

Impact of Government Housing Policies on the Real Estate Industry

Edward J. Pinto (Edward.Pinto@AEI.org)

Co-director, International Center on Housing Risk

HousingRisk.org

American Enterprise Institute

1.22.16

The views expressed here are those of the author alone and do not necessarily represent those of the American Enterprise Institute

Principles of Home Valuation for Lending Purposes

- Since value depends on location, and location on convenience, and convenience on nearness, the intermediate steps may be eliminated and say that value depends on nearness (1903)¹
- If a new utility does not arise, exchange [sales] prices may advance and recede, while intrinsic values do not change. If a new utility arises, both exchange prices and intrinsic values will alter their levels (1903).¹
- [s]peculative elements cannot be considered as enhancing the security of residential loans [rather they] enhance the risk of loss to mortgagees who permit them to creep into the valuations of properties...(1938)².
- In [a seller's market] it is more likely that the liberalization of mortgage terms will increase both price and the amount of the debt with debt service remaining approximately unchanged.... [l]iberalization of terms easily becomes capitalized in higher prices (1951).³
- [in transitioning] from a buyer's to a seller's market, maximum terms become so commonly used they tend to be considered the minimum (1951).³
- Never underestimate the government's willingness and ability to add leverage to stimulate the market and ignore the impact on raising home prices or default risk (Pinto - 2009).

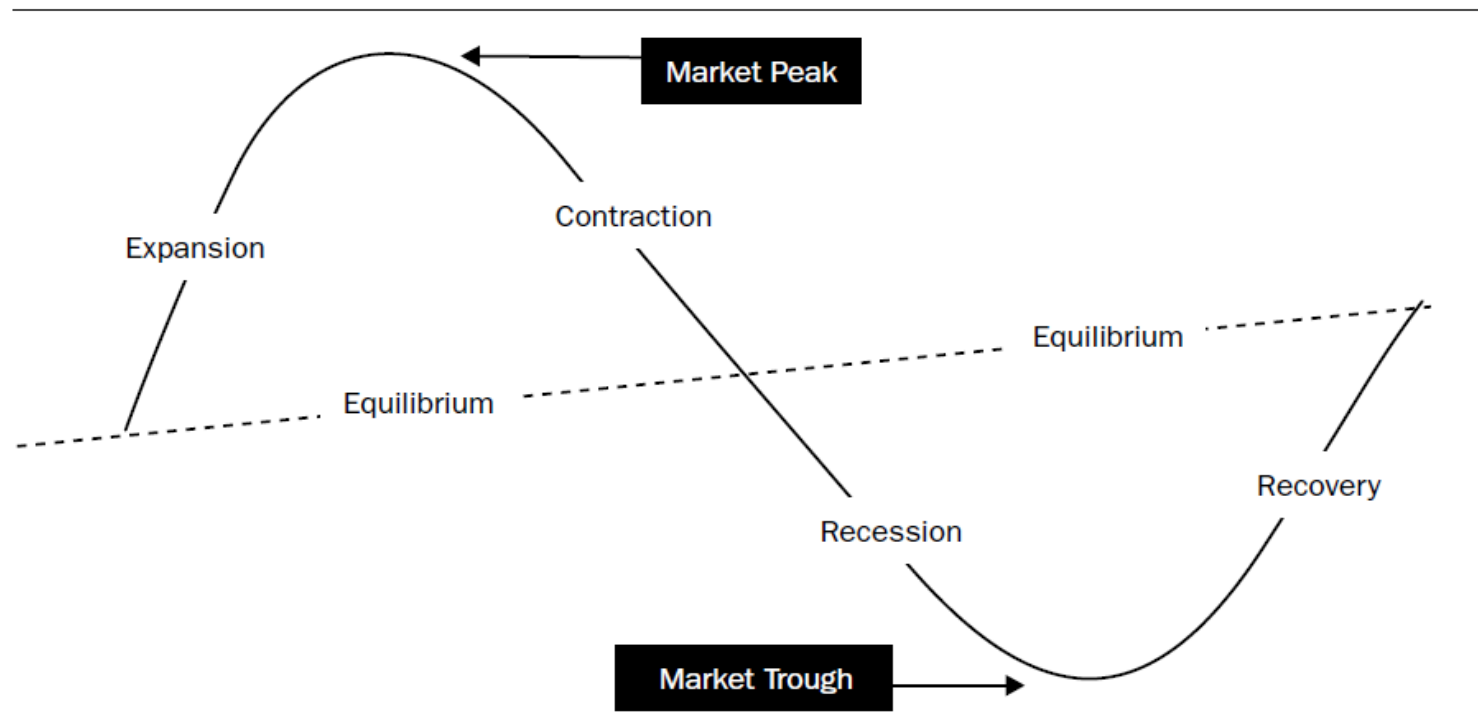
¹ Hurd, *The Principles of City Land Values, 1903*

² FHA 1938 Underwriting Manual (main authors: Ernest Fisher and Frederick Babcock)

Real estate markets are cyclical and constantly changing⁶

The Dictionary of Real Estate Appraisal, fifth edition, defines *market equilibrium* as, “The theoretical balance where demand and supply for a property, good, or service are equal. Over the long run, most markets move toward equilibrium, but a balance is seldom achieved for any period of time.”

