BUILDING NEW FOUNDATIONS

Credit conditions limit the housing recovery

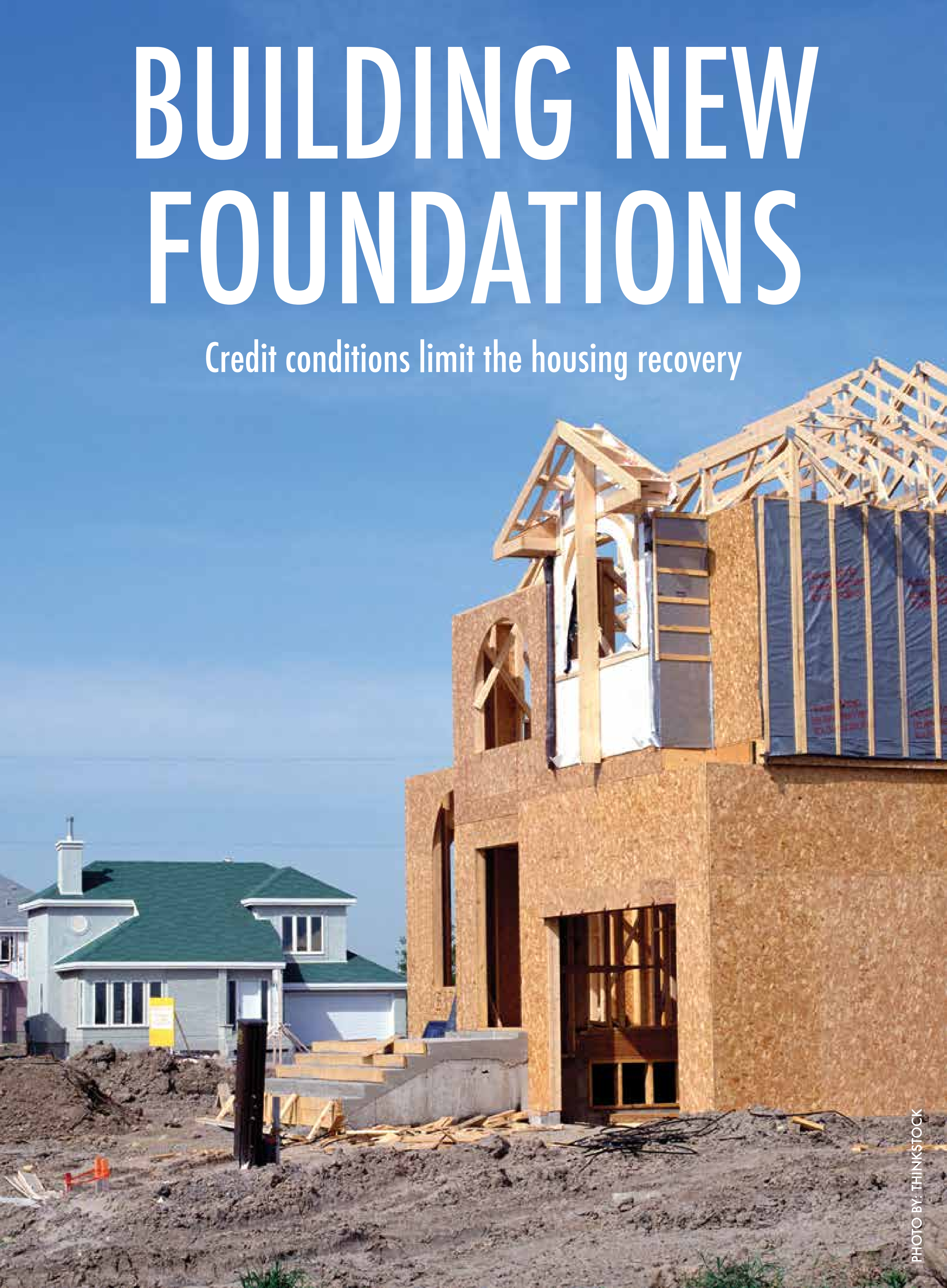


PHOTO BY: THINKSTOCK

Homes sales fluctuate with the economy. Prices increase, decline, then increase again. Credit thresholds for mortgages tighten and loosen. Inventory expands and contracts.

