

Ben S Bernanke: Housing markets in transition

Speech by Mr Ben S Bernanke, Chairman of the Board of Governors of the Federal Reserve System, at the 2012 National Association of Homebuilders International Builders' Show, Orlando, Florida, 10 February 2012.

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The economic recovery began more than two years ago, but it doesn't feel like much of a recovery for many Americans – certainly for those of you who depend on the housing sector for your living, as well as for the millions of others who have seen their home values plummet or lost their homes through foreclosure. Though some progress has been made in reversing the losses in jobs and income sustained during the recession, the pace of expansion has been frustratingly slow and the unemployment rate remains very high by historical standards. The state of the housing sector has been a key impediment to a faster recovery. In the typical economic recovery, a resurgent housing sector helps fuel reemployment and rising incomes. But as you know all too well, that scenario has not played out this time. Although the precipitous declines in construction that began in 2006 are, thankfully, now behind us, homebuilding remains depressed in most areas, relative both to where it was before the downturn and to where it will need to be to meet the needs of a growing population in the longer term.

The Federal Reserve has a keen interest in the state of housing and has been actively engaged in analyzing the housing and mortgage markets.¹ Issues related to the housing market and housing finance are important factors in the Federal Reserve's various roles in formulating monetary policy, regulating banks, and protecting consumers of financial services. Traditionally, mortgage interest rates have been a key transmission channel of monetary policy; and banks' mortgage lending policies directly affect their own safety and soundness as well as the access of creditworthy households to mortgage credit. My remarks today will focus on current housing market conditions and on how housing problems have affected borrowers, lenders, communities, and the broader economy. I'll also discuss some specific sources of our housing problems, including tight conditions in the mortgage market and the overhang of foreclosed and vacant homes.

Overview of the state of the housing market

One way to understand conditions in the housing market is to focus on the balance of supply and demand. For the past few years, the actual and potential supply of single-family homes has greatly exceeded the effective demand. The elevated number of homes that are currently vacant instead of owner occupied reflects the imbalance. According to the most recent estimate, about 1-3/4 million homes are currently unoccupied and for sale. While this figure has declined slightly during the past few years, it is nonetheless up dramatically from the first half of the 2000s, when readings of about 1-1/4 million vacant homes were the norm. Of course, housing conditions vary by region, and vacancy rates in some locations are

¹ These remarks draw heavily on research conducted by Federal Reserve staff, including work presented in the white paper on the U.S. housing market that was transmitted to the Congress in January (see Board of Governors of the Federal Reserve System (2012), "The U.S. Housing Market: Current Conditions and Policy Considerations (PDF)," white paper (Washington: Board of Governors, January), <http://federalreserve.gov/publications/other-reports/files/housing-white-paper-20120104.pdf>) and in a publication on real estate owned and vacant properties (see Federal Reserve Banks of Boston and Cleveland and the Board of Governors of the Federal Reserve System (2010), *REO and Vacant Properties: Strategies for Neighborhood Stabilization*, report (Washington: Board of Governors, September), www.federalreserve.gov/newsevents/conferences/reo_20100901.pdf).

substantially higher than the national average. For example, here in Florida the homeowner vacancy rate in the third quarter of 2011 averaged 3.2 percent, compared with the national average of 2.4 percent.²

Moreover, a very large number of additional homes are poised to come on the owner-occupied market. In each of the past few years, roughly 2 million homes have entered the foreclosure process, and many of these homes have been put up for sale, crowding out much of the need for new building. Looking ahead, the relatively high rate of foreclosures is likely to continue for a while, putting additional homes on the market and dislocating families and disrupting communities in the process.

At the same time, a number of factors are constraining demand. Household formation has been down, particularly among young adults. High unemployment and uncertain job prospects may have reduced the willingness of some households to commit to homeownership. Availability of mortgage credit is an important constraint, to which I will return later. Additionally, housing may no longer be viewed as the secure investment it once was thought to be, given uncertainty about future home prices and the economy more generally.

