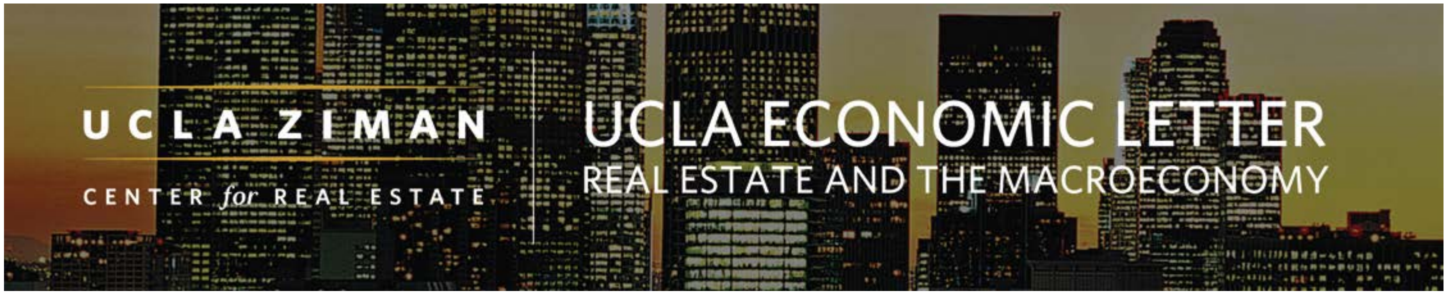

A partnership between the UCLA Ziman Center for Real Estate and the UCLA Anderson Forecast

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Monthly condensed analyses of crucial real estate and economic issues offered by the UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. Here, Stephen D. Oliner and Edward J. Pinto, Co-directors of the International Center on Housing Risk at the American Enterprise Institute, offer new research on risky home loans and the threat of another housing bubble.

Homebuyers: Proceed With Caution

By Stephen D. Oliner and Edward J. Pinto, Co-directors of the International Center on Housing Risk at the American Enterprise Institute. Mr. Oliner is also a Senior Fellow at the UCLA Ziman Center for Real Estate.

This article was first published April 23, 2014 in the Los Angeles Times: "A New Housing Bubble?" It has been updated to include new data on the California housing market and it includes a new chart on down payments and debt-income ratios.

Even though the recent financial crisis is barely in the rearview mirror, risk is starting to build once again in both the U.S. mortgage and housing markets.

"Many of today's mortgages would not perform well under stressful conditions."

Contrary to the prevailing view that only borrowers with pristine credit records can get a mortgage these days, many risky loans are still being made. A new index published by the International Center on Housing Risk at the American Enterprise Institute measures this risk month by month, based on about three-quarters of all home purchase loans extended across the country. And the index clearly shows that many of today's mortgages would not perform well under stressful conditions. This conclusion holds for the nation as a whole and for nearly every state individually, California included.

Here's why. For the country as a whole, fully half of all the recent home purchase loans covered by the risk index had a down payment of 5% or less (see figure 1). In California, about 40% of recent purchase loans had such a small down payment — not quite the national share but high nonetheless. With so little money down, these borrowers would be underwater with only a modest decline in housing prices. In addition, for nearly half of the recent home purchase loans nationally, borrowers' monthly payments on their mortgage and other debt exceeded 38% of their pre-tax income, the traditional threshold for acceptable payment burdens. In California, the share of recent borrowers with total payment burdens above this threshold is even greater, reflecting the high house prices here relative to income. Such borrowers could find it difficult to make their monthly payments if they came under even moderate economic stress such as a temporary layoff or a reduction in work hours.

