

Viewpoints

July 2011

Are There Any Rungs Left on the Housing Ladder?



Rod Dubitsky
Executive Vice President, Global Structured Finance Specialist
PIMCO Advisory

Mr. Dubitsky is an executive vice president in the Newport Beach office and global structured finance specialist in PIMCO's Advisory group, which advises institutions globally on complex portfolio risks and valuations, and other challenges. Prior to joining PIMCO in 2009, he was managing director and head of asset-backed securities research at Credit Suisse, where he helped create residential mortgage-backed securities (MBS) surveillance and analytics systems. He was ranked as a leading analyst in asset-backed securities by Institutional Investor magazine in 2002-2008. Mr. Dubitsky was previously a senior analyst focusing on MBS at Moody's Investors Service and an agency MBS portfolio manager at BankAmerica. Before that, he was chief investment officer of a savings and loan and also worked at the Office of Thrift Supervision during the savings and loan crisis. He has 23 years of investment experience and holds an MBA from the Fuqua School of Business at Duke University and an undergraduate degree from the State University of New York, Binghamton.

While the housing market is well off its bubble-era peak, the pending distressed supply has been frequently mentioned as creating additional headwinds, thereby preventing the housing market from mounting a meaningful recovery. Perhaps less discussed, we believe demand-side drivers are just as important.

Additional headwinds contributing to what we see as a dramatic cyclical and secular decline in housing demand will likely continue to weigh on the housing market for the foreseeable future. In spite of what may be considered good affordability (driven by dramatically reduced prices and low interest rates), it appears that limited mortgage availability and vulnerable consumer health across the income and age spectrum are restraining demand and may continue to do so. Also weighing on the market is regulatory uncertainty over the future structure of mortgage finance and the resolution of foreclosure overhang. For all of these reasons, we believe the housing market, considered to be a key driver of the economic recovery, will generally remain weak for the foreseeable future.

Affordability vs. Availability

Housing affordability in many markets may be considered compelling relative to historical levels, but it appears to be increasingly difficult to get a mortgage. We believe tighter mortgage underwriting criteria and the generally weakened financial state of the average consumer is reducing demand. For example, the Federal Housing Administration (FHA), which allows a 3.5% down payment for the best borrowers, has significantly increased its annual mortgage insurance premiums and halved the closing costs that can be financed in the loan balance (which effectively means more cash up front to cover closing costs). Recently it was reported that the FHA is considering tightening its debt to income ratio standards. This, plus general credit tightening by the FHA, suggests that what once was considered the nation's affordability loan product may no longer be as widely available or as affordable as it once was.

For conventional mortgages, Government-Sponsored Enterprises (GSEs) such as Fannie Mae and Freddie Mac have imposed Loan Level Pricing Adjustments requiring a 25% down payment in order for the most qualified borrowers to get advertised rates. Those with credit blemishes and/or less cash to put down could face up to 3.25 additional points in fees (or an additional 65 basis point annual cost assuming a five-year life), according to Fannie Mae.

Viewpoints

July 2011

In addition to GSE and FHA tightening, lenders and mortgage insurers often have even tighter criteria imposing more stringent underwriting, additional fees and rate adjustments on top of the GSEs (FHA lenders in particular are generally requiring stricter underwriting than FHA's guidelines).

