PMI
Making Risk Rewarding ℠

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Back to Basics

By Mark F. Milner, Chief Risk Officer, PMI Mortgage Insurance Co.

The Office of Federal Housing Enterprise Oversight (OFHEO) House Price Index showed a year-over-year appreciation rate of 3.2 percent in the second quarter – down from 4.45 percent in the first quarter and 9.98 percent a year ago. Delinquency rates for home loans are surging, and you can't turn on the news without hearing stories about the real estate "crisis."

Real estate is cyclical – marked by periods of solid appreciation, and equally by periods of stagnation or decline. Cycles tend to be long, because real estate, for most people, is not a terribly liquid investment. The rapidity of the recent changes in the real estate cycle may be a surprise, but the fact that things have changed should not be. As with changes in other asset cycles, we are reminded again that there is no new paradigm. After the dot com bust, the financial markets came back to the idea that fundamentals matter for companies. Similarly, today we're recognizing that when it comes to the real estate market, the fundamentals of lending have not changed.

Geographic Distribution of Risk Scores
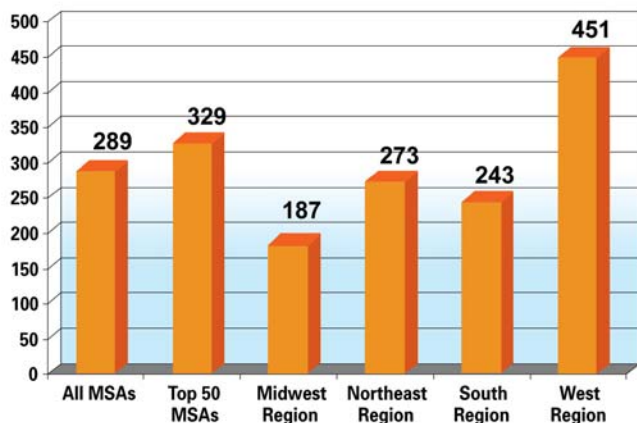
OFHEO House Price Appreciation Rates

Back to Basics

(continued from page 1)

With that in mind, it's a good time to consider what we can learn from this most recent cycle. At the top of the list, for me, are the four Cs of good credit risk management.

Capital: First, some equity – even as little as 3 percent – helps everyone. For lenders and investors, it's a cushion that offers some protection against the downside, which is important for the long-term health of the loan. For borrowers, it's an indication of their commitment: they've thought about the step they're taking, they've prepared for it, and they feel ready to own a home. For the mortgage finance system, it's a stabilizing force that helps ensure long-term health. That's not to say that 100 percent financing should never be made available – there are times when it can be appropriate, under the right terms and conditions. But like other niche products, it should be matched with the group of borrowers whose individual circumstances make it appropriate, and who are likely to be successful over the long term.

Capacity: For borrowers to be successful, and for lenders and other industry participants to thrive over the long term, home-ownership has to be sustainable. This means taking a hard look at cash flow – verifying income, monthly cash flow, and the borrower's ability to repay the loan. Low documentation loans, where income is stated but not verified, were developed as a legitimate solution for a small group of borrowers, and under the right terms and conditions there's a place for them. They certainly can streamline the underwriting process, but in many cases the borrower, the lender, and the investor will have a better foundation on which to build long term, sustainable homeownership with a fully documented loan.

Character: A home purchase involves people – their hopes, their dreams, their communities, and their families – to a much greater degree than any other investment. A positive character component in a credit transaction means a history of responsible credit behavior. A home purchase transaction, and related mortgage, is the largest financial transaction most people ever make. It means taking on a large obligation, and to be successful, a borrower will need to manage his or her finances carefully. A responsible credit history is the best indicator we have of whether a borrower has demonstrated the willingness and ability to manage their debt and if they are ready to shoulder the financial obligations of homeownership.

Collateral: The valuation of a home is a critical part of the lending decision. Borrowers want to know they are paying a fair price for their homes. Lenders need an appraisal they trust to understand fully the risk they are taking. That makes an appraiser's job especially difficult in these times of slowing or declining home price appreciation. In light of changing market conditions, appraisers should consider carefully the factors that lead to a valuation. The lender should review the appraisal thoroughly and, particularly in softer markets, use other sources to confirm the value, as well as consider making adjustments to their loan or underwriting guidelines. Overly aggressive appraisals can lead to transactions that may not be financially sound over the long term.

Careful underwriting is ultimately what ties these four Cs together. Experienced underwriting is required in order to review the loan characteristics, balance the various factors involved, and determine whether all the pieces fit the requested loan. Automated systems can help with this task, but they often can't interpret nuances or identify potential problems the way an experienced underwriter can. Experienced, quality underwriting ensures that the borrower has the willingness and ability to repay the loan on a properly valued home.

The real estate industry is endlessly innovative, which means that the next cycle won't look exactly like this one. But these basic lessons – the four Cs of good credit management – will hold true tomorrow, as they have in the past. Sustainable homeownership is everyone's goal. Remembering the fundamentals of credit can help us get there. ◆

Economic and Real Estate Trends in the Nation's MSAs

PMI's U.S. Market Risk Index℠ ranks the likelihood of home price declines in two years for the nation's 381 metropolitan statistical areas (MSAs). It is based on economic factors including home price appreciation, volatility, employment, and affordability.

The risk of home price declines dropped in the second quarter for the first time in 2.5 years. The average risk score for the 50 largest MSAs remains near an all-time high at 329, meaning there is a 32.9 percent chance home prices across the country will decline. This is down from an average score of 346 in the first quarter.

The minor reduction in risk is the result of declining home prices, which slightly improved affordability. Despite this drop, the risk for future price declines among the nation's largest MSAs remains high. The largest concentrations of risk are in California, Florida, Las Vegas, NV, and Phoenix, AZ.

