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National Sub Prime Market Crash:
Is El Paso Living in a Bubble?

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In a capitalist economy where goods and commodities are bought and sold, the ability to buy or one's "purchasing power" is an important aspect of daily life. Under such an economy you either have to have money readily available or be able to 'borrow' money with the intention of repaying it over time. This is the concept on which credit is based. According to investopedia.com, a Forbes Media Company, "credit" refers to the borrowing capacity of an individual.[1] Having credit options essentially allows people to increase their purchasing power. Based on this principle, people and institutions, otherwise known as lenders, have set up systems to extend credit in the form of loans, with the expectation that monies will be repaid. Credit histories are kept to track a persons borrowing and repayment habits and are a major determinant of whether a person is qualified for a loan. Loans are often necessary for things such as vehicles, education, and buying a house. Thus, most loans are based on credit history. In this next section we will discuss loans and credit in detail.

What is a Loan?

A loan is defined as the temporary provision of money with interest.[2] The two parties who participate in this relationship are lenders and borrowers. The lenders, such as banks, credit unions, etc, loan money to borrowers. The borrower then becomes indebted to the lender. The reasons for taking out a loan may vary according to the needs or wants of the borrower. When a borrower takes out a loan, they normally go through a process called "loan underwriting". Loan underwriting is the process of the lender reviewing all of the borrower's information such as credit history, employment, assets, existing debt, and other factors resulting in a decision of whether the borrower qualifies for the loan.[3] This is done to prescreen borrowers and decrease the risk of loan default. Default on a loan simply means failure to pay the loan on time or at all. A loan is accredited to the borrower meaning it works on a credit system. For this reason a person's credit history is fundamentally important to the loan process.

Credit

According to Investopedia.com, the definition of credit is a contractual agreement that states a borrower receives something of value now, and agrees to repay the borrowed value with interest at a later date. In this way credit is a loan. However, a distinction can be made between a loan and a line of credit for example, because a line of credit indicates that a certain amount of money is available to be borrowed. The amount of the available credit that is actually used then becomes a loan which has to be repaid with interest. A borrower may or may not use their total line of credit. Credit is also referred to as the borrowing capacity of an individual and or company. Personal credit is usually measured by a credit score.[4] The credit score follows the Fair Isaac Corporation or FICO system, and is a number that indicates to a lender or creditor how likely you are to repay a debt. The credit score basically reflects one's credit history.[5] If the score is low, it signifies to the lender that one is less likely to pay back debt. A high credit score, however, indicates a borrower is more likely to repay debt.

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[1] "Credit." No Date. Investopedia 16 June 2008 <http://www.investopedia.com/terms/c/credit.asp>.
[2] "Loan." Dictionary.com Unabridged (v 1.1). No Date. Random House, Inc. 24 Jul. 2008. <http://dictionary.reference.com/browse/loan>.
[3] Olivas, Dan. President of Greater El Paso's Association of Realtors. Personal Interview. 18 June, 2008.
[4] "Credit." No Date. Investopedia. 16 June 2008 <http://www.investopedia.com/terms/c/credit.asp>.
[5] "What is a Credit Score and Why is It So Important?" 8 Dec. 2006. Quicken Loans. 17 June 2008 <https://www.quickenloans.com/mortgage-news/what-is-a-credit-score-and-why-is-it-so-important-5091>.

A term that we need to be intimately familiar with in regards to obtaining a loan is the annual percentage rate. The annual percentage rate (APR) is a way of comparing the relative costs of loans on a percentage basis. For example, if a car loan has a 10% interest rate, the purchaser is paying $10 for every $100 borrowed annually. Obviously, borrowers want the loan with the lowest rate.[6]

Credit Score

FICO scores set the standard in mortgage lending and are used by each of the three major credit bureaus to determine a person's credit rating. The three major bureaus are Experian, Equifax, and TransUnion.[7] As mentioned above, a credit score indicates how likely a borrower is to repay debt. A good credit score is very important and serves as the foundation when applying for most loans. Most importantly, it is used to determine what type of loan you qualify for, how much credit you may receive, and what your interest rate will be. Below is a general example of the credit rating scale according to the FICO system.

