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The Subprime Mortgage Situation

LEGISLATIVE ANALYST'S OFFICE

Presented to:

Assembly Banking and Finance Committee

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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.

  - Reduction 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.

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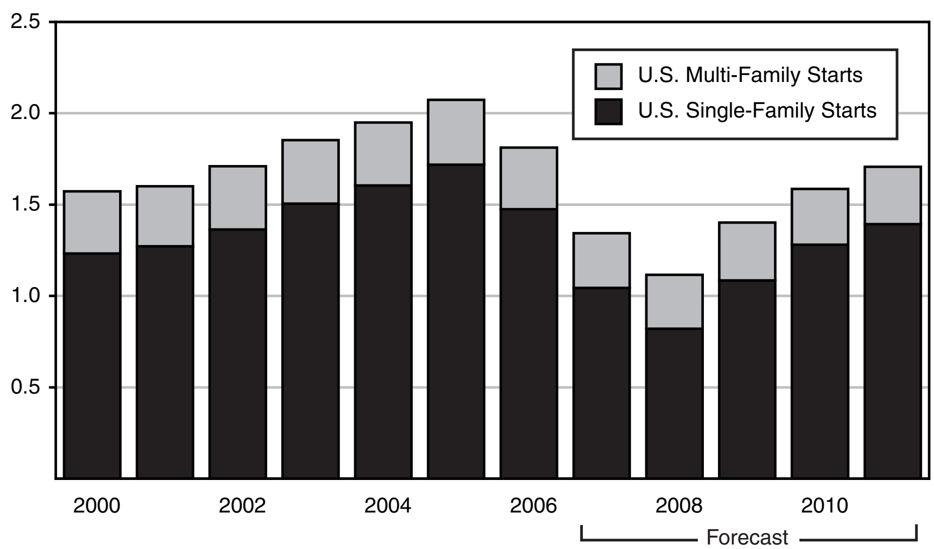
How Has the Housing Market Been Impacted?

Housing Starts

(In Millions)



☑ ***Housing Has Been Hit Hard.*** For the nation:

- U.S. housing starts in September were down by over 30 percent compared to the previous September. For all of 2007, starts are expected to total only 1.3 million units, the lowest in many years.
- Home values have also softened considerably, and inventories of unsold homes are up.
- The hit on single-family homes has been greatest. In contrast, the multi-family market has been less affected.
- Many forecasters now expect the beginning of the housing recovery to be delayed until the middle of 2008.

How Has the Housing Market Been Impacted? *(Continued)*

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

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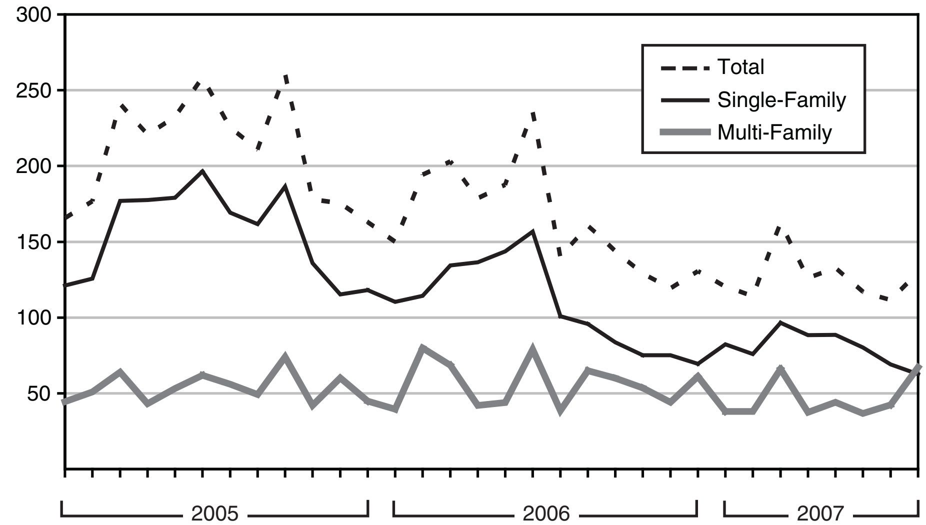
How Is California's Housing Market Doing?

New Housing Permits

(In Thousands)



☑ ***Permits Are Way Down.*** As shown, housing permits in the state in August 2007 were 19 percent below their August 2006 level and 38 percent below their August 2005 level.

☑ ***Prices Are Declining.*** In September 2007, the median sales price of a single-family home in the state was reported to be $531,000. This was 5 percent lower than the previous September and 11 percent below the record of $597,000 set in April 2007.

