

## Measuring Progress in U.S. Housing and Mortgage Markets

U.S. housing and mortgage markets have experienced historic distress over the past three years. Housing starts dropped from more than 2 million units in 2005 to only 553,000 in 2009, while foreclosures soared from 780,000 to about 3 million during the same period. However, the signs of eventual recovery are beginning to emerge. Home price declines have boosted affordability, which in turn helped to push existing home sales in the fourth quarter of 2009 to their highest level in almost three years. Meanwhile, a number of government initiatives, from mortgage modification programs to outright purchases of mortgage-backed securities (MBS), have been put in place to help stabilize these highly distressed markets.

After more than three years of mostly unremitting bad news from the housing and mortgage sectors, analysts are now trying to evaluate the tentative signs of stabilization that emerged in late 2009. For example, home prices, by some measures, rose slightly on average for six consecutive months through November. Does this signal the “all clear” for homeowners and mortgage lenders? The answer is certainly “no.” At the same time, the combination of more affordable home prices, reduced inventory, and a leveling-off of home prices does suggest that a new equilibrium in the housing sector might not be that far off.

What worries analysts is that the mortgage delinquencies, foreclosures, and distressed sales that have driven home prices sharply lower since 2006 will outlast the policy support that has been slowing foreclosures, lowering mortgage rates, and encouraging first-time homebuyers to enter the market. This *chartbook* examines U.S. housing and mortgage markets for tentative signs of recovery and evaluates those hopeful signs against the challenges that remain.

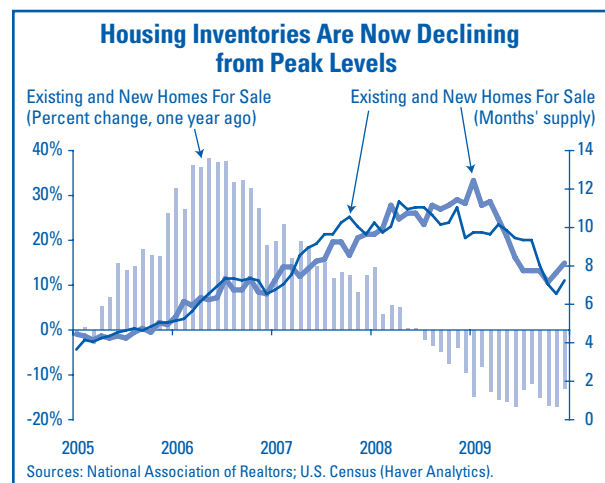
### Housing: Signs of Recovery

After more than three years of decline, the beleaguered U.S. housing market has shown some apparent signs of stabilizing in recent months. Inventories are down, existing home sales are up, and residential construction activity has stopped falling, at least for the time being. In relative terms, these trends represent a welcome departure from the continuous deterioration of market conditions that began in 2006.

#### Sales, Construction, and Inventories

- The inventory of unsold new homes in December was 13 percent lower than one year ago (see Chart 1).

Chart 1



- The months' supply of existing homes on the market has fallen to the lowest levels since late 2006, while the supply of new homes on the market has also dropped from an all-time high of 12.4 months in January 2009.

- Home sales increased during 2009 in markets across the South, West, Northeast, and Midwest (see Chart 2).
- Existing home sales nationwide are near their highest level in more than two years.
- Although permit issuance and new residential construction generally remain weak across the nation, the rate of decline is slowing, possibly indicating a bottom in the market (see Chart 3).
- Housing construction made its second consecutive positive contribution to gross domestic product growth in fourth quarter 2009, after more than three years of decline.
- Residential real estate investment rose again in fourth quarter 2009, increasing at nearly an 8 percent annual rate, albeit from an already depressed level.

### Continued Progress Hinges on Prices

Just as falling home prices came to represent the fundamental source of uncertainty in mortgage markets after 2006, so too will a sustainable recovery in housing markets depend on the stabilization and slow recovery of home prices. This is why indications of a leveling-off in home prices at more affordable levels during the second half of 2009 represent a hopeful sign that housing activity and mortgage credit distress may soon stabilize or even improve.

