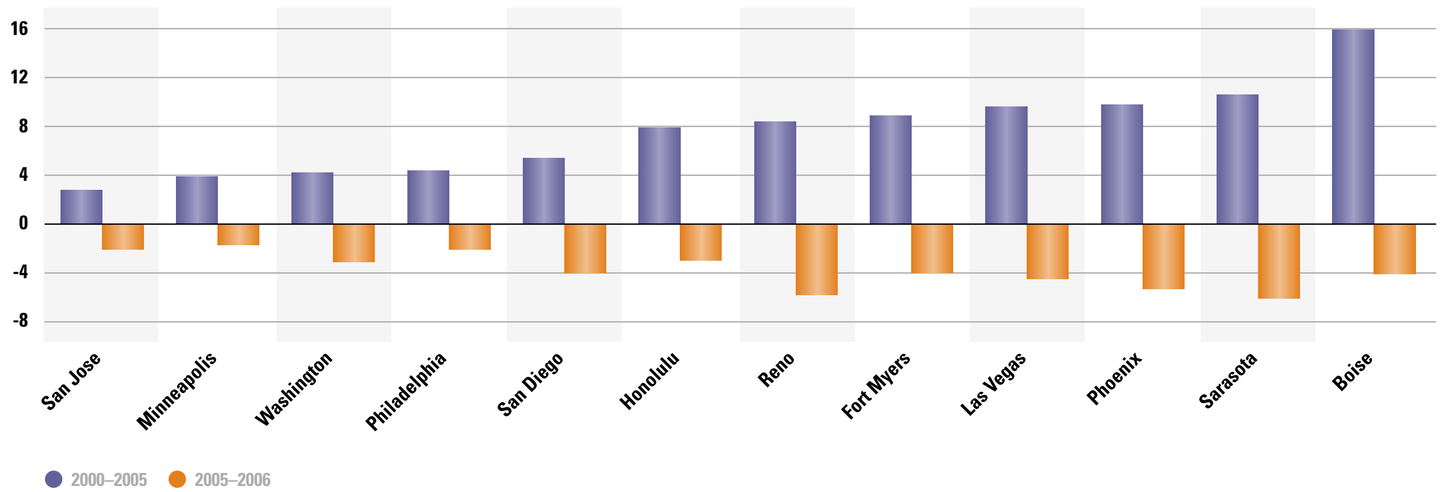
While traditional ARMs lost market share last year as interest rates rose, nontraditional products saw meteoric growth. According to First American LoanPerformance, prime and non-prime loans with interest-only and payment-option features went from serving a fringe market to over 32 percent of all originations in 2006. While concentrated primarily in high-cost states, these products also took off nationally as a tool to help offset rising interest rates and home prices.

From less than five percent in 2002, interest-only prime and non-prime loans accounted for almost 30 percent of all originations in 2005, before falling back to 20 percent at the end of 2006. Most of these are adjustables that entail not only interest-rate resets, but also higher payments to amortize the principal over a shortened term.

The share of payment-option loans grew even more rapidly, more than tripling in just two years. In 2006, these loans—allowing borrowers to defer a portion of principal and interest by paying credit-card-like minimums—made up about 12 percent of originations. When these loans first became available, most borrowers exceeded their minimum pay-

FIGURE 18 After Pumping Up Demand, Investors Began to Exit Markets in 2006

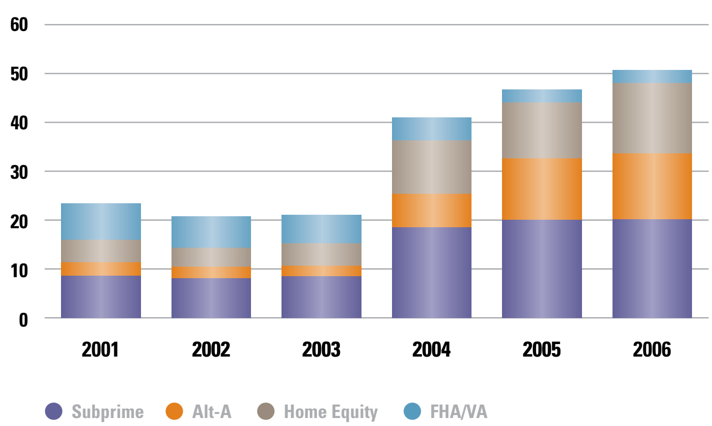
Change in Investor Share of Loan Originations (Percentage points)



Source: First American LoanPerformance.