Not surprisingly, the large imbalance of supply and demand has been reflected in a drop in home values of historic proportions. Nationally, house prices have plunged about 30 percent in nominal terms from their peak and nearly 40 percent in real, or inflation-adjusted, terms. The imbalance of supply and demand has also been reflected in the decline in home construction that I mentioned earlier. Since 2009, the pace of single-family housing starts has averaged less than 500,000 units per year. During the 15 years before the financial crisis, the pace of single-family starts had never fallen below 1 million units per year.

In contrast to the situation for owner-occupied homes, rental markets around the country have strengthened somewhat. In particular, vacancy rates for rental properties have declined and now stand near the lower end of their range over the past eight years. Not surprisingly, rents have been increasing and the construction of apartment buildings has picked up.

To recap, the housing sector continues to suffer from serious imbalances – a marked excess supply for owner-occupied housing accompanied by a stronger rental markets. The narrative of the housing market over the next several years will revolve around the resolution of those imbalances.

Broader implications of the problems in the housing market

As homebuilders, you naturally pay close attention to the demand for new homes and their prices. These factors are important for the health of your industry, including its ability to create jobs in construction and related activities. But the problems in housing also have important implications outside the construction industry.

For instance, consider the effects on neighborhoods and communities. Foreclosures, particularly when they are geographically concentrated, can diminish the values of nearby properties.³ Many foreclosed homes are neglected or abandoned, as legal proceedings or

² National and state level homeowner vacancy rates are available on the U.S. Census Bureau website at www.census.gov/hhes/www/housing/hvs/charts/index.html.

³ See, for example, John Y. Campbell, Stefano Giglio, and Parag Pathak (2011), "Forced Sales and House Prices," *American Economic Review*, vol. 101 (August), pp. 2108–31; Dan Immergluck and Geoff Smith (2006), "The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values (PDF)," Fannie Mae Foundation, *Housing Policy Debate*, vol. 17 (1), pp. 57–79, http://findaforeclosurecounselor.net/network/neighborworksProgs/foreclosuresolutions/pdf_docs/hpd_4closehs_gprice.pdf; and Jenny Schuetz, Vicky Been, and Ingrid Gould Ellen (2008), "Neighborhood Effects of Concentrated Mortgage Foreclosures (PDF)," Furman Center for Real Estate and Urban Policy Working Paper 08–03 (New York: New York University, October), <http://furmancenter.org/files/foreclosures08-03.pdf>.

other factors delay their resale. Deteriorating or vacant properties can, in turn, directly affect the quality of life in a neighborhood, for example, by leading to increases in vandalism or crime. Moreover, the continuing price declines typical in neighborhoods with many foreclosures depress the tax base of the community. A vicious circle can get started: Increasing vacancies together with decreasing tax revenue and consequent cutbacks in services can further depress home prices, putting the goal of neighborhood stabilization even further out of reach.

As I mentioned earlier, problems in the housing market have also restrained the broader economic recovery. For example, by some estimates, declines in house prices have reduced homeowners' equity by more than 50 percent in the aggregate since the peak of the housing boom, resulting in more than a \$7 trillion loss of household wealth.⁴ Indeed, about 12 million homeowners – more than 1 out of 5 with a mortgage – are underwater, meaning they owe more on their mortgages than their homes are worth. One of the effects of declines in housing wealth is to reduce the ability and willingness of households to spend. While estimates vary, homeowners are believed to spend somewhere between \$3 and \$5 per year less for every \$100 of housing value lost.⁵ Based on those estimates, it appears that recent declines in housing wealth may be reducing consumer spending between \$200 billion and \$375 billion per year. That reduction corresponds to lower living standards for many Americans. And, importantly, lower sales of goods and services also reduce the incentives of firms to invest and hire, thereby slowing the recovery. Of course, these consumer-related effects are on top of the direct consequences of low rates of home construction for job creation and income.

