

Understanding the Subprime Mortgage “Crisis”

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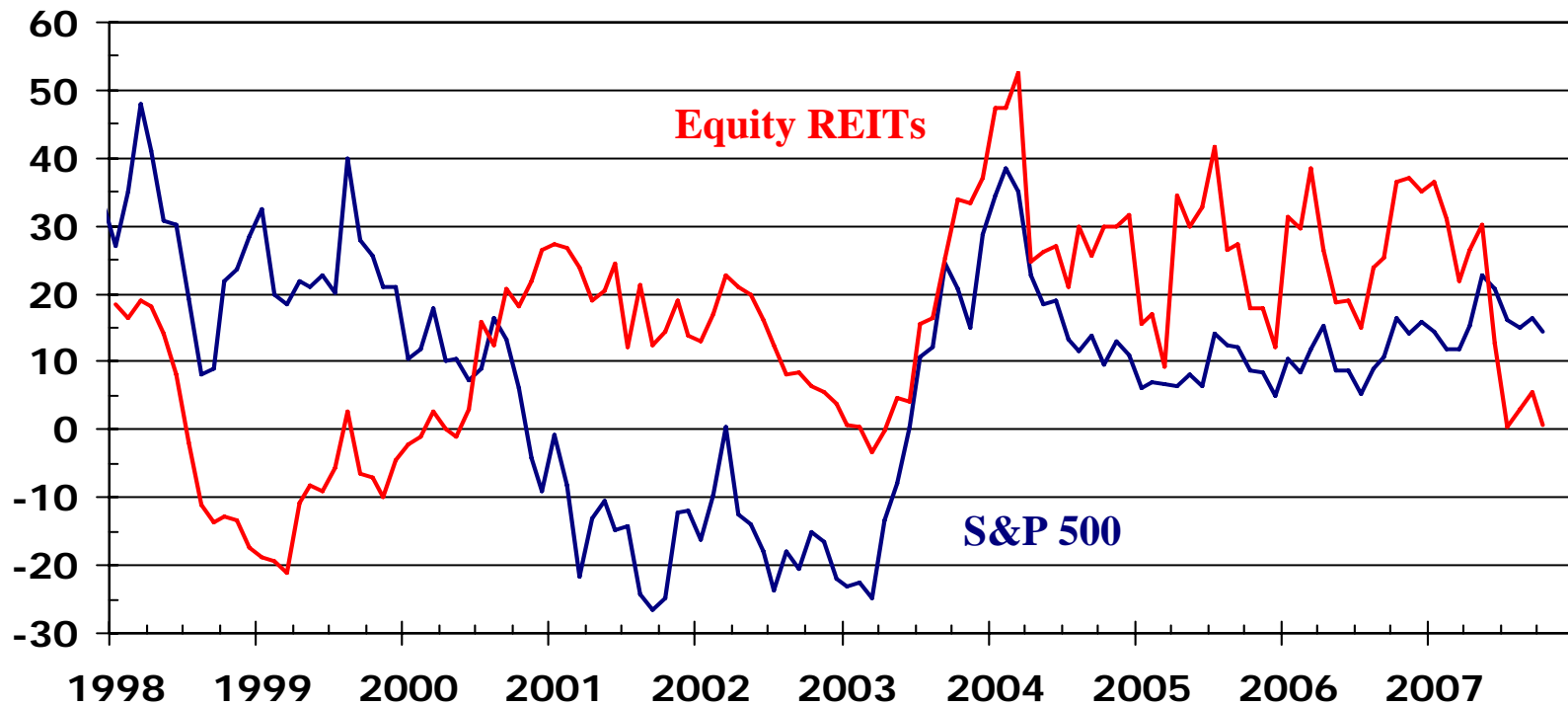


Anatomy of a “Crisis”

- Real estate was the one solid asset class in the wake of the bursting of the “tech bubble” and the 2001 recession
 - Stocks took a beating for nearly 3 years
 - Low interest rates held down bond returns
 - Commercial real estate returns remained strong despite questionable fundamentals

