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Housing and Mortgage Market Review

HaMMR – Winter 2021

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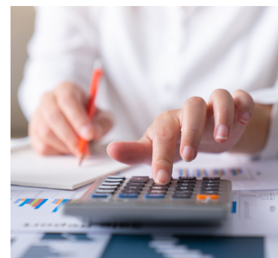
A New Deal for Housing?

By Rob Hardie, Senior Vice President, Head of Data Analytics, Arch Capital Services LLC

The 2020 housing market recovery has been nothing short of amazing, as we highlighted in the Fall 2020 *Housing and Mortgage Market Review®* (HaMMR℠). Housing data has continued to show strength in the market in terms of both demand and price growth. The Q3 numbers for home price growth were phenomenal whichever way you cut them. The national median sales price was up 12% year-over-year, according to the National Association of Realtors® (NAR), and the Federal Housing Finance Agency (FHFA) purchase-only index increased 7.8% year-over-year at a national level.



Naturally, this continued strong price growth has raised affordability concerns. However, we believe looking at affordability over a much longer time horizon removes what we see as a tendency toward recency bias on this topic. To assess affordability, we look at a debt-to-income (DTI) ratio to determine the proportion of the median household income needed to make mortgage payments on the median home in a geography.[1] At a national level today, the median DTI is 29%, which is only up one percentage point from five years ago. If we look back 20 years to Q3 2000, the median DTI was 35% prior to the boom and peaked at 41% in the period before the financial crisis.

[1] *Calculations are based on pretax median household income, a 10% down payment, escrow of annual expenses of roughly 1.75% of the initial home price (for insurance and property taxes, which we vary by state) and the prevailing 30-year fixed rate, plus 0.75% to cover mortgage insurance and risk add-ons.*

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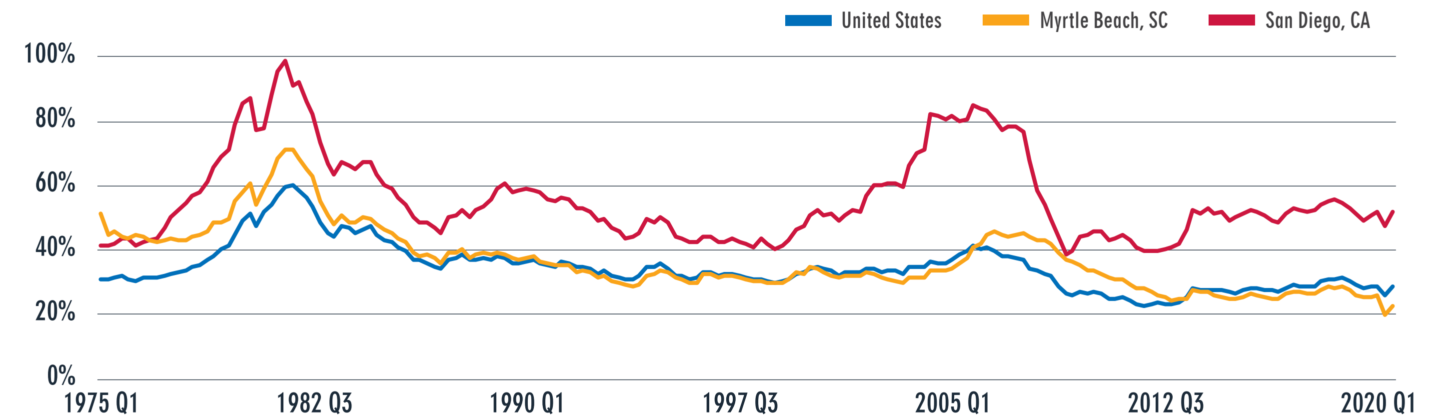
Figure 1: Hypothetical Median House Debt to Median Income



Source: *U.S. Census Bureau/Freddie Mac/NAR/Moody's Analytics/Arch MI*

While affordability at the national level is better today than it has been in 20 years, it is not universally true and varies, depending on where you live. For example, let's compare the Metropolitan Statistical Area (MSA) of Myrtle Beach-Conway-North Myrtle Beach (which straddles the North Carolina-South Carolina border) to San Diego-Chula Vista-Carlsbad in California. Since Q3 2000, the median DTI in the Myrtle Beach MSA has fallen considerably from 33% to 23%, whereas in the San Diego area, the median DTI has remained effectively flat, moving from 51% in Q3 2000 to 52% in Q3 2020.

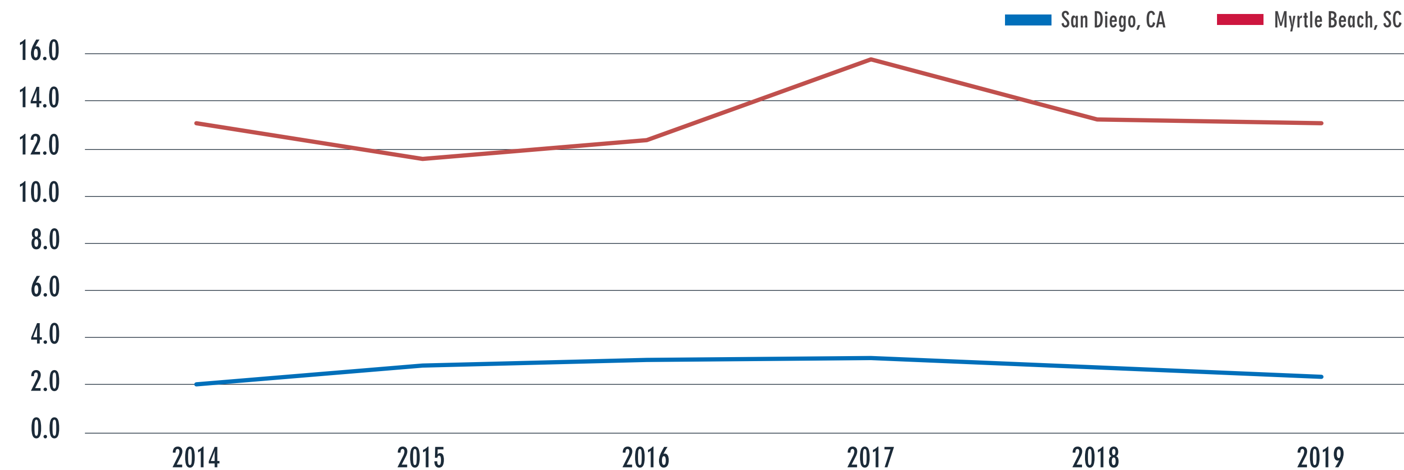
Both are coastal cities with attractive climates, and while the San Diego metro (with 3.3 million residents) has a larger population competing for available housing, the Myrtle Beach metro area had the fastest population growth in the U.S. over the past five years. It grew 18% — from 423,000 residents at the end of 2014 to 500,000 at the end of 2019 — driving increased demand for housing. So, why did affordability improve in Myrtle Beach over the last 20 years while remaining roughly flat in San Diego?