Figure 1 Typical Stages Fundamental Market Cycle

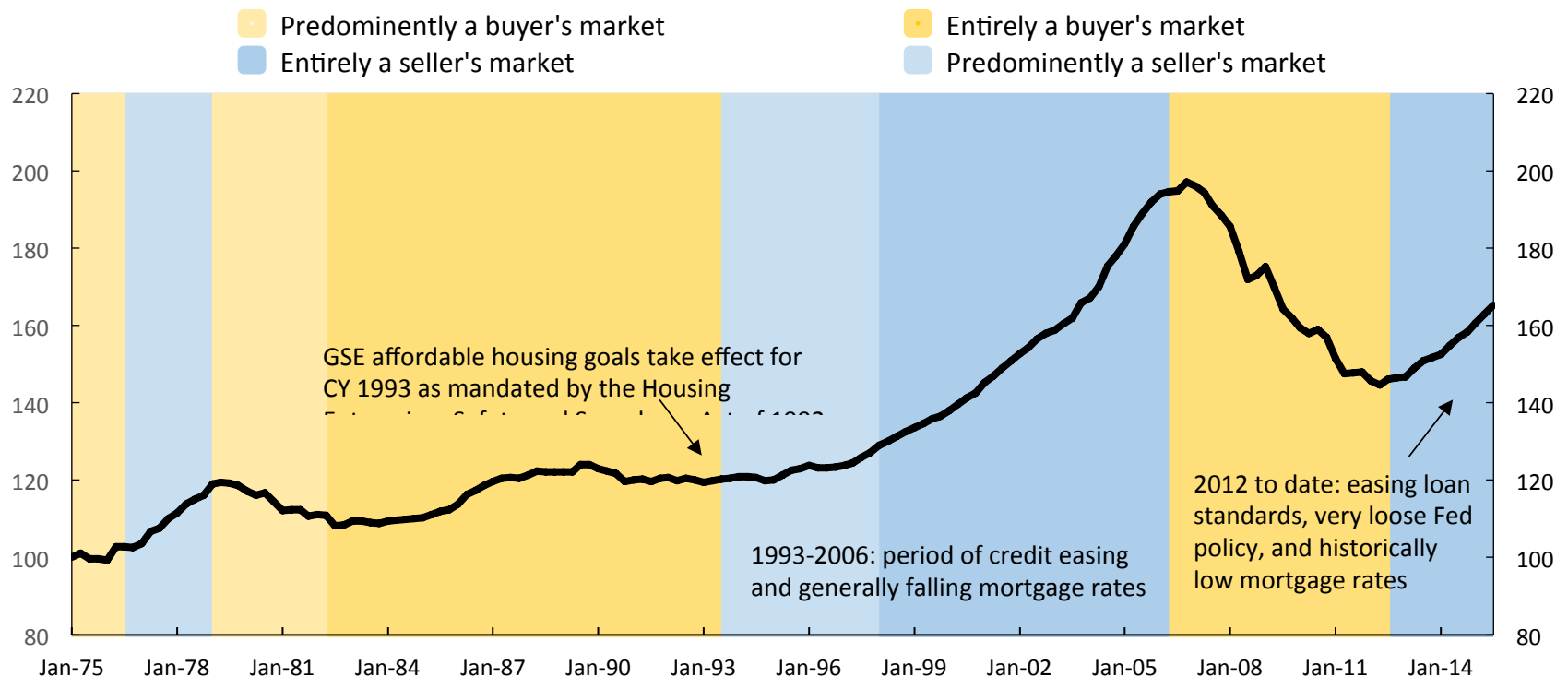


⁶Jorgensen and Fanning, *One Step Further—Implementing the Recommendations of Guide Note 12*, *The Appraisal Journal*, Summer 2013

Increasing Leverage in a Seller's Market Fuels Price Booms

14% increase in real home prices since early 2012 trough. Pattern is similar to initial years of the prior full-blown seller's market that begin in 1998. If this trend continues, risk of a serious house price correction will become ever larger.

