

Industry Update

The State of the U.S. Housing Market Living the American Dream....But at What Cost?

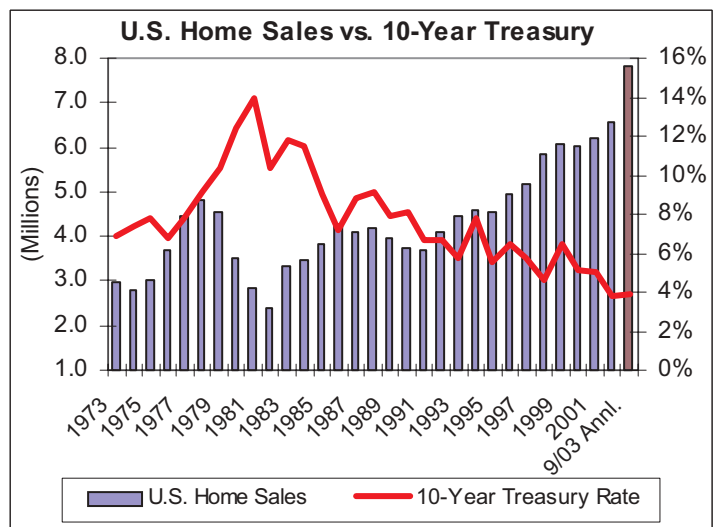
December 2003

Fueled by record low interest rates, rising incomes and strong demographic trends, housing demand has remained at record levels over the past few years, as more and more households have sought to achieve the American Dream of homeownership. In turn, this strong demand has led to extraordinary home price appreciation throughout the U.S., particularly along the coasts and in many major metropolitan areas. In a perverse way, these rising home prices have further stimulated housing demand as expectations for future price appreciation have driven an increasing number of households and investors to look to residential real estate as a “relatively safe” way to generate wealth.

Yet, there are warning signs on the horizon that suggest the booming housing market may soon be coming to an end and, in certain market areas, be on the verge of a bust – causing serious problems for many homeowners and the financial institutions that have financed their home purchases. Bankers and investors should carefully monitor these warning signs and be prepared for the potential fallout from a deteriorating housing market – namely, rising delinquencies and foreclosures and falling stock prices for those companies involved in the residential construction and consumer finance industries.

Home Sales on Pace for Third Straight Record Year

Coming off record years in 2001 and 2002, home sales are on pace to set another record in 2003. According to the National Association of Realtors, existing home sales, which account for roughly 85% of all homes sold, rose to a record annual rate of 6.69 million in the month of September. Combined with new home sales, which were down slightly from a record 1.2 million homes in June, total U.S. home sales reached a record annual rate of 7.84 million in September, almost 20% higher than total sales of 6.54 million in 2002. As can be seen, however, much of this rise in home sales has directly corresponded with the extraordinary decline in interest rates that has occurred over the last twenty years.

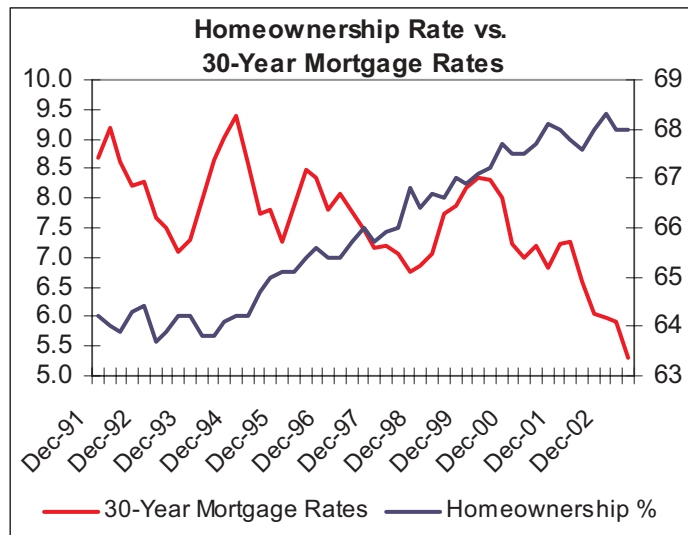


Source: National Association of Realtors

Strong Demographic Trends Lead to Record Homeownership Rates?

