PERSPECTIVES ON THE HEALTH OF THE U.S. ECONOMY: RESTORING BALANCE TO HOUSING’S ECOSYSTEM

CENTER FOR CALIFORNIA REAL ESTATE EXECUTIVE REPORT

ROUNDTABLE SERIES 2015
CALIFORNIA ASSOCIATION OF REALTORS®
This executive report presents analysis from a panel convened by the CALIFORNIA ASSOCIATION OF REALTORS® (C.A.R.) in July 2015 featuring four leading economists. This report is the second installment of the Center for California Real Estate’s 2015 Roundtable Series. The Center, founded by C.A.R., engages experts in substantive conversations to bring clarity to the policy challenges and economic opportunities that will shape the future of housing.

We were gratified to have such distinguished discussants join C.A.R. Chief Economist Leslie Appleton-Young for this event. Special thanks to Nela Richardson, Jonathan Smoke, Christopher Thornberg, and Laurie Goodman for sharing their invaluable expertise with the membership of C.A.R. Their insightful analysis provided greater understanding of the economic dynamics at play in the marketplace—which are of pressing importance to real estate professionals in California, especially as housing affordability remains a lingering concern.

Led by Appleton-Young, the wide-ranging conversation covered macroeconomic analysis of current conditions in the market, housing prices and affordability, the reasons behind persistently low inventory, the declining homeownership rate, credit availability, and policy solutions to strengthen the market. Actively pursuing such dialogues in order to elevate the best of industry thinking is reflective of C.A.R.’s commitment to promoting a new standard of intellectual engagement in real estate.
• PARTICIPANTS

• LESLIE APPLETON-YOUNG

**Chief Economist, CALIFORNIA ASSOCIATION OF REALTORS®**

Leslie Appleton-Young is Chief Economist of the CALIFORNIA ASSOCIATION OF REALTORS® (C.A.R.), a statewide trade organization with 175,000 members dedicated to the advancement of professionalism in real estate. Appleton-Young directs the activities of the Association’s Member Information Group. She oversees the analysis of housing market and brokerage industry trends, member communications, and membership development. She is also closely involved in the Association’s strategic planning efforts.

Before joining C.A.R. in 1984, Appleton-Young was a consultant with Telesis Inc. in Rhode Island. She also spent several years working as a research associate at the Federal Reserve Bank of Philadelphia and as an instructor at the University of Pennsylvania. Appleton-Young earned a Bachelor of Arts degree in economics from the University of California, Berkeley. She earned a Master’s degree in economics from the University of Pennsylvania.

• LAURIE GOODMAN

**Director, Housing Policy Finance Center, Urban Institute**

Laurie Goodman is the center director of the Housing Finance Policy Center at the Urban Institute. The center is dedicated to providing policy makers with data-driven analysis of housing finance policy issues.

Before joining the Urban Institute in 2013, Goodman spent 30 years as an analyst and research department manager at a number of Wall Street firms. From 2008 to 2013, she was a senior managing director at Amherst Securities Group, LP, a boutique broker/dealer specializing in securitized products, where her strategy effort became known for its analysis of housing policy issues. From 1993 to 2008, Goodman was head of Global Fixed Income Research and manager of US Securitized Products Research at UBS and predecessor firms.

She is a member of the Bipartisan Policy Center’s Housing Commission, the Federal Reserve Bank of New York’s Financial Advisory Roundtable, and the New York State Mortgage Relief Incentive Fund Advisory Committee. Goodman has a Bachelor of Arts degree in mathematics from the University of Pennsylvania and a Ph.D. in economics from Stanford University.

• NELA RICHARDSON

**Chief Economist, Redfin**

Nela Richardson, Ph.D., joined Redfin in 2014 as the company’s first chief economist. Richardson comes to Redfin from Bloomberg LP, where she served as a senior economist with Bloomberg Government. She also served in past roles in the mortgage industry, capital markets, and financial policy. Richardson leads the Redfin team of economists and data scientists responsible for providing compelling industry reports.

At Bloomberg Government, Richardson was a senior economist specializing in financial policy. Before joining Bloomberg, she worked as a research economist at the Commodity Futures Trading Commission (CFTC), and was a member of its Dodd-Frank financial reform rule-making team. Prior to her work at the CFTC, Richardson was a researcher at Harvard University’s Joint Center for Housing Studies, a senior
Richardson has taught economics and finance courses at both the University of Maryland and the John Hopkins Carey School of Business.

Richardson holds a Ph.D. in economics from the University of Maryland, a master’s degree in economics from the University of Pennsylvania, and a bachelor’s degree from Indiana University.

• **JONATHAN SMOKE**

**Chief Economist, Realtor.com**

In 2014, Move, Inc., selected Jonathan Smoke as the first chief economist for realtor.com®, the official site of the National Association of REALTORS®. Smoke, based in Washington, D.C., is a 20-year real estate veteran, and leads a team of real estate analysts.

For the past six years, Smoke has served in key executive roles for Hanley Wood, serving the residential, commercial design, and construction industries, including chief economist and senior vice president, executive director of market intelligence, and senior vice president of products and innovation. As an entrepreneur, in 2006, Smoke founded BlueSmoke, LLC, of Atlanta, a housing market research company. Prior to founding BlueSmoke, LLC, he served in several executive roles for Beazer Homes of Atlanta where he developed its online business strategy. Smoke started his career as a management consultant with Deloitte.

He graduated from Rhodes College in Memphis, Tenn., magna cum laude and Phi Beta Kappa with a Bachelor of Arts degree in Economics and Religious Studies. He also earned a Master of Business Administration from McCombs School of Business at the University of Texas at Austin.

• **CHRISTOPHER THORNBERG**

**Founding Partner, Beacon Economics, LLC**

Christopher Thornberg is Founder of Beacon Economics, LLC. An expert in economic forecasting, regional economics, employment and labor markets, economic policy, and industry and real estate analysis, he was one of the earliest predictors of the subprime mortgage market crash that began in 2007 and the global economic recession that followed.