Trends in Risk

In the second quarter, risk decreased in 28 of the Top 50 MSAs. California MSAs continue to dominate Risk Ranks 1 and 2. Risk scores for Miami and Tampa, FL, decreased, causing the MSAs to drop to Risk Rank 3. Other Florida MSAs are experiencing rapid price deceleration and volatility, thus keeping them in the higher risk ranks. MSAs that previously ranked low in the Top 50 saw increased risk scores.

Risk scores rose significantly for many MSAs in the industrial Midwest. In the second quarter, risk scores increased in the Michigan MSAs of Detroit (up 44 points to 328) and Warren (up 64 points to 300), and the Ohio MSAs of Columbus (up 36 points to 129), Cleveland (up 33 points to154), and Cincinnati (up 30 points to 127). Increased risk in the region, where price volatility has historically been low, is due to major increases in unemployment. Demeaned unemployment – the current unemployment rate compared to the five-year average for an area – in the MSAs increased an average of 0.6 percentage points in the second quarter. The actual unemployment rate in these MSAs averaged 1.6 percentage points above the national average of 4.5 percent. Risk in the region will continue to adjust as the auto industry undergoes a restructuring that is expected to create job losses through 2008.

The three largest drops in risk were in Boston, MA (down 101 points to 400), West Palm Beach, FL (down 75 points to 532), and Phoenix (down 71 points to 575). However, risk scores for all three are above the national average. Boston has seen price declines in four of the last five quarters, improving affordability by approximately 8.1 points. Employment in Boston improved, with the demeaned unemployment rate falling 0.3 percentage points.

In West Palm Beach and Phoenix, improved employment and housing affordability led to a decline in risk. Both areas also saw substantial declines in the rate of appreciation. The appreciation rate in Phoenix is still positive for the year at 1.6 percent but declined 0.5 percent for the quarter. The appreciation rate in West Palm Beach declined by 4.5 percent for the year and by 2.5 percent for the quarter.
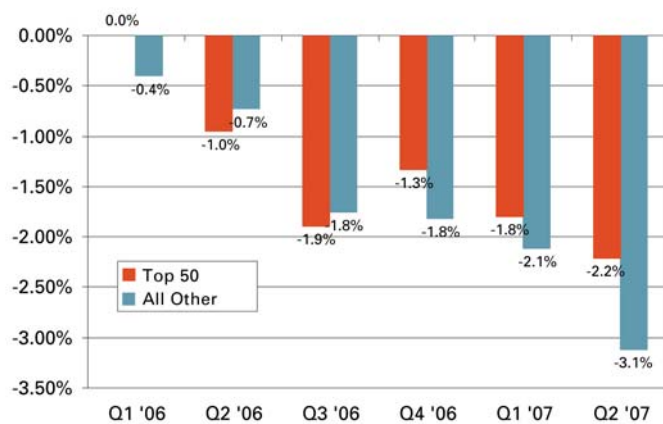
Percent of MSAs with Declining Prices (vs. 1 Year Earlier)
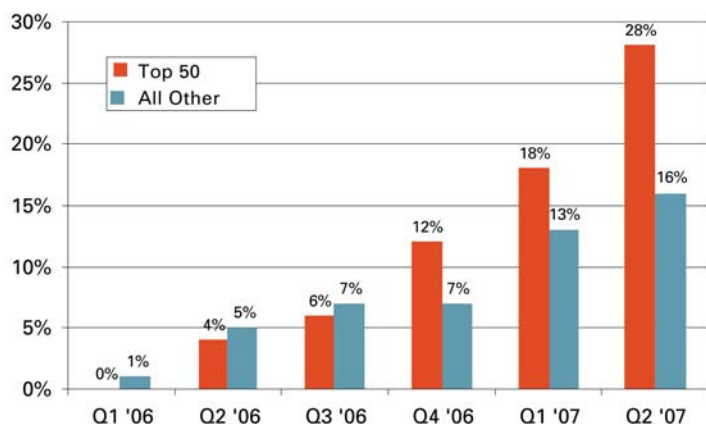
Source: OFHEO

Average Decline in Price for MSAs Experiencing a Decline (vs. 1 Year Earlier)

Source: OFHEO

The Value of Homeownership

In this period of slowing or declining home price appreciation, many new and prospective homeowners want to know whether buying or owning a home now is a smart move. PMI wanted to address this concern on a national and regional level so we looked at quarterly data for the 50 largest MSAs in OFHEO's House Price Index from 1975 through the first quarter of 2007, and then took a closer look at three of the worst housing price declines over the last 25 years.

To calculate the return on equity, we assumed that the average homeowner made a 20 percent down payment. We then calculated the annualized rates of return on the initial equity investment at the 2-, 5-, 10- and 15-year marks.

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The Big Picture

What we found was that, on a national level, owning a home for 10 years remained a good way to build wealth and increase net worth over the long term. Homeownership produced a positive return on investment 98.9 percent of the time. Over 15 years, that number increased to 99.9 percent. Individual rates of return varied across MSAs, but some common observations emerged from reviewing the data in its entirety.

Observation 1: The risk of loss drops the longer one owns a home. With long-term ownership, the risk of loss is dispersed over a number of years, and the likelihood that one will receive a positive return increases.

Observation 2: The variation around the expected rate of return on equity decreases the longer one owns a home. The range of possible returns narrows as time passes, increasing the stability of the investment. The average annualized rate of return decreases slightly over time but never dips below zero, even in markets with high price volatility.

Observation 3: If your goal is a predictable, positive return on your investment, the timing of a home purchase is less important than the length of time that you own your home. The volatility around short-term investments is greater, meaning that the potential for both gain and loss is higher if you invest for the short term. The longer one holds the investment, the more stable the return will be. This result is found to be largely independent of when one purchases the property.

Up Close

When we took a regional look at three of the worst housing price declines in the last 25 years, we found that in two instances home prices rebounded inside of 10 years, and that in one instance – the Texas oil patch crisis – home prices took nearly 15 years to show a positive return.

Los Angeles: 4th Qtr 1990 to 1st Qtr 1997

The end of the Cold War brought about a recession in the defense and technology industries in Southern California in 1990. The loss of employment reduced demand for homes, and foreclosures increased the supply of homes on the market.