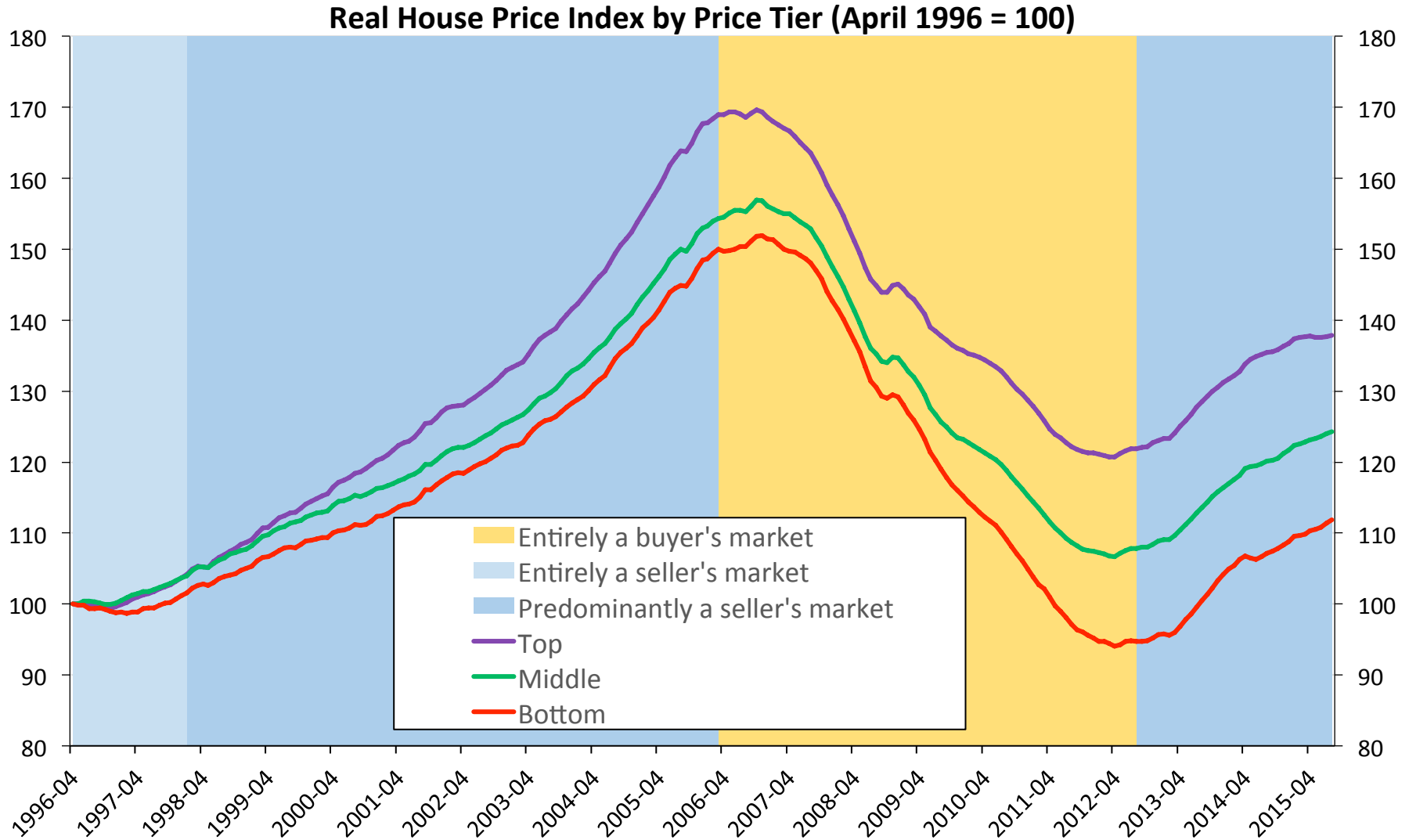
Real House Price Index (1975:Q1 = 100)*



* Calculated as FHFA's all-transaction house price index divided by BEA's price index for personal consumption expenditures.

Note: National Association of Realtors (NAR) defines a seller's market as inventory that is less than or equal to 6 months of sales. NAR data pertain to existing homes; not available before June 1982. Data from the Census Bureau for new home inventories used before June 1982.

