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Highly Leveraged Homeownership and Severe Financial Crises

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These views are ours alone and not necessarily those of the Federal Reserve Bank of St. Louis or the Federal Reserve System.

Highly Leveraged Homeownership and Severe Financial Crises

- Homeownership is risky; adding leverage magnifies it.
- *Ex ante* vulnerable families (young; no college; African American and Hispanic) often are not well-served by highly leveraged homeownership.
- International evidence shows that housing bubbles & busts create deep, damaging recessions and financial crises.
- So why do we promote highly leveraged homeownership? Follow the money—strong vested interests benefit from it.

Homeownership Includes Idiosyncratic Catastrophic Risk (e.g., Hurricane Florence)

Under

Water

Photos by Victor J. Blue for the *New York Times*

Homeownership Includes Idiosyncratic Catastrophic Risk (e.g., wildfires, mudslides, earthquakes, tornadoes, etc.)

A t

Southern CA

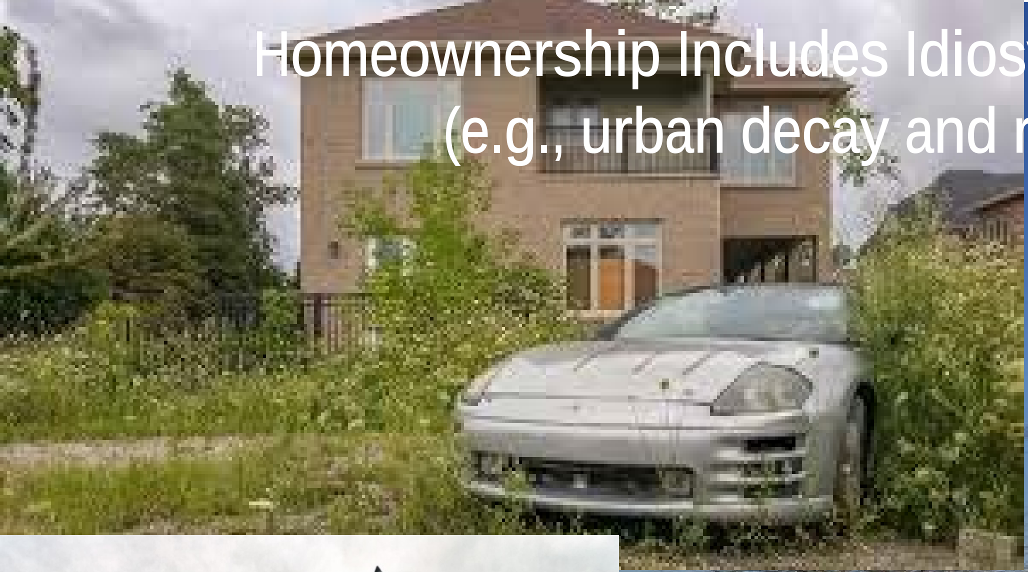
Santa Barbara CA

Miller CA

Ventura County CA

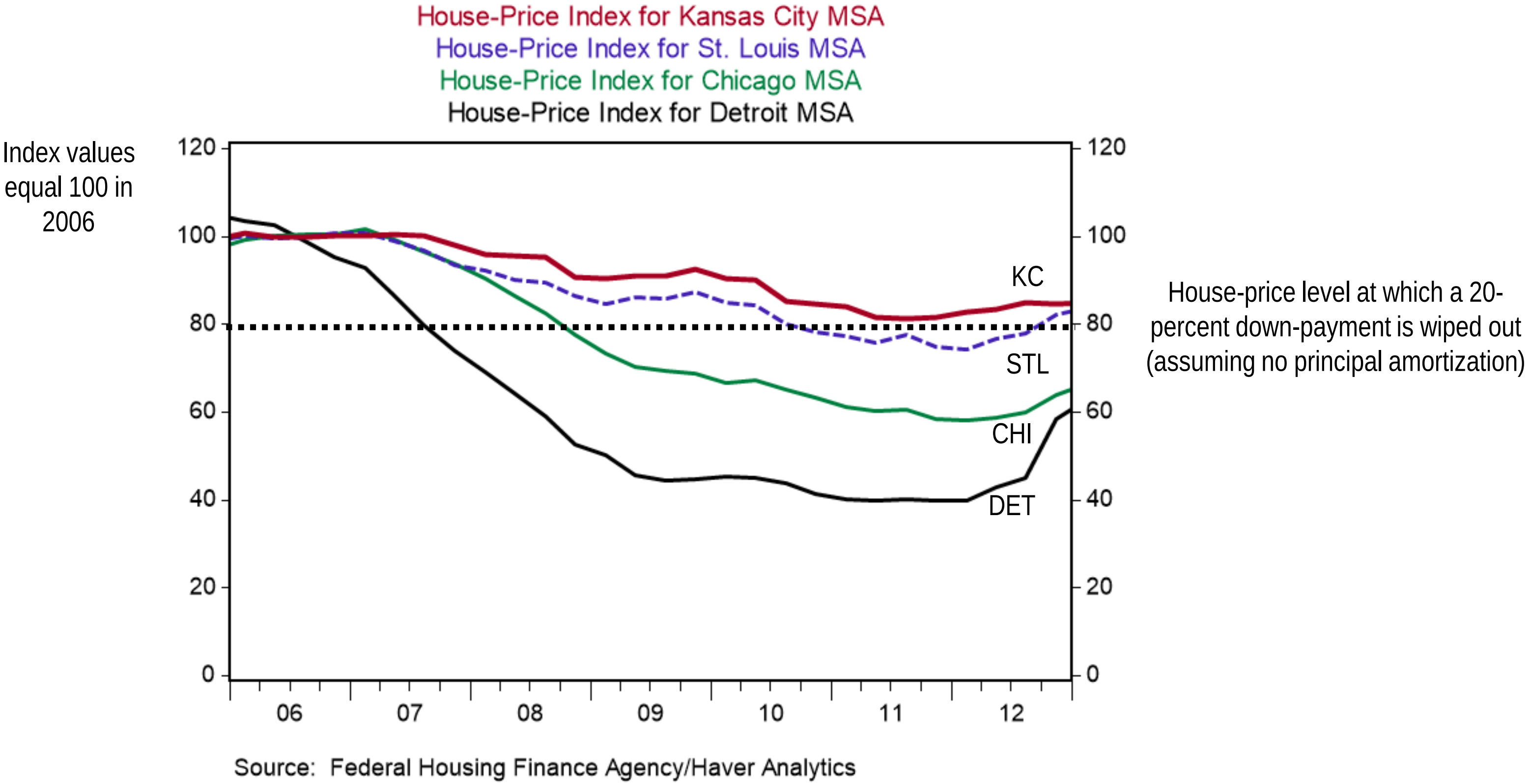
R i s k

Homeownership Includes Idiosyncratic Catastrophic Risk (e.g., urban decay and rural out-migration)



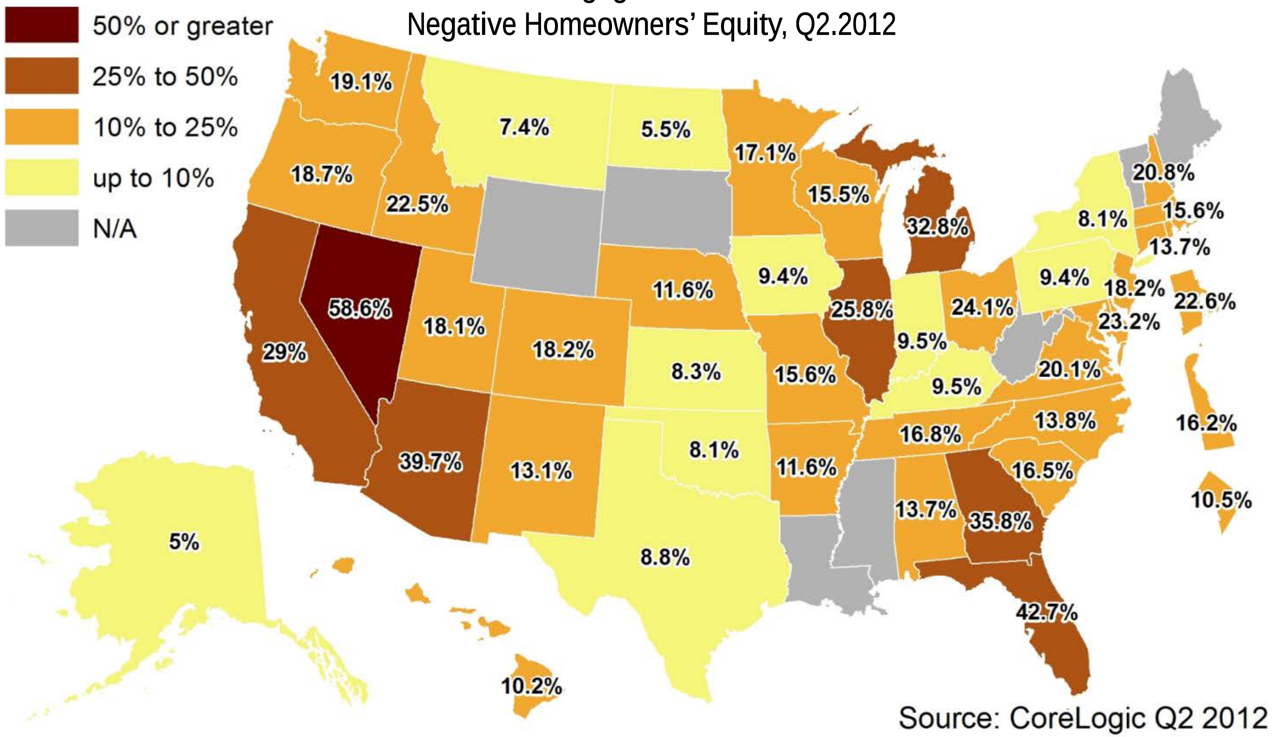
Abandoned

Even Midwest Homebuyers in 2006 With 20-Percent Down-Payments Lost All Their Equity



