

## THE DISAPPEARING COLATERAL

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When the dust finally settles will lending institutions be looking at substantial hidden losses from eroding real estate values? Per the Wall Street Journal, real estate values have peaked, a looming drop in value could impair many loans. While much of the recent run up in values has focused on the residential market, the commercial sector has followed suite with low interest rates pushing multiples to all time highs. The speculative fervor has not only allowed people to make millions in real estate, it has allowed troubled companies to use sky-high real estate prices to increase their leverage using inflated appraisals. Consumers have been a driving force in the US economy for some time. Much of the liquidity was created by ever increasing housing prices that many people used as a never ending cash spout to fund their life styles. The cycle is coming to a screeching halt. Will the increase in productivity, continued corporate growth, and China keep the US economy out of a recession?

Perhaps the most notable development in the financial markets is the rise in Credit losses – albeit from a low base. Hurricanes and new bankruptcy legislation might have exaggerated this, but the case is becoming stronger that the consumer Credit cycle may be peaking. In Massachusetts, The Boston Globe noted on December 7<sup>th</sup> that foreclosures are up 35% from last year and show no signs of slowing down. Even though there appears to be a peak in the Credit cycle, Mortgage companies appear to continue to lend away at a record pace. While margins are nothing to write home about, mortgage earnings are being driven by staggering origination volume. Third quarter earnings also provide further evidence that commercial lending is strong, both in real estate and business lending. In addition, Mortgage companies have been able to sustain origination volume through riskier mortgage offerings such as Option-ARMS (Adjustable Rate Mortgage). According to UBS AG, Option Arms made up 30% of Jumbo Loans over the summer. These loans usually carry temporary interest rates as low as 1% and give the borrower the option to pay only partial interest, allowing the principal value to grow. Roughly 70% of borrowers with option ARMS are currently making the minimum payment. According to UBS, even if interest rates remain stable, a borrower who made the minimum payment could see their payment jump more than 50% when the borrower must begin to make full payments. And if rates rose two percentage points during the loan's first five years, the monthly payment could nearly double.<sup>1</sup>

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<sup>1</sup> Ruth Simon, *Wall Street Journal*, “Demand for Option ARMS Drops As Short-Term Interest Rates Rise “, 12/1/2005

If you analyze today's Mortgage Finance Bubble it will bring to mind speculative dynamics that were at play during the late 80's commercial real estate Bubble. Despite the increasing signs of late-cycle stress and fundamental deterioration (rising vacancy rates, over-supply, and sagging rents), it took quite some time to pacify the speculative spirits that had blossomed during the boom of the late 80's. The boom-time financial infrastructure and the resulting Wall of Liquidity continued to finance additional building, with both the quantity and quality of the projects guaranteeing a devastating down-side of the Credit cycle. The similar dynamics were at work throughout the tech and telecom industry during late nineties.

The cycle has clearly come to an end based upon a Wall Street Journal article in the December 7<sup>th</sup> issue. The professional investors have left the market leaving the amateur investor holding onto parcels that are declining in value. Some will lose their deposit; others have closed and will try to rent only to suffer losses. Overall it appears it is going to get ugly in certain parts of the country. According to The Boston Globe, inventories in and around Boston are up over 40% from last year. In Massachusetts the average "month's supply" a measure of how long it would take to sell the existing stock, rose to 8.6 months in September from 6.9 in August. Nationally, the rate was only 4.7 months, but has been growing. A neighbor of Armand's was baffled over the summer when his house did not sell. "I expected there to be a line of people bidding on the house, two deals fell through, and I ended up giving the house away." His idea of giving the house away probably reflected a substantial price increase over 2000 but it is indicative that the party is over.

While asset backed lenders may feel safe from a downturn in real estate by avoiding development projects and direct real estate purchases, they may not realize that they are increasing their exposure to a real estate bubble and its subsequent pop by using inflated real estate as collateral for already risky loans. The unfortunate thing is that a drop in real estate will increase the chances of recession, which will increase the chances that the companies that have been lent money will default, leaving the lender, who was thought to be 100% secured, holding a piece of real estate worth less than was once thought. Don't say you weren't warned!