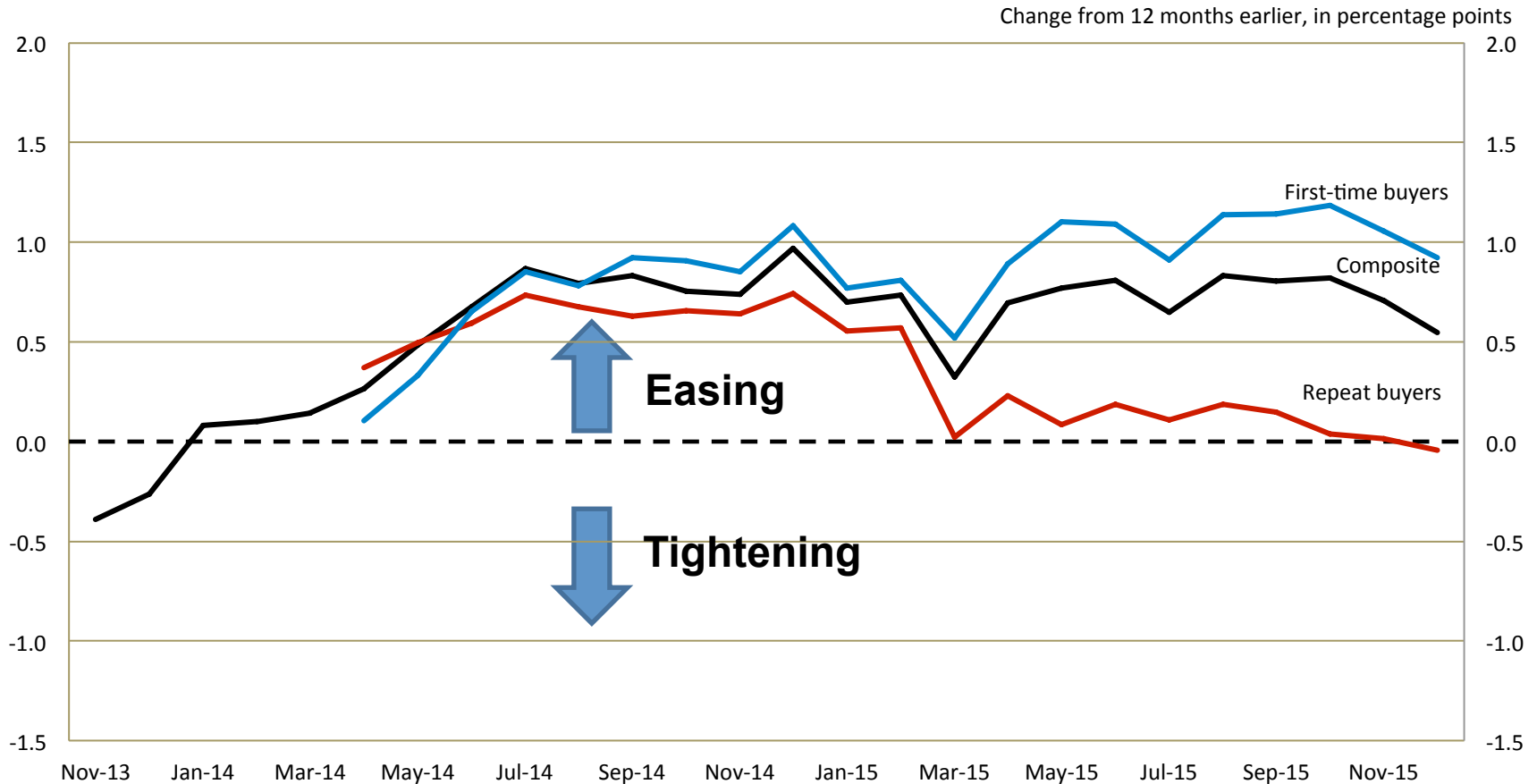
Volatility Impact Greatest on Lower Income Borrowers (Bottom Price Tier): up 19% since 2012 Trough and a Total of 12% in 20 Years



Source: Zillow national tier price indices divided by BEA's price index for personal consumption expenditures.

Purchase NMRI: Credit Easing Trend Nears 3 Years

Purchase National Mortgage Risk Index has increased an average of about ¾ ppt. year-over-year since Jun. 2014, with first-time buyers accounting for nearly all the rise since early this year. At this pace, NMRI would rise to 18% by 2023, near level reached in 2007.

