May 2006

Real Intelligence – Real Advantages

In This Issue

Existing-home sales edged up in March, posting 6.92 million seasonally adjusted annualized units – a 0.3 percent increase from February. Single-family home sales rose 0.3 percent to a seasonally adjusted annual rate of 6.07 million, and existing condominium and cooperative housing sales increased 0.2 percent to a seasonally adjusted annual rate of 854,000 units. The national median existing-home price for all housing types was $218,000 in March, up 7.4 percent from March 2005. As interest rates rise there could be some minor slowing in home sales, but the market is stabilizing. NAR analysts expect 2006 to be the third strongest year on record for home sales. **Read more.**

Breathe, breathe. We've gotten used to record-setting home sales, very low mortgage rates, double-digit home price appreciation. But now that the housing market is coming in for a "soft landing," NAR Chief Economist David Lereah says it's time to catch our breath. In his commentary this month, Dr. Lereah looks at how we can start to breathe easily and steadily through the rest of this year. **Read more.**

Cooking with gas (prices). We all have felt the pain at the pump recently. With oil having topped $70/barrel, what could be the impact of fuel prices on the rest of the economy – and on housing? Our Senior Forecast Economist Lawrence Yun tells us we can keep cooking with gas. **Read more.**

Been there, done that – no, not again! Language in recent letters issued by the Office of the Comptroller of the Currency (OCC) give three banks – two of them among the nation's largest – expanded authority to invest and develop a variety of real estate projects. This puts those banks on the way to breaking down the wall separating banking and commerce. NAR continues to oppose such authority. Our market intelligence feature this month gives us a brief history lesson in what happens when banks own and run commercial businesses. **Read more.**

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NATIONAL ASSOCIATION OF REALTORS®
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Real Estate Monitor

Monthly Indicator	Recent Figures		Likely Direction Over the Next Six Months	Forecast
Existing-home Sales rose 0.3% in March, posting 6.92 million seasonally adjusted annualized units. The median sales price of an existing single-family home was $218,000 – a 7.4% increase from March of 2005. Housing inventory rose to a level of 3.194 million units – the highest on record – representing a 5.5 months' supply. **Read more.**	Jan Feb Mar	6,570 6,900 6,920	↓	Pending sales have been pointing downward
New Home Sales rebounded in March, rising 13.8% to a seasonally adjusted annual rate of 1.23 million units. The inventory of new homes on the market continued to build, with 555,000 new homes listed for sale representing a 5.5 months' supply. Homebuilders should be cautious of not oversupplying the market. **Read more.**	Jan Feb Mar	1,197 1,066 1,213	↓	More expensive new homes are more interest-rate sensitive
Housing Starts declined 7.8% in March, posting 1.96 million units. But the decline comes after a 30-year high recorded in January. Single-family starts slipped to 1.59 million units (off from February's 1.81 million), due in large part to rising mortgage rates and a substantial build-up in unsold inventory of new homes. Multifamily units rose to 369,000, primarily the result of a robust job market. **Read more.**	Jan Feb Mar	2,307 2,126 1,960	↓	Builders need to take note on noticeable cooling sales
Housing Affordability NAR's housing affordability index fell 1.1% in March to 111.9. In spite of an increase in median family income, the decline in affordability was expected in light of rising mortgage rates. Please note: NAR has revised the HAI series back to 1989 due to revisions made to the Median Home Price series. **Read more.**	Jan Feb Mar	111.3 113.1 111.9	↓	Higher interest rates raise monthly payment obligations
Mortgage Rates The 30-year fixed-rate mortgage rose steadily to 6.51% in April – the highest mortgage rate since the summer of 2002. Rates are expected to rise higher throughout 2006. The one-year adjustable rate shifted upward to 5.62% during the month. **Read more.**	Feb Mar Apr	6.25% 6.32% 6.51%	↑	A few more upward ticks before stabilizing by Autumn
Purchase Applications After plunging in February and March, the Mortgage Bankers Association's Purchase Application Index rose in April to 412.0. This confirms that while the housing market is cooling off, it is now entering a period of stabilization. **Read more.**	Feb Mar Apr	406.6 407.6 412.0	↓	Mortgage brokers should be nervous
Employment The economy added 138,000 jobs in April – well short of the 200,000 jobs most analysts anticipated. Both March and February figures were revised downward. Retailers cut just over 36,000 jobs. Manufacturing, financial firms, education and health services, and professional and business services – boosted payrolls. Annual wages rose 3.8% since April of 2005. **Read more.**	Feb Mar Apr	200 200 138	↑	High corporate profits and high stock market valuation could boost headcount
Inflation The consumer price index rose 0.4% in March. While fuel prices accounted for some of the increase (rising 1.3%), prices increased across the board, including those for housing (0.2%), food and beverages (0.1%), and medical care (0.4%). The core index (excluding food and energy) rose 0.3%. Core prices will continue to rise steadily through the spring, **Read more.**	Jan Feb Mar	0.7% 0.1% 0.4%	↔	Will be at the high-end of the comfort level for a while

Notes: All rates are seasonally adjusted. Existing home sales, new home sales and housing starts are shown in thousands. Employment growth is shown as month-to-month change in thousands. Inflation is shown as a month-to-month percent change in the Consumer Price Index. Sources: NAR, Bureau of the Census, Bureau of Labor Statistics, Mortgage Bankers Association and Freddie Mac. This report reflects data as of May 5, 2006.

