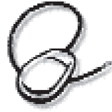

Technology and Mortgage Economics

"It was a terrific year for our insurance business, but the big boost that gave to earnings was largely offset by the pathetically low interest rates we earned on our large holdings of cash equivalents (a condition that will not last)," wrote the Oracle of Omaha, Warren Buffett, in his 2003 annual letter to shareholders. With $44 billion to invest, you can understand why Buffett calls today's rates pathetically low. What I find interesting about his most recent letter to stockholders is that he knows interest rates are artificially low. Federal Reserve Chairman Alan Greenspan spoke similarly when he said, "Interest rates are too low for long-term economic stability, and will have to rise at some point."

I continue to become increasingly concerned by a confluence of indicators that looks like the perfect storm. It seems each day I read a newspaper in which something anecdotal pops up about how home prices are simply out of hand. Yes, I worry about a potential real estate bubble, for reasons that have as much to do with economics as with technology.

Another tidbit I recently read was how the percentage of adjustable-rate mortgage (ARM) loans to all loans in San Diego has almost doubled in the past 12 months, to 57.1 percent in January. We've seen jumps in ARM percentages in the past, but only when rates took a big jump up. This time, there has been no real increase in rates. I don't believe the industry has ever seen ARMs jump in popularity without a corresponding jump in rates.

Today we are seeing consumers opting for one-year ARMs, with more than half of their income going toward their monthly payment. Given how low rates are, it's pretty easy to see how the ARM index might double in the years to come. So what happens to these consumers when their mortgage payments rise significantly?

I recently heard presentations by two housing experts from Harvard University's Joint Center for Housing Studies, Cambridge, Massachusetts. Much of what they presented concerned me. Most telling was a chart of national real home-price appreciation (adjusted for inflation) since 1976. According to this chart, anytime we had significant home-price appreciation for several years, there was a corresponding drop in home values for several years. This occurred in the early 1980s and again in the early 1990s. This time around, though, the significant rise in home-price appreciation has lasted much longer (about 10 years). It reminded me of one of my most important lessons gained from college: "The longer the party, the greater the hangover." This house party has lasted for quite a long time and, interestingly, the Harvard Joint Center for Housing Studies chart shows decreasing real appreciation for the last year. In the previous two peaks, once the chart peaked and turned downward, it didn't stop until it was well into negative appreciation territory.

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Now I hate to be an alarmist, and to be fair, I've heard many claim they don't foresee a national drop in home values. Greenspan falls into this category, as do others, including the Harvard Joint Center for Housing Studies experts. Not too many highly public people want to come out and say, "Stop buying homes, because we could have a national housing valuation crisis." I, for one, was happy when Greenspan called a spade a spade when he uttered the infamous phrase "irrational exuberance" in describing the stock market bubble of the 1990s. He was right, though it took the market a few more years to prove it.

A lot of attention has been directed toward the government-sponsored enterprises (GSEs) recently, and Buffett sold his shares and became critical of their activities. Like Buffett, I would love to hear his words of wisdom about today's skyrocketing housing prices (beyond his quote of "I'm baffled by it").

I could go on and on. However, let me get to the technology sector and the impact that I foresee from technology on this home-price issue.

The automated underwriting systems (AUS) are approving far more borrowers today than ever before. Remember the old "top and bottom ratios" of 28 and 36? These consistent rules served us well for at least 25 years, and we understood their performances through the worst of times. At the beginning of the current housing boom (the mid-1990s), the GSEs came out with their AUS. One of their marketing statements touted how these systems would approve more borrowers, and in fact they did. In addition, almost every year since their introduction, the GSEs have tweaked their models to further "refine" their AUS to accept even more borrowers. While we all want to approve more borrowers and

increase the homeownership rate, there may be a price to pay for this.

The real issue is that neither Freddie Mac's Loan Prospector® nor Fannie Mae's Desktop Underwriter® has been through a housing downturn. I'm concerned that these new technologies are glossing over the reality that the old top and bottom ratios have been increased each year for almost 10 years. In their defense, I do agree that AUS are better at predicting defaults than the old ratios, but these models need real-world testing in a housing downturn before we bet so heavily on them. To rely on them so blindly could become a recipe for disaster. Why are default rates as high as they are with such low interest rates?

My other concern has to do with the loan servicing arena. In the last several years, loan servicers have become heavy users of loan workouts. We can all commend their efforts to keep consumers in their homes using the latest loss-mitigation tools and practices. My concern is that like the AUS, workouts change the formulas relied on by the industry. Today a very large percentage of borrowers are having their mortgage payments forgiven, their terms extended or their mortgage recast. Whatever the method, the result is that a default is prevented . . . at least for now. This may end up skewing the default statistics. While some consumers will recover, which makes this process commendable, others will simply default at a later date—thus making today's loan underwriting look better than it actually is. I believe today's default rates are understated, as loan workouts are increasingly being used more each year. This has an impact on the AUS, since the default rates are how the strength and accuracy of an AUS are ultimately measured.

Introducing new technologies into our industry is generally a great thing. However, we must be cautious to ensure that new technologies aren't used to mask underlying changes in our industry fundamentals that may need reexamination.

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