Following years of double-digit price appreciation, price growth peaked in the third quarter of 1990 and then turned negative for 24 of the following 26 quarters – 6.5 years. By the time the recovery began in the second quarter of 1997, average prices were 21 percent below their peak in 1990. Prices recovered at an average rate of 6.9 percent per quarter, annualized for the next 14 quarters.

Those who purchased at the worst possible time—the peak of the cycle—recouped their lost capital by the third quarter of 2000, 10 years after the downturn began.

Boston: 4th Qtr 1989 to 1st Qtr 1993

The technology market in Boston expanded rapidly throughout the 1980s and then stalled suddenly in 1989. The loss of jobs cost people their homes and drove buyers out of the market.

After peaking during the third quarter of 1989, the MSA saw 14 quarters — 3.5 years — of negative price appreciation. By the time the recovery began in the second quarter of 1993, average prices were 7 percent below their peak in 1989. After a false start at a recovery in 1993, prices fell again for three quarters between the third quarter of 1994 and first quarter of 1995. Price appreciation began in earnest in the second quarter of 1995 at an average rate of 4.5 percent.
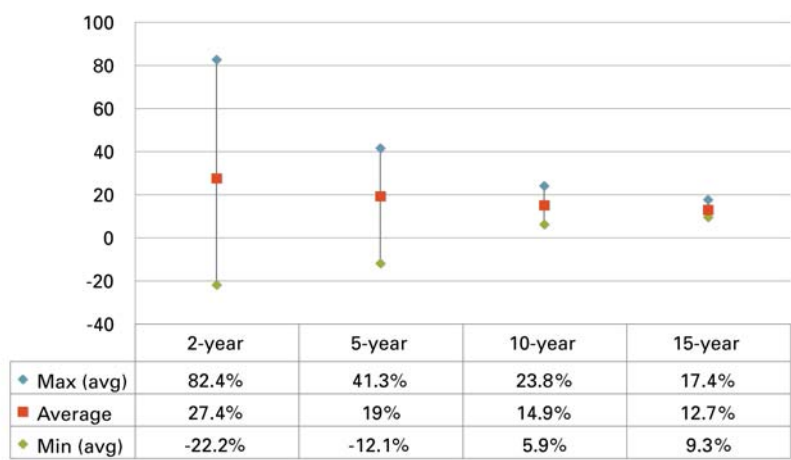
Those who purchased at the worst possible time — the peak of the cycle in 1989 — fully recouped their lost capital by the first quarter of 1998, 8.5 years after the decline began.

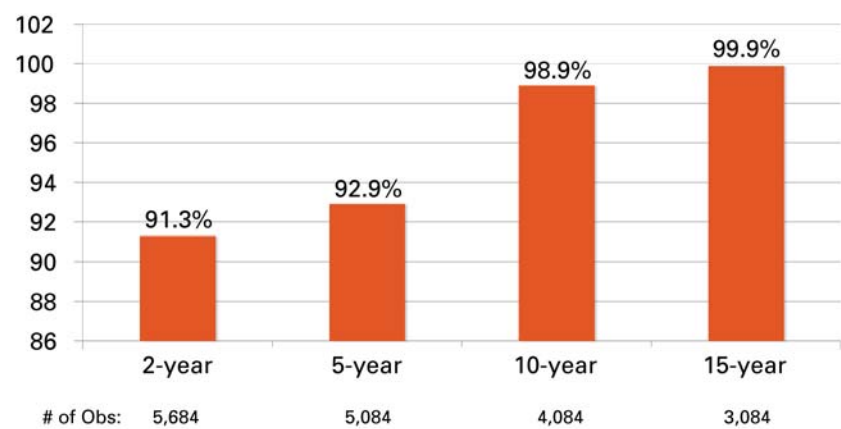## Houston: 4th Qtr 1983 to 2nd Qtr 1988

In the early 1980s house prices in Houston appreciated rapidly as the oil industry boomed. In the mid-1980s oil prices dropped and domestic oil production ground to a halt. Houston was the epicenter of the industry shakeup, which cost thousands of workers their jobs.

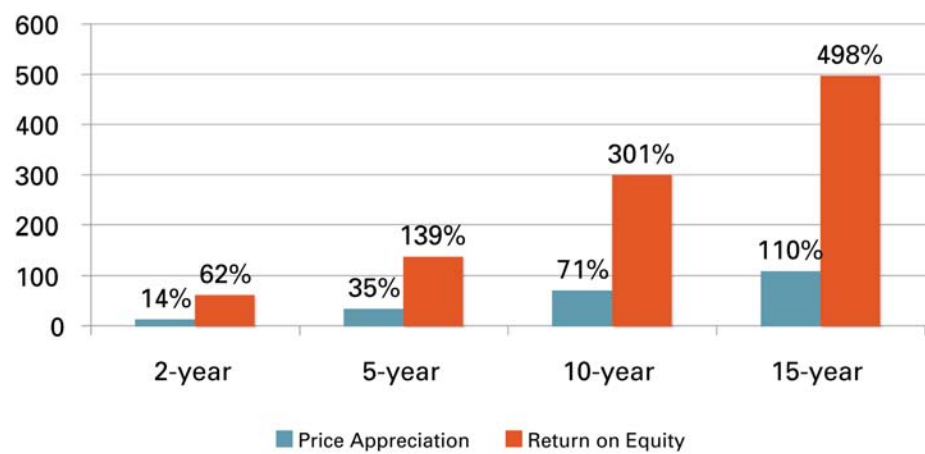# The Value of Homeownership *(continued from page 4)*

Comparison of Annualized Rates of Return on Equity

	2-year	5-year	10-year	15-year
◆ Max (avg)	82.4%	41.3%	23.8%	17.4%
■ Average	27.4%	19%	14.9%	12.7%
◆ Min (avg)	-22.2%	-12.1%	5.9%	9.3%