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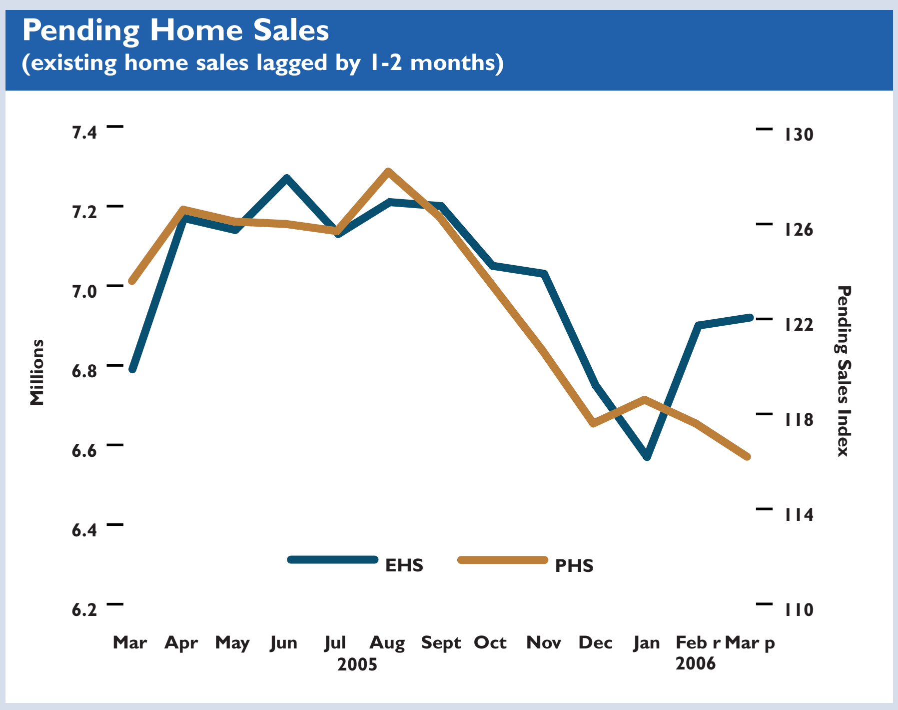
NAR's Pending Home Sales Index

NAR's Pending Home Sales Index (PHSI) eased 1.2 percent in March to 116.2. The index is derived from pending sales of existing homes. A sale is listed as pending when the contract has been signed but the transaction has not yet closed; pending sales typically are finalized within a month or two of signing. An index of 100 is equal to the average level of contract activity during 2001, the first year to be examined, and was the first of five consecutive record years for existing-home sales. The latest index shows that pending home sales have slowed as interest rates have continued to rise. This means a modest slowing in sales can be expected in the months ahead, although resales will hold at historically strong levels. **Read more.**



Source: NAR Research
Note: Reflects revised data for 2005

Catching Our Breath

by David Lereah, *Chief Economist*

For the past five years (2001 to 2005) the real estate boom gave us as much as we asked for – and more. Home sales registered record numbers for four consecutive years. Inventories were lean and price appreciation was running at high levels. The collective wealth of property owners grew by over $4 trillion during this period. Those in the real estate industry also fared well: REALTORS®, homebuilders and mortgage lenders all shared in a growing revenue pie. You could say that "everything was coming our way" during the boom. But I remember what my father said to me when he taught me how to drive a car. He said when everything is coming your way, you are probably in the wrong lane!

We can apply my dad's lesson to today's real estate markets. We got fat and some of us got too confident. With housing markets running wild, discipline was in short supply. Some of us moved away from the fundamentals that keep housing on track. The hot housing market attracted a high number of speculators; flipping became a fad; and pre-construction deals were in high demand. Overconfidence also led to loose credit standards, as lenders offered a heavy dose of interest only mortgages, option adjustable-rate mortgages (negative amortization) and low down payment and low documentation mortgage loans to virtually anyone who wanted to purchase property. Boomers purchased second homes without a second thought and condominium conversions were in vogue.

Almost everything has limits, even real estate markets. You cannot sustain a record-setting sales pace forever. Double-digit price appreciation may be a boon for sellers, but eventually a market becomes unaffordable. So the party is now over, and the punch bowl is empty. Officially, I would say the boom ended in August 2005, and real estate markets have been cooling ever since. Price appreciation, which was 13 percent in 2005, has slowed to a 7 percent pace as of this writing. The red hot metros of the past several years are now experiencing 5 to 10 to 20 percent declines in home sales during the first half of this year. Days-on-market has been lengthening and housing inventories building.

But there is a silver lining to the new real estate marketplace. Not all local markets are cooling, just markets that boomed in the past. The non-boom markets, like Houston and Cincinnati are gaining momentum, having registered double-digit home sales *gains* during the past several months. The non-boom markets are also losing inventory, not adding to it. Another positive outcome is that the cooling boom markets are shedding themselves of speculators. Both investors and speculators are exiting local markets, permitting basic fundamental investing to come back. Once-hot real estate markets are undergoing a cleansing and becoming more affordable.

Looking forward, my best guess is that the non-boom housing markets will continue to grow for the remainder of this year, while the boom housing markets will continue to cool, but under a soft landing scenario – sales will fall and price appreciation will remain positive but slow. The U.S. economy promises to provide a favorable backdrop for housing activity, generating both job gains and income gains. Under an optimistic but likely scenario, home sales bounce back in 2007 with most metro markets across the nation posting modest increases.

The U.S. economy promises to provide a favorable backdrop for housing activity, generating both job gains and income gains.

There is another influence to watch, and that is the Federal Reserve Board. The health of the housing sector is more dependent on Federal Reserve monetary policy than it was a year ago. Some metro housing markets are now vulnerable to rising interest rates due to the high concentration of interest-only loans in those mortgage markets and a relatively high number of interest-sensitive investors holding properties. Thirty-year mortgage rates are approaching 6.75 percent and if rates go beyond 7 percent, some metros could experience some price softening. Higher rates could also result in higher delinquency and foreclosure rates.

So, except for a few local markets softening, the rest of the nation's real estate markets are expected to survive this year of contraction rather nicely. By early 2007, we could actually be in a healthier market environment compared with 2005. All it takes is some time to correct and catch our breath in 2006.

