

Recent Financial Turmoil and its Implications for Kansas Housing Markets

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Five Keys to Understanding the Recent Credit Market Turmoil

- Maturity mismatch

- Long-term assets are financed using short-term liabilities – you can't avoid this

- Trust is a must

- People only lend if they believe the borrower will be *able* to repay the loan



Five Keys to Understanding the Recent Credit Market Turmoil

■ Illiquid vs. insolvent

- A firm is insolvent if its assets are worth less than all it owes; it is illiquid if it cannot make a current debt payment even though it is solvent
- Insolvent firms should be shut down; illiquid firms should get new loans and continue



Five Keys to Understanding the Recent Credit Market Turmoil

■ Transparency

- How do you tell who is insolvent and who is illiquid?

■ Leverage

- Financial firms often use high leverage ratios to magnify their returns
- This also magnifies risk



Leverage Example

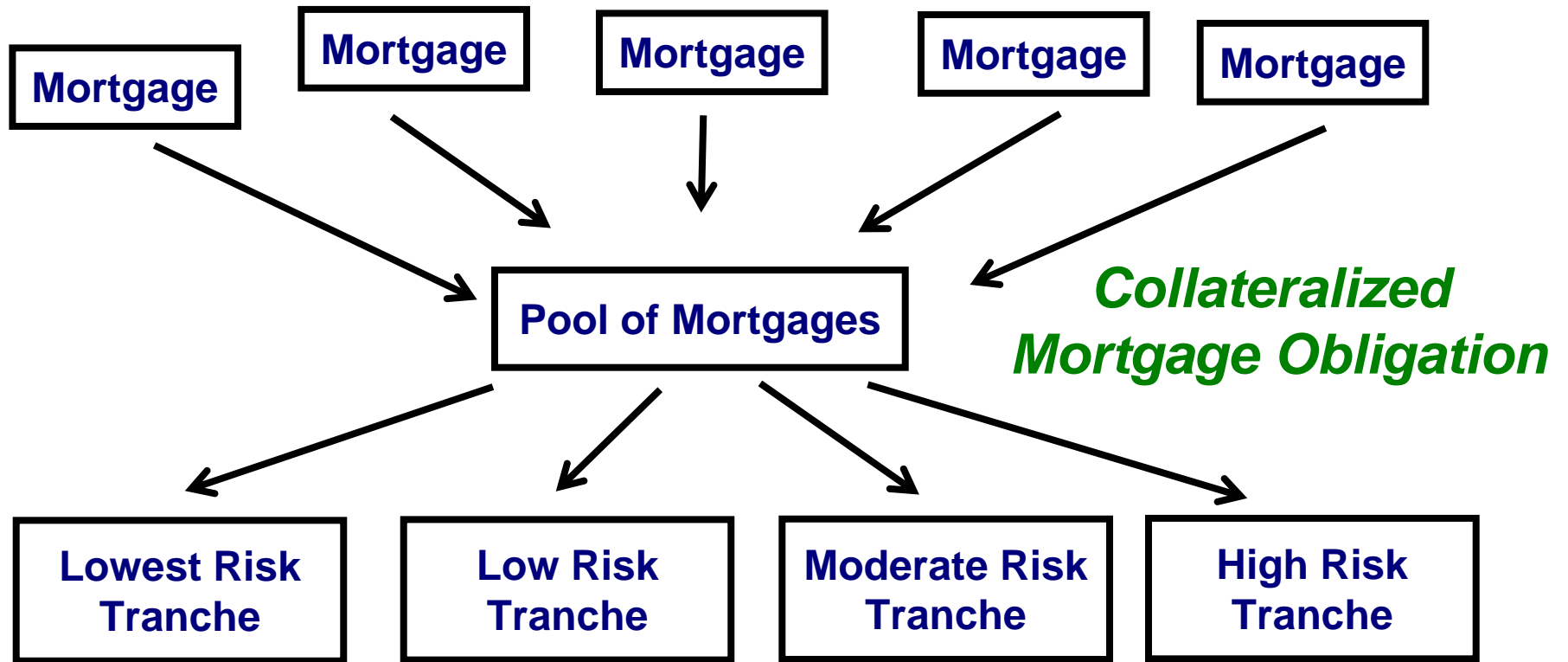
- Suppose you have \$1 million cash that you invest
 - If the investment increases in value by 5% (\$50,000), you receive all the gain and make a 5% return on your investment
- Suppose instead that you “lever up” your investment by borrowing an additional \$24 million (a total investment of \$25 million)
 - Now the 5% return earns you \$1.25 million in profit, a 125% return on your 1 million equity investment



Leverage Example

- But what happens if your investment *falls* in value by 5%?
 - With a cash investment, you end up with \$950,000 (you lose 5%)
 - With a levered investment you end up losing \$1.25 million – You lose all of your equity investment and your lenders take a loss as well
- Small losses can make a highly-levered firm insolvent!

Securitization of Mortgages





Prelude to a “Crisis”

- Subprime mortgage loans would be bundled into pools and used as collateral for mortgage-backed securities
 - Their popularity as investments is why so many alternative financing options (including zero-down mortgages) were available to home buyers
- These subprime MBSs were then often repackaged into collateralized debt obligations (CDOs)
 - This could sometimes be layered several levels deep



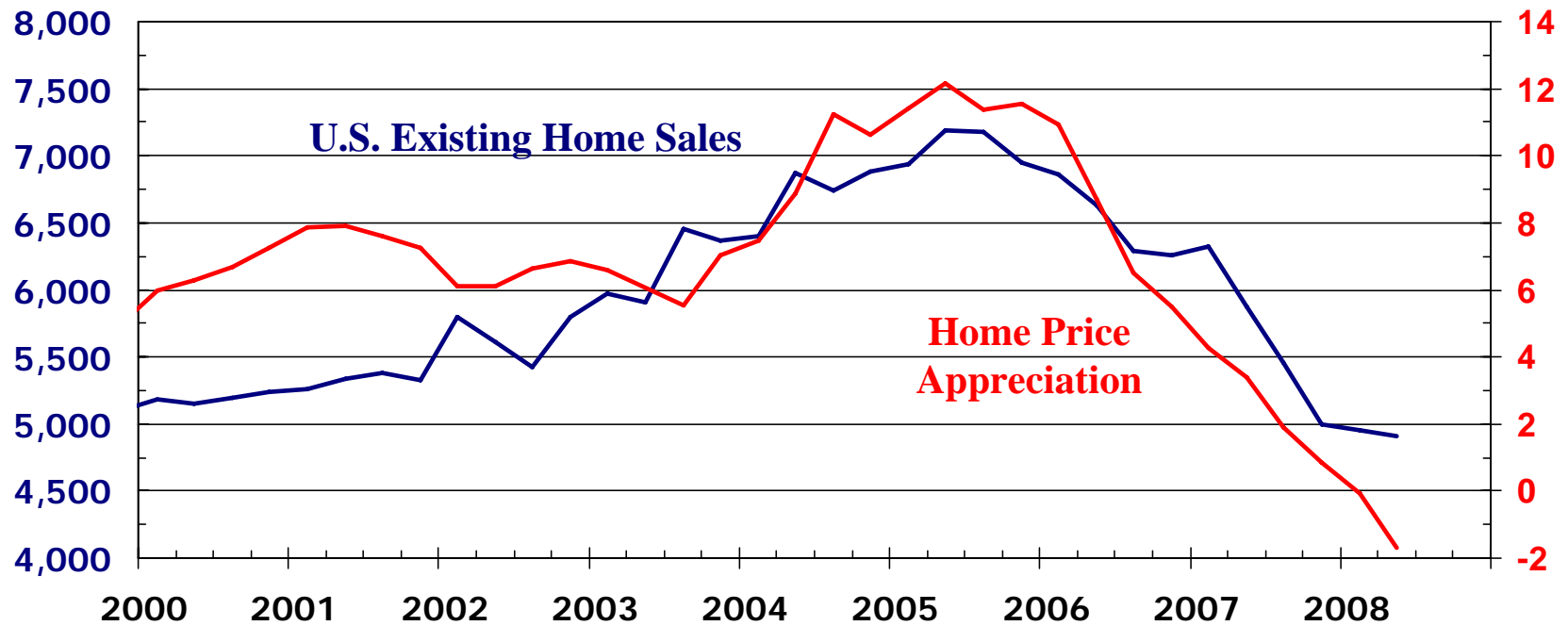
Prelude to a “Crisis”

- Wall Street investment banks and other firms would create special purpose vehicles (SPVs) to purchase these CDOs
 - Off-balance sheet investments
 - High leverage used to increase returns
 - Financed using short-term debt (commercial paper)
- These were great investments as long as home sales were strong and prices were rising

U.S. Existing Home Sales

Sales in 1,000s (SAAR)

