“The Housing Market Recovery?”

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Chairman Johnson, Ranking Member Shelby, and other distinguished members of the committee:

Thank you for the invitation to testify at today's hearing. It is my honor to be here to discuss the current state of the nation's owner-occupied housing markets.

At this time, housing markets for single-family-owned homes are fragile. The most recent data available from Radar Logic's Residential Price Index show that home prices continued to decline in January 2011, with prices down over 34% from peak values. According to the S&P/Case-Shiller Home Price Index, the US National Home Price Index declined 3.9% during the fourth quarter 2010 and is down 4.1% for the year. In the most recent data, for the fourth quarter of 2010, the Census Bureau reports homeowner vacancy rates at 2.7%, up from 2.5% in the third quarter of 2010. This is nearly 50% higher than the historical average vacancy rate for single-family homes. Looking ahead, the size of the current inventory of unsold homes and the so-called 'shadow' inventory will likely depress the price of homes further before prices stabilize. Industry estimates predict that housing prices will fall 5% to 10% more this year. The expectation of continued price declines will in itself deter home buying. Thus, the most pressing issue in the housing market today is how and when the excess inventory of homes will be cleared.

Existing single-family home sales have increased in recent months. The National Association of Realtors reports an annualized rate of 5.36M in January, which is significantly higher than the 5.09M level of January 2009. Over a quarter of these homes sold in 2010 were distressed (including those in default, scheduled for foreclosure auction, and REO) according to RealtyTrac. Homes in process of foreclosure sell for a 28% discount in RealtyTrac's most recent data. Not only do distressed homes sell for less, but with many homes still potentially in the foreclosure pipeline, an estimated 4 million homes—approximately 2 million in the foreclosure process and 2 million in default—this potential additional supply suppresses expected home prices. Homes with mortgages that are currently underwater may add to this potential excess supply. According to CoreLogic's report of March 8, 2011, 23.1% of all residential properties with a mortgage were in negative equity at the end of the fourth quarter of 2010, up from 22.5% in the third quarter, resulting in an aggregate level of negative equity of $751 billion.

Although this supply overhang threatens to depress home prices further, national housing prices may not be far from reaching a bottom. The most important factors affecting the fundamentals of demand for owner-occupied housing are employment, income, interest rates, and the availability of financing. These factors impact demand for owner-occupied homes through household formation and the desired rate of homeownership. Household formation in particular depends upon job growth and is critical for the growth in demand for housing whether rental or owner-occupied. The recovery of housing markets requires that underlying fundamentals continue to improve. This includes critically that jobs continue to grow and that interest rates remain stable or increase within limited bounds as the economy gains strength.

Today the national housing price-to-rent ratio, as calculated by Case-Shiller, is near the level observed in 2002-2003, which, given the low interest rates then prevailing, was not, I believe, significantly inflated. At today's lower interest rates, the current rent/price ratio today is not inconsistent with a bottoming of housing prices nationally. Homes today are affordable relative to income. According to the National Association of Realtors' Housing Affordability Index, a family at the median income has 185% of the income needed to purchase a median-priced home.

Nonetheless, in the short run and intermediate run, the big threat facing the housing market is the uncertainty surrounding the supply overhang. The glut of foreclosed and delinquent homes currently sitting on the market could take years to work through. How long might it take to absorb the excess housing inventory? According to the Census Bureau, the total US housing stock consisted of 130 million units in 2010. It is generally estimated that average population growth requires approximately 1.5 million housing units to be constructed annually. Combining this number with the number of units that need to be replaced due to deterioration, 0.4 million according to the Congressional Budget Office, results in demand for approximately 2 million units annually. Housing starts are at historic lows, approximately 500k units annually, thus far from the historic average demand, and the current overall vacancy rate is approximately 10% or 13 million units. To reduce overall vacancy to historic norms of approximately 7% requires the absorption of 3% (or 4 million) homes. Assuming household formation rates return to their historic levels, the excess vacancy could be absorbed in as little as two to three years so that by 2014, markets could reach equilibrium, on a national basis. However, the threat to this scenario is the supply of homes waiting on the sidelines. We run the risk of overshooting on the downside and falling beneath the price level justified by fundamentals—just as we far overshot equilibrium prices on the way up to the peak in 2006.

Thus pending foreclosures and potential future foreclosures from the shadow supply weigh heavily on the housing market. This potential additional supply of unsold homes suppresses home prices today and adds to uncertainty in the future. Last year, over a quarter of homes sold were foreclosures and short sales. If prices increase, underwater homeowners will be made whole as the market restores their equity, thus over time reducing the number of homes sold in distressed sales. If the share of distressed sales rises, housing prices will fall further. A reentry into a vicious cycle of house price declines could push more homeowners underwater, precipitating more defaults, which will drive prices lower again. I am not predicting this, but it is a possible outcome.

Distressed home sales and underwater mortgages are concentrated regionally. According to RealtyTrac, in January 2011, five states -- California, Arizona, Florida, Michigan, and Nevada --

accounted for over half of the nation's foreclosure filings. The differences in job growth and inventory across states add to the regional disparate housing outcomes.

In addition to regional differences, national uncertainty remains. In the short and intermediate run, a slowing of job growth, a rise in interest rates, or a decline in the availability of credit would cause further price declines on a national scale. In any case, distressed properties will continue to account for a large proportion of total sales in the coming months, although defaults appear to be diminishing with the overall increased stability of markets. We may be at a turning point or may shortly be in the second half of 2011. But a recovery will depend upon continued strengthening of job markets and increased consumer confidence. For an incipient recovery to take hold, the availability of financing and, given the policy direction of moving away from federal support of mortgage markets, the availability of private capital to finance mortgages is crucial. Uncertainty affecting the housing market includes the availability of financing, the terms under which loans will be made, as well as the path of disposition of mortgages that are currently in distress.

Today approximately 90% of housing finance is federally supported. Borrowers who do qualify for home loans are able to access historically low mortgage rates for 30-year, fixed-rate loans. During the housing bubble, the market abandoned the 30-year, fixed-rate mortgage. Instead of long-term, fixed-rate, amortized mortgages, the bubble featured the wild growth of non-amortized, adjustable-rate mortgages with short, introductory teaser periods. They were designed to be refinanced upon the expiration of a short 2-3 year teaser period, as the promotional interest rate expired. The 30-year, fixed-rate mortgage has served American homeowners well; it was a source of tremendous stability for consumer finance and the national economy. Questions about whether such mortgages will be available or what will replace them is likely to be an additional and increasingly important factor creating uncertainty in housing markets. Private markets have now recognized the instability that can be a feature of housing finance, especially with volatile capital flows and potential interest rate rises with global capital market disruptions. Going forward, the housing finance system will be less vulnerable to economic disruptions affecting the ability to refinance if borrowers continue to have access to standardized fixed-rate mortgages.