Supply vs. Demand

Home prices, like the price of most goods, are driven by supply and demand dynamics. When demand is higher than supply, prices will go up, which is exactly what we have been seeing in the last few quarters with record-low housing inventory. However, as Robert Shiller theorizes in his book *Irrational Exuberance*, "If ever home prices were to exceed the cost of construction, there would be an incentive for builders to supply more homes, and a steady increase in supply would continue until the extra supply depressed price back down to cost." This ability to add new supply is, in theory, a safety valve that helps regulate housing cost in most of the country.

To understand this ability to add new supply, we looked at housing construction as measured by new private housing units authorized by building permits, including both single-family and multi-family units, in both areas. We see a stark contrast when San Diego and Myrtle Beach are compared on this basis. The Myrtle Beach metro area has averaged 13.2 permits per 1,000 residents from 2014 to 2019, whereas the San Diego metro has averaged only 2.7 permits per 1,000 residents.

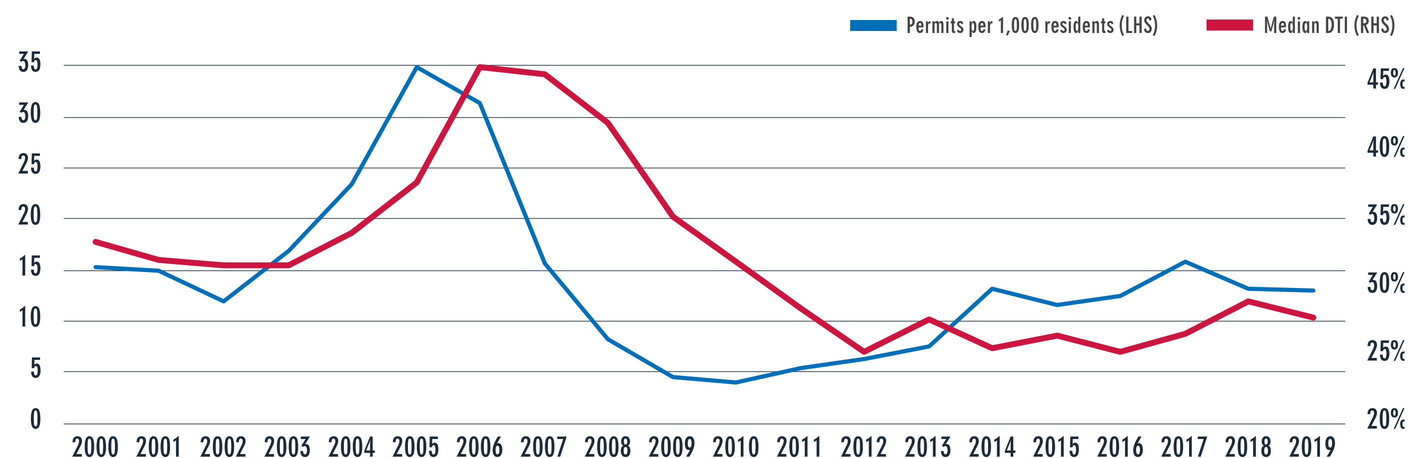
Figure 2: Building Permits per 1,000 Residents



***Sources:** Department of Housing and Urban Development (HUD)/U.S. Census Bureau*

More new construction in Myrtle Beach can help increase the housing stock to ensure there is sufficient supply to account for the growing population and obsolescence of the current stock. The effectiveness of the new construction safety valve to increase affordability depends on timing that is not always perfect, as was evident in the housing boom of the mid-2000s. Affordability in Myrtle Beach degraded during the boom years of 2004–2006 even though permits per 1,000 residents were growing, and it wasn't until after the permits had peaked that affordability started to normalize. While the rise in permits shows that builders saw the opportunity to add new supply in response to rising home prices, the time lag from permit to completion of the construction, and hence supply being made available to the market, meant the large demand could push up prices in the short term. Once that extra supply came to market, prices and affordability snapped back to more normal levels.

Figure 3: Building Permits per 1,000 Residents vs. Median DTI for Myrtle Beach



***Sources:** HUD/U.S. Census Bureau/Freddie Mac/NAR/Moody's Analytics*

Why Such a Difference in Building Levels

Land availability was the primary driver of the difference in the level of construction between the Myrtle Beach and San Diego metros and the same is true across the country at large. Albert Saiz in his article in *The Quarterly Journal of Economics* in August 2010, "The Geographic Determinants of Housing Supply," discusses this topic in detail, but the key concept is the ability for new supply to respond to demand is constrained by access to prime construction land.

Access, Saiz writes, can be further constrained by either geography or regulations. For example, San Diego has the Pacific Ocean to the west, mountains and state parks to the east and the Mexican border to the south, each of which limits the amount of prime land for new development and prevents a supply safety valve from being activated. As such, we can expect to see prices rising as long as strong demand for a limited supply continues.

Will This Upward Pressure on Prices Continue Forever?

We would expect continued home price growth, potentially at a rate faster than income growth, as long as there is a constrained ability to build new housing in areas where demand outstrips supply. At some point, housing will become too expensive, and the population will start to level off or drop as the cost deters new people moving to the area — or causes current residents to leave. Such population drops can act as an alternative safety valve to new supply in tempering home price growth until affordability normalizes once again.

This effect has been seen in the New York metro area (which includes Jersey City, New Jersey, and White Plains, New York), where the population declined from 14.3 million in Q3 2015 to 14.2 million in Q3 2020. It's also important to note that this population decline was underway well before COVID-19. Over that same Q3 2015 to Q3 2020 time period, the median DTI dropped from 44% to 36%. Even though there was a low level of new construction to add new supply, the lack of an increasing population resulted in reduced demand and improved affordability. That is not to say that a declining population always leads to falling home prices; over this time frame of improved affordability, median home prices in the New York metro area rose 14%.

What Does This Mean Going Forward?

At a national level, we expect demographics to drive continued robust housing demand as more Millennials reach the age where they will form households and buy homes, particularly in this rate environment. The potential for greater flexibility to work remotely may also lead to more population growth in the suburbs, exurbs and smaller cities. We see this movement as a good thing for affordability given the lack of ability to increase housing stock easily in the downtown areas of larger cities. Even if we see this shift, net new demand is likely to be greater than the rate at which builders are building new homes, which will exacerbate the multi-year low levels of available supply. As President-elect Joe Biden takes office, maybe he should take a page out of President Franklin D. Roosevelt's book with a "Housing New Deal" to incentivize the addition of new single-family housing stock to keep affordability in check while creating jobs in the construction sector.