At the Worst Point, 1/3 of Mortgaged Homeowners Were Under Water

Share of Mortgaged Homeowners with Negative Homeowners' Equity, Q2.2012



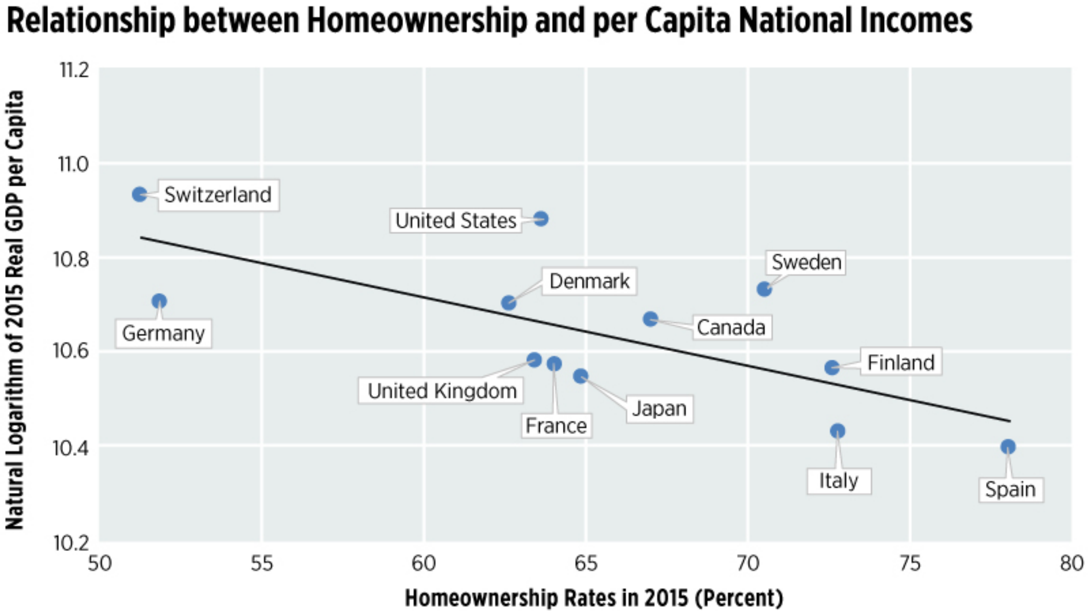
Housing Crisis

Negative Equity => 9-10 Million Involuntary Exits from Homeownership

Policies Encourage Leveraged Homeownership

- "The American housing market is subject to a mind-boggling array of government interventions by various levels of government" (Harvey Rosen, 1985).
- Examples:
  - Restrictive zoning (minimum lot size; single-family only).
  - Non-taxability of imputed rent; generous mortgage interest deduction; deductibility of property taxes.
  - Sprawl-supporting public infrastructure (roads, sewers).
  - Fannie & Freddie support for 30-year mortgage.

Homeownership Rates and Real Income Levels



SOURCES: For income levels, International Monetary Fund's World Economic Outlook database (2018); for homeownership rates, Goodman and Mayer (2018).

NOTES: Ireland is excluded from the figure because the level of its GDP per capita is affected much more by foreign transactions than are any other countries' levels in the sample. The correlation co-efficient for the 12 countries shown is –0.71 (–0.48 including Ireland).

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Source: "High Homeownership Rates in 2005: A Powerful Negative Predictor of Post-Crisis Recovery," https://www.stlouisfed.org/publications/housing-market-perspectives/2018/national-homeownership-rates-negative-predictor

Why Encourage Leveraged Homeownership?

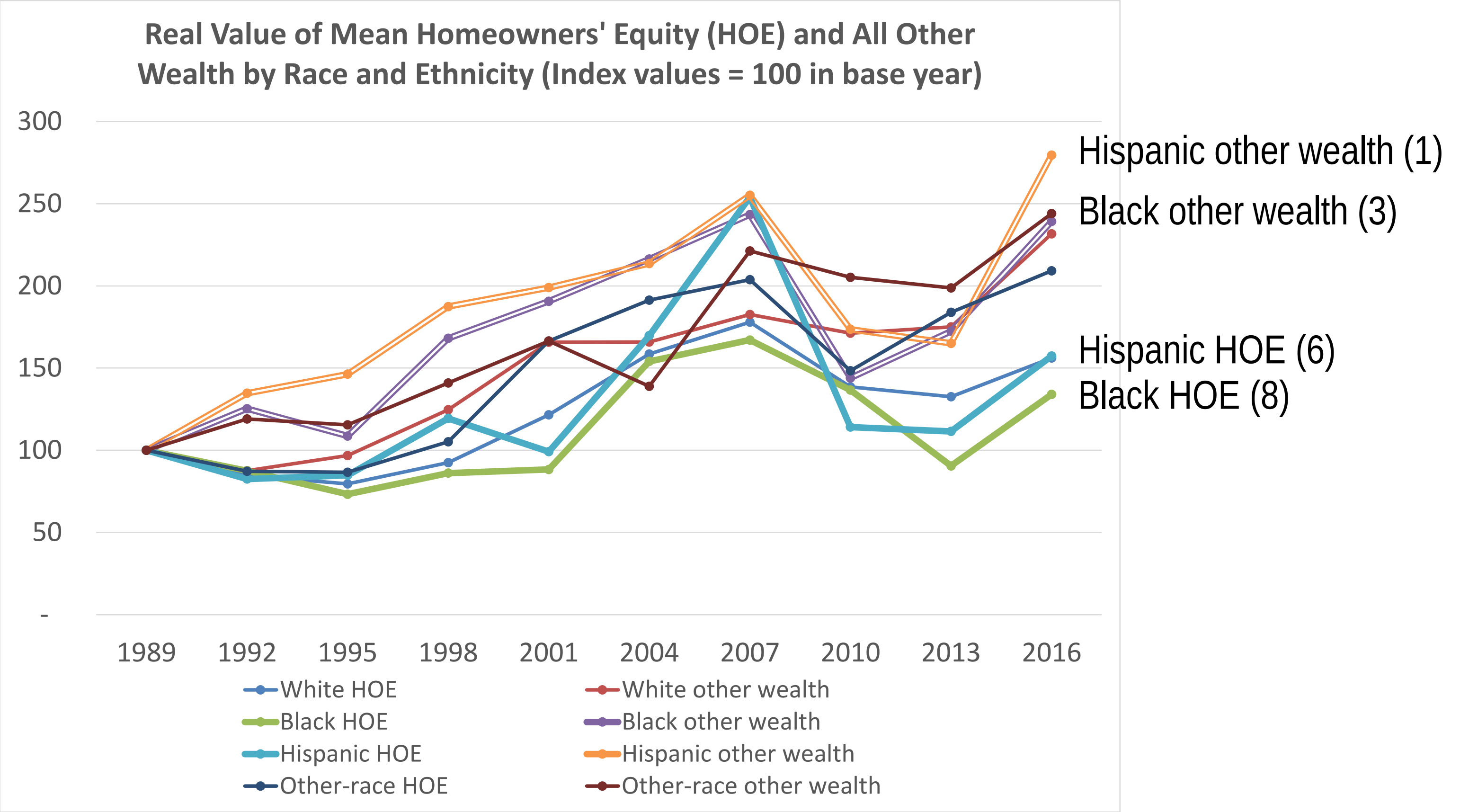
- Why homeownership?
  - “Wealth accumulation; strong communities; economic growth.”
  - But the evidence is mixed—not clear what causes what.
- Why debt?
  - Adverse selection, moral hazard (this actually makes sense).
- Why very high LTVs (80 percent or more)?
  - Marginal buyers are poor (no savings; other debt; low FICO).
  - Tax incentives also encourage infra-marginal leveraging.

