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2009

The New Financial World

and

Its Impact on Real Estate!

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How Did This Mess Happen?

1933 Ended Commercial and Investment Banking Activities!

Prior to the stock market crash in 1929, both investment and commercial banks took on too much risk, with depositors' money by using those funds for active speculation in the stock market. These banks became greedy, taking on huge risks in the hopes of even bigger rewards. Banking became sloppy and unsound loans were made. Congress deemed that these banks had been the culprit in the crash. In 1933, the Glass Steagall Act was passed to separate investment and commercial banking activities.

Congress and Lending:

In 1977, Congress passed the Community Reinvestment Act which was signed by President Jimmy Carter. This allowed lending to less qualified borrowers, with the hopes of increasing homeownership. By 1994, President Clinton broadened this act by having both Fannie Mae and Freddie Mac use their funds for these types of loans. In 1997, Congress allows both agencies to lower their reserve requirements to 2.5%, allowing more home loans to be made. Other lenders were still required to hold 12% in reserves. In 1999, Congress tells both agencies to ease the credit requirements to low-income buyers.

Gramm-Leach- Bliley Act of 1999:

After many years of investment bank lobbying, Congress passed the Gramm-Leach-Bliley Act in November of 1999 – once again allowing the consolidation of commercial and investment banks into one entity.

From 1999 to 2002, demand for houses and the ensuing price rises could be attributed to economic fundamentals such as low unemployment, expanding household incomes and population growth. With the events of 9/11 and the Fed's later decision to lower the discount rate to 1%, future home buyers were lured (by lower interest rates) into acquiring property sooner than they had planned. At this time, the biggest players (in home mortgages) were Freddie Mac and Fannie Mae, which actively issued and purchased conventional, conforming mortgage-backed securities. Loan volume almost doubled to \$5 trillion by 2002, with Pay-Option ARMs representing only 3% of loans.

Wall Street Takes-Over Lending:

In 2002, federal regulators found (in both companies) irregularities and mismanagement by senior officers, who later resigned. By 2003, regulatory and political factors forced both Freddie and Fannie to significantly lower their future lending volume. With the Gramm-Leach-Bliley Act in place and demand for housing still increasing, the “new” investment banks created private funding in the form of mortgage and asset-backed securities, which replaced the standard conventional lending with looser underwriting standards. In 2004, these investment banks were successful in changing their reserve requirements on securities, which required \$1 in reserves for every \$12 loaned. The new reserve ratio became \$1 to \$40! Now new loan programs (created by mathematicians with PhDs) could be designed to meet the needs of the investment bankers' clients, who were demanding higher returns. By 2005, loan volume had grown to \$9 trillion.

- ◆ 68% of home mortgages were securitized
- ◆ 40% of loans were low or no doc loans
- ◆ Pay-Option ARMs grew to 30% of securitized non-prime mortgages.
- ◆ 33% were non-prime loans

These new lending programs allowed *less-than-credit-worthy* borrowers to obtain loans. With rapidly appreciating home prices, home equity loans were added to the mix and the consumer was living large!

Sources: Glass Stegall Act, Gramm-Leach-Bliley Act, UC Irvine's Paul Merage School of Business, FDIC

The Structured Investment Vehicle (SIV) – The New Lending Instrument!

Even by 2005, charge-off rates for mortgages and home equity loans were well below the long term averages. This allowed Wall Street's new credit environment to continue to offer looser lending standards and increased tolerance for riskier, high-yield loan products. The structured investment vehicle was designed to help diversify these risks.

Their Structure: Sub-Prime, 8.3%; Alt-A ,6.7%; Prime, 13.3%; Residential Mortgage-Back Securities, 0.2%. Asset Backed Securities, 12.1%; Collateralized Debt Obligations, 15.4%; Commercial Mortgages, 7.7%; Collateralized Loan Obligations, 6.3%; Nonfinancial Corporation Debt, 0.2%; Financial Institution Debt, 28%; Insurance Debt, 1.8%.

Participation: U.S./Foreign Banks, 59%; Hedge Funds/Sovereign Trusts, 28%; Insurance Companies, 6%; Pension Funds, 2%; Corporations, 2%; Mutual Funds, 2%; Others, 1%.

What It Allowed Them To Do:

1. Credit was made available to various types of borrowers (sub-prime, businesses, credit card users, leasing contracts, commercial loans, manufacturing, auto loans, etc.) who would otherwise have not been able to obtain such credit.
2. Transferred risk to their off-balance sheets (OBSEs), to reduce reserves.
3. Permitted exposure to remain mostly undisclosed to regulators and investors.
4. Improved loan liquidity; generated fees; obtained relief from regulatory capital requirements.
 - ◆ \$6.8 trillion (out of \$12 trillion in mortgages) are securitized.
 - ◆ 20% are owned by foreign investors, 16% by commercial banks and 16% by Freddie/Fannie.