- The S&P/Case-Shiller 10-city home price index registered a sixth consecutive monthly increase in November, with a 0.24 percent gain, following more than two years of declining prices (see Chart 4).
- The year-over-year change in the home price index, while still negative, has progressively moved closer to zero for the ninth month in a row, reaching -4.5 percent in November.

Chart 2

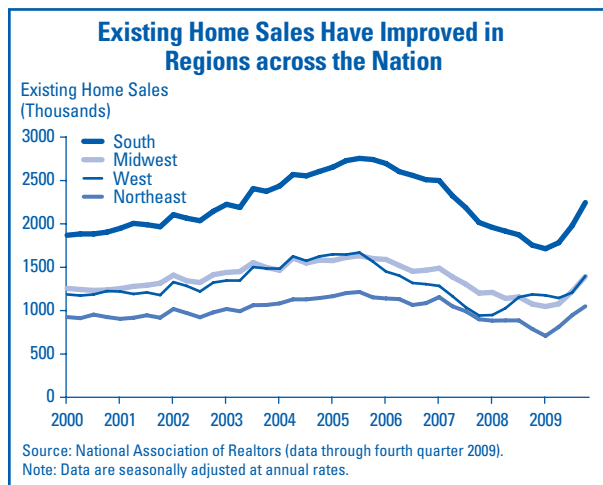


Chart 3

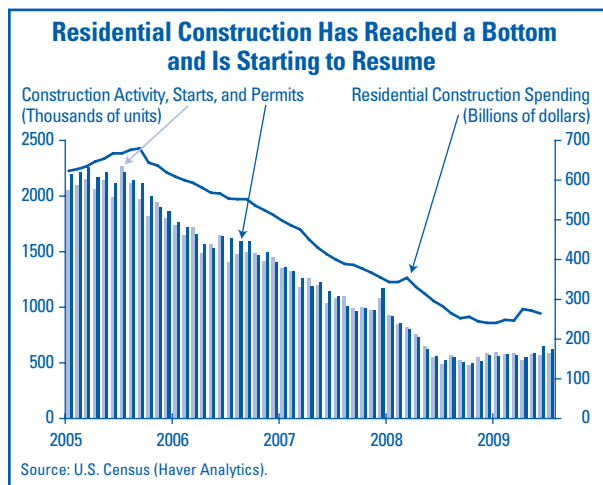
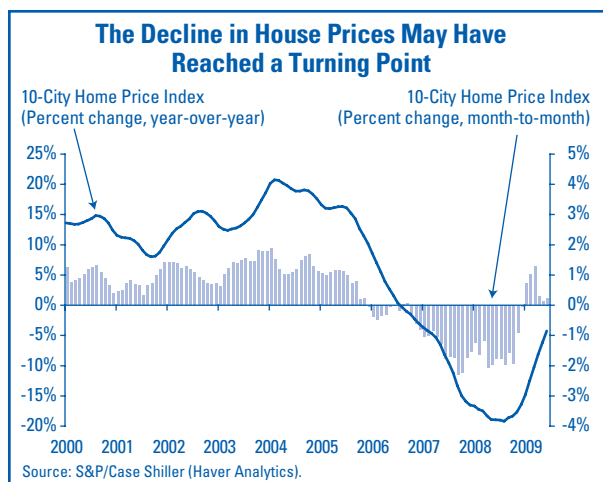


Chart 4



- Year-over-year declines in home prices have eased in several of the hardest hit housing markets, such as Las Vegas, Phoenix, Miami, and Detroit (see Chart 5).
- Recent price trends may be either a sign of sustained recovery ahead or a temporary lull that will give way to further price declines once government stabilization programs begin to expire in early to mid-2010.
- Home price declines and low interest rates have contributed to dramatically improved housing affordability during the past two years.
- The National Association of Realtors' Housing Affordability Index stood at 163.8 in December 2009 (see Chart 6). This means that a family earning the median income had about 164 percent of the income needed to qualify to purchase the median-priced home using a standard mortgage.
- The December reading is well above the long-term average for the index and indicates that housing remains near its most affordable level in decades.
- The improvement in housing affordability since late 2007 extends to all 50 states (see Chart 7).
- Affordability has particularly improved in some of the higher-priced coastal markets. In California, a family earning the median income can now qualify to purchase a home worth 115 percent of the median price, up from a level of just 60 percent in 2007.