Is Housing a Good Investment?

- Yes, according to Jorda, Knoll, Kuvshinov, Schularick and Taylor (2017*).
  - In a long international sample, average housing total returns were as good or better than equity returns with lower risk.
- Not necessarily, say Piazzesi and Schneider (2016**): Rent not fungible or scalable; idiosyncratic housing risk is high.
  - Idiosyncratic housing risk is 4X housing-index risk.
  - Housing Sharpe ratios are exaggerated in the literature.

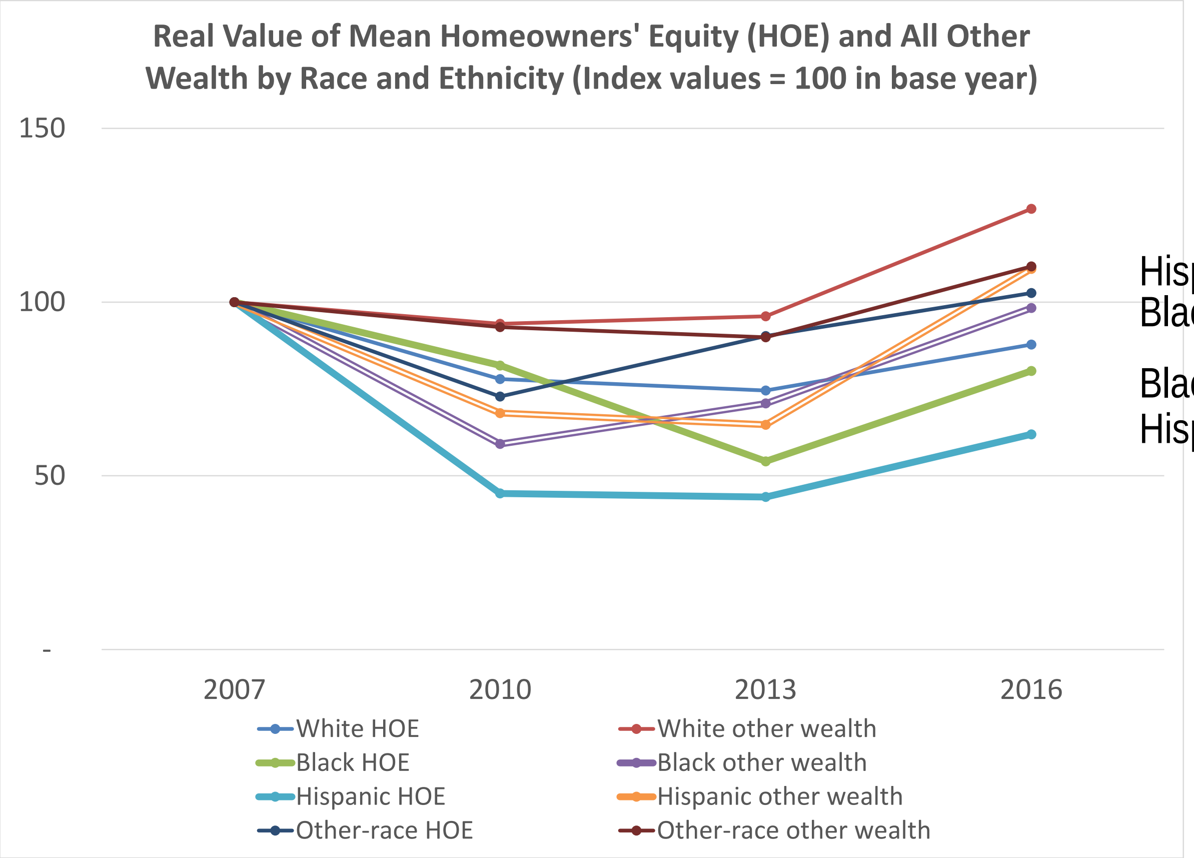
* Jorda, Oscar; Knoll, Katharina; Kuvshinov, Dmitry; Schularick, Moritz; and Taylor, Alan M. “The Rate of Return on Everything, 1870-2015,” NBER working paper, Dec. 2017.
** Piazzesi, Monika; and Scheider, Martin. “Housing and the Macroeconomy,” *Handbook of Macroeconomics 2* (2016), pp. 1547-1640.

Hispanic & Black Families *Haven't* Accumulated



Source: Federal Reserve Survey of Consumer Finances

ΔHOE (2007-16): Hispanic -38%, Black -20%



Hispanic other wealth (3)
Black other wealth (5)