Their Problems:

1. Default rates exceeded earlier assumptions. Freddie Mac had a projected model (risk factor) of price declines of 13.4%. Today, their Alt-A loans are 10% of its portfolio but more than half of its losses.
2. The three main credit rating agencies were forced to make precipitous downgrades on a large number of these SIVs.
3. To make matters worse, they made long-term loans with short-term deposits. *Auction Rate Securities* (\$300 billion) were “pitched” by Wall Street as money market funds, but they made long term debt instruments with them. This year, legal action was taken by these depositors and Citigroup had to return \$7 billion, Bank of America, \$4.5 billion and Merrill Lynch returned \$10 billion.
 - ◆ Option ARMs were 19.5% of loan volume in 2005 and 28.7% in 2006.
4. Investors did not have a clear idea of what portion of an SIV they owned, with whom they owned it with, what portion (if any) was insured, what was their “tranche” position, and were the insuring companies covering any of the losses. Due to a lack of this knowledge, many investors withheld funding from these very complex structured products, even those with high-quality underlying assets.
5. By the summer of 2007, the securitization market was dead and the credit crunch hit all aspects of the lending markets. With little money for refinances and rapidly falling housing prices, short sales and foreclosures began to dominate the market. Today, these types of sales contribute to almost 50% of all recorded sales in southern California.

Sources: Federal Reserve, Standard & Poor's, Federal Deposit Insurance Corporation

III. The Current State of Orange County Housing

As of December 1st:

- ◆ 12,947 – the current housing supply is 5.29 months.
- ◆ 49.7% – of our entire inventory is priced below \$500,000, representing 69% of the demand
- ◆ 44.8% – of our entire inventory (5,795) is distressed properties, representing 66.0% of demand.
 - a. Short-sales make up 77% of distressed properties with a market time of 7.21 months.
 - b. Bank-owned make up the remaining 23% and have a market time of only 1.40 months.
- ◆ 41.5 % of homes and 27.6% of attached homes are vacant.

In October:

Foreclosure re-sales represent 51.1% of all sales in the State. In southern California last month, 51% of all sales were foreclosed properties.

In California, 27% of homeowners with a mortgage, had no or “negative” equity.

<u>COUNTY</u>	<u>SFR SALES</u>	<u>PRICE</u>	<u>DECLINE</u>	<u>CONDO SALES</u>	<u>PRICE</u>	<u>DECLINE</u>
LA	4,941	\$355,000	32.4%	1,344	\$335,000	20.3%
RS	3,699	\$220,000	37.1%	267	\$195,000	29.3%
SB	2,490	\$190,000	38.7%	127	\$184,000	34.4.0%

With 17 months of declining sales in jumbo purchases, the actual median sales price is greatly distorted.. Normally, 40% of all sales are jumbo purchases; today they represent only 12%!

- (1) Fewer sales reduces the sample size, thus reducing the validity of the conclusions.
- (2) The dominance of foreclosures and short-sales usually concentrated in a smaller area.
- (3) Median sales price is now being distorted by the low-end/smaller property market.
- (4) Larger price declines on distressed sales actually distorts factual metro sales prices.

Sources: Altera Orange County Market Time Report, DataQuick News,

IV. Our Government to the Rescue?

This year, the federal government has tried to “prop-up” both the housing and financial markets through various measures:

1. Economic Stimulus Act of 2008

The IRS mailed out 132 million rebate checks in an effort to help stimulate the economy. Unfortunately, 78% of the rebates went to the payment of bills — not to purchase goods and services in the economy!

2. Housing and Economic Recovery Act of 2008

This was to shore up Freddie Mac and Fannie Mae so that they could continue to bring a steady supply of mortgage capital to homebuyers. The Treasury Department was to inject \$100 billion into each company. Conforming loan amounts were raised and FHA was authorized \$300 billion to help troubled homeowners (HOPE Program) by refinancing their loans. Increasing the loan amounts was also to help lower interest rates for high-priced areas. A new \$7,500 tax credit was given to first-time homebuyers, and \$4 billion was allocated go to Community Development Block Grant funds to purchase and fix-up foreclosed homes. The government also extended “forgiveness” to 2013 on debt losses.