While it is clearly evident that falling interest rates have had a significant impact on home sales over the last two decades (particularly in the last five years), those with a more bullish view of the housing market would argue that increased household formation and rising homeownership rates have been the primary drivers of housing demand, both of which have been supported by strong demographic trends (i.e., an aging baby-boom generation reaching its peak homeownership years; their children – the echo boomers – entering adulthood and purchasing homes for the first time; and continued strong immigration). According to the 2000 U.S. Census, 13.6 million new households were created from 1990 to 2000, bringing the total number of U.S. households to 105.5 million, an increase of 14.8% (1.4% on an annual basis). Yet, total home sales increased by more than 60% over that same time period.

Although it is difficult to discount the impact that favorable demographic trends have had on overall household formation, the correlation with rising homeownership rates is much less clear. Since 1993, the homeownership rate in the U.S. has risen from just under 64% of all households to a record 68.3% at the end of 2002. Although some of this increase may be due to changing demographic trends and an increase in minority homeownership rates, it is also apparent that the recent rise in the overall homeownership rate has been very closely correlated with the sharp decline in mortgage rates. More and more households that were previously unable to afford a monthly mortgage payment have taken advantage of lower interest rates to make their first home purchase.



Source: U.S. Census Bureau

Extraordinary Housing Demand Leads to Extraordinary Home Price Appreciation

Regardless to what one attributes the extraordinary housing demand and record home sales, it is obvious that this strong demand has led to extraordinary home price appreciation over the last few years. According to Freddie Mac, the average U.S. home price has increased by almost 40% in the last five years. Home price appreciation has been even more robust along the coasts and in many major metropolitan areas, with cities like San Diego, San Francisco, Boston and New York all experiencing price appreciation of more than 70% over the last five years.

In just the last year, home prices in San Diego and Miami are up an extraordinary 14%. To put that in

U.S. Home Prices 5-Year Price Appreciation Rank		
1	San Diego	87.5%
2	Sacramento	82.0%
3	San Francisco	78.1%
4	Boston	77.2%
5	New York City	74.3%
6	Orange County, CA	73.6%
7	San Jose	73.5%
8	Los Angeles	63.7%
9	Miami	57.1%
10	Washington	54.5%
11	Denver	50.0%
12	Philadelphia	42.0%
13	U.S. Average	39.4%

perspective, overall inflation in the U.S., as measured by the Consumer Price Index (CPI), has been only 12.6% over the entire five-year period.

Although some of these price increases can be attributed to rising income levels, much of the recent increase in home values can be directly tied to the record low interest rate environment. As we have outlined in past *Industry Updates*, many homebuyers are now valuing real estate simply on the affordability of the monthly payment, rather than the true underlying value of the home. As an example, consider the following scenario in which a homebuyer first purchased a \$200,000 home five years ago, when 30-year fixed mortgage rates were around 7.25%. In this case, the homeowner’s monthly mortgage payment would have been \$1,323.

Now, let us assume that five years have passed and the original homeowner wants to move and sell their home. However, 30-Year fixed mortgage rates have now fallen to 5.25% (the average level reached in June of this year according to Freddie Mac). In this case, let us assume that a new buyer can also afford the same original monthly payment as the original purchaser (\$1,536 - adjusted for inflation). With the lower mortgage rate, the new buyer would now be able to pay \$78,158 more for the same house, while maintaining the same inflation-adjusted monthly payment as the original purchaser. This equates to a profit of more than 39% for the original purchaser. It is very easy to see, from this example, how lower interest rates have affected overall housing demand and the prices that buyers have been willing to pay for their homes.