Table 3.1

FICO Credit System

Rating	Score
Excellent	720+
Good	660 to 719
Fair	620 to 659
Poor	619 and Below

Source: Quicken Loans

Although there are several factors that are used to assess a borrower's credit worthiness, one set of general guidelines used to measure characteristics of a borrower, and minimize default, are called the 5 C's of credit. They are as follows: character, capacity, capital, collateral and conditions.

- **Character**- A lender determines a borrower's ability to repay a loan by looking at past credit reports, and judging a person's financial integrity.
- **Capacity**- Past indicators such as employment history and income are used to analyze the borrower's ability to deal with future debt.[8]
- **Capital**- indicates the amount of funds the borrower has on hand for the down payment and closing costs of a loan. This includes any assets that can be liquidated.
- **Collateral**- In order to receive a loan, borrowers may have to back the loan using their property as collateral. This collateral protects the lender in case of default. When the borrower defaults the property can be liquidated, or sold for cash, to repay the lender.[9]
- **Conditions**- Refers to the local, national, and global market and economic conditions as well as the purpose of the loan.[10] As for the economic conditions, lenders want to make sure borrowers will be able to handle any economic

[6] Pritchard, Justin. "Annual Percentage Rate (APR) Overview and How to Calculate APR." No Date. About.Com: Banking / Loans. 17 June 2008 <http://banking.about.com/od/loans/a/calculateapr.htm>.

[7] "Other Names for FICO Scores." No Date. MyFICO. 5 July 2008 <http://www.myfico.com/CreditEducation/CreditScores.aspx>.

[8] Graham, Stephanie. "The 5 C's of Credit." No Date. Ezine Articles. 19 June 2008 <http://ezinearticles.com/?The-5-Cs-of-Credit&id=612144>.

[9] Graham, Stephanie. "The 5 C's of Credit." No Date. Ezine Articles. 19 June 2008 <http://ezinearticles.com/?The-5-Cs-of-Credit&id=612144>.

[10] "The 'Five C's' of Credit Analysis." 30 Jan. 2004. U.S. Department of Commerce: Minority Business Development Agency. 21 July 2008 <http://www.mbda.gov/?section_id=3&bucket_id=131&content_id=2517&well=entire_page>.

downturns in their market, or other markets that may affect them as well.[11] For example, a downturn in both the housing market or in a related field, construction, affects the borrower.

As we have discussed above, loans are based on credit and more specifically, credit history. In turn there are five common characteristics that credit is based on. In this next section we will discuss some of the common types of loans. These loans are used most often and will arise later in our discussion of the sub prime lending crisis.

Types of Loans

There are many different types of loans. In this section we will briefly detail what a fixed-rate, adjustable rate, and hybrid loans are. For purposes of this report a mortgage refers to a loan given to buy a home.

Fixed-Rate

Fixed-rate loans are loans in which the interest rate stays the same throughout the life of the loan. Even though the amount of principal you pay in relation to the amount of interest you pay will change each month, the actual payment amount does not change. The principal is the original amount of debt that must be paid back on which interest is based.[12] These types of loans are normally available for 30 years, 20 years, 15 years, and 10 years, but the most common loans are the 15 and 30 year loans.[13] According to Gus Haddad, President of Haddad Mortgage Group, "El Paso has a history of good 30 year fixed-rate loans." He went on to offer that this tradition could be one of the contributing factors as to why El Paso has been doing better than other major cities across the nation in terms of the housing market.[14]

Adjustable-Rate

Adjustable-rate loans typically begin with a lower interest rate, compared to a fixed-rate loan. After an introductory period during which the interest rate is fixed, the rate 'adjusts' to a potentially much higher rate. Payments can increase by hundreds of dollars each month because of the changes in the interest rate.[15] This type of loan was popular during the most recent housing boom because of their lower initial interest rates and because it was easier to qualify for them. When applied to mortgages the term is Adjustable-Rate Mortgages or ARMS. During the rise of the housing market in 2001, ARMS became very popular due to low interest rates. In terms of mortgages, the date at which the mortgage changes from initial to the "adjustable" rate is referred to as the reset date.[16]

