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# Housing Market Developments and Their Effects on Low- and Moderate-Income Neighborhoods

Remarks by

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Good morning. I very much appreciate your invitation to speak today. The theme of this ninth annual Federal Reserve Bank of Cleveland Policy Summit, "Housing, Human Capital, and Inequality," could not be timelier. Almost no community in America has escaped the effects of the economic downturn, but many low- and moderate-income communities were hit especially hard, including a large number in and around our host city of Cleveland. As one sobering example, almost 10 percent of current Cleveland residents who have ever taken out a mortgage have a foreclosure reflected on their credit report--a rate double that of the rest of the nation.[1]

I will focus today on the state of the housing market and emphasize developments pertaining to low- and moderate-income neighborhoods. I will then discuss policy initiatives to address some of the challenges confronting the housing market.

**The State of the Housing Market**

As you know, house prices are a critical element in understanding the state of the housing market. Nationally, house prices have been falling for six years, and most industry analysts expect further declines before prices bottom out. Households are equally pessimistic about the trajectory of house prices. According to one prominent survey, only 15 percent of homeowners expect house prices to increase over the next year, and barely half expect house price increases over the next five years.[2]

Largely because of the fall in house prices and the sustained high rate of unemployment, about 4-1/2 percent of mortgages in the United States are currently in foreclosure, and three or more payments have been missed on an additional 3-1/2 percent.

[1] I am indebted to Federal Reserve Board staff members Karen Pence and Larry Slifman for their assistance in preparing these remarks. These remarks reflect my own views and not necessarily those of others in the Federal Reserve System.
[2] See Thomson Reuters/University of Michigan Surveys of Consumers.

In total, 2-1/2 million foreclosures were initiated in 2010, and a similar number of foreclosure starts are expected in 2011.

One factor depressing house prices is the large number of "distressed" home sales. A distressed sale occurs when a borrower sells a house through a short sale or when a lender sells a property that it acquired through a foreclosure; these sales have represented about half of all home sales in recent months. The condition of the property can deteriorate considerably over the course of the foreclosure proceedings, and these damaged properties are typically sold to the next buyer at a significant discount. Commonly, market values of properties and the selling price of similar homes in the neighborhood become depressed as a consequence. The blight associated with these properties can further depress the value of nearby homes.

Housing market conditions are also being hurt by the large inventory of empty and unsold homes in the United States. Nearly 2 million homes were estimated to be vacant in the first quarter of 2011. Although this number is down some from the highs seen in 2008, it is about 60 percent higher than the average level over the 20 years before the 2008 surge. And, with the pipeline of delinquent and foreclosed homes overflowing, the inventory of empty and unsold homes will likely stay elevated for some time, which will maintain downward pressure on house prices and damp construction of new homes.

Recovery in the housing market is being restrained further by tight mortgage credit. According to the Federal Reserve's April 2011 Senior Loan Officer Opinion Survey on Bank Lending Practices, commercial banks have begun to ease standards on credit card and other consumer loans, but they have not yet started to ease standards for residential mortgages, even for those extended to borrowers in the prime market.[3] One sign of this tight credit is the higher credit scores on recent mortgage originations. For example, the median credit score on a prime mortgage originated to purchase a home rose from around 740 in the 2005-07 period to around 780 since mid-2010. Part of this rise may reflect borrower characteristics--perhaps demand for housing has fallen more among borrowers with lower credit scores--but tighter terms and standards undoubtedly play a significant role. These tight standards indicate that some households that might like to purchase a home simply can't obtain the credit to do so.

Under these circumstances, it's not surprising that the demand for housing remains weak. Builders of new homes overwhelmingly report "low to very low" traffic of prospective buyers, as well as expectations of "poor" sales in the months ahead. Similarly, about one-third of the respondents to the Senior Loan Officer Opinion Survey noted weaker demand for mortgages in the first quarter of 2011. Demand is low, in part, because households remain uncertain about the durability of the economic recovery and therefore do not want to commit to such a large investment--especially an investment that may decline further in price.

