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Ten Events That Shook the Real Estate World

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It was the top story throughout the country: the poor performance of real estate markets, especially residential housing markets, which have been in crisis in most parts of the country beginning in mid-2006. At the time, few observers, including yours truly, recognized the seriousness of the pending decline. Surely things would “return to normal” in a few months. Property value declines continued through 2007 as the credit crunch grew in intensity. Activities accelerated with additional declines throughout 2008, a year few of us will soon forget.

Here is a brief listing and summary of the major events affecting real estate during this period:

#10: The term “subprime mortgages” became part of our vocabulary. With continuing increases in housing prices and the availability of cheap mortgage credit, more and more households entered into homeownership. With this tenure, however, came greater exposure to financial risk through a variety of mortgage instruments. These included adjustable-rate mortgages with aggressive resets, interest-only mortgages and mortgages with 40- and 50-year amortizations. Many of the borrowers who used these instruments were riskier than traditional mortgage applicants and were classified as “subprime” or “Alt-A” borrowers. In an expanding housing market with continuously rising prices, the financial risk was not treated very seriously: refinancing or flipping would be preferred options to covering the contractual obligation. However, by late 2006, house prices began to fall and talk of a “housing bubble” appeared to be gaining credibility.

#9: Foreclosure filings rose significantly during 2007. Typical foreclosure rates in housing markets were a few fractions of 1 percent of the national market. However, with slowing and often declining house prices, the strategy of refinancing to bail out borrowers as they approached resetting of their ARM rates on their subprime loan proved deadly. (Some homeowners never expected to pay the new mortgage payment since it was 50, 75 or even 100 percent of their monthly income!) By early 2007, there were more than 3,000 foreclosure proceedings filed per month throughout the U.S. The use of foreclosures was regarded as a last resort remedy by lenders, since it is costly to file this legal procedure to recover their interests.

#8: Financial problems led to bankruptcies. Ownit Mortgage, ResMae Mortgage and New Century Financial, all large residential lenders, failed in early 2007. These institutions were heavily involved in subprime lending (New Century was the second-leading subprime lender after Countrywide Financial, a bank whose trouble came a few months later.) With weakening conditions in residential housing and credit markets, financial troubles multiplied for these aggressive lenders.

#7: Mergers and acquisitions grew in the mortgage market. Countrywide Financial showed signs of distress and was acquired by Bank of America in early 2008. Bear Stearns was acquired by JP Morgan in March 2008 with controversial federal government assistance. Lehman Brothers filed for bankruptcy on September 15. Few observers predicted that any of these major institutions would fail. Countrywide grew rapidly into a financial giant with subprime lending. Bear Stearns' stock price plummeted so quickly few knew what had happened (JP Morgan purchased for only \$10 per share using Treasury financing). Lehman Brothers was not rescued but instead let go into bankruptcy. This foreshadowed future rounds: troubles at Fannie Mae and Freddie Mac and AIG (see #5 below), Merrill Lynch sold to Bank of America and Washington Mutual sold to JP Morgan in September. Citigroup tried to acquire Wachovia Bank but the deal fell apart.

#6: Mortgage and mortgage-backed security (MBS) write-downs hit Wall Street. Every major player (except one) wrote off major losses from mortgage and MBS transactions. In the third quarter of 2007, these included UBS (\$10 billion), Morgan Stanley (\$9.4 billion), Merrill Lynch (\$8.4 billion) and many others from \$1-3 billion. These were viewed as shocking losses, especially as a percentage of their portfolios. Yet during the next quarter, the losses were considerably larger. Citigroup announced a \$18.1 billion loss, Merrill Lynch wrote off \$15 billion more, UBS lost \$13.7 billion more, AIG announced \$11.1 billion, Bank of America lost \$5.3 billion, and so on. In the first quarter of 2008, the bleeding continued: Citigroup announced \$13.9 billion more, Merrill Lynch had \$6.5 in additional bad loans, HSBC added \$5 billion more and so on. What was shocking was that these were billion-dollar losses by every firm throughout the industry. The only investment bank to avoid the losses was Goldman Sachs, which sold its holdings early in 2006.

#5: Fannie Mae and Freddie Mac became illiquid and nationalized on September 7. AIG, the giant international insurance company, was bailed out with a government loan of \$85 billion on September 17. The cost of the Fannie/Freddie acquisition was estimated to be \$200 billion and as this goes to press, the cost of supporting AIG continues to rise, now perhaps as much as \$150 billion. Fannie Mae and Freddie Mac were the government-supported enterprises (GSEs) which made the secondary mortgage market. In this role, they had enormous holdings and influence on mortgage finance in the US. AIG's business extended to about 130 countries in a variety of ways, including writing credit default swaps, an instrument used to insure firms' corporate bonds between institutions.

#4: "Underwater" took on a new meaning. With growing property values, equity down payments and systematic equity build-up through amortization of typically fixed rate mortgages, borrowers rarely, if ever, owed more than the property was worth. No more: the era of "underwater homeowners" was upon us. By 2008, was estimated that 12-20 percent of homeowners owed more money than their houses' market value. This level was about 7.5 million homeowners but may go as high as 15 million, experts say. However, the early signals existed but were widely neglected: in 2006, 30 percent of new mortgages had no down payments. As soon as prices began to fall, many homeowners were "drowning."

#3: The federal government took an active and historic role in the mortgage markets. Not since the 1930s was the financial system so affected. Working with the Federal Reserve Bank, the Treasury Department developed a wide range of new tools for making credit available to banks and other institutions, often for the first time. In addition, the Hope for Homeowners program was created by and housed at FHA, to rescue homeowners facing foreclosure. Begun October 1, it is expected to save as many as 400,000 households from foreclosure. The results were slow to come in and delinquencies and foreclosures continued to rise. The number of foreclosures is now expected to reach 2.5 to 3 million households, so even if the \$300 billion Hope program reaches all 400,000

households, it will only help a fraction of those in trouble. A larger and increasingly controversial rescue package was passed on October 3 for \$700 billion and included the option of purchasing mortgages and assistance for Fannie and Freddie. With an additional \$150 billion, the federal government's commitment was more than \$1 trillion to this financial crisis, not counting the earlier bailouts!

#2: The nation continued to witness declining house prices. Once thought to be impossible, at least over an extended period of time, there was no doubt that house prices have fallen throughout the country, including now in Pennsylvania. In some markets, the price declines were as much as 40 percent from their peak prices. In other cities, prices had fallen about 10-15 percent. With an increasing supply of houses due to foreclosures, prices continued to fall in most cities. However, aggressive pricing of foreclosed properties has led to a slight uptick in sales activities. For example, it is reported that number of sales is up significantly in Los Angeles as buyers venture into the market at rock-bottom prices. Yet forward contracts as well as the leading indices suggest future price declines in 2009. The bottom did not appear to be forthcoming ... yet.

#1: Finally, welcome to 2009: the "year of the thaw." CNN is cautiously predicting that by mid-2009, the recession will be coming to a close and while the ride has been truly bumpy, it is not nearly like a depression in a variety of ways. Unemployment in the 1930s reached nearly 25 percent, GDP fell significantly more than 10 percent and stock and house prices fell as much as 90 percent. No doubt, those who have been laid off feel the crunch and unemployment rates are expected to continue to rise. Shareholders in many well-known firms cited above have been wiped out. Housing markets have slowed significantly, even in stronger markets including parts of Pennsylvania, causing reductions in transactions and at lower prices throughout the industry. A new year is almost upon us and there are hopes and prospects of a recovering economy. These events have truly shook our world but the future continues to look bright.