Hybrid Loan

Another form of adjustable rate loan is the hybrid loan. These differ from regular adjustable rate loans because they have a more clearly defined set of terms and conditions. To explain, with regular adjustable rate loans, the borrower was not always aware of when an adjustment might come. Another way to think about it is that the borrower did not have

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[11] "Financing for Your Future-- the 5 C's of Credit." PNC. 21 July 2008 <https://www.pnc.com/webapp/unsec/ProductsAndService.do?siteArea=/PNC/Home/Small+Business/Financing+Your+Future/The+Five+Cs+of+Credit>.
[12] McWhinney, Jim. "Mortgages: Fixed-Rate Versus Adjustable-Rate." No Date. Investopedia. 11 June 2008. <http://www.investopedia.com/articles/pf/05/031605.asp>.
[13] McWhinney, Jim. "Mortgages: Fixed-Rate Versus Adjustable-Rate." No Date. Investopedia. 11 June 2008. <http://www.investopedia.com/articles/pf/05/031605.asp>.
[14] Haddad, Gus. President of Haddad Mortgage Group. Personal interview. 7 July 2008.
[15] Lee, Mara. "Subprime Mortgages: A Primer." No Date. National Public Radio. 23 March, 2007. 9 June 2008. <http://www.npr.org/templates/story/story.php?storyId=9085408>.
[16] "Hybrid ARM" No Date. Investopedia. 11 June 2008 <http://www.investopedia.com/terms/h/hybridarm.asp>.

security as to how long the initial rate would remain in place. Hybrid loans, in contrast, indicate the length of the fixed rate and of the adjustable rate periods. Common examples of these loans are the 2/28 adjustable rate mortgages (ARMs) and 3/27 ARMs. For example, in the case of the 2/28 ARMs, the interest rate would remain fixed for the first two years, and then adjusts according to the housing market for the remaining 28 years.[17]

Mortgages

A mortgage is a home purchase loan, defined as a financial agreement between a lender and a buyer in which the property being purchased is used as collateral for the loan. Basically, mortgages help homeowners purchase a home without having to wait until they are able to afford it outright.[18] A mortgage gives the lender the right to collect payments on the loan until the loan on the property is paid off. The lender also has the right to foreclose on the property if the payments are not made.[19] As discussed above, the two most common mortgages used are the fixed-rate mortgages and the adjustable-rate mortgages (ARMs).[20]

Home Equity Loans and Home Equity Lines of Credit

Home equity is deferred as the current appraised value of a home less the amount currently owed on the house.[21] The amount owed on the house equals the amount of money that was borrowed less the amount of money that has been paid on the principal. Some people borrow against their equity to make improvements to their home, to pay off debts, and even to pay for such things as college expenses.[22] A home equity loan allows homeowners to obtain a loan by using the equity in their home as collateral.[23]

Another way to use a home to obtain credit is to take out a line of credit based on its equity. More and more lenders are now offering home equity lines of credit. In a home equity line of credit, the home of the borrower serves as collateral. By using the equity in a home, borrowers may be able to qualify for a sizable amount of credit. This credit is then available to them for use whenever they need it and the interest rates tend to be lower because the loan is backed by collateral. However, because the home is likely to be the borrower's largest asset, many homeowners typically use their line of credit for major expenses such as education, or medical bills, as opposed to normal expenses. Also, since it is a line of credit as opposed to an actual loan, homeowners use the amount they need instead of having to take one lump sum. Like any loan, however, failure to repay the borrowed portion of the line of credit plus interest, can result in the bank or lender repossessing or foreclosing on the home.[24]

Subprime Mortgage

A bad credit mortgage or sub prime mortgage is a loan product that was made specifically to assist people with credit problems, or 'bad credit'. The sub prime market was initially smaller than the regular mortgage market but has grown considerably. Like a standard mortgage, a bad credit mortgage borrower has the choice between a fixed-rate mortgage and