Economic crises have greater impacts on these fluctuations; but home sales, in the past, have recovered fairly quickly following recessions. The most recent financial crisis—and the aftermath of regulatory reform—however, have made the recent housing recovery somewhat more difficult.

Making a sale

Existing home sales continued to improve for the fourth month in a row in July. Single-family existing home sales rose 2.7 percent to a seasonally-adjusted annualized rate of 4.6 million units, the highest pace since September 2013. The consecutive increases show the housing market continues an upward trajectory and is consistent with the improving labor market.

Despite these good numbers, however, the housing market remains sluggish.

Char MacCallum, owner and broker of Char MacCallum Realty in Kansas City said people are still buying homes, but the market could be better.

"We are having a hard time getting people approved for loans," she said.

And available homes are in short supply, she added.

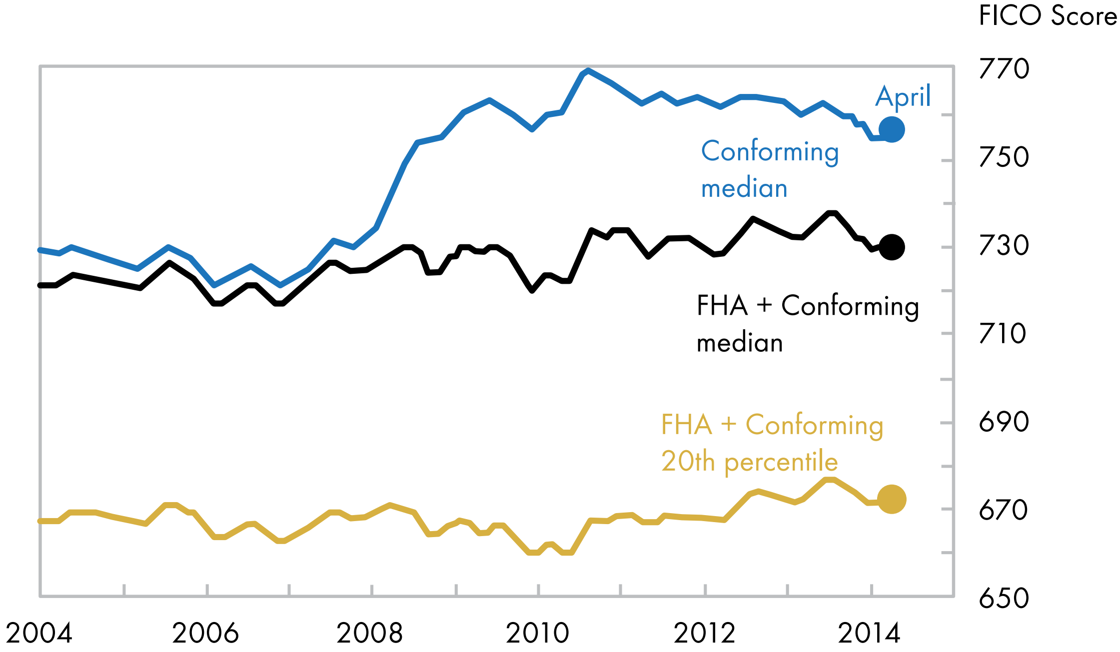
The months of supply remained at 5.5 at the current sales pace in July, as total housing inventory increased at about the same pace as sales. Existing homes sales have had a minor effect on GDP growth, which remained unchanged at 2.5 percent.

Home prices continue to remain below pre-crisis levels, which is good for buyers, but prices are increasing. Closing a sale, however, is not the same as it was before the financial crisis, MacCallum said.