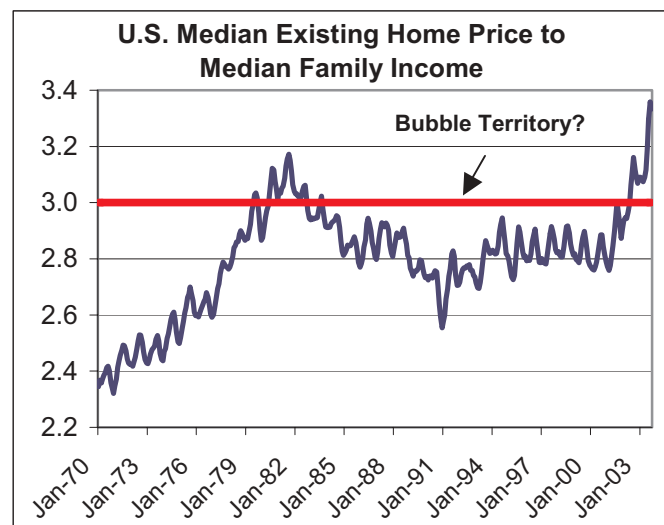
Home Purchase Price Example #1		
	<u>Original Buyer</u>	<u>2nd Buyer</u>
House Price	\$ 200,000	\$ 278,158
Mortgage Rate	7.25%	5.25%
Monthly Payment*	\$ 1,364	\$ 1,536
Change in Price		39.1%

*2nd Buyer Monthly Payment Adjusted for 12.6% Inflation

Warning Signs on the Horizon – Are We in Bubble Territory?

Although the recent level of home sales suggests that housing demand remains extremely strong, there are a number of warning signs on the horizon that suggest the housing market and home price appreciation may soon be headed for a decline.

As outlined, home values have risen at an extraordinary pace over the last few years. Although price appreciation has been subdued in some areas of the country, prices are now at or near what many would consider bubble levels in many major metropolitan areas and along the coasts. As can be seen, the median home value across the U.S. has increased to almost 3.4x the median family income, far surpassing the previous peak reached in the early 1980s. Holding income levels constant, home prices would



Source: National Association of Realtors

holding income levels constant, home prices would

have to decline by almost 18% to come back down to the average level of 2.8x the median family income that existed for most of the 1990s.

Many argue that the recent rise in home prices can be justified and maintained by the fact that record low interest rates have lowered monthly mortgage payments and kept housing affordability at relatively high levels. However, what this argument fails to take into consideration is the prospect of rising interest rates and the significant effect that higher mortgage rates have on overall housing affordability. Since July, when Freddie Mac’s index of 30-year fixed mortgage rates reached a record low level of 5.21%, mortgage rates have increased by almost 80bp and are now hovering around 6%. Some contend that this rise in rates – and the prospect of even higher rates – is irrelevant to those homeowners who have already locked in a low mortgage rate for 30 years. However, they fail to consider that most homeowners typically stay in the same home for less than seven years and many are often forced to move prematurely due to changing work and marital situations. In those cases, rising mortgage rates will clearly have an effect on housing affordability.

Moreover, with the recent rise in interest rates, more and more homebuyers are now opting for adjustable rate mortgages (ARMs) in an effort to keep their mortgage rates low and continue to buy as much house as possible. ARM loans now account for more than 27% of all mortgage applications. While buyers may be able to lower their mortgage rates in the short-term by choosing an ARM, these loans provide little or no protection in a rising interest rate environment, putting the homeowner at significant risk of higher mortgage payments should interest rates continue to rise.