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[17] "2/28 Adjustable-Rate Mortgage - 2/28 ARM." No Date. Investopedia. 11 June 2008 <http://www.investopedia.com/terms/2/228arm.asp>.
[18] "Mortgages." No Date. National Relocation. 24 June 2008 <http://mortgages.nationalrelocation.com/>.
[19] "Real Estate Glossary + Mortgage Glossary." No Date. Home Buying Institue. 24 June 2008 <http://www.homebuyinginstitute.com/glossary.php>.
[20] "Mortgages." No Date. National Relocation. 24 June 2008 <http://mortgages.nationalrelocation.com/>.
[21] "What Equity Debt is: Introduction." No Date. Bankrate. 21 July 2008 <http://www.bankrate.com/brm/green/loan/basics1-intro.asp>.
[22] "Mortgages." No Date. National Relocation. 24 June 2008 <http://mortgages.nationalrelocation.com/>.
[23] "Compare Home Equity Quotes!" No Date. Mortgageloan. 21 July 2008 <http://www.mortgageloan.com/home-equity-loans>.
[24] "What is a Home Equity Line of Credit." 12 June 2007. The Federal Reserve Board. 25 June 2008 <http://www.federalreserve.gov/Pubs/equity/equity_english.htm>.

an adjustable rate mortgage. The main difference between a standard mortgage and a bad credit sub prime mortgage is that the interest rates are typically higher than the standard mortgage and there may be greater restrictions involving the loan.[25] The higher interest rate is reflective of the greater risk that the lender is assuming for making a loan to an individual with poor credit.

Housing Market

This section will explore how the United States housing market operates at its basic level. In this paper, government sponsored enterprises (GSEs) are involved in what is known as the secondary market in the housing process. They play a very important role in the normal housing market and have been one of the central entities caught up in the current housing crisis. For this reason we will begin our discussion of the current housing market in the US, with a brief overview of GSEs.

Government Sponsored Enterprises

Government Sponsored Enterprises (GSEs) are private shareholding corporations. Private shareholders are not government owned and are instead held by a small number of stock holders who don't trade the stock publicly on the stock market. Government sponsorship means that GSEs are financially protected by the federal government.[26] GSEs are chartered specifically to fulfill public purposes established by Congress. One such purpose is to enhance the flow of credit to targeted sectors of the economy, housing, education, and agriculture.[27] Government Sponsored Enterprises are granted several privileges in exchange for fulfilling the public purposes mandated by Congress, including tax exemptions at the local and state level (not including property tax) and a conditional access to the U.S Treasury Department $2.25 billion line of credit.[28] For the purpose of this report, Community Scholars will look at the GSEs Fannie Mae and Freddie Mac. Freddie Mac and Fannie Mae will be described as key players in the secondary market when we discuss the way the U.S housing market operates.

(For additional information regarding Fannie Mae and Freddie Mac: See Appendix A)

How the Market Works

The mortgage market can be simplified into five steps which show how a mortgage travels through the market. This market works well when everyone is making their payments and fulfilling their purpose in the market. However, when one group begins to fail, the whole market suffers because every part is dependent on the other. Just because the investors on Wall Street usually don't have direct contact with the original borrower doesn't mean that what the borrower does has no effect on the investors. Below, Figure 3.1 provides a simplified illustration of how the housing market works by following a mortgage through the system.

