Highly Leveraged Homeownership and Severe Financial Crises

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William R. Emmons, Ana H. Kent and Lowell R. Ricketts

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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)

Photos by Victor J. Blue for the New York Times
Homeownership Includes Idiosyncratic Catastrophic Risk (e.g., wildfires, mudslides, earthquakes, tornadoes, etc.)
Homeownership Includes Idiosyncratic Catastrophic Risk (e.g., urban decay and rural out-migration)
Even Midwest Homebuyers in 2006 With 20-Percent Down-Payments Lost All Their Equity

Index values equal 100 in 2006

House-price level at which a 20-percent down-payment is wiped out (assuming no principal amortization)

Source: Federal Housing Finance Agency/Haver Analytics
At the Worst Point, 1/3 of Mortgaged Homeowners Were Under Water

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

Source: CoreLogic Q2 2012
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

Relationship between Homeownership and per Capita National Incomes

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 coefficient for the 12 countries shown is -0.71 (-0.48 including Ireland).

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.

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Hispanic & Black Families Haven’t Accumulated

Real Value of Mean Homeowners' Equity (HOE) and All Other Wealth by Race and Ethnicity (Index values = 100 in base year)

- White HOE
- Black HOE
- Hispanic HOE
- Other-race HOE
- White other wealth
- Black other wealth
- Hispanic other wealth
- Other-race other wealth

Source: Federal Reserve Survey of Consumer Finances
△HOE (2007-16): Hispanic -38%, Black -20%

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

Homeownership Rate (%): 1970-79 Birth-Year Cohort vs. Predicted

Source: Federal Reserve Survey of Consumer Finances
Non-College Families’ HO Rate: Born in 1970s

Homeownership Rate (%): 1970-79 Birth-Year Cohort vs. Predicted

Source: Federal Reserve Survey of Consumer Finances

SCF Predicted: All families
Non-college graduate 1970s families
Black, Hispanic Families’ HO Rate: Born in 1970s

Homeownership Rate (%): 1970-79 Birth-Year Cohort vs. Predicted

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.

Leveraged Housing Bubbles Are Devastating

Five-year 29 percentage-point cumulative loss of per-capita real GDP (17 countries, 1870-2013)
Homeownership Rates and the Great Recession

Relationship between Homeownership before the Crisis and Change in per Capita Growth after the Crisis

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

NOTE: The correlation co-efficient for all variables shown is ~0.88.

Housing Market Now Hinting At A Recession

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?