Analysis

US property market

Streets behind

A crucial sector of the world's biggest economy remains resistant to attempts to revive it, intensifying concern about the country's struggling recovery. *By Shahien Nasiripour, Michael Mackenzie and Nicole Bullock*

Unseated: a child looks at furniture piled outside her foreclosed family home. A glut of such properties is expected to keep prices low Getty

It was October 2010 and a suburban Washington auditorium was packed with a hushed crowd of housing experts and financial regulators as a senior adviser at the Federal Reserve Bank of Boston picked apart federal aid programmes meant to stem the rising tide of mortgage defaults and home seizures crippling the US economy. The efforts, concluded Paul Willen, amounted to "three years of failed policies".

Just over a year on, the story remains grim. Homeowners are still struggling as two White House administrations and the Federal Reserve have failed to stop the bleeding in a crucial sector of the world's largest economy.

"There isn't a lot the government can do to prevent foreclosures," a frustrated Mr Willen says now. "And we've just been banging our heads against the wall now for four years, trying."

Nearly five years after America's housing market showed the first signs of distress, prices are once more falling after false dawns in 2009 and 2010, with forecasters aiming for prices to return to last year's levels some time in 2014.

Construction of homes for families remains depressed. Sales of new homes are at record lows while those of existing homes are a third below their 2005 peak. Delinquencies remain near record highs, and the pipeline of seized or soon-to-be-seized homes waiting to hit the market continues to grow, leaving would-be buyers fearful that the largest investment of their lifetimes will soon be devalued thanks to a flood of distressed homes dragging down prices.

All of which leaves US homeowners in the lurch as government policies and record low interest rates fail to arrest the property slump. About 700,000 troubled borrowers have been able to cling to their homes through permanently reduced monthly payments – that is less than one-fifth of President Barack Obama's goal when the programme began in 2009. Lenders seized 2m homes in 2009 and 2010 combined, and are expected to repossess another 1m this year.

The Fed for its part is focusing on the sector with renewed intent, mindful that the economy needs to gain traction amid threats to global growth prospects such as the eurozone debt crisis and a slowdown in China.

"The housing sector is a very important sector," Ben Bernanke, the nation's top central banker, said on Wednesday after this month's federal open market committee meeting at which official borrowing rates are set. "The problems in that sector are clearly a big reason why our economy is not recovering more quickly."

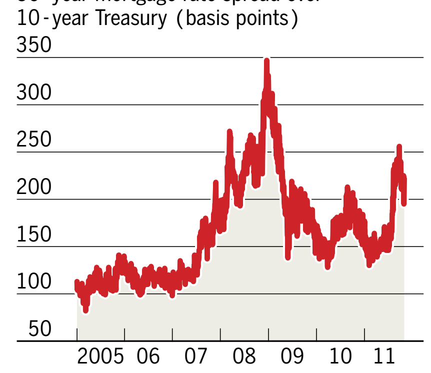
In a normal US expansion, housing contributes half a percentage point to real growth in gross domestic product, according to economists at Goldman Sachs. Today, it is having the opposite effect. In the past year, says Goldman, housing has subtracted 0.15 of a percentage point from the economy's gross domestic product – the result of what many analysts call a negative feedback loop.

About 25m Americans were unable to find full-time work last month, according to the labour department. The lack of steady pay cheques fuels the delinquency rate, pushing borrowers into foreclosure. That, in turn, increases the number of distressed homes on the market, which drags down overall prices. Lower valuations make homeowners feel poorer, reducing consumer confidence and overall consumption. Lower confidence leads to fewer buyers, which hits sales, dragging prices down further.

The Fed, after nearly three years of extraordinary measures, is seen as being powerless to reverse the cycle. Daniel Tarullo, a member of the central bank's board of governors, argues that it should now "move back up toward the top of the list of options the large-scale purchase of additional mortgage-backed securities".

US homeowners are paying a high premium...

30-year mortgage rate spread over 10-year Treasury (basis points)

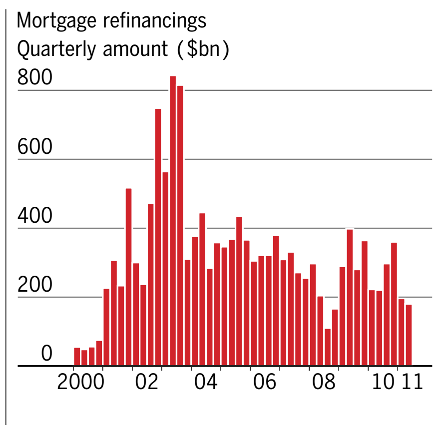


Sources: Haver Analytics; CoreLogic

...and few are able to switch to a cheaper rate...

