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## Creative Lending, A Sign of Trouble?

I was interviewing lenders today to get a pulse on their business. It was a trip down memory lane. One lender and I, were reminiscing about the creative financing tools we had in the early 90's. Then the market was at it's top and affordability was a big issue. Here are two creative ways we helped people qualify back in 1990-2.

Easy qualifier loans were used when a buyer did not have the income to qualify, but if the buyer had 20% down and good credit, the bank offered to look the other way.

40 year negative amortization loans stretched the term of the loan and allowed negative amortization. This lowered payments so buyers could qualify, but at the expense of a loan balance that increased because payments didn't even cover the interest charges.

Fast forward 10+ years and lenders have a new set of creative financing tools at their disposal. However, the creation of these creative financing tools is not a good sign. It is an indication that buyers are struggling to afford today's higher prices. It is a precursor to a market top, and may produce instability and lead to future foreclosures.

Today's aggressive financial manipulations include the following.....

1) **100% financing** - yes that's right. For many of you old timers this seems like it should be illegal, but it's not. "About 60% of the loans that go through our mortgage company are 100% financing loans" says Gregg Mullery, Asst. VP at Pacific Republic Mortgage.

Why has nobody made an issue about 100% financing? Because home prices continue to rise, making it a smart gamble. Why slave for 5 years to save 10% down when you can use 100% financing, wait one year and have appreciation give you 20% equity. This type of lucky market timing makes the cautious saver seem like a dumb stodgy fool.

But what happens if property prices drop 5% or just stay the same for the next 3 years? If a buyer has to move, then they are faced with 2 choices. Either walk away from the property or bring in lots of cash to close the sale. Just how much cash? Closing costs with commissions can total about 7% of the sales price. A homeowner with a \$350,000 home and \$350,000 loan may

have to bring in \$20,000-\$30,000 in cash just to sell their home. Making matters worse, a 100% buyer usually pays a premium since sellers often pay the buyer's loan fees and closing costs. Now if they didn't have any money to buy the home, it is unlikely they will have the cash to just walk away. This is the makings for a foreclosure.

2) **Artificially low introductory rates** lower payments to help buyers qualify, but at the expense of future risk.

Many of the loans made today, are not 30 year fixed loans at 5.75%, Not because it is not the smart thing to do, but because buyers can't even qualify for these great rates. Lenders have several options, firm loans and variable rate loans. Firm loans are fixed for several years and then convert to adjustable rate loans, like a 5% rate for 5 years or a 4.25% rate for 2 years. Both then convert to an adjustable loan. If a buyer still can't qualify, how bought a 3% adjustable rate loan. "It pains me when a buyer doesn't opt for a 30 year fixed at 5.75%, because rates are so good, but they usually have no option" says Tammy Colangelo at Wells Fargo Home Mortgage.

Wells Fargo also recently re-introduced an interest only adjustable loan, not quite as bad as a negative amortization loan. But once again, the lenders are responding to higher house prices with products that offer lower payments so that buyers can qualify.

But what if rates jump? It is a consensus among many investors that rates are artificially low. This is a likely scenario since the Federal Reserve tries to keep rates low in times of economic trouble. When a recovery is seen on the horizon rates will likely climb. Higher loan payments will bury these buyers already stretched to the max.

3) **High debt ratios** - The old rule of thumb used to be 40% was the maximum allowable debt ratio. This 40% was calculated by taking the buyer's proposed monthly housing expense (PITI) plus other minimum monthly payments on other credit obligations (such as car and credit card payments) and divide the total monthly debt payment by the buyer's GROSS monthly income. Now lenders are approving debt ratios as high as 50% and even to 60%. I recently saw a buyer get loan

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approval with a 69% debt ratio. Now unless that buyer's income increases drastically, this home is destined for foreclosure.

Keep in mind that buyers with high debt ratios are often the ones that also use 100% financing and artificially low introductory rates. The whole combination spells foreclosure should rates jump, prices drop or even hold steady, or should incomes drop.

### Lenders are concerned

Lenders are caught between a rock and a hard place. They need to make loans and be competitive by offering the same programs that other lenders offer. On the other hand, they need to make good loans that will not result in loss.

So many lenders are tightening up because they sense that some of their lending practices might be too loose. One trend that several loan agents and mortgage brokers mentioned was that debt ratios above 50% are now harder to get through underwriting. Lenders are also tightening up on buyers with marginal credit. It used to be a FICO score above a 620 would put you into an "A" paper loan, Now the bar has been raised to 660+ to get the best rates available.

### Conclusion

The fact that lenders have responded to rising prices with creative financing spells trouble. When the market gains momentum like it has, buyers become more willing to leverage their future. Getting in at all costs becomes the goal at the expense of financial discipline. In addition, a buyer that uses 100% financing, may bid more aggressively than a buyer that saved for 5 years to purchase a home.

