Hovde

Industry Update

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Housing Update:

Still Living the Dream... But Waiting for the Other Shoe to Drop

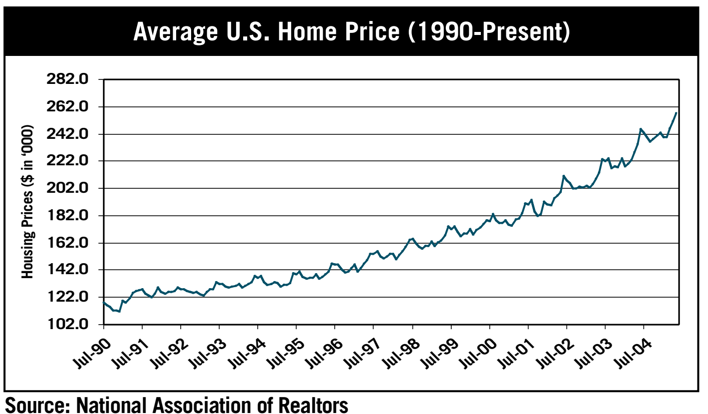
It has been about a year and a half since we last expressed our concerns regarding the U.S. housing market in an *Industry Update* entitled "Living the American Dream ... But At What Cost?" In that December 2003 paper, we argued that the record pace of home price appreciation could be jeopardized by an end to record-low interest rates, a decline in home affordability, and an increase in fraud and coercive practices by real estate professionals. We also felt that the financial services industry had become increasingly vulnerable to a potential downturn in the housing market given the significant rise in mortgage and home equity exposure of many banks and thrifts, coupled with the abnormally low levels of credit provisions and loss reserves then being taken by many lenders against real estate loans.

What has happened since? As any homeowner or buyer can attest, if the housing market was hot in 2003, it is white-hot now. In the five-year period ended March 31, 2005, existing home prices in the U.S. increased by 50% (versus. a 12% increase in general inflation during the same period as measured by the Consumer Price Index, or CPI). In the first quarter alone, home prices increased by 12.5% from a year earlier, compared to a 3.1% increase in the CPI, with double-digit increases in 23 states and the District of Columbia. Home prices in some of the hottest markets – such as Nevada, California and Washington, D.C. – increased at rates of 20% or more year-over-year, and have doubled in the past five years, according to the Office of Federal Housing Enterprise Oversight. National median existing home prices were a record $219,000 in June, with existing homes selling at an annualized rate of 7.33 million (seasonally adjusted), an all-time high, according to the National Association of Realtors. While it is difficult to obtain reliable housing statistics going back over many decades, our analysis of the available data suggests that ***the past five years represent the largest increase in home prices in American history.*** The housing boom is a global phenomenon, as well. Spurred by low rates in much of the world, *The*

Exhibit 1: Home Price Appreciation By State (%)
Period Ending March 31, 2005

State	Rank	Qtr.	1-Yr	5-Yr
Nevada	1	3.5%	31.2%	84.7%
California	2	3.8%	25.4%	103.0%
Hawaii	3	4.0%	24.4%	82.9%
District of Columbia	4	2.7%	22.2%	108.1%
Florida	5	4.4%	21.4%	80.5%
Maryland	6	3.8%	21.0%	77.9%
Arizona	7	5.2%	19.4%	52.7%
Virginia	8	3.6%	18.6%	67.5%
Rhode Island	9	1.9%	17.1%	97.6%
New Jersey	10	2.5%	15.8%	76.5%
Total US		**2.2%**	**12.5%**	**50.5%**

Source: Office of Federal Housing Enterprise Oversight (OFHEO)



Average U.S. Home Price (1990-Present)

Source: National Association of Realtors

Economist's home-price index for South Africa was up 24% in 1Q05 and has increased 244% since 1997; Spain was up 16% in 1Q05 and is up 145% since 1997; and U.K. home prices were up 6% in 1Q05 and are up 154% since 1997.

To glance at almost any general interest newspaper or magazine these days, it is easy to see that the continued strength in home prices is causing others to look at the housing market more skeptically (one commentator noted recently that there appears to be a bubble in media coverage *about* the housing bubble). However, despite the heightened scrutiny, the issues we raised in our initial report remain largely unresolved, and indeed, in some cases, have been exacerbated by the further increase in prices. In addition, new forces at work in the housing market – most notably the proliferation of new, more risky mortgage products – will intensify the impact on the financial system and the economy as a whole when the breakneck pace of home price appreciation reverses course or levels off. ***As such, we continue to believe that the U.S. housing market contains substantial and growing risks that, if left unaddressed, will have major negative implications for the financial system and the economy as a whole.***

What Has Continued to Fuel the Housing Boom?