Closing the sale

Senior Economist Jordan Rappaport with the Federal Reserve Bank of Kansas City and Paul Willen, a senior economist at the Federal Reserve Bank of Boston, found that

CREDIT SCORE BY LOAN SEGMENT



Note: Percentiles are for purchase loans with FICO ≥ 620
Source: Black Knight Financial

originations of mortgages to purchase a home fell in the first quarter this year—the lowest level since early 2011.

"Credit conditions have been a key factor constraining the recovery," the economists explained. "With the onset of the housing crisis, banks and other lenders significantly tightened their criteria for making mortgage loans. Most visibly, they stopped making 'subprime' loans to households with especially poor credit histories."

Households with FICO credit scores below 620—a score that might be triggered by being 90 days late on a loan payment—essentially lost any access to mortgage borrowing. Lenders no longer allowed borrowers to take out a "piggy back" second mortgage to make a down payment.

Rather than exclude or cut off poor-credit households outright, the economists said, lenders have been applying strict underwriting conditions on all borrowers.

Federal Housing Administration (FHA) lending has allowed many buyers with imperfect credit or the inability to make a large down payment—the average requirement is 20 to 25 percent—maintain access to mortgage borrowing. FHA-guaranteed purchase loans typically require a down payment of 3.5 percent.

MacCallum says this leaves potential buyers even more dependent on government-guaranteed loans, and the increase in guaranteed-government loan applicants has caused a lending log jam, especially when agencies, such as the United States Department of Agriculture (USDA), make cutbacks.

"It used to take six weeks to close, now it takes 10 weeks," she said.

Buyers who receive approval from traditional mortgage lenders, such as banks, can watch sales fall through because of strict underwriting, a conservative appraisal process and strict documentation requirements, including questions over title.

Rappaport and Willen say these standards constitute sound lending practices and are a positive development in lending. But the level of vigilance suggests that regulatory uncertainty may also play a role.

"Regulations and standards have made it more difficult to buy a home," MacCallum said. "It's keeping many people who might otherwise qualify from getting a loan."

Mortgage tightening

The tightening of mortgage credit is reflected in the Senior Loan Officer Opinion Survey. Each quarter the Federal Reserve asks a large number of banks whether they have tightened, loosened or left unchanged their standards for mortgage lending. The percentage of banks reporting they had tightened standards minus the percentage reporting they had loosened standards remained high, quarter by quarter, from early 2007 through early 2010. Since then, there has been almost no offsetting loosening.

According to Rappaport and Willen, beginning in 2007, FHA lending grew rapidly. It accelerated in 2009 after Congress authorized the FHA to more explicitly target a broader set of households. To do so, the FHA increased the maximum loan it would guarantee to $730,000. Single-family purchase mortgages guaranteed by the FHA grew from 300,000 in 2006 to 1.1 million in 2010. Over these years, originations of all other types of purchase mortgages plunged. Correspondingly, the FHA share of single-family purchase originations jumped from 5 percent to 44 percent.

The success of FHA lending in maintaining access to credit is borne out by credit scores on newly originated purchase mortgages. From early 2007 to mid-2010, the median FICO score on a conforming mortgage increased by almost 50 points. But the median FICO score for the combination of conforming and FHA-guaranteed mortgages increased only 10 points. Over this same interval, the 20th percentile FICO score for combined purchase originations—a better measure of access to mortgage borrowing—was unchanged.

FHA lending has traditionally focused on helping low- and moderate-income households purchase a first house. Hence, it allows for some credit impairments and requires only a modest down payment.

For the combination of conforming and FHA purchase mortgages, the share of households making a down payment of 5 percent or less—net of any secondary liens—has remained comparable to what prevailed during the housing boom and higher than what prevailed previous to it. Consistent with this, the share of lending in the combined segments to purchase a house in a low- or moderate-income community is actually higher today than during the housing boom.

Buying a home

Despite the new regulatory conditions, people are still able to buy a home.

Kimberly Teen purchased a home in the Kansas City area in December 2013. She worked with a mortgage adviser and real estate agent to secure a mortgage and buy a home that was within her means.