A buyer's equity position is analogous to a term in the stock market call "Commitment". It is a measure of the equity that stock owners have in their stocks. The less "Committed" an owner is to a stock (the less equity he has) the more willing he is to sell the stock come hard times. Lack of "Commitment" is a risk for homeowners with no equity.

On the other side of the fence, we are experiencing extremely strong demand. Demand greatly outweighs supply. So much of the price gains have been justified.

But how much of the demand has been ampli-

fied by easy money programs? If there was no 100% financing, would the market have already cooled? Has the market been sustained by 100% financing, artificially low introductory rates, and the acceptance of high debt ratios?

For the last 6 years property prices have climbed, and in the last 2-3 years the trend has accelerated with close to 20% gains each year. Contrast this to pay raises of 4-5% and we see that home prices have outstripped a buyers ability to pay the mortgage.

Trees don't grow to the sky and most buyers are already at their limit to make a purchase happen. This leads me to believe that the market will have to moderate soon. But it hasn't yet, and as I write this article the market is still as crazy as ever. How much higher prices go is anybody's guess, but it is my contention that the next set of price increases will be the straw that breaks an already strained buyers back.

## New Withholding Law

Quite a few years back, California enacted a requirement that sellers withhold 3 1/3% of the sales price for potential state taxes owed. However, there were so many exclusions that very few sellers had to withhold funds. So few that I can't remember one client that had to withhold.

This is no longer the case. As of January 1st, 2003, the law has changed significantly and many more sellers will find that they will be required to withhold 3 1/3%, even if no profit was made.

The withholding requirement will not effect owners selling their principle residence, as defined as having lived in the property for 2 of the last 5 years. Nor will it affect owners selling and then repurchasing through a 1031 exchange. But all other sellers should be aware that they may have to withhold. Which on a \$400,000 sale, amounts to over \$13,000.

To determine if the new withholding law affects you, log on to our web site, [www.LBRE.com](http://www.LBRE.com), and click on the tab Market-News.

# Market Activity

The following information is from the Multiple Listing Service as of 2/25/2003.

Address	Br/Bth	Sq Ft	Lot Size	List Price
<b>Alamitos Heights</b>				
820 Havana	3/2	2322	6092	470,000
716 Havana	3/2	2149	6500	485,000
360 Panama	3/1.5	1509	4940	559,000
370 Winslow	3/3.5	2373	6560	744,500
600 Santiago	3/3	2505	8400	769,000
530 Los Altos	3/2.5	3022	9750	995,000
<b>La Marina Estates</b>				
6561 Bacarro	4/1.75	1400	8770	475,000
1231 Hackett	3/2	1874	7035	625,000
<b>Los Altos (S. Fwy)</b>				
1864 Palo Verde	4/2	1700	7130	304,000
2170 Stearnlee	2/1	893	6300	313,999
1840 Elmfield	3/1	1200	5500	349,000
1980 Josie	3/1.5	1450	6104	350,000
1801 Hackett	3/2	1435	6050	354,900
2144 Vuelta Grande	3/2	1322	5880	354,900
6417 Madera	3/2	1372	6104	355,000
1933 Tulane	3/2.75	1568	5775	355,000
5485 Garford	3/2	1564	6300	360,000
2249 Radnor	3/1	1297	5820	365,000
2243 San Vicente	2/2	1260	6000	365,000
2158 San Vicente	3/2	1208	6195	376,500
1937 Volk	4/2	1322	5900	379,900
5862 Los Arcos	3/1.75	1428	6000	385,000
1960 Knoxville	3/1	1114	6216	399,000
1809 Tulane	3/2	1393	6450	399,000
6020 Los Arcos	3/2	1696	6000	399,000
1830 Snowden	3/2	1530	6090	410,000
2081 Snowden	3/2	1596	6090	424,000
1809 Ostrom	3/2	1234	5936	429,000
2221 McNab	4/3	2220	6000	457,500
2206 Carfax	3/2	1967	6900	459,000
2070 Senasac	5/3	2544	6380	549,000
<b>University Park Estates / College Park</b>				
441 Laurinda	4/1.75	1746	6380	499,000
<b>Park Estates</b>				
5524 Oleta	3/3	2414	8400	635,000
5419 Anaheim	3/2	2144	8297	659,000
1411 Greenbrier	3/2.5	2562	6900	674,000
5550 La Pasada	3/2.75	1989	8450	739,000
900 Bryant	3/2.5	2568	11500	750,000
5450 La Pasada	4/3	2643	8145	839,000
5530 El Parque	3/2	2311	10500	849,000
5520 Anaheim	3/2.5	2038	8200	859,000
5341 El Parque	3/2	2650	11390	879,000
5511 El Jardin	3/3	2423	8900	889,000
5451 El Parque	4/4	3781	19110	1,700,000
1410 Bryant	4/3.5	4771	22500	2,695,000

## 60 Day Notice Now Required

*As of January 1st, landlords are required to give a tenants a 60 day notice when changing terms or terminating a month to month tenancy. This applies if the tenant has lived in the property for more than one year.*

*Previously only a 30 day notice was required.*