America's Most Affordable Cities

By Rob Hardie

As laid out in our opening article, national affordability today is better than it was 20 years ago, but there are still some metros that have not seen similar improvements in affordability due to the inability to create new housing stock to keep up with demand. Against this backdrop, we wanted to identify the country's top five affordable large metros. In addition to affordability, we applied the following three criteria to ensure we focused on growing cities with strong job markets:

- Population of at least 1 million.
- Population growth of at least 5% over the five years from 2014 to 2019 compared to a national growth of 3% over this same time.
- Employment rate in the top 50% of U.S. metros. (Note: to account for the impact of the pandemic, we are using Q4 2019 data for this metric.)

Despite experiencing at least a 10% year-over-year median home price growth, all of the metros on the list have remained highly affordable. Less than 25% of the median household income is needed to cover monthly mortgage payments on the median-priced home in the five cities on our list compared to 29% at the national level, which makes these the country's most affordable "large cities."

METRO	MEDIAN DTI[1]	YOY MEDIAN HOME PRICE GROWTH	POPULATION (Q4 2019)	POP. GROWTH (Q4 2014–Q4 2019)
Indianapolis, IN	21%	14.2%	2.1 million	5%
Atlanta, GA	22%	10.8%	6.1 million	7%
Raleigh, NC	23%	10.2%	1.4 million	12%
Columbus, OH	23%	13.5%	2.1 million	5%
Nashville, TN	24%	12.0%	2.0 million	9%

Sources: *U.S. Census Bureau/Freddie Mac/NAR/Moody's Analytics*

[1] Median DTI is the proportion of the median household income needed to make payments on a mortgage for a home at the median price. Calculations are based on pretax median household income, a 10% down payment, escrow of annual expenses of roughly 1.75% of the initial home price (for insurance and property taxes, which we vary by state) and the prevailing 30-year fixed rate, plus 0.75% to cover mortgage insurance and risk add-ons.

Indianapolis, Indiana

Even after experiencing a 14% year-over-year growth in median home prices in 2020, Indianapolis tops our list with a median home price of $233,515 and a hypothetical median DTI of 21%. Indianapolis's relative affordability may explain its tight housing inventory. As of October 2020, there was only 0.9 months of housing supply in Indianapolis, which means that if no new listings were added, the entire supply of homes for sale would be sold in less than a month.

Atlanta, Georgia

Atlanta's population of 6.1 million makes it the fifth-largest metro in the U.S. and the largest on our list. It's the headquarters for a number of Fortune 500 companies, including Home Depot, UPS and Coca-Cola. Yet in spite of its size, diverse economy and median household income above that of the country as a whole, home prices have remained affordable. Even after median home prices increased 11% in the past year to $257,980, the median DTI required to purchase the median-priced home is still only 22%. Housing demand remains strong in Atlanta, where 53% of homes listed in October 2020 had a pending sale within two weeks.

Raleigh, North Carolina

Raleigh has become a thriving tech hub with the Research Triangle Park, providing a large number of science and technology jobs to the Raleigh metro area and the neighboring MSA, Durham-Chapel Hill. With a number of top-tier universities in the area feeding the talent pool, 10.3% of Raleigh's workforce is employed in high-tech industries as compared to 5% of the national workforce. In spite of its status as a tech hub, Raleigh is not seeing the same affordability challenges as a number of its peers. Raleigh has the highest median price on our list at $322,723 in Q3 2020, up 10% over the last year, but the median DTI still comes in at only 23%.

Columbus, Ohio

Columbus is a large city (population 2.1 million) with a diverse economy; in addition to being the state capital, Columbus is home to a major university (Ohio State) and a number of large financial services companies. In October 2020, 45% of homes sold above list price. With a median home price of $245,636, the median DTI for Columbus is just 23%.

Nashville, Tennessee

Nashville entered 2020 with a booming population (growing 9% over the prior five years) with 75% of that growth coming from migration into the metro from other parts of the country. With affordability consistently better than the national average and a strong job market, it's no surprise that Nashville was so attractive to newcomers. Its unemployment rate was 2.5% in March 2020, which was even better than the low national level of 3.5%. Yet even with this population inflow and median home prices growth of 12% over last year, the median DTI in Nashville is still only 24%. The median home price is $310,576.

Sources: *Redfin: Month's Supply/percent homes with pending sale within two weeks/percent of homes sold above list price.*

How the New Administration Could Reshuffle Housing Policy

by Kirk Willison, Vice President of Government and Industry Relations, Arch MI

With just days to go before Joe Biden becomes the nation's 46th President, HaMMR looks at the incoming administration's ambitious housing plan designed to increase the stock of homes and address staggering inequalities between the haves and have-nots.

However, the Trump administration is putting its own stamp on housing policy in its waning days. The ramifications of those policies could extend well beyond the day it exits power on Jan. 20. So, let's start our review with the here and now before trying to predict the future.

New Capital Rule Will Drive Prices, Risks Higher

In the most significant regulatory step since Fannie Mae and Freddie Mac (the GSEs) were placed into conservatorship in September 2008, the Federal Housing Finance Agency (FHFA) finalized its Enterprise Capital Framework rule in late November 2020. The new rule provides financial guideposts for the GSEs to begin the process of exiting conservatorship. Together, Fannie and Freddie will need to hold the greater of $283 billion in risk-weighted capital (based on their June 30, 2020, balance sheets) or 4% of their total assets. While requiring the GSEs to build substantial capital will ensure the safety and soundness of the mortgage finance system, the aggregate is more than $100 billion higher than a proposed rule issued in 2018 called for and will likely increase GSE guarantee fees (G-fees) by up to 30 basis points. That, alone, could raise mortgage rates by 10%, according to Seamus Fearon, Executive Vice President of Credit Risk Transfer and Services, Arch Capital Group Ltd.

There are additional facets of the rule that could increase both the risks undertaken by the GSEs and the financial risks borne by U.S. taxpayers. The rule places a premium on the GSEs raising most of their capital through common equity and eviscerates the capital relief value of transferring credit risk to private investors by nearly 50% over current practice. That, in turn, will likely increase the risk the GSEs are willing to accept to meet the higher rates of return demanded by equity investors while discouraging them from shifting credit risk to other investors. In short, it risks a return to the failed buy-and-hold model that was a significant contributor to the GSEs' collapse a dozen years ago.