Percent of Observations with Positive Rates of Return on Equity

- 2-year: 91.3%
- 5-year: 92.9%
- 10-year: 98.9%
- 15-year: 99.9%

| # of Obs: | 5,684 | 5,084 | 4,084 | 3,084 |

Cumulative % Returns to Homeownership

- 2-year: Price Appreciation 14%, Return on Equity 62%
- 5-year: Price Appreciation 35%, Return on Equity 139%
- 10-year: Price Appreciation 71%, Return on Equity 301%
- 15-year: Price Appreciation 110%, Return on Equity 498%

■ Price Appreciation   ■ Return on Equity

MSA	RANK	SCORE[1]	PRICE APPRECIATION[2]			
			Volatility[3]	2Q '07	2Q '06	Acceleration[4]
Riverside-San Bernardino-Ontario, CA	1	608	14.23	1.47	18.12	-16.65
Las Vegas-Paradise, NV	2	587	20.58	-0.87	11.84	-12.72
Santa Ana-Anaheim-Irvine, CA (MSAD)	2	579	11.50	-1.62	15.87	-17.49
Phoenix-Mesa-Scottdale, AZ	2	575	22.17	1.57	26.05	-24.48
Los Angeles-Long Beach-Glendale, CA (MSAD)	2	536	12.34	2.06	19.99	-17.93
West Palm Beach-Boca Raton-Boynton Beach, FL (MSAD)	2	532	13.49	-4.51	19.47	-23.98
Sacramento-Arden-Arcade-Roseville, CA	2	522	11.75	-6.07	6.05	-12.12
San Diego-Carlsbad-San Marcos, CA	2	521	12.31	-3.63	5.21	-8.84
Oakland-Fremont-Hayward, CA (MSAD)	2	516	10.79	-3.28	11.56	-14.84
Fort Lauderdale-Pompano Beach-Deerfield Beach, FL (M	2	507	11.73	0.83	21.41	-20.58
Orlando-Kissimmee, FL	2	506	17.04	3.63	26.46	-22.83
Miami-Miami Beach-Kendall, FL (MSAD)	3	466	11.00	7.47	25.19	-17.71
Tampa-St. Petersburg-Clearwater, FL	3	462	11.73	1.52	22.38	-20.86
Washington-Arlington-Alexandria, DC-VA-MD-WV (MSAD)	3	439	10.78	1.17	15.76	-14.59
San Jose-Sunnyvale-Santa Clara, CA	3	433	13.45	0.62	11.46	-10.84
Providence-New Bedford-Fall River, RI-MA	3	427	7.69	-0.96	5.23	-6.19
Nassau-Suffolk, NY (MSAD)	3	427	4.79	-0.09	10.11	-10.20
Virginia Beach-Norfolk-Newport News, VA-NC	3	418	13.90	5.65	17.43	-11.78
San Francisco-San Mateo-Redwood City, CA (MSAD)	3	405	9.81	-0.86	9.20	-10.06
Boston-Quincy, MA (MSAD)	3	400	7.21	-1.78	1.72	-3.50
Jacksonville, FL	3	377	9.22	5.14	18.53	-13.39
Baltimore-Towson, MD	3	347	9.85	5.65	15.83	-10.18
Seattle-Bellevue-Everett, WA (MSAD)	3	345	10.60	9.89	17.86	-7.97
Edison, NJ (MSAD)	3	335	4.76	0.39	11.52	-11.14
Portland-Vancouver-Beaverton, OR-WA	3	333	12.15	8.06	20.33	-12.27
Detroit-Livonia-Dearborn, MI (MSAD)	3	328	4.00	-3.31	-1.44	-1.87
Cambridge-Newton-Framingham, MA (MSAD)	3	323	5.56	-0.53	0.83	-1.36
Minneapolis-St. Paul-Bloomington, MN-WI	3	313	3.86	0.69	4.20	-3.51
Warren-Troy-Farmington Hills, MI (MSAD)	3	300	2.99	-2.78	-0.46	-2.31
New York-White Plains-Wayne, NY-NJ (MSAD)	4	287	4.75	2.73	12.07	-9.34
Newark-Union, NJ-PA (MSAD)	4	274	4.44	2.05	10.89	-8.84
Philadelphia, PA (MSAD)	4	227	5.31	3.76	11.38	-7.61
Atlanta-Sandy Springs-Marietta, GA	4	213	1.60	3.84	4.26	-0.42
Chicago-Naperville-Joliet, IL (MSAD)	4	196	3.30	3.69	9.09	-5.40
Milwaukee-Waukesha-West Allis, WI	4	191	3.90	2.98	6.08	-3.10
St. Louis, MO-IL	4	184	1.94	4.02	5.32	-1.29
Nashville-Davidson--Murfreesboro--Franklin, TN	4	179	4.77	6.65	10.02	-3.37
Kansas City, MO-KS	4	159	1.31	3.64	3.06	0.57
Denver-Aurora, CO	4	156	3.33	0.76	2.21	-1.45
Austin-Round Rock, TX	4	154	5.73	10.76	8.65	2.11
Cleveland-Elyria-Mentor, OH	4	154	1.88	-0.63	1.58	-2.21
Charlotte-Gastonia-Concord, NC-SC	4	147	3.34	8.61	7.18	1.43
Columbus, OH	4	129	1.39	0.40	2.11	-1.71
Cincinnati-Middletown, OH-KY-IN	4	127	1.09	2.30	2.21	0.09
San Antonio, TX	4	121	4.09	9.63	8.08	1.55
Indianapolis-Carmel, IN	4	101	1.28	2.52	1.32	1.20
Dallas-Plano-Irving, TX (MSAD)	5	95	1.88	5.01	3.49	1.52
Houston-Sugar Land-Baytown, TX	5	94	1.78	5.66	6.49	-0.83
Fort Worth-Arlington, TX (MSAD)	5	89	1.47	3.57	3.70	-0.13
Pittsburgh, PA	5	85	1.15	3.53	3.28	0.25