Real Estate vs. Equity Returns

Year-over-year Percentage Change



Sources: NAREIT; S&P

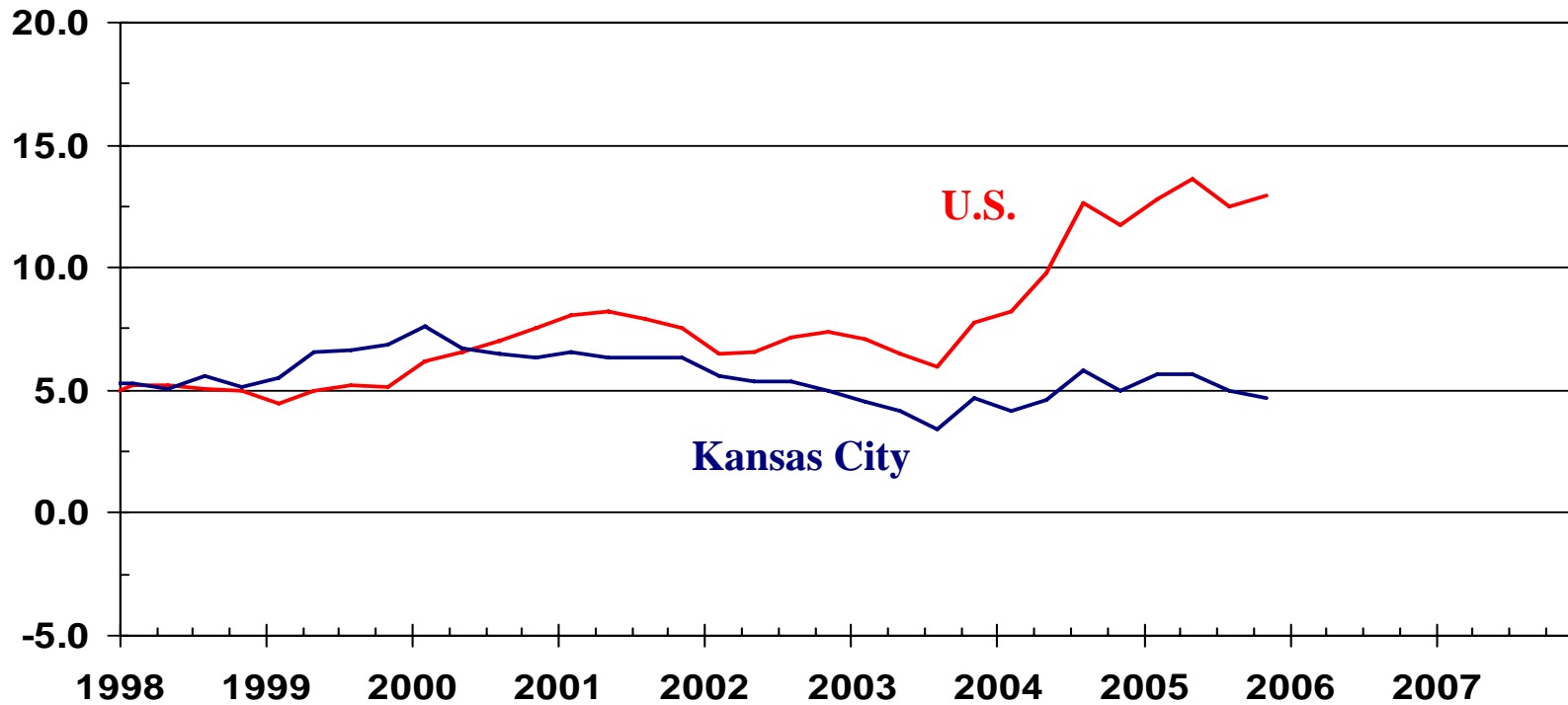


Anatomy of a “Crisis”

- As real estate returns remained robust, speculators began to enter some markets
 - The use of Alt-A (subprime) and ARM products by investors became more prevalent
 - Home price appreciation began to accelerate