Negotiations Underway to Speed Exit from Conservatorship

Working in tandem with the new capital framework, the U.S. Treasury Department is in discussions with FHFA about a joint agreement that could release the GSEs from the bonds of conservatorship before they meet their capital goals. One likely point of agreement will be to lift the restrictions on the amount of profits the GSEs can retain so they can build capital faster. They currently have a $45 billion cap on the retained GSE earnings. Treasury and FHFA are also likely to codify restrictions capping the GSEs' investment portfolios and permanently prohibiting pricing discounts offered to the largest lender customers.

Redefining "Qualified Mortgage"

Long-awaited revisions to the Qualified Mortgage (QM) Rule were finalized on Dec. 10, 2020, by the Consumer Financial Protection Bureau (CFPB). The new rule will eliminate the 43% cap on borrower DTI ratios when it takes effect on July 1, 2021. In its place will be a price-based QM standard.

A loan will be considered QM if the annual percentage rate exceeds the indexed Average Prime Offer Rate (APOR) by less than 2.25 percentage points. A loan receives a conclusive presumption (also known as the "safe harbor") that the consumer had the ability to repay if the annual percentage rate does not exceed the APOR rate for a comparable transaction by 1.5 percentage points as of the date the interest rate is set.

Many industry and consumer groups urged the CFPB to broaden the safe harbor from 1.5 to 2.0 percentage points. Lenders are hesitant to lend at rates exceeding the safe harbor and, according to an analysis done by the Urban Institute, minority borrowers are disproportionately represented at rates between the safe harbor and the rebuttable presumption thresholds.

Inequality Headlines Biden's Housing Goals

The new administration will view its housing objectives predominantly through the lens of leveling the inequalities between white and minority, affluent and poor households. The effort will be largely led by Secretary-designee for the Department of Housing and Urban Development (HUD), Rep. Marcia Fudge (D-Ohio), whose Cleveland-area congressional district highlights such inequality.

"Communities of color are disproportionately impacted by the failures in our housing markets, with homeownership rates for Black and Latino individuals falling far below the rate for white individuals," reads the Biden campaign's housing platform. "Because homeownership is how many families save and build wealth, these racial disparities in homeownership contribute to the racial wealth gap. It is far past time to put an end to systemic housing discrimination and other contributors to this disparity."

The administration's first action will probably be to restore the Affirmatively Furthering Fair Housing (AFFH) rule that requires communities that receive federal HUD grants to proactively identify and address potential housing discrimination. The regulation was established during the Obama-Biden administration and revoked this past July.

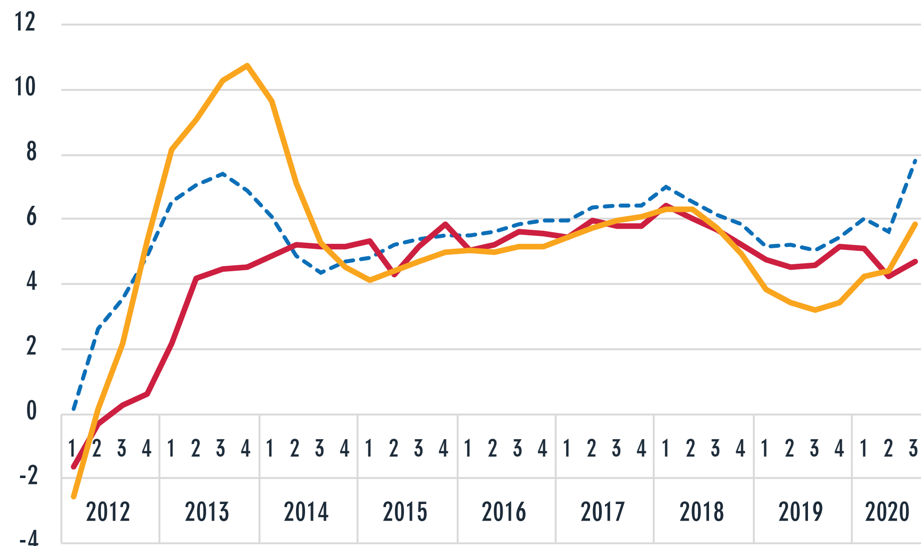
The campaign's pledge to invest $640 billion over the next decade to increase access to affordable and stable housing, as well as its desire to offer first-time homebuyers a tax credit up to $15,000 toward down payments, is likely to be tested by a Congress with narrow majorities in both the House and Senate. Instead, look for proposals that can help address inequities without a significant cost to the budget. Such efforts might include promoting appraisal standards that will improve valuations of properties in communities of color, strengthening the Community Reinvestment Act rules for depository institutions and persuading states and cities to eliminate barriers such as single-family-only zoning so that more housing units could be built.

Part of the equation to increasing access to affordable homeownership must include increasing the supply of affordable homes. In many areas, eliminating single-family-only zoning is a small step toward addressing the problem, but a more comprehensive program to boost new home construction in line with growing household formation is essential, particularly in regions where job growth is outpacing increases in housing stock.

To that end, there is a growing chorus in Washington arguing that "housing is infrastructure, too" and calling for its inclusion in plans that would repair and build new roads, bridges and airports. Builders face an average of $80,000 in regulatory and development costs before putting a shovel in the ground to build one home. So, federal funding to pay for the utility lines, sewers, roads and schools resulting from new developments would likely spur construction and reduce homebuyer costs. The issue is sure to be debated over the next two years. Obtaining the necessary funding, however, will be a significant hurdle.

Housing and Mortgage Market Indicators

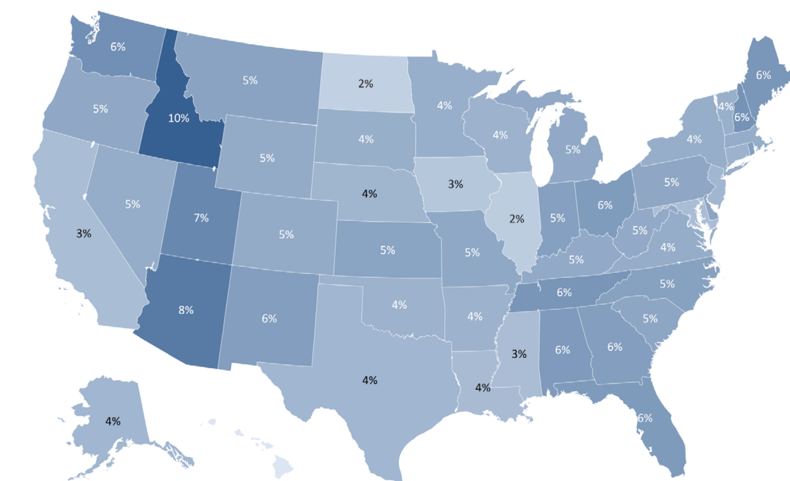
YEAR-OVER-YEAR PERCENTAGE CHANGE IN HOME PRICES



National home prices continue to grow. Home price growth in Q3 2020 was strong across all three indices, with the FHFA purchase-only index up 7.8% year-over-year — its strongest quarter on record. These home price indicators differ in methodologies and data sources (the FHFA only uses GSE loans, while the Case-Shiller index includes many jumbo and other types of loans).