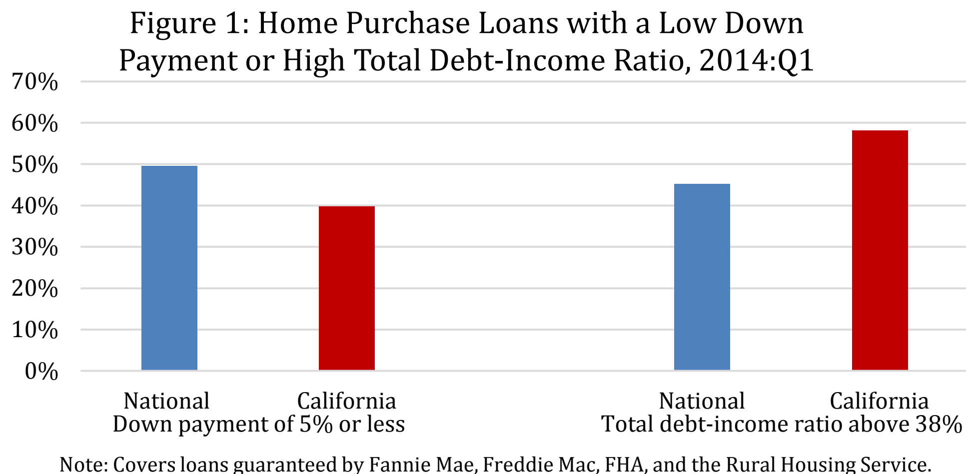
The Federal Housing Administration is the prime source of this risk. It now guarantees more than a quarter of the newly originated home purchase loans and does so with little regard for risk. Under the banner of expanding homeownership, the FHA provides risky loans to households that often lack the resources to make the payments if anything goes wrong. In California, the FHA's footprint is especially large in the Central Valley and Inland Empire, where the volume of FHA lending relative to population is nearly three times higher than in the rest of the state.

Home prices are also rising at an unsustainable pace. For the nation as a whole, prices increased 11% last year, according to the S&P Case-Shiller index. The jump was even larger in the major California markets — 21% in Los Angeles, 23% in San Francisco, and 19% in San Diego.

The Fed's easy monetary policy, which has kept mortgage rates very low, has been a key factor behind the rise in house prices. Another factor has been strong investor demand for distressed properties. At the same time, the supply of available homes has been limited. Housing starts, while up from their lowest point, remain well below normal, in part because builders shed capacity during and after the recession. Reflecting these factors, house prices in the hotter markets around the country may already be above the levels warranted by household income, rents, and other economic conditions.

Does this mean we're likely to see another housing bubble? That's hard to say. Nonetheless, the risk of a price overshoot of some magnitude is especially high in California. According to analysis by Fitch Ratings, homes in Los Angeles, San Francisco, Oakland, and San Diego are already overvalued by 20% or more. Fitch is not alone in seeing elevated risk in the California market. In the risk ratings produced by John Burns Consulting, home values in the six largest California metros went from about an "A" rating in late 2012 to a "C" in early 2014. And Trulia finds that three of the five most overvalued housing markets nationwide are in southern California: Orange County, Los Angeles, and Riverside-San Bernardino. Other analysts see California markets as fully valued rather than overvalued. But even if this is correct, it is worth noting that historically, many areas of California have had extremely volatile home prices.

Figure 1: Home Purchase Loans with a Low Down Payment or High Total Debt-Income Ratio, 2014:Q1



Note: Covers loans guaranteed by Fannie Mae, Freddie Mac, FHA, and the Rural Housing Service.

Given that risk is rising, how should a prospective California homebuyer decide whether to jump into the market? Start by comparing the price of a home you're considering to what it would cost to rent. Go to Zillow.com, look up the home's "Rent Zestimate," and then divide the annual rent estimate by the home price to calculate the home's gross yield. For example, a $500,000 home with a rent estimate of $3,000 a month ($36,000 per year), would have a yield of 7.2% , before accounting for maintenance, utilities, taxes, and other costs of home ownership. As a rough rule of thumb, a yield of 8% or more means the home is a relative bargain, while a yield below 5% means the home is likely overpriced. For yields between 5% and 8%, the rule of thumb doesn't produce a clear conclusion about valuation. In this situation, a buyer should plan to stay in the home for at least five years to spread the costs of buying and selling the house over a longer period, which will reduce the odds of losing money on the purchase.

For a more in-depth analysis, try using an online calculator that assesses the merits of buying versus renting, such as The New York Times' Buy-rent calculator. It allows you to input many variables for buying and renting and calculates whether you will be up or down after six years. Although this is a useful tool, keep in mind that the result will depend on your assumed outlook for home prices.

Even if a house appears to be a good deal, the more important question is whether it's something you can comfortably afford. To gauge whether the mortgage you'd be taking on is affordable, go to Table of Risk at HousingRisk.org. The

table estimates the risk of defaulting on the mortgage in a severe real estate correction. You will need three pieces of information to use the table: the ratio of your proposed loan amount to the purchase price of the house (the loan-to-value ratio), your FICO credit score, and the ratio of your total debt payments for the mortgage and other loans to your pre-tax income. If you don't know your FICO score, you can get a free estimate here.

With house prices already up substantially from their lows, today's homebuyers need to pay close attention to risk. Prospective buyers can protect themselves by using newly-available tools to analyze local market conditions and by realistically assessing their own financial situation before making such an important decision.