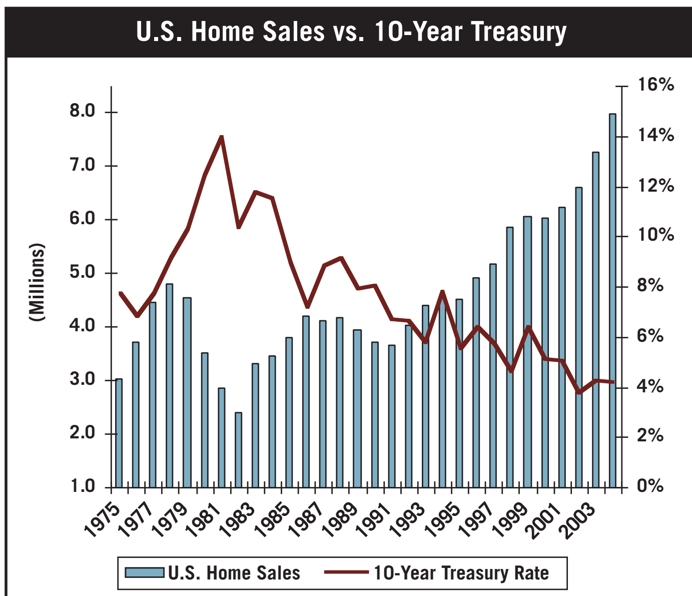
What has caused the housing market to continue this breakneck pace of appreciation? Two years ago, the Federal Reserve's decision to take interest rates to 45-year lows and substantially increase the money supply to address the bursting of the technology bubble and the aftereffects of the September 11, 2001, terrorist attacks provided the fuel for dramatic increases in home prices above and beyond what had taken place over the previous few years. The unprecedented level of federal and fiscal stimulus set in motion rapid price appreciation of housing even as the economy was struggling. ***However, since June 2004, when the Fed started to take away some of that stimulus by raising interest rates, the biggest reason the housing bubble has continued to inflate is the actions of the financial services industry.***

The financial sector has been a key player in the housing boom by offering a vast array of new, more aggressive mortgages designed to reduce down payments and lower monthly payments in the early years so purchasers can keep up with home prices that are increasing far faster than wage growth. In fact, the U.S. Census Bureau recently reported that incomes stagnated in 2005, the first time on record that household incomes failed to increase for five straight years. While appealing in the near-term, because many of these new mortgage products are adjustable-rate and/or allow flexibility in principal repayment, many homeowners are now highly vulnerable to rising interest rates, declining property values or both. The wide availability of these new mortgage products has allowed the increase in housing prices to feed on itself: with access to cheap financing, speculators have chased high returns on real estate investments, which has increased prices still further. Because of the dramatic rate of price appreciation, real estate-related credit losses and reserves have remained at record low levels, prompting banks to be even more aggressive in their mortgage lending practices and allowing more people who would otherwise not be able to afford houses of their own to become homeowners. The aggressive lending leads to higher prices, which leads to more speculation, and so on.

Momentum can build on itself in any financial market, but only if a structure exists to support that momentum. What has allowed the housing bubble to continue to inflate? In this first edition of our 2005 two-part series on the current state of the U.S. residential housing market, we will focus on the primary reasons for this continued inflation, particularly the four factors that have served as key contributors to this long-term residential housing explosion. In the near future, in the final piece of this series, we will analyze the potential implications of some notable demographic trends that are currently taking hold within the bloated housing market. Further, we will more closely analyze the financial implications for America's consumers and, importantly, will give our predictions for how this seemingly unending cycle will, in time, end.

There exist, in our opinion, four major catalysts that have enabled the U.S. housing boom to perpetuate for what is now an unprecedented period of time:

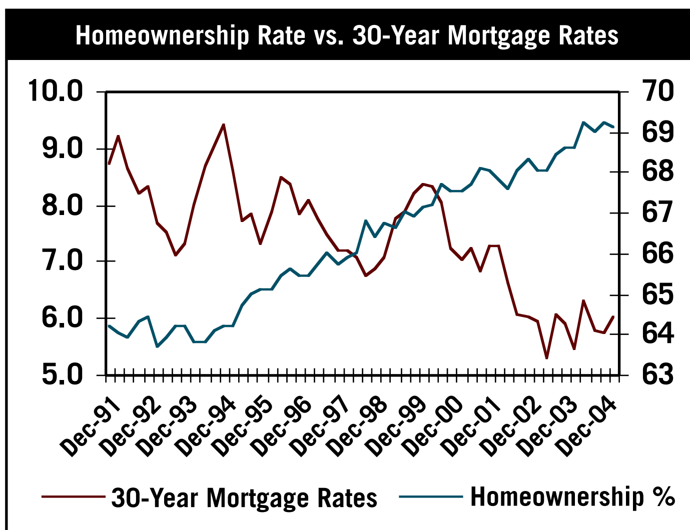
- The persistency of low, long-term interest rates, despite the rise in short-term rates over the past year;
- The proliferation of new, more risky mortgage products;
- The dramatically increased role of speculators; and
- A rising incidence of mortgage and appraisal fraud.



Source: National Association of Realtors

Yields Remain Low and Money is Still Cheap

A common saying at Hovde is, "Real estate values floats on a sea of finance." What we mean by this is that, because nearly all real estate purchases are made using some form of financing, the price and availability of that financing is a key determinant of the level and strength of demand. Clearly, there has never been a time in U.S. history like today when residential real estate financing has been so plentiful and inexpensive. This has been one, if not THE, primary reason that housing demand and home prices have risen so much over the last decade and even more dramatically in just the past few years.