Sources: *CoreLogic Case-Shiller/FHFA/Moody's Analytics/Arch MI*

YEAR-OVER-YEAR PERCENTAGE CHANGE IN HOME PRICES



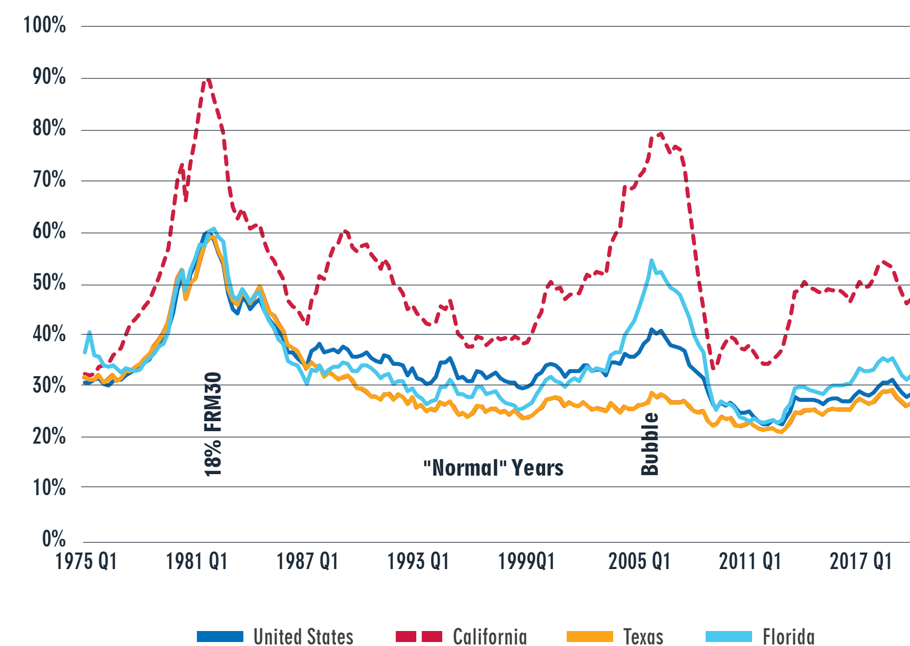
Home prices are up in all 50 states over the past year. The fastest growth in home prices was in Idaho, Arizona and Utah. The slowest growth was in Hawaii, North Dakota, the District of Columbia and Illinois.

Sources: *FHFA All-Transactions HPI/Moody's Analytics/Arch MI*

SA *stands for Seasonally Adjusted.*

Housing and Mortgage Market Indicators

PERCENTAGE OF MEDIAN INCOME NEEDED FOR PAYMENTS ON A MEDIAN-PRICED HOME

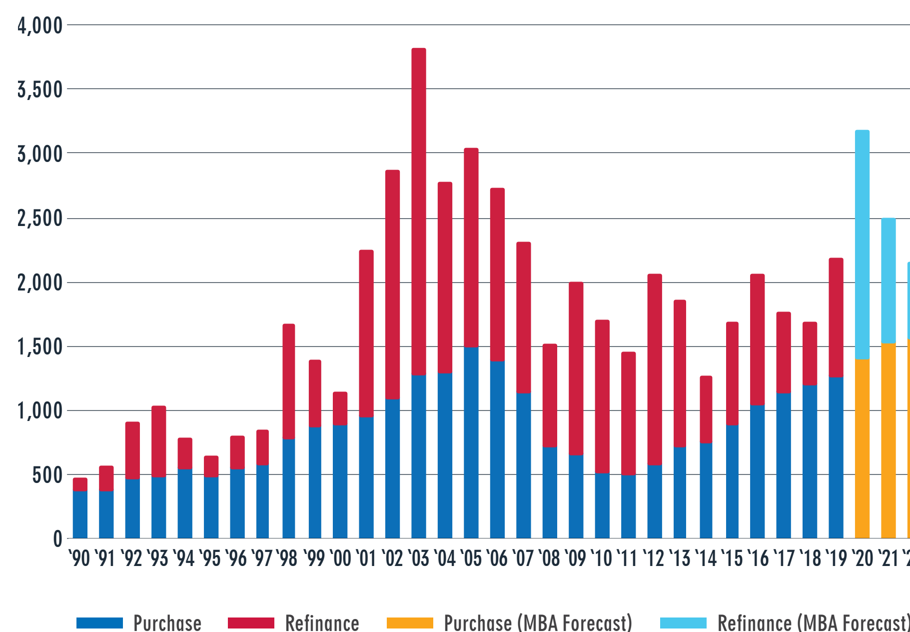


Housing affordability improved because of lower mortgage rates. It remains better than historic norms nationally. Arch MI's affordability measure is the percentage of a median income required for monthly payments on a median-priced home. For the U.S. overall, the affordability measure increased from 27% to 29% due to increased property prices. This level is still well below the national average of 34% from 1987 to 2004.

This is a calculation and not based on the front-end DTIs of actual loans. Calculations are based on pretax median household income, a 10% down payment, escrow of annual expenses of roughly 1.75% of the initial home price (for insurance and property taxes) and the prevailing 30-year fixed rate, plus 0.75% to cover mortgage insurance and risk add-ons.