Low or negative equity creates additional problems for households. It reduces financial flexibility: Homeowners who are underwater on their mortgages cannot tap home equity to pay for emergency health expenses or their children's college educations. Mobility may be affected to some degree; underwater borrowers who have difficulty selling their homes may find it more difficult to move to take new jobs. Moreover, homeowners with underwater mortgages may find it difficult or impossible to take advantage of low interest rates by refinancing their mortgages, even if they are current on their payments.⁶

The state of housing and mortgage markets may also be holding back the recovery of our financial system and the normalization of credit conditions. Mortgage delinquencies surged between 2007 and 2009 and remain high, imposing losses on lenders, mortgage insurers, and investors. Although some of the losses were the result of poorly underwritten mortgages, an increasing share of losses have arisen from prime mortgages that were originally fully documented with significant down payments, but that have defaulted due to the weak economy and housing market. The Federal Reserve and other bank regulators have used stress tests and other tools to help ensure that banks have enough capital to cover mortgage

⁴ See Board of Governors, "The U.S. Housing Market," p. 1 (see note 1).

⁵ See, for example, Raphael Bostic, Stuart Gabriel, and Gary Painter (2005), "Housing Wealth, Financial Wealth, and Consumption: New Evidence from Micro Data (PDF)," Marshall School of Business and School of Policy, Planning and Development Working Paper (Los Angeles: University of Southern California, June), www.rst.nus.edu.sg/research/symposium_files/s.gabriel.pdf; Christopher D. Carroll, Misuzu Otsuka, and Jiri Slacalek (2011), "How Large Are Housing and Wealth Effects? A New Approach," *Journal of Money, Credit and Banking*, vol. 43 (February), pp. 55–79; Karl E. Case, John M. Quigley, and Robert J. Shiller (2011), "Wealth Effects Revisited 1978–2009," NBER Working Paper Series 16848 (Cambridge, Mass.: National Bureau of Economic Research, March), www.nber.org/papers/w16848; and, John V. Duca, John Muellbauer, and Anthony Murphy (2011), "House Prices and Credit Constraints: Making Sense of the U.S. Experience (PDF)," Research Department Working Paper 1103 (Dallas: Federal Reserve Bank of Dallas), <http://dallasfed.org/research/papers/2011/wp1103.pdf>.

⁶ For more discussion of the effects of low household equity on the ability of homeowners to improve their financial positions, see Christopher Mayer, Karen Pence, and Shane M. Sherlund (2009), "The Rise in Mortgage Defaults," *Journal of Economic Perspectives*, vol. 23 (Winter), pp. 27–50.

losses while continuing to lend. On the margin, though, some lenders might be inclined to respond to losses by tightening credit terms or being more cautious about extending loans rather than by raising additional capital.⁷ In short, housing problems affect the homebuilding industry, of course, but also have much broader effects – on neighborhoods and communities, on homeowners, on the financial system, and on the vitality of the economy as a whole. This observation underscores the importance of efforts to improve the condition of the housing market.

Availability of mortgage credit

So why has the recovery in housing been so slow? One important factor is restraints on mortgage credit. Since its peak in 2007, U.S. home mortgage credit outstanding has contracted about 13 percent in real terms. In prior recoveries, mortgage credit had begun to grow four years after the business cycle peak – but not this time around.⁸

One reason for the very slow recovery in mortgage credit, despite monetary policy actions that have helped drive mortgage rates to historically low levels, is that many lending institutions have tightened underwriting conditions dramatically, relative to the pre-recession period.⁹ Given the lax standards during the credit boom, some tightening was doubtless appropriate to protect consumers and ensure lenders' safety and soundness. However, current lending practices appear to reflect, in part, obstacles that are limiting or preventing lending even to creditworthy households.