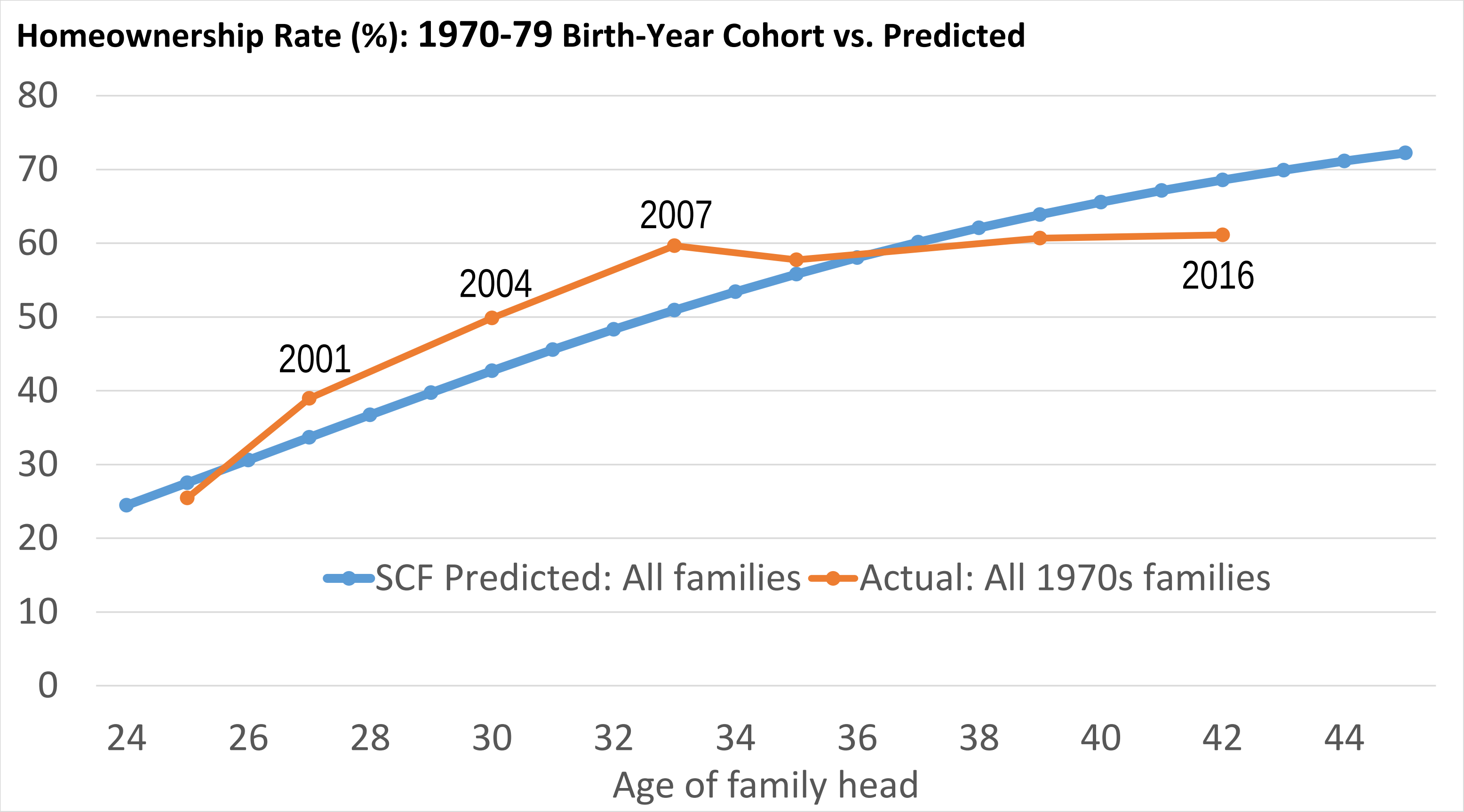
Black HOE (7)
Hispanic HOE (8)

Source: Federal Reserve Survey of Consumer Finances

Housing Crash Hit Vulnerable Families Hardest

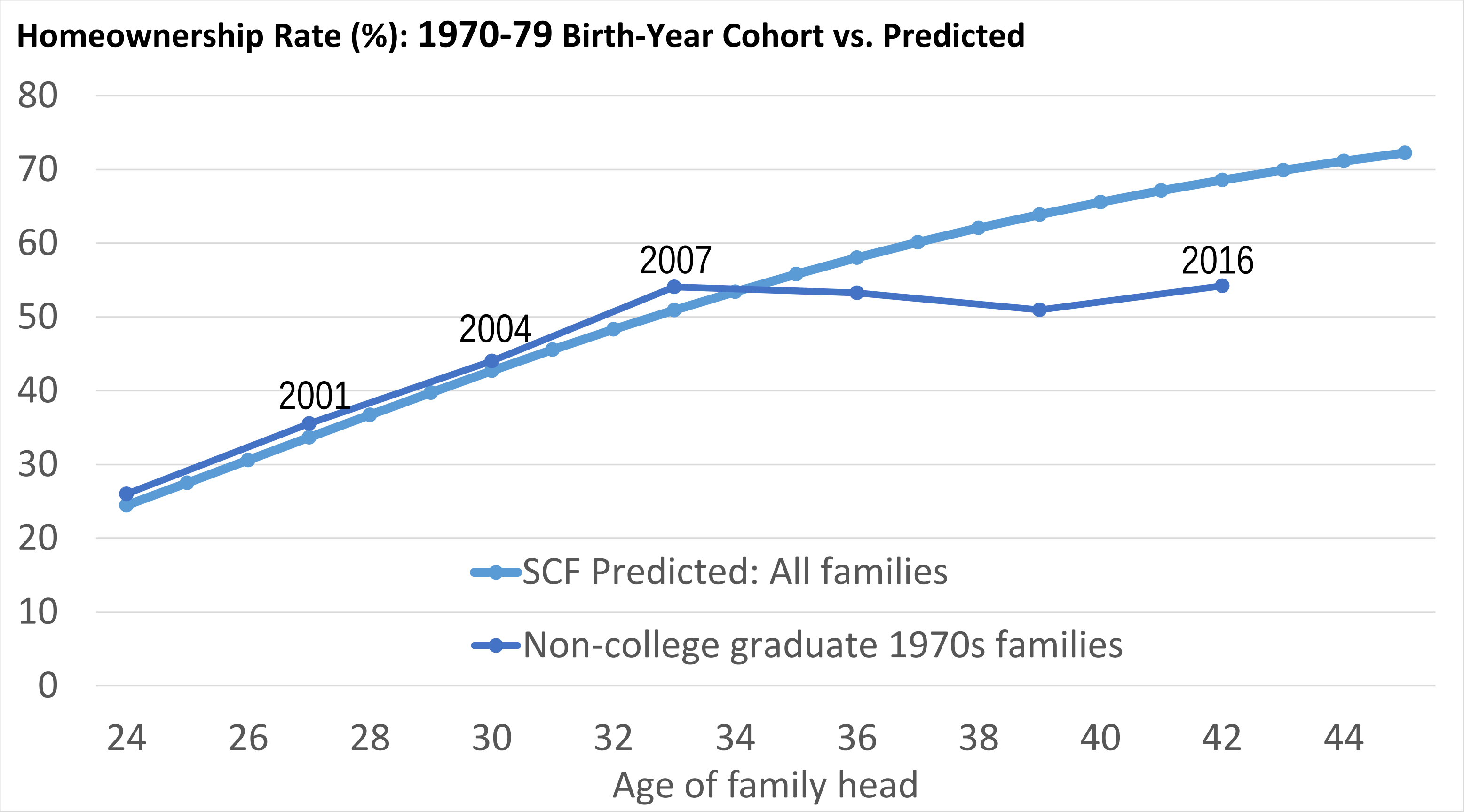
- Young
  - For example: Family heads born in the 1970s
  - Ages 28-37 in 2007 (median 33); 34-43 in 2013 (median 39)
- No college
  - Vast majority of families have less than a 4-year degree
- Non-white
  - Hispanic
  - African American