Although economists may disagree about which of these factors is playing the largest role in the ongoing fall in house prices, all agree that the collapse has left deep scars on many American families and their financial well-being. The drop in house prices is a major factor in the sharp declines in household net worth during the recession. Newly released data from the Federal Reserve Board's 2007-09 Survey of Consumer Finances panel, for example, indicate that the typical homeowner saw a drop in his or her

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[3] See the Senior Loan Officer Opinion Survey on Bank Lending Practices; data are available on the Board's website at www.federalreserve.gov/boarddocs/SnLoanSurvey.

real net worth of about 19 percent over the 2007-09 period. For some homeowners, the loss in net worth was much larger; indeed, nearly one-fourth of homeowners saw their net worth drop by 50 percent or more.[4]

House prices have continued to decline, on net, since 2009, and at this time, more than one-fourth of mortgage borrowers are underwater--that is, have mortgage balances that exceed the current values of their homes. Because of their negative equity stake, many households cannot take advantage of lower interest rates by refinancing their mortgages, nor can they easily sell their homes to pursue better job opportunities elsewhere. In addition, borrowers who are underwater--especially those who also experience a job loss or a cut in work hours or wages--are more likely to default on their mortgages and possibly face foreclosure.

One consequence of the weak demand for housing and the sky-high rate of foreclosures has been a significant drop in the homeownership rate. After fluctuating in a fairly narrow range around 64 percent for nearly three decades, the homeownership rate rose significantly between 1994 and 2004, reaching a peak of 69 percent. Since then, however, the homeownership rate has retraced about half of its earlier increase as many former homeowners have moved into rental housing or made other living arrangements, such as moving in with family members.

Are there any bright spots in this gloomy picture? As the macroeconomy has begun to improve, albeit at an uneven rate, the share of homeowners becoming newly delinquent on their mortgages--that is, missing a payment for the first time--has

[4] For more findings from the 2007-09 Survey of Consumer Finances panel, see Jesse Bricker Brian Bucks, Arthur Kennickell, Traci Mach, and Kevin Moore (2011), “Surveying the Aftermath of the Storm: Changes in Family Finances from 2007 to 2009,” Finance and Economics Discussion Series 2011-17 (Washington: Board of Governors of the Federal Reserve System, March), www.federalreserve.gov/pubs/feds/2011/201117/201117abs.html.

decreased. In addition, low interest rates and lower house prices have made homeownership potentially more affordable. In fact, by one measure, housing is hovering around its most affordable level in the 22-year history of the series.[5] Of course, tight credit standards have precluded many households from taking advantage of the affordable conditions. Over time, however, as the economy continues to grow and credit conditions improve, more households should be able to benefit from the greater affordability.

**The Housing Market in Low- and Moderate-Income Communities**

As I indicated earlier--and as many of you already know--these sobering national trends have had even more devastating effects in low- and moderate-income neighborhoods. To investigate this issue further, researchers at the Federal Reserve classified neighborhoods into three broad categories: low and moderate income, middle income, and high income.[6] A comparison of housing and mortgage market conditions in low- and moderate-income neighborhoods with conditions in high-income neighborhoods reveals several interesting facts.[7]

One notable fact is that house prices in low- and moderate-income neighborhoods rose more than in other neighborhoods during the national boom in house prices, and subsequently fell more during the bust. For example, from 1998 through 2006, house prices, as measured by the CoreLogic repeat-sales house price index, rose 11 percent per

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[5] See National Association of Realtors (2011), "Affordable Housing Real Estate Resource: Housing Affordability Index," National Association of Realtors, www.realtor.org/research/research/housinginx.

[6] Zip codes and census tracts were classified by whether median household income in that Zip code or census tract was below 80 percent of the median in its metropolitan statistical area, 80 to 120 percent of the median, or more than 120 percent of the median. These income thresholds are used under the Community Reinvestment Act to identify neighborhoods as low and moderate, middle, or high income. Under this scheme, a neighborhood is low income relative to other neighborhoods in its own metropolitan statistical area.

[7] As might be expected, conditions in middle-income neighborhoods lie between the low- and moderate-income and high-income neighborhoods.

year on average in low- and moderate-income neighborhoods, compared with 9 percent per year in high-income neighborhoods. Likewise, during the bust from 2007 to 2010, house prices fell 8 percent per year in lower-income neighborhoods, compared with 7 percent per year in high-income neighborhoods. House price changes also varied more across lower-income neighborhoods than high-income neighborhoods, implying that a greater share of lower-income neighborhoods exhibited price swings that were more dramatic than the overall average.

Linked inextricably to the volatility in house prices in these communities was the volatility of mortgage lending. Mortgage lending surged in low- and moderate-income neighborhoods during the housing boom, and subsequently contracted sharply. Over 2003 to 2006, purchase mortgage originations increased 60 percent in low- and moderate-income neighborhoods but less than 20 percent in high-income neighborhoods.[8] Unfortunately, during this surge in lending many borrowers were encouraged to take out subprime mortgages with teaser rates and prepayment penalties as well as alt-A mortgages with negative amortization features. When these markets collapsed, precipitating an overall tightening in credit conditions, mortgage originations through 2009 fell by 65 percent in low- and moderate-income neighborhoods and 50 percent in high-income neighborhoods.