Chart 5

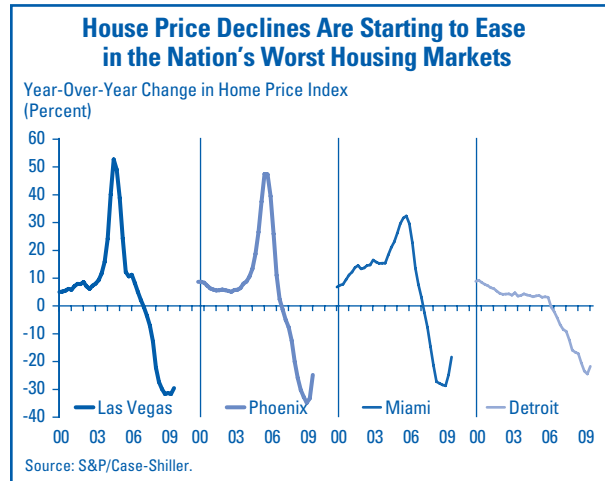


Chart 6

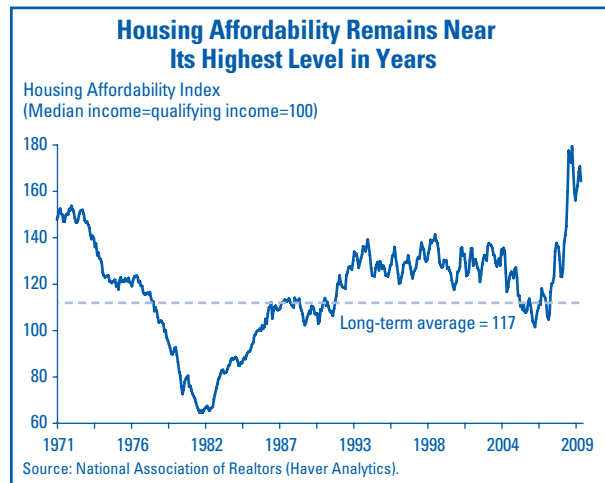
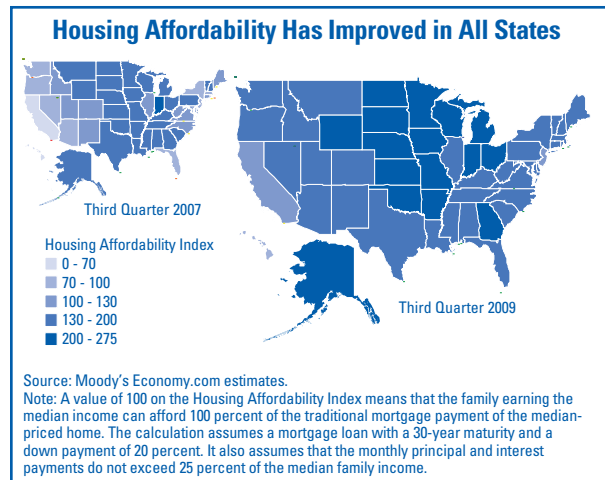


Chart 7



### Foreclosures Cloud an Uncertain Future

Among the biggest challenges to a recovery in the housing market is the near-record high level of foreclosures and the excess inventory and distressed home sales those foreclosures could impose on the market. The more than tripling of the annual number of U.S. foreclosures since 2006 has destabilized the housing market and placed additional downward pressure on home prices in what became a self-reinforcing cycle. If both foreclosures and unemployment continue to increase, the housing market could retrench in coming months and the tentative recovery in housing fundamentals could falter.

### Foreclosures

- Delinquencies and foreclosures have now spread into prime space. In fourth quarter 2009, the past-due rate for prime loans was near a record high 6.7 percent. Prime fixed-rate loans accounted for 35 percent of the foreclosure starts during the quarter (see Chart 8).<sup>1</sup>
- The poor performance of prime fixed-rate loans will likely get worse because those loans represented an increasing share of loans 90 days or more past-due but not yet in foreclosure.
- About 32 percent of home sales nationwide in December were distressed or foreclosure related.<sup>2</sup>
- An estimated 2.82 million homes entered foreclosure during 2009, a marked increase from the estimated 2.28 million foreclosures in 2008 (see Chart 9).<sup>3</sup>
- The abundance of foreclosure resales has contributed to continued home price depreciation.
- In California, nearly 5.6 percent of all mortgages were in foreclosure in fourth quarter 2009.<sup>4</sup>
- Although foreclosure resales in California are declining, they remain an important consideration for both home buyers and sellers, accounting for 40 percent of existing home sales in fourth quarter 2009 (see Chart 10).

