BROOKINGS

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Credit Crisis: The Sky is not Falling

U.S. stock markets are gyrating on news of an apparent credit crunch generated by defaults among subprime home mortgage loans. Such frenzy has spurred Wall Street to cry capital crisis. However, there is no shortage of capital – only a shortage of confidence in some of the instruments Wall Street has invented. Much financial capital is still out there looking for a home.

Above: A foreclosure sign in front of a home in Perris, California. Reuters/Mark Avery

As this brief describes, the facts hardly indicate a credit crisis. As of mid-2007, data show that prices of existing homes are not collapsing. Despite large declines in new home production and existing home sales, home prices are only slightly falling overall but are still rising in many markets. Default rates are rising on subprime mortgages, but these mortgages—which offer loans to borrowers with poor credit at higher interest rates—form a relatively small part of all mortgage originations. About 87 percent of residential mortgages are not subprime loans, according to the Mortgage Bankers Association's delinquency studies.

Subprime delinquency rates will most likely rise more in 2008 as mortgages are reset to higher levels as interest-only periods end or adjustable rates are driven upward. Unless the U.S. economy dips dramatically, however, the vast majority of subprime mortgages will be paid. And, because there is no basic shortage of money, investors still have a tremendous amount of financial capital they must put to work somewhere.

On the immediate problem of mortgage defaults, some aid to the subprime borrowers might be justified, but bailing out the lenders even more than we have up to now would create a moral hazard by merely encouraging them to do it again.

Policy Brief #164

The Great Capital Inflow into Real Estate

Throughout the 1990s, the investment community had largely considered real estate undesirable because of its falling rents, occupancy rates, and prices; so investors shifted most of their attention and funds to stocks and bonds. This helped launch a record price rise in world stock markets. Soaring stock prices drew money away from real estate into stocks until the Internet stock bubble burst early in the new century.

Overnight, real estate morphed from a pariah among investors to the major viable and easily accessible way

to invest funds, since stock markets were plummeting in value. The NASDAQ composite index fell over 70 percent in value from its 2000 peak in two years, and the other major indices also declined sharply. But real estate investment trust (REIT) stock prices started a steady climb as money flowed into both residential and commercial property markets.

This money came mainly from a global over-supply of savings from rapidly developing nations like China and India, from newly independent Eastern European nations just returning to market economies after almost a half-century of Soviet domination, from soaring profits in oil-producing states like Russia, Saudi Arabia, Venezuela, and Iran, from zooming corporate profits in the U.S. economy, from investors borrowing money at almost zero interest in Japan and investing it elsewhere at higher rates and from a variety of other sources. A fundamental paradigm shift took place in the attitude of world financial institutions and investors toward the relative desirability of real estate – especially commercial properties – as compared to other asset classes.

The Impacts of Securitizing Real Estate Finance

The expansion of a financial technique known as securitization helped to encourage the change in attitude toward real estate. Formerly, mortgage lenders often held onto the entire mortgage until it was repaid. But under securitization, lenders put many such mortgages into a single pool, dividing the interests into several different "tranches." With differing yields and access to mortgage repayment flows, tranches offered differing degrees of risk. Mortgage repackagers could sell off tranche pieces to other investors, spreading the risks of any one mortgage among many lenders. This technique reduced the risks and allowed for the expansion of world capital available to real estate. The globalization of capital markets also aided the flow.

Securitization also generated more private mortgage lenders and packagers who were not covered by extensive federal regulations. Residential mortgage-backed securities issues by private labels rather than federally regulated agencies accounted for $135 billion, or 21 percent, of all such securities issued in the first quarter of 2003, but rose to about $320 billion, or 56 percent of the total issued, in the fourth quarter of 2005. Private label issuers were more likely to engage in reckless subprime lending with extremely easy credit terms for subprime borrowers. So their expanded responsibility for residential mortgage lending increased the risks of such lending through 2005.

Securitization of real estate debt also created great uncertainty about who would be responsible for absorbing losses or working out repayment problems if borrowers were unable to pay on time. The actual sources of capital for any one loan were so scattered among multiple lenders, each with a relatively small piece of each total loan, that no one was certain who would bear the costs for defaults or delinquencies. The massive amount of securitized debt outstanding had never been subjected to a large-scale repayment crisis; so past experience was not much of a guide.

Effects of the Massive Capital Flow into Real Estate Markets

As capital poured into real estate, especially after 2000, it generated a worldwide upward movement in real property prices. This was most evident in housing prices, not only in the United States, but throughout the developed world – except in Japan and Germany. According to Freddie Mac's home price index for 381 U.S. metropolitan areas, based on repeat sales of the same properties, housing prices had risen 46.5 percent in all of the 1990s, but they then rose almost another 59.8 percent in just the first six years of the new century.

