The PROBLEM with HOUSING

BY QUINN EDDINS

A severe supply overhang means national home prices are not likely to increase for many years to come.

The fundamental problem facing housing markets is one of supply. Even if the demand for homes, which is currently quite weak, were to return to peak levels, it would take years to absorb the current supply of homes for sale, in foreclosure and in the inventories of financial institutions. The longer it takes to reduce this supply, the longer home prices will languish. ■ Prices increased in the first half of 2010, as seasonal factors and federal government initiatives temporarily bolstered housing demand and prevented new supply from entering the market. Both seasonal strength and government support ended by mid-summer, exposing the underlying imbalance of supply and demand, and driving prices and sales volumes sharply lower. ■

Flagging demand in the face of overwhelming supply will almost certainly cause home prices to fall over the next several months. Given the huge numbers of Americans with little or no equity in their homes, falling home prices could create a vicious cycle of new foreclosures and further price declines.

Housing market trends, 2008–2010

During 2008, home prices declined continuously and home sales were at or near their lowest levels in a decade. Then, in 2009, housing markets started to stabilize. In January, the composite Residential Property Index^{SM} (RPX^{SM}), produced by Radar Logic Inc., which reflects home prices in 25 of the country's largest metropolitan areas, leveled off after 18 months of rapid declines (see Figure 1).

In February, home sales began to increase rapidly (see Figure 2). Home sales follow a predictable seasonal pattern, increasing in the spring and decreasing in the fall, but in 2009 home sales continued to increase through November. Sales declined again from December 2009 to February 2010, but remained well above their near-record lows the year before.

The return of stability to the nation's housing markets in early 2009 was due in large part to the release of pent-up demand. By January 2009, the RPX composite price had fallen 33 percent from its peak in June 2007. Thanks to this substantial reduction in prices, homebuyers who had been priced out of the housing market during the boom were once again able to afford to own a home and came flooding back. Investors re-entered the market as well, believing the price reductions had created enormous opportunities.

Demand was also bolstered by unprecedented government support in the form of tax credits for homebuyers, low-down-payment loans through the Federal Housing Administration (FHA) and the Federal Reserve's purchase of \$1.25 trillion of mortgage-backed securities (MBS) and \$175 billion of housing agency debt. These purchases helped keep mortgage rates at record lows and maintained the flow of mortgage credit.

The federal government also helped by temporarily reducing the number of foreclosed homes for sale. In March 2009, the Obama administration put in place ambitious programs to reduce foreclosures by modifying or refinancing mortgages. The trial modifications offered by the Home Affordable Modification Program (HAMP) temporarily reduced foreclosures and staunched the flow of bank-owned homes into the housing market.

Sales of foreclosed homes, which Radar Logic calls "motivated sales," tend to be priced significantly lower than homes sold in other sales (see Figure 3), and homebuyers are chasing these discounts. In 2008, as motivated sales increased from 13 percent of total home sales to 38 percent, sellers were forced to lower their prices in order to compete with financial institutions. Thanks at least partially to the interventions of the federal government, motivated sales fell to 21 percent of home sales by July 2009, and prices stabilized.

In 2010, the federal government's support measures started to wear off, and while home prices and sales activity increased in spring 2010 due to seasonal factors, the seasonal gains were not as strong as in spring 2009.

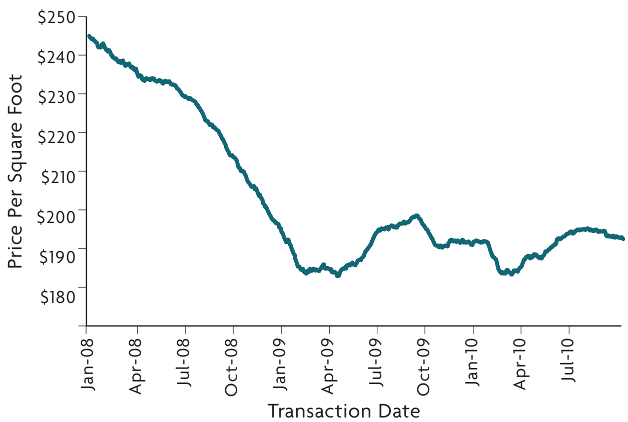
Demand plunged in May 2010, after the final contract-signing deadline for the homebuyer tax credits. Transaction closings, which typically lag contract signings by two months, peaked for the year in late June and then plunged 27 percent by the end of August. Changes in sales activity have historically prefigured like changes in home prices, so Radar Logic expects that home prices fell significantly from September on.

The underlying weakness in the housing markets

Over the past two years, inefficiencies in the foreclosure process and trial modifications have limited the flow of foreclosed homes into the market, while low mortgage rates, tax credits and low home prices have fueled demand. The result has been apparent stability in home prices.