Sources: *U.S. Census Bureau/Freddie Mac/NAR/Arch MI*

ORIGINATIONS IN MILLIONS OF $

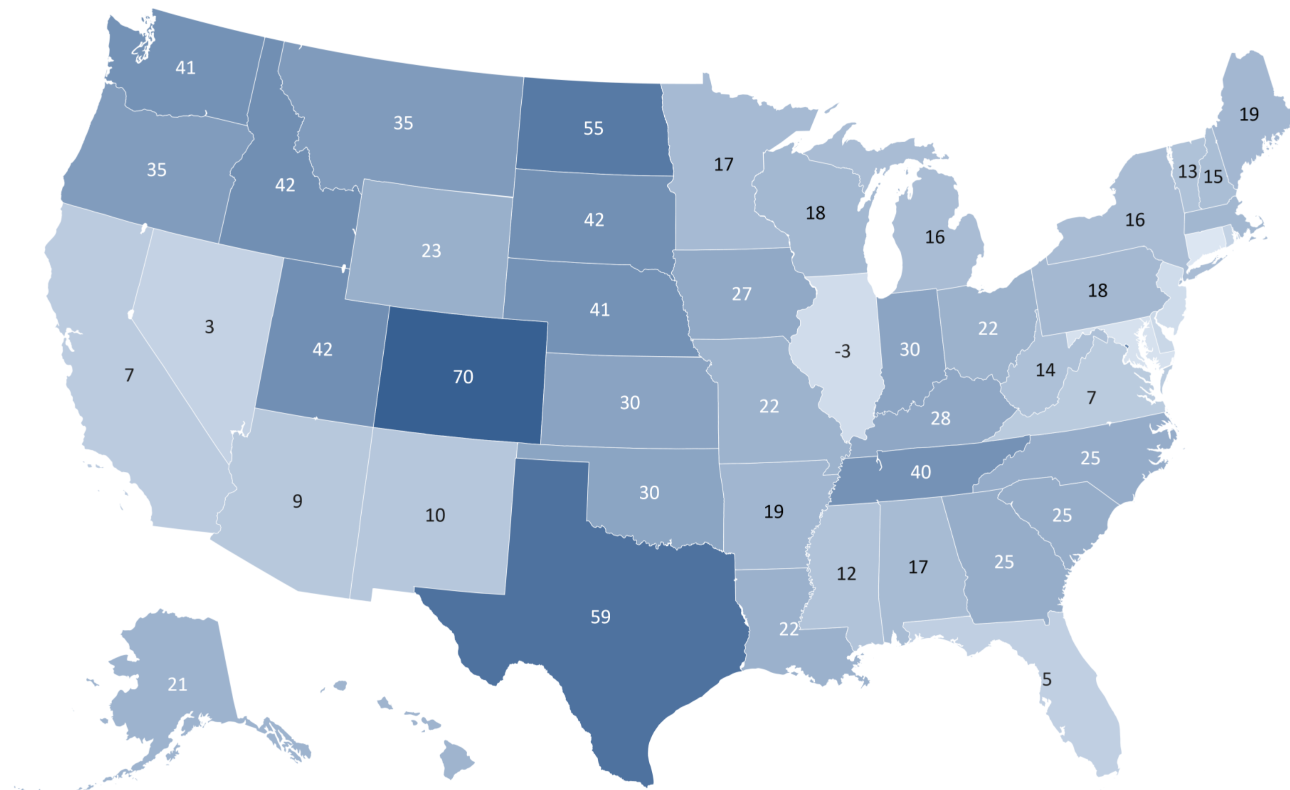


Future mortgage originations are likely to tilt toward purchase loans. 2020 refis are projected to be more than $1.7 trillion, which is nearly double 2019's volume, while purchase originations of $1.4 trillion would be up over 10%. The total market for 2020 of $3.18 trillion is set to be the largest since 2003. Dollar volume of purchase mortgage originations is projected to continue its upward trend for the next two years while refi volumes decline.

Source: *Mortgage Bankers Association (MBA)/Arch MI*

Housing and Mortgage Market Indicators

HOME PRICE PERCENTAGE CHANGE FROM PRIOR PEAK (2005–2008)



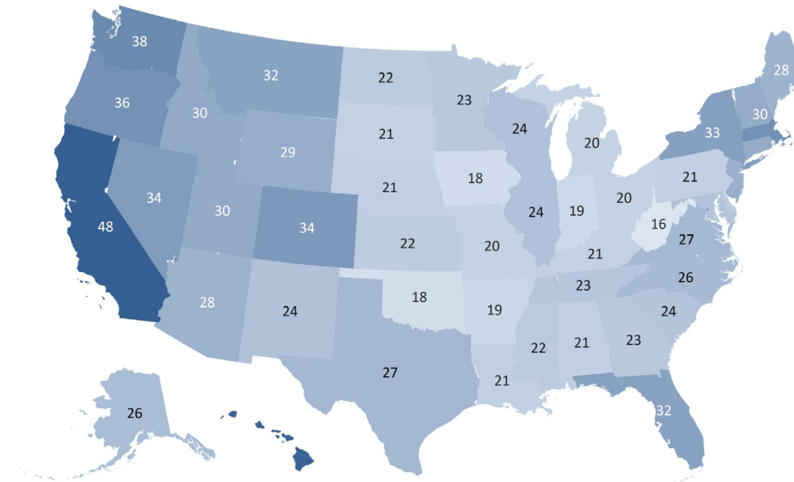
Home prices are still below their prior peak in four states: Connecticut (-9%), Maryland (-6%), New Jersey (-3%) and Illinois (-3%). Cumulative home price growth has varied widely since prices last peaked around 2006 (we measure since the peak for each state, which varied around 2006/2007). The **largest cumulative home price growth since home prices peaked is in Colorado, followed by Texas and North Dakota**, which have gone up more than twice as fast as the national average of 23%. This chart is intended to aid understanding of market strength over the past decade and doesn't indicate any overvaluation since it doesn't account for changes in income or reasonableness of prices at their prior peak.

Values shown are in nominal (not inflation-adjusted) terms.

Sources: *FHFA/Moody's Analytics/Arch MI*

Housing and Mortgage Market Indicators

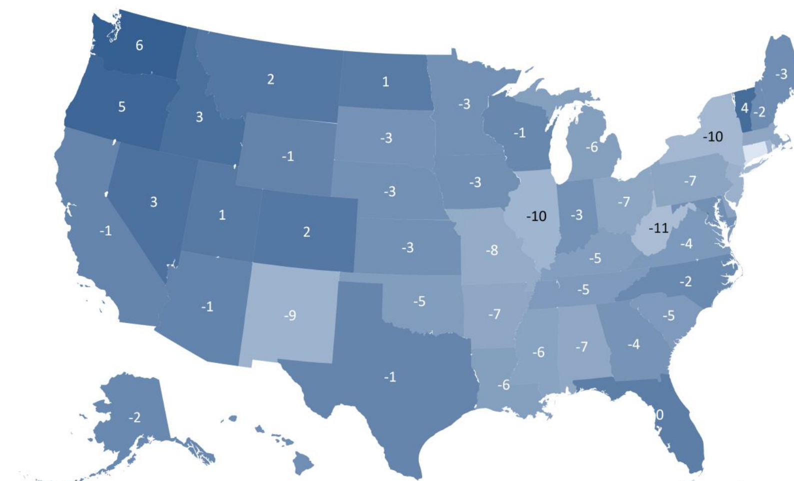
PERCENTAGE OF MEDIAN INCOME NEEDED FOR PAYMENTS ON A MEDIAN-PRICED HOME



Our affordability measure is the percentage of median income required to make monthly mortgage payments on a median-priced home. Lower values indicate better affordability, such as in West Virginia, Iowa and Oklahoma. It is a calculation and not based on the front-end DTIs of actual loans. Calculations are based on pretax median household income, a 10% down payment, escrow of annual expenses of roughly 1.75% of the initial home price (for insurance and property taxes, which we vary by state), and the prevailing 30-year fixed rate, plus 0.75% to cover mortgage insurance and risk add-ons.