Want more insights from NAR Chief Economist David Lereah? Visit **REALTOR.org** to see some of his latest comments from press interviews and speeches at **www.REALTOR.org/Research.nsf/Pages/housingoverview**

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THE FORECAST

by Lawrence Yun, *Senior Forecast Economist*

At the end of 1998, crude oil prices were under $10 per barrel. In the two years following, the price doubled. Further gigantic leaps in the recent three years have brought the price to the $70 range today. The futures market hints that the high prices are here to stay.

A bit of history …

OPEC boycotts in the 1970s raised the price tenfold from the beginning to the end of that decade: roughly from $3.50 to $35 a barrel. The result? The economy was havoc. The misery index – a politically motivated new economic indicator then – rose to an astonishingly high 21% (a combination of the inflation and unemployment rates). The rising "misery" triggered a sharp drop in home sales. Existing home sales declined by more than 50% as a result. That is to say more than half of REALTORs business disappeared.

That experience back in the 70s begs the question: Are we in for a similar scenario? The short answer is: NO!

In the long- and short- run

It is true that the current $3 per gallon gasoline price eats up money that consumers could spend elsewhere for far greater pleasure – an iPod, a good meal, or a luxurious vacation. So consumer complaints about high gas prices and the desire to assign blame for them are only human. But high gasoline prices do not tip an economy into a recession. Ask any European what they pay for petrol. It is not the level of the price, but *the rise in price* that affects the economic impact over the short run. Lower sales of those iPods and other consumer goods do dampen short-run economic growth. Over the long run, however, high gasoline prices do not matter that much for economic growth.

Impact on business

High oil prices are placed not only on consumers but are literally the grease that helps the wheels of business turn. Although oil companies are flush with profits, energy-using companies – that is to say most businesses – are seeing lower profits than they would otherwise. High oil prices mean companies could decide to hold back on hiring workers. Perhaps more importantly, companies may pass on their increased cost to consumers, thereby raising inflation.

Over the long run, high gas prices do not matter that much for economic growth

Fortunately, most companies are in fine financial shape. Corporate profits – at $1.5 trillion – are almost double what they were just five years ago when the stock market was hitting successive record highs. Today, the Dow Jones Index is retesting the record high, this time with real profits in hand. Therefore, the high oil prices will at best place financial strain on only a minimal number of companies. Also, energy matters less now compared to 30 years ago because only about half as much of oil is required to produce the same output. It's just that the U.S. keeps producing more, so more oil is needed.

Inflation around the corner …

The higher oil prices, if sustained, will lead to higher inflation. Inflation rose by an average of 3% in the past two years and is projected to rise 3.4% this year. That is a one-percentage point higher than what would have been expected in the absence of the oil price rise. Nonetheless, a 3.4% inflation rate is not frightening. The Federal Reserve's principal task is to contain inflation, and the way to do it is through much larger and continuing interest rate hikes. The Fed also understands that the major cause of 1970's type inflation was due to too much money supply, *not high oil prices*. The Fed, therefore, has been putting monetary policy on a tight leash – witness its 16 straight rate hikes. There is little worry about inflation getting out of hand.

What's ahead …

The forecast is for continuing economic expansion, but at a decelerated pace. After the 4.8% GDP growth recorded in the first quarter of this year, expect mid-3% expansion for the remainder of the year and well into 2007. This is based on inflation being contained and oil prices remaining near the $70 for the rest of the year.

But if oil rises to $90 a barrel, inflation will hit 4%. The market will not appreciate that. The Fed will need to further measurably raise rates. That's not good for housing. Oil prices are tricky to predict, but the best bet is that they have peaked. If that is the case then housing will do just fine.

Assuming oil prices stay put and the Fed to soon end its rate hikes, mortgage rates will stabilize at near 7%. That rate, though higher compared to the recent norm, is historically favorable. Jobs are being added so only a few households will be forced to sell their homes. There will not be a glut of homes on the market. The recent significant rise in months' supply from 4.0 to 5.5 over the past 12 months is an adjustment to the norm. (Generally, a 6-months' supply of homes available for sale is considered a "balanced" inventory.) The projected existing home sales level of 6.6 million in 2006 (third best ever) and then higher sales in 2007 are comforting.

The "misery index", meanwhile, is forecast to be 8.1% in 2006 – one of the lowest ever. Be happy – you have less misery.

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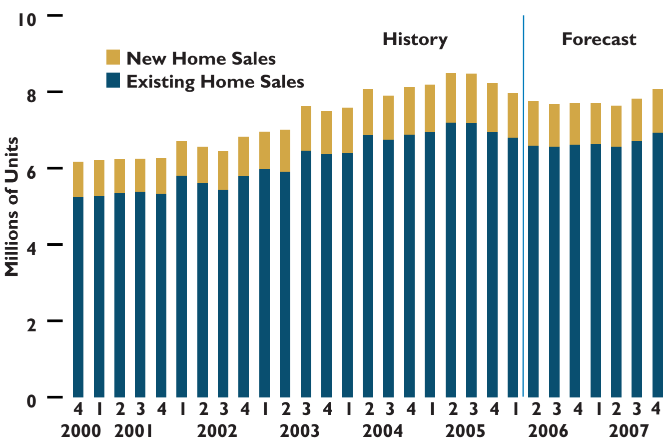
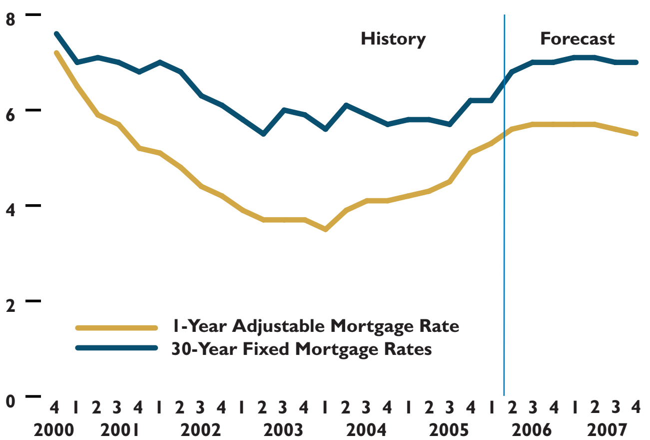
Home Sales
Leveling off at a healthy pace