FIGURE 19 Non-Prime Lending Has Surged

Share of Mortgage Originations (Percent)



Note: Shares are of total dollar value of originations.
Source: Inside Mortgage Finance, *Mortgage Market Statistical Annual.*

ments. By March 2006, however, UBS's Mortgage Strategist reported that more than three-quarters of borrowers with payment-option loans originated since 2004 were making only minimum payments and thus adding to rather than paying down principal.

Despite the recent run-up, the share of homeowners with these so-called "affordability" products is likely less than eight percent. Furthermore, borrowers with interest-only and payment-option loans are more apt to refinance than borrowers with fixed-rate loans. As a result, the share that retains their loans long enough to reach fully amortizing payments is even smaller. Still, as many as six million households could face sharply higher mortgage payments in the next three to five years if they do not refinance or sell first.

THE RISE OF SUBPRIME LENDING

Subprime lending soared from near zero in the early 1990s to 8.6 percent of originations in 2001 and 20.1 percent in 2006 **(Figure 19).** At least seven percent of homeowners, or more than five million households, have subprime loans. These mortgages carry higher rates to cover the risks associated with lending to people who have had problems making payments in the past and many who choose not to state or confirm their incomes and assets when they apply for a loan.

Meanwhile, Alt-A loans, which fall between prime and subprime loans on the risk spectrum, increased from 2.7 percent of originations in 2001 to 13.4 percent in 2006 **(Table A-8).** These loans allow some combination of low documentation, slightly subpar credit scores, and features such as interest-only or payment options. FHA loans, once the only haven for non-prime borrowers, went from a 10–15 percent market share in the 1990s to just 2.7 percent in 2006.

Loans with risky features found their way into the subprime market just a few years after arriving in the prime market. First American LoanPerformance reports that almost half of securitized subprime debt originated in 2006 was in "2/28" adjustable-rate loans with deep two-year discounts, and nearly a fifth had interest-only features. With the introduction of these products and looser credit standards, the risks associated with subprime loans multiplied for borrowers and lenders alike.

TROUBLED LOANS

While inching up in the prime market, the incidence of troubled loans in the subprime market has risen rapidly since 2005. Stating the share of troubled loans at any point in time, however, masks the often higher, cumulative default rate on a group of loans several years after the loans are made. As an example, the share of subprime loans originated in 2000 and foreclosed as of May 2005 was a distressing 12.9 percent—even though fewer were the riskier payment-option and interest-only types, and they benefited from falling interest rates from 2000 to 2003 and from rising prices since 2000.

Recently originated loans, which make up a much larger share of outstanding subprime mortgage debt, are on track to accumulate defaults at an even higher rate. Among subprime adjustable-rate loans originated in 2006, data as of March 2007 show that the share at least 60 days delinquent or in foreclosure within six months was already over seven percent. This compares with shares of less than four percent for 2005 loans and less than two percent for 2003 loans shortly after their origination. This is the worst performance for subprime loans since they became a major force in the market.

Job loss, illness, divorce, and death remain the principal causes of defaults. Even so, the geographic concentration of certain loan products puts some states especially at risk. On the subprime side, First American LoanPerformance data for 2006 indicate that shares are particularly high in some Southern states, including 20 percent in Mississippi, 18 percent in Tennessee, and 17 percent in Florida, compared with 13 percent nationally **(Table W-9).**

Loans with interest-only and payment-option features have been popular in states with high housing prices. Interest-only loans accounted for over 30 percent of originations last year in California, Nevada, Colorado, and Arizona, compared with 22 percent nationally. California also led with a 24 percent share of payment-option loans, followed by Nevada, Florida, and Hawaii at 13–17 percent, compared with 11 percent nationally.