This worldwide inflow of financial capital into real estate was a crucial factor influencing U.S. housing prices and the general boom in housing production after 2000. As the value of housing soared, U.S. homeowners realized they had more equity in their homes; so many borrowed against that equity or refinanced their homes at falling interest rates and used some of the acquired funds to stimulate their general consumption. That helped keep the entire U.S. economy booming. It also led to bigger U.S. trade deficits with the rest of the

world as we imported more than we exported, and paid for that deficit by issuing Treasury securities and other I.O.U.s to foreign investors and governments.

Much of that gigantic pool of capital from around the world is still out there looking for something in which to invest, and investors are still willing to consider real estate – including American real estate. The outcries of Wall Street that there is a capital crisis are exaggerated – there is only a shortage of confidence in some of the instruments that Wall Street has invented to capture some of that capital. Though the resulting uncertainty has spread to banks and other financial institutions, plenty of capital is still out there and looking for a home.

The Current Overall U.S. Housing Market Situation

In both 2004 and 2005, the U.S. housing industry built 2 million new housing units, including mobile or manufactured homes. Yet most demographers believe our economy actually needs only about 1.3 million new housing units to supply shelter to all new households formed each year, plus 200,000 to 400,000 new units to replace obsolete older ones. This means the homebuilding industry was reaching into future demand to support its high levels of new housing production in 2004 and 2005. Four previous high-level bursts of new housing production have been followed by two-to-five year production declines averaging 37.5 percent. Housing starts have already fallen below 2005 levels by 13 percent in 2006 and 29 percent so far in 2007. So the housing industry's production decline is not over yet, and will continue through 2008.

Sales of existing homes have also decreased in number from a peak rate of 7.2 million per year in September 2005 to 5.5 million per year in August 2007, a drop of 23.6 percent. However, that does not mean housing prices as a whole will collapse, even though such prices have risen dramatically in the past decade. According to Freddie Mac's home price index, housing prices in 381 U.S. metropolitan areas rose an average of 46.5 percent in 10 years from the first quarter of 1990 to the first quarter of 2000, then soared an average of 59.8 percent in the six years from the first quarter of 2000 to the first quarter of 2006. From early 2006 to the second quarter of 2007, home prices continued to rise in 314 of those metropolitan areas, or 82 percent, by an average increase of 7.3 percent. In the other 41 metropolitan areas, prices dropped by an average of 3.4 percent. The areas with continued price increases included 24 of the 29 largest metropolitan areas in terms of population.

As of September 2007, National Association of Realtor data show that the median price of existing homes sold was down only 4.2 percent nationally vs. one year earlier, though down 8.8 percent in the west. These data show that prices of existing homes are not collapsing, despite large decreases in both new home production and sales of existing homes.

Why is that happening? Most American home owners do not have to move. So when prices start to fall below what they think their homes are "really worth," they will simply withdraw those homes from the market and wait for prices to improve. This puts a floor under the prices of most single-family homes. Where overbuilding has been spectacular and many buyers were speculating on flipping the units they bought rather than occupying those units, a price collapse could occur. That is most likely in condominium markets in big cities like Miami and Las Vegas, but probably will not spread to typical single-family homeowner units in most U.S. metropolitan areas.

The Subprime Mortgage Situation

The subprime mortgage market has recently generated the most concern that credit markets may completely seize up and paralyze the economy. In fact, subprime mortgages form a relatively small part of all mortgage originations. They are mortgages made to households with poor credit records at interest rates 3 to 4 percent above normal prime mortgages. Lenders liked them because they had higher interest rates than prime mortgage rates, which had fallen very low in the early 2000s. Borrowers with poor credit liked them because

they enabled such households to buy homes when they otherwise could not do so.

But when prices stopped rising and began to decline, as they did in many markets after 2005, subprime default rates began to rise. Since many mortgage-backed-bonds had been based on subprime loans, the conduits floating those bonds had a hard time making their payments to the persons or institutions investing in such bonds. Surprisingly, those persons and institutions included many in Europe and even in Asia who had been attracted by high-interest rates and the prospects of continuing increases in housing prices. Moreover, the conduits creating such bonds were largely unregulated, private firms, unlike Freddie Mac and Fannie Mae, and took many risks by making loans with no down payments, monthly payments of interest only and even no checking of borrowers' incomes.

Yet among all U.S. residential mortgage originations, subprime loans altogether comprised a cumulative total of under 13 percent from 1994 through 2005, though they rose to 19 percent in the year 2004 and 21 percent in 2005, according to the Mortgage Bankers' Association (MBA). This means at least 87 percent of residential mortgages as of mid-2007 were not subprime loans, according to the MBA's delinquency studies.