Sources: NAR, Bureau of the Census, NAR Forecast

Mortgage Rates
Highest rates in 4 years, but still historically low



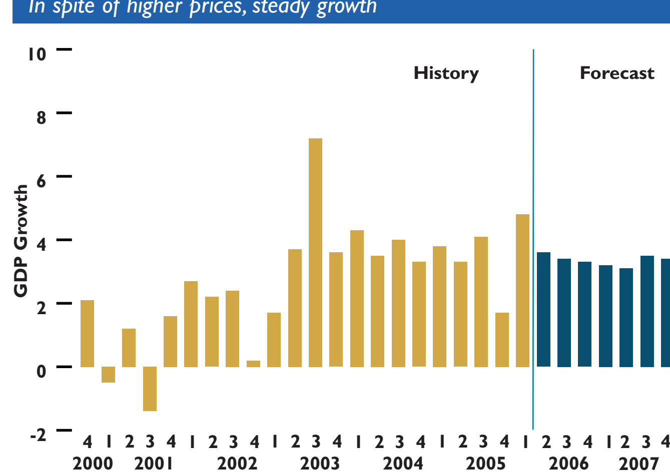
Sources: Freddie Mac, NAR Forecast

Housing Starts
Inventory needs to be "bought down"

Multi-Family Housing Starts
Single Family Housing Starts
History
Forecast
Thousands
2000 2001 2002 2003 2004 2005 2006 2007

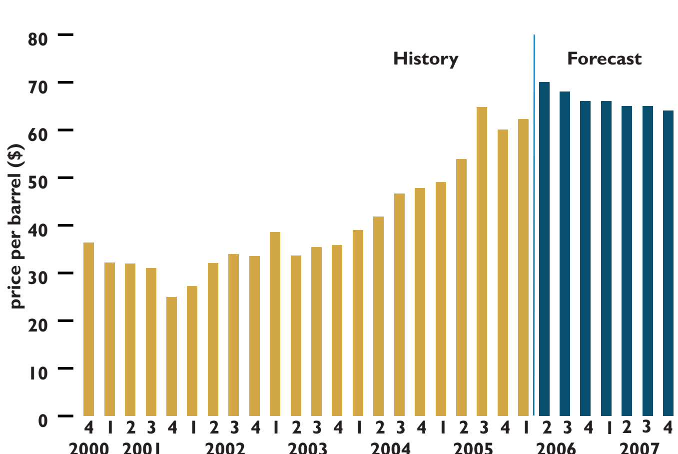
Sources: Bureau of the Census, NAR Forecast

Economic Growth
In spite of higher prices, steady growth



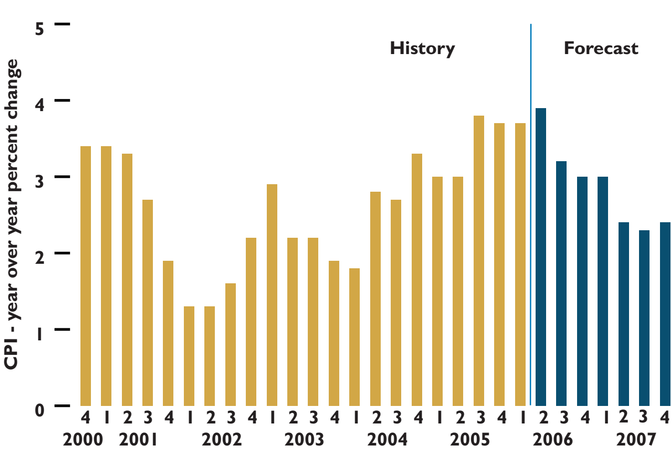
Sources: Bureau of Economic Analysis, NAR Forecast