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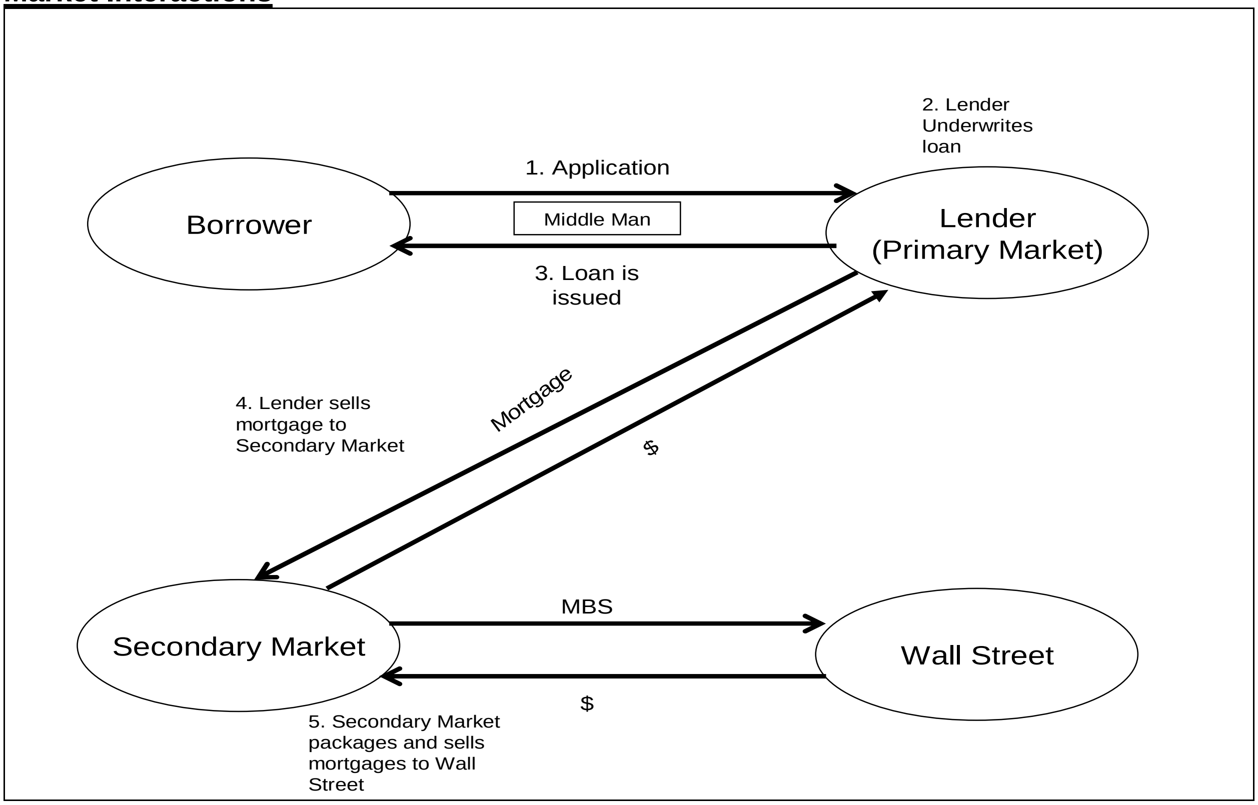
[25] "Bad Credit Mortgage | Get the Facts." No Date. The Adverse Mortgage Centre. 25 June 2008 <http://www.adverse-mortgage-centre.co.uk/bad-credit-mortgage.html>.
[26] Alford, Rob. "What are the Origins of Freddie Mac and Fannie Mae?" 8 Dec 03. HNN: History News Network. George Mason University. 21 July 2008 <http://hnn.us/articles/1849.html>.
[27] "HUD's Regulation of Fannie Mae and Freddie Mac." No Date. Homes & Communities: U.S. Department of Housing and Urban Development. 24 June 2008 <http://www.hud.gov/offices/hsg/gse/gse.pdf>.
[28] "HUD's Regulation of Fannie Mae and Freddie Mac." No Date. Homes & Communities: U.S. Department of Housing and Urban Development. 24 June 2008

Figure 3.1

Market Interactions



Source: Freddie Mac

Apply

The first step in the process is that a borrower must for a loan, as shown in the chart above. In a majority of the loans that are applied for, there is a middle man involved in the process who works with both the lender and the borrower. This middle man can be a mortgage broker or a real estate agent.

Lender's Underwriting Process

Once the lender, such as a bank, has received the loan application, they begin an underwriting process to determine what type of loan the borrower will qualify for. During the underwriting process, the borrower will be evaluated on in several different areas. The underwriters check to make sure that the borrower actually makes the income stated on the application and also employment stability.[29] The underwriters also check what is known as a *loan to value ratio*. If the loan to value ratio is greater than 80%, a private mortgage insurance company is contracted to provide insurance for the loan. The loan-to-value ratio is the amount of the loan divided by the market value of the home; the lower the ratio is, the lower the interest rate typically will be.[30] Many lenders also take out private mortgage insurance (PMI), or lenders mortgage insurance (LMI). They are polices that protect the lender against loss resulting from a borrower defaulting on their loan.[31]

[29] "Underwriting." 1 May 2006. Bankrate.Com. 15 July 2008 <http://www.bankrate.com/bosre/green/mtg/basics5-1a.asp?caret=30>.

