Popular Economics Weekly

WEEK OF MARCH 12, 2007—SUB-PRIME DELINQUENCIES HURT MARKETS

Sub-prime lending is on the defensive, hit by rising foreclosures and tougher federal regulations. And this is beginning to affect housing sales, as fewer sub-prime (and first-time) buyers are able to enter the market.

"Although the U.S. Economy and job market remain solid, the housing market continued to decelerate in the fourth quarter of 2006. Nationally, house prices increased at a slower rate and the pace of sales and construction activity continued to slow," said Doug Duncan, chief economist of the Mortgage Bankers Associations.

New-home sales plunged 17 percent in February as well, though existing-home sales rose 3 percent on signs that existing sales' declines, at least, may be leveling out.

Sub-prime lending has become a larger part of the home mortgage market in 2005 and 2006, with up to $600 billion issued (of $2.6 trillion) in 2006, reports the MBA.

Sub-prime borrowers are those with credit problems, including recent bankruptcies. But incomes—or assets that give an indication of income—are usually verified, contrary to media reports. This means that most stated income, Option ARMs with low teaser rates are issued to prime borrowers with good credit, not currently a sector with problem loans.

Be that as it may, the Seasonally Adjusted (SA) delinquency rate increased during the fourth quarter for all loan types. The delinquency rate increased 13 basis points for prime loans (from 2.44 percent to 2.57 percent), still a very low figure. But it increased a much larger 77 basis points for sub-prime loans (from 12.56 percent to 13.33 percent), 66 basis points for FHA loans (from 12.80 percent to 13.46 percent), and 24 basis points for VA loans (from 6.58 percent to 6.82 percent).

Why the increase in delinquencies? It is mainly due to the rise in the Federal Reserve's short-term fed funds rate that has caused ARM indexes that determine ARM rates to soar. "Sub-prime borrowers are more likely to be susceptible to the cumulative increases in interest rates that we have experienced and the resultant nationwide slowing of home price appreciation including outright declines in some markets," said the MBA's Duncan.

This is in the face of a softening jobs market, even though February's unemployment rate slid to 4.5 percent (from 4.6 percent). How is it softening? Both the employment and work force totals used to calculate the unemployment rate fraction actually shrank. But the work force (its denominator) lost more—190,000 workers—who simply stopped looking for work. In fact, 374,000 were added to the 7 million plus no longer in the work force, according to the Labor Department's Household Data survey on which it is based.

Of the 97,000 net payroll jobs created, only 58,000 were created in the private sector. The rest were government jobs. Construction lost 62,000 jobs, of which half may be due to bad February weather, half to slowing new-home sales, according to Economy.com. It remains to be seen if the housing slowdown will continue to shed construction jobs.

One result of the worsening sub-prime problem is that federal regulators are calling for stricter qualification standards that must assess a borrower's ability to repay their loan. This can be achieved with either higher credit score minimums, or with more income and/or asset verification.

Also, the Federal Reserve, the Office of the Comptroller of the Currency and other regulators have cautioned banks about predatory lending practices including concealing the true nature of a mortgage loan. This will definitely put a crimp in sub-prime lending, although it is too early to assess its extent.

The National Association of Realtors doesn't believe the delinquencies will impact the prime lending market. "Lending problems in our nation's sub-prime marketplace are building, which could inhibit future housing activity and further dampen our forecast," said NAR chief economist David Lereah in his latest update. "Even so, these problems are likely to be contained and not spill over into the prime mortgage market."

Existing-home sales are projected at 6.42 million this year and 6.66 million in 2008, compared with 6.48 million last year. "Although existing-home sales will be marginally reduced due to sub-prime lending restrictions, they should be gradually rising this year and next. However, total sales this year will be fairly close to 2006 because last year started high and ended low," Lereah said.