Oil Prices
Coming down, but just slightly



Sources: Department of Energy, NAR Forecast

Inflation
Peaking through Spring, then trending down



Sources: Bureau of Labor Statistics, NAR Forecast

U.S. ECONOMIC OUTLOOK
May 2006

	2005		2006				2007				2004	2005	2006	2007
	III	IV	I	II	III	IV	I	II	III	IV				
U.S. Economy														
Annual Growth Rate														
Real GDP	4.1	1.7	4.8	3.6	3.4	3.3	3.2	3.1	3.5	3.4	4.2	3.5	3.5	3.3
Nonfarm Payroll Employment	1.6	1.2	1.8	1.5	1.4	1.3	1.0	1.0	1.3	1.4	1.1	1.5	1.5	1.2
Consumer Prices	5.5	3.2	2.2	4.6	2.8	2.2	2.2	2.3	2.5	2.6	2.7	3.4	3.4	2.5
Real Disposable Income	-1.4	6.7	3.8	2.8	4.4	5.0	5.1	3.4	3.2	2.9	3.4	1.5	3.4	4.1
Consumer Confidence	99	96	106	109	109	108	106	106	107	107	80	100	108	107
Percent Unemployment	5.0	4.9	4.7	4.7	4.7	4.8	4.9	4.9	4.9	4.9	5.5	5.1	4.7	4.9
Interest Rates, Percent														
Fed Funds Rate	3.5	4.0	4.5	4.9	5.0	5.0	5.0	5.0	4.8	4.8	1.3	3.2	4.8	4.9
3-Month T-Bill Rate	3.4	3.8	4.4	4.7	4.8	4.8	4.8	4.8	4.5	4.5	1.4	3.1	4.7	4.6
Prime Rate	6.4	7.0	7.4	7.9	8.0	8.0	8.0	8.0	7.9	7.7	4.3	6.2	7.8	7.9
Corporate Aaa Bond Yield	5.1	5.4	5.4	5.9	6.2	6.2	6.3	6.4	6.3	6.3	5.6	5.2	5.9	6.3
10-Year Government Bond	4.2	4.5	4.6	5.1	5.3	5.3	5.4	5.4	5.3	5.3	4.3	4.3	5.1	5.4
30-Year Government Bond	4.4	4.7	4.6	5.2	5.6	5.6	5.6	5.6	5.5	5.5	5.1	4.6	5.2	5.6
Mortgage Rates, percent														
30-Year Fixed Rate	5.7	6.2	6.2	6.8	7.0	7.0	7.1	7.1	7.0	7.0	5.8	5.9	6.7	7.0
1-Year Adjustable	4.5	5.1	5.3	5.6	5.7	5.7	5.7	5.7	5.6	5.5	3.8	4.5	5.6	5.6
Housing Indicators														
Thousands														
Existing Home Sales*	7,180	6,943	6,797	6,587	6,561	6,620	6,630	6,559	6,712	6,934	6,779	7,075	6,620	6,701
New Single-Family Sales	1,298	1,283	1,159	1,168	1,117	1,083	1,070	1,074	1,104	1,128	1,203	1,283	1,134	1,093
Housing Starts	2,101	2,059	2,131	2,043	1,930	1,859	1,815	1,811	1,838	1,855	1,956	2,068	1,991	1,830
Single-Family Units	1,747	1,716	1,749	1,669	1,573	1,504	1,446	1,432	1,453	1,465	1,611	1,716	1,624	1,449
Multifamily Units	354	343	382	374	358	356	368	379	385	390	345	352	367	381
Residential Construction**	610	614	618	619	607	589	575	567	568	574	562	602	608	571
Percent Change – Year Ago														
Existing Home Sales	6.5	0.9	-2.1	-8.4	-8.6	-4.7	-2.5	-0.4	2.3	4.8	9.8	4.4	-6.4	1.2
New Single-Family Sales	11.5	3.2	-7.2	-9.2	-14.0	-15.6	-7.7	-8.1	-1.1	4.2	10.8	6.7	-11.6	-3.6
Housing Starts	6.4	4.3	2.3	-0.1	-8.1	-9.7	-14.9	-11.3	-4.8	-0.2	5.2	5.7	-3.7	-8.1
Single-Family Units	6.9	5.9	2.3	-1.4	-10.0	-12.4	-17.3	-14.2	-7.6	-2.6	6.6	6.5	-5.4	-10.8
Multifamily Units	4.2	-2.6	2.1	6.4	1.1	3.7	-3.6	1.5	7.8	9.7	-0.9	1.9	4.3	3.7
Residential Construction	7.2	7.6	5.8	3.2	-0.5	-4.1	-7.1	-8.4	-6.4	-2.6	10.3	7.1	1.0	-6.1
Median Home Prices														
Thousands of Dollars														
Existing Home Prices	227.3	225.3	218.7	233.2	238.7	235.5	227.9	242.8	248.7	245.6	195.4	219.6	232.2	241.9
New Home Prices	236.6	240.1	234.6	238.3	246.0	250.9	245.6	249.7	258.1	263.5	221.0	237.3	242.5	254.3
Percent Change – Year Ago														
Existing Home Prices	14.2	13.4	9.5	6.0	5.0	4.5	4.2	4.1	4.2	4.3	9.3	12.4	5.7	4.2
New Home Prices	10.5	5.4	2.0	3.5	4.0	4.5	4.7	4.8	4.9	5.0	13.3	7.4	2.2	4.9
Housing Affordability Index	112	110	112	105	103	104	105	103	103	104	134	122	106	104

*Quarterly figures are seasonally adjusted annual rates. / * Existing home sales of single-family homes and condo/coops; ** billion dollars / Source: Forecast produced using Macroeconomic Advisers quarterly model of the U.S. economy. / Assumptions and simulations by Dr. David Lereah and Dr. Lawrence Yun.*

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Home Price Appreciation: Still Strong But Beginning to Cool

by NAR Staff

In many metropolitan areas, home price appreciation continued to post double-digit annual gains in the first quarter of 2006. The latest quarterly Metropolitan Area Home Price report from the National Association of REALTORS® shows 60 metro areas with double-digit annual increases in prices of existing single-family homes. Twenty-seven areas posted double-digit increases in the median price of condominiums/co-ops.

But the growth in single-family and condominium home prices is cooling. The national median existing single-family home price was $217,900 in the first quarter, up 10.3 percent from a year earlier when the median price was $197,600. In the fourth quarter of 2005, the annual rate of home-price appreciation was 13.6 percent. Metro area condominium and cooperative prices, covering changes in 56 markets rose 5.2 percent from the first quarter of 2005 to $224,100. The national condo price is higher than the median single-family home price because there is a high concentration of condos in the most expensive metropolitan areas. Within a given area, the typical single-family home costs more than the median condo price.

Median first-quarter metro area single-family prices ranged from $52,500 in Danville IL to 14 times that amount in the San Jose-Sunnyvale-Santa Clara area of California, where the median price was $746,800. The largest single-family home price increase was in the Phoenix-Mesa-Scottsdale area of Arizona, where the first quarter price of $268,300 rose 38.4 percent from a year ago. Next was Orlando FL at $260,500, up 34.0 percent from the first quarter of 2005.