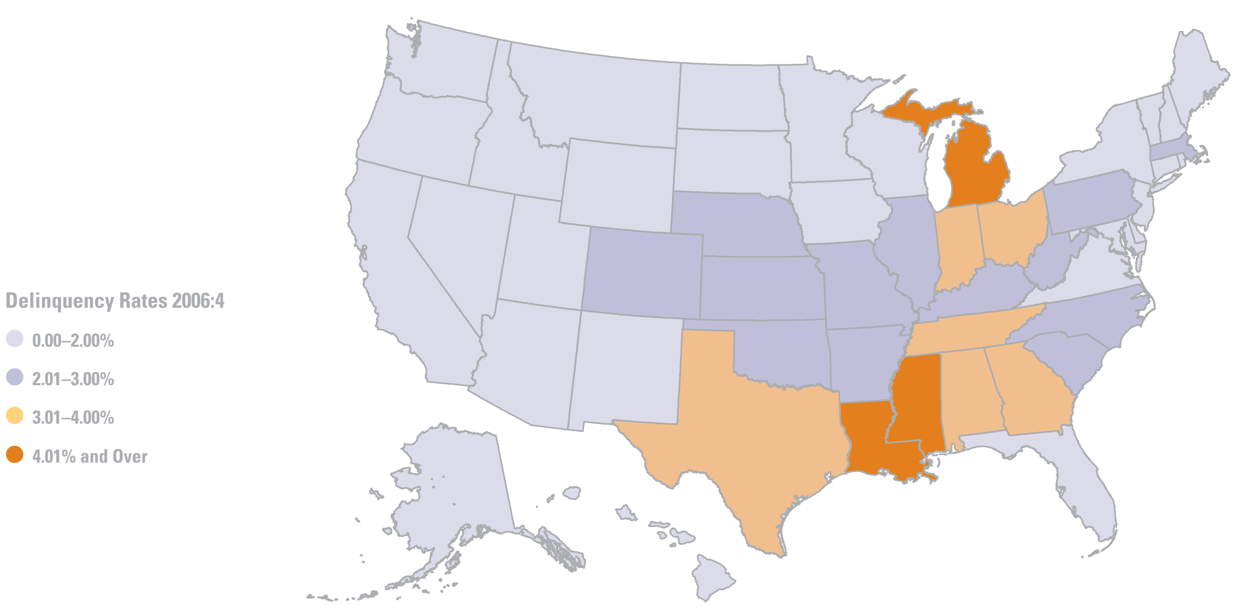
So far, the highest default rates are primarily in states with weak economies or recovering from natural disasters, such as Michigan, Louisiana, and Mississippi. Still, other states with stronger economies but significant exposure to subprime loans—including Tennessee and Texas—are now showing distress **(Figure 20).**

With mortgage performance worsening, the number of prime loans at least 90 days delinquent or in foreclosure at the end of 2006 almost reached 290,000 and subprime loans 465,000 **(Figure 21).** As a result, dozens of smaller subprime mortgage lenders went out of business and some larger lenders had to boost their loan reserves. Even more disconcerting, nearly 250,000 homeowners entered foreclosure proceedings in the fourth quarter of 2006 alone, up from 150,000 in the second quarter of 2005 on a non-seasonally adjusted basis.

INCREASING DEBT LOADS

Americans have grown much more tolerant of debt. Indeed, total household debt exceeded total personal income starting in 2003. Home mortgages make up a growing share of this outstanding debt, increasing from 65 percent in 2000 to 73 percent in 2006. Even more telling, a larger portion of households are spending considerable portions of their incomes on debt service. Between 1995 and 2004, the share of households devoting more than one-fifth of their monthly incomes to debt climbed from 30 percent to 34 percent, while the

FIGURE 20 States with the Highest Delinquency Rates Have Struggling Economies Or Are Recovering from Natural Disasters

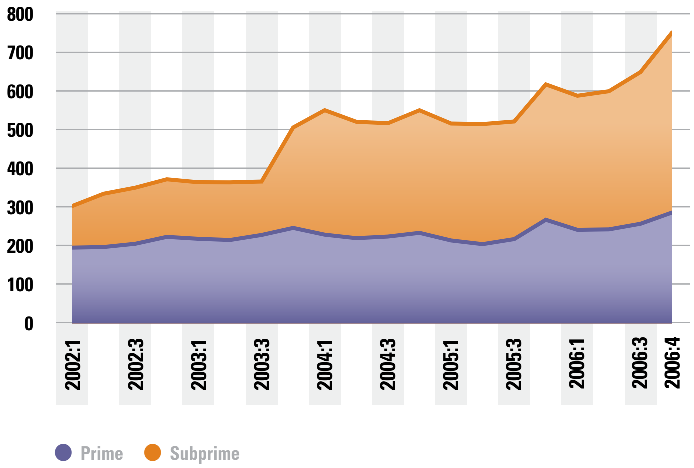


Notes: Delinquency rates are the share of all loans 60+ days past due or that entered foreclosure. Data are based on seasonally adjusted rates.
Source: Mortgage Bankers Association, National Delinquency Survey.