Since 2006, Thornberg has served on the advisory board of the Wall Street hedge fund Paulson & Co., Inc. In 2015, he was named to California State Treasurer John Chiang’s Council of Economic Advisors. He is on the boards of the Los Angeles Area Chamber of Commerce, the Central City Association (Los Angeles), the Asian Real Estate Association of America, and America’s Edge.

Prior to launching Beacon, he was an economist with UCLA’s Anderson Forecast. Thornberg holds a Ph.D. in Business Economics from the Anderson School at UCLA, and a B.S. degree in Business Administration from the State University of New York at Buffalo.
TABLE OF CONTENTS

PART I
The Economy: A Macroeconomic Perspective

PART II
Housing Prices and Affordability

PART III
Credit Availability
PART B. Inventory

PART IV
Homeownership

PART V
Housing Demand and Prices

PART VI
Policy Solutions

PART VII
Concluding Remarks

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BACKGROUND

The Center for California Real Estate (CCRE) is an institute founded by the CALIFORNIA ASSOCIATION OF REALTORS® (C.A.R.) dedicated to intellectual engagement in the field of real estate. Its mission is to advance industry knowledge and innovation with an emphasis on convening key experts and influence-makers. CCRE reflects C.A.R.’s increasing role in shaping the future of the industry by advancing innovative policy solutions and active dialogue with experts and industry stakeholders. The Association works in conjunction with 120 local associations of REALTORS® throughout the state, as well as with the National Association of REALTORS®. Serving nearly 175,000 members statewide, C.A.R. provides a wide array of products and services to meet its diverse member needs. Additional background on CCRE and C.A.R. can be found at centerforcaliforniarealestate.org.
PART I. THE ECONOMY: A MACROECONOMIC PERSPECTIVE

“The U.S. economy’s chugging along, and I think you’re definitely starting to see that in the housing market again.”

- Christopher Thornberg

The health of the U.S. economy – following the worst financial crisis since the 1930s and the largest emergency, economic stimulus in history – has been understandably a fixation in a period of recovery. As the volatility of economic ups and downs fades under conditions that would seem to put the country’s economic winds at its back, there is increased optimism about the strength of the U.S. economy. The unemployment rate fell to a seven-year low in July, and the level of financial stress in the money, bond, and equity markets is the lowest under the current Federal Reserve than it’s been in the preceding 25 years, according to the Bloomberg Financial Condition Index, a measure of market health. Greater stability has brought a sigh of economic relief, with the fundamentals of the economy all experiencing positive developments, namely some improvement in labor, wages, industrial production, consumer spending, and credit. However, while progress in the fundamentals of a sound economy reflects a far healthier U.S. financial system, a panel of experts drew attention to the importance of housing for achieving the right balance that long term viability requires.
The panel framed housing as an ecosystem of interconnected parts—all of which play a vital role in contributing to the economic health of not only the housing market but also the economy as a whole. Panelists discussed which components of the housing ecosystem are creating a state of imbalance, since all areas of a complex network must function optimally to ensure the whole system is in harmony. Challenges abound for the housing market, despite positive signs for key economic fundamentals, so restoring balance to housing’s ecosystem by addressing the underperforming components was emphasized as central to the continued recovery of the U.S. economy.

As panelists sat down with C.A.R. Chief Economist Leslie Appleton-Young, they were presented an opportunity to reflect on the interplay and balance of all the parts contributing to the health of the housing ecosystem and the economy at large. Appleton-Young began by asking panelists to provide their view of current economic conditions from a macroeconomic perspective. Chris Thornberg, Founding Partner at Beacon Economics, LLC, posited that the fundamentals of the economy continue to strengthen after a weak first quarter, so he expects the remainder of 2015 to be a good year for the economy, stating, “The U.S. economy’s chugging along, and I think you’re definitely starting to see that in the housing market again.”

Laurie Goodman, Director of the Urban Institute’s Housing Policy Finance Center, expressed similar positive sentiments about the overall economy and the promising developments accentuated by Thornberg. She added that wage growth is likely higher than widely reported figures: “I would argue that you’ve actually had a fair bit of acceleration in wage growth already from 1.5 percent up to slightly above 3 percent, and that’s going to continue. The passage of minimum wage laws and the continued recovery is going to drive that up even higher.”

In turning the conversation to interest rates and their effect on the economy, Goodman noted the Federal Reserve will likely raise rates before the end of the year, as is widely expected. Goodman added she does not anticipate such an increase having a detrimental impact on housing anytime soon because she opined that housing is undervalued nationally. She stipulated, “Of course, it’s overvalued in California, or not necessarily overvalued, but it’s very pricey relative to where it was in 2000 to 2003, relative to incomes. But I would argue for most of the country housing is actually slightly undervalued.”

Goodman believes that even if interest rates were to rise to 6 percent, the effect would restore affordability nationwide to levels experienced from 2000 to 2003. To her point on homes being undervalued, Thornberg agreed that “When you think about real estate markets, they are still undervalued because of these low interest rates.” Appleton-Young added that the process of raising rates will be gradual, with Thornberg stating that in the end, mortgage rates are driven by the 10-year Treasury bond yield, and he does not anticipate the Fed’s move to “matter at all for real estate.”
Jonathan Smoke, Chief Economist for Realtor.com, joined the consensus on the panel that the impending increase in interest rates will have no discernible impact on the housing market. Perhaps counter to prevailing wisdom, Smoke argued that higher mortgage rates may further loosen credit:

“I think the banks have too much to risk in the current environment. If rates were 40 to 50 to 60 basis points higher, you would start to see the scenario in which their pool of easy money coming from refinancing has to come instead from the purchase market. And that’s when we’re probably going to see a lot more variation in, for example, the average credit score or the average LTV or average debt-to-income ratio because all three of those metrics have not moved. They are more or less exactly what they have been for the last two or three years, give or take a point, in any given month.”

In describing the overall economic climate, Smoke stated that movement ahead is sustainable but he feels the economy has fallen into a “Goldilocks type of environment.” That is to say current conditions – if experienced in other cycles – would have led to a boom-and-bust scenario, but that has not occurred this time around, despite the robust increase in permits, starts, and activity typically leading to boom and bust cycles. He concluded, “As a result, this sort of rate could go on for much more than just a year or two because of it being a Goldilocks-like [environment].”