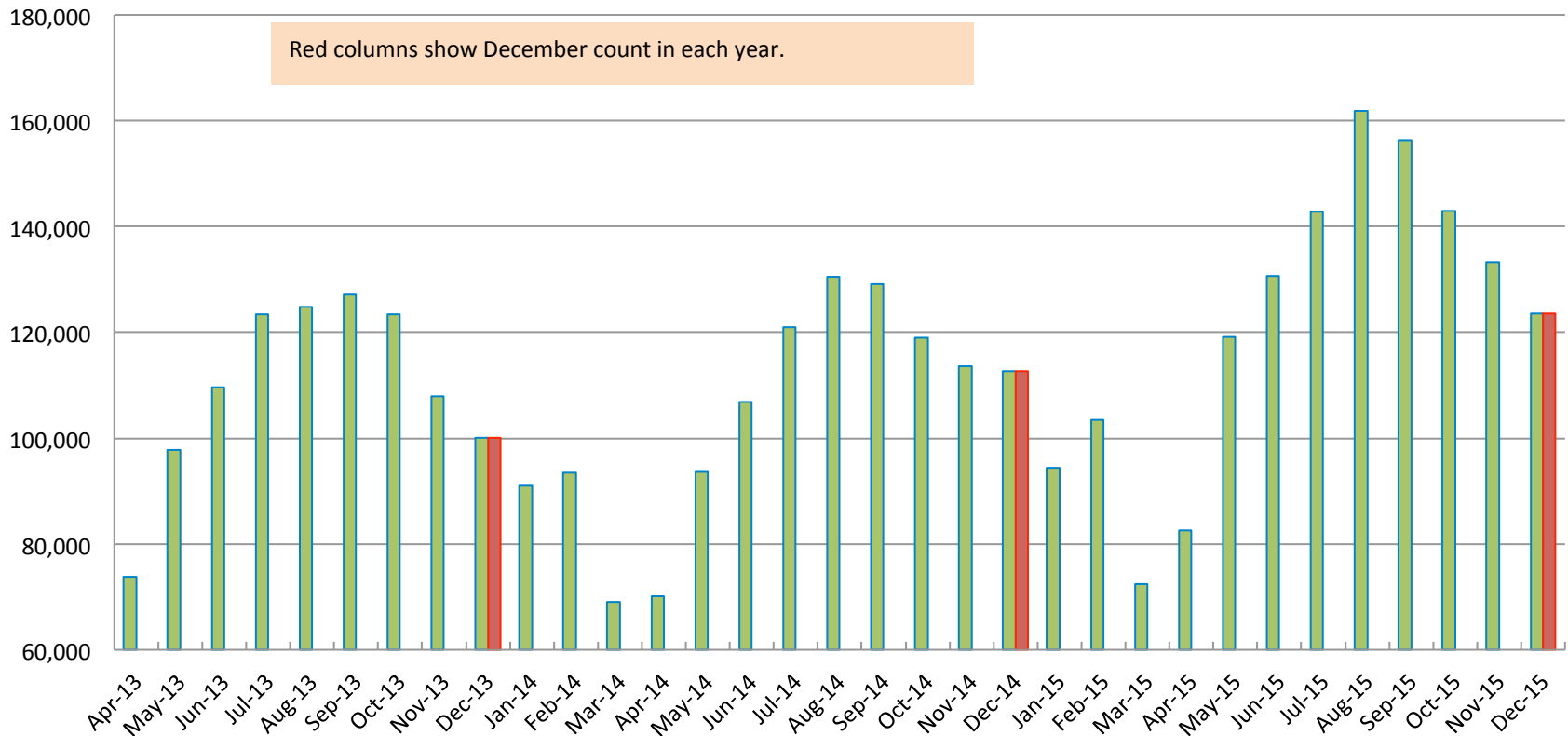


Note: Includes all types of NMRI purchase loans (primary owner-occupied, second home, and investor loans).

Source: AEI International Center on Housing Risk, www.HousingRisk.org.