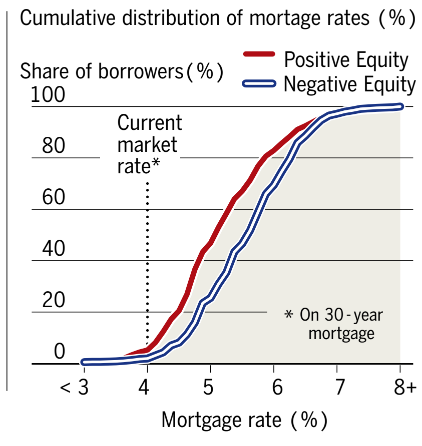
Mortgage refinancings

Quarterly amount ($bn)



...so the prudent can be charged as much as the rest

Cumulative distribution of mortage rates (%)



These bundles of home loans, purchased by the Fed, would provide lenders with liquidity – and borrowers, in turn, with lower rates, thereby easing a burden Mr Tarullo likens to "an albatross around the necks of homeowners and the economy as a whole". This month, Mr Bernanke called the idea a "viable option".

The myriad problems preventing the Fed from playing a more effective role include timidity on the part of banks when it comes to financing home loans; diminished capacity in the mortgage industry to process new loans; and home equity at historic lows.

Thanks to the Fed, however, there is one bright spot in the market. Interest rates for buyers and those hoping to refinance existing loans have never been lower, data from state-controlled mortgage financier Freddie Mac show. The National Association of Realtors' monthly index shows that housing has never been more affordable than it is this year, taking into account home prices, the cost of a mortgage and household income.

But the picture is less rosy for those without access to loans, warns Scott Simon, head of mortgage and asset-backed securities at Pimco, the world's biggest bond fund manager. "If you cannot get the mortgage," he says, "it is infinitely expensive", putting even the most modest purchase out of reach.

Therein lies the central difficulty plaguing Fed policymakers as they attempt to stabilise the housing market and prevent it from dragging down economic growth. Mr Bernanke says that, in the mortgage market, monetary policy has been "blunted . . . very tight credit standards have prevented many people from purchasing or refinancing their homes. The low mortgage rates that we have achieved have not been as effective as we had hoped."

Some 28m mortgage holders out of a total of about 55m are paying above-market interest rates, defined as a percentage point or more over the average rate for a new 30-year mortgage, estimates CoreLogic, a data provider. Close to three-quarters of them, or 20m, have equity in their homes, making them at least in theory prime candidates for a refinancing. But lenders, still smarting from losses on loans to borrowers not required to prove their incomes, are more reticent now. The most recent Fed data show most that senior loan officers say lending standards for home loans are among the toughest seen in the past six years.

Conditions are so tight that even in Denver, where the property market is relatively healthy, buyers are having a hard time. Prices in the Colorado city fell just 10 per cent from their peak in 2006, compared with a national average of nearly one-third; today, however, applications for refinancing from homeowners with equity of up to 5 per cent are being tossed aside as non-creditworthy, estate agents report.

During the go-go years of the previous decade, "anybody could get a loan", says Karen Beville, a property dealer based in Denver. "All you had to show was that you were breathing." Now, she says, "good-qualified borrowers are having to jump through so many hoops in providing different types of documentation that they feel insulted".

It does not help that, according to Laurie Goodman of US-based broker-dealer Amherst Securities, the four largest mortgage lenders in the US control nearly two-thirds of the market and are not passing on cheaper borrowing rates to homeowners.

'There isn't a lot we can do to stop foreclosure. We've been banging our heads against the wall for four years, trying'

The story is especially grim for borrowers who owe more on their mortgage than their property is worth. Nearly one-quarter of homeowners with a mortgage, or about 11m borrowers, owe more on that debt than their homes are worth, putting them "under water" to the tune of about $700bn, according to CoreLogic. Banks are exceedingly cautious about lending to such borrowers, who are at greater risk of default.

The Obama administration last month announced that the Federal Housing Finance Agency, the regulator for Freddie Mac and sister company Fannie Mae, would ease standards for "under water" borrowers with Fannie and Freddie loans to refinance into cheaper government-backed mortgages. But the FHFA expects only 1m homeowners to benefit.