Home Price Appreciation

Year-over-year Percentage Change

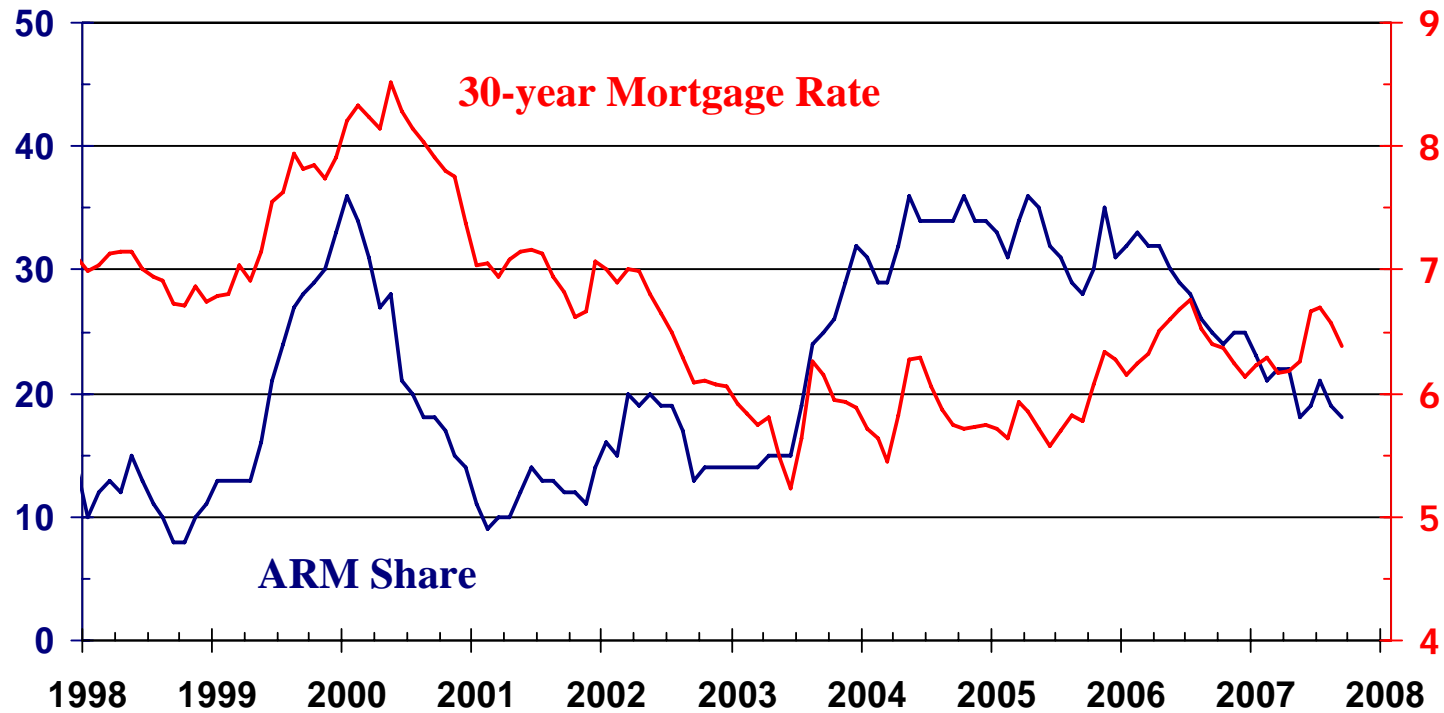


Source: OFHEO

ARM Share of New Mortgages

