

2009 Michigan Conference on Affordable Housing

Understanding the Housing and Economic Crisis

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PART I

SUBPRIME LENDING

Prevalence of “Subprime”

- American Dialect Society voted “subprime” the word of the year for 2007.

Subprime Lending – Key Points

What Subprime Lending is NOT:

1. Not a “four letter word”
2. Not a bad thing per se
3. Not a synonym for Predatory Lending
4. Not a synonym for Adjustable Rate Mortgage (ARM)

What is Subprime Lending?

- Simple Definition: Subprime Lending is the extension of credit to those who do not qualify for credit at prime rates.
- Prime rates are only extended to those who are considered low credit risk.
- Subprime Lending is not unique to mortgages.

Risk of Default is the Key

Banks use the same logic you would use in deciding whether to loan money to two different friends. Consider the following examples:

Who is the credit risk?

■ (Example #1)

- 1) Steady Job
- 2) Good Income
- 3) Known for a long time
- 4) Previous loans always repaid on schedule

■ (Example #2)

1. Only known for six months
2. Self Employed
3. No regular cash flow
4. Mutual friend not repaid for loan

What makes an Applicant Subprime?

1. Generally Credit Scores (FICO) below 620 (shows negative payment history)
2. Debt to Income Ratio (ability to pay your debt obligations, generally want it under 36%).
3. Loan to Value Ratio above 90% (small down payment)

▶ NO ONE ISSUE IS DISPOSITIVE!!!

Subprime Lending: Good or Bad?

Proponents of subprime lending argue the following:

1. People need access to credit regardless of history.
2. Credit, even at subprime rates, gives individuals a method to repair their payment histories and refinance back into prime rates.
3. Many individuals with poor credit histories had life events outside of their control (such as divorce, medical problems or unemployment) which may have solely contributed to their financial situation and not pose a reoccurring risk.

Subprime Lending: Good or Bad?

(Continued)

Critics of Subprime Lending Contend:

1. Many subprime loans have adjustable rates and buyers inappropriately bet that they will be able to pay the higher rate when they adjust, or refinance prior to adjustment.
2. Subprime loans financially cripple individuals if they cannot refinance.
 - \$150,000 30 year loan at 5.75% = 315,000 total.
 - \$150,000 30 year loan at 9.5% = 454,000 total.
 - \$150,000 30 year loan at 12%= 556,000 total.

What is all the fuss about?

(Mortgage Bankers Association Data)

1. Delinquency and Foreclosure rates are much higher for those with subprime mortgages.
2. Current total Delinquency Rate (not yet in foreclosure) is highest ever recorded (7.88%- 4th Quarter, 2008).
3. Current Foreclosure rate is 3.3% and is the highest ever recorded (4th Qtr, 2008, 1 in 33 home loans and growing with many communities suffering much greater foreclosure rates).

Mortgage Bankers Association Data

(1st Quarter 2008 Data)

Type of Loan	Percent of Outstanding Loans	Percent of Foreclosures Started
Prime-Fixed	65%	19%
Prime ARM	15%	23%
Subprime Fixed	6%	11%
Subprime ARM	6%	39%
FHA and VA	8%	8%

Mortgage Bankers Association Data (Continued)

Subprime mortgages represent only 12% of all loans, but half (50%) of foreclosures started.

Real World Example

Many adjustable rate subprime mortgages have low “teaser” rates that readjust to the higher subprime rates after a set period of time.

Example:

\$150,000 2/28 Subprime ARM loan with a 4% introductory “teaser” rate for the first two years which then readjusts to the 9.5% subprime rate at the beginning of year 3 of the loan.

Real World Example

(continued)

- ▶ First 2 years: Monthly payment is only \$716 based on the 4% Interest Rate.
- ▶ When interest rate readjusts to 9.5% at the beginning of year three, monthly payment jumps to \$1261- an over 75% increase in mortgage payment. (12% rate would result in a monthly payment of \$1,542, an over 100% increase.)

PART II

Reasons for Subprime Collapse

The Technology “Bubble”

- The Technology “Bubble”: From 1995 to 2000 there was a dramatic appreciation in the value of internet and technology stocks.
- Subsequent Collapse of the technology “bubble” was just as dramatic.

The Technology “Bubble”

(Cont)

- NASDAQ: In March, 2000 it closed at 5,048. In October of 2002 it closed at 1,114, representing a decrease of nearly 80%.
- NYSE: In January, 2000 it closed at 11,723. In October of 2002 it closed at 7,286, representing a decrease of nearly 40%.

Recession of 2001

- National Bureau of Economic Research: Most recognized authority for defining the length and depth of a recession.
- Recession: Common definition is two or more consecutive quarters of negative economic growth (GDP).
- 9-month recession of 2001 did not follow the “common” definition- 3 out of 5 negative, but non-consecutive, growth quarters, but total cumulative contraction.

Investment Psychology

- Prior to the tech bubble bursting and subsequent recession, certain sectors of the investment market had become viewed as “safe havens,” real estate being one of them.
- As the tech bubble burst, and especially after the subsequent recession, investment money poured into real estate, further igniting the housing market.

