development of automated underwriting by the GSEs. In 1996, Freddie Mac indicated that up to 35% of borrowers who obtained mortgages from the subprime market could have qualified for a conventional loan through Loan Prospector, its automated underwriting system.[12]

- Other traditional lenders and secondary market players, including Fannie Mae and Freddie Mac, began to feel further market pressure to accept an increasingly substandard product. These GSEs were government chartered, which gave them access to cheap capital based on the assumption by investors that they would be bailed out in a crisis. The federal government is not legally required to cover these entities' liabilities, but the belief to the contrary was a good assumption nonetheless. The GSEs had actually been privately owned since the late 1960s and early 1970s, which drove them to maximize profits. Therefore, Fannie Mae and Freddie Mac had both the incentive and the capacity to take on excessive risk, and they did so with vigor. Many industry experts, regulators, and elected government officials—liberals, conservatives, and progressives alike—attempted to rein in these excesses as the possible consequences were well known, but their efforts were stymied by some of the most well-funded lobbying campaigns in history. (Fannie Mae and Freddie Mac spent some $164 million on lobbying from 1999 through 2008.)[13]
- Events that occurred during the summer of 2007 in the structured investment vehicles (SIV) financing market began to expose the flaws in agency ratings methodologies—flaws that did not become fully apparent until housing prices stopped appreciating. The general market's acceptance of the high ratings on mortgage-backed securities and collateralized debt obligations belied the liquidity risk contained in the fact of these substandard products backing commercial paper issued by many major banks. The first banking regulators to see the danger to financial institutions in time to avert major damage were the Canadian banking regulators. This revelation had a ripple effect, leading to a spike in interest rate spreads and collateral values, causing many firms to incur losses not thought possible just a year earlier in the United States and Europe. (No Canadian banks went

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[12] OCC Working Paper. "Economic Issues in Predatory Lending." Accessed July 10, 2015 at http://www.occ.gov/static/news-issuances/news-releases/2003/nr-occ-2003-59-paper.pdf

[13] Angelides, Phil. "Fannie, Freddie and the Financial Crisis." *Bloomberg*, Aug. 8, 2011, Op-Ed.

out of business during the Great Depression or during the recent financial crisis;[14] there may be some lessons to be learned from our neighbors to the north.)

Where Are We Now?

What the Future Holds

Since the creation of the Federal Housing Administration, the number of loans insured in any given year has varied dramatically. When conventional lenders were making high loan-to-value (LTV) loans and those loans were being readily purchased by the secondary market, the demand for FHA-insured loans virtually disappeared. However, when FNMA, FHLMC, and other players in the secondary market became insolvent and unable to provide money for the purchase of mortgage loans, FHA became very popular again. Just as government agencies were essential to the recovery after the Great Depression, their role will be equally important in recoveries from current and future depressions and recessions. If anything has been learned from the disasters of 2008 through 2011, it is that proper oversight is critical. Private sector lending will always be the most important aspect of mortgage lending, but it must work in tandem with well-structured, well-monitored, and well-controlled government programs.

Oddly enough, as of the beginning of 2015, no real decisions have been made about how to bring FNMA or FHLMC out of government conservatorship. Current profits made by these entities are funding federal government operations, and members of the House of Representatives would have to either raise taxes to replace this new source of revenue or reduce federal spending. Investors, seeing recovered profits going to the U.S. Treasury instead of the investors themselves, filed suit to try and recover, but recently lost their bid to remove FNMA and FHLMC from full government control.[15]

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[14] Perry, Mark J. "Due North: Canada's Marvelous Mortgage and Banking System." *The Journal of the American Enterprise Institute*. Feb. 26, 2010. Accessed Aug. 11, 2011 at: http://www.aei.org/publication/due-north-canadas-marvelous-mortgage-and-banking-system/

[15] Shenn, Jody, Margaret Cronin Fisk, and Clea Benson. "Fannie Mae, Freddie Mac Plunge after Court Ruling on Profit." Bloomberg News, Oct. 1, 2014. Accessed Dec. 11, 2014 at http://www.bloomberg.com/news/2014-10-01/fannie-freddie-plunge-after-court-ruling-on-profits-correct-

Home Buyer Education Programs

A corollary to the need to improve mortgage lending to existing and other markets is recognition that many people are simply not familiar with normal real estate acquisition and lending procedures.