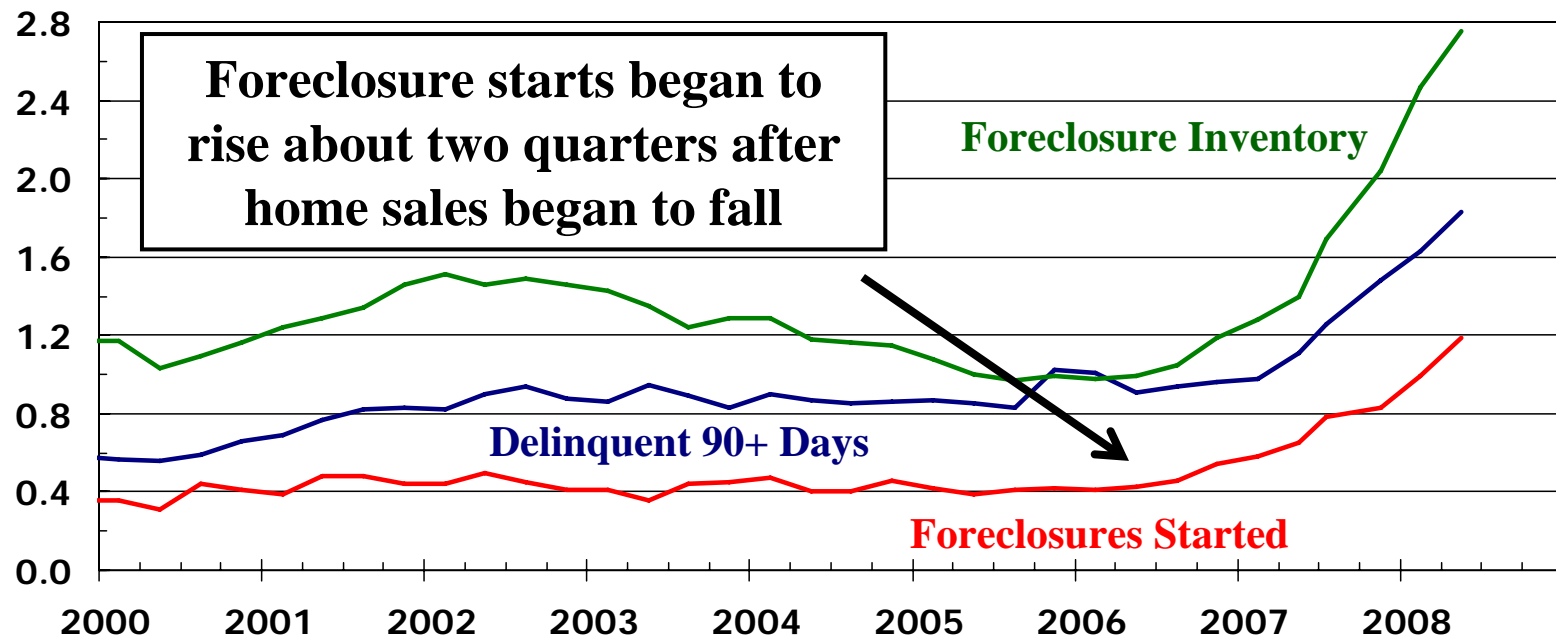
Year-over-year Percentage Change



Source: NAR; OFHEO

U.S. Foreclosures & Delinquencies

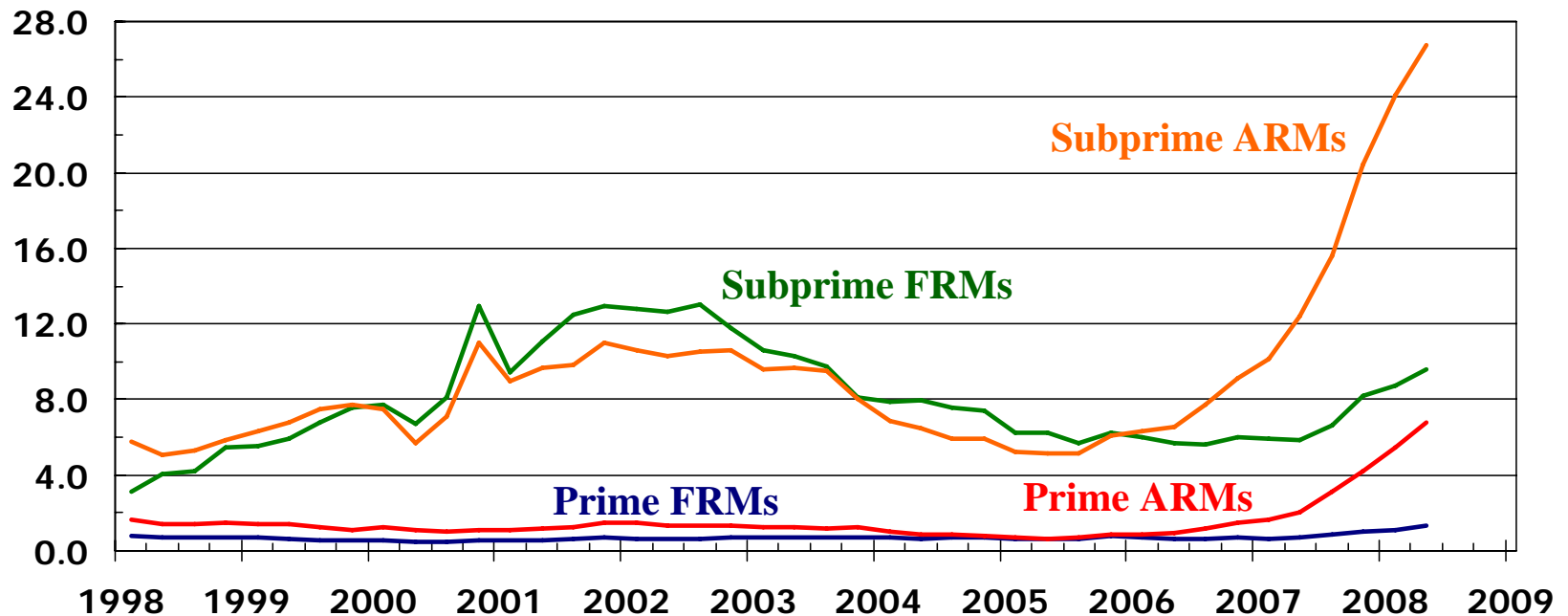
Percent of Loans Serviced



Source: MBA

US Severely Delinquent Loans

Percent of Loans Serviced



ARMs make up about 46% of subprime loans in the U.S. but only 17% of all prime loans

Source: MBA



So What Happened?

- As subprime loans starting going bad, many on Wall Street began to be worried about who was holding the junk
 - High leverage
 - No transparency
 - Illiquid or insolvent?
- Financial institutions began to be afraid to lend to one another
 - Who's next?



So What Happened?

- Losses that started with subprime loans has been magnified through the high leverage
 - Counterparty risk
 - Massive de-leveraging

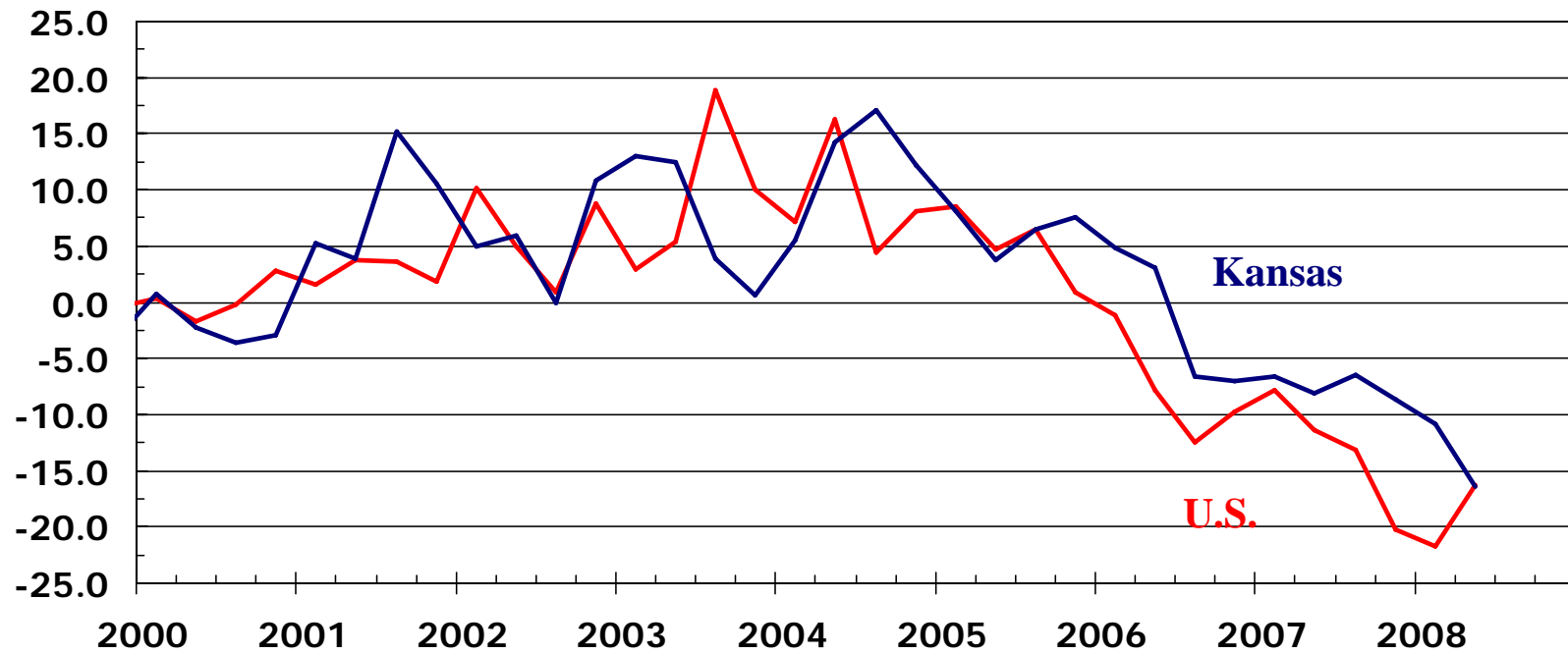


How Does This Affect Kansas?