Percent of New Loans

Percent

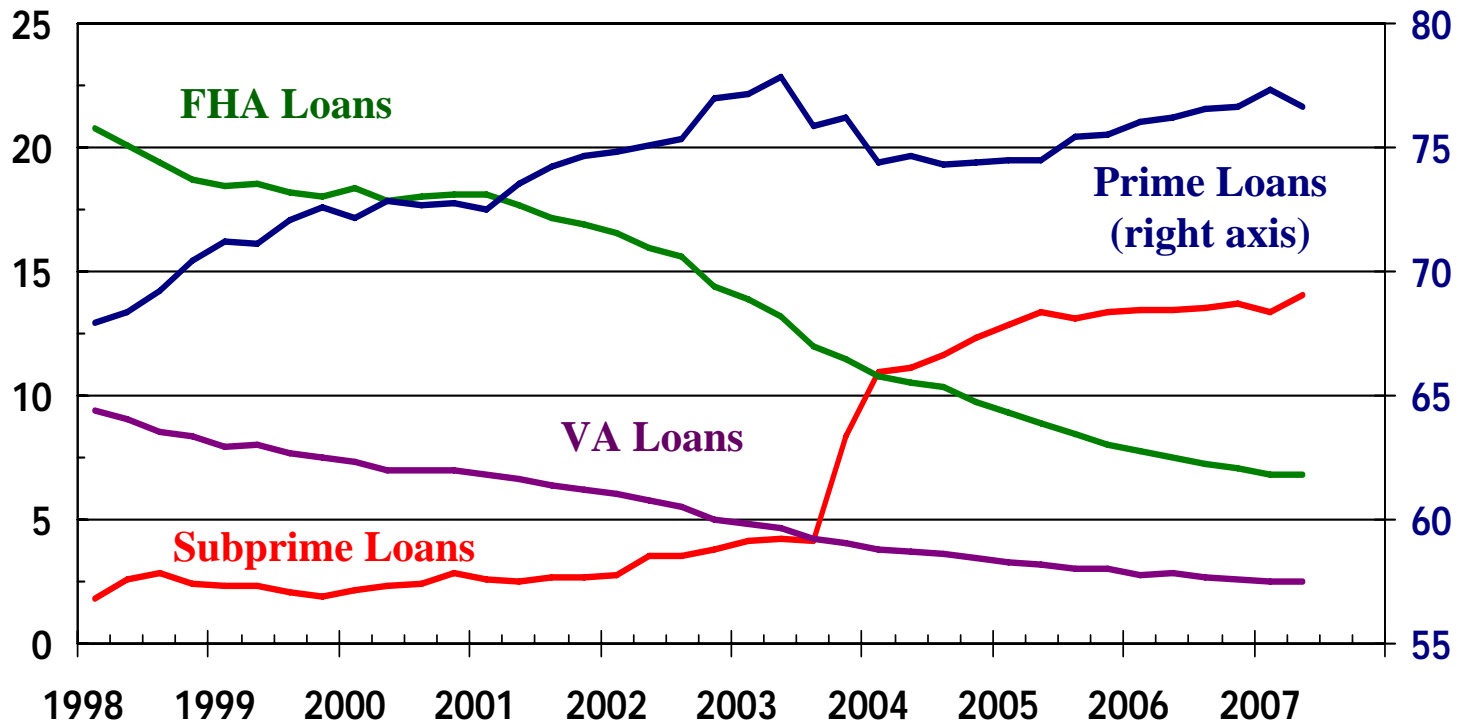


Source: Freddie Mac

The Growth of Subprime Lending

Percent of Loans Serviced

