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3-21-2005

FDIC Memo from Richard Brown to the National Risk Committee re Rising Risks in Housing Markets

Richard A. Brown

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Federal Deposit Insurance Corporation
550 17th St. NW Washington DC, 20429

Division of Insurance and Research

March 21, 2005

MEMORANDUM TO: National Risk Committee

FROM: Richard A. Brown
Chief Economist

SUBJECT: Rising Risks in Housing Markets

Background
U.S. home prices, on average, have been growing faster than disposable incomes since 2000. During the past five years, the average U.S. home has risen in value by 50 percent, while homes in the fastest-growing markets have approximately doubled in value. Throughout this boom period, the FDIC has been analyzing home price movements and mortgage lending patterns to assess the risks of declining home prices and associated credit quality problems.

These activities have included:

- "Housing Market Roundtable," November 2002
- NRC Presentation: "Housing Markets, Consumer Finances, and Related Credit Quality Issues" December 2003
- RAC Presentation on Home Equity Lending, July 2004
- NRC Presentation: "Assessment of Risk in Home Equity Lending," September 2004
- *FDIC Outlook* articles: Fall 2000, Winter 2000 (NY), Spring 2002, Spring 2003 (SF, CHI), Winter 2003 (SF), Spring 2004, Winter 2004
- *FYI* articles: February 2002, March 2002, April 2002, September 2002, February 2005.
- Presentations to FDIC Regional Training Conferences and at FFIEC Examiner Schools (2002-04)

In our analysis, concerns have been expressed about the underprediction of credit losses in subprime portfolios, the interest sensitivity of adjustable-rate borrowers in subprime portfolios and in high-cost metro areas, the rapid growth of home equity lending, and the possibility that home prices could decline in the wake of the current housing boom. However, to date the consensus of our analysts has been that the current housing boom is not dissimilar to previous booms, and that local economic conditions would continue to be the primary determinant of future home price trends, including any harmful home price declines.

Recent Developments
The recent update of the OFHEO home price index for fourth quarter 2004 has enabled us to bring forward the historical analysis of home price booms and busts that was recently published in *FYI*. The results, summarized in Table 1 and Chart 1 (attached), show a disturbing increase in the number of markets that meet the criteria for a boom, from 33 in 2003 to 55 in 2004. The

implication of this development is decidedly negative. Through 2003, when the boom extended to 33 metro areas, price trends could be largely explained in terms of historical price volatility in these markets and strong market fundamentals. However, the dramatic broadening of the housing boom in 2004 strongly suggests the influence of systemic factors, including the low cost and wide availability of mortgage credit. **In short, the situation is beginning to look like a credit-induced boom in housing that could very well result in a systemic bust if credit conditions or economic conditions should deteriorate.**

Coincident with the broadening of the housing boom in 2004, a number of other developments took place during the year that raise our concerns about home price trends, including:

- A sharp uptick in the U.S. average annual rate of increase in home prices, from 7 percent to 11 percent – the fastest growth in nominal prices since 1978. Nominal home prices in 2004 grew almost twice as fast as disposable incomes, which grew by 5.8 percent. Adjusted for inflation, the price of the average home in the OFHEO sample increased by 7.9 percent – the fastest pace recorded in the 30-year history of the data.

- A widening gap between price increases and income growth that has become especially pronounced in high-cost metro areas. The housing affordability index (for first-time homebuyers) of the National Association of Realtors, which takes into account home prices, incomes and interest rates, slipped 3.4 points in 2004 to 77.9. This marks the second-lowest annual level for the affordability index since the recession year of 1991. The lowest reading during this interval was 75.9 in 2000, when 30-year mortgage rates were over 8 percent.

- A rising share of mortgage loans being made to investors as opposed to owner-occupiers of housing. Data from ***Loan Performance*** indicate that the investor share is approaching 10 percent nationally (from about 2 percent in 1995) and is significantly higher (20 percent) in local markets that are experiencing the strongest home price appreciation. Purchase activity by investors is troubling because they are more likely to dump properties onto the market after the onset of a downturn.

- A dramatic rise in the share of adjustable-rate mortgage (ARM) applications, from 28 percent in 2003 to 46 percent in 2004. What is troubling about this development is that it occurred despite the fact that that the average annual fixed rate for a 30-year mortgage remained virtually unchanged from 2003. ***Loan Performance*** data indicate that the ARM share is highest in areas experiencing the highest rates of home price appreciation. Taken together, these trends indicate that highly-leveraged borrowers are increasingly taking on interest-rate risk as they stretch to afford high-cost housing.

- Rising volumes of new ARM products (interest only (IO) and "option" ARMs) specifically designed to minimize initial mortgage payments. These new ARM products have become mainstream, and are increasingly being offered to borrowers with low/no documentation and blemished credit. How these products would perform in an environment of higher interest rates and/or lower home prices remains uncertain.

