

Foreclosure Forecast

Texas Floats While Nation Fails

By James P. Gaines

The downturn in the capital and mortgage markets has been far more severe than originally anticipated. Already several major financial organizations — Countrywide, Fannie Mae, Freddie Mac, Bear Stearns and Lehman Brothers — have failed and required substantial federal support. Others teeter dangerously close to the brink.

Nationally, the culprits behind high foreclosure numbers are the widespread decline in residential property values from peak levels in 2005–06, the volume of high-risk home mortgages originated and the worthless mortgage-backed securities that fueled the boom. Without question, the home price bubble has burst. The mortgage delinquency and foreclosure issues have carried over into the consumer and business credit lines, adding to the mounting capital market financial pressures.

Figure 1. U.S. Home Price Change

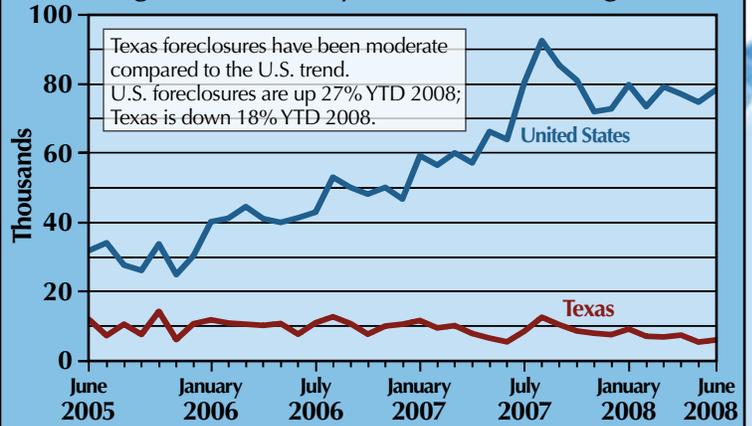


Source: NAR, OFHEO Y/Y percent change in quarterly estimates.

The current housing market bust is affecting every locale but appears to be concentrated in several states that experienced the most rapid price increases. The boom saw housing prices deviate way out of line with basic market fundamentals including income, employment, buyer credit histories and prudent lending practices. In today's sophisticated, computer-connected markets no place is immune to the repercussions of national and even international financial conditions as these directly affect the cost and availability of credit down to local levels.

These problems have resulted in solvency questions and strained liquidity in the banking and capital market sector. The capital market has lost confidence in bond underwriting practices. As a result, investors have been forced to reevaluate risk for all securities previously purchased, which makes determining the current price of existing bonds and securities difficult if not impossible. This mess will probably result in broader government regulatory controls and expanded laws concerning mortgage lending and origination underwriting, not to mention commercial banking and Wall Street.

Figure 2. Monthly Foreclosure Fillings



Source: RealtyTrac Inc. (Data include notices of trustee sales plus notice of foreclosure sales.)

How Has Texas Done?

So far, Texas' housing markets have fared comparatively well despite all the turmoil, but the state's housing sector increasingly reflects the effects of the general downturn.

The Office of Federal Housing Enterprise Oversight (OFHEO) reported 22 states had lower home prices in second quarter 2008 compared with first quarter 2007. Other data (the First American Home Price Index) suggest that as many as 33 states suffered declining home prices in the second quarter. Falling home prices appear to be concentrated in major metropolitan areas (according to the Case-Schiller Index, for one).

Many small and medium-sized metro areas around the country are still reporting increasing values. So far, Texas is one of the major states still posting home price increases. Falling home prices mean delinquent owners and borrowers lose

Percent of Foreclosures Started by Type of Loan, 1Q2008

Type of Loan	Percent of Outstanding Loans	Percent of Foreclosures Started
Prime Fixed	64%	19%
Prime ARM	14%	23%
Subprime Fixed	6%	11%
Subprime ARM	6%	37%
FHA & VA	10%	8%

Source: Mortgage Bankers Association, National Delinquency Survey, March 31, 2008. Estimates by Real Estate Center at Texas A&M University

the option of refinancing or renegotiating a loan or selling a property. When properties are "upside down" (the loan amount exceeds the current value of the property), homeowners get discouraged and are less likely to keep up their payments, and lenders have less room to negotiate without sustaining a significant loss.

The significant drop in home prices that began in 2006 is depicted in Figure 1. Both OFHEO's repeat-sales index and the

median home price reported by the National Association of Realtors (NAR) indicate a substantial and declining rate of change, which is bad news for the market.