For example, mortgage originators appear to be reluctant to extend credit to some potential borrowers who could meet the underwriting standards currently set by the government-sponsored enterprises (GSEs). Indeed, fewer than half of lenders are offering mortgages to borrowers with a FICO score of 620 and a down payment of 10 percent, even though such loans could be within the GSE purchase parameters.¹⁰ A number of possibilities could

⁷ The effect of bank capital on lending is a critical determinant of the linkage between financial conditions and real activity, and has received special attention in the recent financial crisis. Modest effects of bank capital ratio changes on lending are reported in Jose M. Berrospide and Rochelle M. Edge (2010), "The Effects of Bank Capital on Lending: What Do We Know, and What Does It Mean?" *International Journal of Central Banking*, vol. 6 (December), pp. 5–54.

For an example of a macromodel where the balance sheet condition of financial institutions plays an important role in determining asset prices and economic activity, see Michael T. Kiley and Jae W. Sim (2011), "Financial Capital and the Macroeconomy: Policy Considerations," Finance and Economics Discussion Series 2011–28 (Washington: Board of Governors of the Federal Reserve System, May), www.federalreserve.gov/pubs/feds/2011/201128/201128abs.html. Empirical evidence on bank capital shocks affecting the level of economic output is provided in Macroeconomic Assessment Group (2010), *Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements*, final report (Basel, Switzerland: Bank for International Settlements, December), available at www.federalreserve.gov/pubs/feds/2011/201128/201128abs.html.

⁸ For an analysis of four types of credit-home mortgages, commercial mortgages, consumer credit, and nonfinancial business credit-around business cycle peaks since 1952, see Diana Hancock and Rochelle M. Edge (2009), "U.S. Credit Cycles: Past and Present (PDF)," study available at www.treasury.gov/initiatives/financial-stability/results/cpp/cpp-report/Documents/Fed%20US%20Credit%20Cycles%20072409.pdf.

⁹ For example, bank responses to the Federal Reserve Board's quarterly Senior Loan Officer Opinion Survey on Bank Lending Practices indicate net tightening in lending standards for mortgage originated from 2007 through 2009. Surveys since then have yet to provide evidence of unwinding that tightness even for prime mortgages that can be backed by guarantees from Fannie Mae, Freddie Mac, or the Federal Housing Administration.

¹⁰ FICO scores are based on information that a credit bureau (for example, Experian, TransUnion, and Equifax) keeps on an individual. The higher the score, which ranges from 300 to 850, the lower the credit risk. Credit scores are used to inform lenders when they assess an individual's credit risk. See Board of Governors, "The U.S. Housing Market," p. 6 (see note 1).

explain this reluctance to lend. In some cases, borrowers cannot obtain private mortgage insurance required by the GSEs. Thus, the weakened finances of private mortgage insurers could be damping mortgage credit availability for some potential borrowers. In other cases, lenders may be concerned about high servicing costs if mortgages become delinquent. Another set of concerns relates to so-called representations and warranties, which are contractual commitments by an originator concerning the quality of the loan. These contracts were designed to protect the GSEs or other purchasers of loans, but originators appear uncertain about how they will be enforced going forward and thus have been very cautious about making loans that could be viewed as less than perfect from an underwriting perspective. Learning from our experience with securitizations over the past decade, lenders and regulators alike should look carefully at rules and practices that may unduly diminish the origination of prudently underwritten mortgages.

Another reason for tight lending standards is that private-label mortgage securitizations have virtually disappeared. The difficulty of funding loans in the private-label securitization market may have discouraged lenders from originating loans to some borrowers who may be creditworthy but may not exactly fit the criteria of the GSEs or the Federal Housing Administration (FHA).

Potential first-time homebuyers have been disproportionately affected by the very tight conditions in mortgage markets. Lending to potential first-time homebuyers has dropped precipitously, even in parts of the country where unemployment rates and housing conditions are better than the national average. Indeed, the propensity of younger households – headed by adults aged 29 to 34 – to take out their first mortgage has been much lower recently than it was 10 years ago, a period well before the most recent run-up in home prices.¹¹ First-time homebuyers are typically an important source of incremental housing demand, so their smaller presence in the market affects house prices and construction quite broadly.¹² Moreover, the lack of demand from first-time homebuyers may prevent current homeowners from moving up to larger homes, for example, to accommodate growing families.