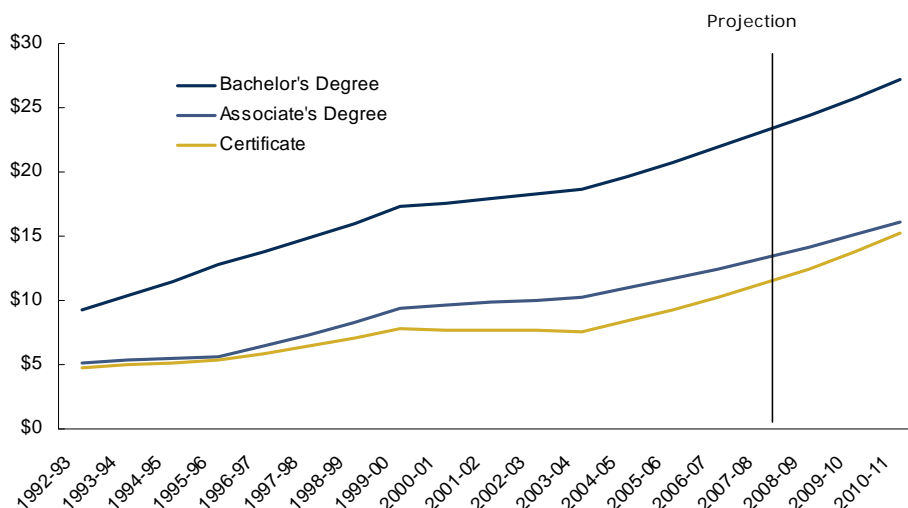
Saving for the traditional 20% down payment may increasingly become an insurmountable hurdle. To help gauge how much of a hurdle the 20% down payment can be (which outside of FHA loans is becoming the de facto standard), we estimated how long it would take the typical consumer to save for a down payment on a median-priced home, which was \$158,700 as of 1Q 2011, according to the National Association of Realtors. Liquid assets held by consumers under 45 years old available for a housing down payment average \$22,600, according to the Federal Reserve Board's Survey of Consumer Finances. In order to cover a 20% down payment and 5% closing costs for the median-priced home, consumers need \$39,667. Therefore the amount needed for a 20% down payment on the median home (and likely a modest home at that) was nearly two times the average savings rate.

Looked at another way, factoring in the personal savings rate from after-tax income as reported by the Bureau of Economic Analysis, we can arrive at a "saving duration rate" expressed in years. We have applied this methodology to calculate the saving duration on a 20% down payment mortgage, which seems to be what the country is migrating towards as the standard mortgage down payment. Based on the current savings rate of 5.1% and after-tax income of \$48,300 (as of 1Q 2011), it would take 16 years for buyers to save the 20% down payment based on the national median-priced home and well over 20 years in many coastal cities where prices are higher. This metric assumes a complete depletion of savings and no retirement savings and other simplifying assumptions. The dramatic spike in sales that occurred as a result of the recently expired housing tax credit shows that relatively nominal assistance in purchasing a home can have an impact on home purchases and affordability. This is a direct reflection of the sparse savings most potential homeowners have available.

Viewpoints

July 2011

Average Student Debt (\$000)



Source: U.S. Department of Education National Postsecondary Student Aid Study, as of 2008

Figure 1

Next Generation Balance Sheets

The hypothetical balance sheet of the next generation of would-be homebuyers looks grim. Average student debt for a bachelor's degree reached \$23,118 in 2008 [and it is projected to go higher (see Figure 1)], according to the most recent National Postsecondary Student Aid Study (NPSAS) conducted by the U.S. Department of Education. This debt roughly equals a 15% down payment on the median priced home in the U.S. as reported by the National Association of Realtors. Moreover, the nominal median salary for recent college graduates declined 10% to \$27,000 in 2010 from \$30,000 in 2007, according to the John J. Heldrich Center for Workforce Development at Rutgers University.

This younger age group will likely constitute the bulk of potential new entrants to the housing market, and whether a corresponding demand in housing will materialize hinges largely on their ability to save. Although some of these grim statistics can be considered a function of recent economic weakness, we believe that some amount of the reduction in graduate earnings power and rise in debt is a longer-term phenomenon that could serve to limit college graduate home purchasing power for the foreseeable future.

Retirement Budget Housing Ramifications

A growing percentage of the population appears to be approaching a limited resource retirement, whether due to inadequate retirement resources or doubts about whether "promised" resources will materialize (e.g. state and municipal retirement plans are under threat).

