

# ON POINT

ECONOMIC AND POLICY INSIGHT FROM THE OCC

## Home Prices Escape Recession Unscathed

Six months into the deepest recession since the 1930s, home prices continue to rise across the nation. According to the Federal Housing Finance Agency (FHFA), average home prices were 1.9 percent higher in the third quarter than the first quarter of 2020, with prices rising in 360 of the 384 metropolitan statistical areas (MSA) tracked. Although home prices react differently during recessions, widespread increases are rare. Temporary factors specific to the COVID-19 pandemic, including a low supply of homes for sale, have supported prices in recent months. However, four fundamental factors are expected to boost home prices for the next several years:

- Widely accessible mortgage forbearance programs
- Historically low mortgage rates
- An acute housing supply shortage
- Tighter underwriting during the recent economic expansion

### Home Prices and Recessions

Although historically, home prices remain stable in nominal (noninflationary adjusted) terms during a recession, in real terms, home prices often decline during these periods.<sup>1</sup> Home prices are usually measured in noninflationary adjusted terms, which makes them appear resilient to economic shocks. Nominal housing data would suggest that national home prices fell only once during the previous five recessions—during the housing-led recession of 2008 as shown in figure 1. From the lender’s and borrower’s perspectives, this makes sense as promissory notes and collateral are based in nominal dollars. However, housing prices need to be measured in real terms to identify economic impacts accurately.

The disconnect between nominal home price declines and recessions is exemplified by the 1981 recession. The Federal Reserve System (Federal Reserve) hiked rates to curb inflation, which triggered a deep recession. Despite unemployment peaking at 10.8 percent and real gross domestic product (GDP) falling 2.6 percent peak-to-trough, nominal home prices rose 4 percent. The rise is belied by a 10 percent rise in inflation. Thus, in real terms, national home prices contracted by 6 percent. Likewise, home prices fell in four of the last five recessions when inflation is accounted for. The exception is the short and mild 2001 recession.

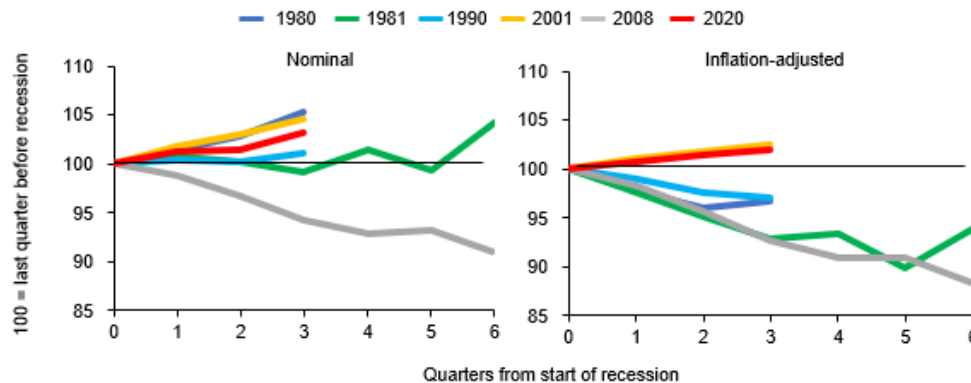
---

<sup>1</sup> Nominal values are measured in terms of money, while real values are measured against goods and services.

Data suggests that the current pandemic recession differs from historical trends. Through September 2020, nominal and real home prices rose despite the unemployment rate peaking at 14.7 percent in April and real second quarter GDP declining 9 percent over the prior year. Why have home prices been immune to the 2020 recession?

To shed light on this question, OCC Economics examined the underlying fundamentals supporting home values, especially those unique to the pandemic recession.

**Figure 1: Changes in Home Prices by Recession**



Source: FHFA, Bureau of Labor Statistics (BLS), and OCC Calculations

Note: Quarterly change in FHFA Home Price Index, 100 = last quarter before recession.