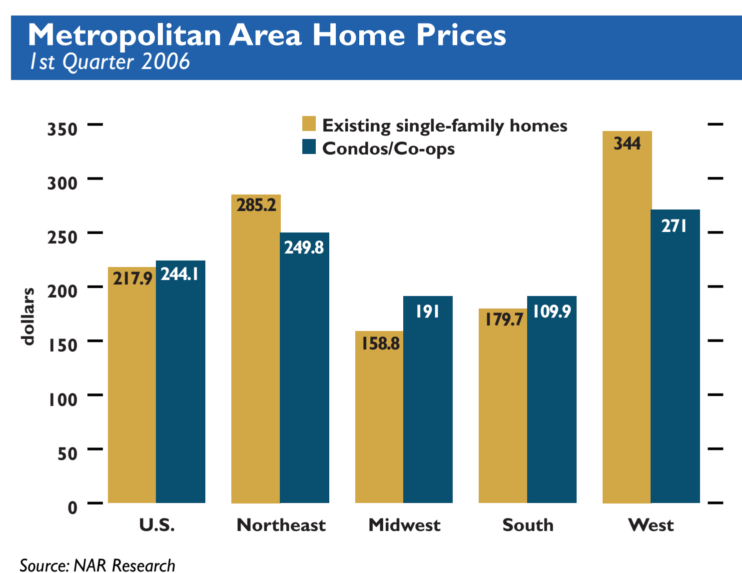
Metro area median existing condo prices ranged from $97,400 in Bismarck ND to $615,300 in San Francisco-Oakland-Fremont. The strongest gains were again in the Phoenix-Mesa-Scottsdale area, where the first quarter condo price of $179,600 rose 38.0 percent from a year ago. In the Honolulu area, the median condo price of $309,000 rose 34.9 percent from the first quarter of 2005. The condo price series will be expanded in the future as more data becomes available.

Behind the Numbers

The slowing growth in appreciation is due primarily to improvements in housing inventory. The supply of homes has been picking up in many areas of the country. Consequently, that decreases pressure on home prices. A rise in inventory was strong especially in the condo sector. While some areas continue to post impressive price growth, there are more broadly balanced conditions across the country for condominiums. But condos still have good fundamentals given the demographics of buyers, with baby boomers focused on the high end and their kids on more affordable units. However, in a handful of areas where there may be an oversupply, prices may level-out.

Regional Differences

Regionally, the strongest increase in the median existing single-family home price was in **the West**, where the price rose 12.0 percent to $344,000 during the first quarter. After Phoenix-Mesa-Scottsdale, the strongest increase in the



Source: NAR Research

The association's first-quarter metro area single-family home price report covers changes in 149 metropolitan statistical areas. Areas are generally metropolitan statistical areas as defined by the U.S. Office of Management and Budget. A list of counties included in MSA definitions is available at **www.census.gov**. NAR began publication of metropolitan area median single-family home prices in 1982; the metro area condo price series was launched earlier this year when fourth quarter 2005 data was reported.

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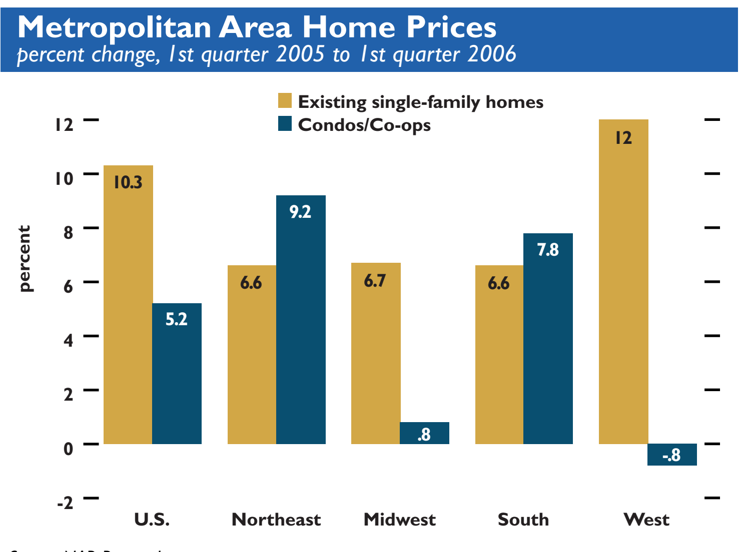
Metropolitan Area Home Prices

percent change, 1st quarter 2005 to 1st quarter 2006



Source: NAR Research

West was in Spokane WA where the median price was $172,100, up 26.3 percent from the first quarter 2005. Other double-digit markets in the West included Eugene-Springfield OR at $223,600, up 25.3 percent, and the Tucson area, at $248,600, up 24.9 percent.

In **the Midwest**, the first-quarter median existing single-family home price of $158,800 rose 6.7 percent from a year earlier. The strongest metro increase in the region was in Waterloo-Cedar Falls IA, where the median price of $109,700 was 26.8 percent higher than the first quarter of 2005. Next was Decatur IL up 14.3 percent, and Cedar Rapids IA at $134,600, up 13.4 percent in the last year.

In **the Northeast**, the median resale single-family home price during the first quarter was $285,200, up 6.6 percent from a year ago. The strongest increase in the region was in Elmira NY at $88,500, up 18.8 percent from the first quarter of 2005. Trenton-Ewing NJ reported a median price of $264,900, up 17.5 percent, and Atlantic City NJ at $251,700, up 15.8 percent.

In **the South**, the median existing single-family home price was $179,700 in the first quarter, up 6.6 percent from a year earlier. After Orlando two other Florida areas posted the next strongest increases in the region: Gainesville median single-family home prices were up 31.9 percent to $210,100, and the median price in Ocala FL was $159,800, up 30.8 percent from the first quarter of 2005. Next was the Virginia Beach-Norfolk-Newport News area of Virginia and North Carolina, where the first quarter median price of $221,100 was 27.1 percent higher than a year ago.

Looking Ahead

The second quarter 2006 metropolitan median home price report will be released in August. NAR analysts expect that report to show most areas returning to normal rates of price growth in the single-digit range. Consumers generally can expect normal price appreciation for the foreseeable future, providing solid returns over time.

Please note: National and regional quarterly prices have been revised back through 1989; the only revision to the metro price series is the normal annual revision for 2005 with revised fourth quarter data. The fixed reporting sample of representative multiple listing services for national and regional data has been updated to reflect geographic changes over time. In addition, regional weights have been updated and aligned to the 2000 Census, but changes in price patterns are consistent with previously reported data.

For NAR's complete report on metropolitan area home prices, please visit **www.REALTOR.org/research**. Click on "Existing Home Sales". Or turn to page 12 of this pdf and click on the appropriate link.