[30] "Loan to Value Ratio - LTV Ratio." No Date. Investopedia. 10 June 2008 <http://www.investopedia.com/terms/l/loantovalue.asp>.

[31] "Private Mortgage Insurance (PMI) New Law Requires Lenders to Cancel PMI." No Date. The Federal Reserve Bank of San Francisco. 24 July 2008 <http://www.frbsf.org/publications/consumer/pmi.html>.

Loan Dispersed

If the loan application is approved, a loan is made to the borrower so that they may purchase the home, which is step three. The borrower is then responsible to pay back the lender with interest. However, a lender such as a bank, is generally not in the business of holding onto a mortgage as it matures.

Secondary Mortgage Market

So, the lender in the primary market often sells the mortgage to the secondary market, which consists of firms such as Fannie Mae and Freddie Mac. The banks do this so as to receive liquidity (money) upfront and continue their business of providing loans and other services. This process is shown as step four in the figure above.

Mortgages on Wall Street

After the secondary market has gathered enough mortgages, they package them together into mortgage-backed securities and sell them to investors on Wall Street, shown as step five. Mortgage-backed securities (MBS) are formed when pools of mortgages or packaged together and used as collateral for the issuance of securities in the secondary market. Stocks, bonds, and mutual funds are some common examples of securities.[32] When the mortgage has reached this stage it stays with the investors who continue to make profit from the interest that is being paid on that security. Both the primary and the secondary markets have received liquidity in order to continue to make and fund more loans to borrowers.[33]

This system works unless a significant amount of borrowers begin to default on their mortgage payments. When a borrower defaults, it not only affects the lender who is currently holding the loan, but all areas of the market. For example, as investors lose money, they begin to put less money into purchasing mortgage backed securities which results in less funds for the secondary market which trickles down to the lender having less funds and ultimately the borrower not receiving the loans they need. In the next section Community Scholars will discuss how this trickle-down process has been magnified to give us what we now see as one of the biggest housing and lending crisis this country has faced.

Subprime Lending Crisis

The subprime mortgage market began with the simple idea of helping credit damaged people finance a house. In the ideal housing market, only prime loans are given as opposed to subprime, or below prime loans. As discussed above, a subprime loan is a loan that is given to a person who does not qualify for a prime loan. This means that this person would not ordinarily qualify for a loan under normal circumstances because of poor credit scores or a lack of income, for example. Subprime loans became very common because they provided a way to get the lower income people into homes. For the lender they were also financially viable enough to make a profit. Subprime loans result in the borrower receiving higher interest rates to compensate for the added risk they pose to the lender. As stated by Pat Carmona, a mortgage development officer for the Greater El Paso Credit Union, "Subprime loans are not a bad thing in and of themselves, it's just the way they were used, or rather abused."[34]

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[32] "About Ginnie Mae." No Date. Ginnie Mae: Government Guaranteed. 24 June 2008 <http://www.ginniemae.gov/about/about.asp?Section=About>.

[33] "Our Role in the Secondary Market." 2008. Freddie Mac. 7 July 2008 <http://www.freddiemac.com/corporate/company_profile/our_role_secmkt/>.

[34] Carmona, Pat. GECU Mortgage Business Development Officer. Personal interview. 18 June, 2008.

Carmona went on to explain, that on a case by case basis, subprime lending could be beneficial and necessary for people truly deserving of one, and who were able to comply with the terms of the loan.[35] However, what occurred was that mortgage loan standards dropped so low that even those who shouldn't have received mortgage loans were approved. Moreover, lenders began creating and using loan products specifically designed to qualify certain people for subprime loans. These loan types were termed creative products and some went as far as overlooking some of the necessary components of the underwriting process such as measuring a person's income and ability to repay the loan.

