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The Subprime Mortgage Situation

LEGISLATIVE ANALYST'S OFFICE

Presented to:

Senate Banking, Finance and Insurance Committee



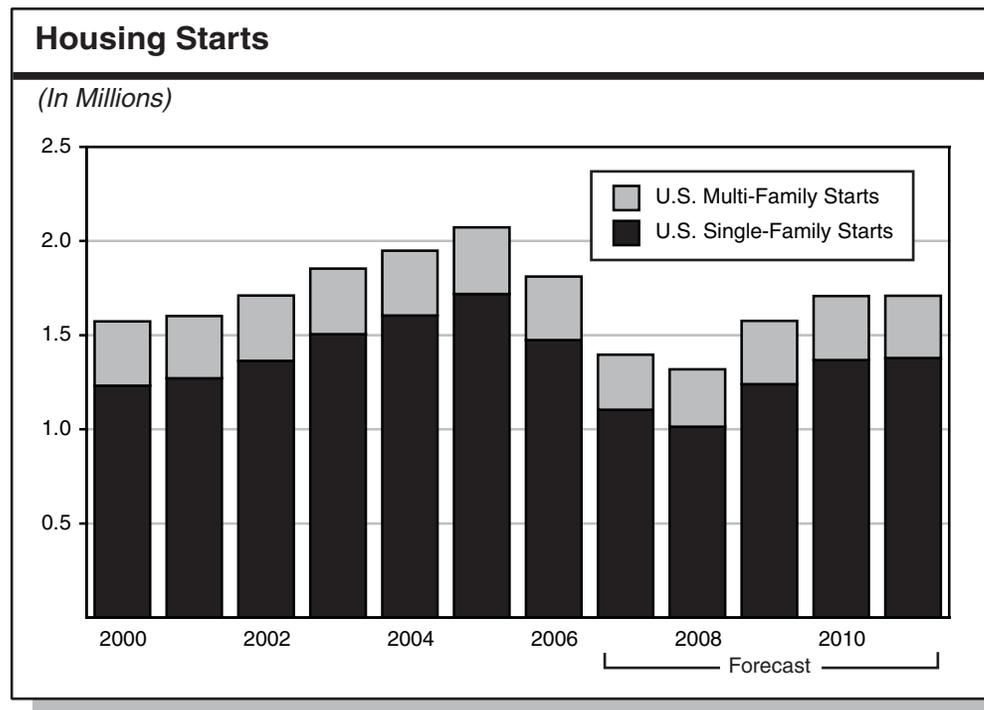


The Current Situation in the Financial Markets

- ☑ In recent years, the financial markets have created many new products. Some of these developments increased the risks associated with certain types of investments and lending.
- ☑ In mortgage lending, one result was an expansion of lending to home purchasers with relatively high default risks.
- ☑ For example, there were increases in mortgage loans offered with low or no down payments, reduced front-end interest rates that reset at higher levels within a few years, and more lax income reporting requirements.
- ☑ Last year, the mortgage market started experiencing increased loan late payments, loan delinquencies, and loan foreclosures. Contributing factors included:
 - Increases in borrowers' monthly payments due to resetting variable rate loans.
 - Reductions in home values in some markets, which prevented some borrowers from refinancing their loans.
- ☑ Initially, the problem with defaults appeared to be confined to the high-risk segment of the mortgage lending market.
- ☑ More recently, however, other financial markets have also been affected, as investors have reassessed risk in markets such as less-risky mortgage products, corporate junk bonds, and leveraged buyouts.
- ☑ At present, the financial markets are still in flux. It is unclear exactly what types of adjustments will be occurring over the weeks and months to follow.



How Has the Housing Market Been Impacted?



Housing Has Been Hit Hard. For the nation:

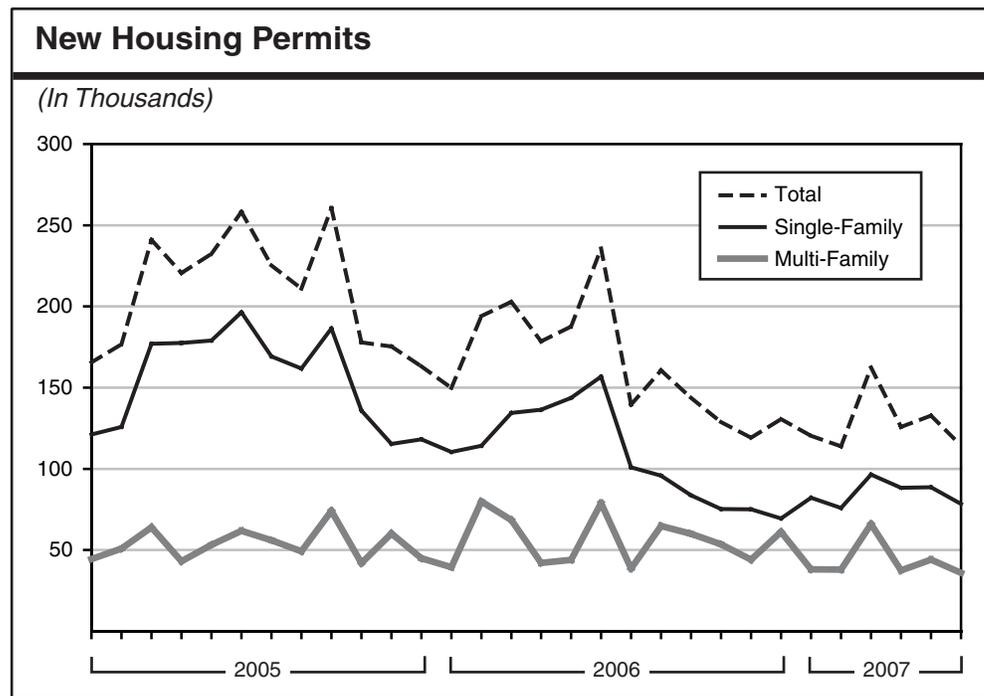
- U.S. housing starts fell to a ten-year low in July and are down by over 20 percent in the past year. For all of 2007, starts are expected to total only 1.4 million units, lowest in many years.
- Prices have also softened and unsold inventories are up.
- The hit on single-family homes has been greatest.
- Many forecasters now expect the beginning of the housing recovery to be delayed until the first half of 2008.



Regional and State Impacts Vary. Although these impacts have been felt nationwide, some state and regional markets are in much worse shape than others, reflecting the more extreme speculative activity that occurred there in past years. Many of California's markets fall into this category.



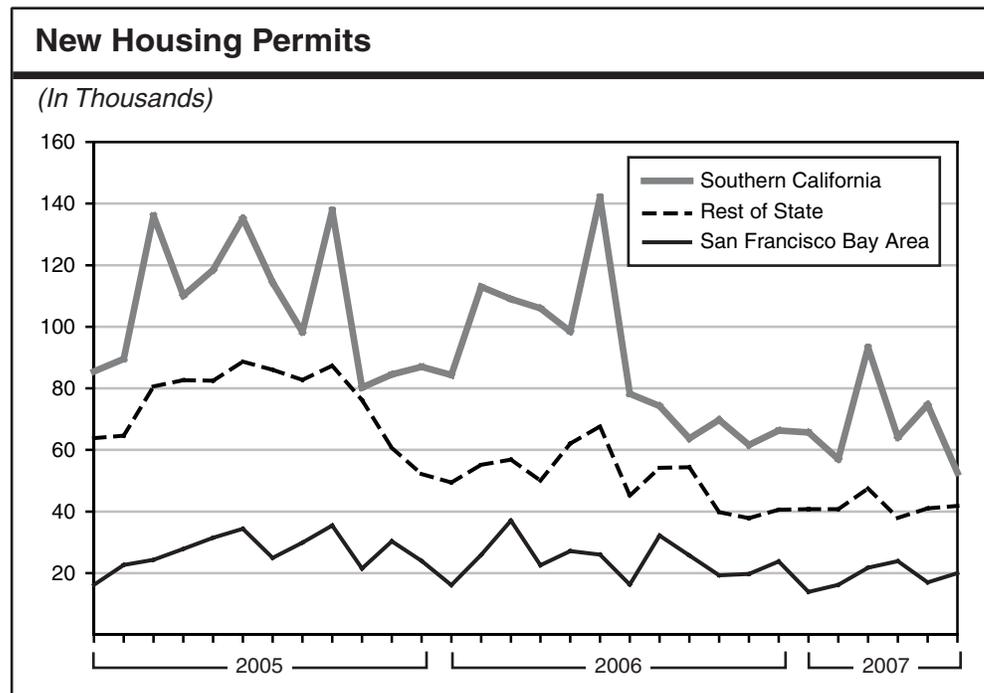
How Is California's Housing Market Doing?



- Permits Are Way Down.** As shown above, housing permits in the state fell to an annual rate of only 114,000 in June 2007.
- Prices Are Soft, Although Somewhat Sticky.** In June 2007, the median sales price of a single-family home in the state was reported to be \$594,000, down only a bit from the record of \$597,000 set in April 2007.
- But Further Price Declines Could Occur.** However, the fact that sales are down and inventories are up indicates that many unsold homes have doubtless decreased in value and are either being kept off the market or not able to be sold for their asking prices.