Similarly, it is unclear how the rising prevalence of these products would affect the selling behavior of home owners in a downturn.

- A resurgence in the origination of subprime mortgages, with the majority of subprime loans characterized by short term ARMs and prepayment penalties. ***Inside Mortgage Finance*** reports that subprime mortgage originations rose to 19 percent of total mortgage originations in 2004 from 9 percent in 2003, reversing a three-year decline in the relative size of the subprime market.

- An acceleration of growth in home equity lines of credit (HELOCs). HELOCs carried on the books of FDIC-insured institutions grew by 42 percent in 2004, up from 35 percent in 2003. Many, though not all, of these loans are thinly collateralized and almost all of them are adjustable-rate products, exposing borrowers to interest-rate risk.

Conclusion

Taken together, these concurrent trends appear to represent a significant increase in the level of risk that home prices could significantly decline in more than a few of the metro areas that have recently experienced rapid home price appreciation.

These risk factors seem to imply that metro-area housing markets are becoming increasingly vulnerable to external shocks that could end the housing boom and even lead to home price declines. These shocks could arise either in the financial markets (sharply higher interest rates or a decline in credit availability) or from adverse macroeconomic or local economic conditions.

If a significant shock were to occur now, either nationwide or in a selected market, history suggests that home price declines could begin as early as late 2005 and could extend for as many as five years after that. If future price busts were to resemble past price busts experienced at the metro-area level, the magnitude of nominal price declines could be range from 15 percent to 40 percent over five years. Based on the history of U.S. metro-area home price busts, significant increases in mortgage delinquencies and foreclosures could be expected in the event of home price declines on this scale.

Even if these risks are not realized, history suggests that, at a minimum, an extended period of stagnation will be necessary to realign home prices with underlying fundamentals in markets that have recently experienced rapid price appreciation. This outcome was shown in the recent *FYI* report to be the most common way for U.S. home price booms to resolve themselves.

Clearly, macroeconomic and local economic conditions will continue to influence home price trends, and home price trends will continue to influence the economy. The recent recovery of corporate profitability, business investment spending, and job growth are positive factors that tend to mitigate concerns about home prices to a degree. However, to the extent that home prices now appear to be driven more by credit conditions than by economic conditions, a strong

economy may not be enough to ward off home price stagnation or decline, particularly if mortgage credit becomes significantly more costly or less available in coming months.

Recommendations

This memo is not a comprehensive analysis of housing and mortgage market risks. We have cited previous FDIC analyses and conclusions, and have briefly summarized the implications of developments that took place in 2004.

Based on these observations, we recommend that the RAC and the NRC begin to consider a plan of action in three areas: 1) further analysis of home price trends and mortgage market credit risks, 2) the development of guidance for examiners and bankers, and 3) options for communicating with the public on these developments.

Because housing market conditions and mortgage loan portfolios continue to perform well at present, the NRC should consider forward-looking strategies that account for the possibility—not the certainty—of deterioration in housing market conditions. Under most adverse outcomes that can be envisioned at present, the timeframe before loan losses rise enough to threaten the solvency of FDIC-insured mortgage lenders is likely to be measured in years.

Three immediate action items are proposed:

1. Purchase additional loan-level mortgage information from ***Loan Performance***. More detailed data will facilitate analysis of how new mortgage loan programs are performing at the metro-area level. Cost estimates for the acquisition of these data are now being prepared, and are likely to range from $100,000 to $200,000 annually depending on exactly which data are purchased. Given the rising level of risk in these portfolios, an expenditure of this magnitude would be advisable.

2. Conduct additional analysis of home price and mortgage market trends. Building on previous research conducted by the FDIC and outside analysts, we propose a formal RAC project to study how a change in credit conditions could affect home price trends given the prevalence of new mortgage market products. Barbara Ryan, DIR Associate Director for Regional Operations, would be a logical choice to direct this project given her recent experience at Fannie Mae and her expertise in mortgage market issues. The project should include analysts from all three RAC driver Divisions.

3. Publish an update of the recent *FYI* article on historical home price trends. A short article providing the 2004 data and discussing the implications could be prepared within one month. However, consideration must be given to what effects an FDIC statement of this type might have on the housing markets themselves. Therefore, we propose that the NRC approve the article before it is published as an *FYI* report.