- A shutdown of financial markets would clearly affect mortgage financing availability
- All real estate markets are local
 - What is the job and population growth situation in your local market?
 - What type of inventory hangover is there in your market?

Existing Home Sales

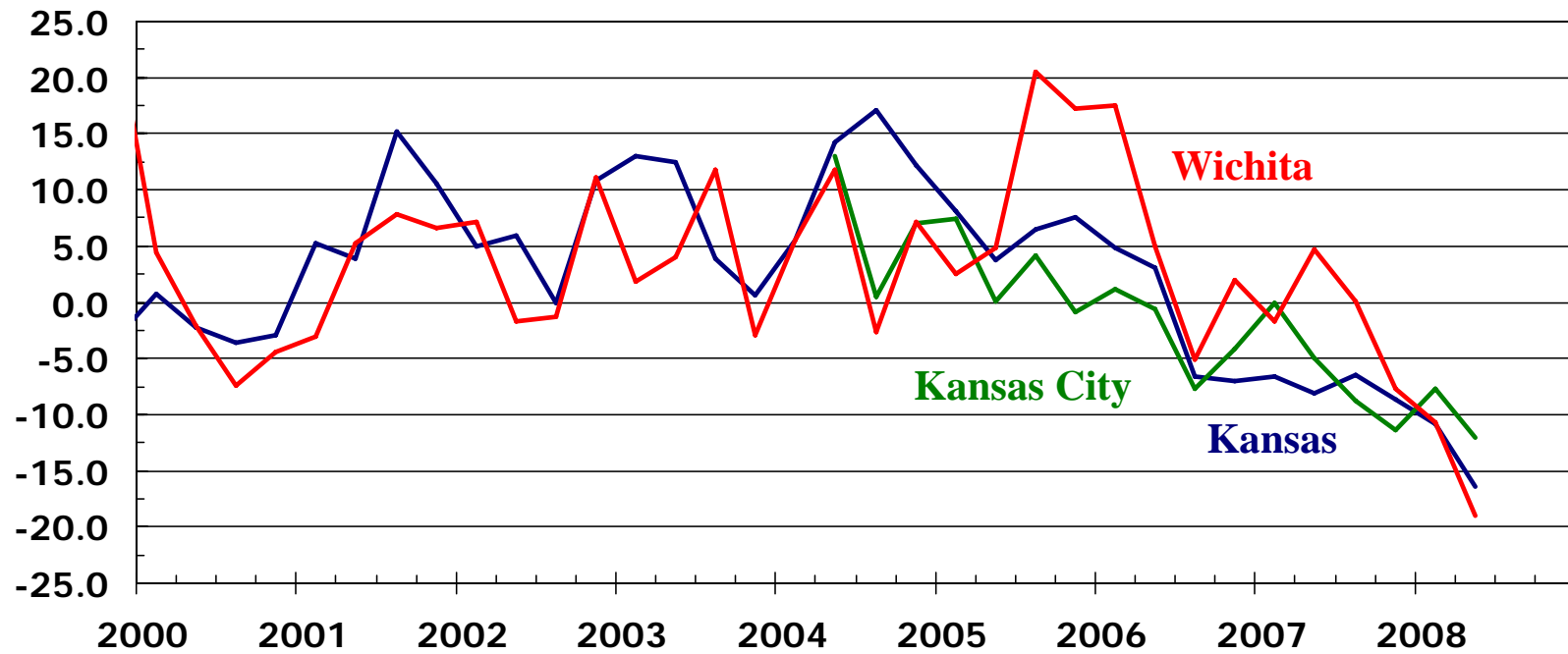
Year-over-year Percentage Change



Source: NAR

Existing Home Sales

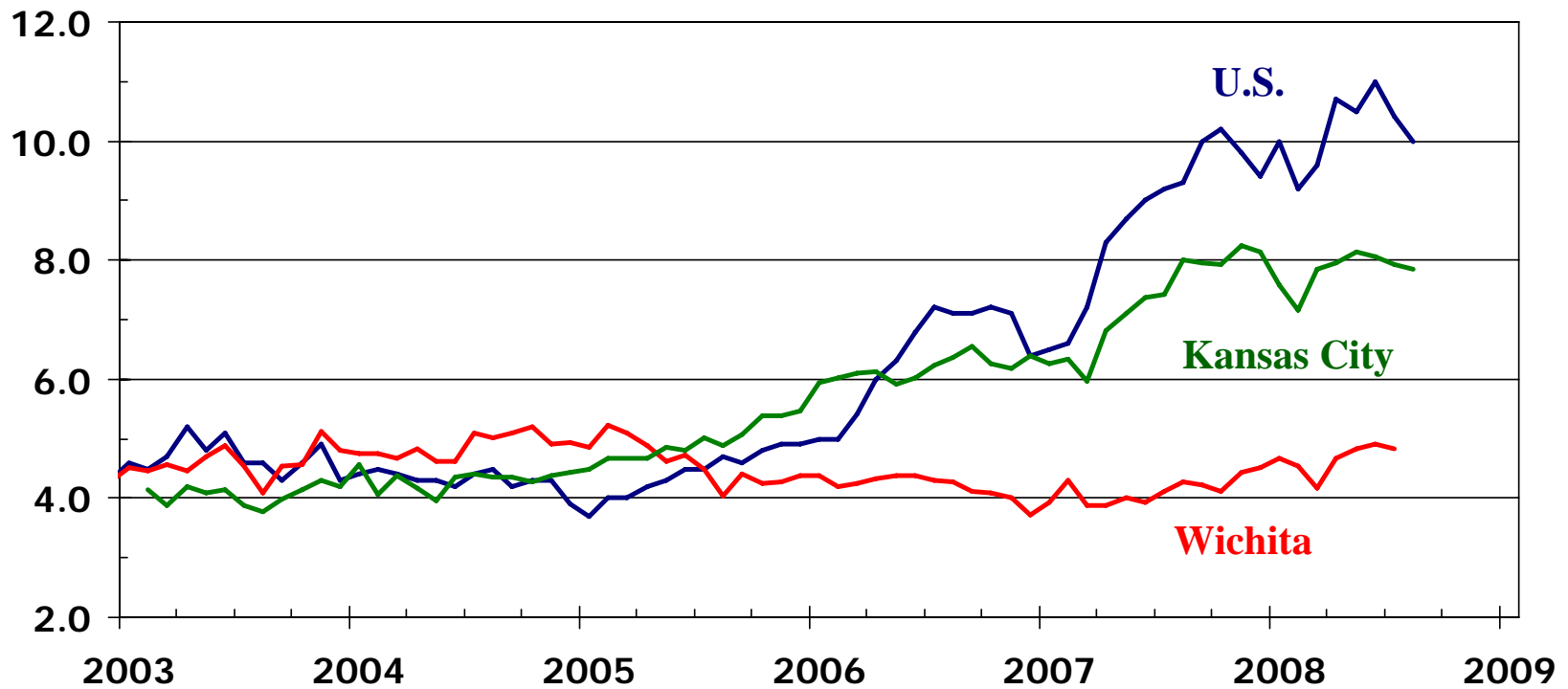
Year-over-year Percentage Change



Source: NAR

Inventory of Existing Homes Available for Sale