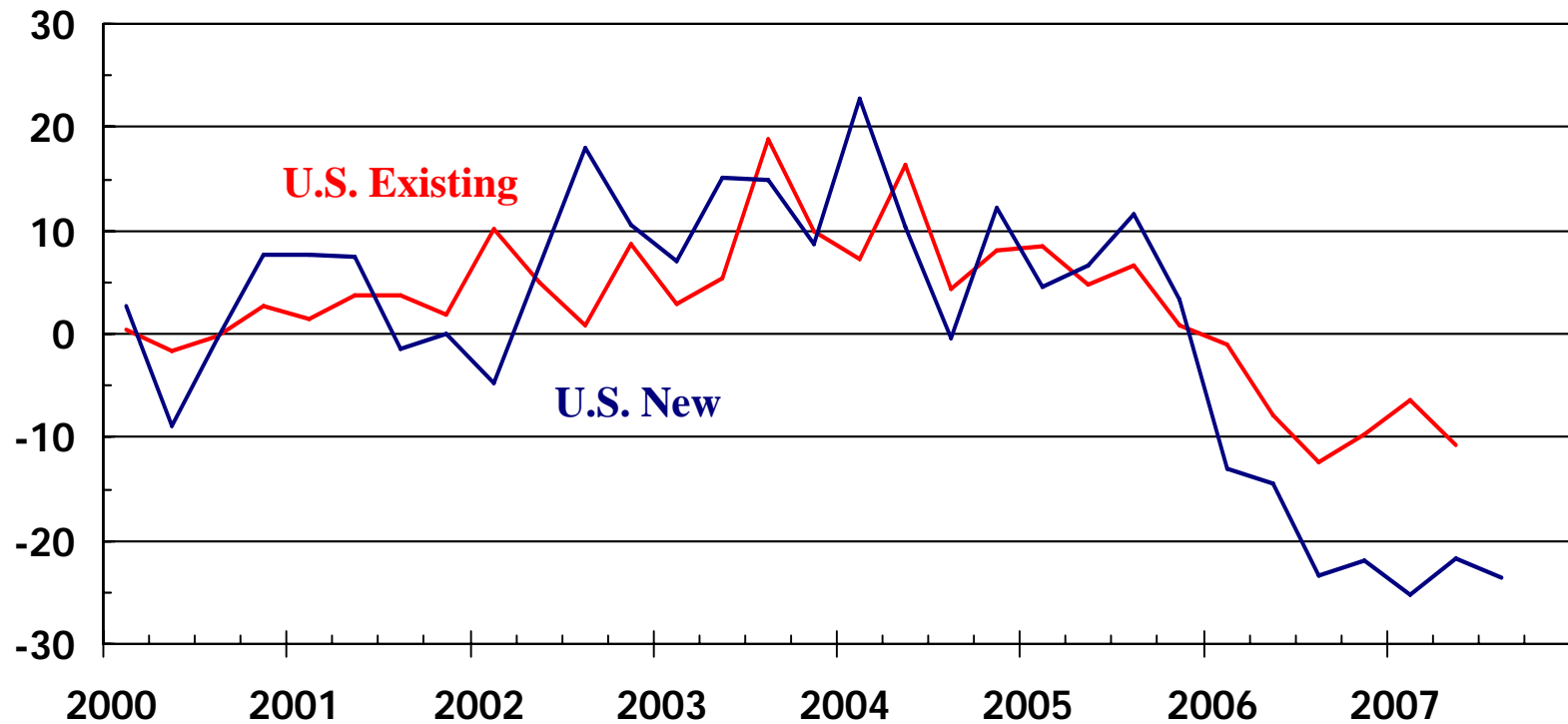
Percent of Loans Serviced



Source: MBAA

New & Existing Home Sales

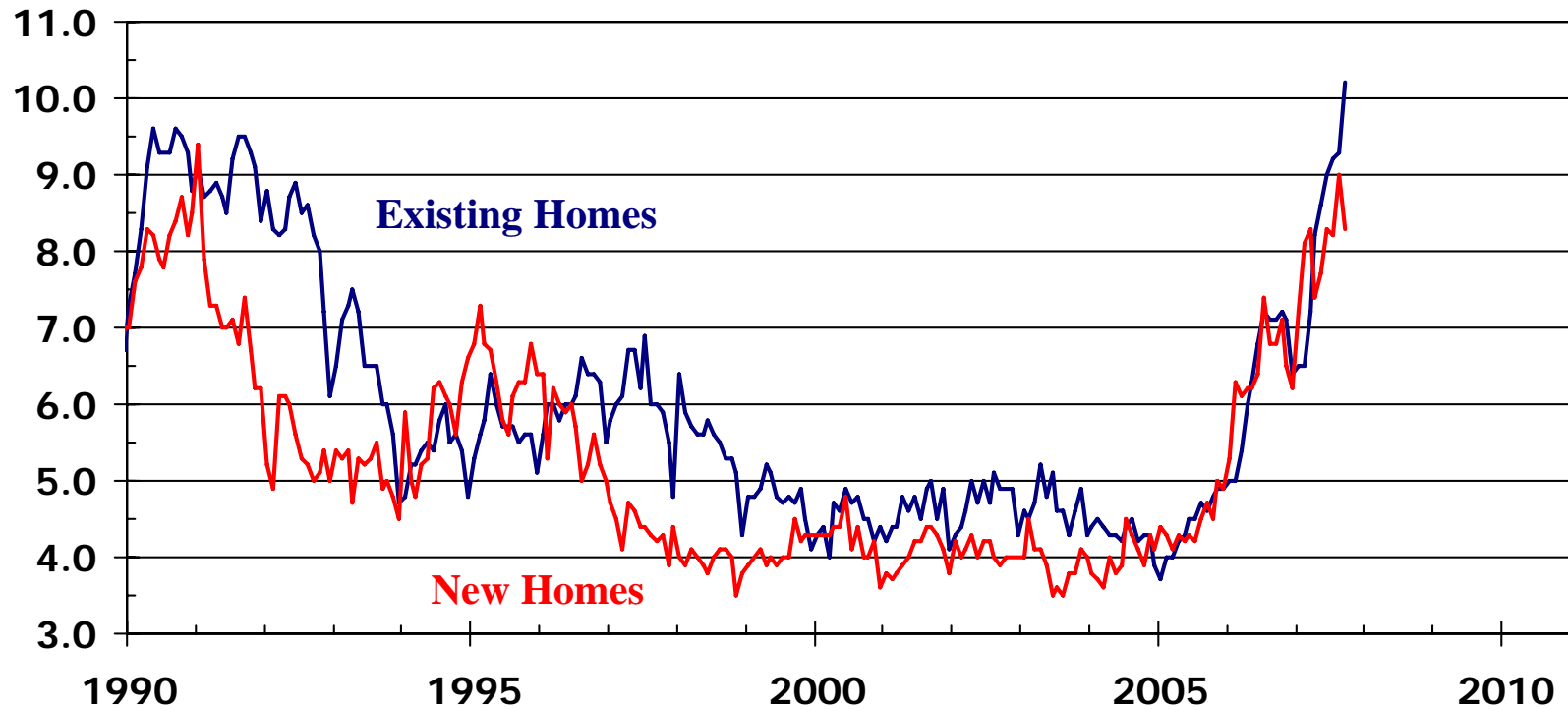