Home Purchase Price Example #2				
	<u>Original Buyer</u>	<u>2nd Buyer</u>	<u>3rd Buyer #1</u>	<u>3rd Buyer #2</u>
House Price	\$200,000	\$278,158	\$225,162	\$204,455
Mortgage Rate	7.25%	5.25%	7.25%	8.25%
Monthly Payment*	\$1,323	\$1,536	\$1,536	\$1,536
Change in Price		39.1%	-19.1%	-26.5%

*2nd and 3rd Buyer Monthly Payment Adjusted for 12.6% Inflation

As we illustrated in a previous example, with interest rates 200bp lower than they were five years ago, a new homebuyer was able to pay 39% more than the original purchaser, while maintaining the same inflation-adjusted monthly mortgage payment. However, let us now assume that some time has passed, mortgage rates have risen back to those original levels, and the second buyer must now sell their home. In this case, if a third buyer were also only able to afford the same monthly mortgage payment of \$1,536, they would only be able to pay \$225,162 for the same house. This is almost \$53,000, or more than 19%, less than what the second buyer paid for the home. Under this scenario, the second buyer would either be forced to sell the home at a loss or stay in the house and wait until another buyer came along who was willing and able to pay more – a tough predicament if the seller was forced to move due to a changing work or marital situation. As can be seen, this drop-off in price would be even more pronounced if interest rates were to rise even higher to 8.25% – a level seen just three years ago.

Fraud and Price Manipulation – The Curse of Any Overheated Market

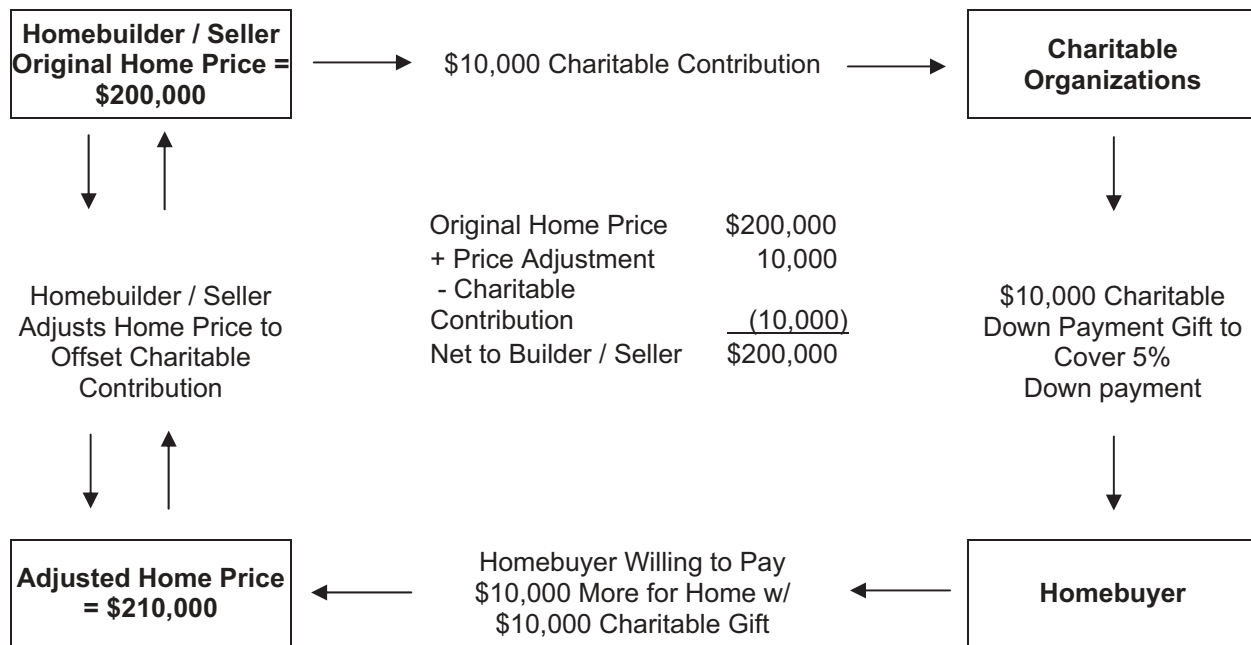
Although lower interest rates and strong housing demand have been the biggest influences on home price appreciation over the last few years, there are a number of other dynamics in the real estate market that have helped fuel the recent rise in home values. Among these has been the undue pressure that unscrupulous loan officers, mortgage brokers and real estate agents have placed on home appraisers to raise their estimates of property values in order to come up with a value necessary for a sale or refinancing to be completed.