Texas Foreclosures Stable

Some leading economic analysts estimate that more than 10 percent of all homeowners in the United States have negative equity in their homes and predict that percentage will increase as prices continue to fall. The major areas affected by lower home prices are six states: California, Florida, Nevada, Arizona, Ohio and Michigan. Through first half 2008, these states accounted for 43 percent of all foreclosures in the country according to RealtyTrac Inc.

Nationally, the number of foreclosures continues to climb, but may begin to stabilize in second half 2008 and into 2009. However, no significant decline in overall foreclosures should be expected until late 2009 or early 2010 as the number of adjustable rate mortgage (ARM) resets for both prime and subprime mortgages will not significantly abate until second quarter 2009. Texas foreclosures have held fairly stable,



compared with a national increase of 61 percent to 1.4 million. Based on Notice of Trustee Sales and Notice of Foreclosure Sales, Texas properties posted for foreclosure during the first half of 2008 totaled 42,705, down 17.7 percent from the same

period in 2007. Foreclosure postings were up 27.3 percent to 462,418 nationally.

The Mortgage Bankers Association (MBA) *National Delinquency Survey* data reveal that adjustable rate mortgages account for the majority of foreclosures. Prime and subprime ARM mortgages represent approximately 20 percent of all mortgages outstanding, and 60 percent of all foreclosures started during first quarter 2008 (see Table).

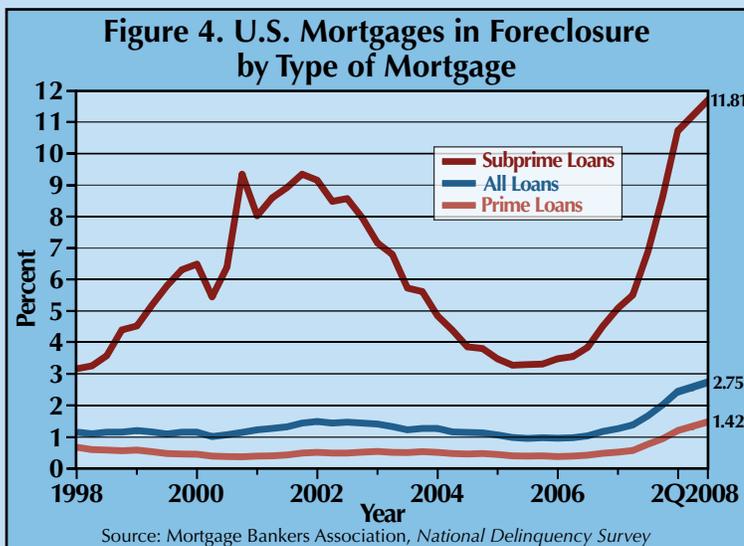
Rate Exceeds '80s Oil Bust

ARM loans plus subprime fixed-rate mortgages account for 26 percent of all mortgages outstanding and 71 percent of all foreclosures. Clearly, the foreclosure issues facing the country and Texas will not abate until the majority of ARM mortgages originated between 2005 and 2007 reset, refinance or are foreclosed. Most subprime loans were one- or two-year ARMs, so the vast majority will reset in 2008 and early 2009. Prime ARM mortgages involved one-, two-, three- and five-year adjustments and may take well into 2010 before the majority reset.

The MBA data further reveal the national mortgage foreclosure rate is at an all-time high, even exceeding the Texas foreclosure rate during the oil bust and depression of the 1980s. Texas' current foreclosure rate is a full percentage point less than the national rate and considerably below the state's mid-1980s level (Figure 3).

Nearly 2.5 percent of all mortgage loans in the United States are in foreclosure, compared with 1.45 percent of Texas mortgages. The foreclosure rate for subprime loans nationally is 11.8 percent compared to Texas' 5.9 percent (Figures 4 and 5).

It is hardly surprising that subprime loans have a substantially higher foreclosure rate because they are high-risk mortgages, a fact that seems to have been ignored by many investors in subprime mortgage-backed securities. The most troublesome data depicted in Figures 4 and 5 is the level of prime loan foreclosures, which is running more than double the long-term average rate for the nation (1.42 percent vs. 0.5 percent). Texas' prime loan foreclosure rate is about 20 percent above its long-term average (0.65 percent vs. 0.5 percent).



slightly declining for the past several years and are expected to continue that general trend (Figure 2).

In 2007, Texas was one of only six states that reported a decrease (4.6 percent) in delinquency-foreclosure filings versus a 75 percent national increase, according to RealtyTrac. During first half 2008, Texas' filings totaled 70,180, up 1 percent,

Following Economic Ups, Downs

A common thread in these figures is that foreclosure activity tends to be cyclical, following the ups and downs of the general economy. Nationally, foreclosures for all loans declined during the late 1990s and accelerated during and just after the 2001 recession. Because that recession was quite mild, the impact on foreclosures was not as pronounced, though the rate increased nearly 50 percent, rising from 1.03 in second quarter 2000 to a high of 1.51 percent in first quarter 2002.

