



Residential Housing: The Problem and the Solution

By Robert Huebscher

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If arresting the decline in residential housing prices is a precondition to a broader economic recovery, then the prospects of a double-dip recessions are more likely. Over the next year home prices will decline 5% to 7%, according to Laurie Goodman, the senior managing director of Amherst Securities, a broker, advisor and asset manager focused on the residential real estate market. At the CFA Institute Fixed Income Conference in Boston on October 13, she identified two key policy initiatives that would break what she termed an ongoing “death spiral” in the housing market.

Goodman, who correctly predicted a decline in home prices in a similar [talk](#) last December, said the government can help package distressed properties into rental units to satisfy a rental market that has not kept pace with demand. A principle reduction program with a shared appreciation feature that would aid homeowners and lenders could also address the problem. I’ll review Goodman’s assessment of the state of the housing market today, and then return to those two proposed solutions.

The US mortgage market consists of nearly 55 million loans of approximately \$10.4 trillion in principal, financing properties with a total value of approximately \$16.6 trillion. Goodman provided a detailed breakdown of the characteristics of the outstanding loans, including those that are non-performing, re-performing (i.e., were previously in default), and have been always performing:

Status	3-Month D/TV	Reasonable estimate
NPL	-	90%
RPL	94.7%	65%
APL > 120 MTM LTV	73.6%	40%
APL 100-120 MTM LTV	49.9%	15%
APL <= 100 MTM LTV	15.4%	5%

Legend:

NPL = Non-performing loans

RPL = Re-performing loans

APL = Always performing loans

MTM =Mark-to-market

LTV = Loan-to-value ratio

D/TV = $cTr/(cTr + vPr)$

cTr = Annualized monthly new default transition rate

vPr = Annualized voluntary prepay rate



The table above shows the D/TV ratio, which is an indicator of the probability of future default, for each of five categories of loans. If the three-month historical rates continue, then approximately 10.3 million homes will be in jeopardy of default over the next six years, Goodman said. She provided her own reasonable estimates, shown in the third column, which are more conservative than what we have been experiencing, which would result in 8.3 million homes in jeopardy over that period.

Her analysis assumes there will be no change in overall housing prices, interest rates or new home construction.

Whichever default estimate you use, the projections are dire – nearly 20% of all homes face default.

The shadow inventory of homes continues to grow. Those are homes that are in various stages of foreclosure, but are not on the market for sale. Goodman said there are approximately 3.2 million of these, which represents approximately 32 months of housing inventory assuming the recent rate at which homes have been sold. She said this was a conservative estimate, since it does not include mortgages that have been delinquent for less than 12 months, even though those homes have a very high chance of entering foreclosure.

To provide enough homebuyers to absorb the oversupply of homes – and potentially solve the housing crisis – Goodman said approximately 4.1 to 6.2 million units of new housing demand need to be created over the next six years. Current demand is just over a million units per year. Goodman assumed approximately two million units of new supply yearly, approximately a half million units from new construction and the rest from defaults and foreclosures. So nearly a million units of housing will be added to the residential housing inventory annually over the next six years, she said.

With prices down and interest rates at historically low levels, housing affordability is at a 20-year high. Housing market dynamics, however, are like any commodity and are ultimately driven by supply and demand imbalances. Goodman's estimate is for a further decline in price, at least over the next year.

Indeed, Goodman said the housing supply and demand function is broken, because government agencies have tightened their lending standards. Approximately 19% of homeowners no longer qualify for a mortgage based on their payment history, she said.

As a result, she said, a "housing death spiral" has gripped the market. Falling home prices cause defaults, which result in an increased supply of distressed homes, and the resulting increase in housing inventory causes further price declines. In addition, tighter credit standards are contributing to an inventory buildup.



One way to break the spiral is through the rental market. Goodman said that rental demand is outpacing rental supply, as foreclosed homeowners have no alternative but to become renters. She said the government should take an active role in growing the rental market by helping to package large numbers of foreclosed homes in specific regions, so that they can be sold to private companies and developers that would transform them into rental units.

Those efforts, she said, would decrease the shadow inventory without adversely affecting homeownership demand. Mary J. Miller, the assistant treasury secretary for financial markets, also spoke at the conference and said that such policies are being actively pursued, and that initial efforts would begin within the next six months.

Goodman said a principal reduction program to aid homeowners is also necessary to correct the housing market imbalances. So far, related efforts, including the home affordable modification program (HAMP), have been ineffective; re-default rates remain high, despite significant payment reductions.

An effective program, Goodman said, should incorporate a “shared appreciation” feature, so that the lender and the homeowner would share potential gains if the property appreciates. Otherwise, principal reduction problems face a moral hazard – if a distressed homeowner is granted a principal reduction, their neighbors (even if they don’t face default) will want similar reductions. She said a shared appreciation feature reduces the likelihood of that outcome.

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