

# MORTGAGE AND FINANCING HEADLINES: Making Sense of it All

A Message from Lawrence F. Flick, IV, Chairman and Chief Executive Officer Prudential Fox & Roach, Realtors® and Gerard F. Griesser, President, The Trident Group



Larry Flick, left and Gerry Griesser, right

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There's been a lot of news about mortgage financing and the credit markets, prompting uncertainty and even fear in many consumers. While the problems have caused significant changes, it is important to note that they do not affect all types of lending in the same way. In the past few weeks, we have received many questions from clients and sales associates. In response to this, we are providing information to help clarify some of the issues and explain the changes that have occurred in the different types of financing.

### How did we get here?

In order to understand how we got to this point, we must be able to distinguish between the different types of residential mortgages — Prime, Sub-Prime and Alt-A:

- **Prime lending** describes fully documented and verified loans with an acceptable loan-to-value ratio given to borrowers with good credit. Conventional loans are under \$417,000 and can be sold to Fannie Mae and Freddie Mac. Since Fannie Mae and Freddie Mac are perceived to have the backing of the United States

government, investors have a higher level of confidence in them.

Loans \$417,000 and above are considered to be jumbo loans. Though they don't have this perceived government backing, they meet the established standards for income and asset documentation.

Reliable financing choices are available for most buyers.

- **Sub-Prime loans** are generally given to borrowers with credit scores below 620. Income and assets may or may not have been verified. In the past, investors knew there was a greater risk of default but were able to make informed decisions in order to generate a higher rate of return to mitigate the risk.
- **Alt-A loans**, which are often mistakenly called Sub-Prime loans, are given to borrowers with credit scores of 620 and above who are unable to document income, assets or both. Alt-A loans were most prevalent in markets with a high level of affordability issues or speculative/investor purchases. These markets include the coastal areas of California and Florida, and Las Vegas, Nevada.

During the past few years, a popular form of Alt-A mortgage has been a 2/28 adjustable rate mortgage (ARM). Borrowers who were able to qualify at the low teaser rate were often not able to meet the monthly payment after the initial fixed rate period expired and the rate adjusted upward. Historically, these borrowers would have refinanced or sold the property when the rate reset, but tighter lending standards and flat property values have made this difficult. Since many of these loans were issued in 2005 and 2006, delinquencies in these loans are likely to grow over the next two years.

In 2004, new sources of mortgage funding were created focusing on the Alt-A segments of the market. Many were Wall Street firms that did not understand the risks inherent in this type of lending. Unfortunately, some mortgage brokers originating Alt-A loans participated in fraud and predatory lending practices such as submitting applications for low-doc loans with inflated asset and income figures. In addition, many borrowers were directed to high risk adjustable rate mortgages including the 2/28 or an option payment ARM when their financial situation did not support it. As a result, there has been a rise in mortgage delinquencies in the Alt-A category.

Most Alt-A mortgages were packaged into pools and sold to investors including hedge funds and banks. The increased delinquency rate has made it difficult to value these pools and this has caused concern among investors. In some instances, investors have demanded that they be made whole.

This has caused a backlash among mortgage lenders having to meet these investors' demands. As a result, some lenders are no longer able to provide funding for their current mortgage commitments. In some cases, they have closed their doors.

### **What has changed?**

Overall, credit standards have been raised and product availability is more limited. In the specific mortgage categories, changes are as follows:

- **Prime**

There is no real change in the availability of or qualifying standards for prime conforming loans. The premium on jumbo loans has risen, but these loans are available at reasonable rates.

- **Second Mortgages**

Those seeking second mortgages will find more restrictive credit standards. As an alternative, borrowers should consider a larger first mortgage with private mortgage insurance (PMI) which is tax deductible for most borrowers.

- **Sub-Prime**

True Sub-Prime lending has had limited adjustments to programs and guidelines. It exists as always and is now priced to properly compensate investors for the inherent risks of these loans.

- **Alt-A**

Borrowers interested in Alt-A mortgages will find more restrictive requirements including larger down payments and higher credit scores. Many



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of the higher risk programs in this category (such as little money down and true no-doc loans) have been eliminated.

**What is the impact on the mortgage and real estate businesses?**

In the short term, borrowers with no down payment or credit scores of 620 or below will have difficulty obtaining financing.

All borrowers can expect a return to traditional, full documentation and longer lead times for loan approvals and closings.

The Federal Reserve and other central banks have recognized that market volatility has the potential to be harmful to the economy and they have taken steps to mitigate the risks. These steps will, over time, lead to a normalization of the mortgage markets.

**Conclusion**

The mortgage and financing market has gone from excessively loose to overly restrictive. As markets steady and investors in mortgage loans gain a better understanding of valuation and risk, financing programs and qualification standards will drift back to a middle ground creating more financing options for a greater pool of buyers and borrowers.

Unlike Las Vegas and the coastal areas of California and Florida and similar overheated markets, sales prices are expected to continue to grow in our market. The August 2007 National Association of Realtors® (NAR) regional forecast shows a 2.7% increase in home prices for 2007 and a 2.6% increase in 2008.

...indications are that it continues to be a great time to buy a home.

Reliable financing choices are available for most buyers. Combined with the fact that there is a great selection of homes on the market and interest rates are still at historic lows,

indications are that it continues to be a great time to buy a home.

Sincerely,

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