(For additional information regarding these creative products: See Appendix B)

Similar to the deregulation of the Savings and Loan crisis in the 1980's, this lowering of standards caused more mortgaged-backed securities to be approved as "quality securities," even though the risk of these securities were in fact much higher. This was because the mortgaged-backed securities were actually backed by subprime mortgages and not prime mortgages. These mortgage backed securities were being packaged in such a way that they could earn ratings of AA or even AAA from the top rating companies.[36]

Securities with a rating of AAA or AA are considered high quality investments; however, these securities should have probably received a rating of BB or lower to accurately reflect the underlying subprime mortgages. The reason for this misleading rating was that rating companies believed that the risks involved in individual mortgages in the mortgage backed securities would cancel each other out.[37] Thus, huge investors such as Citigroup, Merrill Lynch, Wells Fargo, etc, bought up these securities in large volumes. However, a significant number of these securities proved to be risky with a high incidence of default. Proof of this was seen on January 15, 2008, when financial giant Citigroup had to "writedown" $18.1 billion dollars. Merrill Lynch reported a $16 billion write down shortly thereafter.[38] A writedown is the recognition of a loss on the value of a company's assets. In this case, it was the value of the investment these companies made in mortgage backed securities.

As figure 1 illustrated, all of the players in the housing market affect each other. According to Jim Jubak, a senior market editor for MSN Money, it is simply impossible to lend more and more money to less- and less-qualified home buyers without driving up the number of borrowers who pay late or can't pay at all. Eventually this causes the number of defaults to rise. Again, a default is when a borrower is unable to repay a lender. When this occurs, the lender usually will start adding late fees to the payment and eventually, if the borrower does not pay or an alternative agreement isn't reached, the home will go into foreclosure. Defaults don't usually occur at the beginning of the loan, but rather later on in the life of the loan when the loan has already been sold to a new owner in the secondary market or to an investor on Wall Street. Because of this, defaults often affect the large banks who bought the mortgage-backed securities in the secondary market as opposed to the originator of the loan in the primary market.[39]

As bad as the subprime crisis has already been, most experts believe it will only get worse. One reason is that consumers are already stretching their money as far as they can, and with increased economic burdens people are choosing to just let their homes be

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[35] Carmona, Pat. GECU Mortgage Business Development Officer. Personal interview. 18 June, 2008.

[36] Jubak, Jim. "The Next Banking Crisis on the Way." 18 January 2008. Jubak's Journal. 25 June 2008. <http://articles.moneycentral.msn.com/Investing/JubaksJournal/TheNextBankingCrisisOnTheWay.aspx>

[37] Bader, Hans. "Federal Meddling Will Only Delay and Increase Inevitable Mortgage Industry Losses." 16 Oct. 2007. Openmarket.Org. 21 July 2008 <http://www.openmarket.org/2007/10/16/federal-meddling-will-only-delay-and-increase-inevitable-mortgage-industry-losses/>.

[38] Jubak, Jim. "The Next Banking Crisis on the Way." 18 January 2008. Jubak's Journal. 25 June 2008. <http://articles.moneycentral.msn.com/Investing/JubaksJournal/TheNextBankingCrisisOnTheWay.aspx>

[39] Jubak, Jim. "The Next Banking Crisis on the Way." 18 January 2008. Jubak's Journal. 25 June 2008. <http://articles.moneycentral.msn.com/Investing/JubaksJournal/TheNextBankingCrisisOnTheWay.aspx>

foreclosed as opposed to struggling to keep up with the higher interest rates, thus higher payments.[40] The reason for this is that some homeowners find it illogical to continue paying for a house that has lost its value.[41] Even though this will damage their credit, some see it as a more reasonable choice.[42] To explain, in an ideal situation an interested homebuyer takes out 30 year adjustable rate mortgage (ARM) for $200,000 with a 5% interest rate. That equals a monthly payment, principal and interest, of $1,073.64 until the ARM resets, or adjusts. In a strong housing market home values increase, increasing equity as explained earlier.[43] Due to over speculation, home values grew very rapidly. As home prices reached abnormally high values, more people were willing to sell their existing home to "upgrade" to a more expensive home with either prime or subprime loans. The belief was that the home values would continue to rise indefinitely and would thus create a profit for the homebuyers in the long run based on the equity they had gained. So in an ideal situation, taking out a subprime loan is not an issue as long as the value of the house was either maintained or continued to increase, thus providing adequate collateral value in the event of foreclosure.