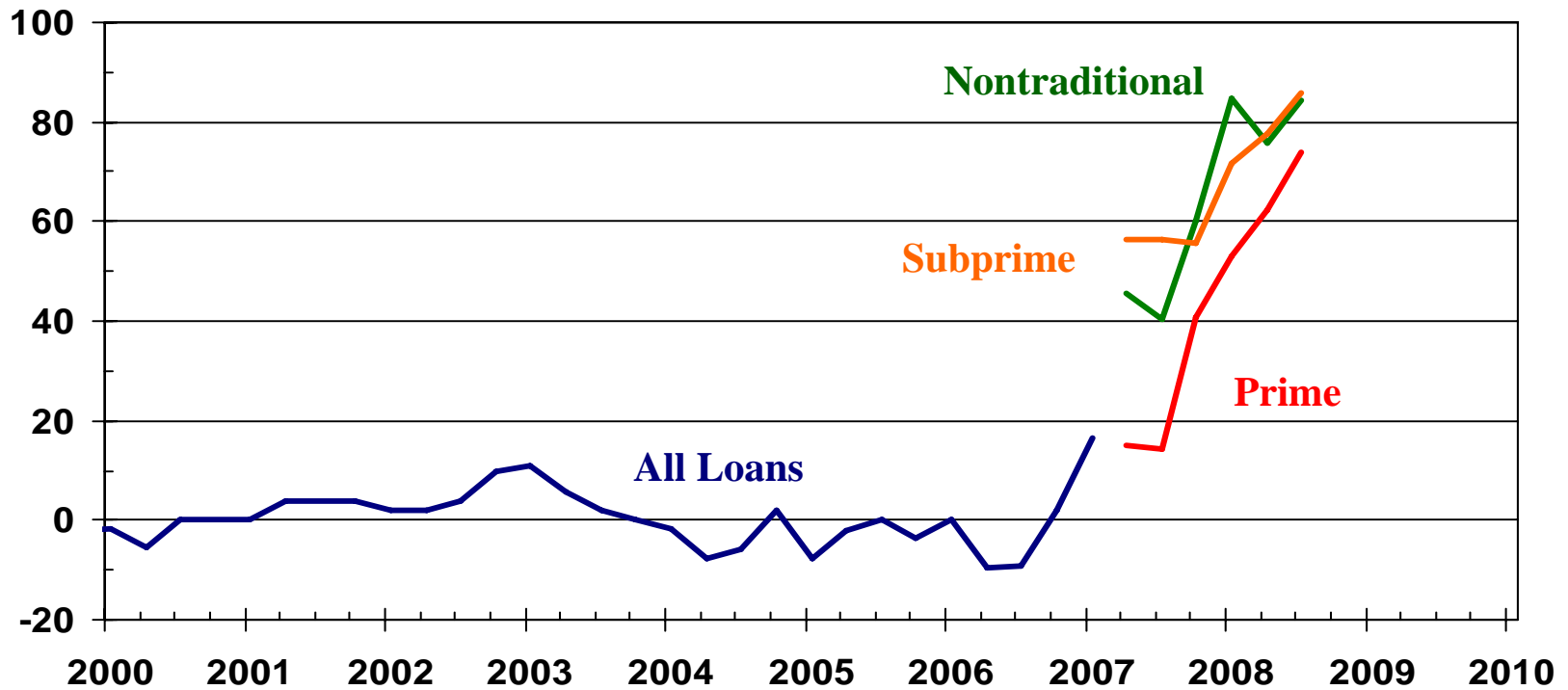
Months Supply (SA)



Sources: NAR; WSU Center for Real Estate
using data from KCRAR and SCK MLS

Mortgage Credit Conditions

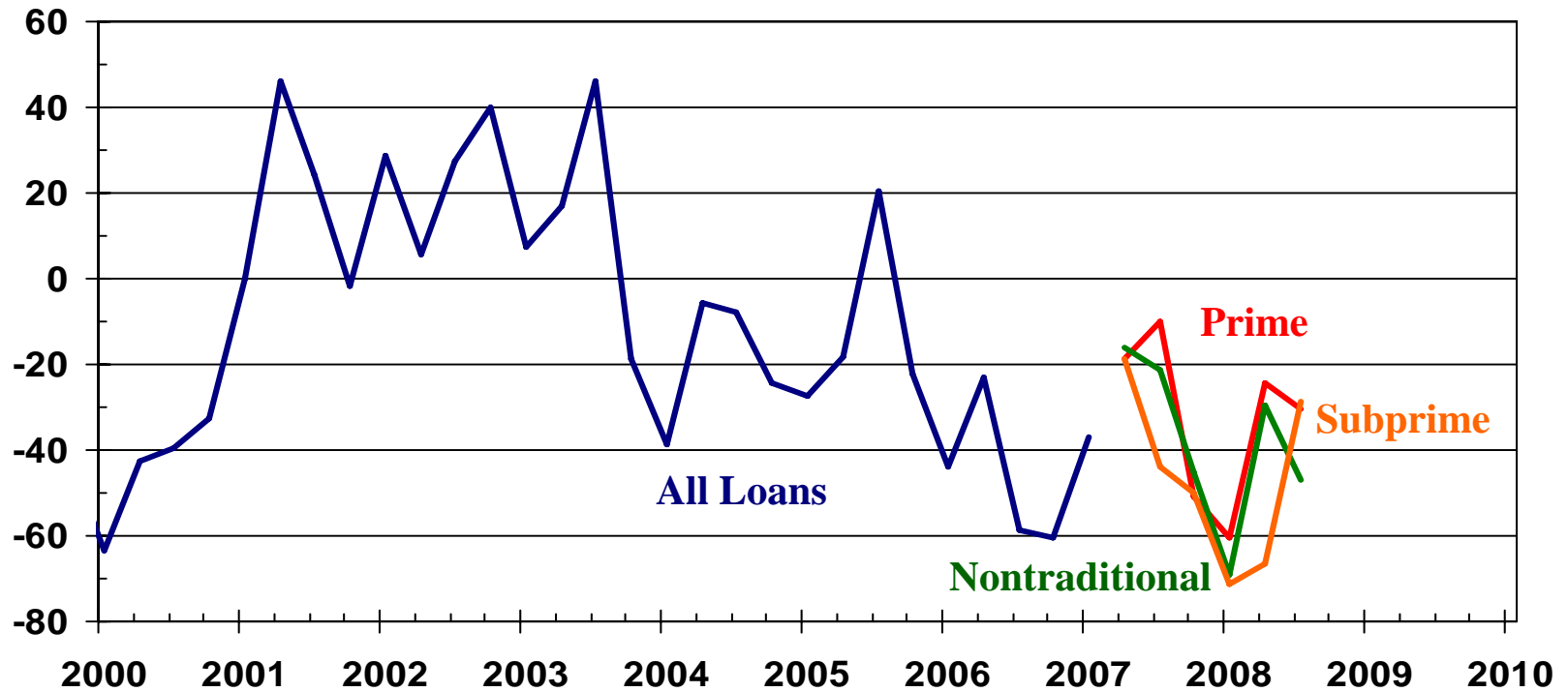
Net Percentage of Banks Reporting Tightening Standard for Mortgages



Source: Board of Governors of the Federal Reserve System

Mortgage Demand

Net Percentage of Banks Reporting Stronger Demand for Mortgages



Source: Board of Governors of the Federal Reserve System



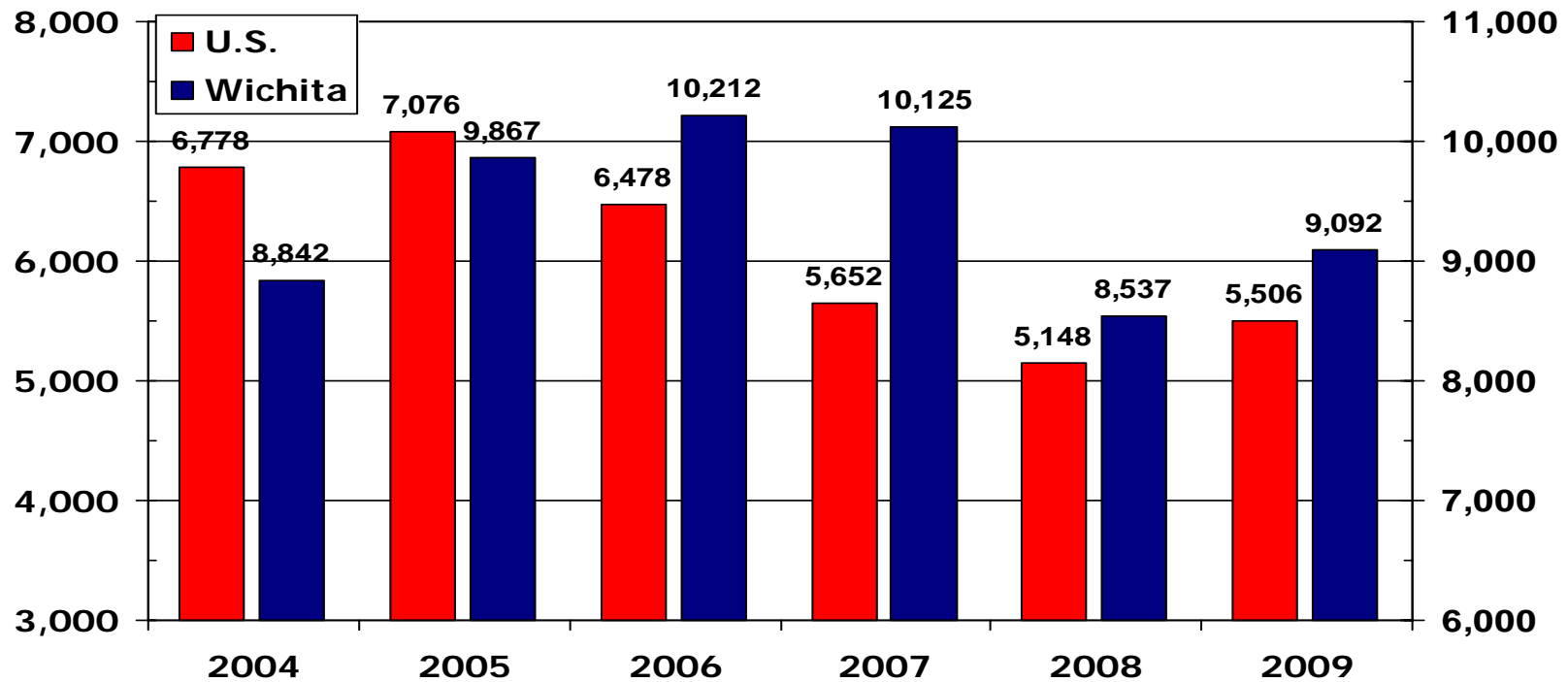
When Will Sales Rebound?