<sup>1</sup> Mortgage Bankers Association, National Delinquency Survey, Fourth Quarter 2009.

<sup>2</sup> National Association of Realtors, news release, January 25, 2010.

<sup>3</sup> FDIC estimates based on data from the Mortgage Bankers Association's National Delinquency Survey for fourth quarter 2009.

<sup>4</sup> Mortgage Bankers Association.

Chart 8

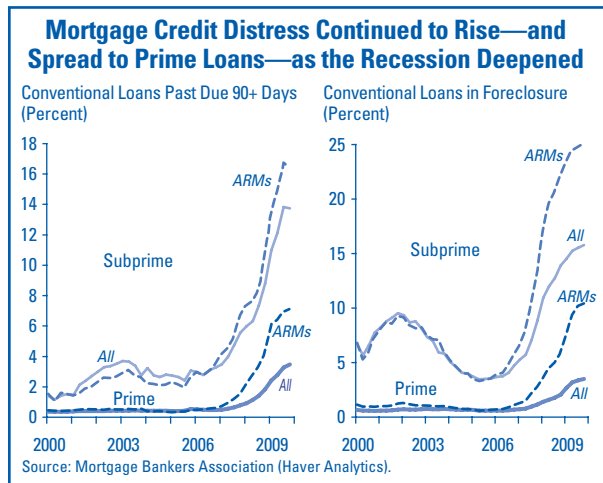


Chart 9

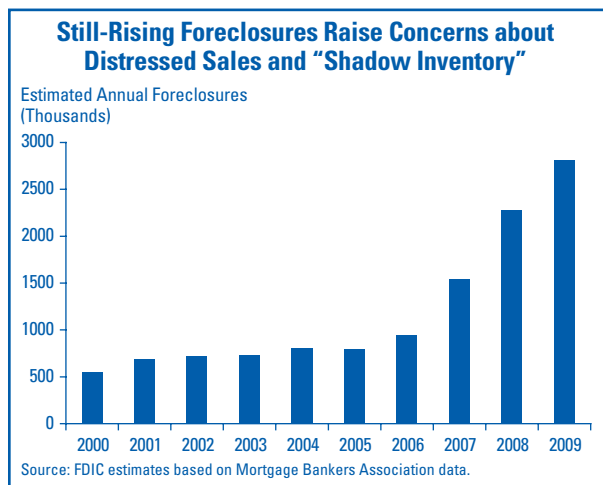
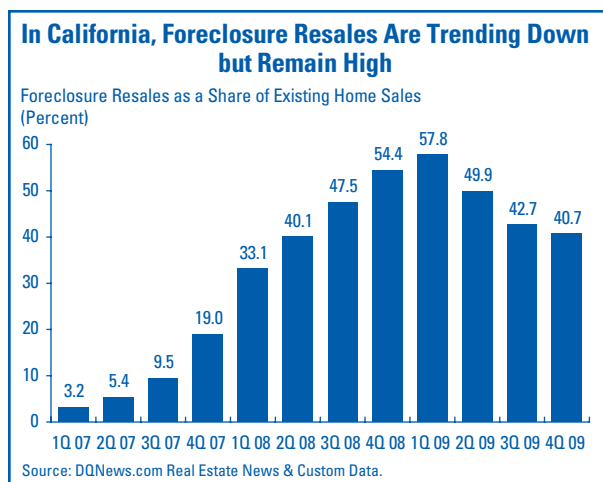


Chart 10



## Shadow Inventory

- The risk posed by still-rising foreclosures is that they will increase the pending supply, or *shadow inventory*, of homes not yet on the market. Shadow inventory is generally made up of current foreclosures and homes owned by delinquent borrowers that are likely to transition into the foreclosure pipeline.
- Shadow inventory, which is estimated to be 1.7 million units as of third quarter 2009, may increase the already high proportion of distressed or foreclosed home resales.<sup>5</sup>