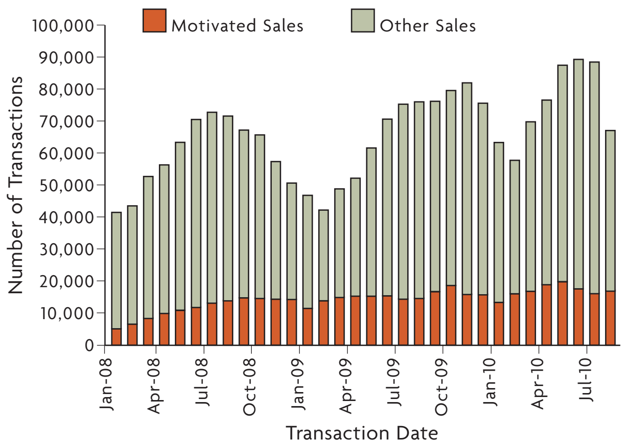
But the end of seasonal strength and government

Figure 1 **RPX Composite Price, January 2008–August 2010**



SOURCE: RADAR LOGIC

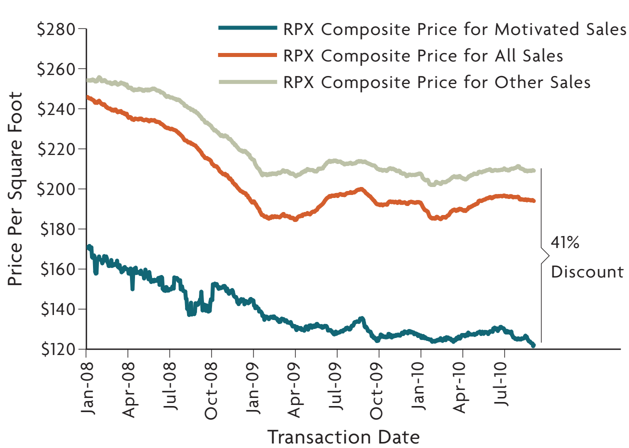
Figure 2 **RPX 25 Metro Area Transaction Counts, January 2008–August 2010***



*Transaction counts reflect the number of transactions included in the calculation of the 28-Day RPX Composite price and, while closely correlated with actual sales volumes, may differ from such volumes.

SOURCE: RADAR LOGIC

Figure 3 **RPX Composite Prices, January 2008–August 2010**



SOURCE: RADAR LOGIC

support in mid-2010 exposed the underlying imbalance of supply and demand, and prices are declining as a result.

The huge and growing inventory of homes, including those for sale and those in the foreclosure pipeline, overwhelms current demand. As of Sept. 30, the total supply of homes for sale, in the inventories of financial institutions and in the shadow inventory was more than 12 million homes. This includes more than 4 million existing homes for sale, according to the National Association of Realtors® (NAR), Chicago; nearly 1 million real estate–owned (REO) properties held by financial institutions, according to data from RealtyTrac Inc., Irvine, California (these homes have not been listed for sale and are not included in NAR's existing-home inventory); and more than 7 million loans in foreclosure or some stage of delinquency, according to estimates by LPS Applied Analytics, Jacksonville, Florida.

These figures dwarf current housing demand. At September's rate of existing-home sales (4.53 million a year, according to NAR), it would take nearly 32 months to absorb the 12 million homes for sale, in REO inventory and in the shadow inventory. And this estimate is probably conservative, as the bulk of the 12 million homes would be sold in motivated sales, which currently account for about one-quarter of all home sales.

Moreover, Santa Ana, California–based CoreLogic reports that 11 million, or 23 percent, of all homeowners with mortgages had negative equity in their homes at the end of the second quarter of 2010.

CoreLogic's research suggests that negative equity is a major factor in changing homeowners' default behavior. Once negative equity exceeds 25 percent, or the mortgage balance is $70,000 higher than the current property values, owners begin to default with the same propensity as investors.

The longer it takes housing prices to recover, and the further housing prices fall, the more likely it is that homeowners with negative equity will strategically default. As this happens, many more homes will enter the shadow inventory.

To make matters worse, housing demand is facing serious headwinds.

First, slow economic growth and persistently high unemployment constrain household formation. Young people are living with their parents longer instead of moving out and forming their own households, and families are combining households to save money or due to foreclosures.

As a result, the number of American households dropped by an estimated 1.2 million between 2005 and 2008, according to an April 2010 study by the University of Southern California's (USC's) School of Policy, Planning and Development, Los Angeles. Given the current rate of job creation—some 151,000 jobs in October—those households are not going to be replaced quickly.