- Existing home sales in Kansas are down for two reasons
 - Financing constraints for first-time home buyers
 - Anxiety is keeping everyone out of the market
- Sales will rebound when
 - First-time buyers adjust to new (old?) underwriting standards
 - Confidence is restored and people return to the market

Existing Home Sales Forecast

U.S. Sales in 1,000s

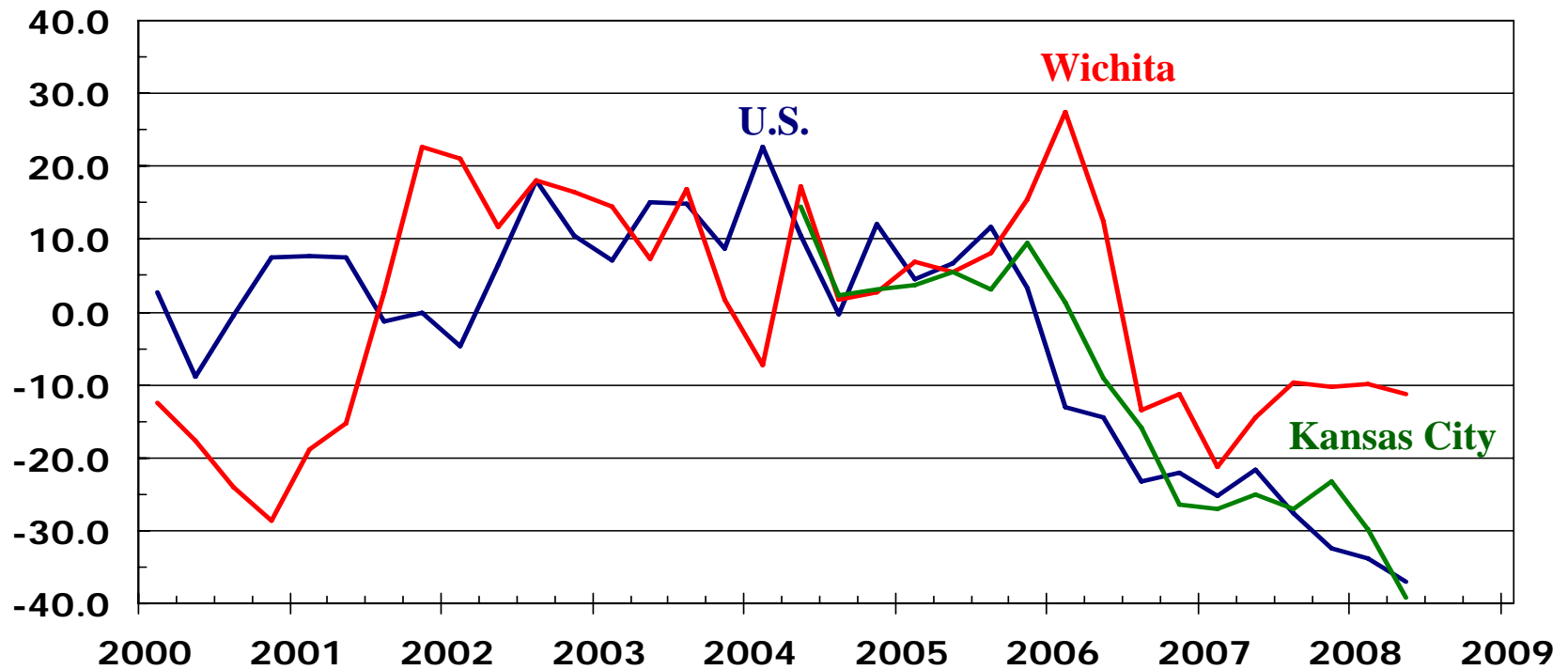
Wichita Area Sales



Sources: NAR; SCK MLS; WSU CRE

New Home Sales

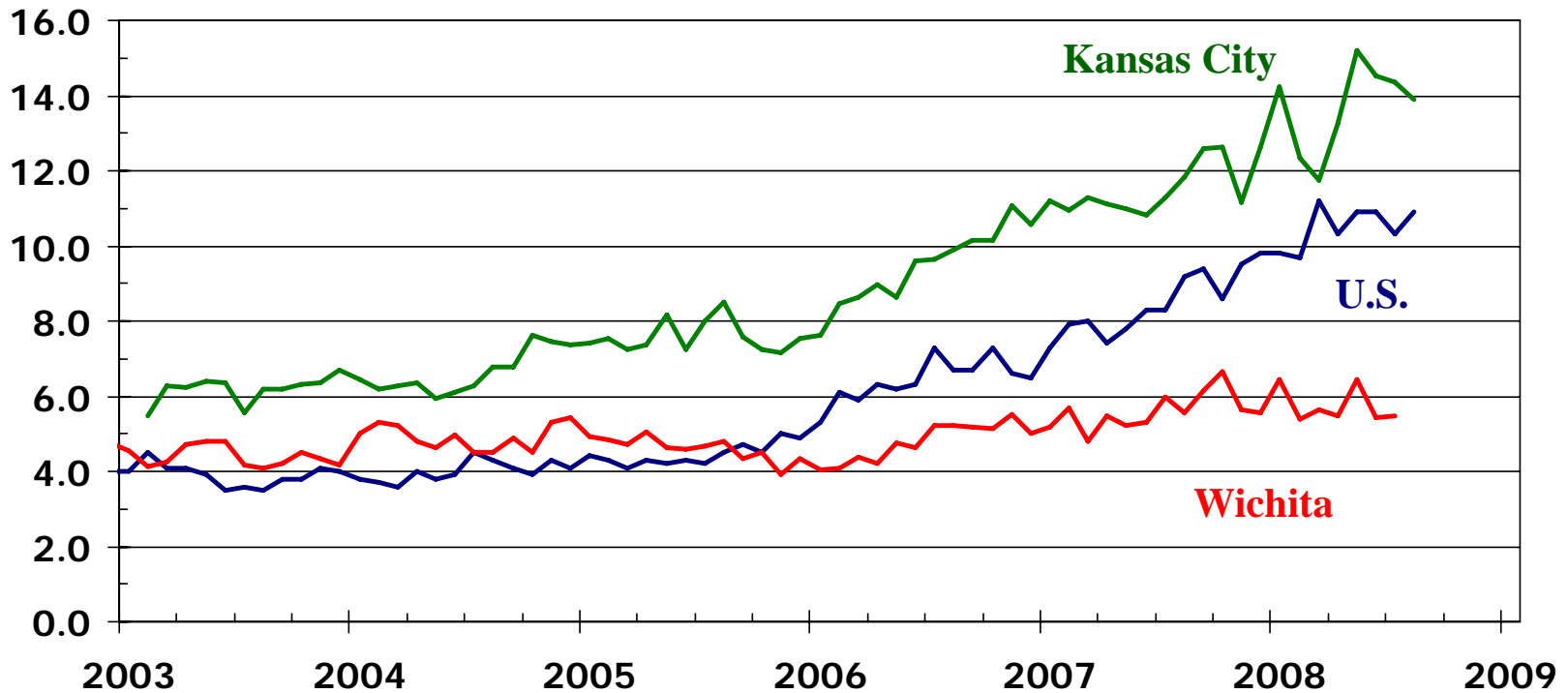
Year-over-year Percentage Change