Sources: U.S. Census Bureau & Freddie Mac

The decline in long-term rates between 2001 and 2004, for the reasons stated earlier, was a classic response to recessionary economic conditions, sparking economic growth and increased financing activity. However, the persistence of low, long-term interest rates, which has kept mortgage rates near historic lows and provided ongoing fuel to the housing market even in the midst of the recent increases in short-term rates, has been more puzzling (a "conundrum," to use Fed Chairman Alan Greenspan's famous phrase from earlier this year).

The Fed's tightening cycle that began in June 2004 was designed in part to reduce speculative excesses that had emerged in parts of the economy, including the housing sector, unwinding trends the Fed itself helped create by dropping rates to a low of 1% in 2003. However, even as the Fed has hiked short-term rates by 2.5% through ten rate increases, long-term rates have *declined* by approximately fifty basis points, and were almost seventy-five basis points lower as recently as June 2005.

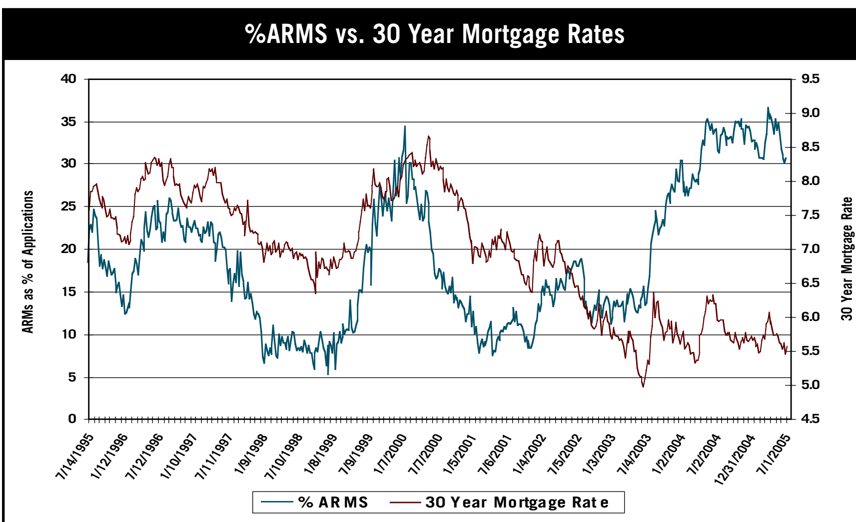
In normal tightening cycles, higher short-term rates would typically be accompanied by higher long-term interest rates, which in turn would lead to higher mortgage rates. However, several factors have counteracted that effect to keep long-term rates unusually low: strong demand for treasuries from foreign central banks flush with cash due to trade surpluses with the U.S.; concern about weakening economic growth (which alleviates pressure on inflation, making bonds more valuable); a search for longer-duration assets by U.S. and foreign pension funds to match their long-term liabilities; and a flight to quality, as investors have periodically sought safety from volatility in other asset classes including corporate bonds, derivatives and equities.

The paradox of falling long-term bond yields amidst a tightening cycle presents a challenge to the Federal Reserve as well as the government agencies that regulate the housing industry. Even as the Fed has raised rates, real estate lenders have become more aggressive, investor activity has increased, and the record pace of home sales and price appreciation has continued. The Fed is likely to continue to raise short-term rates in the future, at least in part (though they would never admit it publicly) to attempt to cool the overheated housing market. However, in continuing on a tightening path, the Fed risks stifling an economy in which growth appears to be steady but not overly strong. Without question, the withdrawal of cheap financing is introducing new elements of risk into the housing system and the economy as a whole.

Risky Mortgage Products and Relaxed Underwriting Standards Provide More Fuel to Housing Market

Working hand-in-hand with record-low interest rates, new, far riskier financing options have also had a dramatic effect on the housing market - helping to keep down payments and initial monthly mortgage payments from skyrocketing along with the rapid rise in home prices and allowing more marginal first-time homebuyers to purchase homes.

In our original *Industry Update* on the housing market in 2003, we highlighted the significant effect that lower interest rates (primarily long-term rates) had on the level of monthly mortgage payments and overall housing affordability. We discussed how the significant drop in mortgage rates over the prior five years had fueled much of the increase in home prices as homebuyers were able to pay more for homes while



Source: Mortgage Bankers Association

keeping their monthly payments flat or, in many cases, even lowering them. We also provided an example of how an increase in long-term interest rates could dramatically reverse that trend – putting significant pressure on overall housing affordability and home prices. That same risk clearly remains today. However, an entirely new set of risks – for both homebuyers and lenders – has come onto the scene in the form of much riskier loan products.

The rapid explosion of ARMs in the past two years has brought this issue to the forefront in terms of risks to homeowners, lenders and the overall housing market. As can be seen in the graph above, despite 30-year fixed rate mortgages remaining near all-time low levels, the percentage of homebuyers opting to finance their homes with ARMs has skyrocketed to near all-time high levels – recently surpassing the levels reached in 2000 when 30-year mortgage rates were above 8%. ***What is striking about this behavior is that it is extremely counterintuitive***. Whereas in the past there was a very strong correlation between the percentage of homeowners choosing ARMs and the absolute level of interest rates, with borrowers opting for the safety of locking in low, long-term fixed rates when rates were low and utilizing lower-rate ARMs only when mortgage rates were high, that correlation has now become totally disconnected.