The greater decline in house prices in low- and moderate-income neighborhoods has had several unfortunate consequences for mortgage borrowers. As of March 2011, borrowers with prime mortgages who lived in these neighborhoods were twice as likely

[8] For a further discussion of the increase in lending over this period, see, Christopher Mayer, and Karen Pence (2008), "Subprime Mortgages: What, Where, and to Whom?" Finance and Economics Discussion Series 2008-29 (Washington: Board of Governors of the Federal Reserve System, June),.www.federalreserve.gov/pubs/feds/2008/200829/200829abs.html.

to be underwater as borrowers with prime mortgages in high-income neighborhoods. Because houses are, on average, a much larger share of assets for homeowners in low- and moderate-income neighborhoods, these homeowners had few other assets to draw upon to compensate for the drop in house prices.[9] As a result, borrowers in these neighborhoods who suffered a job loss or other economic misfortune were more likely to default on their mortgages. Indeed, 13 percent of mortgages originated to borrowers in low- and moderate-income neighborhoods were 90 days or more overdue in the first quarter of 2011, compared with 6 percent of mortgages originated to borrowers in high-income neighborhoods.

The higher rates of delinquency suggest that homeownership may have been a riskier proposition over the past decade for households in low- and moderate-income neighborhoods than in high-income neighborhoods. Delinquency rates are higher, in part, because borrowers in these communities were more likely to end up in complicated or inappropriate mortgage products, unacceptably often as a result of unfair and deceptive lending practices. But borrowers in these communities may also be more sensitive to house price declines because they may have fewer financial resources outside of housing, and they may have had little equity in the property to begin with.[10]

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[9] Houses represented nearly three-fourths of total assets for homeowners in low- and moderate-income neighborhoods in 2007, according to the Survey of Consumer Finances. In contrast, homes typically represented a bit over half of gross assets for homeowners in higher income neighborhoods in 2007.

[10] The median combined loan-to-value ratio on securitized subprime purchase mortgages originated in 2005 through 2007 was 100 percent. See Christopher Mayer, Karen Pence, and Shane M. Sherlund (2008), "The Rise in Mortgage Defaults," *Journal of Economic Perspectives*, vol. 23(1), pp. 27-50, also available at www.federalreserve.gov/pubs/feds/2008/200859/200859abs.html.

For an example of the relationship between house prices and homeownership outcomes, see Kristopher Gerardi, Adam Shapiro, and Paul Willen (2007), "Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures," Working Paper 2007-15 (Boston: Federal Reserve Bank of Boston), www.bos.frb.org/economic/wp/wp2007/wp0715.htm.

Although investing in a home has risks, it also has positive qualities. Households may feel more comfortable investing in housing than in other investments because houses are familiar, tangible, and provide concrete ties to the community. Regular mortgage payments may serve as a useful savings commitment device. Finally, homes pay out a "dividend" in the form of housing services--that is, providing a place to live. The housing services provided by an owner-occupied home--such as control over one's own space--may be preferable to those provided by a rental.

In making a decision about homeownership, prospective buyers need to consider the risks as well as the benefits--in particular, the possibility that house prices can fall and that such declines can have long-lasting effects on their financial well-being. The current decline in national house prices and the preceding run-up were, of course, unusually large even by historical standards. But even during times when house prices were rising nationally, prices fell steeply in certain local markets, such as Texas in the mid-1980s or Massachusetts in the early 1990s. And homeowners are not alone in their difficulty in predicting house prices: The record of industry analysts and economists is also mixed. Although many professionals understood that house values were high at the peak of the recent cycle--probably unsustainably so--there was no consensus about the extent or severity of the coming fall.[11]

In light of this experience, it makes sense to think about the development of wealth-building vehicles for low- and moderate-income households that have some of the

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[11] For examples, see Kristopher Gerardi, Andreas Lehnert, Shane M. Sherlund, and Paul S. Willen (2008), "Making Sense of the Subprime Crisis," *Brookings Papers on Economic Activity* (Washington: Brookings Institution Press, Fall), pp. 69-145, also available at www.bos.frb.org/economic/ppdp/2009/ppdp0901.htm; and Kristopher S. Gerardi, Christopher L. Foote, and Paul S. Willen (2010), "Reasonable People Did Disagree: Optimism and Pessimism about the U.S. Housing Market before the Crash," Public Policy Discussion Paper 10-5 (Boston: Federal Reserve Bank of Boston, September), www.bos.frb.org/economic/ppdp/2010/ppdp1005.htm.

desirable qualities of homeownership as an investment, but perhaps have less of the risk. Such instruments should be simple and transparent and might include a savings commitment component. Although households will likely need to take on some risk in order to accumulate wealth, the risk should not have the potential to destroy a household's financial security. Continued research in this area is badly needed.