Weighted Average Values by Risk Rank:[8]						
	1	608	14.23	1.47	18.12	-16.65
	2	540	14.16	-0.25	17.42	-17.67
	3	383	8.45	2.06	11.90	-9.84
	4	203	3.38	3.58	7.57	-3.99
	5	92	1.66	4.81	4.68	0.13

Top 50 Weighted Averages:	All	329	7.32	2.37	10.97	-8.61

2007

AFFORDABILITY INDEX[5]			UNEMPLOYMENT RATE		
			Rate[6]	Demeaned[7]	
2Q '07	1Q '07	Difference	2Q '07	2Q '07	1Q '07
59.38	57.18	2.19	5.23	-0.44	-0.51
77.06	73.67	3.39	4.40	-0.77	-0.80
65.09	63.16	1.94	3.63	-0.63	-0.79
68.74	67.12	1.62	2.97	-1.56	-1.17
59.72	59.49	0.23	4.67	-1.40	-1.45
67.16	63.96	3.20	3.57	-1.61	-1.51
76.83	72.65	4.18	4.97	-0.12	-0.33
76.45	73.23	3.23	4.30	-0.31	-0.46
70.32	67.41	2.91	4.50	-0.89	-0.95
60.27	60.75	-0.48	3.07	-1.68	-1.83
71.75	70.12	1.63	3.23	-1.28	-1.45
58.74	57.18	1.55	3.27	-2.41	-2.48
69.53	68.86	0.67	3.47	-1.17	-1.34
74.65	73.31	1.33	3.03	-0.66	-0.52
70.33	67.75	2.57	4.53	-1.90	-1.99
83.16	79.67	3.49	4.99	0.04	-0.06
73.41	67.24	6.18	3.43	-0.67	-0.46
83.22	82.19	1.02	3.13	-0.51	-0.51
80.20	75.58	4.63	3.90	-1.18	-1.22
86.48	78.41	8.06	4.71	0.13	0.44
75.85	75.80	0.05	3.33	-1.21	-1.37
85.17	83.41	1.76	3.80	-0.63	-0.48
79.49	83.46	-3.98	3.87	-1.60	-1.26
78.61	76.14	2.47	3.77	-0.67	-0.53
79.66	78.09	1.57	4.70	-2.14	-1.70
102.45	98.57	3.88	8.17	1.18	0.50
91.84	90.72	1.12	3.97	-0.19	0.02
87.44	84.72	2.72	4.20	0.28	0.18
106.26	103.56	2.70	6.57	1.33	0.51
78.32	72.03	6.29	4.47	-1.68	-1.83
86.81	81.38	5.44	4.27	-0.76	-0.62
95.66	93.44	2.22	4.10	-0.92	-0.68
98.74	94.84	3.91	4.17	-0.11	-0.17
96.35	93.01	3.33	5.00	-1.31	-1.67
107.46	103.10	4.36	5.33	-0.08	-0.08
104.37	101.39	2.98	4.80	-0.31	-0.04
107.12	105.76	1.36	3.57	-0.72	-0.16
110.20	108.53	1.68	4.80	-0.31	-0.26
105.68	103.06	2.62	3.60	-1.46	-1.00
108.89	108.23	0.66	3.40	-1.60	-1.25
125.48	122.31	3.16	5.77	0.52	0.12
113.98	110.29	3.69	4.70	-0.68	-0.81
124.19	121.07	3.13	4.93	0.32	-0.32
124.52	121.87	2.65	5.10	0.33	-0.01
118.63	117.02	1.61	3.87	-1.43	-1.03
132.82	127.98	4.84	3.97	-0.02	0.07
124.15	123.60	0.55	4.03	-1.68	-1.24
124.65	121.27	3.38	4.00	-1.66	-1.19
128.58	126.39	2.19	4.03	-1.36	-0.78
131.29	128.60	2.68	4.07	-1.21	-1.07
59.38	57.18	2.19	5.23	-0.44	-0.51
67.04	65.36	1.68	4.08	-1.10	-1.13
80.93	78.68	2.25	4.19	-0.66	-0.67
100.21	96.44	3.77	4.50	-0.85	-0.90
126.18	123.91	2.27	4.03	-1.55	-1.13
88.85	86.16	2.69	4.29	-0.91	-0.89

Looking Ahead

The most recent housing data released by OFHEO, and used in PMI's Risk Index, is second quarter data, but things are changing quickly. In this article we take a look at some additional, more recent statistics that may provide a clue as to where the market is headed.

Mortgage Rates. Credit concerns, coupled with a reduction in liquidity, have created tremendous volatility in mortgage rates. Rates jumped from 6.16 percent in March to 6.7 percent in June before falling back to 6.31 in mid-September. Lenders are tightening product guidelines and underwriting standards in response to investors' flight to quality. But current market conditions will continue to make access to credit difficult for potential buyers as the market sorts itself out.

Home Sales. Existing home sales fell in August and are currently 12.8 percent below their pace of a year ago, according to the National Association of Realtors August estimate. Following a healthy 3.8 percent increase in July, sales fell by 8.3 percent in August. For the year, sales are 21.2 percent below where they were in August 2006. Expect continued volatility until supply and demand come back into balance.

Housing Supply. Weakness in home sales has increased the inventory of new and unsold homes. At the current sales rate, it will take 10.0 months to sell the inventory of existing homes and 8.2 months to sell the inventory of new homes, according to the National Association of Realtors and the U.S. Census Bureau. In more stable periods, sales of existing and new homes take approximately 4.5 months and 4 months, respectively. Supply will continue to be high as current delinquencies and foreclosures work their way through the system.

Employment. Previous significant declines in regional house prices have been precipitated by dramatic increases in unemployment. Jobs leave a community en masse, layoffs ensue, homeowners can't make their mortgage payments, and foreclosures increase. Without new jobs to attract new buyers, homes sit on the market and prices drop, bringing supply and demand into balance. That has not been the case with this decline. Employment numbers remain above their long-term averages, but the number of job creations declined in August — the first decline in payrolls since 2003. This statistic, as well as initial unemployment claims, bears watching. Deterioration could increase stress in the real estate markets.