☑ ***Further Price Declines Could Occur.*** The fact that sales are down and inventories are up indicates that many homes have doubtless decreased in value and are either being kept off the market or not able to be sold for their asking prices.

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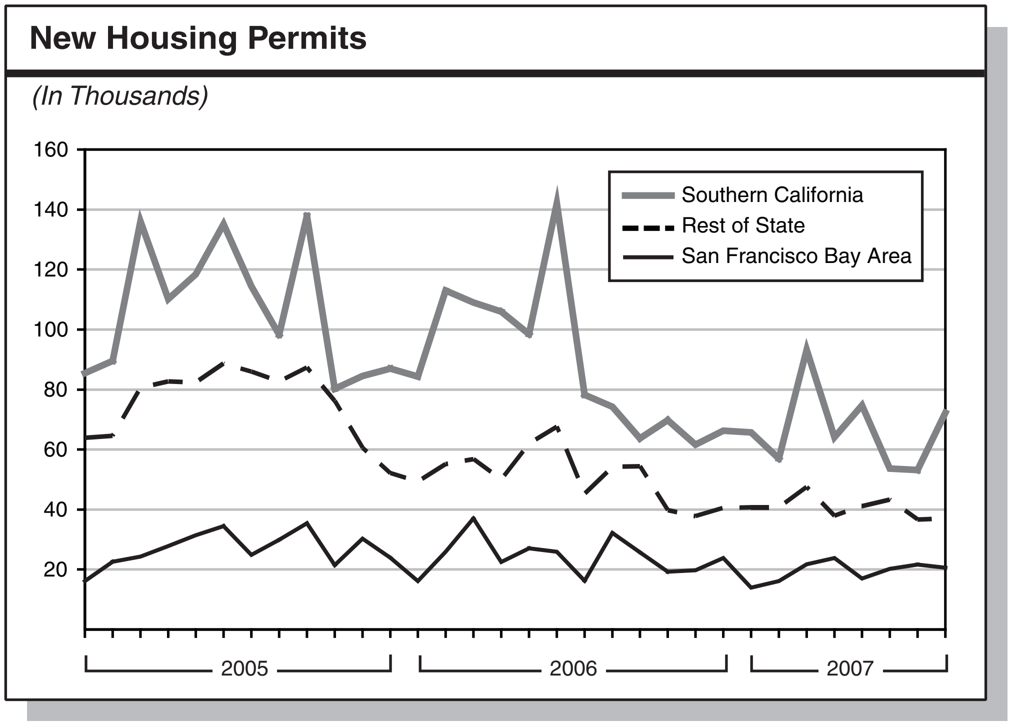
How Have Different Areas In the State Performed?



☑ ***Housing Permits in All Areas of the State Are Down in 2007 Compared to 2005 and 2006.***

☑ ***Southern California Has Been the Most Volatile Region for New Housing Permits.*** Four times since February, permits in Southern California have either increased or decreased relative to the previous month by more than 35 percent.

☑ ***Permits in Other Areas Have Recently Been Relatively Flat.*** In contrast to Southern California, combined new housing permits in the remainder of the state, while soft, have been fairly flat in recent months.

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How Have Different Areas In the State Performed? *(Continued)*

☑ ***What About Geographic Price Variation?*** Here, too, considerable geographic variation exists.

- Prices in some high-demand areas, particularly in the Bay Area, are approximately where they were a year ago.
- However, price softness is present in many areas of California, and, in some, significant declines are occurring.

Which Areas Are Most at Risk For Further Declines?

High-Rate[a] Loan Data and Rankings For Loans Issued in 2006 by California MSA[b]

California MSA	High-Rate Loans Percent of Total Volume	National Rank
El Centro	40.8	3
Visalia-Porterville	36.4	8
Bakersfield	36.0	10
Riverside-San Bernardino-Ontario	35.5	12
Merced	35.0	14
Madera	34.9	16
Stockton	33.4	20
Modesto	33.1	22
Hanford-Corcoran	32.6	24
Fresno	32.0	27
Vallejo-Fairfield	29.9	40
Yuba City	29.5	45
Los Angeles-Long Beach-Glendale	26.4	88
Sacramento-Arden-Arcade-Roseville	24.3	130
Redding	23.2	157
Salinas	22.4	179
Chico	22.2	187
Oakland-Fremont-Hayward	21.1	216
Santa Ana-Anaheim-Irvine	19.4	273
San Diego-Carlsbad-San Marcos	19.2	276
Oxnard-Thousand Oaks-Ventura	17.0	318
San Jose-Sunnyvale-Santa Clara	16.1	330
Napa	15.6	346
Santa Rosa-Petaluma	15.5	348
Santa Cruz-Watsonville	14.6	360
Santa Barbara-Santa Maria-Goleta	14.5	361
San Luis Obispo-Paso Robles	13.1	371
San Francisco-San Mateo-Redwood City	11.7	380

[a] High-rate loans include many, but not all, subprime loans.
[b] Metropolitan statistical area.
Source: *Wall Street Journal*.