**Looking Forward**

Looking forward, I unfortunately can envision no quick or easy solutions for the problems still afflicting the housing market. Even once it begins to take hold, recovery in the housing market likely will be a long, drawn-out process. For its part, the Federal Reserve will continue to use its policy tools to support the economic recovery and carry out its dual mandate to foster maximum employment in the context of price stability. As the economic recovery progresses and potential homebuyers become more confident about the durability of the recovery, it seems probable that more families will be willing to enter the housing market.

The other factors weighing on the housing market--the high share of distressed sales, the large inventory of vacant homes, and tight mortgage credit--are not affected as directly by macroeconomic policy. Alleviating these conditions will require a different set of responses. Next I will discuss some Federal Reserve initiatives in these areas, and highlight areas in which work still remains to be done.

The high share of distressed sales and the large inventory of vacant homes stem, in large part, from the elevated levels of foreclosures. Federal Reserve officials have stated time and again over the past several years that we believe that lenders and servicers should work actively with troubled borrowers to pursue mortgage modifications whenever possible. The consequences of not conducting modifications are simply too high--for borrowers, for lenders, for the local communities, and for the overall economy.

In the event that a borrower in default no longer wishes to remain in the home, we have urged lenders to make every effort to pursue alternatives to foreclosure, such as short sales or deeds-in-lieu of foreclosure.[12] These alternatives may help the borrower transition to a better housing situation as quickly and seamlessly as possible. In addition, these alternatives may shorten the length of time that a property lies vacant. The deterioration of a property while it lies vacant not only reduces the market value of the property, but also imposes considerable costs on the surrounding community by depressing the prices of neighboring homes, attracting crime, and creating financial burdens for local governments.

The effects of vacant homes on local communities are an example of what economists call a negative externality--that is, an action taken by one party that imposes an uncompensated burden on another. In this case, the externality occurs because lenders, investors, and servicers typically do not bear the burdens resulting from the negative effects of foreclosures on neighborhood house prices, crime, and government budgets. As a result, fewer short sales likely occur than would be best for communities overall. This externality is one of the reasons why a government program that provides financial incentives to servicers and borrowers for pursuing short sales or deeds-in-lieu of foreclosure remains undersubscribed.[13] Indeed, as of March 2011, only about 12,000

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[12] In a deed-in-lieu of foreclosure, the borrower voluntarily deeds the home to the lender in exchange for being released from the mortgage obligations.

[13] The program is the Home Affordable Foreclosures Alternatives component of the Making Home Affordable program.

agreements had been initiated under the program. This is an area where lenders can and certainly should do more.

The Federal Reserve, in conjunction with other financial banking regulators and government agencies, has embarked on initiatives to help resolve the existing stock of vacant properties and prevent even more properties from entering foreclosure.[14] The first initiative involves revisions to the rules governing the Community Reinvestment Act (CRA) that took effect in January. Under the revised rules, depository institutions receive positive consideration in CRA examinations for participating in community stabilization activities in areas designated as eligible for funds under the Neighborhood Stabilization Program authorized by the Congress. Such activities might include donating properties that they've taken possession of--known as real estate owned--to nonprofit housing organizations or providing financing for the purchase and rehabilitation of foreclosed, abandoned, or vacant properties. Although it is too early to assess the effect of these CRA changes, the participation of more than 600 banks and industry stakeholders in a webinar recently hosted by the Federal Reserve indicates that there is interest and potential in this tool. Our host today, the Federal Reserve Bank of Cleveland, played a key role in envisioning these changes to the CRA rules.