Year-over-year Percentage Change



Sources: NAR; U.S. Census Bureau

US Housing Inventories

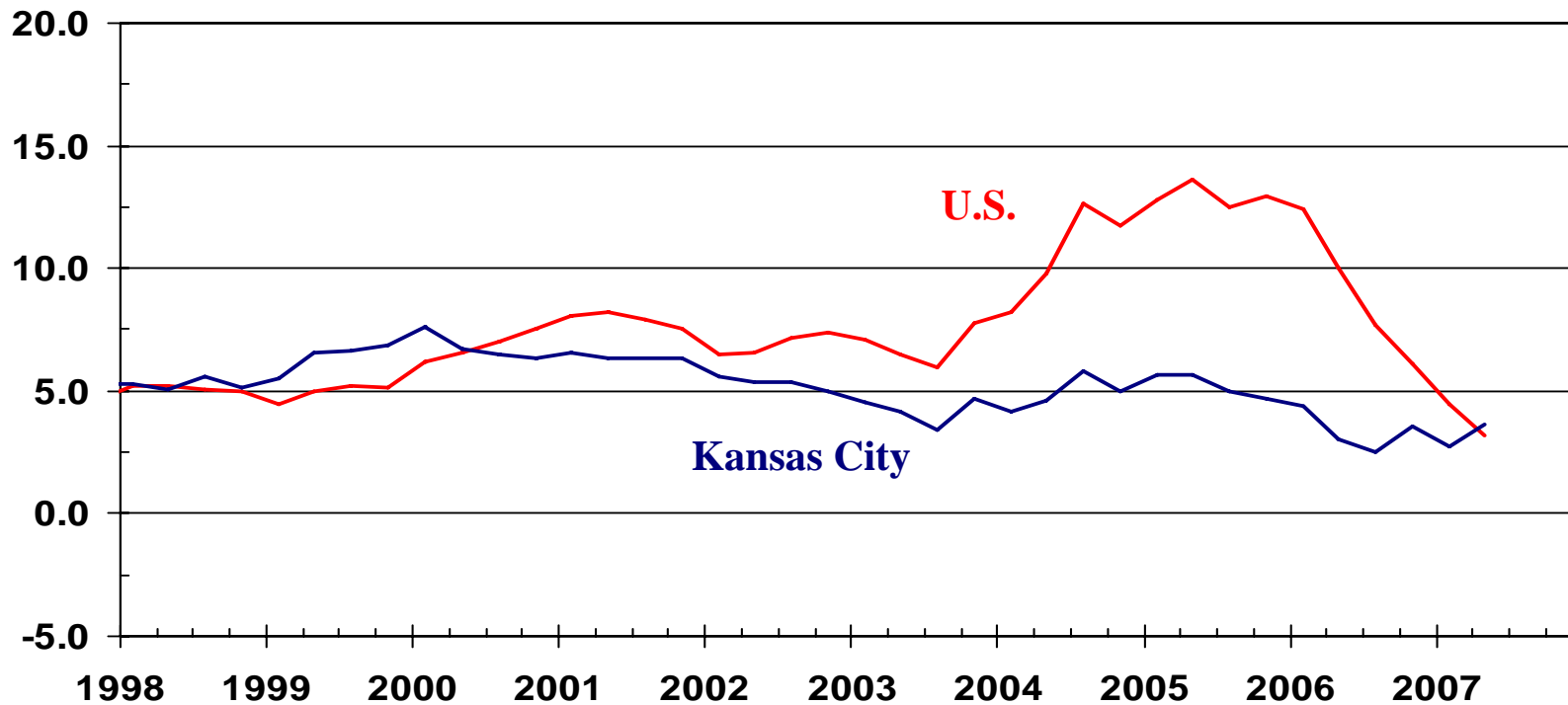
Months Supply (SA)