She began the process two years ago and had originally approached her bank about obtaining a mortgage.

"They told me that my credit needed to be clean," she said. "It wasn't bad; I had a lot of things on my credit report that were inaccurate."

A mortgage adviser—a type of financial adviser who helps people secure home mortgages—helped her work on her credit rating, and within two months, she qualified for a home loan. Teen saved enough money for a down payment, but also enough money in reserve—in case she lost her job—to make mortgage payments.

"If anything were to happen, if I lost my job, I wanted to make sure that along with unemployment I had enough to make the monthly payments," she said.

She also didn't want to get in a situation where the purchase of a home had unforeseen, out-of-pocket expenses.

"I'm a single mother so that was huge for me," she said.

Teen said working with the right people, such as a good real estate agent and financial adviser, made the process seamless. She had heard a lot of horror stories and she wanted to make sure the people she worked with helped her make the right decisions when purchasing her first home.

She purchased a home built in 2011 that was below original market value and in a good neighborhood. Teen secured a mortgage at a 4 percent interest rate, the seller paid the closing costs and she closed on the home within two weeks. Her monthly payment was the same amount she paid in rent before purchasing the home.

"It was definitely worth going through," she said.

And although it's a buyer's market right now, Teen said, people need to be prepared

KIMBERLY TEEN PURCHASED HER FIRST HOME IN DECEMBER 2013 after a two year search. She worked with a mortgage adviser and real estate agent to make sure she found a home that met her needs and fit within her budget.


PHOTO BY BOB GREENSPAN

for the process, such as meeting credit requirements, finding the right home that fits within their means and working with the right people.

Staying put

Homes are more affordable today than pre-financial-crisis markets, but people are not moving like they were before. The number of Americans moving to new cities and buying homes has decreased dramatically. There are a number of reasons besides tight credit standards, including a sluggish economy, weak income growth, student debt and the lack of new homes. But much of it has to do with similarity of job options from city to city.

When people do move, according to studies, they move for family, climate and employment.

Among people who have moved long distances, the number of those who cite housing as their primary motivation for doing so has more than doubled since 2007. And the Tenth District states appear to have some of the most affordable housing and lowest cost of living in the United States. For example, Oklahoma City has outpaced most other cities in growth since 2011, becoming the 12th-fastest-growing city last year. It also has won over a coveted demographic, young adults age 25 to 34, going from a net loss of millennials to a net gain.

But of those who moved more than 500 miles, the share who said they were chiefly motivated by housing has risen from 8 percent in 2007 to 18 percent in 2014, the earliest year such data is available, according to the Census Bureau. The desire for a new, better or cheaper home and the opportunity to buy instead of rent were among the housing-related reasons people cited.

The story was different from 2000 to 2006, when cities with high-cost housing grew more quickly than those with affordable housing, according to an analysis of metro areas by Redfin, a national real estate brokerage firm. From 2006 to 2012—years that encompass the housing bust, recession and recovery—that pattern reversed itself, with most low-cost cities growing 2.5 percentage points more than high-cost cities. The analysis excluded cities with poor job growth.

Improving the market

Since the housing crisis, Rappaport and Willen say the FHA, the Federal Housing Finance Agency, the Consumer Financial Protection Bureau, and other government and private organizations have been continually developing a new regulatory framework. Lenders fear that departures from the evolving standards will result in considerable costs, including the forced buyback of loans sold to Fannie and Freddie and the rescinding of FHA mortgage guarantees.

This has created uncertainty among lenders, causing them to enact restrictions based on possible future standards. It's these type of conditions that have been a key factor constraining the recovery, they said.

The economists suggest that clarifying what constitutes approved lending may help relax credit conditions with minimal increase in risk.

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KEVIN WRIGHT, EDITOR

FURTHER RESOURCES

"Tight Credit Conditions Continue to Constrain Housing Recovery"
By Jordan Rappaport and Paul Willen
www.KansasCityFed.org/publicat/research/macrobulletins/mb14Rappaport-Willen0707.pdf

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.