Smoke went on to contextualize Goodman’s comments about wage growth with analysis of the types of jobs being created in this economy. Singling California out in particular, Smoke noted that California has had roughly a 15 percent increase in households from 2000 to 2015, and the number of households that make over $200,000 has more than doubled during that time. So these households, based on their jobs, can afford to pay the higher cost of housing, which has contributed to difficult conditions in the economy with respect to affordability and supply, but in the long term he expects it will encourage the right kinds of development. He stated, “It’s part of the reason why, in a scarce environment, where new construction’s not picking up, we’ve seen the kind of appreciation that we’ve seen. Is that sustainable over the long term? Absolutely not. But from a pure economics perspective, it’s actually what the market needs to do to encourage the development and the activity that will eventually provide some form of resolution.”

Concern about the types of jobs being created in this economy led Nela Richardson, chief economist for Redfin, to describe her position as more negative on the pendulum of U.S. economic health. She believes the quality of the country’s jobs have shifted over time,
and while those who never lost their jobs through this cycle have recovered, the recovery has not been equally felt across the economy, especially for those who are depending on jobs that may no longer secure a middle-class life. Richardson stated there is reason to worry the middle class won’t share in economic opportunity if new household growth is distant from the economic activity. What will it mean for the economic future of states like California if job creation occurs in urban areas where people simply cannot afford to live? She stated the following:

“I’m concerned that this recovery, if you want to call it that, has occurred without housing. It used to be that housing was the instigator for coming out of a recession or going into a recession. But really it was the economy and the stock market, frankly, that pulled housing along. So I wonder what that means when housing is discounted for widespread economic activity because, for the middle class, housing is the wealth creator. I’m concerned about an economy that is structured in a way that is unequal and is distributed unequally. My last concern is that the geographic concentration of the economic activity is becoming less and less available in terms of where people are living.”

If middle-class people cannot be a part of economic opportunity, then Richardson emphasized that when it comes to housing, the stock might be good, but the flow is suspect. Her comments faced some pushback from Thornberg, who noted that there has been job growth in regions that are not major tech, urban areas like San Jose and San Francisco. For example, the Inland Empire, Fresno, Stockton, Sacramento, and Bakersfield are positive examples he cited to buttress his counterpoint on the distribution of the recovery in the state, stating

-Nela Richardson

Nela Richardson, chief economist for Redfin, shares her concerns about the recovery of the economy.
these regions are experiencing real payroll job growth. Richardson questioned the quality of these jobs and asserted that people are moving to these areas because they cannot afford to live in cities like Los Angeles.

Thornberg made the larger point that affordability is poor in areas like Los Angeles because incomes are climbing so dramatically, which was met with agreement by the panel. He acknowledged that the state has a lot of low-skilled workers who were hurt the most by the recession, and while they are getting service-oriented jobs, the growing state of income inequality is more a function of “technological change,” according to Thornberg—which led him to stress the importance of education as the key to ensuring economic equality.

In fact, on the subject of the economics of education, researchers Erik Hanushek of the Hoover Institution, and professor Ludger Woessmann of the Ifo Institute for Economic Research in Germany, found evidence from across the world that national average student performance at age 15 on an internationally standardized mathematics test is predictive of that nation’s future economic growth. Their research reveals that on an international test where the average score is 500, raising the average by 25 points would generate more than $40 trillion in cumulative additional output over the next 20 years in the U.S. This is the equivalent of two entire years of gross domestic product, a potential payoff that is hard to ignore. The ability of improved education to narrow income disparities was met with consensus on the panel, with Appleton-Young warning that on the topic of current income levels, more millennials could leave California if their incomes cannot keep pace with the cost of living in a state hampered by affordability issues, thereby moving the discussion to the state of housing prices.
In discussing home prices, Appleton-Young began by pointing out that the National Association of REALTORS® reported in July that the national median sales price reached an all-time high. According to NAR, the median existing-home price for all housing types in June was $236,400, which is 6.5 percent above June 2014 and surpasses the peak median sales price set in July 2006 ($230,400). June’s price increase also marks the 40th consecutive month of year-over-year gains. California’s housing prices are also quite striking, as C.A.R.'s research has reported that in the second quarter of 2015, the statewide median price reached $446,980, which was nearly 50 percent higher than what a California household with the median income of $60,244 could afford to purchase. C.A.R. also reported that the July statewide median home price was $488,260, which is an increase of 5.4 percent from July 2014. Appleton-Young asked the panelists to consider whether a bubble is forming and to offer their perspective on the current state of housing prices and whether it is appropriate to use the peak as a benchmark to understand the state of the market.
“We actually have less financing supporting real estate in this country now than we did prior to 2000. So what has happened in this recovery has been more of a natural recovery, more driven by the jobs and the nature of creation. The hottest places in the country consistently are the places that have the most significant job growth.”

- Jonathan Smoke

Goodman explained the Urban Institute's findings on affordability relative to median income, and how they compare to 2000 to 2003 levels. It was found for the major metropolitan statistical areas (MSAs) nationwide that the three most unaffordable areas relative to 2000 and 2003 are, number one, Los Angeles; number two, San Francisco; and number three, San Jose. She added that California doesn’t look like the rest of the country in a lot of ways and there are some distortions in house prices, commenting:

“Just to quote the CoreLogic HPI, their home price appreciation measure, from 2000 to the peak, we went up about 99 percent. From peak to trough, we dropped about 32 percent. We’ve gone up 35 percent since then, but obviously you’re starting from a much lower base. So in order to achieve peak levels nationwide, home prices would have to rise another 9 percent. That means we’re about 9 percent below peak on that type of measure. Obviously, some areas are well past the peak, and some areas [such as] in the Inland Empire remain well below the peak.”

When it comes to making a peak-to-peak price comparison, Thornberg stipulated that, “The reason California hasn’t gotten back to the previous peak is because our previous peak was massively out of whack.” He added it’s misguided to fixate on peak-to-peak prices because “it’s not inflation adjusted. It’s not income adjusted. And most importantly, it’s not interest rate adjusted.” Smoke pointed out that it is still worth keeping in mind that if you adjust for inflation, the NAR number is 20 percent, on real terms, beneath its prior peak.