Sources: NAR; U.S. Census Bureau

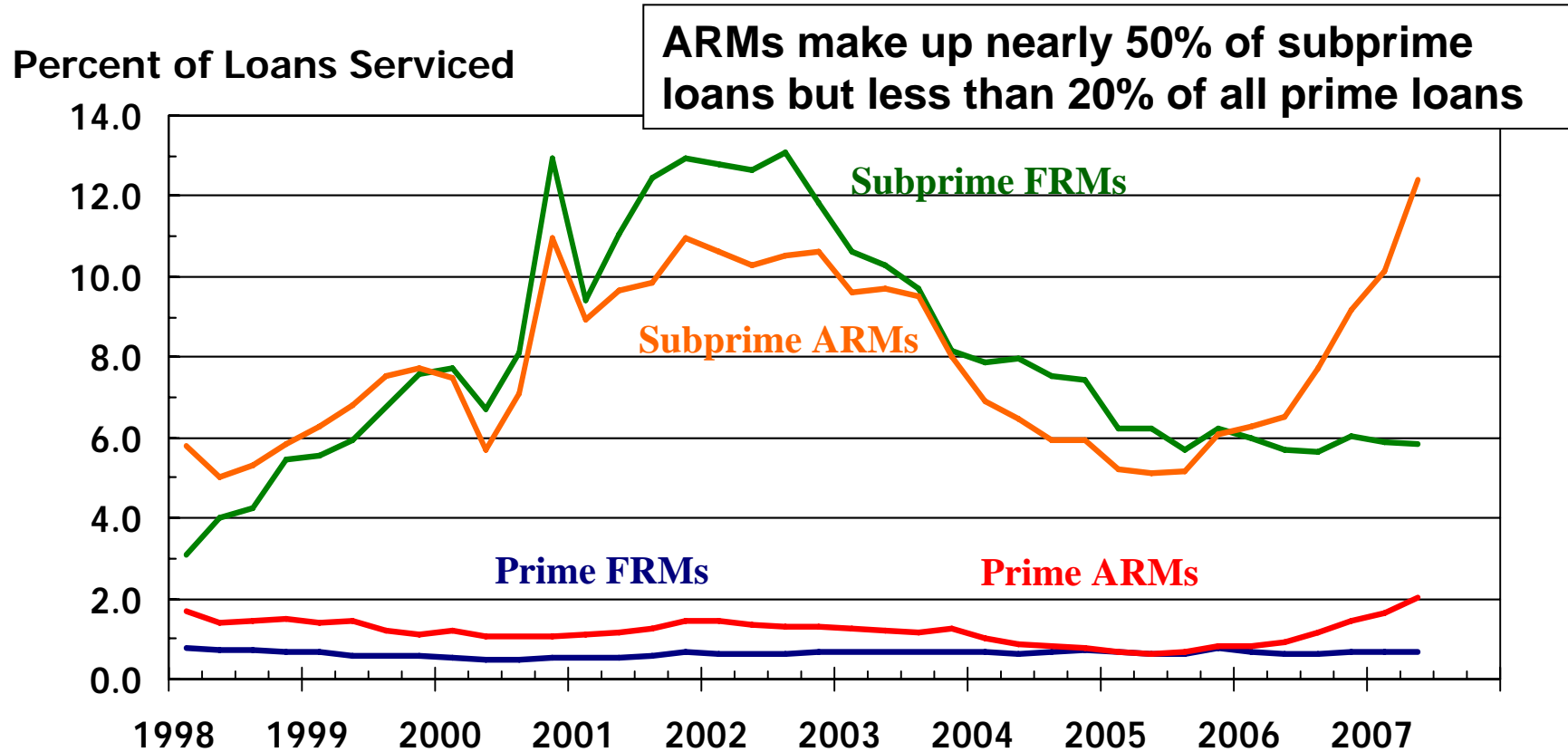
Home Price Appreciation

Year-over-year Percentage Change



Source: OFHEO

Severely Delinquent Loans



Source: MBAA



The Foreclosure Debacle?

- Ignore data from RealtyTrac
- According to MBAA, foreclosures would have fallen in the 2nd quarter if not for two problem areas
 - A regional recession in the rust belt
 - Four states with a high percentage of investor loans: Arizona, California, Florida, and Nevada



So What Happened?