Young Families' HO Rate: Born in the 1970s



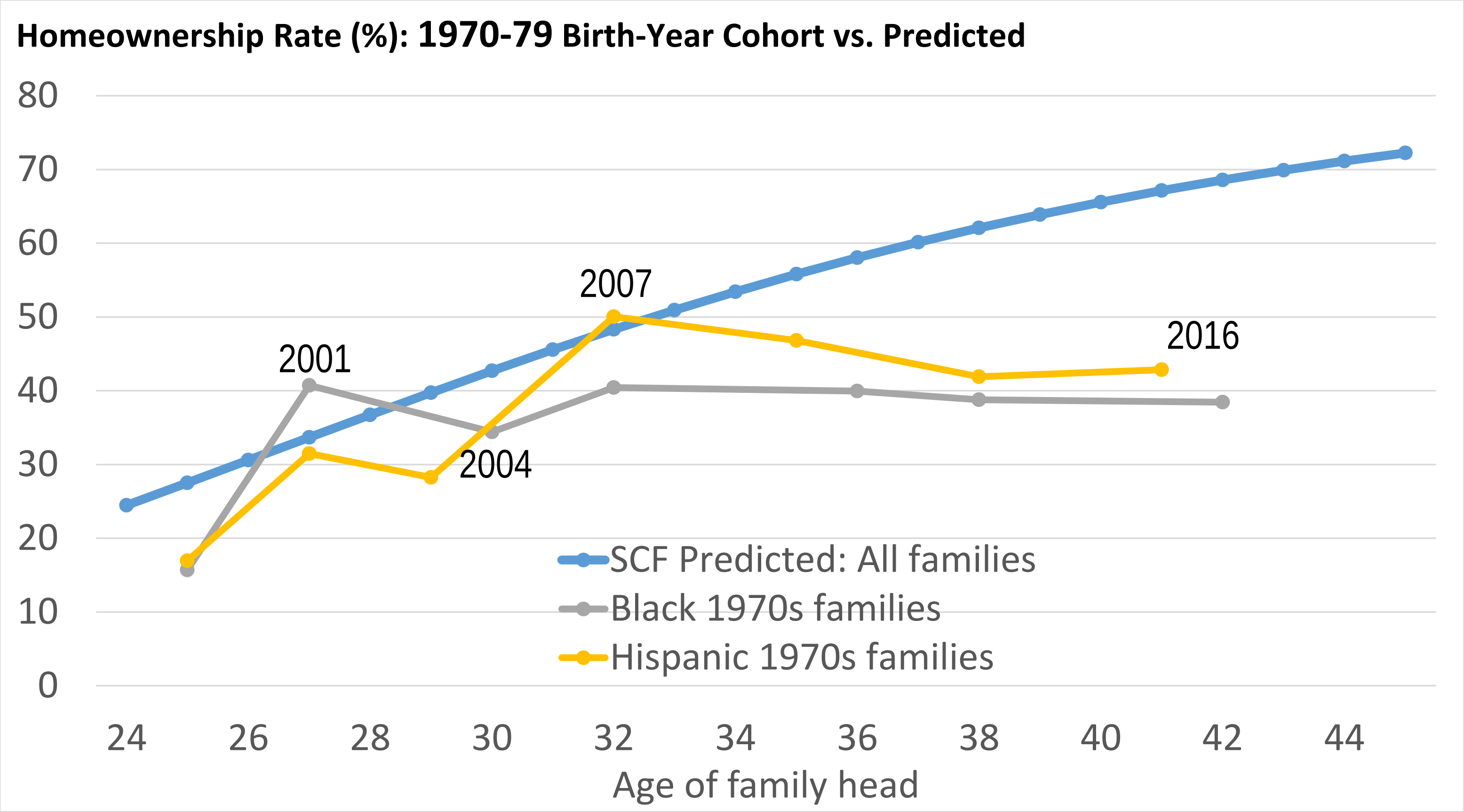
Source: Federal Reserve Survey of Consumer Finances

Non-College Families' HO Rate: Born in 1970s



Source: Federal Reserve Survey of Consumer Finances

Black, Hispanic Families' HO Rate: Born in 1970s



Source: Federal Reserve Survey of Consumer Finances

Leveraged Housing Bubbles Damage Economy

- Jorda, Schularick and Taylor (2015*) evidence
  - Annual data on equity and housing markets, bank credit growth; 17 countries, 1870-2013.
  - Broadest, longest dataset available.
- Conclusions
  - Bursting stock-market bubbles make recessions worse.
  - Bursting credit-fueled housing bubbles turn recessions into financial crises.