Sources: HUD; SCK MLS; KCRAR

Inventory of New Homes Available for Sale

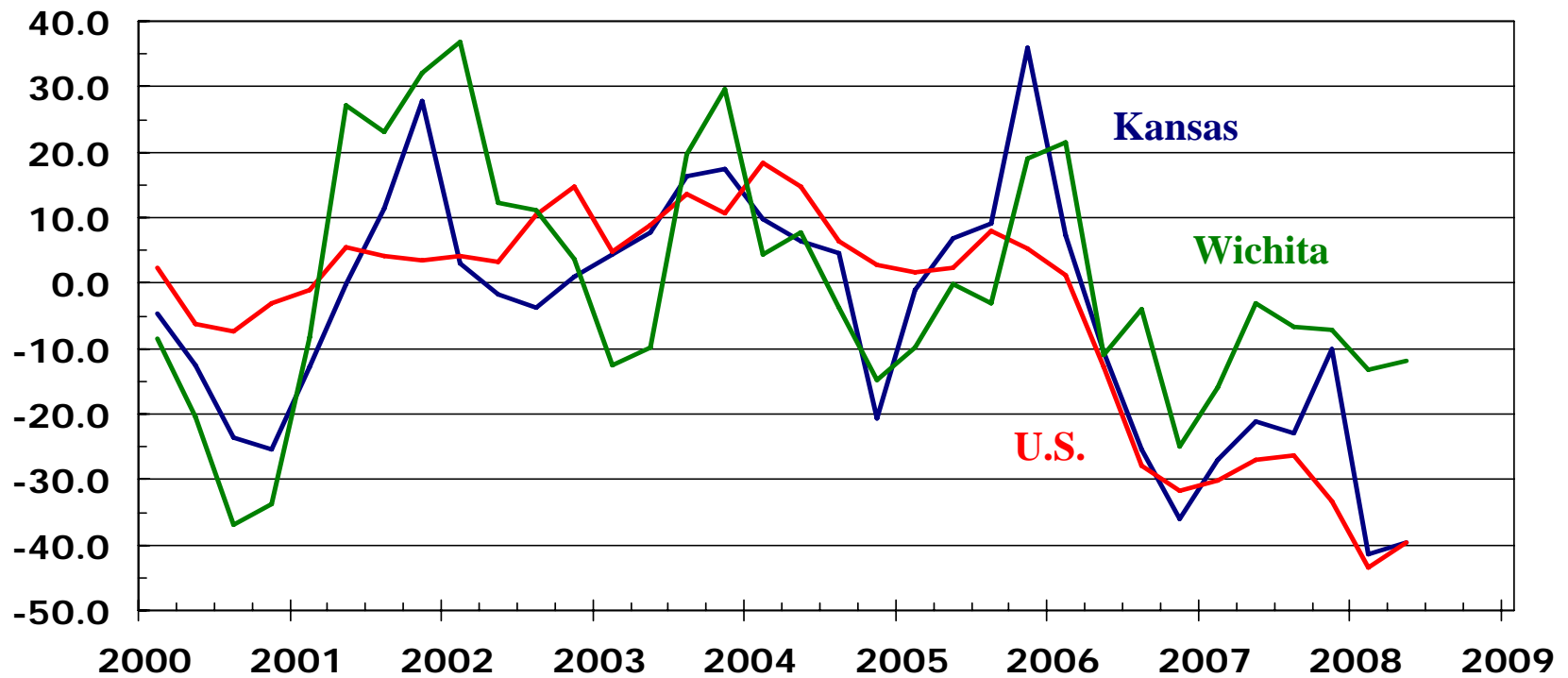
Months Supply (SA)



Sources: HUD; WSU Center for Real Estate
using data from KCRAR and SCK MLS

New Home Construction

Year-over-year Percentage Change in Single-Family Building Permits



Sources: HUD; WABA



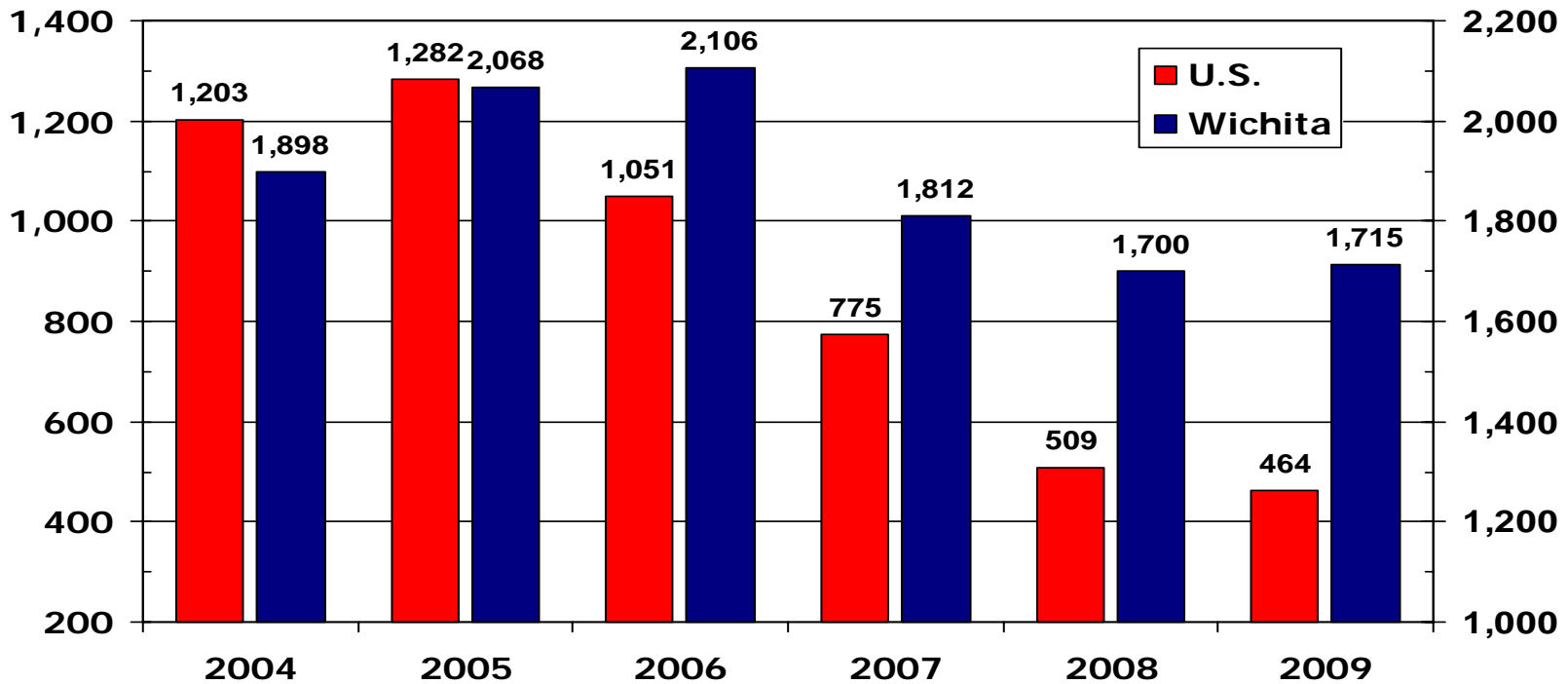
New Home Rebound?

- New homes will be slower to rebound than existing homes
- Construction won't begin again in earnest until the overhang of inventories begins to be taken down

