Is Automation Influencing Real Estate Cycles?

I CAN REMEMBER MY FATHER TALKING about real estate cycles back in the 1960s, and he would often discuss the seven-year average. The up and down cycles of real estate have long been studied. Both the exact number of years and the severity of these cycles were a little in question, but the general rule was still a good one.

It's been 13 years (1992 to the present) since the start of the current real estate boom, which is one of the longest expansions on record. From my perspective, automation is playing a role in both the length and strength of this boom. Unfortunately, it will likely exaggerate the down cycle as well.

From the 1960s to the late 1990s, the industry grew up with the standard 28/36 top and bottom ratios (housing cost-to-income and total debt-to-income percentages). What was great about the underwriting standards during these years is their consistency. During good times and bad, these ratios and other guidelines remained little changed. The few changes that did occur took years to implement. This stability may prove more important than we ever realized.

In the mid-1990s, several prominent automated underwriting systems (AUSes) came into being. With this new automation, all the rules changed. Initially we found the old 28/36 ratios obsolete, as they were just too general. With automation, we could look at far more detail on each loan and segregate consumers into much better risk categories. Like never before, we could segment the population and qualify new groups of borrowers. While a few took exception to whom the purveyors of these systems were, few questioned their value to the industry.

One of the features of this automation was the ability to make changes very quickly to the underlying rules. As one would almost expect, if one AUS was accepting a certain group of borrowers that the other didn't, competition would soon lead the other to adopt the more-accepting modification to its system. This is where I believe things have begun to go astray. Soon after the introduction of these AUSes, a pattern of one-upsmanship ensued. Instead of changes taking a year or more to implement, they were now taking months or even weeks.

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What used to be considered subprime borrowers became prime borrowers. By the beginning of this decade, the AUSes were approving borrowers with a bottom ratio over 60—such a borrower would never have been given a conforming mortgage in years past.

For essentially the last 13 years, interest rates have dropped significantly. Of course, this by itself creates conditions that would foster a housing boom. Clearly, there are several other key trends that are creating escalating housing prices that have nothing to do with the AUSes. However, I believe the current boom has been even stronger and longer-lasting than it otherwise would without this newfound automation. It's sort of a "witches' brew" with lower interest rates, aggressive lenders, strong demand and the AUSes causing housing prices to climb abnormally fast.

Recently I heard a speech by the CEO of a top-five lender, who gave his audience a stern warning about today's loan products being too aggressively marketed. This CEO felt (and I agree) that we are headed for real trouble with extremely high default rates on some of these products. Much of the problem has to do with no-documentation, stated-income and interest-only loans. I believe we have a bubble-like frenzy of investing into housing at almost any cost, with the expectation that homes will always rise in value. There are a lot of discussions in the media about housing price bubbles occurring in many areas of the country, but I've not seen any coverage of how the AUSes could be linked to this phenomenon.

The AUSes are allowing rapid changes in loan product development. Not only do they promote new creativity with loans, but they allow them to be distributed more rapidly. With rates declining and houses appreciating, these AUSes are saying these loans aren't so risky. Given the last 13 expansion years, these systems have been correctly predictive. Yet, they haven't been tested in a down cycle. Could we all find out they were wrong if many local markets prove to be in a bubble, and we see a decline in housing prices?

In my view, the AUS engines are having the effect of extending the current real estate boom. The AUSes have not yet been tested in bad times of the housing cycle when prices are stagnant or dropping. We seem to be in a never-ending spiral where competition drives ever more lenient rules. Even if you believed we weren't in the midst of a bubble, we have not seen evidence that there are hard limits being set on risk by the AUSes. The AUSes keep allowing more and more borrowers to be approved, and where will it end? When will the AUSes' designers realize the loans being approved today may pose great risk tomorrow?

Our industry needs to take a step back and realize that we may be setting ourselves up for a fall. Past real estate cycles were considered a natural part of the economy. Even when the underwriting rules of our industry were consistent, these ups and downs—when they inevitably happened—were still considered harsh. Our rules are now anything but consistent. As an industry, we longed to reduce these cycles in favor of long-term, consistent growth. Today, we have built automated underwriting systems that could make the effects of

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these cycles more dramatic, if my reasoning is correct. We haven't fully tested these systems and seen their problems—I believe we will pay dearly for "bad code" when the bad times arrive.

Once we hit the inevitable "perfect storm" of rising rates, declining home values and skyrocketing defaults, we will have to worry about the fallout. The fallout can come from both within our industry and without.

The current housing boom has been going for 13 straight years, and automation is playing a far larger role than ever before. There weren't a lot of great lessons that I learned in college, though one certainly stands out: The longer the party, the greater the hangover. This is a lesson for the industry to think about, because this party has gone on for a long time.

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