ON THE MONEY

The eternal optimism of spring — except in housing

Barry Ritholtz
ON INVESTING

Ahhh, winter is finally over. Each year about this time, flowers push up through the soil, trees begin to bud — and the stories about a real estate recovery appear.

Am I skeptic? But of course. To understand why, let's consider a few questions:

What is shadow inventory?

This is important, as lowering the total inventory of houses for sale is how prices stabilize and sales volume moves higher.

Most buyers are familiar with ordinary inventory — houses listed for sale with real estate agents or by owners. Unfortunately, shadow inventory adds to the backlog. It includes bank-owned real estate, distressed houses not yet for sale, short sales and delinquencies that have not yet defaulted. Foreclosure properties are also in the shadow inventory.

These houses will eventually become part of the total supply for sale. Although there is no official count, estimates of potential shadow inventory run as high as 10 million.

That's not all. There's also a huge overhang of underwater homeowners — whose houses are worth as much as 25 percent less than what is owed. The owners don't qualify for a mortgage modification. They may be delinquent but aren't in default.

Two-thirds of all U.S. houses have mortgages. Of those, an estimated 21 to 29 percent of the mortgages are underwater, or up to 16 million houses. When prices finally do rise, we can expect many of these no-longer-underwater owners to put their houses up for sale.

Are houses affordable?

Here's where every discussion of affordability seems to start: the National Association of Realtors Home Affordability Index. In my view, it's worthless.

Why did I come to such a harsh conclusion? The index offers little insight into how affordable housing actually is. In the biggest run up in housing prices in American history, the index never dipped into the level of unaffordable. Imagine that.

As ridiculous as that sounds, it's even more absurd when we look at the NAR methodology, which ignores factors such as family savings rates, cash assets, consumer credit, indebtedness, credit servicing obligations, inflation and income gains.

The affordability index looks at the wrong things and ignores the important ones. The correct question is not whether the houses are affordable in theory. Rather, it's whether potential buyers can afford to buy them.

Why does this matter?

In the real world, buyers have to be able to meet two key factors: down payments and mortgages.

Today, most families are cash poor and debt rich. They are deleveraging, not building up savings. Most simply do not have the $40,000 to put 20 percent down on a median priced house.

If you happen to have a down payment, there's another hurdle: Qualifying for a mortgage. You must have a good credit score, not too much debt, a steady income, good employment history, etc.

The simple truth: House prices are down 35 percent from their peaks and mortgage rates are at record lows, but for those lacking the down payment or ability to access mortgage credit, houses are only theoretically affordable — but not for them.

Are the prices cheap?

Few had forecast the steep drop in median house prices.

Some regions that were excessively frothy during the boom — California, Las Vegas, South Florida and Arizona — have seen much greater price drops. Other areas had laws (Texas) or financial conventions (New York City) that mandated significant down payments and other prudent requirements and avoided much of the bloodshed.

The conventional wisdom is that prices have stabilized and are overdue to start rising. The data, however, suggest something else. The most recent Case-Shiller index of national prices (January) shows prices are still falling, about 4 percent year-over-year. There are favorable factors:

- Prices are falling more slowly than they had been earlier.
- Nationally, house prices are back to where they were in 2003.
- The median prices of renting vs. buying now favor buying.

It's not terrific progress, but it's betther than three years ago.

What is the psychology of renting?

As the chart shows, costs of owning vs. renting are back to where they were in 1997, 1988 and 1976. The context is obviously different today. However, this is a favorite metric to show that houses are not all that expensive.

While rentals look less appealing as they go up in price, the other side of the equation is simple mean reversion. By most other metrics, house prices have nearly reverted to the mean.

The relationship between median income and median purchase price is yet another crucial factor, as any buyer must earn enough to pay the mortgage.

Therein lies the rub: Real incomes have been mostly flat for a decade. Without growth, buying power remains flat.

House prices relative to income have come back down nearly to the mean. The uptick in 2009-10 was based on the first-time buyer tax credit. Once that expired, the prices dropped again.