An additional issue is the implication of tight mortgage credit conditions for monetary policy. Because some creditworthy households are finding it difficult to obtain mortgage credit or to refinance, the strong actions taken by the Federal Reserve to put downward pressure on longer-term rates and to improve financial conditions have had less effect on the housing sector and overall economic activity than they otherwise would have had.

The problem of tight mortgage credit will not be solved easily or quickly. The Federal Reserve, in its supervisory capacity, continues to encourage lenders to find ways to maintain prudent lending standards while serving creditworthy borrowers. But the slow recovery of the housing market and the economy, continued uncertainty surrounding the future of the GSEs and the regulatory environment for mortgage lending, the likely continued absence of a private-label market, and more cautious attitudes by lenders are all barriers to rapid normalization of the flow of mortgage credit.

Overhang of empty and foreclosed homes

To date, policymakers have been focusing on refinancing creditworthy (but sometimes underwater) borrowers, on loan modifications, and on other ways to avert additional foreclosures. This work is obviously very important. But unfortunately, not all foreclosures

¹¹ For example, consumer credit record data show that the share of 29- to 34-year-olds obtaining their first mortgage was significantly lower in the past two years (mid-2009 to mid-2011) at 9 percent than it was 10 years earlier (mid-1999 to mid-2011) at 17 percent.

¹² See U.S. Department of Housing and Urban Development (2001), U.S. Housing Market Conditions (PDF) (Washington: HUD, November), available at www.huduser.org/periodicals/ushmc/fall2001/index.html.

can be prevented. Given the weak economy and high unemployment rates, some borrowers simply do not have the wherewithal to meet monthly mortgage payments even if their loans were to be substantially modified. Therefore, we have seen increased interest in whether anything can be done to reduce the overhang of empty and foreclosed homes.¹³

We estimate that about one-fourth of the excess supply of vacant homes for sale in the second quarter of 2011 was owned by creditors; these homes are often referred to as real estate owned, or REO properties.¹⁴ Moreover, Federal Reserve staff estimate that distressed sales, which include both short sales and non-auction sales of foreclosed homes by REO holders, now account for 30 percent of home sales. Although it is difficult to forecast future REO flows, we estimate that an additional 1 million foreclosed properties could be added to the REO held by banks, guarantors, and servicers in each of the next few years. These inflows will continue to exert downward pressure on home prices.

In contrast to the markets for owner-occupied homes, rental housing markets across the nation have recently strengthened somewhat, as I mentioned earlier. Fueled by increased demand from families who are either unable or reluctant to purchase homes, rents are up and vacancy rates for multifamily properties are down in most metropolitan areas.

With home prices falling and rents rising, it could make sense in some markets to turn some of the foreclosed homes into rental properties. According to Federal Reserve staff calculations, most REO properties are in neighborhoods with median house values and incomes that are roughly similar to the medians for the metropolitan area overall.¹⁵ Moreover, these properties are not unusually far, in terms of commuting times, from where jobs are located.¹⁶ We have compared computations of the expected annual cash flows from renting properties to the discounted prices that REO property holders typically receive when selling a home. The comparison suggests that some REO holders might come out ahead by renting, rather than by selling, some of their properties.

Moreover, keeping paying tenants in homes—including leasing to the former owners at market rents – may, in some cases, be the best way to maintain property values and the quality of neighborhoods. REO-to-rental programs could potentially also minimize the amount of time that a vacant property languishes in REO inventory. That is, appropriately structured programs could help some involuntary renters become owners again by giving them options to purchase the homes they are renting.

REO-to-rental programs are not a “silver bullet” for the housing market, and, indeed, implementing them presents some challenges. For example, selling the properties in bulk to investors to rent out has proven difficult at times because of lack of financing, although the GSEs have just announced a pilot program to facilitate such purchases. In addition, many REO properties may not be appropriate for REO-to-rental programs, either because they are in very poor condition or because they are not part of a sufficiently large cluster of properties to allow for economies of scale in their management.