Although the introduction or increased use of products like hybrid ARMs (i.e., mortgage loans that have fixed rates for three to seven years and then adjust) has contributed to some of the increased use of ARMs, there is really one primary reason that homebuyers have increasingly "chosen" ARMs despite the low level of long-term rates: because many have no other choice. With home price appreciation far outstripping gains in household incomes, housing affordability levels have been pushed to the limit – particularly in markets along the coasts and in many major metropolitan areas. As a result, an increasing number of homebuyers has been forced to abandon the safety of longer-term, fixed-rate loans for much riskier ARM loans in order to keep their initial monthly payments low enough so that they can still afford to purchase a home or, in many cases, trade up to more expensive homes that they could not otherwise afford.

At the same time, banks and other lenders have been more than willing to offer and promote various ARM products to their customers, as these products provide what is viewed as an attractive asset to retain on their balance sheets because they effectively transfer the risk of rising interest rates from the lender to the borrower. Moreover, the proliferation of more innovative ARM products, such as Interest Only (IO) loans and Option ARMs, coupled with low or no down payment options and limited or no documentation requirements, has allowed a greater number of more marginal, lower-income households to purchase homes – further increasing overall homeownership rates and driving up home prices, while expanding lending opportunities for many financial institutions.

What is particularly worrisome about this situation, though, is that these more aggressive financing options are being widely adopted at a time when interest rates are still relatively low, home prices have risen rapidly, employment trends remain favorable and, as a result,

credit losses are at or near all-time low levels – creating a sense of complacency among both borrowers and lenders at a time when the future risks are, in our opinion, the greatest. ***What would likely happen if large numbers of these mortgages reset during a period of rising interest rates, a weaker labor market and/or stagnant or declining housing prices?*** In this scenario, many homeowners would have trouble meeting their higher mortgage payments and could find it necessary to sell their homes, putting further pressure on home prices and the overall housing market – leading to a domino effect on consumer spending and the economy as a whole. ***As a result, while these more innovative loan products and financing options have helped to fuel the housing market over the past few years, we believe that there is a strong likelihood that they will be the very things that derail it.***

Although the risks inherent in traditional ARM loans would appear to be fairly obvious to most homebuyers (i.e., rising short-term interest rates will lead to increased monthly mortgage payments), we believe that the prolonged period of relatively low interest rates and rapidly rising home prices has given many people a false sense of security, perpetuating the attitude that ever-increasing home prices will bail them out of any negative situation. We fear this attitude has also been adopted by many of the banks and other financial institutions providing those homebuyers with the financing to purchase their homes. As such, while the math on many of these loans seems fairly straightforward, we believe that a large number of homebuyers who have opted for ARM products in recent years are ill-prepared for the impact of rising interest rates and higher monthly mortgage payments - particularly if that dynamic takes place at a time when home price appreciation has leveled off.

Interest-Only Loans and Option ARMs

The rapid rise in the use of much more risky, non-traditional ARM products, such as IOs and Option ARMs (particularly in some of the hottest housing markets, that have seen the most significant price appreciation over the last few years and are the most susceptible to a pull-back in prices) should be cause for concern. According to the mortgage monitoring company, LoanPerformance, IO loans accounted for almost 23% of all mortgages in the U.S. in 2004, compared to just over 10% in 2003, and less than 2% in 2001. ***In California, which contains many of the hottest housing markets in the country, IOs accounted for nearly half of all home purchases last year – up from just 1% five years ago.***

Once a product offered almost exclusively to very creditworthy, wealthy individuals who would take out low loan-to-value (LTV) IO loans simply to get a mortgage interest deduction on their taxes, IOs have now become very mainstream and are being offered to homebuyers across the country with extremely varying degrees of creditworthiness. As such, we fear that many of the homebuyers that are now "choosing" these loans are unaware of their inherent risks and are therefore, ill-prepared for the payment shock that will come with higher rates and the ultimate repayment of principal. Or, if they do appreciate these risks, they are simply making a "bet" that they will have sold their home for a tidy profit by then or that home prices or their incomes will have increased enough to provide a cushion against the eventual increase in their monthly mortgage payment.

The risk of payment shock from IO ARMs can come in two forms, each of which can lead to much higher mortgage payments on their own but, when combined, can have a dramatic effect on monthly payments and a homeowner's ability to service his or her debt: (1) the traditional risk that rising rates will lead to a higher ARM rate once the loan reaches its first adjustment period, and (2) the increase in payment needed to repay the loan over a much shorter time period when it reaches the amortization period.

