

Are Banks Vulnerable to a Housing Bust?

House prices in the United States have soared over the past five years. A common measure of the trend in house prices is the repeat sales index produced by the Office of Federal Housing Enterprise Oversight. According to this measure, between 2001:Q1 and 2005:Q3, U.S. house prices increased by an average of 40 percent in nominal terms and 29 percent relative to the consumer price index (excluding the shelter component of the index). This rapid appreciation has led some analysts to forecast a correction in real house prices—possibly even a decline in nominal prices.

A decline in house prices would reduce household wealth, which could restrain the growth of consumer expenditures and overall economic activity. Mortgage default rates could increase sharply if a decline in house prices were accompanied by slower growth of household income or rising interest rates. Furthermore, a decline in house prices would reduce the value of collateral behind the \$8 trillion residential mortgage debt market and would thereby increase the losses lenders experience on loan defaults. The popularity of nontraditional mortgage loans, such as interest-only loans and adjustable-rate loans that permit negative amortization (“option ARMS”), raises additional concern about default risk because such loans expose borrowers to more interest-rate and house-price risk than traditional fixed-rate, amortizing loans.

How exposed are banks to residential real estate? As a share of their total assets, commercial bank holdings of residential real estate loans and securities have risen markedly since the mid-1990s. For example, between 1999:Q1 and 2005:Q1, the sum of bank holdings of 1-to-4-family residential real estate loans and the market value of their holdings of mortgage-backed securities (excluding those issued or guaranteed by a government agency or government-sponsored enterprise, such as Fannie Mae and Freddie Mac) increased from about 15 percent of total bank assets to nearly 20 percent. More comprehensive measures that include all residential real estate loans show similar increases in exposure, as does the ratio of untapped home equity lines of credit to total bank assets.

These simple exposure measures provide little information, however, about whether banks today are more vulnerable to a decline in house prices than they were in the past. Although the share of bank assets consisting of residential real estate loans and securities has increased since 1999, so too has bank equity-capital relative to total bank assets. Between 1999:Q1 and 2005:Q1, equity-capital increased from 8.5 percent of total bank assets to 9.9 percent of total assets. Because capital serves as a cushion against loan and security losses, the increase in real estate loans and securities as a share of bank assets is less worrisome than it would have otherwise been.

The national averages, of course, mask considerable variation across banks in their holdings of residential real estate loans and securities and in their capital-to-assets ratios. One might assume that risks are greater for banks located in regions that have seen the most rapid house price appreciation. Loan-to-value ratios have tended to be lower in such regions, however, suggesting that the mortgage market may have adapted to a possibly higher risk of house price declines in those states. Further, the growth of the mortgage-backed securities market and proliferation of interstate branch banking may have reduced banks’ exposure to local real estate shocks by facilitating greater geographic diversification of their real estate loan and securities portfolios. Finally, a portion of the residential real estate loans and securities held by banks are guaranteed by third parties, and many banks purchase only highly rated securities that have little credit risk. Thus, to get a complete picture of how vulnerable individual banks are to a decline in house prices, we need to know more about the composition of their real estate loan and securities portfolios.

—David C. Wheelock