Attachments

Table 1

Chart 1

Historical Evidence of U.S. Home Price Booms and Busts

Region and City — Year-->	78	79	80	81	82	83	84	85	86	87	88	89	90	91	92	93	94	95	96	97	98	99	00	01	02	03	04
California																											
Bakersfield, CA																											47
Chico, CA																											49
Fresno, CA																											58
Hanford-Corcoran, CA																											38
Los Angeles-Long Beach-Glendale Metro Div, CA	46											49						-20									53
Madera, CA																											57
Merced, CA																											43
Modesto, CA													32													44	44
Napa, CA													34												46		
Oxnard-Thousand Oaks-Ventura, CA		39										50						-17									53
Redding, CA																											52
Riverside-San Bernadino-Ontario, CA		40																	-18								58
Sacramento-Arden-Arcade-Roseville, CA		30											32														47
Salinas, CA																								49			
San Diego-Carlsbad-San Marcos, CA		45										32															55
San Francisco-San Mateo-Redwd Cty Metro Div, CA		39										54											46				
San Jose-Sunnyvale-Santa Clara, CA	40											49											51				
San Luis Obispo-Paso Robles, CA													44					-16							46		
Santa Barbara-Santa Maria-Goleta, CA												34															53
Santa Cruz-Watsonville, CA												45												48			
Santa Rosa-Petaluma, CA													41											48			
Stockton, CA																									38		
Vallejo-Fairfield, CA																									45		
Visalia-Porterville, CA																											36
Yuba City, CA																											56
Other Western Locations																											
Bellingham, WA														43													
Bend, OR														32													
Boulder, CO																	31							31			
Carson City, NV																											44
Corvallis, OR																	36										
Denver-Aurora, CO		35																									
Las Vegas-Paradise, NV																											43
Medford, OR																											31
Mount Vernon-Anacortes, WA														37													
Ogden-Clearfield, UT																		30	30								
Provo-Orem, UT																		34									
Reno-Sparks, NV																											41
Salt Lake City, UT																		36									
Seattle-Bellevue-Everett Metro Division, WA	51												38														
Oil Patch																											
Anchorage, AK												-29															
Austin-Round Rock, TX													-25														
Casper, WY											-34																
Grand Junction, CO										-29																	
Houston-Baytown-Sugar Land, TX											-22																
Lafayette, LA											-39																
Midland, TX										-31																	
Odessa, TX												-24															
Oklahoma City, OK											-26																
San Antonio, TX												-17		-17													
New England																											
Barnstable Town, MA										62						-15	-15								48		
Boston-Quincy Metro Division, MA									74																38		
Bridgeport-Stamford-Norwalk, CT										71																	
Burlington-South Burlington, VT											32																
Hartford-West Hartford-East Hartford, CT											61						-17										
Manchester-Nashua, NH									55							-20	-20								35		
New Haven-Milford, CT										76							-16										
Norwich-New London, CT											50						-16										31
Portland-South Portland-Biddeford, ME										47																	
Providence-New Bedford-Fall River-Warwick, RI										69																	46
Springfield, MA										63																	
Worcester, MA-CT									71																34		
Other Northeast																											
Albany-Schenectady-Troy, NY										49																	
Allentown-Bethlehem-Easton, PA-NJ											48																
Atlantic City, NJ																											40
Baltimore-Towson, MD																											36
Hagerstown-Martinsburg, MD-WV																											30
Kingston, NY																											41
New York-Wayne-White Plains Metro Division, NY										67																	33
Ocean City, NJ																											44
Philadelphia Metro Division, PA											42																30
Poughkeepsie-Newburgh-Middletown, NY										63																	41
Scranton-Wilkes-Barre-Hazelton, PA											31																
Trenton-Ewing, NJ										61																	32
Virginia Beach-Norfolk-Newport News, VA-NC																											31
Washington-Arlington-Alexandria Metro Div, DC											31																40
Winchester, VA-WV																											35
Florida																											
Cape Coral-Fort Myers, FL																											38
Deltona-Daytona Beach-Ormond Beach, FL																											35
Fort Walton Beach-Crestview-Destin, FL																											32
Miami-Miami Beach-Kendall Metro Division, FL																											45
Naples-Marco Island, FL																											35
Palm Bay-Melbourne-Titusville, FL																											43
Panama City-Lynn Haven, FL																											30
Port St. Lucie-Fort Pierce, FL																											54
Punta Gorda, FL																											42
Sarasota-Bradenton-Venice, FL																											37
Vero Beach, FL																											38
Other																											
Peoria, IL							-16																				
Honolulu, HI			30										60									-16					35

Legend
BOOM = Years where real home prices increased at least 30 percent from 3 years earlier
(black bar) Years where nominal home prices declined from 5 years earlier
(City must include at least one 5-year period where nominal price declined by more than 15 percent.)
Numbers in bold indicate maximum 3-year real price increase in a boom, or maximum nominal 5-year price decline in a bust
N/A = Missing price data.

Source: FDIC (OFHEO home price index, nominal and real, using Bureau of Labor Statistics *CPI less shelter* inflation index)