* Jorda, Oscar; Schularick, Moritz; and Taylor, Alan M. “Leveraged Bubbles,” *Journal of Monetary Economics* 76 (2015), pp. S1-S20.

Leveraged Housing Bubbles Are Devastating
(Jorda, Schularick and Taylor, "Leveraged Bubbles," 2015)

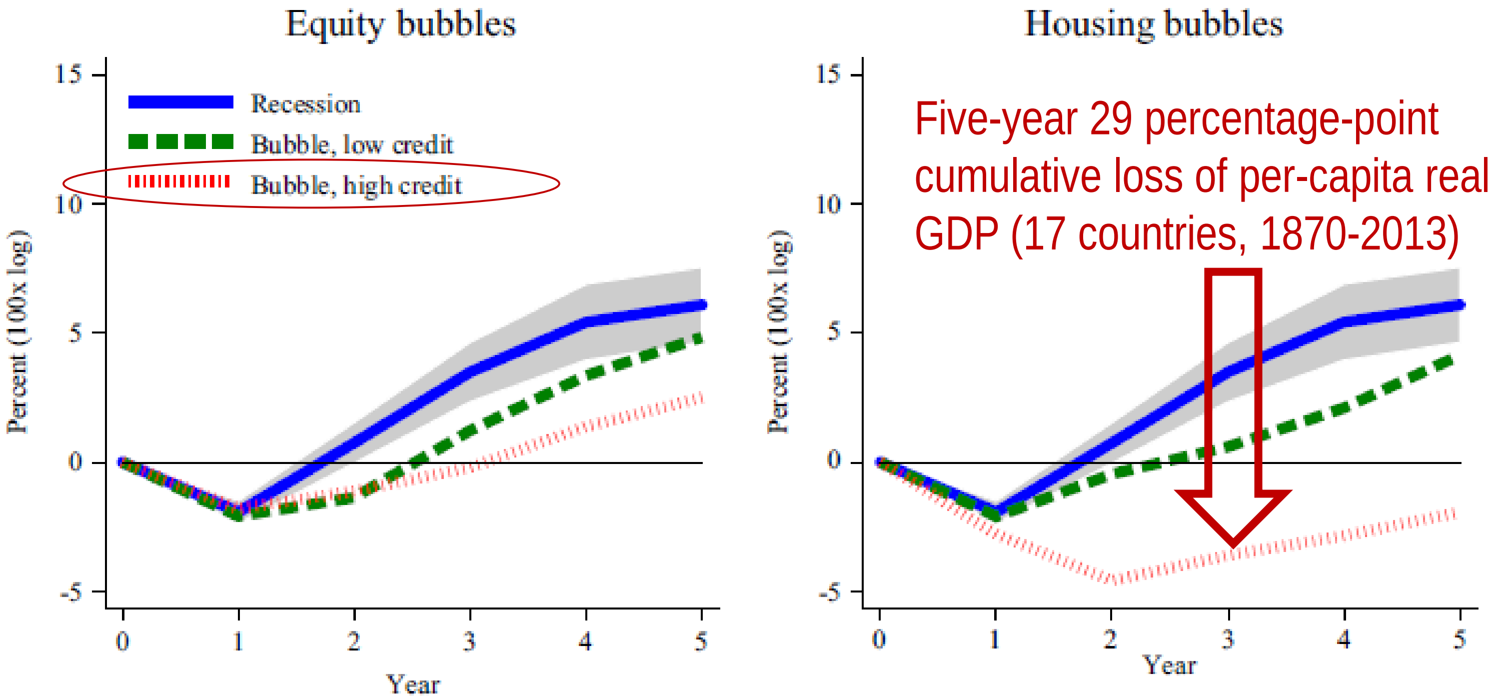
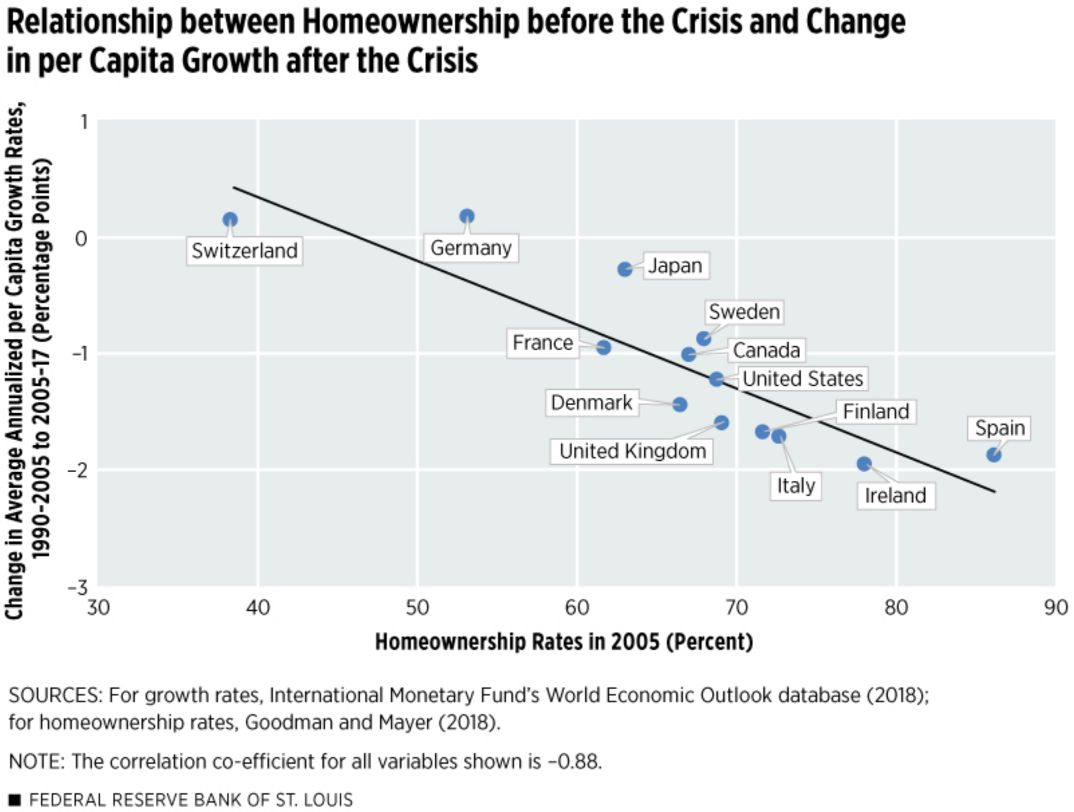