So prices remain slightly elevated relative to where they have been historically. The variable, of course, is mortgage rates. The Fed's zero interest rate policy is keeping mortgage rates at record low levels.

How do asset prices behave following a bubble?

Regardless of the asset class — stocks, bonds, commodities, houses, etc. — assets do not merely stabilize. We have never seen a stock market run up into bubble territory and then revert to fair value. Instead, we careen wildly past that level, to deeply undersold and exceedingly cheap.

That is the marvelous mechanism of markets. It is how assets are repriced, distressed holdings liquidated, capital markets stabilized, fools revealed, speculators punished — and money returned to its rightful owner, the prudent investor.

For a lasting recovery, we need to see houses cheap enough that they fall into "good hands" — long-term owners who can afford their mortgage payments.

Until that happens, houses will stumble along the bottom of the price range. The nation could easily see another 10 percent to the downside — assuming nothing else goes wrong.

This would actually be good news. The government interventions (first-time buyer tax credit, mortgage modifications and foreclosure abatements) have prevented prices from finding their own levels. If they did, houses would be much more affordable, and buyers would come out in droves.

That is how a true housing recovery begins.

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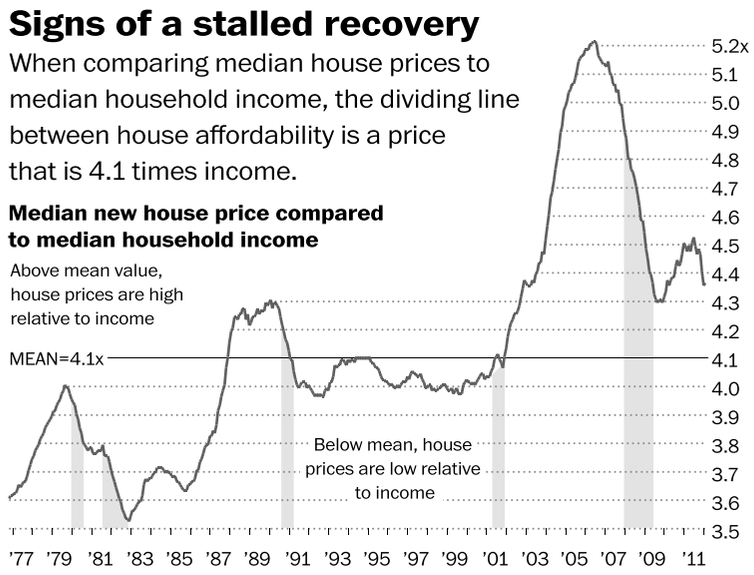
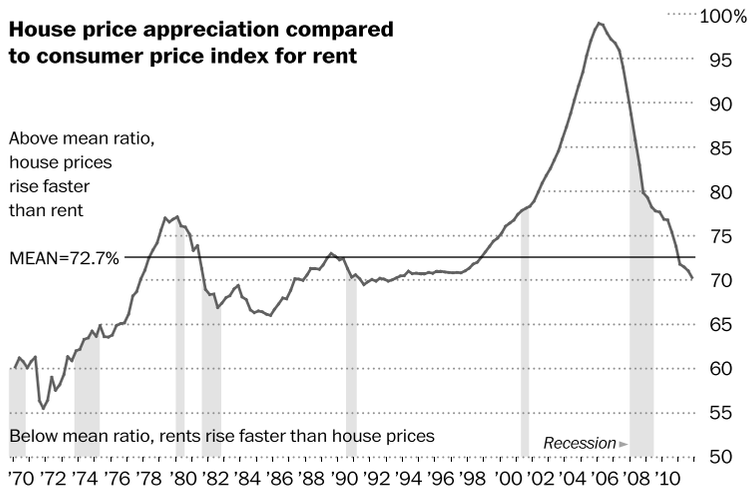
Signs of a stalled recovery

When comparing median house prices to median household income, the dividing line between house affordability is a price that is 4.1 times income.