Those who have lost their jobs and are unable to meet monthly payments form another particularly troubled group. More than 4m homeowners are more than 60 days late on their payments or already in foreclosure, according to the Mortgage Bankers Association and data provider Lender Processing Services. Delinquent borrowers generally do not qualify for new loans.

As limited as the Fed's tools are, it is doing all it can to spur a housing market recovery. Recently, for example, it has attempted to lower the yield on the 10-year Treasury note, the benchmark bond that guides mortgage interest rates, through the Operation Twist asset-purchase initiative announced in September.

It will also take principal payments from its stock of mortgage-backed securities and holdings of Fannie Mae and Freddie Mac's corporate debt and invest those proceeds in fresh mortgage-backed bonds.

The increasing difference in yields between mortgage securities and Treasuries led to the move. Brian Sack, the New York Fed's markets group chief, says this worrying development "was keeping mortgage rates higher than they otherwise would have been".

The programme is helping, but not much. Borrowers are paying about 4.1 per cent for a new mortgage, down from about 5.1 per cent in February – but they should be paying just 3.6 per cent. The Fed's "rates are not the medicine that they used to be for the housing market", says Karen Weaver of Seer Capital Management.

Such limitations on the government's traditional weapons are causing some to argue for new approaches. One proposal involves finding a new source of buyers to reduce the glut of homes on the market.

Giving institutional investors incentives to buy seized properties to rent, in order to support the market for a limited period, is "the missing link" – the key to solving the nation's housing woes, says Bryan Whalen of TCW, an asset manager. "It's not a question of there being too many properties for the population," he argues. "We need to bring down the rate of homeownership and help more people to rent homes."

Federal officials are contemplating such a policy. But, like much of the federal response to the housing crisis, action on a scale commensurate with the problem remains unlikely.

As Mr Willen puts it, little has changed in the year since his Washington lecture except for one thing: "When people come along and say we can do such-and-such and prevent a million foreclosures, they get less of an audience now."

Housing market outlook
From ownership society to a nation of renters

The American dream of owning one's home has become a nightmare in the aftermath of the financial crisis, according to analysts at Morgan Stanley, *writes Shahien Nasiripour*. Some 20 per cent of homeowners are either unable or unwilling to make their mortgage payments, they say. For the remaining 80 per cent, that in turn has helped drive property prices to new lows.

With home ownership rates falling from a record 69.4 per cent in 2004 to 66.1 per cent, and forecast to tumble even further, the Morgan Stanley analysts reckon "it's safe to say that the ownership society is suffering", Stripping out delinquent borrowers, who they say are merely renting homes they will soon be forced to give up, they peg the true rate of ownership at about 60 per cent.

What began generations ago as a state-directed quest to boost Americans' wealth by turning them from renters into owners backfired when the property bubble burst in 2007, after large numbers found themselves unable to cover their monthly instalments. Now an ever greater proportion – including former borrowers whose properties were seized and potential owners shut out of the market because of poor credit histories or a lack of cash – are looking to rent.

The ownership rate could drop to 61 per cent in the next three to five years, says Karen Weaver of US-based Seer Capital Management. It has not fallen below 62 per cent since before 1960, US Census Bureau data show. Ms Weaver says the shrinking of the middle class will drive the rate lower. New households will not pick up the slack as they "will be disproportionately minority, and minorities have disproportionately less access to credit", she says.

Laurie Goodman of US-based broker-dealer Amherst Securities forecasts that another 10.4m borrowers, or one in every five, is likely to default in the coming years, driving the rate yet lower.

That will leave a dwindling band of homeowners who can afford to meet their mortgage payments. The rest will rent. "The beginning of the rentership society is upon us," says Morgan Stanley.

Speed read

Irregular recovery In a normal US expansion, housing contributes half a percentage point to real growth, say Goldman Sachs economists. Today it is having the opposite effect

The Fed's focus Though the central bank is concentrating on the housing sector with renewed intent, mindful that the economy needs to gain traction amid threats to global growth prospects, it is seen as powerless to end the negative feedback loop

Foreclosed and for rent Some propose giving institutional investors incentives to buy seized properties to rent in order to support the market

On the web

In depth: for news, comment, video and interactive graphics on the US, visit **www.ft.com/us**