## Forbearance Suspends Negative Price Feedback Loop

A key difference between the current and previous recessions is the prevalence of mortgage forbearance, which allows borrowers to pause their payments. Under the CARES Act, all federally guaranteed mortgages are eligible for up to one year of forbearance due to a COVID-19-related hardship. When forbearance ends, the borrower may roll forgone payments into the loan balance. Although this only pertains to federally guaranteed mortgages, which comprise two-thirds of all mortgages, many other lenders are offering their own (albeit less generous) forbearance programs.

An enduring lesson from the 2008 crisis is the benefit of keeping borrowers in their homes. By offering forbearance, borrowers can overcome temporary economic hardships without losing their homes or ruining their credit. Lenders and servicers who incur costs in the short term by forgoing mortgage payments are likely to lose far less than they would by pursuing foreclosure (where legal fees, property maintenance costs, forced place insurance, realtor commissions and real estate taxes are incurred). Forbearance also stops a negative home price feedback loop where foreclosures depress property prices for other homes in that neighborhood, whose owners then are unable or unwilling to make payments on their now-devalued homes.

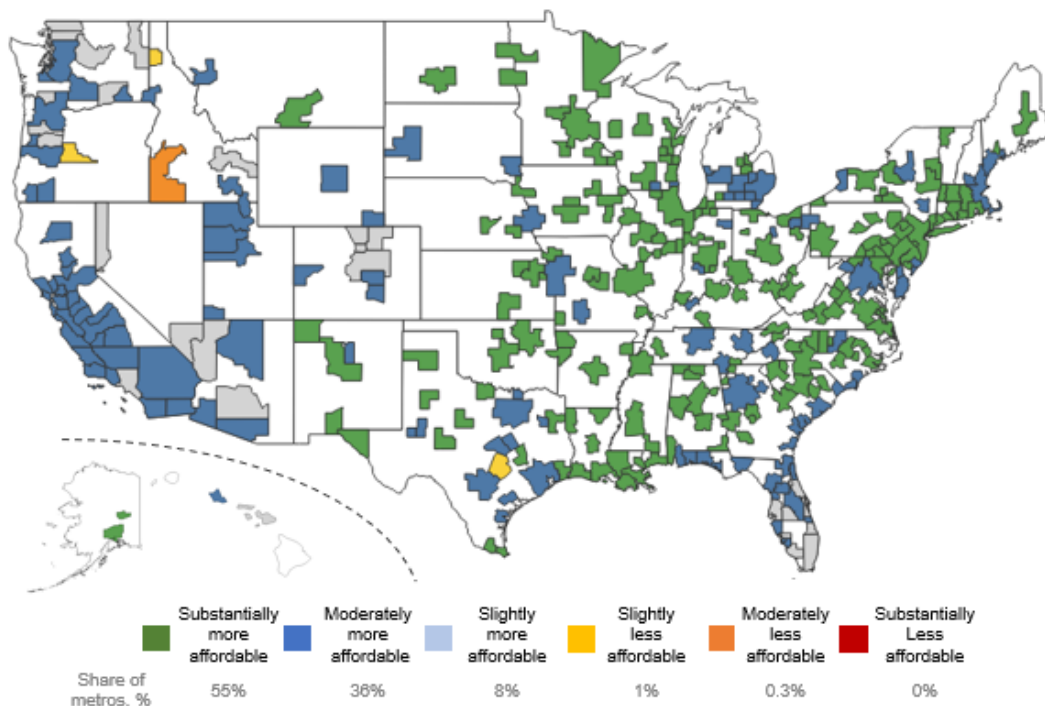
According to the Mortgage Bankers Association (MBA) survey, the share of borrowers in forbearance peaked at 8.5 percent during June. As of November 22, 2020, the share of borrowers in forbearance is 5.4 percent, down slightly from the peak, but still representing 2.8 million loans. Were these loans to default, there likely would be a negative impact on housing prices in some markets.

## Lower Rates Make Housing More Affordable

The average 30-year fixed rate mortgage rate in September was 2.9 percent, the lowest since Freddie Mac began publishing their survey in 1971. Mortgage rates fell steadily from a high of 5 percent in late 2018. COVID-19 accelerated this declining interest rate trend. From January to September 2020, the average 30-year fixed rate fell 75 basis points, lowering the monthly payment on new conventional mortgages by 10 percent.