Basic knowledge of how to acquire a home, how to assure proper title, how the acquisition might be financed, and how to care for a home is critical. To some, home ownership is an impossible dream. The addition of pre-purchase home buyer education programs to the requirements for loan qualification is of benefit to many. Benefits include finding more people who are eligible for home ownership. Education programs also make borrowers more aware of their responsibilities to lenders, resulting in sound loans with fewer defaults. Initial implementation of these programs has already proven their value to home buyers and lenders. A further gain is the fact that restoring the market acceptance of mortgage-backed securities will increase the market for homes, thus creating many new jobs. Home building has historically led the United States out of recessions, but the lack of housing demand due to the nature of the recent financial crisis was a continued drag on economic recovery well into 2012. Single family housing starts dropped to a low of 445,000 in 2009, and by 2011, had continued to decline to 431,000. By the end of 2014, starts increased to over 700,000, still far less than pre-financial crisis levels.[16] According to National Association of Home Builders' Chief Economist David Crowe, the level of single family housing starts at the end of 2014 was just 71% of normal levels. Since new home and commercial construction has been as high as 8.9% of gross domestic product (GDP), this reduced level caused a slower than normal recovery from the recent low point in the residential real estate cycle.

THE REAL ESTATE CYCLE

Business cycles can be thought of as when and how the direction of economic activity changes or peaks from an expansion in the economy and the time that a contraction/recession ends. A business cycle peak represents the last month before several key economic indicators—such as Gross Domestic output, employment, housing starts and retail sales

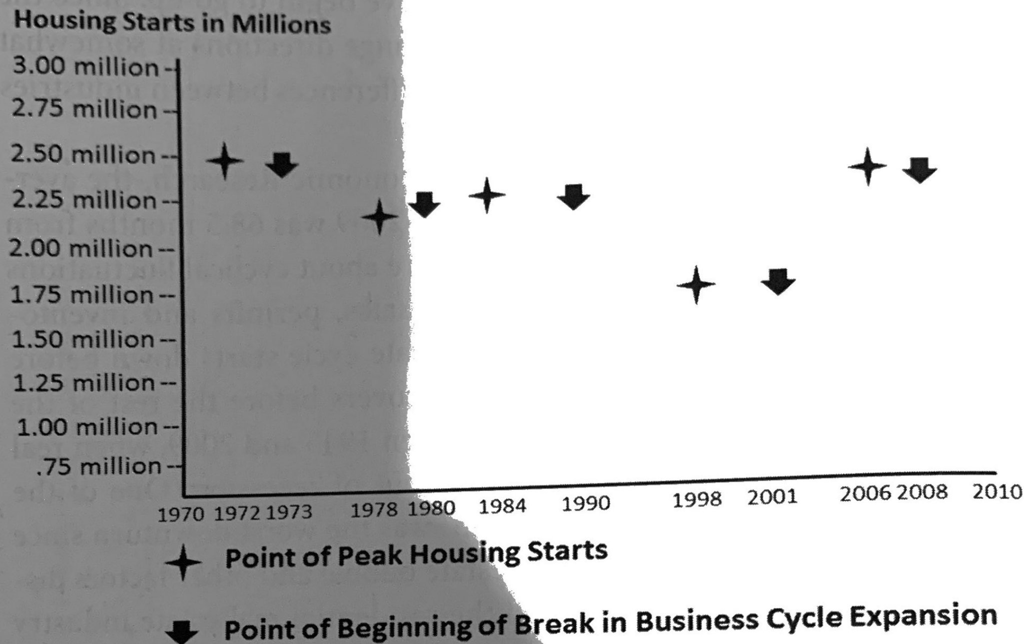
[16] Single Family Housing Starts Jump in Final Month 2015 Jan. 23, 2015 Accessed July 10, 2015 at https://www.strucsure.com/News/Home_Building/Articles/Single_family_housing_starts_jump_in_final_month_of_2014

start to decline. The low point of a business cycle represents last month before the economic indicators mention above begin to go up. Since the differing economic indicators frequently change directions at somewhat differing points in time, there can be some differences between industries declines and recoveries.