## Credit Availability: Continued Strains

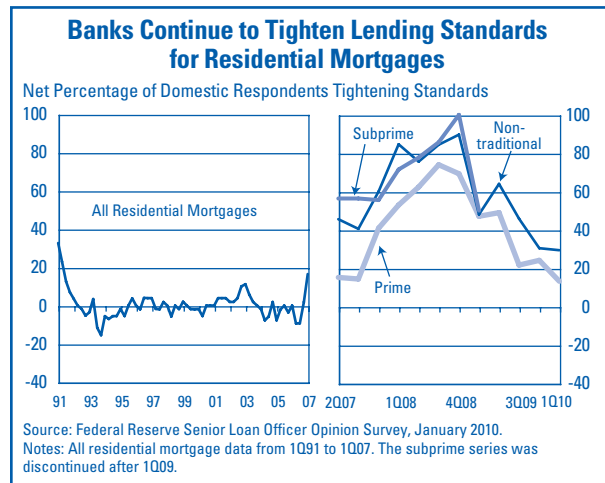
While the national housing market is showing some signs of recovery, credit markets for residential mortgages continue to be stressed. Tightened credit standards, declining consumer net worth, rising delinquency and foreclosure rates, the lack of private MBS issuance, and the collapse of the subprime market have limited funding channels and lending opportunities. Government programs and agencies have filled the void largely through policy initiatives and implicit or explicit guarantees.

### Tightened Credit Standards

Poor mortgage loan performance has prompted tighter underwriting standards.

- Residential credit quality has deteriorated. The noncurrent ratio for one-to-four single-family mortgages increased to a record high 9.9 percent in fourth quarter 2009, nearly double the level of one year ago.
- Banks have tightened credit standards on residential mortgage loans. The Federal Reserve's January survey indicated that banks tightened lending standards, on net, for both prime and nontraditional mortgages (see Chart 11).

Chart 11

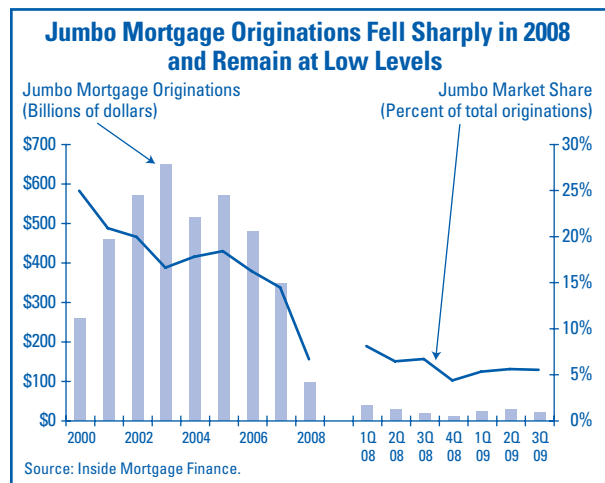


### Shift in the Composition of Mortgage Funding

The most significant result of deteriorating credit quality and tightened lending standards has been the collapse of the private MBS market and a shift toward conforming mortgage originations.

- Through third quarter 2009, 67 percent of new mortgage originations were conforming mortgages that could be readily sold in the agency MBS market, compared with 33 percent in 2006.<sup>6</sup>
- The pace of jumbo mortgage lending increased during the first nine months of 2009, although it remained far below the level reached at the peak of the market (see Chart 12).

Chart 12

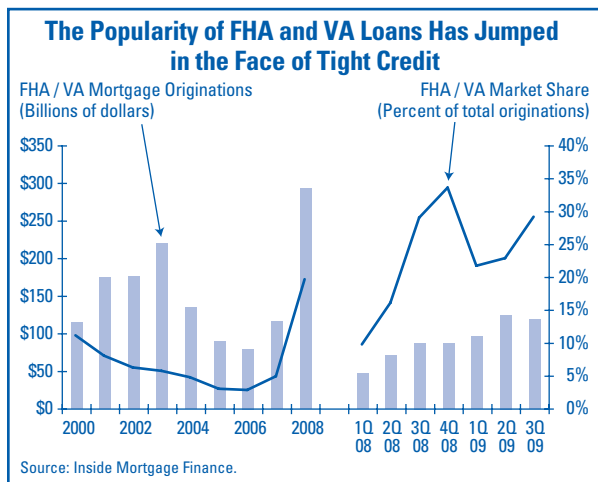


<sup>5</sup> First American CoreLogic, Media Alert, December 17, 2009.