The second initiative, which is ongoing, is the development of uniform national servicing standards. These standards should address the proper handling of both performing and non-performing loans, including loss-mitigation procedures and

[14] The other financial bank regulators for the revised Community Reinvestment Act rules are the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation. The other financial bank regulators and government agencies for the national servicing standards are the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the Federal Housing Finance Administration, the Department of Housing and Urban Development, and the Department of the Treasury.

foreclosure processing, and should lead to improved customer treatment and better transparency and oversight of mortgage servicers' processes. The intent is for servicers to be held to the same standards regardless of their regulator and regardless of whether the loans being serviced are held on the originator's books, have been sold, or have been securitized. By having a common set of standards for the mortgage servicing industry, the financial regulatory agencies will emphasize the importance of servicing practices that promote the best interests of borrowers and the broader housing market.

Let me turn finally to mortgage credit. No one wants to see a return to the loose lending standards that prevailed in the run-up to the crisis, but households and the economy will benefit if we can foster sustainable homeownership with an increase in responsible lending. The Federal Reserve, in coordination with other agencies, has recently published two notices of proposed rulemaking that will affect the provision of mortgage credit. I will describe these rules and explain how we are attempting to balance the objectives of better underwriting and access to credit in the rulemaking process. I should note that both rulemakings are open for comment, and we very much welcome your feedback.

The first set of rules implements the risk-retention provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Broadly speaking, these provisions require issuers of all types of asset-backed securities, including mortgage-backed securities, to retain 5 percent of the credit risk of the assets they securitize.[15] In the run-up to the financial crisis, a disproportionate share of mortgage loans was made by lenders

[15] The proposed rules were issued jointly. See Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, Securities and Exchange Commission, and Department of Housing and Urban Development (2011), "Credit Risk Retention; Proposed Rule," (Docket No. 2011-1411), *Federal Register*, vol. 76 (April 29), p. 24090.

who funded their originations through securitizations and effectively retained none of the risk. These lenders had little financial stake in whether the borrowers ultimately repaid the mortgages--sometimes known as having skin in the game--and thus had a reduced incentive to engage in careful underwriting.

The proposed rules outline a flexible menu of ways that securitizers can meet the risk-retention requirement. The proposed rules also have provisions that affect the mortgage market in particular. The rules recognize that the guarantees provided by Fannie Mae and Freddie Mac lead them to retain 100 percent of the credit risk of the mortgages they securitize, and because this guarantee is currently backed by financial support from the government, the proposed rules do not require these government-sponsored enterprises to retain additional risk. Further, as required by the Dodd-Frank Act, the proposed rules exempt securitizations backed entirely by very high-quality mortgages--so-called qualified residential mortgages (QRMs)--from risk retention. The act directed the regulators with rulemaking authority to define QRMs taking into account "underwriting and product features that historical loan performance data indicate result in a lower risk of default." To define QRMs, regulators conducted extensive research on the types of mortgages that have low credit risk, even in stressful economic environments. Under the proposed definition, a qualified residential mortgage must be a closed-end, first-lien mortgage to purchase or refinance a one- to four-family property. Mortgage features cannot include negative amortization, interest-only payments, or the potential for large interest rate increases. Debt-to-income ratios must be conservative, and the borrower's credit history must be relatively clean. Finally, the maximum loan-to-value ratio is 80 percent for purchase mortgages, with no junior lien at closing; 75 percent on rate and term refinance loans; and 70 percent on cash-out refinance loans.

We know that some have expressed anxiety that this narrow definition will result in many borrowers paying higher mortgage rates or being excluded from the credit markets. However, with many creditworthy mortgages not qualifying under the QRM standards, deep funding markets for these products are more likely to develop. As a consequence, we expect that the price difference between mortgages that do and do not qualify under the QRM standard will be relatively small.

Another recently proposed set of rules seeks to ensure that, from now on, all mortgages meet higher underwriting standards, regardless of whether the mortgages are sold into securitizations or retained by lenders on their balance sheets. The QRM standards must also be at least as conservative as these universal higher standards. These revisions to the regulations implementing the Truth in Lending Act are also required by the Dodd-Frank Act. The proposed rules, which were released by the Board in April, establish expanded "ability to repay" requirements for most consumer credit transactions secured by a dwelling. These rules will be finalized by the Consumer Financial Protection Bureau, the new independent agency created by the act.

I know that we are approaching the end of this session, and I fear that my recital of the woes of the housing market may have prevented you from fully enjoying your lunch. So let me close with a reminder that although the problems in the housing market are challenging, many individuals and groups are making a difference, including several pioneering community groups here in Cleveland. We in the Federal Reserve System are pleased to support these efforts by providing data, research, and support, including facilitating important conferences and conversations like the one here today.

Thank you very much for your attention. I look forward to answering any questions you might have.