- ◆ In 2007, FHA announced their “FHASecure” program to assist almost 400,000 delinquent borrowers. To date, only 4,000 have been assisted.
- ◆ On October 1, 2008, FHA announced the “Hope for Homeowners” program, designed to assist hundreds of thousands of delinquent homeowners. To date they have received only 111 applications!

3. The Federal Reserve opened its discount windows and allowed troubled banks to borrow from them through “auction securities.” This would allow the banks to strengthen their capital reserves and begin making both residential and commercial loans again. By September, banks had borrowed over \$500 billion dollars but banking problems have still persisted.

- ◆ Commercial banks are borrowing \$94 billion daily
- ◆ Investment firms are borrowing \$52 billion weekly.

4. Emergency Economic Stabilization Act of 2008 . . . or “Re-arranging cards in the House of Cards!”

A massive plan designed to provide the Treasury with \$700 billion to buy or insure troubled securities, with the hope that it frees-up the capital markets and helps stabilize future banks from failing. The plan raises the new FDIC limit to \$250,000; limits pay and ends “golden parachutes” for those companies who participate; and directs federal agencies to modify troubled loans whenever possible through the Troubled Asset Relief Program (TARP). The government will borrow \$550 billion in this last quarter plus an additional \$368 billion in the 1st quarter of 2009, to fund all these rescue programs.

Last week, the Fed announced a new plan to put \$600 billion into purchasing home loans and \$200 billion in loan guarantees for AAA rated asset-backed securities.

- ◆ This year, our government and the Federal Reserve (through loans, capital injections and pledges) have “pumped” \$7 trillion into this financial crisis!
- ◆ FDIC has announced that they will “guarantee” \$1.4 trillion in loans between banks.

Sources: FDIC, Federal Reserve, Economy.com, Bureau of Economics

V. The Challenges

Our Economy is Currently Facing Various Headwinds:

1. Wealth Effect – due to declining assets

- ◆ Household equity is at 46.2% vs. 57% ten years ago.
- ◆ Ca. foreclosures in 2007 totaled 94,969 versus 189,998 for the first 9 months of 2008.
- ◆ Through October, Orange County is averaging 1,021 foreclosures monthly.

2. Price Effect – due to higher energy and food prices

- ◆ When prices rise, consumer and business spending decreases.
- ◆ California home prices are down 47% from their peak – 18.8% yearly average (past 2.5 yrs).
- ◆ Consumer spending is at a 28 year low!

3. Income Effect – due to higher unemployment -

- ◆ Current U.S. unemployment is at a 14 year high (6.5%) – 1.2 million jobs lost so far this year.
- ◆ California's current unemployment rate is 8.2% – highest in 14 years.
- ◆ Orange County's unemployment rate is 6.0%, with job losses exceeding 35,100 in the past year.
- ◆ LA County has an unemployment rate of 8.2% and the county lost 23,600 jobs last year.
- ◆ Riverside's unemployment rate is 10.0% while San Bernardino's is 9.0%. Both counties have lost a total of 19,700 jobs in the past year – the 1st job losses since 1964!
- ◆ Less income, less paid taxes, more pressure on federal, state and personal budgets.

4. Funding Conditions – due to the “credit crunch”

- ◆ This is the 22nd month since sub-prime, housing woes, and weak financials were reported.
- ◆ Regulators and thus the banks (85%) have tightened credit standards for all types of loans.

5. “Spill-Over” Effect

- ◆ The October, delinquency rates on U.S. single-family prime loans were 3.7%. In California, the rate is 4.15%. California's prime loans accounted for 26% of all foreclosures – up 11% from last year. Another 26% were Alt-A loans also up 11%. Sub-prime loans were responsible for the remaining 47%, a decrease of 20% from last year.
- ◆ If prices continue to decline, another tier of properties with exhausted home equity lines or increasing loan balances could set off another round of very large foreclosures.
- ◆ 75% of Option ARMs borrowers are paying the minimum payment. This is causing the recast date to be reached earlier than had been projected. There is \$500 billion worth of Option-ARM mortgages that have yet to recast, with \$300 billion worth of mortgages on California properties.