However, mortgage rates are only one component of housing affordability; income and prices are the other significant factors. As noted earlier, home prices rose for the past several years at a rate generally faster than household incomes. The average payment-to-income ratio on a new conventional mortgage can be used to gauge affordability. This metric reflects the three components of affordability and is calculated for 351 MSAs. Specifically, the monthly principal and interest payments on an average-priced single-family home are determined, assuming a 20-percent down payment and a 30-year fixed rate mortgage. This payment is then divided by the MSA's median household income to measure what share of the median household income is required to purchase an average-priced home. Because each housing market is unique, the estimate of September's housing affordability is measured against each market's history.

**Figure 2: Housing Affordability as of September 2020 by Metropolitan Statistical Area**



Source: FHFA; Freddie Mac, Census, Moody's Analytics (data through third quarter of 2020)

Note: Mortgage payment on average priced single-family home in market using 30-year fixed rate mortgage with a 20-percent down payment (principle and interest only) relative to median household income. Mortgage payment-to-income ratio historical average is calculated based on January 1992 to September 2020 period. Substantial = More/less affordable than 90 percent of quarters since 1992. Moderately = More/less affordable than 70–89 percent of quarters since 1992. Slightly = More/less affordable than 50–69 percent of quarters since 1992.

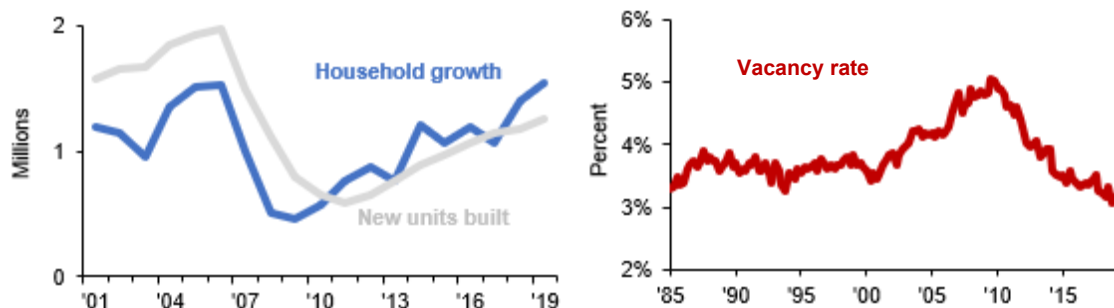
Figure 2 presents estimates of each MSA's housing affordability relative to historical local prices, household income, and prevailing interest rates. Slightly more than half of the MSA's tracked were substantially more affordable—defined as a payment-to-income ratio lower than 90 percent of the ratio in all quarters since 1992. Another 36 percent of areas were moderately more affordable than their own history. Only four MSAs were less affordable (Boise, Idaho; Redmond, Ore.; Coeur d'Alene, Idaho; and Austin, Texas).

This analysis shows that the decline in mortgage rates more than offset price increases. With the Federal Reserve forward guidance indicating low interest rates through 2022, mortgage rates are expected to remain low for years and support further home price growth.

## Years of Underbuilding Created Home Supply Shortages

In eight of the last 10 years, household formation outpaced home building.<sup>2</sup> A well-functioning housing market has an excess supply of homes to accommodate household growth and replace older homes. For a rough measure of housing supply, we examine the national vacancy rate of homes for sale and for rent. By the end of 2019, national vacancy rates were at the lowest levels in decades, which suggests a supply shortage. Of course, housing is dependent upon local factors of supply and demand. Not every metropolitan or state area is suffering from a supply shortage. Supply shortages are most acute in densely populated coastal cities where land is scarce, prices are higher, and permits are more difficult to obtain. The current (relatively) low vacancy rates, particularly in those cities, is helping to keep house prices on an upward trajectory

**Figure 3: Household Growth, Vacancy Rate of homes for sale or rent**



Source: Census Bureau

Note: Household growth is based on a three-year rolling average to account for volatility.

