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**Where is the home ownership rate headed?**

Draft: December 19, 2011

Why do homeownership rates matter? Because they reflect what is happening in two markets simultaneously. If homeownership rates are declining the multifamily rental market is improving and vice versa for the owner-occupied market. We have been observing homeownership rates decline and we should expect this to continue for at least the next three years. Each percent decline in the ownership rate means just over 1.1 million households that have become renters.[[1]](#footnote-1) Until the homeownership rate bottoms out the demand for new homes will be rather limited.

For the average American household we saw the ownership rate peak out at 69.2% in the 4th quarter of 2004, while those with above-median income peaked out that same quarter at 84.6%. Oliver Chang of Morgan Stanley suggests we might be headed towards 59% based on adjustments for all those now delinquent or in default who have not yet lost their homes.[[2]](#footnote-2) A swing of 9% in the homeownership rate would be 10 million households giving up homeownership. 10 million housing units is equivalent to about 10 years of normal new home construction.

Let’s review the factors that may drive future homeownership rates up or down. As Oliver Chang suggests we still have a large number of struggling homeowners, many of whom are underwater and many of whom are delinquent in terms of mortgage payments. This could result in several million more households being foreclosed upon, driving down homeownership rates. Another contributor to lower homeownership rates has been lack of homeowner equity. The low mortgage rates, which would normally be driving home ownership rates up right now have had little impact, in part because so many households do not have sufficient home equity to refinance or trade up. Many households have ratcheted up the leverage every time their home price went up and now that it has dropped, they cannot easily reverse this process. [[3]](#footnote-4) One positive for homeownership rates is

There seem to be several factors at work in the current housing market and they include the following:

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| --- | --- | --- |
| Factor | Positive Impact on Ownership Rate | Negative Impact on Ownership Rate |
| Mortgage rates at all-time lows | **√** |  |
| Credit Ease: Underwriting stringency |  | **√** |
| Credit Access: Absence of Subprime Lenders |  | **√** |
| Lower Credit Scores as Affected by Defaults |  | **√** |
| Increased Burden of College Loans |  | **√** |
| High unemployment, especially among minorities and less-skilled workers |  | **√** |
| Personal Income Tax Rates and Tax Deduction Limits |  | **√** |
| Uncertainty about future employment stability |  | **√** |
| Uncertainty about future home price trends |  | **√** |

Mortgage rates are so low (as of late 2011) as to make the cost of owning less than the cost of renting in several markets for starter homes, such as Las Vegas or Phoenix. But according to surveys of mortgage lenders as many as 11% of all purchase contracts in 2011 are not able to secure financing, even with sufficient equity and a reasonable (80% or less) loan to value ratio.[[4]](#footnote-6) Some lenders blame appraisers, while most suggest that bank examiners are putting extreme pressures on the loan underwriters to exercise extreme caution and extreme diligence. In 2011, stories abounded that border on the ridiculous as to verifications and signatures required by underwriters. For example, a Social Security Administration statement was not enough proof of income for a set of wealthy La Jolla, California borrowers and they were asked to have someone from Social Security to sign a statement verifying that the Social Security statement was correct. This would be silly enough but becomes ridiculous when you consider that the Social Security income was 2% of the household income. The mortgage payment would be less than 20% of the other income and the loan-to-value ratio of the mortgage was less than 60%. With such underwriting there will be almost no defaults or foreclosures going forward on loans with vintages of 2011 and beyond. Of course we know that the pendulum will swing back towards normal and reasonable underwriting at some point in time, but until such time the home ownership rates will be driven downward. Add to this credit access challenge, the burden of college loans which are at an all-time high relative to incomes and this knocks out a large chunk of potential home owners. Next consider the bad credit scores of millions of borrowers which will stay that way for at least three years and this knocks out several million more potential homeowners. The high unemployment rate knocks out another 17 million people and perhaps 12 million households.