During the housing bubble, house prices climbed at a much higher rate than rents, but in 2011, that trend reversed.



Source: Ned Davis Research THE WASHINGTON POST

Quick (and costly) tax advances are fading

TAXES FROM G1

tom line was there was no reason for people to do it," he said. "Even though it promised faster refunds, it wasn't that much faster."

Anticipating a refund

The IRS often took a month or longer to process refunds, and checks were mailed to taxpayers' homes. Longfield said customers reported the money being stolen from their mailboxes. The IRS also tested electronically depositing refunds into bank accounts, but many lower-income taxpayers did not have accounts.

The agency had set ambitious goals for electronic filings and encouraged companies to come up with solutions, Longfield said. The ultimate incentive for consumers to file electronically would be a nearly instant tax refund — money they could put in their wallets within a day or two of leaving Beneficial's offices.

In 1989, Longfield patented the process for what would become known as the tax advance, or, in industry jargon, refund anticipation loan. Beneficial calculated the estimated refund when it filed a customer's tax returns, then issued loans for the same amount, minus fees. When the IRS processed the return, Beneficial took the refund as the payoff for the loan.

Longfield said the industry agreed to safeguards to prevent loan sharks from entering the market: Fees could not be calculated as a percentage of the refund, and only regulated banks could make the loans. Longfield said it was banks that got hit when IRS glitches delayed refund payments by weeks.

"It creates a buffer between . . . the IRS and the taxpayer," he said. "The ones who suffer, if you will, will be the banks, and they can afford to suffer."

Tax policy as rocket fuel

In the 1990s, two changes to tax policy drove demand for the loans to skyrocket.

First, Congress expanded the earned income tax credit (EITC) in an effort to help low-income working families keep more of their paychecks and stay off welfare. Not only did more Americans become eligible for the credit, but their annual refunds increased dramatically.

According to John Wancheck of the Center for Budget and Policy Priorities, the maximum refund for a family with two children more than doubled from $1,511 in 1993 to $3,556 in 1996.

Getting the money, however, required filling out an extra form in each tax return, Wancheck said. The added step encouraged many workers to turn to tax preparers for help. In addition, the refund was often the biggest lump sum these taxpayers would receive all year — and they wanted it as quickly as possible.

"A good aspect of it was the [tax preparation] industry was promoting awareness of the EITC," he said. "Of course, it had a self-serving purpose, too."

Beneficial's banking division pioneered the field by partnering with H&R Block to offer "instant refunds" or "tax advances." Soon, major banks such as JPMorgan Chase and HSBC joined in.

One main challenge in the industry was underwriting what were essentially short-term loans to a risky population. If the refund was less than expected, people had to repay the balance — and banks often had to expend considerable resources to get it.

So the industry pressed the IRS to share a key piece of data, now known as the debt indicator. The code reflects whether the IRS will divert part of a taxpayer's refund to pay outstanding bills, such as child support or federal student loans. If banks could have this information, they argued, they could make better lending decisions, reduce risk for the industry and consumers, and bring down prices.

The IRS agreed, but it soon regretted the move. As concerns over fraud in the industry mounted, the agency briefly stopped providing the debt indicator to tax preparers in the mid-1990s. But it soon returned amid lobbying by the industry and new promises of lower prices and fuller disclosures.

"We went into it with really good intentions," said Ernst, who, as head of H&R Block, pressed the IRS to reinstate the debt indicator. "Over time what we found . . . is that consumers were very price-insensitive. They didn't really know what they were paying. Whatever price concessions were promised by the industry, they long ago had been taken back."

Not 'free money'

Tax advances peaked in 2002, with 13 million people taking out the loans. More than half of those who received the earned income tax credit signed up for the service, and the industry brought in $1.1 billion annually.

That caught the attention of consumer advocates. Because the refunds seemed like "free money," many customers paid little attention to the fees they were paying. In some cases, tax preparers were not disclosing the information.