Goodman conceded that prices peak-to-peak is not always the best comparison, but added, “I still think, when you look at housing nationwide, we are remarkably affordable.” This is because incomes have risen, home prices remain well below the previous peak, and real estate was overvalued at that point in time, leading to real estate being undervalued now, according to Goodman.

As for the process by which prices were driven to hit their peak in the market, Smoke noted it’s important to remember that there is clear evidence, statistically as well as anecdotally, that speculation was driving 20 to 30 percent of it on a nationwide basis and, in some places like California, it was probably far more severe. Smoke explained:

“The prior peak was driven by speculation and loose financing and lots and lots of leverage. We actually have less financing supporting real estate in this country now than we did prior to 2000. So what has happened in this recovery has been more of a natural recovery, more driven by the jobs and the nature of creation. The hottest places in the country consistently are the places that have the most significant job growth.”

Smoke broadened commentary on peak prices to analyze how it reflects whether there has been a full economic recovery, to which he stated, “I would say it depends on where you are and what part of the economy or market you’re talking about because California, from a jobs perspective, and then in places like the Bay Area for home prices, it’s recovered. We can stop describing it that way. But then, in other aspects, like construction, we’re nowhere near recovered.”
Richardson tied the panel’s conversation back to the subject of education when it comes to inequality and affordability because quality education is another barrier toward joining in the economic activity that propels upward mobility and recovery in the market. She pointed out that housing is so closely related to education because where you live determines the quality of education you receive. Since manufacturing jobs are unlikely to ever return, Thornberg reiterated the importance of education to thrive in the future, noting that the country is failing from a policy standpoint because it has yet to “truly reform the education system the way it needs to be reformed.”

The panel agreed that the housing “haves and have-nots” in California are day and night, and Richardson posited that this speaks to greater structural issues underlying the health of the economy:

“When I talk about the mismatch between where the economic activity is and where people are living, it really is an affordability story. It’s a housing story. But it’s also a labor story. There are people who are shut out of the economic activity because what the economy is producing – by and large – has been service jobs in restaurants, retail, hotel, tourism. It hasn’t been the kind of manufacturing and construction jobs that really built the middle class. I still think fundamentally this is more than just cyclical. It’s structural. So my view of where the economy is going is based on the reticence of the economy to create the jobs of the past, and no real policy for creating jobs of the future that are more inclusive.”

Thornberg added that California is unique when considering affordability and prices because it has a very specific issue related to housing, which is we don’t build enough of it. He stated, “That’s because of distortions in the market created by the California Environmental Quality Act (CEQA) and Proposition 13. We haven’t built enough housing relative to population growth for the last 20 years. We’re so far behind, it’s impossible to catch up, even in this shortfall.” Beyond the crucial importance and value of a strong education system to the country’s future economic growth, Appleton-Young next drew the panel’s attention to the state of credit availability.

“The roundtable panelists comment on the state of housing prices.
PART III. CREDIT AVAILABILITY

“If you’re looking for the problem as to why inventories haven’t responded to higher prices and this incredible demand that’s out there, it’s because [homeowners] may not qualify for another mortgage.”
- Jonathan Smoke

While the Great Recession and subsequent drop in home values reduced home equity and quickly led to the crunch of tightening credit, as the recovery has continued to strengthen, so has debate about the impact of lending standards and the challenges many prospective buyers have faced in the new credit environment. Appleton-Young noted that there is a high volume of global capital looking for yield and interest rates remain attractive for borrowers, but the perceived availability of credit has shown little change from what was reported a year ago, and remains somewhat pessimistic looking forward, according to the Federal Reserve’s “Survey of Consumer Expectations.” The survey found that the number of respondents expecting credit to be more difficult to obtain in a year rose nearly 4 percent to 32 percent. So what explains the state of credit availability – or a lack thereof – in the market? After the housing crisis, Goodman noted that the pendulum has swung too far in the other direction and the consequence is a demonstrable lack of credit availability.
While it has been widely reported that credit conditions are loosening, there has not been much proof that borrowers with weaker credit are making a strong return. For instance, Freddie Mac and Fannie Mae indicated in their quarterly earnings reports that the credit scores of loans that they back are actually higher year-to-date than they were last year. This year through June, the weighted average credit score of loans Freddie Mac purchased from lenders was 751—up from 744 in 2014.

Goodman pointed out, “As a society, we have become remarkably risk averse to extending credit to anyone who has the remotest probability of default. So we’ve constructed a housing credit index where essentially we look at the probability of default by origination quarter. What you find is that right now, we’re taking less than half the credit risk we were taking in 2001. We’re taking about a third of the credit risk we were taking in 2006.”

According to the Federal Reserve Bank of New York’s Consumer Credit Panel, which utilizes data from the Equifax credit reporting agency, mortgage originations have not recovered to pre-crisis levels, as new originations were $1.3 trillion in 2014, compared with $2.9 trillion in 2005. While originations have picked up in the second quarter of 2015 and have been rising over the last year, the Federal Reserve notes that new mortgage borrowing has been driven by borrowers with credit scores above 660. Originations by borrowers with credit scores below 660 have not recovered after falling sharply from the Great Recession. Quite notably, the data reveals that “Between 1999 and 2007, 90 percent of borrowers who originated mortgages had credit scores above 590; between 2008 and 2015, 90 percent of borrowers had credit scores above 645, representing a 55-point upward shift of the distribution.”

Goodman cited three key reasons for the tightness of credit still evident in the post-recovery market. First, she posited that banks are worried about mortgage putback risk, which occurs if a bank, i.e. the originator, is forced to repurchase a mortgage from the entity holding the mortgage security. She noted that it is a positive step that the Federal Housing Finance Agency (FHFA) and the government-sponsored enterprises (GSEs) have enacted some clarifications to address this issue and the uncertainty it creates, but there remains concern that “When [banks] sell a loan to Fannie, Freddie, or FHA, they worry that they haven’t really sold the risk; that, after the loan defaults, the entity’s going to look back to the loan files, find some mistake, and put the loan back to them.”