Subprime-mortgage foreclosures, although not nearly as numerous as they would later become, soared from 5.5 percent to 9.2 percent (a 68 percent increase) during the same time. Interestingly, and subsequently disastrously, subprime-backed securities investors failed to notice how much more magnified subprime foreclosures became during even a slight economic decline.

The pattern of change in Texas foreclosure rates followed the national pattern, although the 2001 national recession did not affect Texas until 2002. Nevertheless, Texas' prime-mortgage foreclosure rate trended upward in late 2002 and into 2003 but not to an alarming level.

The subprime-mortgage foreclosure rate during the time spiked at a little over 7 percent in fourth quarter 2002. During the housing boom in Texas, which was somewhat shorter than nationally, both foreclosure rates dipped to near "normal" levels or below.

Since second quarter 2006, foreclosure rates have increased, though not nearly as much as the national rates. The prime-mortgage foreclosure rate is up 44 percent from 0.43 percent to 0.65 percent, and the subprime-mortgage foreclosure rate rose 54 percent from 3.81 percent to 5.89 percent.

3.4 Million Home Mortgages Statewide

According to the U.S. Census Bureau's American Community Survey, of Texas' roughly 5.3 million owner-occupied homes, approximately 3.4 million (64 percent) have a mortgage and 1.9 million have no debt (36 percent). Of the homes with a mortgage, about three million (89 percent) have a first loan and

slightly more than 400,000 homes (11 percent) have some type of second financing. Approximately 173,300 Texas homes (5 percent) have a second mortgage, nearly 200,000 (6 percent) have a home equity loan and about 11,500 (0.3 percent) have both.

Home debt financing nationally exceeds Texas levels, with slightly more than 68 percent of all owner-occupied homes having some type of debt. Of the homes with debt, 73.5 percent have only a first loan and 26.5 percent have some type of secondary financing. Almost ten million homes nationally carry

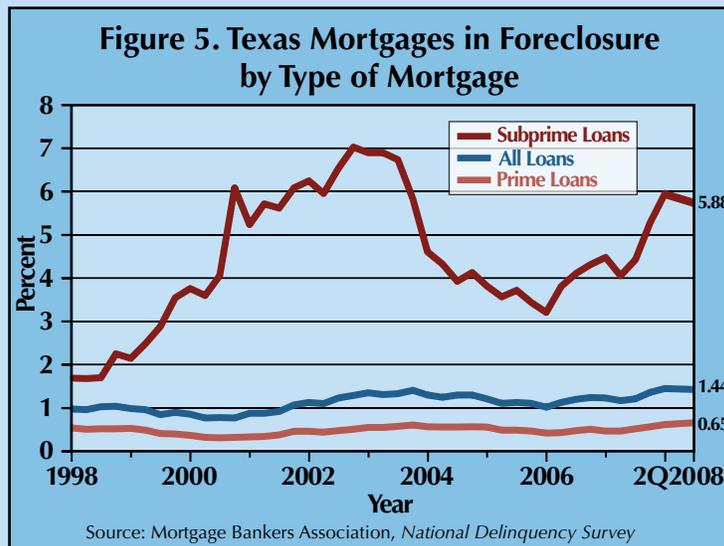
a home equity loan or home equity line of credit (HELOC), representing more than 19 percent of all homes with a mortgage. Secondary financing is most common in the highest home-price states where buyers are forced to obtain greater financing to cover the higher acquisition costs.

Little delinquency-foreclosure data are available on second loans or home equity loans. First American's subsidiary company, LoanPerformance, publishes regular reports on delinquencies and foreclosures for loans held in its sizeable portfolio. Accord-

ing to its data as of June 2008, the states with the most significant home equity and HELOC serious delinquencies were Florida, Nevada and Mississippi. Texas ranked as the third-best state with a 0.67 percent serious delinquency rate.

Texas should continue to weather the current storm well so long as there is not a major falloff in statewide employment and the liquidity problems plaguing mortgage lenders do not result in a major cutoff of funding. ➔

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THE TAKEAWAY

So far, Texas has avoided high foreclosure levels. The housing market continues relatively strong though sales and new construction are down considerably from 2006-07. A stronger-than-national-average economy with fairly low unemployment and continued population growth continues to fuel demand for housing, but not at the unsustainable levels of the boom years.



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