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Mixing Banking and Commerce: Don't Let it Happen Again

by Robert Barr, *Vice President, NAR Research*

The issue of expanding bank powers to allow subsidiaries of national banks to engage in real estate brokerage and property management activities has been on the front burner for REALTORS® for several years. By mixing banking and commerce, the safety net that promotes the safety and soundness of our banks and protects our national payment system is extended to commercial activities. This distorts the free and open markets we rely on for commercial activities, and allows the failure of a bank-owned hotel or another commercial activity to be transmitted to the bank itself. Should the bank become illiquid, the federal government would be obligated to make good on all insured deposits. For the safety net to be effective – and to protect the soundness and economic efficiency of our banking system – the division between banking and commerce must be maintained.

The National Association of REALTORS® has worked diligently to prevent any change in regulations that would allow banks to engage in commerce. There are many reasons underyling NAR's position,* but chief among them is preserving the separation of banking and commerce. NAR's efforts to stem any tide toward tearing down the wall between banking and commerce continues.

And for good reason. In December 2005, the Office of the Comptroller of the Currency (OCC) issued three Interpretive Letters giving three banks – two of them among the nation's largest – expanded authority to invest in real estate projects involving the development of office buildings, hotels, residential condominiums, and windmill farms. To help combat this dangerous precedent, NAR recently released a report illustrating how these seemingly innocuous letters imperil our banking system and the economy at large. Indeed, it provides two case studies where mixing banking and commerce led to disastrous results: the U.S. savings and loan crisis in the 1980's and early 1990s, and the Japanese banking debacle of the 1990s.

Thrift Failures, 1986-1995

Year	Number	Assets (millions of dollars)
1986	54	$16,264
1987	48	11,270
1988	185	96,760
1989	327	135,245
1990	213	129,662
1991	144	78,899
1992	59	44,197
1993	9	6,148
1994	2	137
1995	2	435
TOTAL	1,043	$519,017

Source: FDIC

The S&L Crisis

During the late 1980s and early 1990s 1,043 savings and loan (S&L) institutions, holding a total of $519 billion in assets, were closed by regulators. The number of federally insured thrift institutions open at year-end 1995 was only half the number open ten years earlier. There were a number of causes of the S&L crisis, including high and volatile interest rates, falling oil prices, changes in tax laws, and inappropriate regulatory oversight.

But thrifts were also given expanded powers to move beyond simple banking and into commercial activities. Indeed, the FDIC noted that direct investments in real estate, equity securities, service corporations, and operating subsidiaries were allowed in some states with virtually no limitations. S&Ls invested in everything from casinos to fast-food franchises, ski resorts, and windmill farms. While it is difficult to say exactly how much each element contributed to the total mess, it is clear that allowing banks into commercial businesses was an important factor.

Thrift institutions changed their business models in response to the new operating environment created for them. The incentive structure in commercial real estate was especially skewed, with the government absorbing most of the risk of new commercial real estate ventures. This led to vast overbuilding. During the first half of the 1980's, for example, the supply of new office space far outstripped the demand, or absorption, for new office space. In fact, the amount created was more than 50 percent greater than the amount absorbed in 31 of the top markets from 1980 through 1984.

And depositor insurance programs were also affected. By granting these expanded powers, Congress and federal regulators extended the safety net to virtually all banks in the system – and so to all the activities in which those banks were involved. Although the insurance ceiling (via the Federal Savings and Loan Insurance Corporation – FSLIC) was raised in 1980 from $40,000 to

*NAR's position on the separation of banking and commerce is supported by a number of studies and regulatory analyses. For more details, as well as information on the latest developments on this issue, visit **www.realtor.org**.

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Mixing Banking and Commerce (continued)

$100,000 per account, in practice there was no ceiling. Regulators explicitly covered uninsured deposits of several large banks that failed, including Continental Illinois, Bank of New England and MCorp banks.

The result? A veritable collapse of the savings and loan industry. The insurance programs could not cover the losses for failed banks, and the losses due to those risky commercial real estate activities of some of those large savings and loans. And U.S. taxpayers paid the price of mixing banking and commerce – $124 billion.

Production of New Office Space
31 Major Markets, 1975-1994
Annual Averages, Millions of Square Feet

Years	Completions	Absorption*
1975-1979	33.6	44.3
1980-1984	97.8	64.2
1985-1989	100.7	73.6
1990-1994	28.1	33.3

**Difference in occupied space over a defined period*
Source: FDIC

Japan's Banking Crisis

There is another example of what happens when the wall between commerce and banking is torn down. Japanese banks expanded with a wave of lending based on rapidly rising land values during the 1980s.

But when land values declined in the early 1990s, the value of bank loans imploded. With a staggering amount of troubled real estate loans on their books, Japanese banks limped through the 1990s, and the Japanese economy became stagnant for virtually an entire decade. In fact, the Japanese banking industry was so troubled and under-capitalized that, a year after the collapse of Yamaichi Securities in 1997, the government had to intervene to become part-owners of the 11 largest Japanese banks through the issuance of preferred shares. As with the U.S. savings and loan crisis, there were many underlying factors in the Japanese banking crisis, including over-reliance on real estate lending (which became especially critical when land prices declined precipitously), a sluggish regulatory response to the banks' troubled loans, and monetary policy decisions that exacerbated rather than mitigated the economic crunch.

But another cause of the abysmal economic performance during the 1990s was the mixing of banking and commerce through the *keiretsu* system. The *keiretsu* system allows a network of corporations to link together through extensive stock cross-ownership, including the participation of a bank. The bank performs centralized coordinating and monitoring and is a stockholder in the other (corporate) entities. This arrangement clouds the line between the market discipline required for commercial activity and the regulatory oversight necessary to protect the banking system. It took years for the Japanese banking industry to recover.

Conclusion

Banks are different than typical commercial activities because of their special roles in the economic system. To ensure the high reliability of our payment transactions and the liquidity of the overall economy, the government provides deposit insurance and access borrowing privileges (i.e., the discount loan window) unavailable to commercial enterprises. The need for safety and soundness in the banking system makes them different from commercial operations in our free-market economy.

