

Don't Throw Out the Baby with the Bath Water

California: Ground zero of the "subprime" problems?

The so-called subprime mortgage crisis is playing havoc with the world's financial markets. Rising concerns about subprime mortgages are blamed for everything from falling home prices and staggering losses at some investment funds to a bank run at Northern Rock, a bank based in Newcastle, England, in which panicked customers attempted to withdraw their deposits.¹

And the trouble is far from being over. Approximately 600 billion dollars' worth of subprime adjustable rate mortgages (ARMs) will go through rate-resetting between now and the end of 2008. These loans typically have such low initial interest rates that many borrowers will find it difficult to keep up with payments once their rates are reset at market levels. A large number of these loans will likely end up in default.

As with any previous financial crisis, finger-pointing abounds. The most commonly cited culprits are: questionable practices of some lenders and brokers, lax regulation, ravenous appetite of investors for high-yielding securities, over-optimistic rating agencies, and optimistic views that some borrowers took about their cash flow and income while filling out loan applications.

Many media stories depict California as the ground zero of subprime mortgage woes. The state has certainly seen a rapid increase in the number of subprime loans in serious delinquency (usually defined as more than 90 days past due), though its delinquency rate is below the national average. States in the Midwest and in the South tend to have higher default rates than California.

Not all subprime mortgages are created equal.

While I agree that subprime mortgages have mushroomed into a global financial risk, I would like to point out that not all subprime ARMs are in trouble. First, if about 15% of these loans are in default (as Ben Bernanke, the chairman of the Federal Reserve, recently told Congress), the remaining 85% of subprime mortgage borrowers have so far managed to keep their loans current.

Second, the riskiest of these subprime ARMs are the ones originated after 2004 when lenders began to loosen their underwriting criteria substantially, by allowing limited verification of income and extremely high loan-to-value ratios—with so-called piggyback loans, borrowers could get almost 100% financing. Subprime ARMs originated before 2004 had more conservative terms, and many of their

borrowers have since refinanced and moved on to conventional loan products with more favorable terms.

Third, and perhaps most important, subprime ARMs opened doors to homeownership for people who were previously excluded. These new homeowners include women, minorities, and recent immigrants. Many are young, often with children, and earn less than the national median income. Those families managed to realize the American Dream of owning their homes and often gained substantial equity from rising home prices. What is more, by making regular mortgage payments, they could improve their credit scores, thus gaining access to additional financial resources.

Homeownership rate has risen in California.

According to the Census Bureau, the U.S. homeownership ratio increased from 67.4% to 68.9% between 2000 and 2006. Such improvement was more pronounced in states where homes are less affordable, such as Hawaii and California.

In the Golden State, the homeownership rate in 2000 was 57.1%, more than 10 percentage points below the national average. By 2006, the rate increased 3.1 percentage points to 60.2%, and the gap between the national and state homeownership rates narrowed to 8.6 percentage points. We must remember that all this happened while homes in California became even less affordable!

Obviously, some things about subprime ARMs are working—and some aren't. Fraudulent and deceptive business practices must be stopped and punished. Both consumer education and credit counseling must be more readily available. If some honest people are stuck with the "wrong" kind of mortgages, they should be helped to switch to more suitable loans, such as those without dramatic rate-resetting. If some families are placed in houses that they cannot afford to begin with, downsizing or transitions to renting should be facilitated.

However, doing away with subprime ARMs altogether will make it harder for future generations of home buyers to obtain financing. Further, such a precedent can even stifle financial innovation. Let's just not throw away the baby (increased homeownership) with the bath water (bad loans).