In the past 30 years, there has been a secular shift in retirement plans from Defined Benefit (DB) to Defined Contribution (DC) programs, according to the Employee Benefit Research Institute (EBRI). Research shows that the income replacement ratio for 401(k)

Viewpoints

July 2011

and other DC plans is not nearly as high as that of DB plans, which can be around 70%–80% of income, depending on years of service. As an increasing number of workers retire with DC plans rather than DB plans, we would expect to see a dramatic falloff in their income levels when they retire. The EBRI reports that the share of private sector workers covered by DB plans has steadily decreased to only 30% in 2010 from 84% in 1980.

Further, to achieve the same level of income replacement at retirement, DC plan participants need to contribute 10% more of their pay than they would contribute under a DB plan, according to the National Institute on Retirement Security, which could be difficult absent a material increase in disposable income. The looming retirement income cliff will likely lead to a reduction in housing demand (or at least a change in preferences) from those approaching retirement, as they prepare for financial cutbacks. This could be manifested in permanently postponed home purchases, reduced tendencies to upsize, lower likelihood of buying a retirement home, more affordable post-retirement rental choices, etc. All of this suggests “downsized” housing choices – one home instead of two, rent rather than own, smaller place rather than large. These choices could serve to reduce the dollars committed to housing investment.

Retiree Savings and Investments (excluding primary residence or DB plans)

	2002	2006	2007	2008	2009	2010	2011
< \$1,000					23%	27%	28%
\$1,000 - \$9,999	45%	30%	32%	51%	17	15	14
\$10,000- \$24,999		12	13	9	16	14	12
\$25,000 - \$49,999	7	14	10	9	13	11	6
\$50,000 - \$99,999	14	11	12	6	9	6	11
\$100,000 - \$249,999	19	13	20	13	10	15	12
>\$250,000	15	21	14	12	12	12	17

Source: EBRI and Mathew Greenwald & Associates, Inc., 1993–2011 Retirement Confidence Survey

Figure 2

In addition to inadequate 401(k) savings, retirees face limited resources in non-retirement funds. As shown in Figure 2, some 54% of retirees claim to have less than \$25,000 in the total value of their household’s savings and investments, excluding the value of their primary home and DB plans. We expect most will be hesitant to spend these precious savings on a home, given the destruction in housing net worth and potentially limited income generated from DC plans. This could continue to curtail demand for trade-ups, retirement homes, etc.

Regulatory Headwinds Abound

In addition to these affordability constraints, a number of legislative and regulatory developments could potentially squeeze availability of mortgage loans:

- **Mortgages:** Though it is highly uncertain what the future structure of the mortgage market will look like, one thing is probable: The mortgage market of the future will have less government and more private sector involvement, though

Viewpoints

July 2011

this may take several years. This will likely result in rising mortgage rates in general and more risk-based pricing in particular as the private sector increases rates to weaker GSE-eligible borrowers.

- Basel III: Among other changes potentially impacting the mortgage market, Basel III imposes increased capital charges on retained mortgage servicing, which further increases the cost of securitization as servicers who retain the servicing will be subject to more onerous capital charges. Currently, 100% of the value of mortgage servicing rights is applied to Tier I capital. Under Basel III, the capital benefit of mortgage servicing rights will gradually be phased down to 15% of equity capital.
- Dodd-Frank: Among the elements of Dodd-Frank that could suppress mortgage supply are the risk retention rules that require securitizers to retain 5% of securitizations for loans not meeting Qualifying Residential Mortgages (QRM) criteria. Among other elements, QRM mortgages stipulate a minimum 20% down payment and a maximum mortgage debt ratio of 28%. The comment period has ended on these proposals and the rules are expected to become final within 60 days of the end of the comment period (e.g. 60 days from June 10, 2011).

This could further impair the use of securitization to help stimulate the supply of mortgages. Though the GSEs are exempt from the risk retention rules, given that the future mortgage market will likely be less reliant on the GSEs (and the degree of GSE involvement will be heavily dependent on the political landscape), the securitization market is considered critical to offsetting the dwindling capacity of the GSEs. With a potentially declining presence of the GSEs and a minimalist securitization market, there simply does not appear to be enough bank capital (and banks are the most likely source of alternatives to GSE and securitization funding) to adequately support mortgage lending.