¹³ For a discussion of some of the tradeoffs that policymakers might take into account in considering whether to expand these efforts to reduce the overhang of empty and foreclosed homes further, see Board of Governors, “The U.S. Housing Market” (see note 1).

¹⁴ The inventory of REO for sale is roughly 140,000 units above its 2004 level, while the inventory of vacant homes for sale is roughly 600,000 units above its 2004 level, per Federal Reserve staff calculations based on data from CoreLogic and the Housing Vacancy Survey.

¹⁵ More precisely, Federal Reserve staff estimate that about 75 percent of REO properties are in neighborhoods where the median house values and incomes are greater than 80 percent of the medians for the metropolitan area.

¹⁶ Data on median home values, income, and commute times are from the 2000 census, available on the U.S. Census Bureau website at www.census.gov/main/www/cen2000.html.

Nevertheless, REO-to-rental programs appear to have some potential for success. As of early November 2011, about 60 metropolitan areas each had at least 250 REO properties for sale by the GSEs and the FHA – a scale that could be large enough to realize efficiency gains.¹⁷ Atlanta has the largest number of REO properties for sale by these institutions, with about 5,000 units. The next-largest inventories are in the metropolitan areas of Chicago; Detroit; Phoenix; Riverside, California; and Las Vegas, each of which have between 2,000 and 3,000 units. As I noted, not all REO properties are appropriate for rental, but many do appear to be physically adequate and potentially attractive to tenants. The number of properties suitable for rental is bound to increase, as the number of properties currently in the foreclosure process is more than four times the number of properties in the REO inventory.

Other options can help with foreclosed houses that have low value and are in poor condition, homes that are not likely to be dealt with adequately through the private market. For example, land banks could handle some of these properties. Land banks are typically governmental entities that have the ability to purchase and sell real estate, clear titles, and accept donated properties. Properties may be rehabilitated as rental or owner-occupied housing or, in extreme cases, demolished, depending on the needs of individual markets. While land banks are a promising option, only some states have passed legislation to establish land banks, and most existing land banks lack the resources to keep pace with the number of low-value properties in the current inventory. It is, of course, critical that local governments pursuing land banking, or similar strategies, have staff members with the appropriate skills as well as adequate oversight to ensure that public funds are employed efficiently.

REO-to-rental programs, land banks, and other neighborhood stabilization efforts are just a few examples of the approaches that policymakers could consider to help facilitate the adjustment of the housing market.¹⁸ To be sure, every program requires careful analysis to ensure that it is effective and meets reasonable cost-benefit tests. Experimentation with alternative approaches could help find the best way forward.

Conclusion

In sum, the economic recovery has been disappointing in part because U.S. housing markets remain out of balance. Many local markets have an overhang of empty and foreclosed homes, and many potentially creditworthy homebuyers cannot obtain mortgages. The weak housing market also impairs homeowners' financial health and diminishes the quality and stability of neighborhoods and communities. For these reasons, and because the troubled housing market depresses construction activity and employment, we need to continue to develop and implement policies that will help the housing sector get back on its feet. No single solution will be sufficient. But sustained efforts to address the many interlocking factors holding back the housing market will pay dividends in the long run.

¹⁷ Federal Reserve staff calculations from data on the Department of Housing and Urban Development's Real-Estate Owned Properties Portal available at www.huduser.org/reo/reo.html. Recently, only around half of the properties in the REO inventories of the GSEs have been offered for sale at any given point. The other properties are leased to existing tenants under the provisions of the Protecting Tenants at Foreclosure Act, are located in states with a redemption period after foreclosure, or are under renovation or otherwise unavailable for sale.

¹⁸ Other potential approaches include loan modification programs, principal reduction protocols, and the use of short sales and deeds-in-lieu of foreclosure. Such approaches are discussed in Board of Governors, "The U.S. Housing Market" (see note 1).