The “Missed” Boom in First-Time Buyers

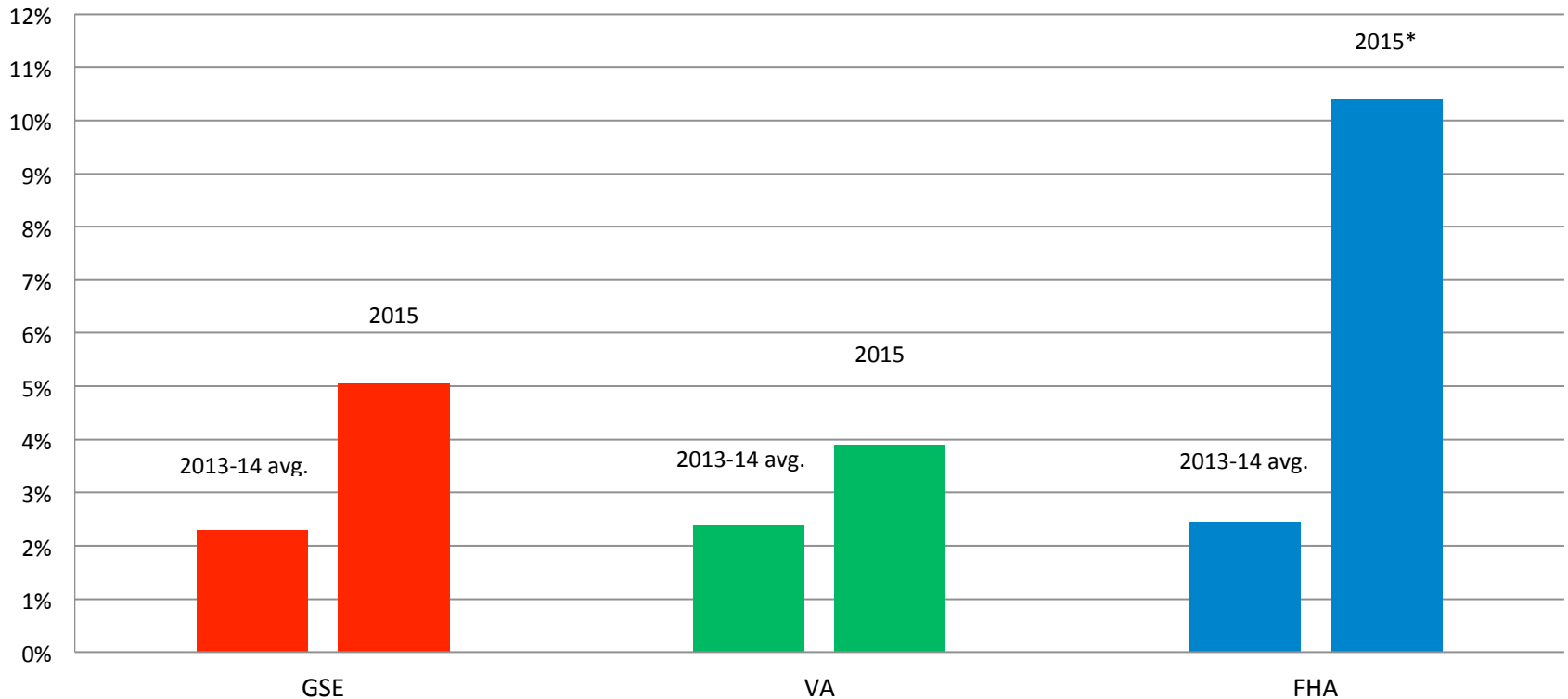
14 month string of year-over-year first-time buyer volume gains (mostly double digit) began in Nov. 2014



Note. The number of primary owner-occupied first-time buyer home purchase mortgages with a government guarantee. December 2015 count is a preliminary estimate. Source. AEI International Center on Housing Risk, www.HousingRisk.org.

House Price Change for First-time Buyers, Mar. to Dec.

Sharp price increase this year for homes purchased with FHA loans, reflecting boost to buying power from MIP cut. FHA price acceleration from 2013-14 is 5 to 6 percentage points more than for GSE- and VA-financed purchases.



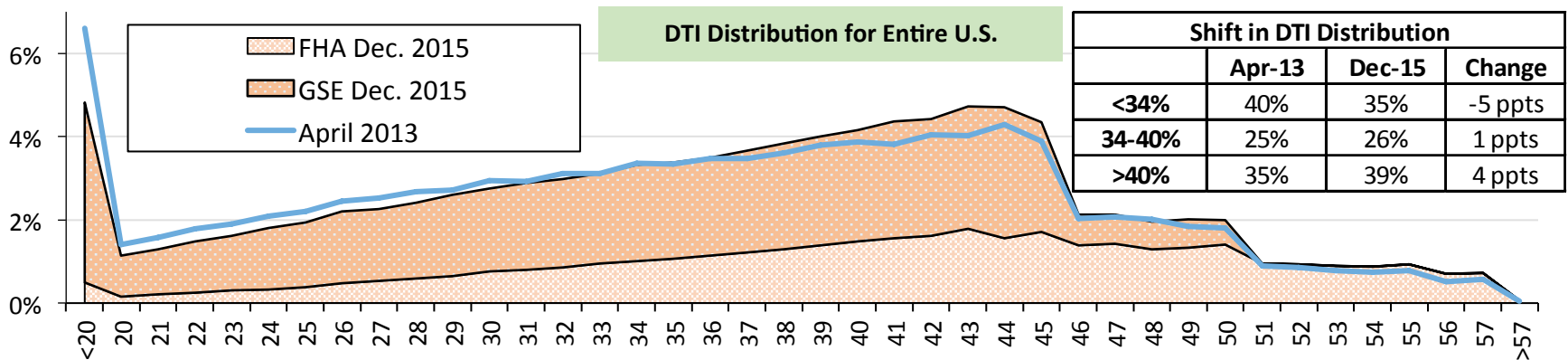
*Excludes March loans with the lower mortgage insurance premium.

