

As presented on mortgage market guide... a cover story regarding ... Current State of Mortgage Financing...What's Going On?

by Barry Habib and Sue Woodard- Sept 2007

We're living through very historic times in the mortgage industry - times that people will refer back to for decades to come. And in recent weeks, there has been increasing angst and consternation over the state of our industry. One of the larger lenders in the US, American Home Mortgage, was recently forced to shut down operations. But why? What is happening, what does this mean to you and your clients, and where are things headed next? Let's take a look at what is happening together, so that you really understand the truth behind the headlines, and more importantly - understand what you should do right now.

Over the past several years, you know that many loans were made to homeowners with somewhat non-traditional or "non-conforming" situations, be it a poor credit history, inability to document income, or any number of factors that do not fit within the traditional "box" for home loans. These loans are often called "Sub-Prime", or "Alt-A", meaning that they are somewhat riskier in nature than "A" credit, prime, or traditional loans. There were also many adjustable rate loans done that were considered somewhat "exotic" - that may well have an ideal client that they are suited for, but may have been sold to many others that did not fully understand what they were getting.

As you also probably know, another type of "non-conforming" home loan is one where the credit and income might be perfectly fine, but the loan amount is higher than \$417K, which is the current maximum loan that can be done using pools of money from mortgage giants Fannie Mae (FNMA) and Freddie Mac (FHLMC). If the loan amount is higher, it can certainly be done - this is of course a "jumbo loan" - but the end money comes from private institutions, not from the large government sponsored entities of Fannie and Freddie.

Most non-conforming loan product rates popped significantly higher, almost overnight. Here's what happened.

The end investor for Subprime or Alt-A loans will charge a premium for taking on a pool of these loans, because they know that traditionally, they might have a higher rate of default and delinquent payments within that risky pool. But lately, default and foreclosure has been on the rise - partly due to the fact that with credit tightening and a soft real estate market, many troubled homeowners are unable to refinance or sell in order to get out of trouble. So now, these end institutions are demanding a much higher "risk premium" for taking on these pools of loans, as they see the rates of default are climbing higher.

But since these institutions are purchasing these pools of loans sometimes months after the borrower has actually closed at a given rate, this increase to the risk premium means that instead of paying \$101K for a \$100K loan that will bear interest, they may only be willing to pay \$95K for that \$100K mortgage to account for the risk. Multiply that times thousands upon thousands of loans...and you have millions upon millions of dollars in loss for the company trying to sell the pool at a much lower price than they were expecting. This is called a "liquidity crisis", and is exactly what happened to American Home Mortgage - there was no mismanagement, but they simply got caught holding too many "hot potato" loans, forced to sell them at massive losses...and eventually they had to make the decision to close the doors and stop the bleeding.

Further, even when a lender is able to take some losses, they may be subject to a "**margin call**". This means that as their losses and risk premiums increase, the value of their loan portfolio decreases. As the value decreases, the credit lines that are secured by those portfolios begin to issue margin calls as the value of the asset that they are secured on is now diminished. This is exactly like margin calls in the Stock market. If you have a loan against a Stock that is losing value, you will get a "margin call" and need to pay down the loan, as the underlying Stock is losing too much value to be considered adequate collateral any longer. So for the big lenders, as their portfolio is losing value due to increased risk premiums and losses...the margin calls start coming in, and they are required to pay down their balances. In turn, this means that they have less availability to fund their new loans, which then exacerbates the problem.

In response to seeing this situation play out in the demise of American Home Mortgage, lenders of other non-conforming loan products increased their interest rates dramatically almost overnight to be better prepared - and likely over-prepared - for increased risk premiums down the road. Even though loans above \$417K are not presently suffering from increased delinquencies like the Subprime and Alt-A loans are, these rates popped higher as well, because they are being purchased by smaller private entities that can't afford to take on any margin of risk.

What happens next? The major damage is probably already done, and the present situation will likely settle out over the coming year. Lenders will stop pulling products off the shelf, and the rates on products that have moved so significantly higher now should trend lower down the road as delinquency rates stabilize.

This is commentary that provides a look into what the markets are doing and the lenders are trying to survive thru. It is predicated by the press. Customer perception is highly tuned to any news that circulates on mortgages.

However, consider these statistics...

Average Rate of Return on the investment in Real Estate (the down payment + Interest paid out + closing costs both in and out) averages 28%, historically.

The average appreciation Rate over the last 43 years has been 6.65% yearly.

w/20% down payment 28.44% is the average rate of 1st year returns.

1 million new housing units need to be built each year to house the growing population.

Inventory tends to build up in a cycle of every ten years except for 1990 where it happened again in 1992 but then went back to every ten years by over increasing again in 2002 this time.

The less you put in to control the homes value, the higher the appreciation of your investment.

With 6.65% on average appreciation of the value of a property, this appreciation money becomes yours whether you put in 5% or 20% down payment. For Financial gains max'd out. It would then follow that 5% down on 4 houses commanding 6.65% each would be more productive than 20% down on 1 home. Of course you have to qualify for all of the homes transactions and there are financial considerations that need to be considered carefully before going along with plans such as these. Please consult with a professional realty partners' agent before acting solely on this information.