Together, the GSEs issued an average \$1.2 trillion in securitized mortgages each year for the past 10 years (source: SIFMA). Though clearly some of this will continue to be funded via the successors to the government-related entities, it's likely that some meaningful proportion of the future mortgage market will need to rely on non-government entities. And banks are the most likely entities to help fill the gap, given the size of their balance sheets and the size of the mortgage market. How much of this can banks assume, on top of the \$2.6 trillion or so the FDIC reports they already hold on their books? Covered bonds (backed by mortgage cash flows) are a possible source of financing, but since covered bonds provide no capital relief, they will likely have a limited role in replacing the GSE-supported capacity.

Though banks aren't the only marginal investors and investors such as real estate investment trusts (REITs) and alternative investors like private equity and hedge funds will help fill in, the size of the mortgage market is such that banks will likely fill a critical gap in demand for mortgages. If the issuance of mortgages by GSEs declines significantly and the private sector cannot keep pace with the remaining demand, it would likely translate into a reduction in mortgage availability and implied higher rates for would-be homeowners. Of course, we still expect a significant role for GSEs (or their successor entities) going forward. However, there could be some reduction in their role, dependent on political winds, and any significant degree of transfer from GSE to private sector would likely impact the pricing and availability of mortgages.

Viewpoints

July 2011

Conclusion: Appearances Can Be Deceiving

A basic concept of personal finance is that as long as borrowers have sufficient funds for a down payment and a stable source of income, the next rungs up on the housing ladder should be within reach. For the typical American homeowner, these requirements have traditionally been satisfied by solid employment for young graduates, reasonable pricing and availability of mortgage credit, accumulation of funds that allow trade-up purchases of larger homes and finally by the view of housing wealth as a potential income supplement during retirement.

However, we believe the challenging economic situation today has dramatically altered this progression. At the bottom of the ladder, dismal employment prospects and the debt situation of young graduates may be impeding their ability to save for a down payment. In the middle of the spectrum, negative equity is effectively preventing many homeowners from advancing (i.e., Core Logic estimates that over 23% of homeowners have negative equity in their homes preventing them from buying a new home). And at the top of the ladder, the erosion of retirement income could result in downscale housing investments and may push retirees to consign themselves to the status of lifetime renters. Instead of serving as a potential wealth builder, housing has in some cases become a potential millstone that can drain limited remaining liquidity and retirement funds. Hence, even buyers who can climb on to the home ownership ladder may opt out of home ownership in favor of what is often times the more flexible, available rental option.

Tight mortgage lending standards, pending GSE reform and weak economic conditions across the demographic spectrum render the prospects for housing demand increasingly grim. Though there will be some rebound in demand as the economy finally achieves escape velocity and income and employment growth return to normal levels, we are arguing that post-recovery demand will be more tempered than it has been in the past. Further, people need to live somewhere, and investors will likely step into the breach (and have already, as a large percentage of today's home sales are all-cash sales to investors) as more housing becomes rental housing. The implication is that we could see further home price declines as we move from a nation of owner occupants to a nation of renters/investors.

Though much has been made of the distressed supply overhang, we believe the demand side of the housing equation could more than overwhelm the impact of distressed housing supply. Absent a significant economic rebound or more dramatic policy response, housing demand will likely remain a drag on the housing market for the foreseeable future.

This material contains the opinions of the author but not necessarily those of PIMCO and such opinions are subject to change without notice. This material has been distributed for informational purposes only. Forecasts, estimates, and certain information contained herein are based upon proprietary research and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Statements concerning financial market trends are based on current market conditions, which will fluctuate. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission. Pacific Investment Management Company LLC, 840 Newport Center Drive, Newport Beach, CA 92660, 800-387-4626. ©2011, PIMCO.