Note: Price changes estimated from coefficients on monthly dummy variables in loan-level regressions that control for variation in CLTV, FICO score, DTI, and property state. Regressions estimate median prices.

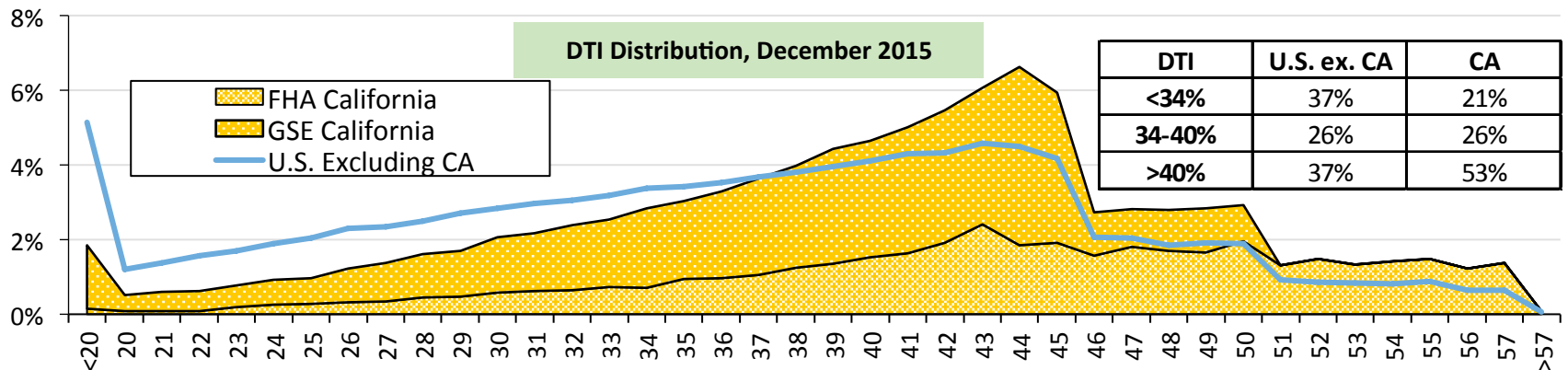
Source: AEI International Center on Housing Risk, www.HousingRisk.org.

DTI Is No Longer A Serious Leverage Constraint*

DTIs have been shifting higher as the rise in house prices has been outpacing income gains. The share of DTIs below 34% has declined, with an offsetting rise in the share of DTIs $\geq 34\%$, but primarily concentrated above 40%.