<sup>6</sup> Inside Mortgage Finance, November 27, 2009.

- The volume of jumbo mortgage originations for 2009 now appears on track to match 2008 levels.
- The change in mortgage production has created a fundamental shift in the composition of mortgage funding.
- The government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac and the government mortgage insurance program Ginnie Mae together account for more than 95 percent of total MBS issuance since 2008.<sup>7</sup>
- Federal Housing Administration (FHA) and Department of Veterans Affairs (VA) guaranteed mortgage loan originations accounted for almost one-quarter (24 percent) of mortgage originations through third quarter 2009, up from a low of 2.7 percent in 2006 (see Chart 13).<sup>8</sup>

Chart 13



- FHA-insured mortgages will remain a strong force in the mortgage market, but the rate of increase may slow as the result of the recently announced tightening of standards.
- The GSEs' higher conforming loan limits and the FHA's higher mortgage limit are helping to support housing markets by increasing the availability of mortgages for homes in higher-priced areas.

<sup>7</sup> Inside MBS & ABS, December 18, 2009.

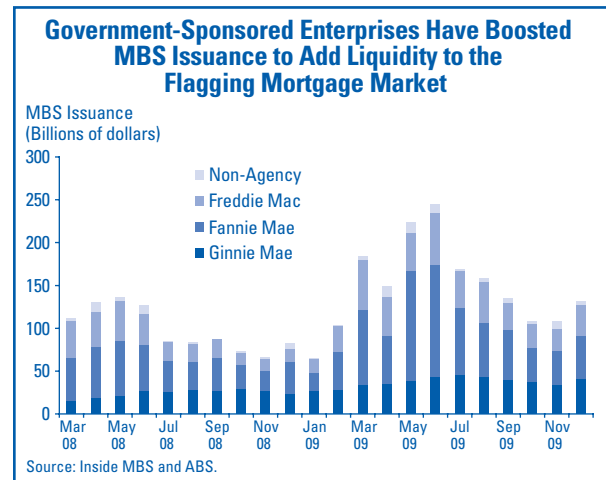
<sup>8</sup> Inside Mortgage Finance, November 27, 2009.

### Government Adds Liquidity to the Market

Throughout 2009, the government added liquidity to the flagging mortgage credit markets as the Federal Reserve and the U.S. Treasury became primary purchasers of agency MBS.

- The Federal Reserve's net purchases of agency securitizations during 2009 totaled \$1.11 trillion, representing 65 percent of the total \$1.71 trillion in agency MBS issued during 2009.<sup>9</sup>
- The government is likely to remain a major investor in the flagging mortgage market for now with its commitment to purchase a total of \$1.25 trillion in agency MBS by the end of first quarter 2010.
- Together, the Federal Reserve and Treasury hold an estimated 12 percent of total agency MBS outstanding.<sup>10</sup>
- The GSEs have spurred issuance of MBS by adding liquidity to a constrained mortgage market. The \$1.71 trillion dollars of agency MBS issued during 2009 represents nearly a 47 percent increase from 2008 (see Chart 14).<sup>11</sup>

Chart 14



- Ginnie Mae MBS issuance during 2009 was 66 percent higher than in 2008.<sup>12</sup>

<sup>9</sup> Federal Reserve Bank of New York; Inside MBS & ABS, January 22, 2010.

<sup>10</sup> Inside MBS & ABS, September 25, 2009.

<sup>11</sup> Inside MBS & ABS, January 22, 2010.

<sup>12</sup> Ibid.



- In contrast, non-agency issuance during 2009 was almost flat, at only 3.5 percent above the 2008 level. Non-agency market share in 2009 was just 3.4 percent of total MBS issuance.<sup>13</sup>

## Mortgage Originations Increased in 2009

Mortgage originations were strong throughout the middle of the decade before declining substantially with the onset of the subprime mortgage crisis.