According to the ongoing National Appraisal Survey being conducted by the October Research Corp., within the last year, nearly 75% of all appraisers had felt pressure from a mortgage broker to “hit a certain value.” Of those appraisers who reported pressure, 48% said that the overvaluations demanded were 1 to 10 percent above the true market value of the properties, while 43% indicated that valuations between 11 to 30 percent above market value were demanded. Many appraisers have little choice but to meet those demands or run the risk of losing future business to another appraiser who will – a dynamic that has undoubtedly led to artificially inflated home prices throughout the country.

Our conversations with a variety of people in the mortgage industry further support these findings and suggest that this form of artificial price inflation has been widespread throughout the industry. This dynamic should be particularly disconcerting to banks and other lending institutions, as they look to these appraisals to establish loan-to-value (LTV) ratios and other lending limits when extending credit. In effect, a bank that makes a typical 80% LTV loan on a home whose appraised value has been artificially inflated by 20% is actually lending almost 100% of the true underlying value, leaving little or no real equity in the home to protect the bank in the event of a default. This dynamic is very reminiscent of the problems that plagued the commercial real estate sector in the mid to late 1980s, when a booming commercial office market and exaggerated property appraisals let real estate developers put less and less of their own money into their projects – leaving banks with little to fall back on when the commercial real estate market cratered.

Another recent development that has contributed to artificially inflated home prices in many areas of the country has been the proliferation of a number of charitable organizations that provide down payment assistance to low-income homebuyers. These organizations receive so-called “charitable contributions” from homebuilders and sellers and pass along those contributions to prospective homebuyers. In turn, the homebuyers use these charitable contributions to pay for the down payment on the home they are purchasing at an inflated value, while receiving a loan guaranteed by the Federal Housing Authority (FHA) to finance the remainder of the purchase price. As outlined in a recent article in *The Wall Street Journal* describing this practice, roughly 17,000 Americans per month buy homes with down payments from such gifting groups (approximately 3% of the total housing market), which turn around and collect contributions covering those gifts from the seller.

While this practice may seem innocent on the surface, evidence suggests that a significant proportion of homebuilders and sellers merely raise the price of the home they are selling to offset the cost of their charitable contribution, further inflating home values. As can be seen, the net effect to the homebuilder/seller is essentially nothing, as they ultimately receive the same value through the inflated amount of the home price as the amount they contributed to the charity.



Although these loans are guaranteed by the FHA and pose little or no credit risk to the lender, they distort comparative sales figures used by appraisers in their valuations and lead to artificially inflated home prices in many areas of the country where these programs are prevalent.

It is also important to recognize that other, often more serious, forms of loan fraud become much more prevalent in overheated housing environments. These other types of fraud typically involve mortgage brokers and loan officers falsifying documentation and submitting incorrect information (e.g., inflated income and asset levels) to underwriters to help borrowers qualify for a home purchase or a higher loan amount. According to the Mortgage Asset Research Institute’s most recent Mortgage Fraud Survey, conducted in the third quarter of last year, 60% of the lenders who responded said that the number of fraud cases they were seeing had either risen moderately or significantly in the last six months, while 65% said that the average potential loss was rising moderately or significantly. While much of the loan fraud that takes place – and the associated losses – is masked in a strong housing market with rapidly appreciating home values, these fraudulent practices will become much more noticeable and have a significantly greater impact on the banking industry in a deteriorating housing market.