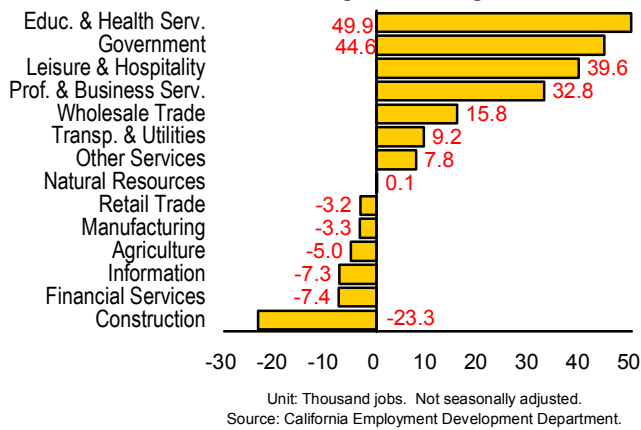
Will the housing-sector weakness spread?

Between August 2006 and August 2007, payroll employment in California rose by 150,000 jobs, or 1.0%. The increase was respectable, but slower than the 1.8% and 1.9% annual growth in 2005 and 2006. As the chart on the next page shows, the housing-related sectors are mainly responsible for this slowdown.

The construction sector lost 23,300 jobs over the above-mentioned 12-month period, reflecting decreased

¹ For the sake of full disclosure, Union Bank of California has never been, nor is it currently, a subprime mortgage lender.

California Job Growth Aug. 2006 – Aug. 2007



homebuilding activities around the state. The financial sector lost 7,400 jobs over the same period, mostly in the mortgage lending industry. Some weaknesses are also observed among wholesalers of building materials and retailers of furniture, appliances, and home improvement and gardening supplies—again, all related to housing. Continued declines in manufacturing and information (mostly media) employment, however, have more to do with long-term structural changes than with the housing-market slowdown.

On the other hand, the largest gains were made in non-financial private services and public services. The educational and health services sector gained 49,900 jobs. The leisure and hospitality sector added 39,600 new positions, due to continued growth of the tourism industry. Recovery of the state's technology sector has produced jobs in computer system design and technical consulting, which are among the 32,800 new jobs in the professional and business services

sector. The government sector also created 44,600 additional positions.

So far, the slowdown seems to be limited to the housing-related industries. The critical question at this time is whether this slowdown will spread to the rest of the state's economy. The answer to this question will depend on 1) the ultimate severity of the home price correction and 2) how it will impact both business and consumer sentiments in California.

The state's growth industries are not housing-driven.

In this regard, California has a couple of positive factors on its side. First, the home price correction to date has been modest compared with the very large increase in home values over the past several years. In other words, much of the accumulated home equity remains intact, and the state will continue to derive a positive wealth effect from the increased household wealth.

Second, the fastest-growing industries in California have a weak correlation with the housing sector. For example, the steady growth of the health care industry is largely driven by changing demographics. Rising home prices did not necessarily cause consumers to seek medical attention (except, perhaps, for the severest cases of sticker shock).

And the technology sector, which has lately buoyed the economy of the San Francisco Bay Area, is known for its unique business cycle and pretty much marches to its own drum. As long as service-sector job growth continues, the probability of a recession in the state seems to be limited.

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Economic Forecast – October 2007

UNITED STATES	2005	2006	2007	2008
Real GDP Growth (%)	3.1	2.9	2.0	3.1
Unemployment (%)	5.1	4.6	4.6	4.8
Nonfarm Employment Growth (%)	1.7	1.8	1.3	0.9
CPI Change (%)	3.4	3.2	2.8	2.4
Federal Funds (%)	3.2	5.0	5.1	4.8
CALIFORNIA				
Real GDP Growth (%)	3.8	4.2	2.7	3.4
Nonfarm Employment Growth (%)	1.8	1.9	1.2	0.8
Personal Income Growth (%)	6.5	6.5	6.0	5.6

Bold: Actual.

The information in this report is based on data available as of October 5, 2007, and has been obtained from sources believed to be reliable, but its accuracy, completeness, and interpretation are not guaranteed. We do not think it should necessarily be relied on as a sole source of information and opinion.