☑ ***The Central Valley and Inland Empire Appear Most at Risk.*** Twelve California metro areas, most of them inland, rank in the top 45 nationally in terms of percentage of value of loans issued in 2006 that are high-rate.

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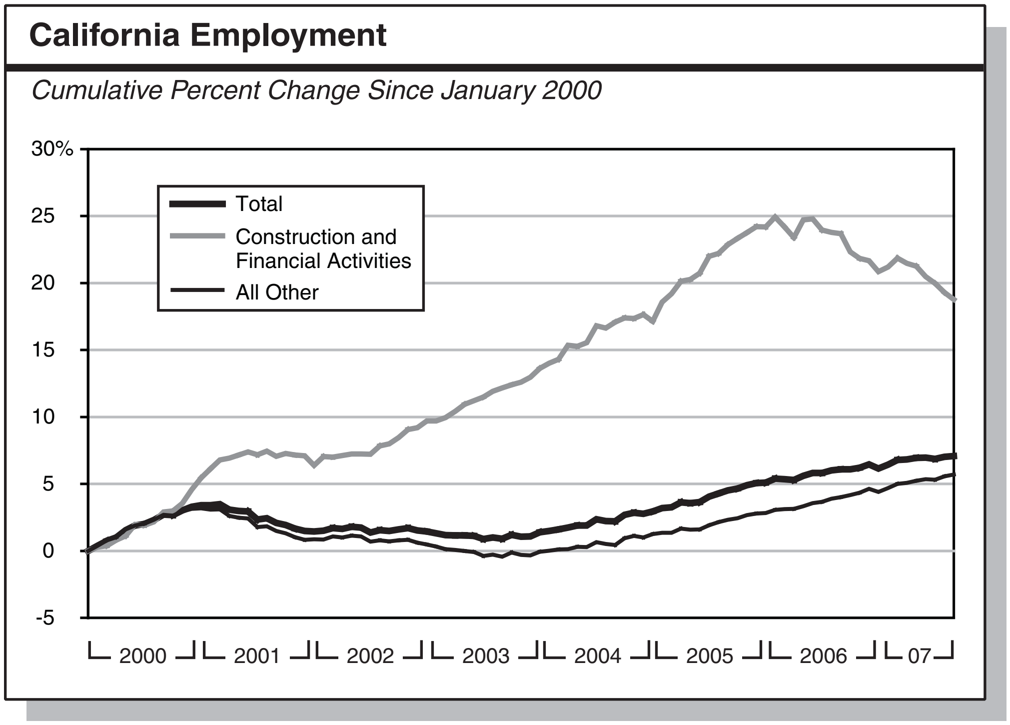
How Has the Overall Economy Been Affected?



- ☑ ***Economy Still Expanding.*** Despite some slowing, the U.S. economy is continuing to experience modest growth despite its housing-related problems, due to such factors as healthy export growth and nonresidential construction.

- ☑ ***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. At least some of this slowdown appears due to factors like the negative effect of the housing downturn on home values, and thus on household wealth. The reduction in home building also has directly and adversely impacted growth in a variety of other sectors of the economy, such as financial services.

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How Has the Overall Economy Been Affected? *(Continued)*

☑ ***What About Economic Effects in California?*** Here, too, the economy still appears to be expanding, but at a modest pace. The figure shows that 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.

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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 some time. The LAO did incorporate a slowdown in the housing sector in its May 2007 state economic and revenue forecasts.

- ☑ The magnitude of the housing slowdown now appears to be greater than previously thought and troubles in the mortgage market may be affecting other financial markets.

- ☑ Despite the corrections taking place in the housing and financial sectors, many other sectors of the economy remain strong.

- ☑ Overall, the national forecast to which we subscribe is now predicting gross domestic product growth to slip to 1.5 percent over the next three quarters, rather than the 2.8 percent growth that it had been predicting last May.

- ☑ One result of slower economic growth is that state revenues have come in below forecast in recent months. For the period May through September, they were more than $1 billion below forecast.
  - The sales and use tax (more than $200 million below projections in the first quarter of fiscal year 2007-08) is often highly sensitive to changes in construction activity.
  - Both the reductions in housing sales volumes and in sales prices will slow the rate of growth of property taxes.

- ☑ While the current turmoil in the mortgage market is producing a drag on the economy in the short run, and is painful for the parties involved, these types of corrections can be beneficial for the long-run health of our market economy.