The serious delinquency rate among subprime mortgage loans remained below 8 percent from 1998 through the third quarter of 2000. Then it rose to between 10 and 13 percent through the second quarter of 2003, and has declined to below 8 percent since the fourth quarter of 2003. Thus, at least 87 percent of subprime home loans had not defaulted as of 2005. True, this is much higher than the serious delinquency rate among prime mortgages, which has remained below 2 percent from 1998 through 2005. Subprime delinquency rates may rise somewhat more in 2008 because monthly payments on many such mortgages will be re-set to higher levels when interest–only periods end or adjustable rates are driven upward. But even then, the vast majority of subprime mortgages are likely to remain fully paid up as long as unemployment remains as low as it is now in the U.S. economy.

The Broader Repercussions of Subprime Mortgage Problems

These facts hardly indicate a credit crisis throughout the economy or even in mortgage markets. But the subprime mortgage problems do glaringly reveal the inadequate mortgage and other credit underwriting standards in practice during several recent years of high-volume, low-interest lending. Subprime mortgage problems make many real estate lenders realize they should have been conducting more thorough underwriting, demanding higher-interest rates and putting more loan covenants into their deals.

Lenders have woken up to the fact that their actual risks were much greater than they had recognized. In response, many recently stopped making any loans until they could better assess the real risks involved. Other lenders raised rates and increased loan covenants. The resulting shock threatened to upset lending activity throughout global credit markets. This fear was encouraged because many complex securitized loan funds contained small portions of delinquent subprime mortgages. If this seizing-up of credit markets became worldwide, that would slow down economic growth everywhere – hardly a desirable outcome.

In response, the Federal Reserve Bank, the European Central Bank, and the Bank of England all cut their discount rates (the rates at which they lend money to banks) and pumped more liquidity into credit markets. Then the Federal Reserve Bank further cut the fed funds rate (at which banks can lend reserves to each other) and the discount rate by 50 basis points each – a dramatic change in past policy. This has seemed to reassure credit markets somewhat, although interest rates and credit terms are almost certain to remain higher than before the subprime mortgage mess – as they should. How long it will take credit markets to recover fully is not yet clear. But investors still have a tremendous amount of financial capital that they must put to work somewhere – there is no basic shortage of money.

The Booming World Economy

The world's generally favorable economic conditions suggest continued prosperity rather than a collapse of market economies. Western Europe, Eastern Europe, Asia's developing nations, and Japan are all prospering and growing economically faster than they have been in the past decade. The U.S. economy has slowed down somewhat, but our gross domestic product is still growing and our unemployment rate is very low compared to historic norms. There are large supplies of capital being generated around the world looking for places to invest. Although growth rates in developing nations are faster than the U.S. growth rate, our economy is still regarded as the safest and most politically secure place to invest in the world, despite the devaluing U.S. dollar. This is shown by the recent decline in U.S. Treasury interest rates as lenders fled into Treasuries seeking guaranteed security. These are not the conditions likely to generate a financial crisis.

As noted above, the world's major central banks have taken steps to pump more liquidity into financial markets to forestall any fears among investors of a credit crisis. The Fed has put billions of additional dollars into U.S. banks, and those banks must lend that money to someone to make it work for them. These actions are designed to offset the feelings of panic generated by the Wall Street purveyors of gloom and doom. Some aid to their borrowers might be justified, but bailing out the lenders even more than we have up to now would create a moral hazard of merely encouraging them to do it again when the next chance appeared.

Is Real Estate's Boom Sustainable?

Nothing in this world lasts forever, and the recent unprecedented prosperity in housing and real estate markets is no exception. Activity in U.S. residential markets has already slowed down, and that slow-down will probably continue for the next year or so, though it may recover after that. But in commercial real property markets, though interest rates are appropriately rising somewhat, there is still considerable capital looking for someplace to go. Thanks to the paradigm shift among world investors about the basic desirability of real property as an investment asset class, much of the money that has moved into real property will stay there.

Yet the impacts of the tremendous inflow of capital into existing real estate have in some respects undermined its continued attractions as an investment. As competition among investors drove prices of existing properties up and their yields down, more investors have begun to consider building new properties rather than buying existing ones. They think they could get higher initial yields from new and "greener" or more high-tech properties than from older, more obsolete existing ones, since the older ones had become so expensive and have such low yields. This change in views could start another new development boom like those that have ended so many real estate cycles in the past. That is especially likely to happen if the oversupply of capital keeps borrowing very cheap and interest rates do not rise much. Eventually, such a new development boom would overbuild world property markets and make it less desirable to keep putting more money into them. But that would take several years of booming new development.

So real estate's boom cannot last forever – nothing does – but it could last a lot longer than it has lasted up to now. There is still plenty of financial capital out there looking for somewhere to go, and there are still plenty of property markets around the world that present good development opportunities. In the absence of some catastrophic world crisis that would upset all forecasts, there is no reason to think we are in the midst of an inevitable credit crisis. Just look at the facts.

Author

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