New Home Sales Forecast

U.S. SF Home Sales in 1000's

Wichita Area SF Home Sales

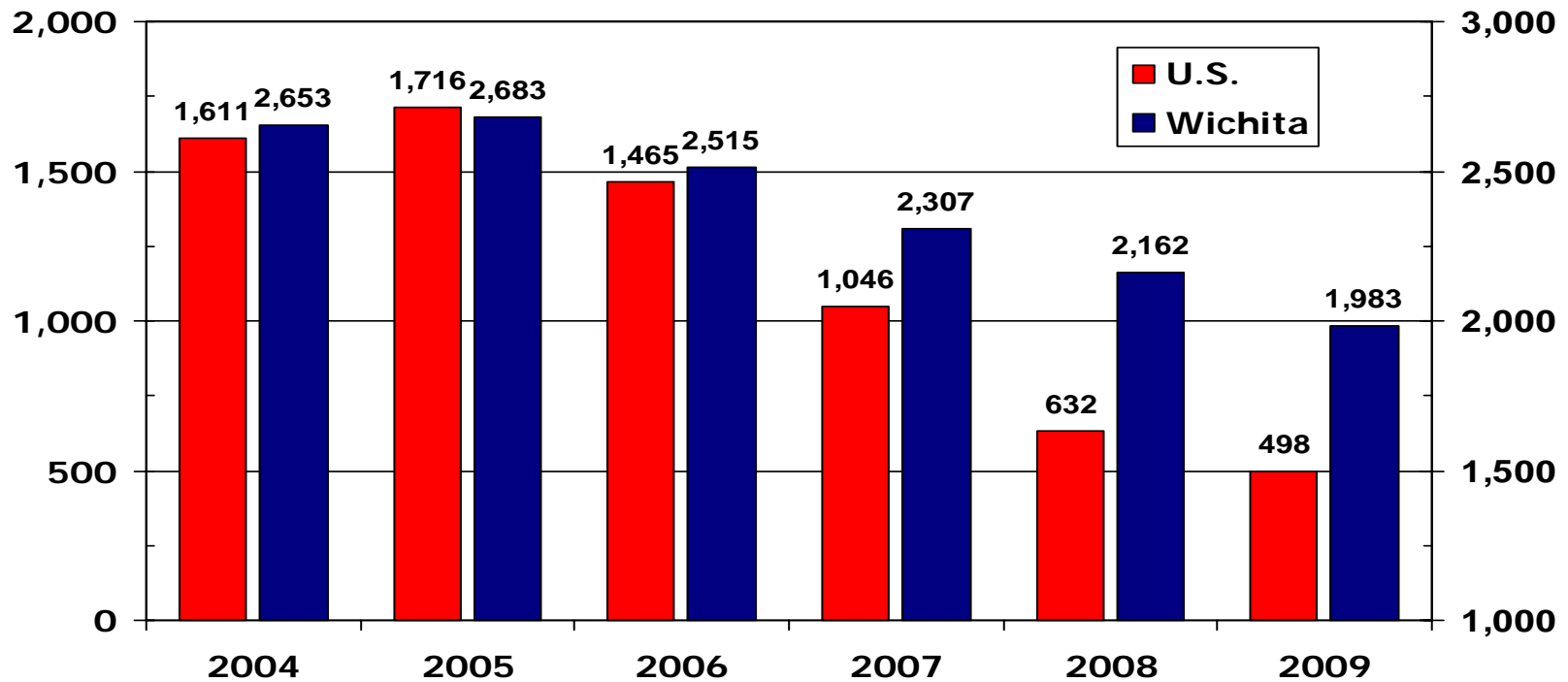


Sources: HUD/Census; SCK MLS;
NAR; WSU CRE

New Construction Forecast

U.S. SF Housing Starts in 1000's

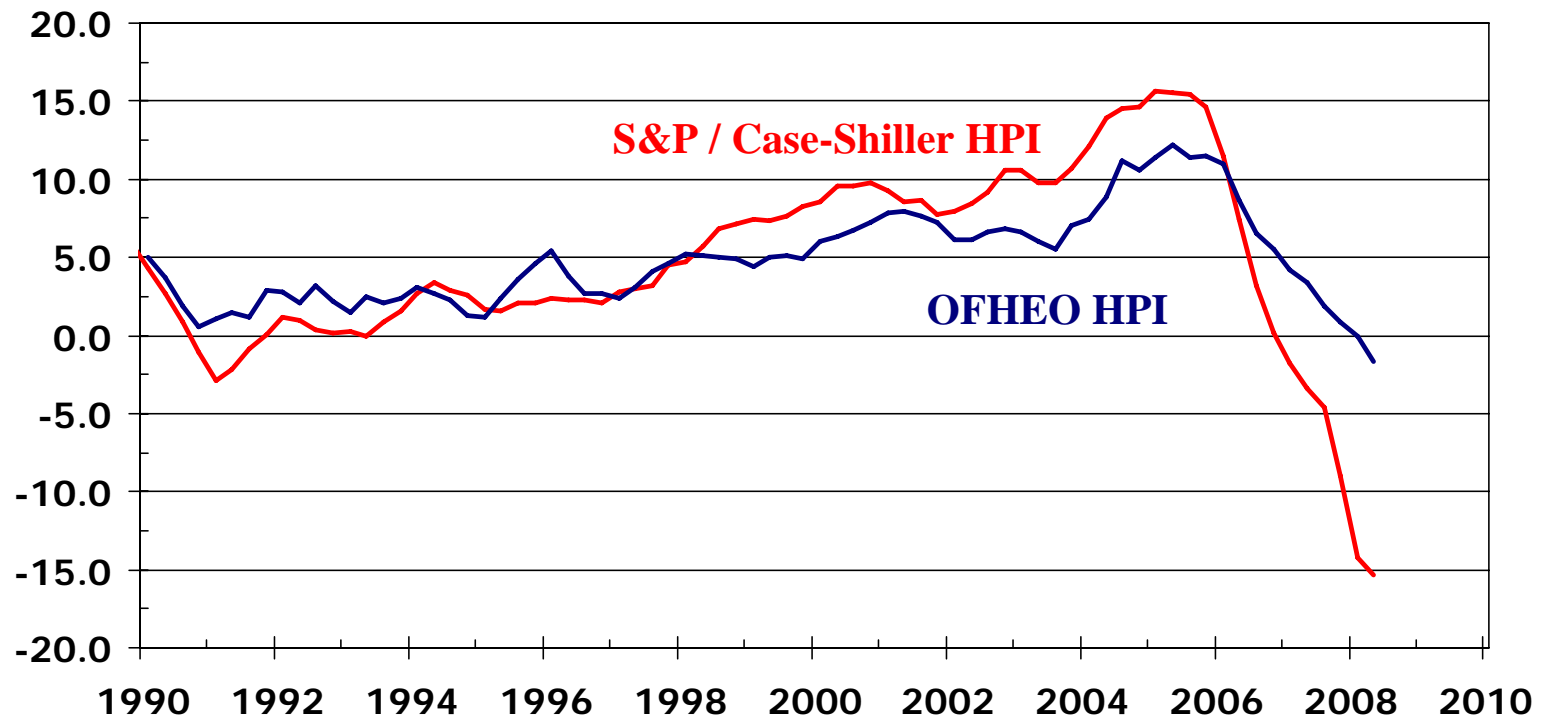
Wichita Area SF Building Permits



Sources: HUD/Census; WABA;
NAR; WSU CRE

U.S. House Price Appreciation

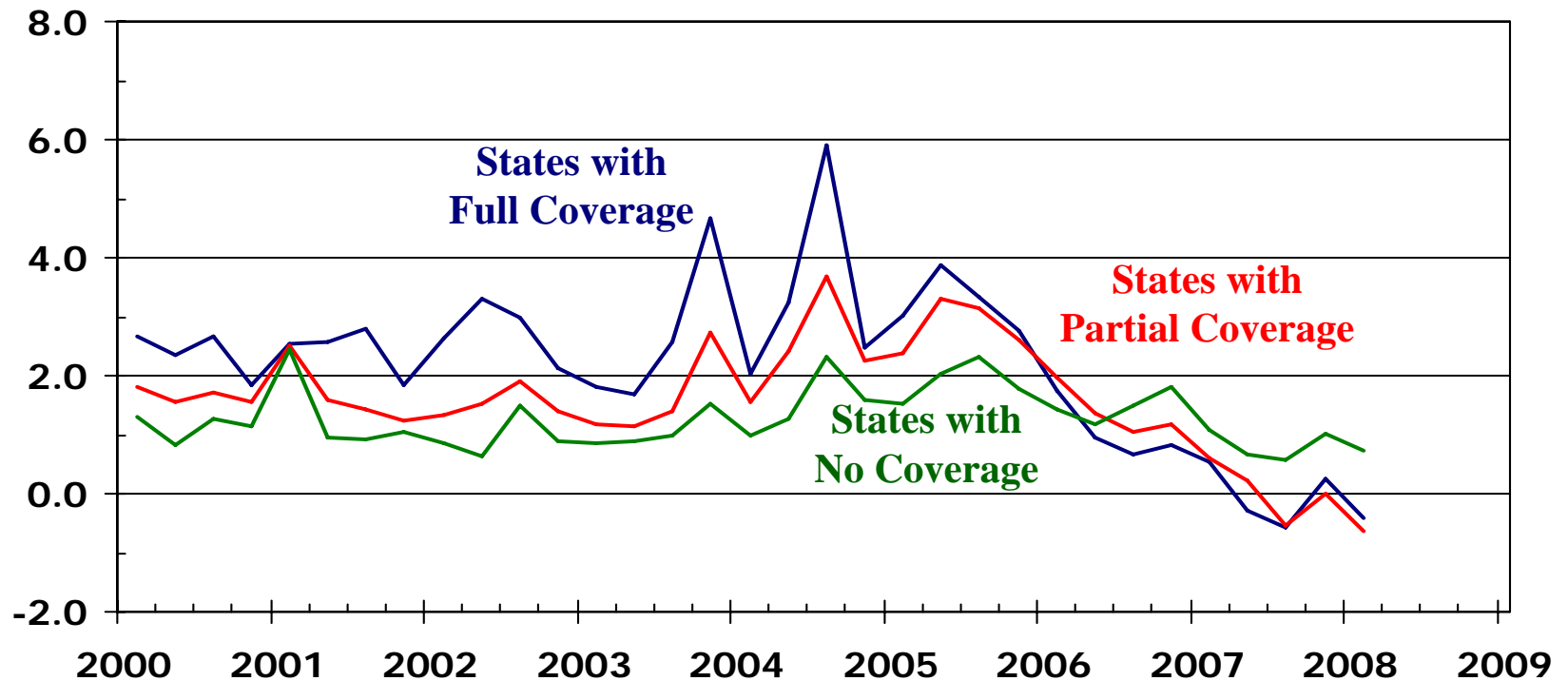
Year-over-year Percentage Change



Sources: NAR; S&P; OFHEO

OFHEO HPI by S&P Coverage

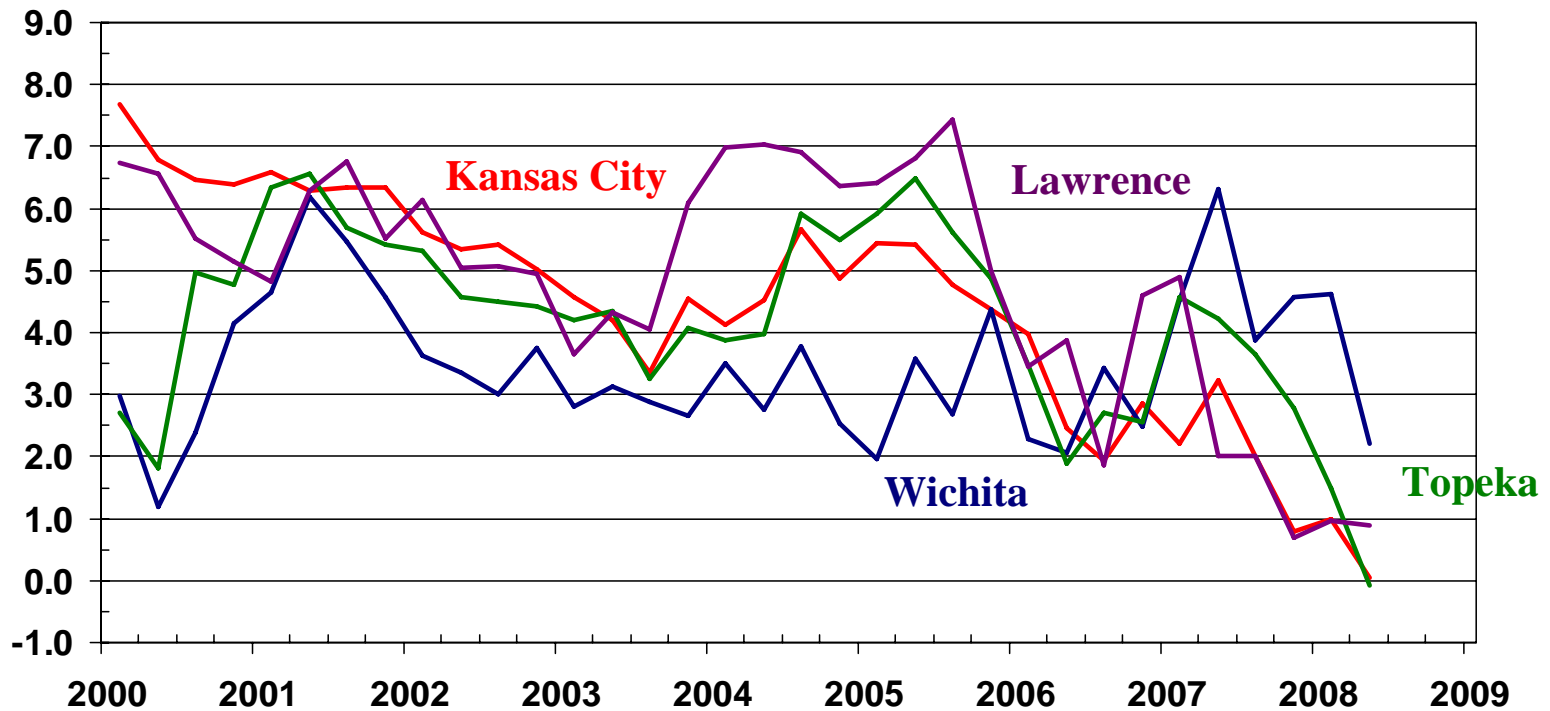
Quarter-over-Quarter Percentage Change