Conclusion. The market is adjusting after a period of unprecedented expansion. It's reasonable to expect price appreciation will flatten or decline in some areas until the excess supply has been significantly reduced. The length and depth of the adjustment remains to be seen, but these statistics deserve continued scrutiny as we try to divine answers. ◆

Mortgage Rates
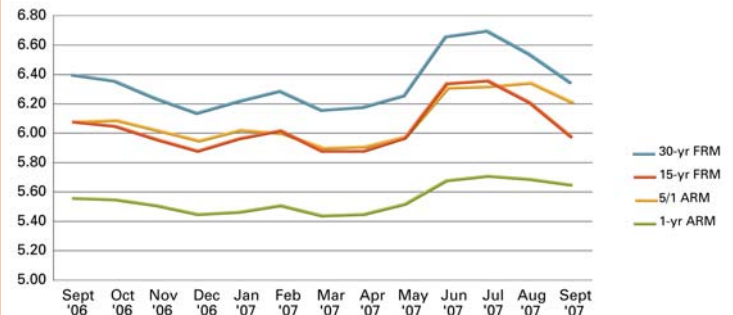
Source: Freddie Mac

Percent Change in Home Sales (from Prior Month)
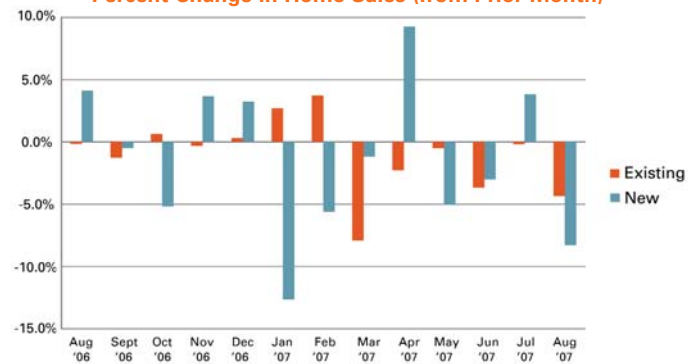
Source: National Association of Realtors - Existing, U.S. Census Bureau - New

Months Supply of Housing

Source: National Association of Realtors - Existing, U.S. Census Bureau - New

Change in Employment Levels

Source: Bureau of Labor Statistics

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Trends in the Nation's MSAs *(continued from page 3)*

Trends in Home Price Appreciation

Since peaking in the second quarter of 2005, appreciation rates have decelerated for seven of the last eight quarters, according to OFHEO. At the end of the second quarter, prices appreciated at a year-over-year rate of 3.2 percent for conventional, conforming loans, a drop from the previous quarter's year-over-year rate of 4.5 percent.

The number of MSAs experiencing negative appreciation also increased in the second quarter. Of the 381 MSAs tracked by OFHEO, 67 MSAs had negative year-over-year price appreciation. Of those that declined, the average decline was 2.9 percent. Among the 50 largest MSAs, 14 had negative year-over-year appreciation rates, with an average decline of 2.21 percent. Of the remaining 331 MSAs, 53 experienced annual price declines averaging 3.12 percent.

For the first time in five quarters the percentage of MSAs experiencing price declines was higher for the Top 50 (28 percent) than for the remaining 331 MSAs (16 percent). This is a trend reversal that tells us the decline in home prices began to affect more people in highly populated parts of the country where prices and employment are typically more stable.

Trends in House Price Affordability

The ongoing decline in home prices, coupled with steady income growth, improved housing affordability across most MSAs. PMI's Affordability Index rose in 297 MSAs, and in all but two of the Top 50. The average Affordability Index score for all MSAs was 105.2: a 1.9-point increase over the first quarter. For the Top 50, the average Affordability Index score increased to 88.9 from 86.1 in the first quarter.

The largest improvements in affordability were in the moderate to low Risk Ranks 3-5. The most notable movement was in Risk Rank 4, where the average Affordability Index score rose by 3.8 points. Within this risk rank, the largest movements occurred in the eastern MSAs of New York-White Plains (up 6.3 points to 78.3), and in Newark-Union, NJ-PA (up 5.44 points to 86.8). The rate of home price appreciation in these MSAs has decelerated substantially over the last year, declining 9.3 percent in New York-White Plains and 8.8 percent in Newark-Union.

HOUSING AFFORDABILITY	
All MSAs	
# Improving	297
Total MSAs	381
% Improving	78%
Largest Decline	23.86
Largest Increase	17.17
Average Change	+1.85
Top 50	
# Improving	48
Total MSAs	50
% Improving	96%
Largest Decline	3.98
Largest Increase	8.06
Average Change	+2.57

Affordability remains challenged in the 11 MSAs with risk scores above 500. Affordability among this group averaged 66.2, largely unchanged from 66.3 in the first quarter.

Improved affordability is the primary driver for reduced risk in each ranking. However, it must be noted that affordability is still poor relative to historical averages. Home prices will need to continue to come in line with incomes before we can expect to see meaningful reductions in risk scores.

Trends in Employment

The average change in demeaned unemployment was zero for the quarter. Overall, unemployment rates remain low in most MSAs. Rates weakened slightly in some areas and strengthened slightly in others.

In the second quarter, 21 of the 25 MSAs with the largest increases in demeaned unemployment were concentrated in just four states – California (7), Ohio (7), Louisiana (5), and Michigan (2). These MSAs saw an average increase in demeaned unemployment of 0.74 percentage points. Increased demeaned unemployment typically raises an area's likelihood of price declines. Risk in these MSAs was offset somewhat by improved affordability.

DEMEANED UNEMPLOYMENT	
All MSAs	
# Improving	192
Total MSAs	381
% Improving	50%
Largest Increase	1.80
Largest Decrease	1.56
Average Change	0.00
Top 50	
# Improving	25
Total MSAs	50
% Improving	50%
Largest Increase	0.58
Largest Decrease	0.82
Average Change	+0.02

At the other end of the scale, the 25 MSAs with the strongest labor markets were largely located in the South. Those leading the pack included MSAs in Texas (7), South Carolina (5), and Tennessee (5). The average decline in demeaned unemployment for these 25 MSAs was 0.8 percentage points. Strong employment data in these MSAs improved risk scores and decreased the likelihood of price declines.