How Have Different Areas In the State Performed?

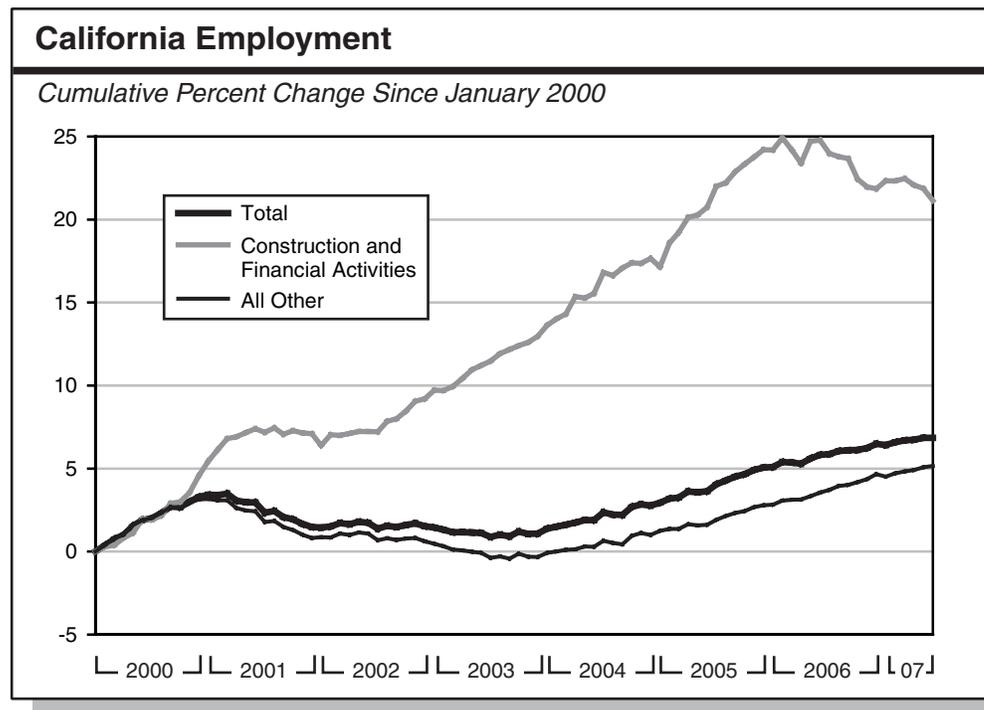


- ✓ ***Southern California Has Been the Weakest Region.*** New building permits in Southern California amounted to only about 53,000 in June 2007, down significantly from earlier months.
- ✓ ***Permits in Other Geographic Areas—Relatively Flat.*** Combined, new housing permits in the remainder of the state, while soft, have been fairly flat in recent months.
- ✓ ***What About Geographic Price Variation?*** Here, too, considerable variation exists:

 - Some very desirable areas are continuing to report rising median prices; Contra Costa County, for example, saw its June 2007 median sales price rise to a new high of \$905,000.
 - However, price softness is present in many areas of California, and in some, significant declines are occurring.



How Has the Overall Economy Been Affected?



- Economy Still Expanding.*** Despite some slowing, the overall U.S. economy is continuing to experience modest growth.
- But the Pace of Growth Has Been Trimmed.*** Consumer spending nationally, while robust in the first quarter of 2007, grew at just a 1.4 percent annual rate in the second quarter. As least some of this slowdown appears due to the housing downturn.
- What About Economic Effects in California?*** Here, too, the economy is still expanding. Statewide employment has been clearly hurt in the areas of construction and financial services (many of which are related to real estate). However, job growth has continued to occur in the rest of the economy, although the pace has only been modest. Likewise, sales tax revenues are thus far meeting estimates, suggesting consumer spending in the state is holding up.



Implications and Outlook

- ☑ The full implications of the mortgage market's problems, both nationally and for California, are still unfolding and will not be known for some time.
- ☑ The slowdown in the housing market has been apparent for a while. Both the LAO and the Department of Finance did incorporate a slowdown in the housing sector in their recent state economic and revenue forecasts.
- ☑ There is, however, some evidence suggesting that the magnitude of the housing slowdown may be greater than previously thought and that the troubles in the mortgage market may affect other segments of the financial markets and economy.
- ☑ Thus far, however, many other sectors of the economy remain fairly strong.
- ☑ While the current turmoil in the mortgage market is producing a drag on the economy in the short run, and requiring painful adjustments in many areas, most economists believe these types of corrections are necessary for the long-run health of the economy.