$500K Interest-Only ARM Loan

(30-Years with initial 5-Year fixed-rate IO period)

Monthly Payment first 5 Yrs. @ 5%	Monthly Payment after 5 Yrs. @ 5%	Monthly Payment after 5 Yrs. @ 7%
$2,083	$2,923	$3,533
Monthly $ Increase	$840	$1,450
Annual $ Increase	$10,080	$17,400
% Increase	**40%**	**70%**

A quick example of how one of the more common IO ARM loans might work in this scenario clearly illustrates how dramatic this payment shock could be. For example, assume a homebuyer needs to borrow $500,000 to purchase a house and has the choice between a traditional 30-year, fully-amortizing, fixed-rate loan at 5.75% or a 30-year IO ARM loan with an initial fixed-rate, interest-only payment of 5% for the first five years of the loan, after which time the interest rate adjusts based on prevailing rates and the loan becomes fully amortizing over the remaining 25 years.

In that scenario, the initial monthly mortgage payment on the IO ARM for those first five years would be only $2,083, which is $834 or almost 29% less than the $2,917 payment for the traditional 30-year fixed-rate loan – providing the homebuyer with significantly more initial "buying power" to purchase a larger home or one which they otherwise would not be able to afford. However, if one fast forwards five years, this "value" proposition can change dramatically – along with the risks to the lenders providing this financing.

If mortgage rates were to stay exactly where they are over that initial five-year period – a scenario we view as fairly unlikely – and the interest rate on the IO ARM loan stayed at the same 5%, the monthly mortgage payment would increase to $2,923 as the initial $500,000 loan balance was amortized over the remaining 25 years of the loan. This equates to an increase of $840 a month ($10,080 per year) or over 40% more than the initial monthly payment for the IO loan. Now, let's assume that interest rates did not stay constant over the initial five-year time period and the new rate on the IO ARM has moved up to 7%. In that case, the homeowner's monthly payment would jump by almost 70% to $3,533 – a $1,450 a month ($17,400 per year) increase relative to the initial monthly payment. This dramatic payment shock would clearly put significant pressure on a borrower's ability to continue to pay the mortgage unless they had experienced a substantial increase in their income over that time period or were able to refinance their loan on better terms – an option which may or may not be available to them at the time. This dynamic also puts the mortgage lender at much greater risk, as the borrower will still owe the full original principal balance on the loan after those first five years – providing a much lower equity cushion than is typically built up over time in a traditional, amortizing loan should the borrower default on the loan.

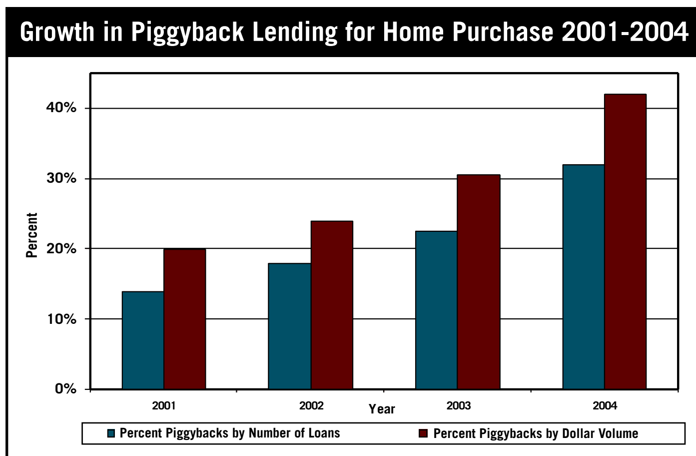
An even more complex and riskier version of the IO ARM loan is the Option ARM, a product that, like traditional IO loans, has exploded onto the scene in many of the hottest housing markets in the country. An Option ARM not only provides a borrower with the "choice" to pay only interest on their mortgage loan but also the option to pay a much lower minimum monthly payment (typically 1% - 2%) that is usually substantially below a comparable interest-only loan payment. As a result, these loans often result in negative amortization, with any difference between the "minimum" payment made and the interest-only payment being added to the principal balance of the loan. Although these loans have many of the same features and risks of a traditional IO ARM, the negative amortization feature poses even greater risk to both the borrower and lender – particularly in a rising interest-rate environment in which home price appreciation has slowed or prices have declined. In this scenario, homeowners that put little money down on their home at the time of purchase could see the equity in their home quickly evaporate and eventually find themselves "upside down" on their mortgage loan – owing more than the home is worth – with the lender ultimately left holding the bag. As we previously pointed out, what makes this dynamic even more worrisome is that the bulk of these loans are being made in the hottest housing markets in the country (e.g. California), which are currently the most susceptible to a decline in home prices.

No Down Payment .... No Problem – Piggyback Loans to the Rescue

Another hazardous byproduct of the booming housing market and the banking industry's willingness to extend more and more credit to homebuyers has been the acceptance of lower and lower down payments on home purchases. As home prices have skyrocketed, many buyers with little or no savings are finding it impossible to come up with the initial 20% down payment that has historically been required for the purchase of a home. However, banks and other financial institutions are increasingly willing to finance some or all of the buyer's down payment, as well as the mortgage on the home, allowing consumers to purchase more expensive homes than they otherwise would be able to afford. According to the National Association of Realtors (NAR), ***less than 20% of first-time buyers made a down payment of 20% or more on their home purchases in 2004, with an astounding 42% putting nothing down at all***. On top of that, investors, who are trying to maximize their return on investment, are taking advantage of this trend of lower down payments to put as little money down as possible on the properties they are buying – meaning that these historically "weak" holders of properties now have even less skin in the game than before should the housing markets falter.