Secondly, Goodman posited that the high cost of servicing delinquent loans has also deterred credit availability since banks are worried about accruing those extra costs. Thirdly, the False Claims Act by the Federal Housing Administration, which requires lenders to certify the soundness of a loan, carries significant damages if there is default.
Overall, the panel agreed that regulatory uncertainty, examples of which were outlined by Goodman, have hampered the availability of credit in the market and the issue has not received the attention it deserves for the seriousness it poses to the economy. Outside the sphere of influence held by the GSEs, the FHFA, the FHA, and the CFPB, the issue has gained little traction, according to panelists.

Speaking of the impact of regulations and attempts to repair market damage after the recession, Thornberg examined the big picture by questioning the merit of bureaucratic rules that did not address the criminality of the crisis:

“I think the biggest failings of this entire adventure is this idea that what happened through this last credit cycle can be fixed with a bunch of bureaucratic rules, which have never really been fully fleshed out, as opposed to just taking a step back and recognizing that there were lots of agents within the mortgage lending industry back in '04, '05, and '06 who were committing more or less flat-out fraud. [...] You’ve got to go to the heart of the matter, which is to root out the people who did criminal things and put them in jail, or take all their money away. And they didn’t do that. Instead, they tried to play this game where we’re going to fix this with bureaucratic rules, and they never really changed the incentives.”

Continuing discussion on mistaken courses of action, Thornberg added that much to the detriment of buyers and the market, too much focus has been placed upon borrower risk as opposed to cyclical risk, thereby imposing the wrong solutions for the wrong time. Such efforts have basically created mortgage conditions that should have been in place in 2006 while they’re really not needed currently because the overall macro risk of default is very low in this kind of environment, according to Thornberg. He added, “It’s probably one of the safest periods of time for lending in the U.S. economy,” which lies in stark contrast to the risk-averse behavior creating a tight credit box.

Goodman provided further context on the extent to which such risk-averse behavior has affected access to credit and the number of loan originations: “In 2002, your average retail loan originator underwrote about 180 loans a month.

“As a society, we have become remarkably risk averse to extending credit to anyone who has the remotest probability of default. So we’ve constructed a housing credit index where essentially we look at the probability of default by origination quarter. What you find is that right now, we’re taking less than half the credit risk we were taking in 2001.”

- Laurie Goodman

Now, they underwrite about 35 loans a month. It has just gotten so much costlier to originate because they’re double-checking and triple-checking every little thing between the putback risk, the high cost and uncertainty associated with servicing non-performing loans, and the risk of litigation.”

Richardson drew the panel’s attention to the larger issue of a lack of financial innovation in the industry, which has limited consumer access to homeownership. She stated the following about financial tools abused during the crisis and the aftereffects:

“It’s not that these [mortgage] products were bad in and of themselves. The problem was they were niche products. They were never meant for mass consumption. There were users for subprime, and there were users for Alt-A that made sense. Now those products don’t exist, and people can’t access them. So the question is: Can the industry continue to innovate? Also, can community banks continue to compete? Right now, we have this trickle-down regulation. The regulation that was targeted for the biggest, largest, and riskiest banks are now trickling down to community banks, making it more burdensome for them to serve their communities, and I think that’s something that bears watching.”

Goodman agreed that borrower risk didn’t change that much from 2001 to 2006; rather, the big increase was “the rise of nontraditional products provided to the masses.” She is particularly worried about the fact that “we have...
eliminated basically the whole bottom half of the borrower base.” She cited research from the Urban Institute and a report she authored that found as many as 1.2 million loans were “missing” in 2012 alone due to lower credit availability when compared to 2001 lending standards — which has impacted disproportionately African American and Hispanic households.

On the subject of minority homeowners, Richardson added that it’s important to pay attention to where the new household formation will occur, i.e. the flow, because “the home buyer in the next 10 years is going to look very different in terms of income, ethnicity, race, foreign born, than the homeowner of 20 years ago.” Problematically, Richardson pointed out that the realities of a changing flow for housing are not reflected in the mortgage market because currently “it would work really well for the market of 20, 30 years ago, but it doesn’t work so well now.”

Smoke supported Richardson’s comments by noting that not only has innovation been lost but also opportunities for wealth creation, as poor credit access has “specifically limited the very people who homeownership is potentially the only path to wealth that previously existed.” The market is further complicated by the fact that effectively 60 percent of the population would not qualify for a mortgage today, according to Smoke. Since this also applies to existing homeowners who have a mortgage, inventory is limited by lack of credit access, as he stated, “If you’re looking for the problem as to why inventories haven’t responded to higher prices and this incredible demand that’s out there, it’s because [homeowners] may not qualify for another mortgage,” thereby setting up the panel’s discussion on the current state of inventory in the market.

B. HOUSING INVENTORY

Building on Smoke’s comment on the difficulty existing homeowners would experience with access to credit, Appleton-Young next asked the panel to consider how a lack of turnover is contributing to the poor state of inventory in the market. If current homeowners cannot reap the benefits of considerable price appreciation due to a lack of affordability and the financial incapacity to purchase elsewhere, people are simply staying put in their homes longer. Demographics also proved to be a key point of the discussion among the panelists when discussing inventory.

Richardson began by elaborating on the state of inventory in the market, as follows:

“It’s not that these [mortgage] products were bad in and of themselves. The problem was they were niche products. They were never meant for mass consumption. There were users for subprime, and there were users for Alt-A that made sense. Now those products don’t exist, and people can’t access them. So the question is: Can the industry continue to innovate?”

- Nela Richardson

She added that Generation X’s importance as a source of inventory is widely ignored, despite the fact that it is the generation that is most likely to move or trade up at this point in the cycle. Homeownership among those aged 35-54 has dropped the most of any other age group since 1993, according to Harvard’s State of the Nation’s Housing
“We just need to hang on for the system to start working a bit more [...] The very people who are most inhibited by the lack of credit, or the very tight credit standards that we have today, are the very people who are at that bottom of the ecosystem, that we desperately need in order to get the whole ecosystem working healthily.”