- Last August, concerns about rising subprime delinquencies led to turmoil in the credit market
 - Investors began to worry that even highly-rated tranches of subprime CDOs (mortgage-backed securities) would suffer losses
 - SIVs could not roll-over the commercial paper they use to finance their operations

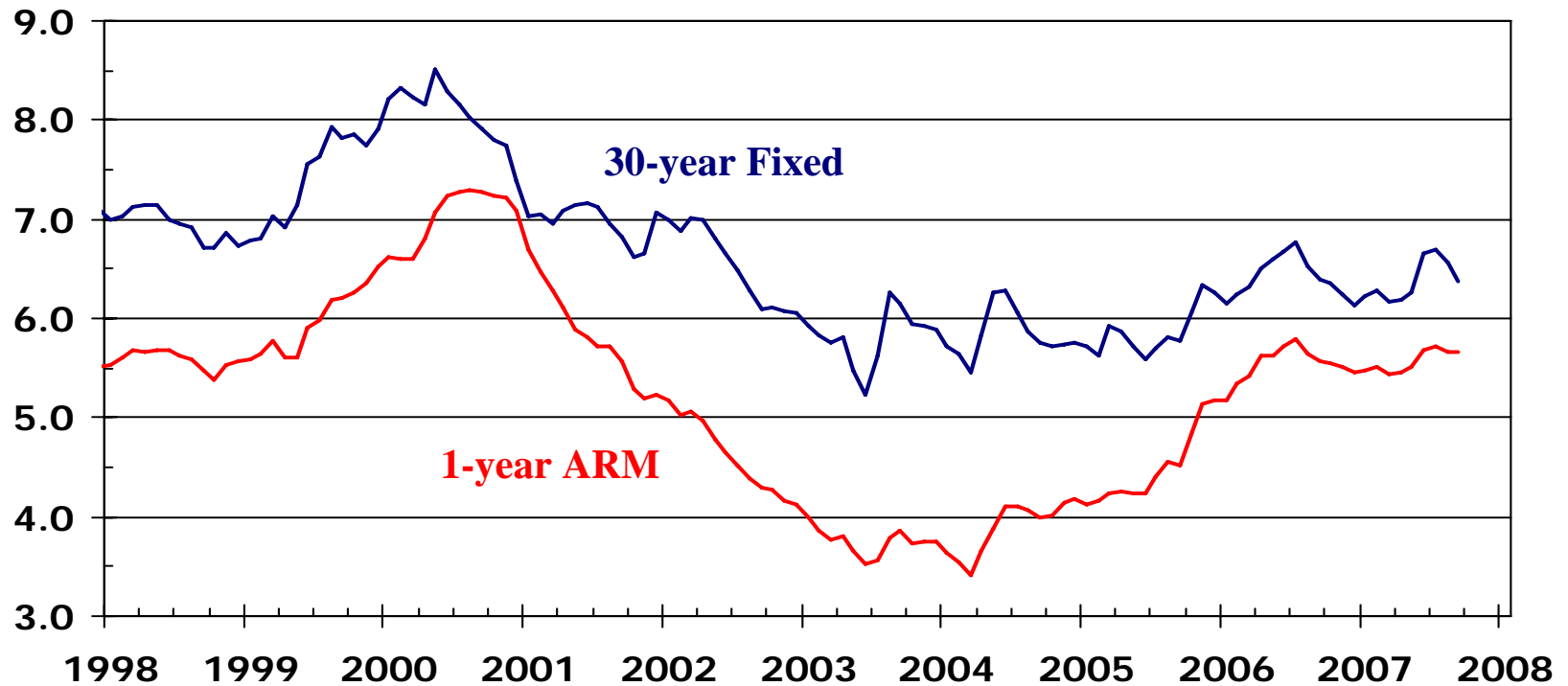


So What Happened?

- Key questions:
 - Which issues are good?
 - Who's holding the junk?
- Flight to quality

Conforming Mortgage Rates

Percent



Source: Freddie Mac



Who's Been Hit?

- Mortgage banks
 - Could not place new subprime mortgages into the secondary market
- Investment banks
 - Indirectly hold a lot of subprime CDOs
- Other holders of subprime CDOs
- While a big deal on Wall Street, the Main Street impact will likely be quite small



When Will the “Crisis” End?

- Home prices will not enter the freefall that some are predicting
 - Home prices rarely fall absent a significant economic contraction
- Instead, prices are likely to remain flat for an extended period of time until fundamentals catch up with inflated prices in some markets



When Will the “Crisis” End?

- Investment banks and other investors who misjudged the risks of subprime mortgage-backed securities will have to take their hits
- Once home sales begin to pick up again, the news media will have to find a new economic “story de jour”
 - Key question: Why have home sales slowed?

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