FIGURE 21

While Prime Loan Performance Is Stable, Subprime Problems Are Rising

Seriously Delinquent Loans (Thousands)

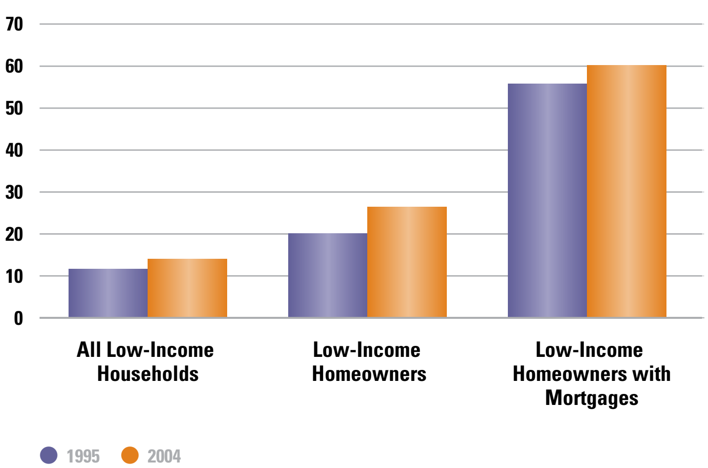


Notes: Seriously delinquent loans were at least 90 days past due or in foreclosure during the quarter. Prime and subprime loans are conventional and conforming. Data are based on non-seasonally adjusted rates.
Source: Mortgage Bankers Association, National Delinquency Survey.

FIGURE 22

Larger Shares of Low-Income Households Are Spending Heavily to Service Debt

Share with Debt-to-Income Ratios Above 40 Percent



Note: Low-income households are in the bottom income quartile.
Source: JCHS tabulations of the 1995 and 2004 Surveys of Consumer Finances.

share devoting more than 40 percent of their incomes rose from 8.5 percent to 9.3 percent—an increase of two million households. The rise in both mortgage and overall debt is evident for all households, all homeowners, and homeowners with mortgages, but is especially marked for low-income households **(Figure 22)**.

The rise in mortgage debt is not just a function of the increase in homeownership. Individual buyers have taken on more debt to offset rising house prices, while lenders have relaxed loan-to-value ratios to attract customers. In addition, many households have substituted mortgage debt for other debt, using home equity loans and lines of credit to pay off credit cards and other expenses. By the Federal Reserve's measure, nominal consumer debt rose by 21 percent between 2002 and 2006, while mortgage debt was up by 62 percent.

The run-up in debt is perhaps less shocking when compared with equity holdings. Mortgage debt as a share of total housing value, though up from 31 percent in 1985, is still under 50 percent despite the huge increase in volume. Aggregate home equity therefore remains higher than aggregate mortgage debt. Still, as house prices climbed during the recent boom, homeowners used their equity gains to add nearly equal amounts to their debt rather than to strengthen their balance sheets. If house prices and values should fall sharply, the debt-to-value ratio would set new records. Meanwhile, American Housing Survey estimates indicate that the share of homeowners with negative net equity (owing more than their homes are worth) was already over three percent in 2005, and up to 13 percent among owners that had bought in the prior two years. These shares likely increased in 2006 and will do so again in 2007.

THE OUTLOOK

Over the next year or so, house prices are likely to rise slowly in most places, drift down in some, and fall more sharply in others. Weaker prices should help to work off the oversupply of homes for sale and sow the seeds for the next expansion. But several factors could extend the correction. The contraction of subprime credit and affordability products could lead to a prolonged reduction in demand, interest rates could rise, the economy could weaken, and many consumers could hold off on buying until the trough is reached.

Uncertainty about credit availability hangs over the housing market. While it is clear that lenders underestimated subprime risks, it is unknown how much worse conditions may get. It is especially troubling that subprime losses have been heavier than expected at only the first sign of softer prices and loan rate resets. Much of the hope for a recovery in the for-sale markets now rests on the economy staging a soft landing, markets drawing down the excess supply, and loan performance improving.

Looking past the current correction, homeownership is still clearly the tenure of choice. In addition, strong gains in income and wealth will favor ownership of both first and second homes. As a result, fully 88 percent of the net growth in households over the next ten years is expected to come from gains in the number of homeowners. Indeed, even if homeownership rates by age and family type remained at 2005 levels through 2015, the owner share of household growth would still be 72 percent.

But affordability will remain a problem. A rare combination of unusually favorable economic conditions and mortgage innovation was responsible for the exceptional growth of homeownership in the latter half of the 1990s and first half of the 2000s. The immediate return of these extraordinary conditions is unlikely.