- Jonathan Smoke

2015 report, and the drop is especially acute for those under age 44. The problem is this generation is stuck due to credit availability, not having better jobs to move for, and homes with better school districts are too expensive, according to Richardson.

According to the 2015 NAR Home Buyer and Seller Generational Trends study, Gen X buyers represented the largest share of single-family home buyers (85 percent). Additionally, the survey found that Gen X sellers were the most likely to have wanted to sell earlier but were stalled because their home had been worth less than their mortgage (23 percent compared to 16 percent for all sellers).

The panel also discussed other demographic issues playing out in the market, such as baby boomers wanting to downsize to smaller, more expensive homes in urban areas, which has been complicated by the fact that Generation Y is not interested in purchasing the large suburban homes that boomers could shed. Richardson aptly summarized the generational tradeoffs not taking place as follows: “This generational kind of tag team isn’t working right now. That’s more of a long-term demographic answer as to why there’s no inventory. The generations aren’t playing the way they used to.”

These demographic issues described by the panel and Richardson were more broadly contextualized by Smoke, who noted the housing ecosystem is experiencing a state of imbalance, as the whole network of interconnected components that comprise a well-functioning economy and housing market cannot function harmoniously if a key area is “not quite right,” and simply put that has economic implications.

He went on to analyze the effects baby boomers are having on the market due to the fact they have no “immediate trigger” compelling them to make a decision about their next home purchase, as children are no longer in the equation. Smoke noted they are some of the hardest buyers to sell to because they have no defined timeframe to make a purchase and will sweat every detail. And when it comes to the much-discussed millennials, he stated, “They are seven to eight million bigger than the boomers.
But the problem is they’re moving through that cycle more slowly because of the context in which they’re entering the market.”

In returning to his comments about the housing market functioning as an ecosystem, Smoke added, “We just need to hang on for the system to start working a bit more [...] The very people who are most inhibited by the lack of credit, or the very tight credit standards that we have today, are the very people who are at that bottom of the ecosystem, that we desperately need in order to get the whole ecosystem working healthily.”

Regardless of these demographic trends and the shape they may take, Goodman posited that “no matter what we do,” the homeownership rate is on a downward trajectory, which led to the panel’s discussion on the future of homeownership.
PART IV. HOMEOWNERSHIP

“The absolute number of homeowners is rising, but the homeownership rate is dropping.”
- Laurie Goodman

The U.S. homeownership rate has fallen to a 48-year low after declining in the second quarter of 2015, reaching 63.4 percent, according to the U.S. Census. When the market was in the midst of its boom at the end of 2004, homeownership peaked at 69.2 percent. California has seen its homeownership rate fall even further than the national rate, as it declined all the way to 54.9 percent in 2014. The panel proceeded to discuss the long term trend for the homeownership rate and whether the traditional patterns of household formation are changing. Goodman began by citing statistics from a study and report she conducted for the Urban Institute titled, “Headship and Homeownership: What Does the Future Hold?” in order to support her assertion that homeownership is on a downward trajectory for the foreseeable future.

The study finds that for the next 15 years, new renters will outpace new homeowners, which will create intense competition for rental housing. The report adds that by 2030, the homeownership rate will have dropped to 61.3 percent from 65.1 percent in 2010, and when millennials have reached their prime home-buying age in 2030, only 38 percent will own homes compared with 46 percent of baby boomers in the 1990s.
Goodman stated, “When you look at the downward trends in homeownership, there are a lot of [factors]. First, the foreclosure crisis was devastating. So you’re starting off from a lower point, and that affected every single age group, so it’s not just millennials who’ve put off homeownership. The rate is down [across the board] and it’s actually been on a downward trajectory.”

Goodman cited a variety of reasons – beyond the data – to support her contention that homeownership is on the downward slide, including the lingering and damaging effects of the foreclosure crisis; delayed marriage rates; a growing share of minorities in the population with traditionally lower homeownership rates; credit availability; and student loan debt for those who don’t manage to graduate. Thornberg and Goodman proceeded to have a back-and-forth over competing numbers and statistics regarding the homeownership rate.

Thornberg pointed to a recent NAR survey that found first-time buyers comprise 30 percent of buyers. He argued that if 30 percent of sales are for first-timers, then it doesn’t add up that homeownership is declining. Furthermore, when accounting for voluntary separations and foreclosures, 30 percent is too high. He explained as follows: “If you sit down and run that basic statistic, there’s no way that homeownership rates are falling right now, because if you believe that 30 percent number, there’s way too many sales out there to first-time buyers. For homeownership rates to be falling, you have to assume a massive number of voluntary separations where people are voluntarily selling their home and moving into rental housing or moving in with family.”

Thornberg pushed back on Goodman’s projections by noting that it’s not clear whether the homeownership rate is actually falling, particularly if one questions the accuracy and validity of data from the Housing Vacancy Survey (HVS). While Goodman agreed that the HVS is not a reliable barometer, she countered that she utilized the decennial census to reach her conclusions, and its data matches well with the American Community Survey. Thornberg again disputed Goodman’s assertions by adding that such numbers still stem from 2013: “That’s my point, 2013 is the most recent data, and that’s a problem. We’re talking about the second quarter of 2015. That’s six quarters. For all we know, this could be going up right now.”
Thornberg added, “It just doesn’t add up. And if you believe the 30 percent number, it really, really, really doesn’t make any sense. So something else is going on.”