Just as the banking industry has provided fuel to the housing market by offering many of the riskier loan products we discussed above, the willingness of lenders to provide much higher loan-to-value (LTV) mortgage and home equity loans has provided additional fuel to the recent housing boom. The dramatic rise in the use of piggyback loans (i.e., a second lien home equity loan offered in conjunction

with a first lien mortgage loan) is a clear example of this dynamic. In this structure, a homebuyer, who is unable to afford the traditional 20% down payment and wishes to avoid the typical premium payments for private mortgage insurance, would take out an 80%



Source: SMR Research Corp.

LTV first mortgage and simultaneously take out a second lien home equity loan to make up the difference between the down payment and the first mortgage. A popular structure is referred to as an "80-10-10" loan, which combines an 80% LTV first mortgage with a 10% second mortgage and a 10% down payment – although evidence suggests that required down payments are often far less than 10%. According to SMR Research Corp.'s recent study on piggyback mortgage lending, approximately 42% of all home purchase mortgage loan dollars included piggyback loans in the first half of 2004, compared to just 20% in 2001.

While these loan structures may look appealing to many borrowers on the surface because the loans enable them to afford a home without putting much money down, they pose much greater risks to both the borrower and lender should the housing markets weaken. With combined LTVs of 90% or more, there is a significantly smaller equity cushion to protect the borrower and lender should the homeowner get into trouble and not be able to make their mortgage payment – a dynamic that will be amplified in a flat to declining home price environment.

What is especially troubling about these structures is that the majority of the second lien loans involved are short-term, adjustable-rate home equity lines of credit (HELOCs) – often combined with adjustable-rate first mortgages – which place the borrower at significantly more risk in a rising interest rate environment. As with the other risky loan products that we previously discussed, what is particularly worrisome about this trend toward lower and lower down payments is that it is occurring at a time when interest rates are still low and home prices have continued to appreciate at a rapid rate. This reinforces the view held by a growing number of both borrowers and lenders that the typical down payments of the past are no longer necessary because ever-increasing home prices will quickly build the equity cushion that a down payment used to provide. Moreover, like the other risky loan products, a disproportionate share of low-down payment, high-LTV mortgage loans are being made in the highest-cost housing markets that are at greatest risk of a home price decline. While this attitude toward risk in mortgage lending (i.e., that there is very little risk) may have worked over the last few years as rates remained low and home prices continued to appreciate, this type of complacency will lead to substantial problems for both borrowers and lenders as these trends reverse.

The attraction of these new mortgage products to financial institutions is apparent in recent surveys indicating continued loosening of credit standards even as short-term rates have increased – a point in the cycle in which banks and thrifts typically become more conservative in underwriting loans. In July, the Office of the Comptroller of the Currency (OCC) reported that it found significant easing in both commercial and retail credit underwriting standards in the past year. The OCC reported that 28% of banks surveyed had eased retail underwriting standards, 10% tightened, and 62% made no change. This easing of underwriting standards is up considerably from 2004 when 13% of banks eased standards and 13% tightened; this is the first time in the survey's 11-year history that the OCC reported net easing of underwriting standards. Of those banks that eased retail underwriting standards in the 2005 survey, increased competition was the most frequently cited reason for the change.

Short-term Returns Have Been Great, But Risks in Mortgage Market Have Started to Attract Attention

The growth and profitability in mortgage lending have been phenomenal over the last five years largely due to ever-improving credit quality, as a result of record-breaking housing appreciation. Credit quality is a major factor that has encouraged looser underwriting standards in recent years. Because credit trends have been so good over the past few years and loan loss reserve levels (i.e., what companies put away for future credit losses) are established based on looking through the rear-view mirror at credit losses over the past few years – as opposed to what they are likely to be in the future – loan loss reserves are now at all-time low levels for many financial institutions. This reserving

methodology, known as migration analysis, has been a key driver of earnings growth in the banking and financial services industry over the last few years as companies have been able to take lower and lower loan loss provisions each quarter, which has also reduced industry-wide reserves to the lowest levels in decades. The low level of loan losses, coupled with lower provision levels required for mortgages, have greatly enhanced risk-adjusted returns and made mortgage and home equity lending an even more profitable business for banks. This has further increased the banking industry's willingness to extend credit to homeowners through products and terms that we believe are not adequately pricing in future credit risk. However, as bank credit losses begin to rise from their unsustainably low levels, banks will have to provision more for loan losses, reported earnings growth will slow down, and the profitability of new loans will decline, causing banks to rein in their underwriting standards. Thus, the amount of liquidity and pricing in the mortgage market will change, further exacerbating a weakened housing market. Remember our saying, "Real estate values float on a sea of finance."