Weakening employment has not become a significant issue for most MSAs in the Top 50, with the exception of the industrial Midwest. However, most of the California and Florida MSAs in the two highest risk ranks had slightly worse employment markets in the second quarter compared to the first.

Conclusion

The overall decline in average risk scores should be viewed objectively. The situation we are currently in – low affordability, increased volatility, and declining appreciation offset somewhat by solid employment rates – took several years to develop and is not likely to resolve itself overnight. ◆

The Value of Homeownership *(continued from page 4)*

As a result, home foreclosures increased and home prices began to decline. After peaking during the third quarter of 1983, the MSA saw 19 quarters—nearly 5 years—of negative price appreciation. By the time the recovery began in the third quarter of 1988, average prices were 23 percent below their peak in 1983. Prices recovered at an average rate of 3.5 percent per quarter, annualized for 9.5 years, in line with the historic price volatility that preceded the price run-up.

Those who purchased at the worst possible time — the peak of the cycle — recouped their lost capital in approximately 14.5 years.

The Bottom Line

These are unique examples of extreme price declines. It remains unclear how today's market will develop, but evidence shows that when buyers treat their homes as long-term investments, the long-term data shows definitively that home-ownership is an excellent way to build wealth. ◆

HOUSTON, TX

BOSTON, MA

LOS ANGELES, CA
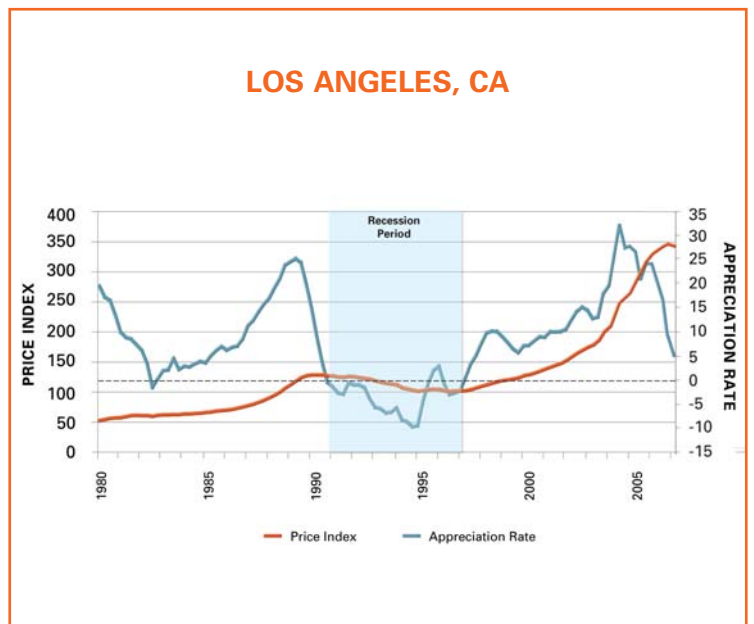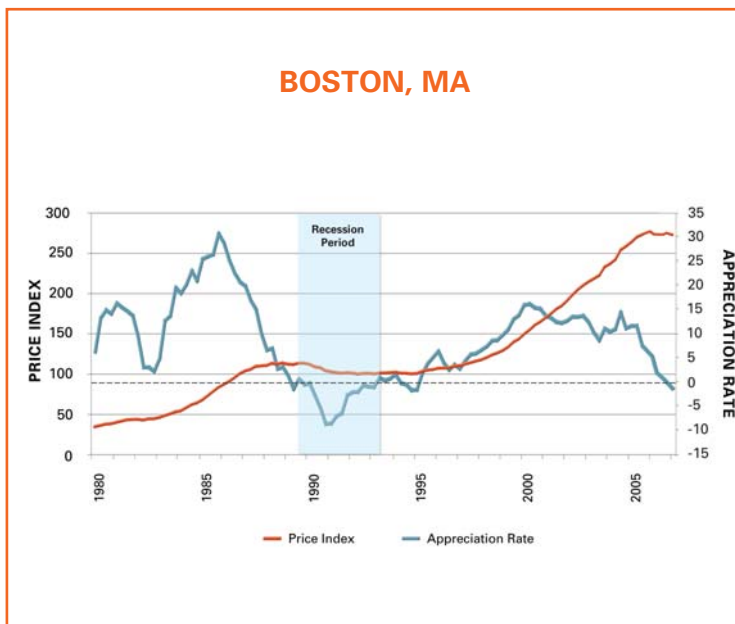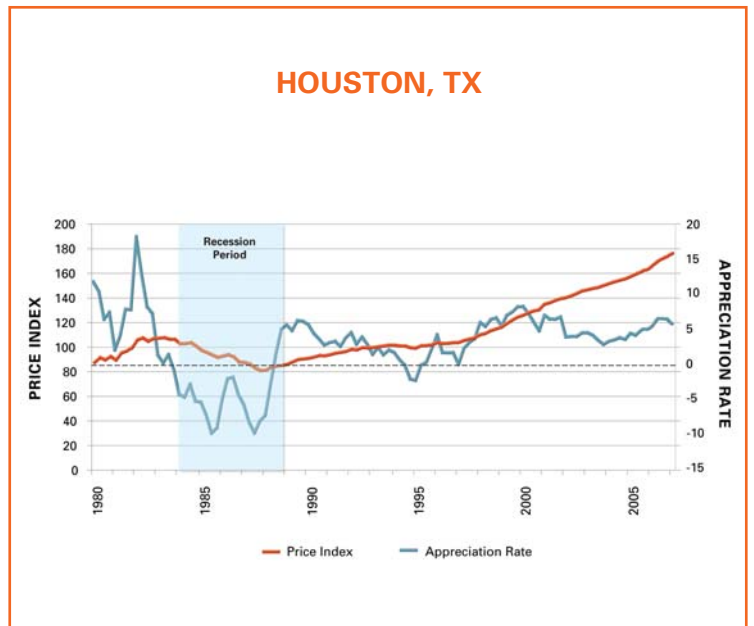
Geographic Distribution of
HOUSE PRICE RISK
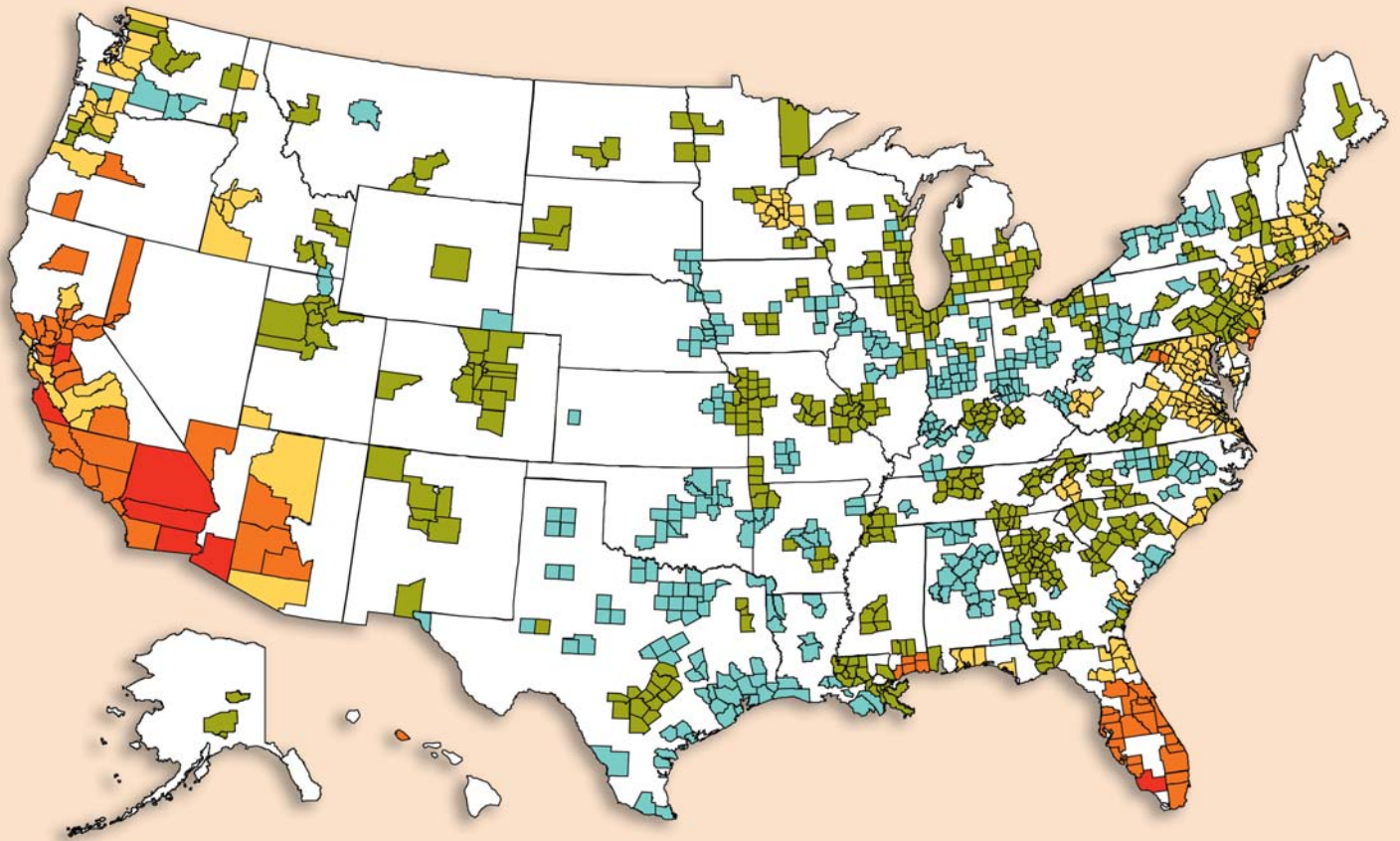