According to the National Bureau of Economic Research, the average duration of a business cycle from 1945-2009 was 68.5 months from peak to peak. Real estate cycles, however, are about cyclical fluctuations of quantities and prices of construction, sales, permits and inventories of real estate. Many times, the real estate cycle starts down before a recession is officially recognized and recovers before the rest of the economy—which was often the case between 1945 and 2009, when real estate related spending led the economy out of recession. One of the reasons that the recent "Great Recession" was the worst downturn since the Great Depression is that the real estate bubble and other factors discussed earlier in this chapter caused the residential real estate industry *not* to be the first mover in economic recovery. At its peak in 2006, real estate construction contributed $1.195 trillion, or 8.9%, to the nation's economic output as measured by GDP. By 2013, this had only recovered to $925 billion, a dramatic decrease to only 5.8% of GDP. This dramatic decline in housing construction was a large contributor to the recent "Great Recession's" high unemployment rate. Real estate cycles do not always follow the same pattern as business cycles, and within the same marketplace, office, retail, single-family residential, multi-family and industrial properties may be at different phases of a cycle and of differing durations.

For office, retail, and multi-family properties, the real estate cycle can be summed up in four general phases: the growth phase, the excess supply phase, the downturn phase, and the recovery phase. The growth phase generally has good absorption of new space, decreasing vacancy rates, and a higher rate of rental income growth. This will in turn lead to increases in the level of new construction and planned new construction, yielding higher employment growth in the construction trades. The excess supply phase shows sustained high periods of new construction, with construction cranes dotting the horizon. New space absorption rates drop, and oftentimes turns negative, triggering a downward spiral in rental rates as firms move out of older building into new, better space for lower rents. The excess supply phase causes lower employment growth, thus slowing the need for new space.

TABLE 1.1



Source: © 2016 OnCourse Learning

The downturn phase usually shows escalating vacancy rates due to low absorption rates for existing buildings and new buildings coming online from the excess supply phase. Often this is caused by an increase in unemployment and lower-to-negative rental rates. The recovery phase shows very little new construction activity, increased space absorption as unemployment decreases, and employment growth and little-to-no rental rate growth.

Residential real estate tends to peak just before business cycles do and, thus, the demand for new housing (thus housing starts) is at a euphoric state beyond what can be absorbed by new household creations. To illustrate this effect, the data presented in Table 1-1 shows how the residential real estate markets have historically peaked shortly before subsequent recessions.

The time lag between the peak in the residential sector and the next recession is just one indicator and must be balanced from a predictive tool, considering the rate of inflation, the interest rate yield curve, whether there are continuing productivity improvements, industry capacity utilization rates, the unemployment rate, the stock and securities market levels, and liquidity.

At any point in time, one market segment or region of the country may be in a period of decline, while another is in expansion. Moreover, a period of decline in one area might push another area into a decline. In the early 1990s, a commercial real estate decline started in the northeastern United States and there was a rolling commercial real estate decline that went through the Midwest and ended with a mild decline in California. Similarly, there was a decline in residential real estate made worse by the "Oil Belt" recession and the Savings & Loan Crisis of the mid-1980s. Oil Belt states like Colorado, Louisiana, Oklahoma and Texas were hit particularly hard.

In the recent mortgage crisis, cities like San Bernardino, California saw home prices plummet by 30% in 2007, not hitting rock bottom until recently. As a result, cities heavily dependent upon real estate taxes to support the municipal budget, such as San Bernardino, have declared bankruptcy, causing the layoffs of many municipal workers and school teachers. The layoffs further negatively affected the economy of the area. This situation might repeat itself in 2015, as oil prices have recently seen a 50% decline. If this were to hold for over a period of more than a year, the plans for drilling many new oil wells may not go forward, as these plans were made based on a higher price of oil. Many injection wells will be closed down, and the investors and workers dependent on these could find themselves in a regional decline. South Dakota, Louisiana, and Wyoming could be hit particularly hard. In Louisiana, state services could be cut if this trend continues.

Questions for Discussion

1. Define security interest and how it has been used in real estate finance since the Industrial Revolution.
2. What is meant by the term *collateral*? By *hypothecation*?
3. What is the purpose of a promissory note? Of a mortgage?
4. Describe the origin of a loan discount.
5. What is the federal agency underwriting function and what does it do for the mortgage market, and ultimately for the borrower?
6. Compare and contrast the two categories of bonds and how they differ from mortgage-backed securities and the collateral pledged for each.