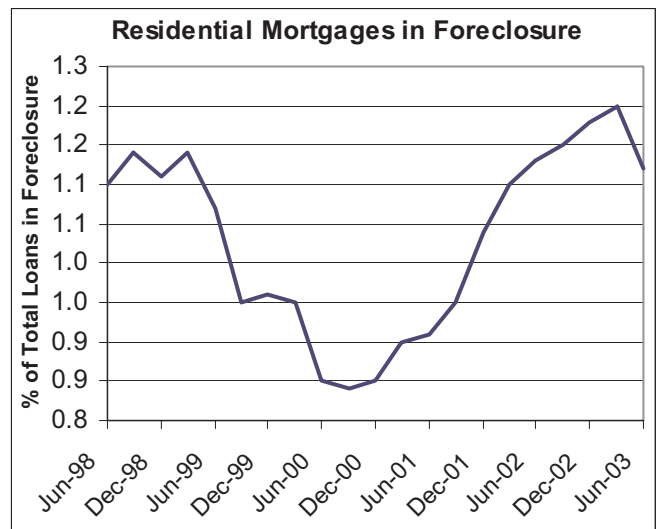
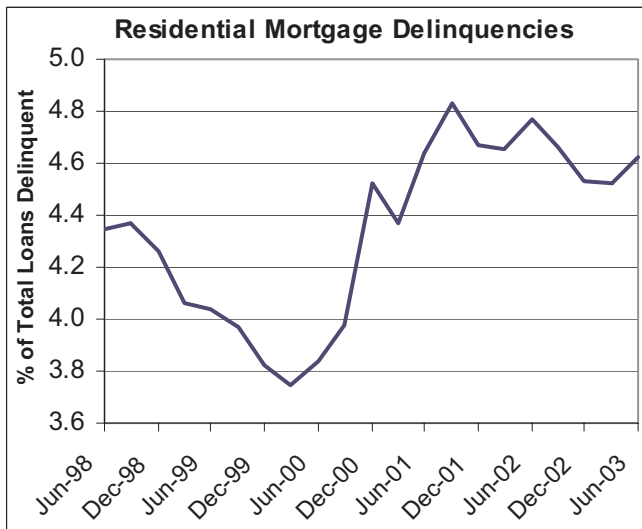
Rising Interest Rates Have Already Slowed Housing Appreciation

Although we have yet to see a slowdown in overall home sales, it is clearly evident that the pace of home price appreciation has slowed in recent months. According to the most recent House Price Index released by the Office of Federal Housing Enterprise Oversight (OFHEO), the average U.S. home price increased by only 0.78% in the second quarter, or an annualized rate of 3.12%. This was the fourth consecutive quarter in which home price appreciation slowed and the lowest level of appreciation since the third quarter of 1996. On a regional basis, 19 of the 220 Metropolitan Statistical Areas (MSAs) included in the index experienced negative quarterly growth in the quarter, with many previously high-growth MSAs, such as San Jose, Denver and Philadelphia, showing little or no growth.

Even more recent data gathered by the National Association of Realtors shows that the median single-family home price in the U.S. has declined by more than 5% over the last two months, falling to \$172,300 in September from a peak of \$181,600 reached in July. It is no coincidence that this decline in home prices corresponded with an almost 80bp increase in mortgage rates over the same time period. Although 30-year mortgage rates are not currently at levels that should seriously affect housing demand and overall home prices, banks and other lending institutions should carefully consider the impact that rising interest rates could have on their borrowers' ability to pay their mortgages and the value of the collateral backing those mortgages.

A Game of Hot Potato – Who Will Be Left Holding the Bag?

Another unsettling trend that does not bode well for the banking sector has been the recent rise in residential mortgage delinquencies and foreclosures. Despite a booming housing market and the positive impact that record low interest rates have had on lowering homeowners' monthly mortgage payments, both delinquencies and foreclosures have been on the rise since reaching 15-year lows in mid 2000. Yet, actual residential loan losses have been virtually nonexistent throughout the banking industry. The primary reason for this divergence has been the extraordinary appreciation in home prices we have experienced over the past few years.