Sources: Mortgage Bankers Association, U.S. Bureau of Labor, Ca. EDD, Federal Reserve, DataQuick

VI. How The Financial World Is Changing Real Estate

For The Buyer:

- ◆ There are 71% fewer mortgages available than a year ago.
- ◆ There are no more “Bail & Buy” loans.
- ◆ Tightening credit standards are now in place at 85% of our banks.
- ◆ Buyers putting down less than 20%, must have a FICO score of at least 720.
- ◆ All assets and income must be verified and could be re-verified at closing.
- ◆ Larger down payments are required, with points to be paid on the loan.
- ◆ Fixed rate mortgages account for 69% of funded loans.
- ◆ New Jumbo and FHA loan Limits for OC/LA: \$625,000 – Riv./SB: \$355,350 – SD: \$546,250
- ◆ FHA is the new “big” player.
 - (a) up-front insurance premium (MIP) is now 1.75%.
 - (b) over 95% financing, .55% monthly and .50% for less than 95%.
 - (c) “Kiddy Condos” for kids in college.
 - (d) down payment goes to 3.5% on Jan. 1st and credit score of 580.
 - (e) 45% front end and 55% back end debt ratios and 2 year employment history
 - (f) buyer must have a valid Social Security number and be a legal resident of U.S.
 - (g) Owner occupied properties only but “gift” is still available for down payment.
 - (h) Ch 7 BK – discharged 2 yrs. / 1 yr. Ch13 and foreclosure/short sale is 3 years.

For The Lender:

- ◆ FHA appraisers must be certified, which will cause a decrease in the number of appraisers.
- ◆ Some lenders may no longer use “in-house” appraisers.
- ◆ Financial institutions will be held liable for any misleading advertising.
- ◆ Adjustable sub-prime loans cannot have a pre-payment penalty for 4 years.
- ◆ Fixed sub-prime loans can not have a pre-payment penalty for 2 years.
- ◆ Truth in Lending statement must be printed in the native language of the borrower.

For The Investor:

- ◆ less than 20% down, introduces PMI; higher rates; added approval by insurance companies.
- ◆ No more than 4 investment properties can be financed.

For The Seller:

- ◆ Foreclosures and short-sales will continue to dominate the 2009 real estate market.
(NOD's filed in the 3rd Qtr: LA 17,073; RS 11,714; SB 11,714; OC 3,995)
- ◆ Listing prices must be competitive with these properties for a successful sale.
- ◆ Regardless of their expectations, their house will be appraised conservatively.
- ◆ Expect the short sale process to take 4 to 6 months.
- ◆ The buyers are still in control of pricing:
 - (a) give careful consideration to a counter offer.
 - (b) expect to pay for all termite work and repairs disclosed by the inspection report.
 - (c) length of escrow will be the buyer's choice, but market conditions can push it longer.
 - (d) making necessary repairs and improvements ahead of time will help the marketing.

Sources: FHA, Mortgage Bankers Association, Federal Reserve

VII. A Final Perspective

For 2009:

- ◆ Delinquent December tax bills should give us a peek into potential problem properties.
- ◆ It will be late January, at the earliest, before we know if the bailout is beginning to work.
- ◆ The housing market below \$250,000 has most likely reached the bottom.
- ◆ Prices now in the \$350,000 range are close to the bottom.
- ◆ The rest of the housing market will continue to restructure their price levels.
- ◆ Expect foreclosures and short sales to dominate the market through 2010, as Orange County foreclosures will most likely continue to rise.
- ◆ Listing inventory should rise due to the large number of foreclosures set to enter the market.

The Light In The Tunnel:

- ◆ The credit conditions should improve, bringing more buyers into the market place.
- ◆ Demand for properties will continue to be higher than the past three years.
- ◆ American households and investors have \$7.4 trillion in checking, savings, and money market funds (including T-Bills) and it has to eventually have to move someplace. Hopefully, a large chunk goes into real estate lending.
- ◆ Most lenders will recover 60% to 70% of their outstanding loan balances through repossessing homes and then reselling them.
- ◆ Price declines have allowed first-time buyers back into the real estate market.
- ◆ Pent-up demand from buyers, who have been “fence-sitting” for the past couple of years and are now re-entering the housing market, should help sales.

Orange County:

- ◆ It has 4 of the top 20 income-earning cities (NB, YL, IR, MV) in America.
- ◆ It has the 4th lowest unemployment rate in the State and job growth is projected to grow next year at a rate of 1% - adding more than 14,000 new jobs.
- ◆ There are 94,000 small-business employers, of which 62% have fewer than 5 workers and 95% employ fewer than 50 people – leading to stability through diversity.
- ◆ There are 8 billionaires who call this county home. There are 24 in LA.
- ◆ OC ranks 4th in the nation with 113,299 millionaires while LA (#1) has 261,081.
- ◆ Rents are up 4.1% (Oct. to Oct), making OC the 6th highest rental market in the U.S.

Sources: OC Business Journal, WSJ, Federal Reserve, World Wealth Report, U.S. Census, EDD, REIS Inc.

On Success

*“Every man should make up his mind that if he expects to succeed,
he must give an honest return for the other man’s dollar.”*

Edward Harriman