Officials at the Federal Reserve and other agencies have become increasingly concerned about the growing popularity of these much riskier mortgage products and the loosening of credit standards. In May 2005, the five major U.S. bank regulatory bodies, including the Fed and the Federal Deposit Insurance Corporation (FDIC) published an unusual warning to lenders regarding the rapid growth of home equity loans, the value of which doubled between 1998 and the second quarter of 2004 to $766 billion. The agencies said, in some cases, that underwriting and risk management practices for these loans have not kept pace with the product's rapid growth, and that the currently low loss rates on home equity could increase if interest rates rise. The report also specifically mentioned concerns about new or newly popular loan features, such as interest-only loans, limited- or no-documentation loans; high loan-to-value or debt-to-income lending ratios; and an increased percentage of loans generated by brokers or other intermediaries. Fed Chairman Alan Greenspan followed the agencies' warning by expressing similar concerns in testimony before Congress in June. "The dramatic increase in the prevalence of interest-only loans, as well as the introduction of other relatively exotic forms of adjustable-rate mortgages, are developments of particular concern," Greenspan said.

While many bankers around the country may argue that they have little or no exposure to these riskier loan products because they only originate more traditional ARMs and fixed-rate loans or sell all of their "riskier" production and, therefore, do not retain any of the credit risk, we believe that this is a very naïve view and would caution bankers against this sort of complacency. Although it may be true that banks that have stayed away from these riskier loans may have little direct exposure to them, they are directly exposed to any impact that these loans might have on the overall housing market. Should homebuyers or investors, who are using these increasingly popular, much riskier loan products, run into trouble as interest rates rise and home price appreciation slows, many of them could be forced to sell their homes, putting further pressure on home prices. This could create a ripple effect on the entire housing market that would directly impact the loans and credit quality of even those banks that have specifically stayed away from these riskier types of loans.

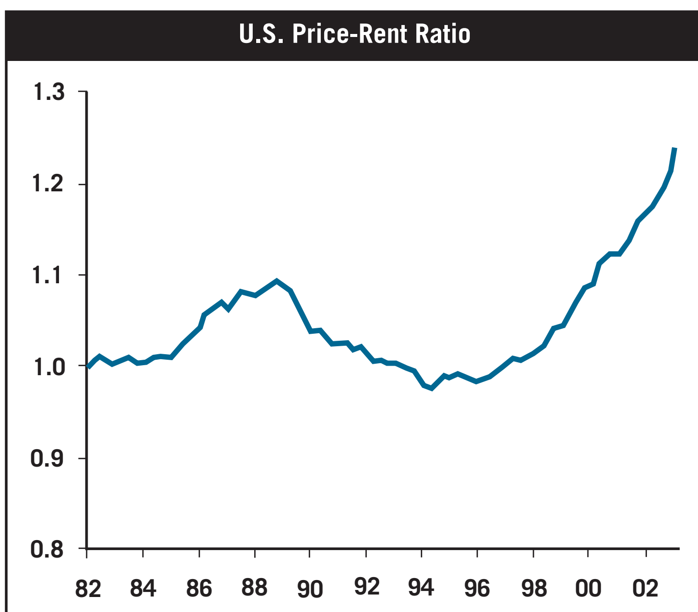
The Rise of the Real Estate Speculator

The rise of interest-only mortgages and related products has occurred hand-in-hand with a sharp increase in speculative activity in the housing market. In 2004, 23% of homes were purchased for investment, compared to just 10% in 2003, according to the NAR. An additional 13% were purchased as vacation homes, according to the trade group. ***In other words, less than two-thirds of homes bought in 2004 were purchased as primary residences by those who planned to live there***. The rise in speculative activity appears to be continuing into 2005, as more and more "investors" look to the housing market as a "can't-lose, get-rich-quick" proposition that requires little or no upfront investment capital. In some hot markets, the investor share of home purchases exceeds 20%, and in certain pockets – condo developments in downtown Miami, for instance – anecdotal evidence suggests that investors account for 50% or more of housing purchases.

A significant portion of investor purchases are financed with the riskier mortgage products discussed above, which weight principal and interest payments to the later years of the loan's term, increasing the investor's return if he or she is able to sell for a quick profit. New condominium developments have become the focus of frequent investor activity. In some cases, condos have been bought and sold multiple times before the unit has even been completed, leading some builders to attempt to crack down by requiring minimum holding periods or higher down payments. This phenomenon is reminiscent of the mid-1980s, when a large number

of speculators were drawn to the strong real estate market. The exit of many of these investors in the early 1990s contributed to the sharp decline in real estate values early that decade. We are concerned this phenomenon may repeat itself when the current housing boom ends.

It is important to place this level of speculation in the context of the traditional motivation for the purchase of an investor property. In the past, these transactions were based on the idea that the investor would charge enough rent on a property to more than cover the monthly mortgage payments and related expenses, providing positive cash flow on the investment while the home gradually appreciated over time. However, that value proposition has shifted as rents have stagnated while home prices have reached record highs. ***Rental yields (rental income/home price) have dropped dramatically and in many cases now result in a negative carry on the property*** – in other words, the mortgage, taxes and other expenses are greater than the rent payments. As a result, an ever-increasing number of investors are buying properties just on the prospect of flipping them for a higher price in a short period, with little consideration for rental yields, the traditional driver of residential investment activity.