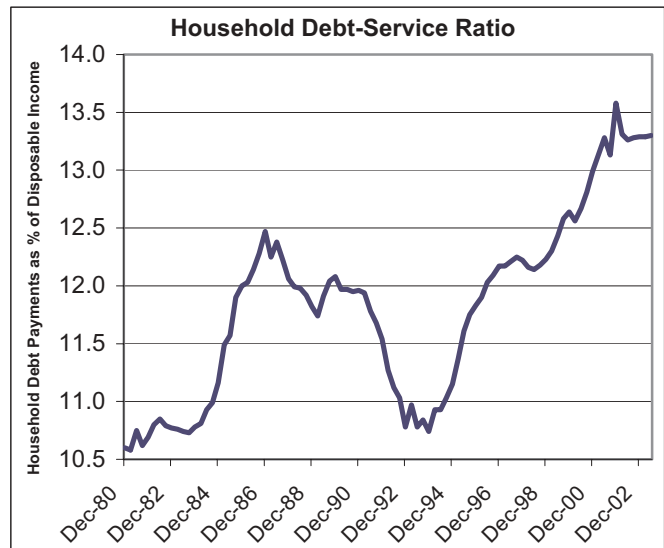
Rising mortgage delinquencies and foreclosures are relatively easy for financial institutions to manage in periods of rapidly rising home values. During such times, most homeowners are easily able to build a significant amount of equity in their homes. As such, rather than let the lender repossess their home and lose the equity that they have already built up, most homeowners will simply sell their home or refinance their mortgage with another institution as soon as they begin to fall behind on their payments – resulting in no loss to the original lender. And, in those rare cases where a bank is forced to repossess the home, they are typically able to sell the home with minimal or no loss.

However, this game of hot potato could quickly come to an end in a period of flat to declining home prices, with banks and other lending institutions left holding the bag. In such an environment, it becomes much more difficult for homeowners to build up equity in their homes, leaving many who are unable to keep up with their monthly payments with no other choice but to turn their property over to the bank. At the same time, without the recent price appreciation and built up equity to act as a cushion, it becomes much more difficult for the bank to sell the home

without taking a loss. This dynamic becomes even more worrisome when you consider the impact that inaccurate appraisals have had on artificially inflating many home prices. As a result, we could see significantly higher residential loan losses throughout the banking industry if home price appreciation continues to slow.

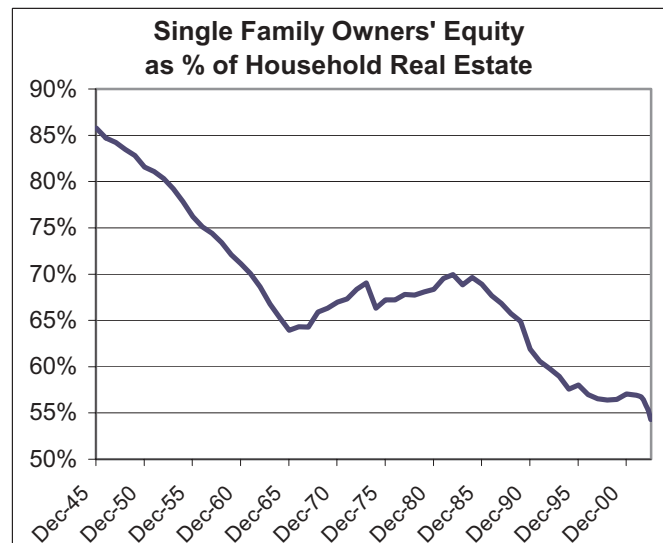
Slowdown or Bust? – Fallout from a Slowing Housing Market

Unfortunately, despite the extremely low interest rate environment and booming housing market, consumer balance sheets are arguably in worse shape today than they were three years ago when interest rates were almost 300bp higher. Consumers have continued to increase their level of borrowing and extract equity from their homes in order to finance their continued spending in a weak economic environment. As can be seen, even with the significant decline in interest rates over the last decade – which should have resulted in lower overall interest payments – the household debt service ratio has continued to climb.