Sources: *U.S. Census Bureau/Freddie Mac/NAR/Moody's Analytics/Arch MI*

DIFFERENCE IN PERCENTAGE OF MEDIAN INCOME NEEDED NOW VS. NORMAL YEARS

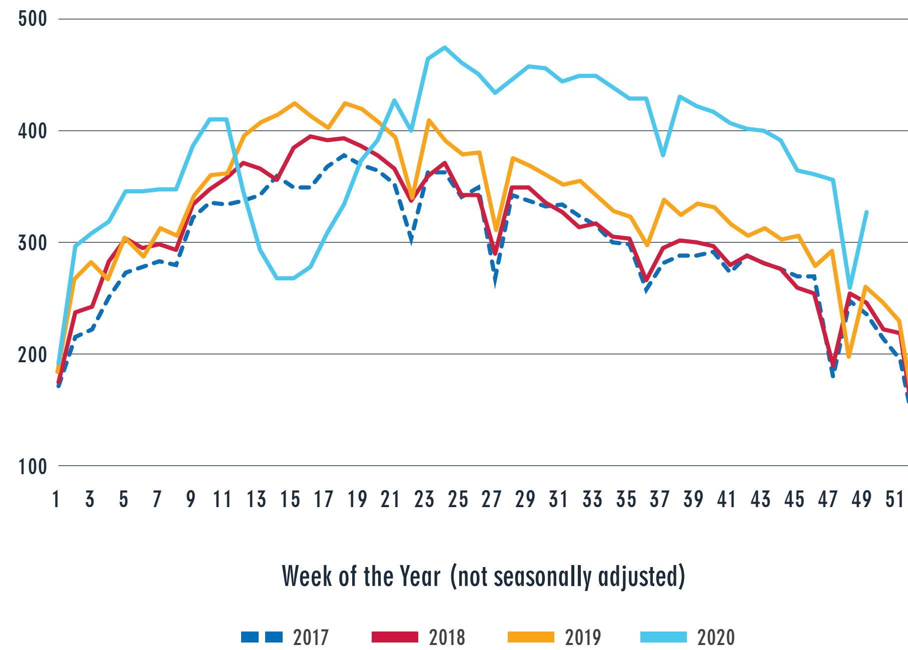


Affordability is worse than historical norms in the Northwest and Mountain West. This map shows how affordability differs now compared to historical norms; a value of five indicates a mortgage payment on the same home requires 5% more of a borrower's income than it did many years ago. It is the percentage of median income needed for monthly mortgage payments on a median-priced home (shown above) minus the average from the pre-bubble years between 1987 and 2004. For the U.S., the median-priced home only requires 29% of the median income, down 5% from its 1987–2004 average of 34%. Washington has the worst state affordability now compared to its 1987–2004 average, followed by Oregon and Vermont.

Sources: *U.S. Census Bureau/Freddie Mac/NAR/Moody's Analytics/Arch MI*

Housing and Mortgage Market Indicators

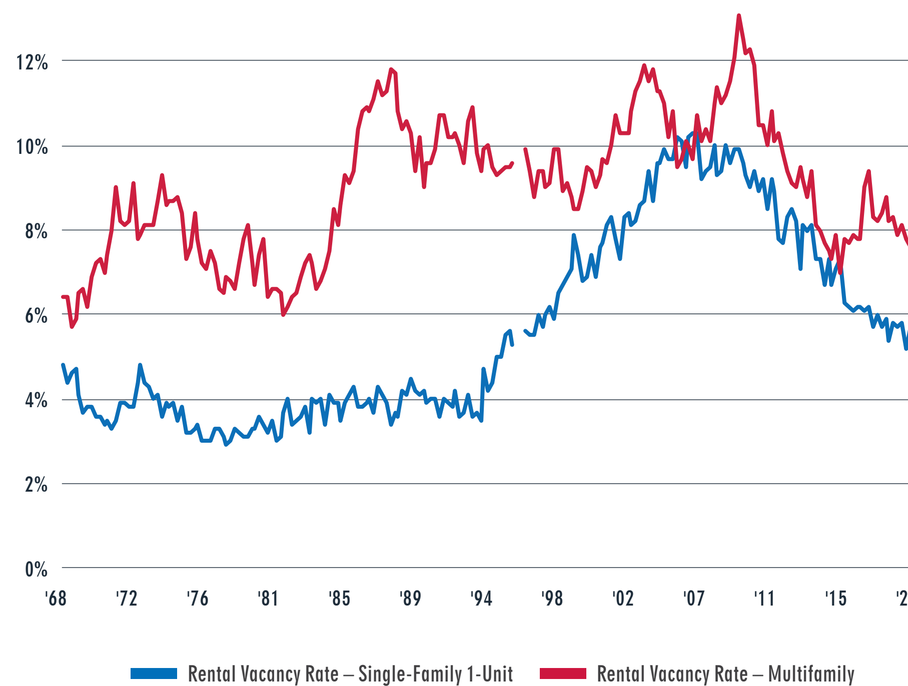
MBA MORTGAGE PURCHASE APPLICATION INDEX



Purchase mortgage applications are up around 25% over the last few months. The weekly MBA purchase mortgage applications index (for conventional loans) has recovered from the early Spring dip and has been around 25% higher since July.

Sources: *MBA/Arch MI*

U.S. RENTAL VACANCY RATE



The U.S. single-family rental vacancy rate remained at the low level not seen since 1994 at 4.7% in the third quarter. This suggests a shift in demand from multi-family to single-family rental. Sustained low rental vacancy rates indicate a tight housing market going into the pandemic.

Sources: *U.S. Census Bureau/Moody's Analytics/Arch MI*

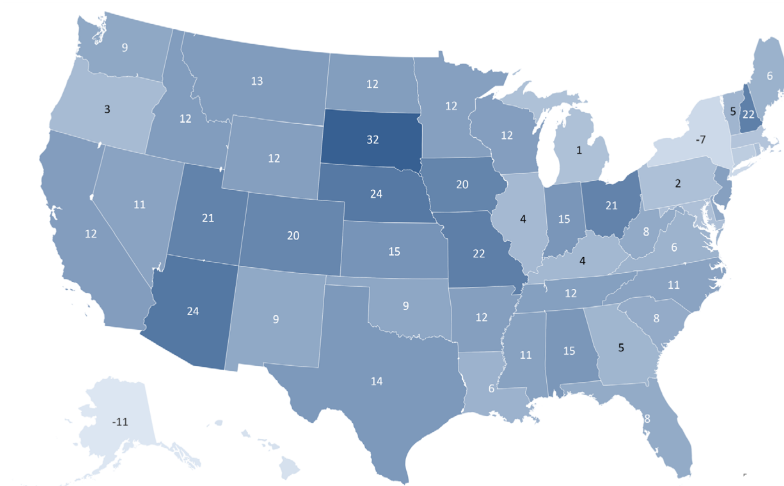
Housing and Mortgage Market Indicators

ANNUAL HOUSING STARTS, IN THOUSANDS

Housing starts bottomed out during the peak of the lockdowns. Single-Family Housing Starts were at their highest level since 2007 in October at 1.2 million units (seasonally adjusted annual rate) and multi-family starts were around an annualized rate of 350,000 units a year. The chart smooths out highly volatile monthly data by taking a 12-month moving average.