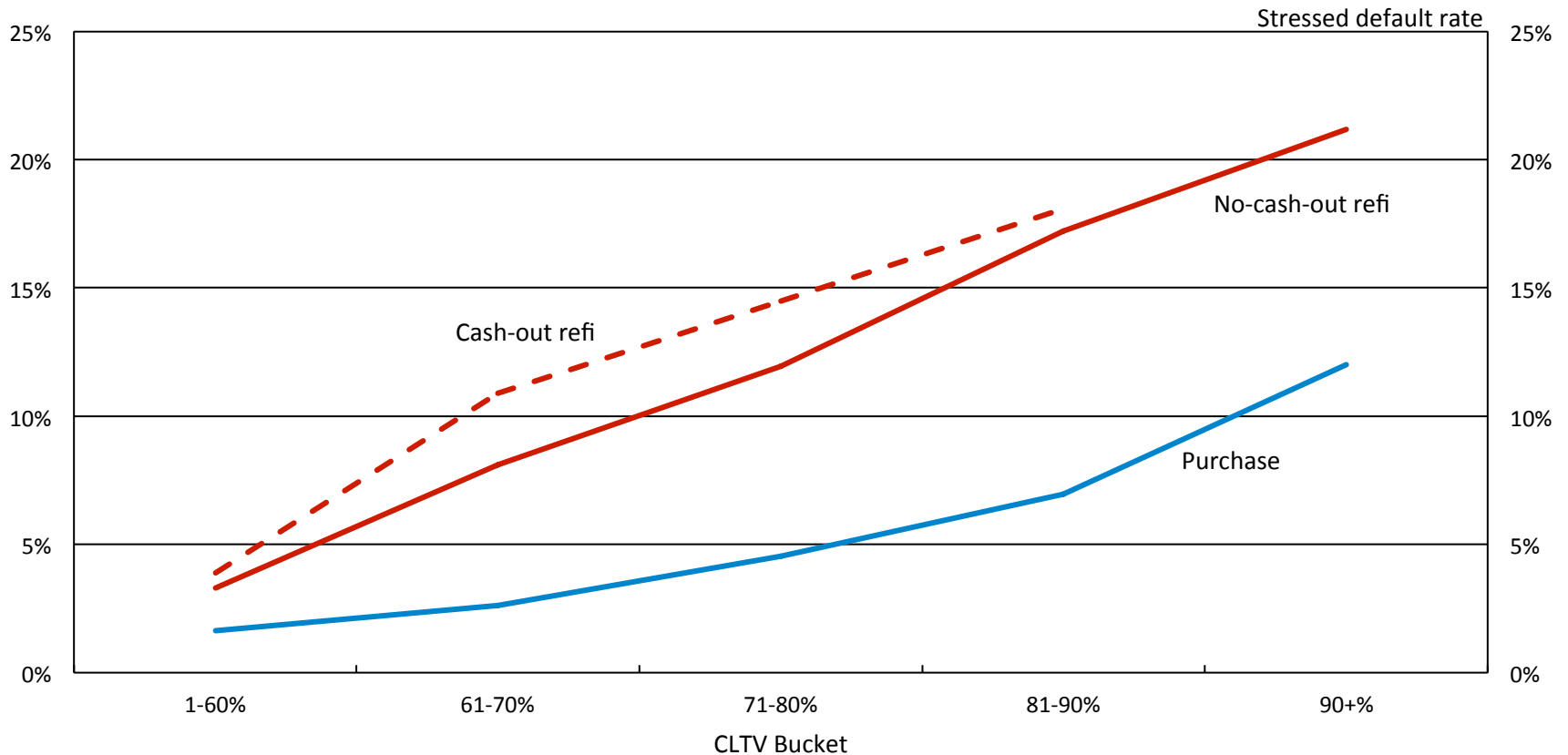
California shows how the shift could intensify as affordability worsens.



*Data pertain to all agency purchase loans for primary owner-occupied properties.
Source: AEI International Center on Housing Risk, www.HousingRisk.org.

Refis: Higher Stressed Default Rates Across All CLTV Buckets

Compared to an identical purchase loan, refis have higher stressed default rates across all CLTV buckets. Cash-out refis are even riskier than no-cash-out refis – a 61-70% CLTV cash-out has the same default risk as a 90+% purchase loan.



Note: All stressed default rates computed for FICO score of 720-769 and DTI of 39-43%.
Source: AEI International Center on Housing Risk, www.HousingRisk.org.

An appraisal should be the guard rail against allowing speculative elements to become predominant in mortgage lending

- Today, the home mortgage appraisal is of limited value to lenders, investors, and borrowers, as it only provides an opinion of a property's most likely market selling price.
 - Confusingly called market *value*, when it is in fact an opinion of current market *price*.
 - Methodology for determining likely selling price is subjective and opaque
- What an appraisal should provide is an opinion as to the relationship between most likely market selling price and intrinsic or fundamental value.
 - Needed to properly evaluate the right amount to lend in a particular transaction.
- Especially true under market conditions where abnormalities in price levels indicate presence of serious quantitative differentials between intrinsic value & selling price concepts.

Components of the appraisal of the future

- Current market *price*
 - *A robust and transparent opinion of a property's most likely market selling price that is based on much more information than three subjectively chosen comparison properties*
- Market cycle history*
 - *Create and review 10-year nominal and real home price trend to determine current position in market cycle relative to equilibrium*
- History of buyer's (>6 mo.) and/or seller's market (<=6 mo.) for existing homes**
 - *Determine whether a buyer's or seller's market based on months of home inventory divided by listings/sales rate; determine whether a buyer's or seller's market*
 - ***If real prices are increasing, it is almost certain that a seller's market is present***
 - ***Market disequilibrium more likely the longer an uninterrupted seller's market continues, particularly with respect to the lowest 1/3 price tier***
- Buying power due to change in leverage**
 - *AEI's Center on Housing Risk plans to incorporate into its Mortgage Risk Index in 2016*
- Land value and change in land share trends**
 - *Calculate land value by extraction using exchange value minus replacement cost*
- Whether real price change due to leverage growth or improving utility or a mix
 - *Evaluate role played by income leverage vs. fundamentals (ie. job & real income growth)*

*For the MSA, the subject property's market area and price tier,(zip code or below), and the subject property

**For the MSA and the subject property's market area and price tier (zip code or below)