Housing Market Overvaluation

- 10% to 30% annual appreciation in some markets from 1997-2006.
- Many markets saw well over 100% total appreciation over the same period.
- Historically, home prices appreciate about 4% annually

Historically Low Interest Rates

Historically Low Mortgage Rates fueled a buying frenzy.

Year	1983	1993	2003
Average Mortgage Rate (30 Year Fixed)	13.40	8.12	6.05

Federal Funds Rate and the Housing Bubble

- Generally, though not always, changes in the Federal Funds Rate result in similar changes in mortgage rates and the indices that adjustable rate mortgages track.

Federal Funds Rate and the Housing Bubble

(Cont)

- Beginning in January of 2001, and continuing in the aftermath of September 11th, the Federal Reserve cut the federal funds rate 13 consecutive times to a 40-year low of 1%.
- Federal funds rate was left unchanged at 1% from June, 2003 to June, 2004 despite ongoing economic recovery.
- Prime lending rate hit a 45-year low in June, 2003 at 4%, and remained near historical lows.²⁴

Federal Funds Rate and the Housing Bubble

(Cont)

- Beginning in June, 2004 the federal funds rate was increased 17 consecutive times.
- Many adjustable rate mortgages that reset during or after this period of federal funds rate increases, readjusted to much higher and unaffordable levels.
- Federal funds rate was not cut until September, 2007, but has been cut very aggressively since that time.

Banks forfeited the risk of default

Lending practices have changed dramatically.

Proliferation of Mortgage Backed Securities (MBSs), and their high investor ratings, allowed risk to be “passed through” to investors.

Boom in Subprime Loans and Products

Proliferation of Mortgage products, and higher commissions charged for subprime loans, encouraged brokers to push exotic and risky products.

1994: Subprime loans equal 5% of total.

2004-2006: Subprime loans equal over 20% of total.

Questionable or Fraudulent Lending Practices

1. False Income Reporting
2. No Income Verification (liar loans)
3. Fraudulent Appraisal Practices
4. Targeting of poor and/or minority communities

Effects of the Subprime Collapse

Full effects not known for several years:

1. Millions will or have lost their homes.
2. Cyclically contributes to overall housing collapse (more foreclosures = more inventory = lower prices = reduced home values = difficulty refinancing = more foreclosures).
3. Devastating effects on property tax base, greatly reducing local government funding and services.
4. “Credit Crunch” makes obtaining credit much more difficult for all but the most qualified buyers.

PART III

Mortgage Origination, Mortgage Backed Securities, Mortgage Servicing and Foreclosure

Mortgage Origination

- **Mortgage Broker:** An individual who does not work for a lending institution (e.g. a bank), but who qualifies individuals for home loans and works with lending institutions to distribute their products. Brokers originate between 60% and 70% of all mortgages.
- **Loan Officer:** An individual who works directly for a lending institution and qualifies individuals for loan products offered by the lender.

Bank vs. Broker: Pros and Cons

Banks	Brokers
Banks only sell their own products.	Represent many different lenders and market their products.
One set of origination fees	Brokers act as a middle man- hence there is an additional layer of fees
Possibly more flexible since lenders need only follow their own guidelines	Generally less flexible since they must follow the guidelines of the lenders they serve.
Generally a better choice for those with good credit.	Generally a better choice for those with credit issues.

The Secondary Mortgage Market

- Traditional lending practices have largely disappeared.
- Most mortgages are packaged and sold as investments known as mortgage backed securities.
- Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal National Mortgage Association (Fannie Mae) and the Government National Mortgage Association (Ginnie Mae), as well as other financial and investment institutions create the secondary mortgage market.

Mortgage Backed Securities (MBSs)

- MBSs exploded in popularity over the last two decades, and were commonly used for everything from funding pension plans, to securing foreign financial institution debt.
- The rate of return and value of MBSs is directly tied to the strength (or perceived strength) of the underlying pool of mortgages.
- As delinquency and foreclosure statistics started rising at historically high rates, the legitimacy of the underlying assets were questioned. Once the markets became suspicious of the viability of many MBSs, the credit markets began to unravel.

The Sale of a Mortgage

A mortgage basically consists of two pieces of paper:

1. The “note” is the promise of a certain payment at a certain interest rate over a certain period of time.
2. The “deed of trust” is a document that gives the holder the right to take the property if the payments are not made under the terms of the note.

Who Owns the Mortgage?

The major parties:

1. **Loan originator:** Broker or lender who actually qualifies and extends credit to the borrower.
2. **Lender:** Institution that underwrites (funds) the initial loan.
3. **Issuer:** Financial institution that pools (securitizes) mortgages and sells them to investors.
4. **Servicer:** Party responsible for collecting the mortgage payments, distributing them to the issuer and pursuing delinquencies.
5. **Trustee:** Party that represents the interests of the investors.

Who Owns the Mortgage?

(Cont)

Issues:

1. Mortgages and servicing contracts can be sold numerous times.
2. Contracts between the parties are not uniform and terms can vary.
3. Given the sometimes lengthy transaction trail, proper documentation is not always easy to track down.

Foreclosure

- Only the party that owns the mortgage has the right to foreclose on the property.
- Foreclosure actions have been thrown out of court due to insufficient documentation showing who owns the mortgage.

Questions or Comments:

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