The uncertainty about future home price trends could be the most important factor of all. Housing as an investment has lost its appeal for now. Case and Shiller used to run annual surveys of homeowners, asking them what next year’s home appreciation rate would be in their neighborhood. The results were generally equal to whatever the homeowners had experienced during the last year. This rather simple model which assumes that whatever happened last year will happen next year, if reflective of reality, would suggest that most US households would not be eager to jump back into the housing market until they see others jumping back into the market and driving prices up. Shiller would probably refer to this behavioral aspect of the market as “Animal Spirits” but there is no doubt that much of the housing market is behavioral in nature.[[5]](#footnote-7) Jim Follain recently provided an analysis of housing bubbles and also came to the conclusion that not all of the price changes could be anticipated with informed and fundamental economic drivers.[[6]](#footnote-8)

Using estimates of excess housing supply, Shiller suggests that housing as an investment will remain rather bleak for several years. In an Economist issue published July 7th, 2011titled “Rooms with a view” Professor Shiller was quoted as saying “more hard times lie ahead. Prices may slide another 10-25%, … as the economy wrings out the excess supply of the bubble years.” Moody’s on the other hand estimates the current excess supply as perhaps 1.8 million units above normal and the web site calculatedrisks.com suggests the excess at 1.2 million units or so.[[7]](#footnote-9) With new home sales typically running above a million units each year and very little new construction coming online, 2012 would seem to be a reasonable guess as to when many markets come back into balance. Shiller seems to be on the pessimistic and extreme end of the forecast range, but he has been there before.

The problem that most aggregate analysis often ignores is that the excess is not evenly distributed. Michigan and Ohio, affected by job losses, and Nevada affected by over-building, seem to have the greatest excess supply and yet many states have no excess supply at all. This suggests that prices should start to rebound soon in many localized markets. Only the tough underwriting and the certainty gripping our economy will hold prices down in those markets where the foreclosure rates have slowed to a relatively low rate such as New York or Washington, DC. The point often made at Collateral Analytics is that markets are local and aggregate analysis of excess inventory has never made sense and fails to predict trends very well.

Where homeownership rates will be in a decade or so also depends very much on the tax code. The tax code which can drive some renters at the margin to buy or, if flat taxes are enacted, may drive some owners to rent, seems to be up for political debate with broad agreement that it is too complicated. The United States’ marginal tax rate is not nearly as high as it was three or four decades ago when marginal rates reached 70%. If we raise our marginal tax rates to 40% or 45% and retain the deductibility of mortgage interest and property taxes, this will drive the equilibrium ownership rate up a few percent to something north of 60%. If housing regains its investment appeal, we could be looking at 64% or 65% again within a decade of reaching the bottom. If we moved to a flat tax of any kind the after-tax cost to own will increase and there will be fewer renters pushed over the edge into wanting to own. Canada, where tax advantages from home ownership do not exist and where mortgage underwriting was never as lax as in the US has only had a 1% lower home ownership rate than in the US.[[8]](#footnote-10) This suggests a flat tax may dissuade over-consumption of larger and more expensive homes but not have that much impact on the overall homeownership rate.

We could easily see home ownership rates reach down to near 60% before bottoming out. Where we will end up as a long-term equilibrium solution depends on several factors including interest rates, the tax code and attitudes towards housing as an investment. What is clear is that we have yet to see the next bottom of the homeownership rate which should occur in 3 or 4 years, as the foreclosures are finally squeezed out of the system and the average credit scores that were wrecked in the housing crash start to finally improve.

1. There are just over 113 million households occupying 132 million housing units, noting that some households own more than one and some of this housing is vacant. Source: US Census [↑](#footnote-ref-1)
2. See “Housing Market Insights”, September 30, 2011, by Oliver Chang of Morgan Stanley. [↑](#footnote-ref-2)
3. |  |  |
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   | See <http://hbswk.hbs.edu/item/6291.html> “Systemic Risk and the Refinancing Ratchet Effect” By Amir E. Khandini, Andrew W. Lo and Robert C. Merton, October 1, 2009, Harvard Business School |  |
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   [↑](#footnote-ref-4)
4. In the distressed home markets the percent of contracts which fall through is much higher than 11%. [↑](#footnote-ref-6)
5. “Animal Spirits” is the name of Robert Shiller’s latest book. [↑](#footnote-ref-7)
6. See “A Look at US House Price Bubbles from 1980-2010 and the Role of Local Market Conditions” by James R. Follain and Seth H. Giertz, 2010 Lincoln Institute of Land Policy

   Lincoln Institute of Land Policy Working Paper available at <https://www.lincolninst.edu/pubs/dl/1928_1251_Follain%20Final.pdf> [↑](#footnote-ref-8)
7. See [www.calculatedriskblog.com](http://www.calculatedriskblog.com) [↑](#footnote-ref-9)
8. For a discussion of financing instruments and ownership rates by country see “International Comparison of Mortgage Product Offerings” by Dr. Michael Lea, Director, Corky McMillin Center for Real Estate, San Diego State University, September 2010. [↑](#footnote-ref-10)