Sources: OFHEO and BLS

This disconnect between rents and home prices can easily be seen when looking at the recent trends in the nationwide price-to-rent ratios, which measure the change in existing home prices in the U.S. relative to rental rates since both data sets became available in 1982. It is quite obvious that generating an adequate return on an investment property through the collection of rental income over time is no longer a consideration for many residential real estate investors. Anecdotally, one needs only to look at the extraordinary number of apartment-to-condo conversion projects that are currently underway in many of the hottest housing markets to witness this dynamic – where traditional, more experienced real estate investors are taking advantage of the extraordinary price environment by cashing out now, realizing that they can generate a greater risk-free return on their investment by selling their buildings today than they would through renting them out over a number of years.

The increase in speculative activity presents new risks for the housing market. ***First***, speculators help to drive up prices, increasing the affordability gap for those looking for homes in which to live. ***Second***, as with any market, an increase in shorter-term investors can lead to greater price volatility. Clearly, no one is purchasing a home as an investment in hopes that its value goes down. However, there could be a rush for the exits if there are signs of weakness. ***Third***, speculative investors and purchasers of second or vacation homes are weak holders: because these properties are not their primary residences (and because in many cases these purchasers rely more on the speculative mortgages we have discussed previously), these owners would be the first to sell, or might be pushed into bankruptcy, should housing values fall.

Mortgage and Appraisal Fraud

The dramatic increase in home prices has clearly increased incentives for loan officers, mortgage brokers, and other real estate professionals to relax their standards in selling homes, underwriting mortgages and appraising properties. Unfortunately, these practices have contributed to further price inflation, as coercive sales practices, aggressive lending standards and dishonest appraisals can increase the prices consumers pay for homes or allow people, who do not have the sustainable means, to own a home. The sheer increase in volume has placed a strain on real estate firms, lenders and regulators, and has left less time to screen potential employees as staffing levels have grown rapidly. This phenomenon is another playback from the strong housing market of the 1980s, but it is occurring on a much larger scale this time around given the sheer rise in price appreciation and housing activity. The Federal Housing Authority recently reported that it had more than 450 open criminal investigations related to fraud claims covered by federal mortgage insurance, with arrests up 800% over the past four years related to single-family

mortgage fraud. Last year, the FBI announced it had 533 pending mortgage fraud investigations, compared with 102 in 2001.

Appraisal fraud is one of the most damaging practices in the housing industry, and one that appears to have become more common as the housing boom has stretched on. The problem has also been exacerbated by the rise of mortgage brokers, adding a third party that may be responsible for hiring appraisers – and a third commission paid on the value of that appraisal. When a home is purchased or refinanced, a property must be appraised. In many cases the mortgage broker may hire the appraiser. The problem is that the broker is generally paid a commission based on the value of the mortgage. Rising property values, therefore, increase the stakes in the appraisal fraud game, increasing the incentives for dishonesty. In addition, the rise of the mortgage securitization market, as well as the increased role of Fannie Mae and Freddie Mac in the secondary mortgage market, means that mortgage lenders are holding fewer loans that they originate, providing less incentive to ensure an accurate appraisal.

Appraisers can face pressure from lenders or agents to give an inflated value for the property, or may lose future business if they do not "hit the number." One of the more comprehensive studies on this topic was conducted in late 2003 by October Research's National Appraisal Survey. ***The firm surveyed 500 appraisers in 44 states, 55% of whom said they had been pressured to overstate property values.*** More recently, 8,000 appraisers signed a petition to the federal government complaining of pressure to engage in appraisal fraud. And an April 2004 report by the Mortgage Asset Research Institute found that appraisal fraud represented anywhere from 10% to 38% of mortgage fraud cases annually in the U.S. from 2000 to 2003. In our last housing piece, we also discussed the dangers of fraud and other improprieties among non-profit groups that provide housing finance for low-income consumers. We continue to view these non-profit groups as another factor that is artificially driving up housing prices in the current market.

Summary

In this piece, the first edition of our 2005 two-part housing series, we have discussed the genesis of our now long-standing housing boom as well as the catalysts that have continued to fuel this boom; namely, the persistence of low long-term interest rates, the advent of more creative and riskier mortgage products, the increased role of speculators and the increased incidence of fraud. Consumers, in their quest to buy bigger and better homes and to profit from housing investments, have been aided and abetted by not only record-low interest rates, but also the financial services industry, which has risen to the occasion by providing an array of products that provide the illusion of affordability. As a result, the U.S. consumer now sits in an extremely precarious position, facing record-high mortgage and unsecured debt. And this situation will, without doubt, become even more complicated in the future.

In the second and final installment of this housing series, we will address these and other relevant issues at greater length and also examine the bull case argument for the current housing boom, including the positive demographic trends and other sustainable developments that have clearly helped to fuel some of the recent strength in the housing market. In addition, we will provide evidence that demonstrates that the U.S. is currently in the midst of a housing bubble, despite some of those positive underlying dynamics. Finally, we will offer our answer to what is the most relevant question relating to the housing market today, if not to the U.S. consumer and entire economy as a whole. That is, how and when will this seemingly everlasting housing boom finally come to an end? In other words, when will the other shoe finally drop?

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