Second, the huge supply of homes in foreclosure reduces the demand for new homes, as it produces anxiety over future home-price declines and hinders job growth and economic recovery. On one hand, the large distressed supply makes buyers think values may go down, discouraging market participation and reducing the amount buyers are willing to pay. On the other hand, the large supply of low-priced foreclosed homes gives builders a strong incentive not to start new construction projects. They simply cannot compete profitably with REO properties sold at substantial discounts. Home building has lagged as a result, which prevents employment growth, delays economic recovery and restricts household formation—all of which limits demand for housing.

Third, the furor over defects in the way financial institutions process foreclosures threatens to further erode demand. Banks have taken steps to resume foreclosure proceedings after suspending them in October, arguing that the problems with the foreclosure process are merely technical and easily resolved. But these technical problems are sparking questions about who has the legal standing to foreclose, and these legal questions could deter potential buyers of foreclosed homes or, worse, undermine the mortgage securitization system.

For more than 30 years, banks have bundled and securitized mortgages in a process that requires mortgage rights to change hands a number of times. If banks cannot convince investors that their processes for transferring mortgage rights are sound and can stand up in court, then securitization could break down. As securitization supplies lenders with cash for new mortgage loans, a breakdown in the process would make financing the purchase of a home much more difficult, and demand for all homes—not just those sold by banks—would dry up.

The outlook

In light of the supply overhang, home prices are not likely to increase on a national basis for many years, and they could decline dramatically in coming months. Whether and how much prices decline will depend on the rate at which homes enter the market through short sales, foreclosure auctions and REO liquidations.

In a relatively optimistic scenario, homes trickle into the market at a rate that can be absorbed by weak demand while maintaining price stability. This could happen if financial firms and the government-sponsored enterprises (GSEs) continue to hold much of their REO inventories off the market in order to protect the value of their assets.

Legal challenges and the inefficiencies they impose on the operations of major lenders could also help limit the rate at which foreclosed homes are sold. But while we would avoid a second major decline in national home prices under this scenario, we would likely suffer from years of home-price stagnation as we slowly work through the excess housing supply.

Alternatively, financial institutions could ratchet up short sales and REO liquidations, flooding the market with heavily discounted homes and driving down prices. According to CoreLogic, 2.4 million borrowers had between 0 percent and 5 percent equity in their homes at the end of the second quarter. Even a modest decline in home prices could drive many more Americans underwater with their mortgage loans, potentially driving up defaults, foreclosures and the inventory of REO properties. As these properties are sold, home prices could enter a self-perpetuating downward spiral.

Is there another way out?

The only way to avoid years of stagnation or decline in home prices is to address the supply problem. The number of homes for sale or in the pipeline is just too large for the markets to absorb in the near term, even if job growth, low mortgage rates and additional government support were to boost demand.

To date, initiatives to reduce the supply of homes have met with little success. HAMP was supposed to reduce the shadow inventory by allowing distressed borrowers to modify their mortgages, but the program has resulted in fewer than 500,000 of the 3 million to 4 million permanent modifications originally predicted.

There are discussions under way, both in the private and public sectors, about new and creative programs for modifying mortgages that would allow borrowers to stay in their homes with positive equity and payments they can afford, while at the same time minimizing the losses suffered by lenders and investors. If successful, such programs would go a long way toward reducing the excess housing supply.

The programs under discussion center on the concept of shared appreciation, in which a portion of a distressed loan is replaced with an equity investment in the home by a third party. In return for the investment, the investor will receive a portion of any future appreciation in the value of the home.

The equity investment allows the lender to replace the borrower's current loan with a smaller one with affordable monthly payments. The lender does not have to absorb the entire cost of writing down the loan principal as a portion of that cost is offset by the equity investment. As a result, the costs associated with the modification would be significantly less than the costs associated with foreclosing on the property and selling it at a heavy discount in an REO sale.

There has already been some discussion in Congress regarding shared-appreciation programs. The Dodd-Frank Wall Street Reform and Consumer Protection Act passed this year contained language directing the government to study shared-appreciation arrangements as a potential solution for the country's housing ills.

Rep. Gary Miller (R-California) has introduced a separate bill that would establish pilot programs through which the Federal Housing Administration or its subsidiary agencies would help ailing homeowners sell a portion of their home equity to investors. The homeowners would then use the proceeds to pay down principal and get a lower mortgage payment.

The nation's housing markets have not faced circumstances this dire since the Great Depression. The conventional approaches have failed to solve the problem of oversupply, so creative and unconventional initiatives are required. Shared-appreciation programs may be the best and only alternative to years of stagnant home prices, or worse. **MB**

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