- Mortgage market turmoil since 2007 has necessitated tighter credit standards and a realignment of funding sources, resulting in a greater government role in providing liquidity to the market.
- Mortgage originations peaked in 2003 at almost \$4 trillion. By 2008, mortgage originations had fallen to \$1.5 trillion for the year, the lowest level since 2000 (see Chart 15).<sup>14</sup>
- The Federal Reserve's purchases of agency MBS in 2009 helped to reduce mortgage rates to historically low levels and generate a refinancing boom (see Chart 16).
- Refinance originations surged to 76 percent of originations in the first half of 2009. Refinancing activity slowed around mid-year as mortgage rates increased, but it picked up again in the second half of 2009 as rates fell.<sup>15</sup>
- The Mortgage Bankers Association expects that total mortgage production in 2009 rose by about 40 percent to \$2.1 trillion, largely on the strength of refinancing originations.<sup>16</sup>
- Total originations are expected to decline by 40 percent in 2010 to \$1.3 trillion, as the drop in refinancing originations in 2010 will far outweigh the expected 5 percent increase in purchase originations.
- A key question going forward is the extent to which mortgage rates may rise in 2010 as some government support programs expire.

<sup>13</sup> Ibid.

<sup>14</sup> Inside Mortgage Finance, November 27, 2009.

<sup>15</sup> Ibid.

<sup>16</sup> Mortgage Bankers Association, Mortgage Finance Forecast, January 12, 2010.

Chart 15

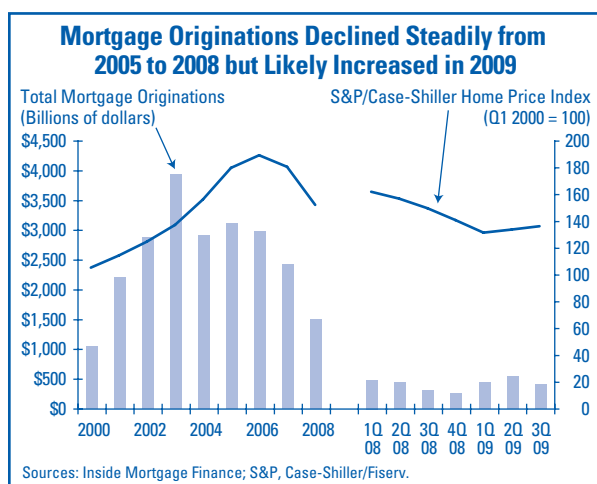
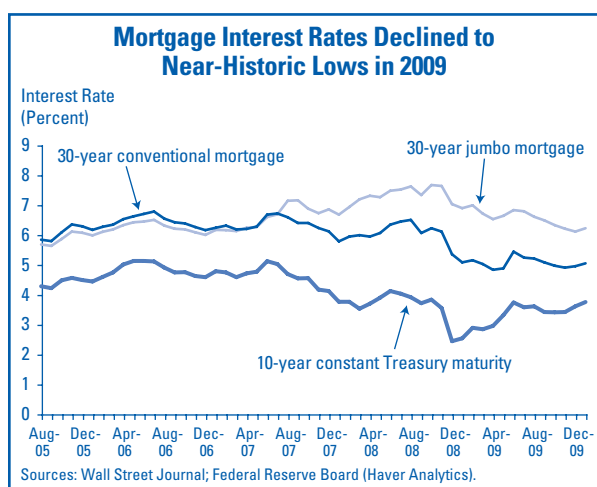


Chart 16



## Conclusion

The U.S. housing market showed tangible signs of improvement in 2009 as home price indices stabilized, inventories declined, and housing affordability reached historic high levels. Improvements in these fundamentals are still tentative, however, and are at risk of faltering after the withdrawal of the exceptional government support that helped to stabilize the housing and mortgage markets in 2009. Even if the signs of recovery continue, residential construction, home prices, and lending activity may remain subdued for years. But after more than three years of historic turmoil, a return to stable and self-sustaining housing and mortgage markets would bring welcome relief to lenders, homeowners, and the U.S. economy as a whole.

Authors: Cynthia Angell, Financial Economist  
Robert M. Miller, Economic Analyst