Source: WSU Center for Real Estate, using data from OFHEO and U.S. Census Bureau

Home Price Appreciation

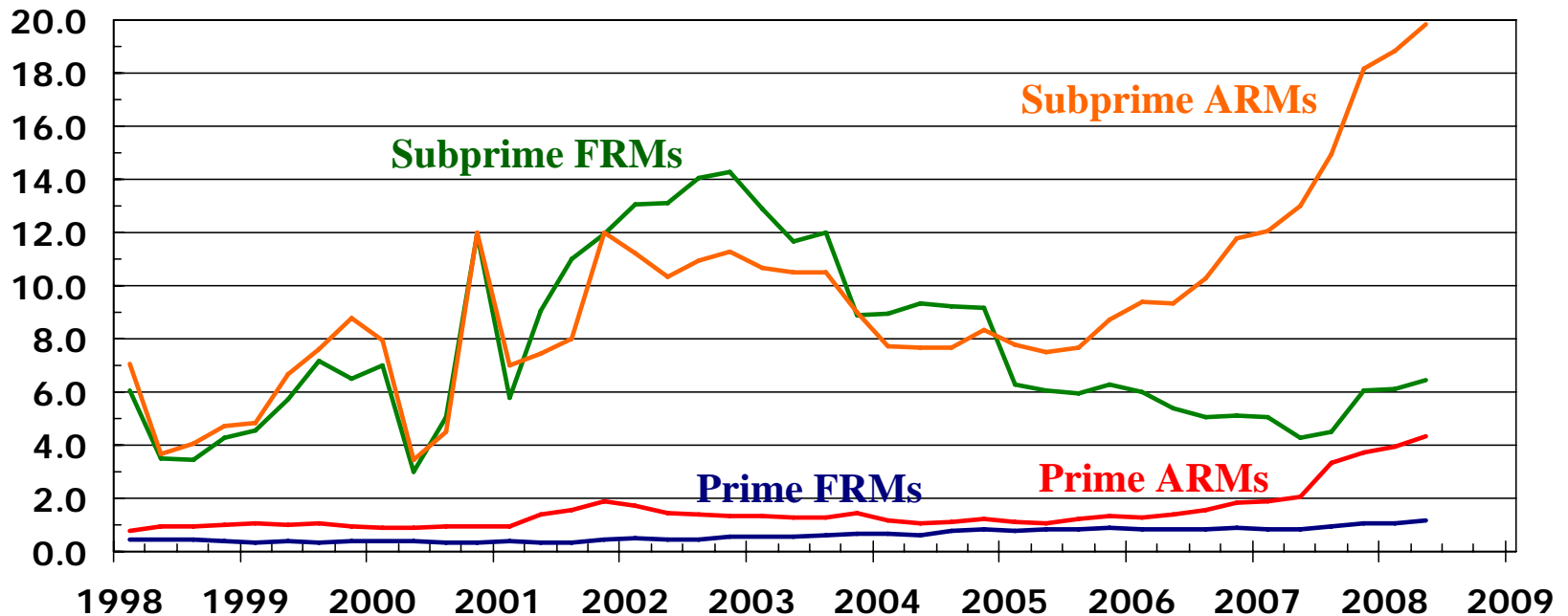
Year-over-year Percentage Change



Source: Office of Federal Housing Enterprise Oversight

KS Severely Delinquent Loans

Percent of Loans Serviced

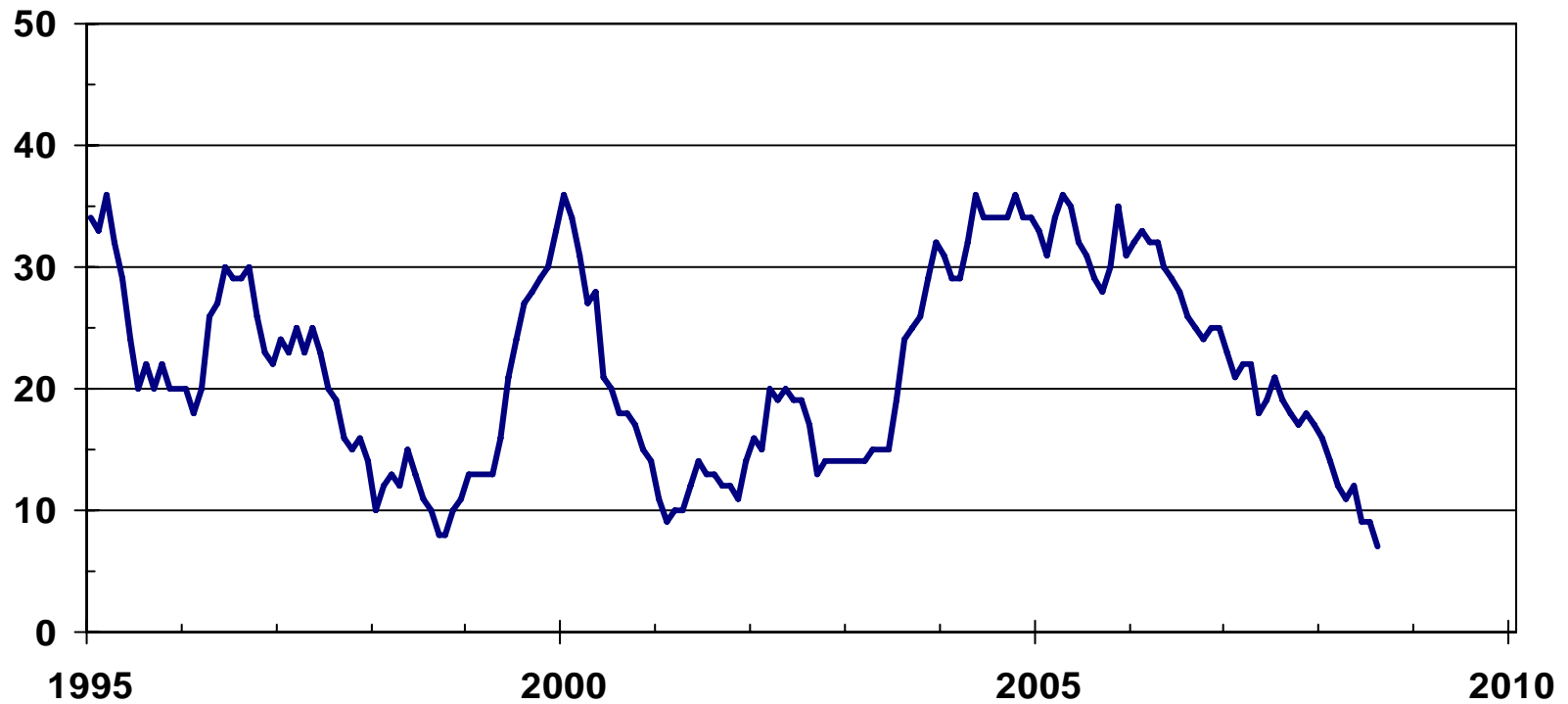


ARMs make up about 37% of subprime loans in KS but about 9% of all prime loans

Source: MBA

ARM Share of New Mortgage Originations

Percent



Source: Freddie Mac

Wichita State University Center for Real Estate

*Laying a Foundation for
Real Estate in Kansas*



WICHITA STATE UNIVERSITY