Source: Federal Reserve

Even more concerning has been the recent trend in homeowners' equity. At the same time that home values have been rising to record levels, the overall level of owners' equity in their homes has been declining to record lows. Since the early 1980s, when home values reached their previous peak relative to median family income and the overall level of owners' equity reached a near-term high of 70%, owners' equity has steadily declined – reaching an all-time low of 54% this year. This trend is clearly counterintuitive, as one would expect rising home values to lead to increased levels of equity. Yet, with lower and lower down payment requirements and the continued extraction of equity through home equity loans and “cash-out” refinancings, the overall level of homeowners' equity has continued to decline.



Source: Federal Reserve

Summary

While we will discuss various macro- and micro-economic issues and their impact on the overall economy in much greater detail in our first 2004 *Industry Update* and economic overview, we believe that it is extremely important for financial institutions to be aware of the factors that could lead to the potential fallout from a slowing housing market.

In particular, banks and thrifts with large residential and consumer loan portfolios should carefully evaluate the adequacy of their reserves, with the realization that reserve levels based on historical loss rates over the last few years – which have been extremely low due to the booming housing market and continuous refinancing and repackaging of marginal credits – may be inadequate in a period of rising interest rates and flat to declining home prices. Lenders should also reexamine their residential underwriting standards and loan-to-value requirements, with the understanding that the true value of the collateral backing those mortgages may have been overstated at the time of origination and also be at risk of declining in a slowing housing market, particularly in those markets that have experienced the greatest level of home price appreciation.

It is important to point out, however, that there are many areas of the country that have not experienced the same extraordinary level of home price appreciation that we have seen along the coasts and in many major metropolitan areas. For example, many states in the central part of the country (i.e., Arkansas, Indiana, Idaho, Nebraska, New Mexico, North Dakota, Tennessee, West Virginia and Utah) have seen home prices increase by less than 20% over the past five years – not that much higher than the rate of inflation. Lending institutions in those particular markets should feel much less of an impact from a slowing housing market.

Another factor that should be carefully evaluated by banks and thrifts that have aggressively promoted ARM loans and prime-based home equity products is the impact that rising rates and interest payments will have on their borrowers' monthly payments and ability to service their debts.

Finally, those institutions with large, fixed-rate residential loan and mortgage-backed securities (MBS) portfolios should carefully analyze their asset/liability mix and current interest-rate sensitivity, with the understanding that traditional assumptions regarding the duration and extension risk of those portfolios may be extremely inaccurate given the record-low interest rate environment out of which we are coming. The rapid decline in interest rates we experienced over the last few years dramatically accelerated prepayments and shortened durations. However, the reverse will happen in a rising rate environment, with prepayments drastically slowing and durations extending, placing banks and thrifts with large fixed-rate mortgage and MBS portfolios at significant interest-rate risk – particularly those institutions that have aggressively utilized the “carry trade” of borrowing short and lending/buying long.

All in all, we would caution banks and thrifts to carefully monitor the warning signs of a deteriorating housing market and, in light of the potential fallout, ensure that they have not taken any undue credit or interest rate risk.

If you would find it helpful to discuss the status and outlook for the housing market at greater length and how a slowing housing market may impact the overall banking and thrift industries or your institution's financial health and market value, we would welcome the opportunity to meet with you. Please feel free to contact us in Washington, D.C. at 202-775-8109, in Chicago at 847-991-6622, in Newport Beach at 949-566-9454, in San Francisco at 415-288-0730, or in West Palm Beach at 561-659-0061.

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