Fig. 6. Recession and recovery paths: the role of bubbles and credit, no controls, full sample. *Notes*: The figure displays the coefficients reported in Table 5. The solid blue line reports the average no-bubble path. The grey area represents the 90% confidence region around the average path. The green dashed line is the sum of the average no-bubble path and the bubble coefficient when credit is below the mean, whereas the dotted red line is the sum of the average no-bubble path and the bubble coefficient when credit is high. Full sample: 1870–2013, excludes the World Wars and a window of 5 years around them. (For interpretation of the references to color in this figure caption, the reader is referred to the web version of this paper.)

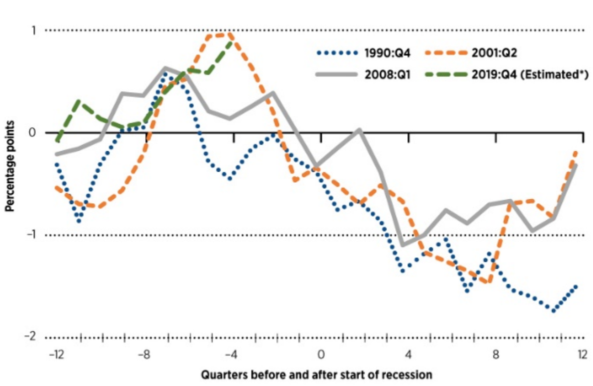
Homeownership Rates and the Great Recession



Source: "High Homeownership Rates in 2005: A Powerful Negative Predictor of Post-Crisis Recovery," https://www.stlouisfed.org/publications/housing-market-perspectives/2018/national-homeownership-rates-negative-predictor

Housing Market Now Hinting At A Recession

Deviation of 30-Year Fixed Mortgage Rate from 12-Quarter Average



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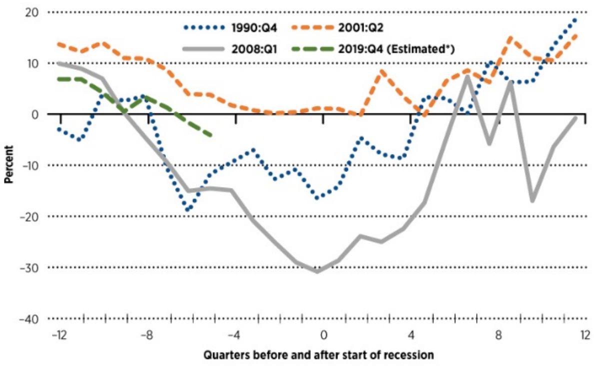
Deviation of Four-Quarter Existing-Home Sales Rate from 12-Quarter Average



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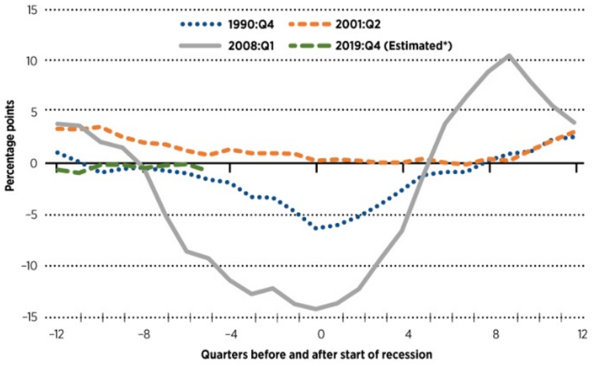
Deviation of Four-Quarter Real Home-Price Change from 12-Quarter Average



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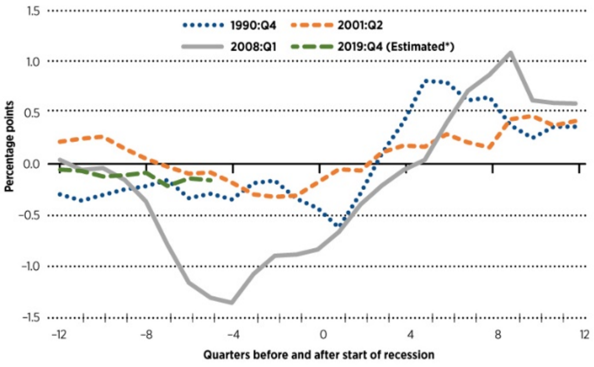
Deviation of Four-Quarter Contribution of Residential Investment to Real-GDP Growth from 12-Quarter Average



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Source: "Recession Signals: Four Housing Indicators to Watch," https://www.stlouisfed.org/publications/housing-market-perspectives/2018/housing-indicators-to-watch

What Is the Future of Highly Leveraged Homeownership (HLH) in the U.S.?

- Policy changes in 2017 tax act reduced benefits of HLH.
  - Higher standard deduction; lower limit on mortgage-interest deductibility; limited SALT deductions; lower marginal rates ALL reduce the financial attractiveness of HLH.
- Permanently(?) lower long-term interest rates reduce the value of the mortgage-interest deduction even more.
- Changes in demographics (growth of non-white population) and the economy (weakness of middle and lower incomes) suggest the HLH “dream” could wane—will policies adjust?