

The Housing Market, After the Boom

After going gangbusters for years, the housing industry faces loan problems, weaker building activity and soft prices. John V. Duca, a Dallas Fed vice president and senior economist, tracks the national housing market.

Q: Talk about the recent evolution of the subprime mortgage market.

A: In 2006, subprime loans accounted for 24 percent of mortgage originations, including re-financings. To put things into perspective, the subprime share has more than tripled so far this decade. The rapid run-up coincides with the strong spurt we saw in home construction, home sales and home-price appreciation.

Q: When did the subprime market start to unravel?

A: We started hearing some early rumblings late last year, but it really didn't get noteworthy until February. At that point, we started seeing a noticeable pullback in lending, mainly because loose standards had led to a deterioration in loan quality beyond what lenders had anticipated.

But we can't ignore the fact that home-price appreciation started slowing in late 2006. Borrowers were no longer as able to obtain new financing to service higher mortgage payments.

Until then, rapid home-price appreciation had enabled many homeowners to either borrow more to meet their mortgage payments or sell at a profit and retire their loans. With home prices flat or down in parts of the country, many recent subprime borrowers could no longer tap gains, nor could they sell their homes at a high enough price to cover selling costs, outstanding principal and mortgage payments they'd missed.

Q: What about the so-called Alt-A mortgages we're hearing about?

A: Alternative-A mortgages are loans to buyers who don't qualify for low-risk conforming loans because their credit score is too low, down payment is too low or payment-to-income ratio is too high. In some



cases, borrowers fall into the Alt-A category because they didn't provide the documentation of income normally required to get a conforming loan.

The Alt-A mortgage market is new. In 2001, it accounted for only 3 percent of mortgage originations. But by 2006, Alt-A's share had risen to 16 percent. When you add up subprime and Alt-A, you really begin to appreciate their importance. As recently as 2003, they accounted for 11 percent of originations; by last year, the total had risen to nearly 40 percent.

Q: Have problems with these mortgages caused any ripples?

A: We're likely in the midst of a shakeout that will cause some retrenchment in mortgage availability. We've already seen more than 70 mortgage lenders close, with more sure to follow. Keep in mind, though, that there are still more than 8,000 lenders.

Keep in mind, too, that many subprime loans haven't gone sour, and the advent of subprime lending has increased homeownership. In addition, expanded credit availability has helped younger families buy bigger homes, which will help them avoid many of the costs previous generations encountered

when they bought starter homes, then had to "buy up" four to five years later.

Q: Aren't many of these families in a distressed state because they bought more home than they could afford?

A: Yes, this is suggested by data from the Mortgage Bankers Association, which show that overall delinquencies were running at 4.9 percent in the fourth quarter of last year, up from a recent low of 4.3 percent in the first quarter of 2005. The deterioration is even more pronounced on the subprime side, where delinquencies rose to 13.3 percent from their recent low of 10.3 percent in the second quarter of 2005.

Subprime mortgage problems are concentrated among borrowers who don't have fixed-rate mortgages. The vast majority of subprime loans have teaser interest rates. After two to three years, many reset at higher rates and borrowers in some cases also begin making principal payments. This resetting can trigger a dramatic rise in mortgage payments, which many borrowers are unprepared to make.

Q: Is the worst over?

A: Several questions remain unanswered about the ramifications of the pullback in nonprime lending—regarding home construction, foreclosures and home prices.

Q: OK, let's start with home construction.

A: Unwinding the dramatic rise in nonprime mortgages could have a noticeable effect on home construction beyond what we've seen through the first quarter. Some industry analysts speculate that the lending pullback could slow homebuilding another 10 to 15 percent. At this point, though, it's hard to gauge the full impact. With nonprime lending at nearly 40 percent last year, the effect could be even greater.

Q: What about the outlook for foreclosures?

A: According to the Mortgage Bankers Association, foreclosures initiated in the fourth

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quarter rose to a record high of 0.5 percent. Looking down the road, though, it's difficult to forecast how much foreclosure rates could rise. For one thing, home-price trends have changed dramatically.

The decline in documentation adds uncertainty about the debt service burdens of many nonprime borrowers. According to Credit Suisse, subprime loans with low to no documentation rose from 30 percent in 2001 to 60 percent in 2006. On the Alt-A side, the share of low- to no-documentation mortgages rose from 66 percent to 81 percent.

Q: Finally, where do you think home prices are headed?

A: Open questions remain about how much the increase in mortgage availability in recent years pushed up home demand and prices.

So it's hard to forecast the impact of the recent pull-back in lending. It will likely vary across the country, partly because nonprime mortgages have tended to be used more on the coasts, where borrowers have had to reach to qualify to buy. Take California, for example. In 2006, nonprime loans accounted for 55 percent of originations, compared with 40 percent for the nation.

Previous regional price misalignments have unwound, with home prices remaining roughly flat for many years, while incomes and other prices rose. Nevertheless, some noticeable home-price declines did occur in the early 1990s. But the decade's long

economic expansion allowed households to work through the realignment.

By keeping inflation under control, the Fed hopes to sustain the current economic expansion, which should enable many, but not all, of today's households and lenders to work through their mortgage quality problems.



D'Ann Petersen, the Dallas Fed's regional housing analyst, discusses developments in Texas.

Q: How are Texas housing markets faring compared with those in the rest of the country?

A: They've cooled, but they're holding up better than in other areas. While home sales remain good by historical standards, they've moderated from last year's vigorous pace. That's not to say all Texas markets are in sync. Austin and Houston sales remain at good levels, while the Dallas-Fort Worth housing market is the weakest among the major metros. Hardest hit have been homes priced below \$200,000. Sales remain strong at higher price points.

Builders have pulled back significantly on new home starts, especially in Dallas-Fort Worth, as inventories rose with slower sales, rising cancellations and reduced investor activity. Tighter lending standards have also dampened demand, especially at the market's lower end. Problems with subprime mortgages could reduce starts even more.

Our business contacts remain cautiously optimistic, however. Housing prices have held firm in Texas, unlike other areas of the country, and have even ticked up recently. While there will be some short-term pain from reduced construction and layoffs, the state economy's continued expansion, along

with attractive home prices, bodes well for the Texas housing industry's future.

Q: How much has Texas relied on subprime and Alt-A financing?

A: According to Credit Suisse, subprime mortgages' share of the Texas market was about 22 percent in 2006, slightly higher than the U.S. average of 20 percent. Subprime loans tend to be more prevalent in lower-income areas, which would explain Texas' slightly higher share. Texas' share of Alt-A loans was 13 percent, below the nation's 20 percent.

Q: Why have the state's foreclosure rates tended to be higher?

A: The Texas foreclosure rate began running higher than the national average in 2002. At that time, the Texas economy was mired in a recession, spurred by the high-tech bust. The state had a large share of high-tech employment, and it took several years for job losses to level off. Many who lost their jobs were white-collar workers, so a large share of foreclosures involved conventional prime loans.

The Texas economy has been strong for several years, yet the state's foreclosure rates remain high. This probably has a lot to do with the moderate rate of home-price appreciation during the housing boom. Unlike homeowners in California and Florida, Texans who got in over their heads were unable to tap their home's equity to make mortgage payments.