While Smoke agreed that the HVS numbers incorrectly imply the nation has lost home-owning households, Goodman specified that she believes “The absolute number of homeowners is rising, but the homeownership rate is dropping.” Smoke also provided his perspective on the accuracy of the NAR figure that 30 percent of buyers are first-timers, noting that he concurs with it as the overall trend. He stated, “That [percentage] actually matches the composition of what we see in more complete surveys that are done, panel research, as well as the traffic that we see on the website [realtor.com®]. So I think that is materially correct.” Related to the status of the homeownership rate, the panel turned the conversation to who can afford to become homeowners in a market that has seen rapid price appreciation.
PART V. HOUSING DEMAND AND PRICES

“My point is there is a level at which buyers will not cross, and also that prices are not always completely transparent. There is a discovery process, and the market must feel it when there’s a revision.”
- Nela Richardson

Research from C.A.R.’s Traditional Housing Affordability Index (HAI) recently found that a sharp increase in spring housing demand elevated home prices to levels last seen during late 2007 and reduced California’s housing affordability considerably in the second quarter. Home buyers needed to earn a minimum annual income of $95,980 to qualify for the purchase of a $485,100 statewide median-priced, existing single-family home in the second quarter of 2015, C.A.R. also reported. In light of rising housing prices and home price appreciation, Appleton-Young asked the panel about the implications of the dramatic increase in prices, particularly in relation to housing demand.

Richardson explained that there are places where prices have escalated beyond the appetite of today’s consumers, and that such prices are playing a role in dampening demand. She said, “No matter how wealthy the person is, no one wants to overpay. [...] What we’ve been seeing is people are starting to balk at the escalation, the multiple bids, the craziness of certain pockets of this market, the bubbly areas. No one wants to feel like they’re the chump who bought right before the market turned.”
Thornberg challenged Richardson’s points by positing that prices are a reflection of consumers, stating, “The prices are going where they’re going because people are willing to pay those prices. And they should damn well be willing to pay those prices because affordability is still good when you take into account interest rates. That’s a fact.” He added that the incomes of buyers are also supporting these prices, and “even here in crazily unaffordable California, price affordability is still better today than it was in 2002,” which was disputed by Goodman in another example of warring numbers and data.

Richardson drew on her previous experience as an economist at the Commodity Futures Trading Commission (CFTC) to expand the panel’s discussion on prices to include some thoughts on what price discovery means in a post-recession environment, as buyers are far more cognizant of price declines. She commented, “Price discovery in a private transaction is very difficult, and I think that the market is not completely transparent. You will see swings in prices occasionally. [But] You don’t know whether the house you’re about to buy is really worth the amount you pay for it until after you close the deal. And that’s a very expensive discovery process. I think people are more and more unwilling to go on that ride because what we’ve learned is that prices can decline. That’s new information [nationally]. […] My point is there is a level at which buyers will not cross, and also that prices are not always completely transparent. There is a discovery process, and the market must feel it when there’s a revision.”

While Thornberg reiterated that prices are based on transactions and therefore won’t go above what people are willing to pay, Appleton-Young stipulated that people have been forced to move elsewhere and indeed have been priced out of many markets. She also asked Smoke to provide further context on prices and demand based on the data and web traffic from realtor.com® as market indicators. Smoke said that many of the hottest markets are in California, which is reflective of how quickly the inventory is moving and also the number of views the individual listings are receiving. In his view, this is evidence that the demand is there and there’s really no sign of a material decline. He also commented the following:

“So far it kind of fits my description of the economy as a bit of a Goldilocks effect. We’ve had just enough listings growth every month in the spring and summer that’s been keeping the level of supply, albeit tight, not getting tighter. You’ve seen price appreciation, both in list prices and in what Case-Shiller and everybody else reports, moderating from the higher levels we had before. To me, that’s a solid sign because we don’t want to see double-digit pricing.”

Richardson next cited findings from Redfin, which created a Demand Index to quantify the level of demand. She noted that while web traffic is positive, there are fewer offers being written, so it has been forecast that prices will slow, and Richardson commented, “Later-stage demand, before the actual transaction is completed, that is slowing as well.” After providing a holistic view of the housing market and the U.S. economy, Appleton-Young proceeded to have the panel address potential policy solutions to the challenges described by the panelists.●
PART VI. POLICY SOLUTIONS FOR HOUSING

“It seems like the consumer is going one way, and our mortgage industry is going another. How can we get them closer together without having another crisis?”

- Nela Richardson

While greater credit availability and an improved education system and jobs market were among the prescriptions panelists focused on in their earlier remarks, Appleton-Young called on the panel to consider what ideas – from a policy perspective – should be implemented to improve the state of the market. Richardson and Goodman began by touting the benefits of smarter density choices and thoughtful approaches to building urban centers. They called for more multi-family units since there is simply not enough housing to meet population growth or supply in areas where there is greater economic opportunity.

Goodman mentioned simple actions that can help address the issue at the margins, including clarification on zoning laws, not blocking more multifamily units, and greater use of the long-term housing tax credit. She also noted that credit availability is an issue that is much easier to tackle since it mostly requires administrative action, stating “It’s all very unglamorous, as it’s revising this set of rules and that set of rules. But I think in the end it will make a big difference.”

Smoke proffered that new construction has to be a priority or the consequence will be “that it’s worse in the years ahead, especially if we continue at the pace that we’re at today.” He added that the financial crisis had a big impact on the construction industry, as it no longer receives lending from community and regional banks; as a result, there’s not as much activity, which is a problem that needs to be addressed.
He also added that the fate of homeownership has not been sealed and that more can be done to ensure it remains an aspiration and tool for wealth-building:

“There’s a place for education and encouragement about homeownership. I do agree that one of the challenges demographically is that the household composition will be very different over the next 20 years than we have historically seen. And that would tend to stack the deck against homeownership increasing. But that’s not to say that should be our destiny. One issue for addressing the affordability of renting is to try to convert as many renting households to owning households so that they do have a path to wealth building that’s related to owning a home. An unfortunate outcome of the whole crisis was homeownership itself essentially became the culprit, and I think some good intentions, done the wrong way, essentially led to much of the problems that we had.”

Smoke concluded that a key policy goal for the future should be supporting homeownership and finding avenues for people to reach homeownership that makes risk-appropriate sense. Richardson once again cited the industry’s lack of innovation as a deterrent to more people achieving the status of homeowner. She noted that the industry has not adapted to the realities of the marketplace, as is evident by failing to provide different products that reflect the consumer base and the sharing economy that has taken over. “It seems like the consumer is going one way, and our mortgage industry is going another. How can we get them closer together without having another crisis?” Richardson queried. For example, people now may want to move a little bit more than they did in the past, but she pointed out that mortgage products don’t allow for mobility. From a more big-picture perspective, she added that it’s worth thinking about how homeownership can be redefined in the future and that it may be too limiting to confine it to “a single-family, white-picket-fence place.”

