Knowledge@Wharton

Falling Prices, Foreclosures and Fear: What's Next for the Housing Market?

Published : October 27, 2010 in Knowledge@Wharton

The U.S. housing market has been wobbly for several years, but it has shown some signs of perking up in recent months. The latest reports, however, indicate a setback, with median home prices dropping slightly and sales well below the already depressed levels of 2009. Yet a combination of low mortgage rates and apparent home-price bargains should still be drawing some buyers into the market. Knowledge@Wharton spoke with Wharton real estate professorSusan M. Wachter about the housing market's slow recovery, the prospect of another sharp dip in prices, the effect of foreclosures on the economy, and what it will take to get the market back on track.

An edited transcript of the conversation follows.

Knowledge@Wharton: The latest figures are showing a slight dip in home prices, and sales are still well below where they were a year ago, which was below where they had been previously. Is this just a bump in the road or an anomaly in the figures, or is this serious?

Susan Wachter: It's not just a bump in the road, by any means. We had this run-up -- if we could call it that -- it was only a very slight run-up during the period of the [federal] tax credit [created by the stimulus bill]. That was the anomaly. We are in a period of uncertainty and the uncertainty is affecting consumer confidence and it is reflected in housing markets. This was [apparent] before the tax credit and we are back to that again.

Knowledge@Wharton: Do you think there is a prospect for a dramatic drop in prices -- 10% or 20%?

Wachter: Well, of course, there is always a possibility. That would depend on the overall economy. But with the overall economy slowly improving -- and I emphasize the word "slowly" -- then we should see this kind of bouncing along the bottom in the overall housing market.

Knowledge@Wharton: What are the various factors that are affecting the housing market and keeping it from reviving faster?

Wachter: It's mostly unemployment. As long as the job market is recovering at this slow pace, then we will likely continue to see a very slow up pace ... and even a decline in housing markets because on top of the unemployment picture there is also just overall consumer confidence, which is very weak. Putting that in front of this large decision -- a large purchase -- clearly people are hesitant to go over that fence to purchase during a period of such uncertainty. On top of that and the overall economy, prices have been declining. And you can get into an expectation situation where prices are anticipated ... to fall and then clearly the buyer is going to want to hold off.

Knowledge@Wharton: There has been a lot of news about foreclosures and it wasn't long ago that everybody was complaining about the high numbers of foreclosures. Now there seems to be a lot of worry that they are not proceeding fast enough due to this paperwork problem that has been in the news. To what extent is the overhang of foreclosures a factor in the market?

Wachter: It is a big factor -- the overhang in foreclosures, the heightened inventory and the heightened vacancy rate. Even if foreclosures ... are slowing -- and of course there is this potential discussion of a moratorium [or] a slowdown in some of the banks -- in the short run, that could

actually lead to a slight spike in housing prices. But the bigger picture is that it contributes to uncertainty and that is the negative at this moment.

Knowledge@Wharton: And then another factor is the high percentage of underwater mortgages -- somewhere around a quarter of the home owners who have mortgages owe more than their homes are worth. Why is that not resolving itself faster?

Wachter: Well, that is of course the shadow potential foreclosure pool right there and people don't want to strategically default on their homes -- some do, but that's a very small percentage ... overall. Borrowers who are currently in default are usually simply unable to make their mortgage payments because of a lack of a job or because their mortgage has re-priced -- reset -- at a point where their current wage income cannot cover it. So really, again, whether this overhang results in increasing defaults and increasing foreclosures going forward depends very much on the overall economy. And, particularly, we should take note of [Federal Reserve] Chairman Ben Bernanke's recent move, which is to absolutely make certain that markets do not anticipate falling prices. The commitment to preventing deflation is absolute. That should help prevent a continuing slow slide in overall prices and in housing prices. But that doesn't really bring the full weight of recovery. Only job growth can do that.

Knowledge@Wharton: And nobody wants to buy a home they think is going to be worth less six months later.

Wachter: Correct.

Knowledge@Wharton: It has been about a year and a half since the Making Home Affordable program, which includes opportunities to modify or refinance mortgages to make monthly payments more affordable, was announced. And the numbers have been very disappointing. This was the plan that was going to allow people to re-cast their mortgages somehow with lower payments.

Wachter: Right.

Knowledge@Wharton: Why have there not been more homeowners able to do that or willing to do that?

Wachter: Well, it's really the bank's modification process. Banks are hesitant to modify. This is a very difficult negotiated proceeding. The investors are [looking] over the shoulders of the banks. There are conflicts. There is no simple answer to this problem of underwater borrowers. If there were, we would have resolved it a long time ago. Again, if people cannot make their payments, at some point along the lines they are likely to be foreclosed and the modification can only help if there is a job in sight.

Knowledge@Wharton: A prominent part of the housing and mortgage market for quite a long time has been the securitization process where mortgages are bundled and turned into securities that investors buy. What is happening in that market? That's been troubled. Is it improving?

Wachter: There is no securitization other than Fannie [Mae] and Freddie [Mac] and FHA through Ginnie Mae, and that [means that] upwards of 90% of all the loans that are being originated today are basically coming with federal support. So in that sense, the securitization market is doing just fine. If you are referring to the private label securitization market -- that's gone.

Knowledge@Wharton: Any chance it will come back?

Wachter: Well, absolutely. There needs to be going forward a private securitization market, but that's going to take reform of Fannie and Freddie.

Knowledge@Wharton: And that's my next question. Is there progress with Fannie and Freddie? Do you see them being more reckless or less reckless than they were in the past? Or should we be confident in the way things are going?

Wachter: Well, confident is exactly what we cannot be. But that's not because of Fannie and

Freddie. Fannie and Freddie are very much at this point, if anything, like other lenders. They have raised the standards tremendously. In fact, the book of business that they are ensuring right now is being extremely carefully underwritten. And Fannie and Freddie really were not the most egregious of the lenders by any means. The private label securitization was really the source of these infamous mortgages that were ninja mortgages -- [going to buyers with] no income, no job, no assets.

Knowledge@Wharton: Do you have a projection of the prospects for this market in the medium and the long-term?

Wachter: I think first of all, it does depend on job growth. We could be surprised. We could have job growth. Clearly corporate profits are up. At some point there is going to need to be a move on hiring and that will be the bellwether for the housing market to recover. In the meantime, as long as interest rates remain low, I think we are finished with this plunge -- this downward plummeting of crisis. So we are bouncing along the bottom, and if you are an investor there are very potential profitable opportunities in the multi-family sector out there.