The bank safety net, designed to protect the nation's depositors, was extended to protecting the banks' forays into commercial businesses. The result was the S&L crisis, and we paid for the failure. Allowing banks to own and operate commercial concerns is a threat to the smooth functioning of our nation's payment system and to the taxpayers' wallets.

The lessons are simple: let banks be banks, and don't allow banks to own or control commercial enterprises. Bank ownership of commercial firms subverts the normal, effective market discipline that has made us the world's strongest economy. The seal between banking and commerce must be extremely tight to be effective. In terms of sound banking, economic efficiency and protecting the taxpayer, the OCC's December 2005 letters embrace the wrong approach.

Ignoring the wide understanding that banking is different, the OCC letters carve out new areas in which banks can own and operate commercial enterprises. As Interpretive Letters, they'll have an impact well beyond just the specific cases cited. By allowing other national banks to make similar deals, the OCC letters set a costly precedent.**

The full text of the OCC letter, as well as the responses from NAR Leadership is available at **www.realtor.org.

Links to Statistical Data Series

To view the latest housing statistics from NAR, click on the links below.

Existing Home Sales – Monthly series

- **March existing home sales and median sales prices** – single-family and condominiums/co-ops
- **Single-family home sales and median sales prices**
- **Condominium/co-op sales and median sales prices**
- The latest EHS statistics in spreadsheet format available **here**

Existing Home Sales and Metropolitan Area Median Home Sales Prices – 1st Quarter 2006

- 1st Quarter 2006 **existing home sales by state**
- Existing home sales by state in **spreadsheet format**
- 1st Quarter 2006 **Median Home Prices by Metropolitan Area**
  - **1st Quarter Single-family median home prices**
  - 1st Quarter Single-family median home prices in **spreadsheet format**
  - **1st Quarter Condominium/Co-op median sales price**
  - 1st Quarter Condominium/Co-op median sales price in **spreadsheet format**

NAR's Pending Home Sales Index

- **March pending home sales index**
- The latest pending home sales index in spreadsheet format available **here**

NAR's Housing Affordability Index

- **March HAI Index**
- March Housing Affordability Index in spreadsheet format available **here**
- Quarterly Housing Affordability Series
  - **1st Quarter 2006 Affordability Index**
  - 1st Quarter 2006 Affordability Index in spreadsheet format available **here**
  - **First-time homebuyer Affordability Index**, 1st Quarter 2006
  - First-time homebuyer Affordability Index in spreadsheet format available **here**

Click **here** for more details about NAR's existing home sales, pending home sales, and housing affordability index series, including methodology, links to the latest news releases, statistical release schedule, and how to access historical information.

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Coming in May from NAR Research!

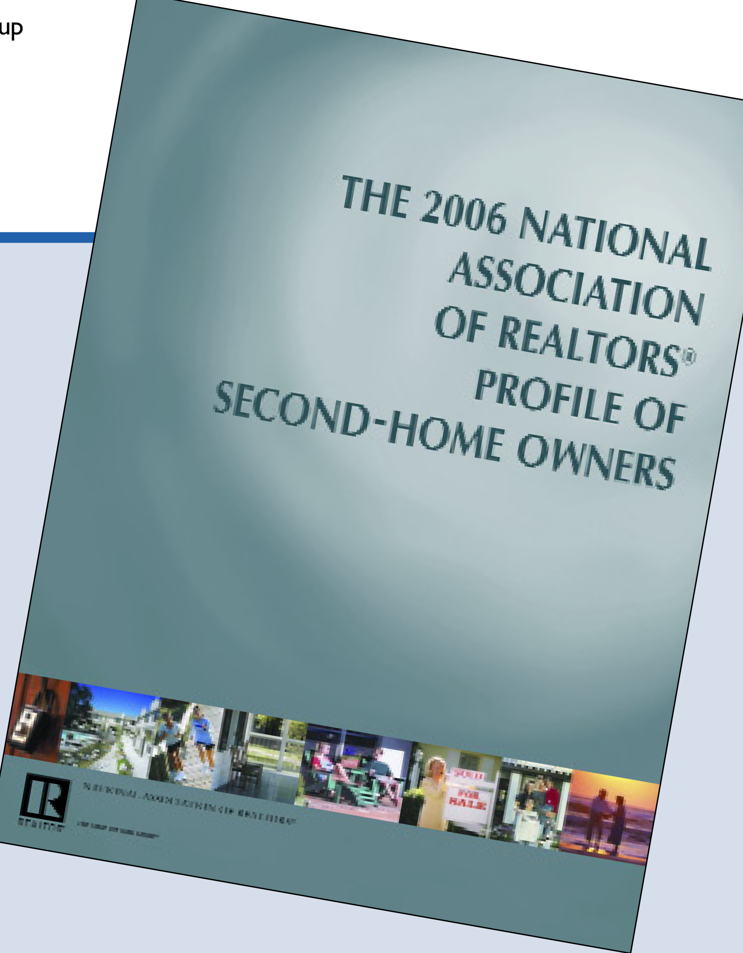
The new 2006 Profile of Second-Home Owners

Did you know …

- the median age of vacation-home owners is 59
- the typical vacation home is 220 miles away from the owner's primary residence
- 35 percent of investment properties are located in the suburbs
- 85 percent of investment properties were previously owned
- vacation-home owners spend a median of 39 nights in their vacation home

Owning a second home is becoming more and more popular. Whether a second home is used as a vacation retreat, an investment, or as an eventual retirement residence, second-home owners have taken advantage of historically low interest rates and the equity they've built up from owning their primary residence. The newest information about second-home owners will soon be available from NAR.

For more information about purchasing the new ***2006 Profile of Second-Home Owners***, call 1-800-874-6500; ask about item #186-55-06, or visit **www.realtor.org/research**, and click on "Buy Research."



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