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The Subprime Mess

By David Lereah, NAR Chief Economist

Just as children in an orderly classroom stir up a wild ruckus when the teacher leaves the room, some people and businesses stray from fundamental behavior during a frenzied market environment. It happens every time. During the savings and loan crisis of the 1980s, S&L senior management wastefully purchased expensive fine art while their institutions were crumbling. Investors purchased company stock at triple-digit price/earnings multiples during the giddy 1990s dot.com boom, ignoring fundamental investing principles. And in the aftermath of the nation's biggest real estate boom, we learn once again, about behavior in a frenzied environment. I call it, the subprime mess.

How it Began

Caught in the real estate boom's great momentum, lenders granted mortgage loans with low starter (teaser) interest rates to high-risk borrowers without sound underwriting. Many of these loans were made to borrowers with little or no documentation of their financial capacity to service debt and required little or no down payment, leaving borrowers with virtually nothing at stake in the property if something went wrong. Of course, something went wrong -- it always does.

Lenders bet that property prices would continue to rise, thus enabling borrowers to "refinance their way" out of trouble or sell for a nice profit. When property prices flattened or fell in many of the post-boom markets across the nation, that could no longer happen. Poor underwriting has led to higher delinquencies and foreclosures as the teaser rate periods end and monthly mortgage payments are re-set at higher interest rates. Over 30 subprime lenders that have made problematic loans have gone belly up with more on the way. Large lenders (insured banks and other lenders) and Wall Street companies that provide funding for the subprime marketplace got caught with their collective financial pants down. Now they and many of their borrowers are paying the price. Banks regulators -- the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the Federal Reserve tolerated a level of risk which was, in retrospect, excessive. And now the regulators have begun, justifiably, to toughen lending standards.

Hold On, Chicken Little

So now we are left with a subprime mess. The media is all over this, calling it a subprime tsunami, a debacle, a crisis. The regulators are responding with tough lending standards and restrictions. And Congress is holding hearings which promise to lead to tougher consumer protection laws. Some analysts are predicting that subprime problems will do meaningful harm to the housing sector, possibly leading to an economic recession. But let's take a deep breath and assess the situation, before succumbing to a subprime tsunami.

The subprime mortgage market comprised about 20 percent of the nation's lending volume during the past two years. Clearly, the recent fall-out has stifled subprime lending activity today. Many subprime lending companies have closed their doors and their sources of funds—the large banks and Wall Street—have tightened credit. The regulatory agencies have proposed stricter subprime lending guidelines, emphasizing sound underwriting, greater documentation, a debt-to-income analysis that includes taxes and insurance, and qualifying borrowers on a fully indexed mortgage rate rather than the starter rate.

The Fall Out

What's ahead? I would expect a drop-off of subprime originations this year and next. Yes, it is possible that half of the subprime high risk borrowers will be unable to get a loan, thus depressing overall home sales. But that is not likely. Many of these households will seek mortgage loans from a revitalized FHA, from lenders making loans that meet Fannie Mae and Freddie Mac standards, and from other lenders offering fair and affordable mortgage options to subprime borrowers. Remember, many of these borrowers are low-income, minorities and first-time buyers -- all important participants in the home buying marketplace. Tougher lending standards imposed by the market (i.e., Wall Street and banks) and the regulators

April 2007



Justen



Larry



Wayne



Jim



Kristin



Jill



Cheryl



are necessary, but we need to be mindful of overcorrection. Responsible lending practices are what the doctor orders, not practices that cause a credit crunch.

On balance, I expect about 10 to 25 percent of subprime households to be unable to secure a mortgage loan because of today's stricter lending standards. However, many of these households will probably, over time, purchase a home when they have attained the financial capacity to do so (e.g., saving for a down payment, growing their income). So the long-term health of the housing market will probably stay in tact. In the near-term, I would expect home sales to fall by 100,000 to 250,000 annually during the next two years due to tighter underwriting practices, slowing the nation's housing recovery.

As for the over 8 million adjustable-rate loans (25 percent of which were subprime) originated during the past three years, First American Corelogic estimates that about 1.1 million of them totaling about \$326 billion are likely to end up in foreclosure. A bit over \$300 billion of subprime adjustable mortgage loans are due to re-set by October 1st of this year. Most lenders will attempt to work out problem loans by refinancing borrowers into other mortgages. A disproportionate share of these foreclosures will occur in high cost regions, like California. Certainly, a rise in foreclosures results in an upward blip in housing inventories, depressing home values. But the good news is that these foreclosures will occur in relatively healthy local markets that boast decent levels of economic activity and job creation, improving the prospects of selling the foreclosed properties in a reasonable amount of time. Foreclosures will create temporary inventory problems, but inventories will be eventually worked out.

The Big Picture

Today's subprime problems are most certainly going to spill over into the housing sector and the economy a number of ways. First, if lenders exercised poor underwriting in the subprime market, it is likely that these practices carried over into their Alt A and possibly even their prime lending markets as well, suggesting that delinquencies and foreclosures in these markets may reach higher than historical levels. Second, going forward, lenders that are tightening underwriting standards in the subprime market may be overcautious and tighten standards in the prime market, keeping some households from purchasing with prime loans even though they are well able to afford them. Third, continual problems and media reports about subprime activity may reduce overall consumer confidence in the housing sector, bringing some home buyers to the sidelines. And fourth, an increase in foreclosures could raise the inventory of homes in a local market, soften prices and the demand for home buying. But from a broader perspective, today's subprime problems are occurring against a backdrop of cyclically low mortgage rates and a growing, healthy economy. Jobs and liquidity are plentiful in the marketplace, suggesting that the subprime problems may be a manageable problem within our \$10 tril-

TexInvestors Investment Club Meeting

Join the TexInvestors at our next Investment Club meeting. Thursday, April 19th, starting at 7 p.m. at RE/MAX Premier Properties in Plano.

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