Panelists agreed that the industry should consider innovative products, with Smoke adding, “There’s plenty of great ideas: Assumable mortgages, shared equity programs, [options] that essentially help to reduce the upfront down payment, but don’t essentially eliminate the skin in the game and produce more risk.” Appleton-Young pointed out that the lack of innovation cited by the panel makes the industry even riper for disruption, since “the lending industry is one that needs to be reconfigured.” She also cited troubling research from C.A.R. as further proof that the lending industry has failed to serve current demographics:

“We did a survey of millennials, and one of the questions that really hit me the hardest was asking them whether they could qualify for a mortgage, and 45 percent of them said they did not know. So this lack of financial literacy and lack of understanding of an instrument that essentially will get you on the path to building wealth is just startling. Homeownership is the most important instrument if you don’t have inherited wealth. It’s not acceptable, and we need to do something about that.”

Goodman concurred with these sentiments and questioned whether millennials still see homeownership as a safe “asset creation vehicle,” rather than just a place to live. In response, Smoke reiterated his point about poor promotion of homeownership to the next generation, stating “I actually believe in the intellectual aptitude of the millennials as
“We did a survey of millennials, and one of the questions that really hit me the hardest was asking them whether they could qualify for a mortgage, and 45 percent of them said they did not know. So this lack of financial literacy and lack of understanding of an instrument that essentially will get you on the path to building wealth is just startling.”

- Leslie Appleton-Young

being the smartest generation we have ever had. So I think it’s a lack of promoting, explaining, and educating about it, and then providing the options.”

Speaking of innovation – or a lack thereof – in the industry, the panel was also asked to name a key action that could help people achieve homeownership. Goodman noted that improving financial literacy would be a positive step, but also noted that coming up with a down payment – while always a struggle – has been exacerbated by flat wages. To a large extent, in her opinion, it comes down to credit availability, adding, “Credit has been so tight that people sort of believe it’s futile to even begin to think about a mortgage and apply for a mortgage.”

Richardson expanded on Goodman’s comments on wages to say the issue is bigger than just housing. While she sees no trouble in homeownership being something that takes time to achieve through hard work, she does see trouble in the economy of the future and the success of the middle class. Technology is facilitating a change, and “I think until this economy figures out how to help people make that transition to wherever we’re going, I’m not sure what this new economy is made up of, and I’m not sure how middle-class people participate in it,” Richardson said. If the only way the middle class can participate in the tech economy is to become Uber drivers, then that leaves much to be desired and presents a problem, according to Richardson.

The panel also cited new credit scoring standards as an important policy directive for allowing more people to participate in homeownership, especially multi-generational households. Alternative credit scoring should be in the pipeline, according to Goodman, who stated, “Cell phone bills, utility payments, rental payments, cable bills, absolutely [should be included]. I think it’s all under development. The shocking thing is that people are sort of qualifying by FICO score [because] the FICO score model that Fannie Mae and Freddie Mac are using was estimated in the late ‘90s and doesn’t even account for student loan debt properly.”

In regards to his previous comments about the housing ecosystem’s imbalance, Smoke pointed to the construction market ignoring entry-level affordable housing—which has created a dearth of options without that much-needed source of supply. That cycle can’t be broken without some sort of policy directive and efforts to intentionally break it, according to Smoke. “The demand we see is essentially self-selected. When we ask people on realtor.com® – again, record visits all year long – how many of you are having trouble qualifying for a mortgage, it’s 3 percent. That’s essentially proof that the people in the market today are not the people who can’t get into the market.”

Smoke’s comment speaks to an immediate and long term concern for the housing market because a lack of affordable housing means people will be unable to save for a down payment, or improve their credit scores, especially if they’re spending 40 to 50 percent of their income on rent. To solve housing’s issues, Smoke said, “It’s going to take leadership for somebody to say we have to fix this and that it’s a priority, rather than the kind of cartoonish stuff we have going on with the primary election. The people who are lining up to become president right now are not concerned about housing.”

The issue of affordability has resonated greatly with Californians, according to Appleton-Young, when they consider the future prospects of their children and the likelihood their kids won’t be able to live near them due to no affordable options. “California’s the only state talking about housing affordability. It doesn’t seem to resonate on the national level at all yet,” Appleton-Young said. Goodman warned that it takes a crisis for a problem to be solved and the affordability crisis is clearly fomenting as a big issue, with her opining that “Rental affordability is going to be sort of ground zero for the crisis,” which was met with
agreement by Appleton-Young.

Despite gloomy talk of a crisis being a requirement for moving the needle forward on affordability and some of the market’s major challenges, panelists noted that real change can be achieved if the issues related to housing are viewed holistically, in the same vein as an ecosystem that requires a delicate balance of parts. Richardson clarified this point by stating the issues facing our cities don’t exist in isolation, and added, “For me to feel optimistic, I want to see cities that are solving this problem by looking at the whole picture instead of just pulling out pieces and trying to figure out how to pull a lever here or there to make a marginal difference.”

Laurie Goodman and Nela Richardson give their solutions for affecting change via policy.
PART VII: CONCLUDING REMARKS

The panel’s edifying comments reflect the importance of housing, as one of many balancing parts, that contributes to the growing momentum behind a healthier U.S. economy. After all, the continued recovery of the U.S. housing market and the broader economy are interconnected parts that require a holistic view to ensure long term economic growth. Providing an accurate picture of the health of the U.S. economy, as well as how the economy can only grow healthier, were key takeaways from the discussion, and C.A.R. and the Center for California Real Estate are grateful to the panelists for shedding light on the current state of the market with their invaluable expertise.

Bringing balance to the housing market so that its recovery regains steam in the year ahead will allow prospective buyers and sellers to overcome the lingering effects of the Great Recession and the housing crash. It is clear that achieving homeownership for more Americans as well as affordable housing for all will take greater commitment to meet the country’s growing needs. •