A National Consumer Law Center report in 2002 described three fees consumers paid for tax advances: an electronic filing fee, a preparation fee and a loan fee. Together, they typically amounted to $129 to $429. The NCLC said that amounted to an annual percentage rate of 67 to 774 percent for what usually was a 10-day loan.

"It sort of all came together, the realization that tax preparation was a little bit of the Wild West out there," said Chi Chi Wu, a staff attorney. "The refund anticipation loans were contributing to that."

In 2007, the Justice Department sued several of Jackson Hewitt's major franchisers, alleging more than $70 million in fraud. The complaint described inflated tax returns, including a barber who claimed he was eligible for tax credits for buying 25,000 gallons of fuel in one year — the equivalent of a 1,370-mile commute each day.

The franchisers agreed to settle the case and leave the industry.

In a 2008 report, the Government Accountability Office recounted tax advances being peddled out of a trailer in a gas station parking lot and auto dealers marketing the loans as down payments for used cars.

When the financial crisis hit, public sentiment against such risky, high-cost loans swelled, and lawmakers and regulators searched for ways to curtail the industry.

Reenter Ernst. He resigned as head of H&R Block in 2007 amid millions of dollars in losses on subprime mortgages. He landed at the IRS as a deputy commissioner and quickly was named to lead a task force charged with scrutinizing tax advances. He zeroed in on the debt indicator.

"Having come from the industry, I knew what it was that enabled this product to exist and what would happen if certain of those enablers didn't exist anymore," he said. "This one policy tool that had been given to the industry was the thing that was holding the product together."

Ernst said that after he lobbied to keep the debt indicator while at H&R Block, he tried to make good on the promise of lower prices, partly out of fear of more draconian regulations if he didn't. But he said his competitors never followed suit, and customers didn't seem to mind.

"Frankly, people were making too much money," he said. "The industry, for its own sake, needed to reform."

By 2010, Ernst's task force had its answer for the tax advance industry: The debt indicator was going away for good.

Post-financial crisis, banking regulators did not look favorably on loans made without the underwriting tool of the debt indicator. On Christmas Eve 2010, H&R Block said its partner bank, HSBC, would no longer provide tax loans after receiving a notice of concern from the Office of the Comptroller of the Currency. JPMorgan Chase, one of the three biggest providers of tax advances, had pulled out of the market earlier that year.

This tax season marks the final year that a bank can offer the loans. Republic Bank, based in Kentucky, is the lone holdout. Early last year, the Federal Deposit Insurance Corp. notified the bank that extending the loans without the debt indicator compromised its "safety and soundness." The regulator also alleged numerous violations, including failure to disclose the annual percentage rate and discrimination based on marital status. The FDIC said nearly half the tax preparation centers it visited that distributed Republic's loans committed three or more regulatory violations.

The FDIC proposed a $2 million fine. Republic settled the case for $900,000 late last year and agreed it would stop making tax advance loans.

Timed out by technology

Some analysts say the industry was on its last legs anyway. Advances in technology have shortened the time it takes for the IRS to process refunds to a week or two, reducing demand for the loans.

But others say that the loans filled a critical niche in many consumers' budgets and that demand was inelastic.

"The people who think they know more than the consumer does and what's good for them — and that's an opinion — decided that they don't like this, that people shouldn't have to pay to get their money faster," Longfield said. "The pendulum, as it always does, swings too far in the other direction."

Tax preparers have developed alternatives to tax loans for customers who do not have bank accounts. Refund anticipation checks or prepaid cards allow customers to deduct the cost of tax preparation from their refunds. Also, some non-banks have begun offering tax advance loans on a more limited basis.

According to the NCLC, about 5 million tax loans were made last year, generating roughly $338 million in fees — one-third of the size of the market at its height. It is expected to shrink even more this year.

"It had kind of served its purpose to solve a problem when people weren't getting refunds as quickly as before," Ernst said. "The need to enable an industry to exist to accelerate refunds, we didn't believe that was a good policy choice."

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