The above map depicts in color the geographic distribution of house price risk for all 381 MSAs and the District of Columbia. Each MSA is assigned a risk rank and corresponding color. Among the 50 largest MSAs, **Riverside, CA** ranks the highest on the index, with a 60 percent or greater chance that home prices will be lower in two years. At the other end of the risk spectrum lies a group of MSAs, largely located in the central and southern part of the nation, whose risk scores are moderate to low.

The Risk Index scores for all 381 MSAs are provided in an appendix, available on the publications page of the media center at www.pmigroup.com.

Risk Rank 1: >= 600

Risk Rank 2: 500 to 599

Risk Rank 3: 300 to 499

Risk Rank 4: 100 to 299

Risk Rank 5: 0 to 99

METROPOLITAN AREA ECONOMIC INDICATORS STATISTICAL MODEL OVERVIEW

The U.S. Market Risk Index is based on the results of applying a statistical model to data on local economic conditions, income, and interest rates, as well as judgmental adjustments in order to reflect information that goes beyond the Risk Index's quantitative scope. For each Metropolitan Statistical Area (MSA) or Metropolitan Statistical Area Division (MSAD), the statistical model estimates the probability that an index of metropolitan-area-wide home prices will be lower in two years, with an index value of 100 implying a 10% probability of falling house prices.

Home prices are measured with a Repeat Sales Index provided by the Office of Federal Housing Enterprise Oversight (OFHEO). This method follows homes that are sold repeatedly over the observation period and uses the change in the purchase prices to construct a price index. The index is based on data from Fannie Mae and Freddie Mac and covers only homes financed with loans securitized by these two companies. Consequently, this index does not apply to high-end properties requiring jumbo loans.

Periodically, we may re-estimate our model to update the statistical parameters with the latest available data. We also may make adjustments from time to time to account for general macroeconomic developments that are not captured by our model.

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