## Tighter Underwriting and Traditional Products Shield Home Values

The absence of exotic mortgage products and tighter underwriting buoyed home prices during the current economic crisis. First, unlike the 2008 crisis, exotic mortgage products and loose credit did not increase home prices. Heading into this recession, all the exotic products of the mid 2000s—including negative amortization loans, prepayment penalties, no-doc loans, teaser rates, option adjustable-rate mortgages, etc.—were either eliminated by the Dodd–Frank Wall Street Reform and Consumer Protection Act or disappeared when private capital vanished.

<sup>2</sup> Household formation occurs when children move out on their own, couples separate, or when individuals choose to live alone after sharing a residence.

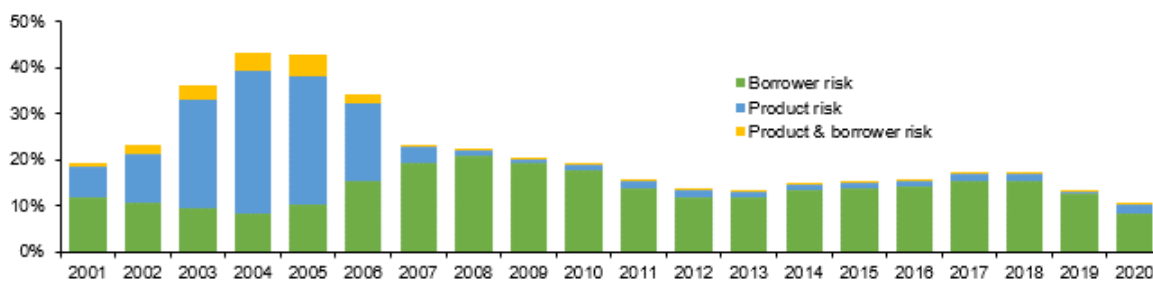
Second, after a decade of tighter underwriting, today's homeowners are better positioned to weather economic shocks and are protected from the payment shocks associated with exotic products. While there are still loans made to borrowers with lower credit scores, higher debt-to-income ratios, and/or lower down payments, the volume and structure of these loans mitigates widespread negative effects on home prices.

Figure 4 separates mortgage originations used for home purchases into three risk groups: product risk, borrower risk, and product and borrower risk. Product risk is defined as loans with any of the following terms: prepayment penalties, negative amortization, a balloon or interest-only payment. Borrower risk is defined as loans with any two of the following: an original loan-to-value ratio greater than 95 percent, a debt-to-income ratio greater than 43 percent, or a credit score less than 640. Using these rough measures of mortgage risk, the share of higher risk purchase originations has hovered around 15 percent since 2012, well below the 2004–2007 levels. Therefore, today's mortgaged homeowners are not exposed to payment shocks and are less likely to be in a home they cannot afford.

Today's higher risk mortgages are primarily guaranteed by the Federal Housing Administration (FHA) or by one of the government-sponsored entities, Fannie Mae or Freddie Mac. The FHA program is designed for first-time and lower-income homebuyers. There are key differences between FHA and subprime lenders. First, all FHA loans are owner-occupied, fully amortizing, and predominantly fixed-rate loans. Therefore, borrowers pay principal balances beginning with their first payment and experience no principal or interest payment shocks during the life of their loan. Second, FHA loans fully document employment and income.

As a result of tighter underwriting, borrowers are in a better position to withstand economic stress, which in turn reduces defaults and distressed sales, thereby supporting housing price levels.

**Figure 4. Share of Mortgage Purchase Origination Volume by Risk Categorization**



Source: National Mortgage Database (data through third quarter of 2020)

Note: Borrower risk = Loans with at least two of the following: loan-to-value>95%, debt-to-income ratio>43%, or credit score<640  
 Product risk = Loans with a prepayment penalty, negative amortization, or a balloon or interest-only payment

## The Point?

Residential real estate values across the United States continue to rise despite a severe economic shock from COVID-19. Four key factors supporting home values during the pandemic recession include

- the foreclosure moratorium prevented distressed sales;

- low interest rates enhanced affordability of housing;
- years of slow building created an undersupply of housing; and
- tighter loan standards in recent years resulted in better qualified borrowers who are able to withstand more economic stress.