Sources: *U.S. Census Bureau/Moody's Analytics/Arch MI*

ANNUAL PERCENTAGE CHANGE IN HOUSING STARTS

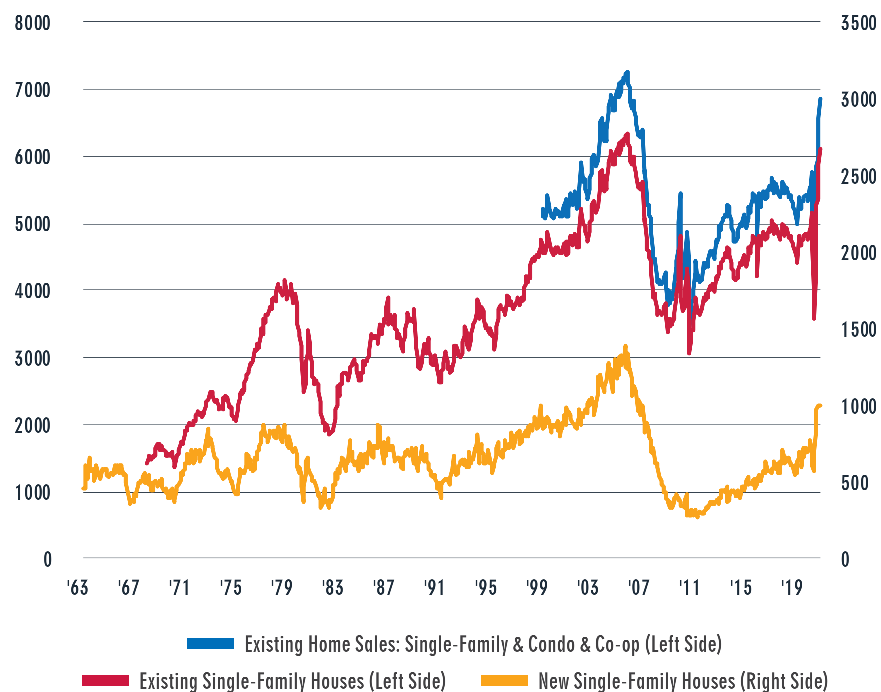


The percentage change in housing starts varies widely and is strongest in the middle of the country. The growth in Single-Family Housing Starts is weakest in the Northeast. **Housing starts increased the most in South Dakota,** followed by Arizona and Nebraska. To get a clearer understanding of the trend, unlike numbers seen elsewhere, we smooth the data by showing a 12-month moving average to dampen short-term volatility due to weather, survey limitations, etc.

Sources: *U.S. Census Bureau/Moody's Analytics/Arch MI*

Housing and Mortgage Market Indicators

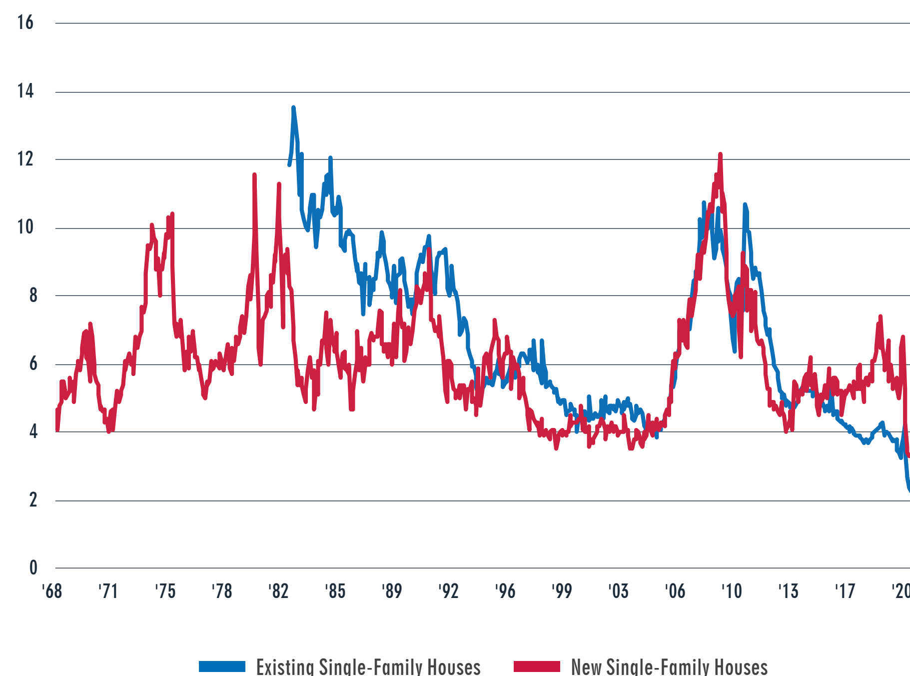
NEW AND EXISTING HOME SALES IN THOUSANDS



Both new and existing home sales have bounced back strongly. Sales of existing homes (including single-family, condo, and co-ops) were 6.9 million units (after annualizing the seasonally adjusted monthly number) in October. That was 26% higher than the year before. Sales of newly constructed homes were 1 million units (annualized rate). Existing home sales are based on the closing of contracts signed one to two months earlier, while new home sales are counted at the time of signing.

Sources: *NAR/U.S. Census Bureau/Moody's Analytics/Arch MI*

MONTHS' SUPPLY OF HOMES FOR SALE



The inventory of homes for sale once again hit record lows.

The months' supply of existing single-family homes for sale (total current listings ÷ last month's sales) was 2.3 months at the end of October, compared to 3.7 months a year ago. The months' supply of new homes for sale, shown in green, remained low at **3.3 months**. This is much lower than its post-crisis high of 7.4 months reached at the end of 2018 and lower than its long-term average of 6.1 months.

Sources: *NAR/Moody's Analytics/Arch MI*

SA stands for Seasonally Adjusted.

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[1] *Subject to any applicable regulatory requirements, Arch MI reserves the right to terminate the program at any time without notice.*

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