However, what occurred was that the actual demand for homes never met the speculated demand and thus home values began to decrease. As values declined refinancing wasn't an option because the loan-to-value ratios were too high; other people were unable to pay their mortgages and had to default once interest rates adjusted to a higher rate, thus increasing the required monthly rate. As foreclosures went up, home values began to decrease even more as the supply of housing increased while demand fell. Lenders sell the repossessed or foreclosed houses to the highest bidder as quickly as possible and often, for much less than the actual value of the house. As Dan Olivas, President of the Greater El Paso Association of Realtors, put it, "One foreclosure in a neighborhood will not affect housing values, but ten will."[44] This is because the foreclosed homes will be selling for less than market value in the area, which will cause other homes to lose value. If those other homes are also financed with a subprime adjustable loan, the decrease in the home value becomes problematic for the homeowner because they still have to pay a monthly amount based on the original principal of the loan as opposed to the new decreased value. This means they are essentially paying more for a house than what it is currently worth.

El Paso's Foreclosure Situation

Texas ranks 9[h] in the most foreclosures out of the 50 states. The states with the highest rankings were California and Florida, respectively.[45] Over speculation was the main cause of the foreclosure problems in these states. The speculation was based on the industry and/or population growths these states were expecting, especially in certain cities. Community Scholars looked specifically at El Paso and its housing market in relation to other Texas cities to see how we are faring amidst the subprime crisis. Table 2 below shows Texas loan statistics for select cities in comparison to El Paso.

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40 Shedlock, Mike. "Credit Crisis Vs Savings and Loans Crisis." The Market Oracle. 30 May 2008. 25 June 2008. <http://www.marketoracle.co.uk/Article4895.html>

41 "Walking Away." 27 Jan 2008. Yahoo News. 25 June 2008 <http://60minutes.yahoo.com/segment/134/subprime_meltdown>

42 "Walking Away." 27 Jan 2008. Yahoo News. 25 June 2008 <http://60minutes.yahoo.com/segment/134/subprime_meltdown>

43 "Simple Loan Payment Calculator." No Date. Mortgage-Calc. 21 July 2008 <http://www.mortgage-calc.com/mortgage/simple.php>.

44 Olivas, Dan. President of Greater El Paso's Association of Realtors. Personal Interview. 18 June 2008.

45 "The Latest Updated Foreclosure Rates." No Date. RealtyTrac. 11 November 2008 <http://www.realtytrac.com/foreclosure/foreclosure-rates.html>

Table 3.2

Texas Home Loan Statistics

City	Subprime	Other
Austin	14.7%	85.3%
Dallas	19.7%	80.3%
San Antonio	20.0%	80.0%
Ft. Worth	21.7%	78.3%
Houston	23.7%	76.3%
El Paso	26.1%	73.9%

Source: Dataplace.org

As shown above, El Paso has the highest concentration of subprime loans, with about 26% of all home loans considered subprime.[46] The data would suggest that since El Paso has such a large percentage of subprime loans its rates of foreclosures must also be high. However, the available data seems to suggest otherwise. As Table 3.3 below illustrates, despite having the highest percentage of subprime loans in comparison to other Texas cities, El Paso also has the lowest percentage of foreclosures than the same comparison cities.

Table 3.3

Texas Foreclosure Rates

City	Foreclosure/Homes
Travis County (Austin)	1 in 1,037
Dallas County (Dallas)	1 in 1,237
Bexar (San Antonio)	1 in 852
Tarrant (Ft. Worth)	1 in 767
Harris (Houston)	1 in 911
El Paso County (El Paso)	1 in 2,266

Source: Realtytrac.com

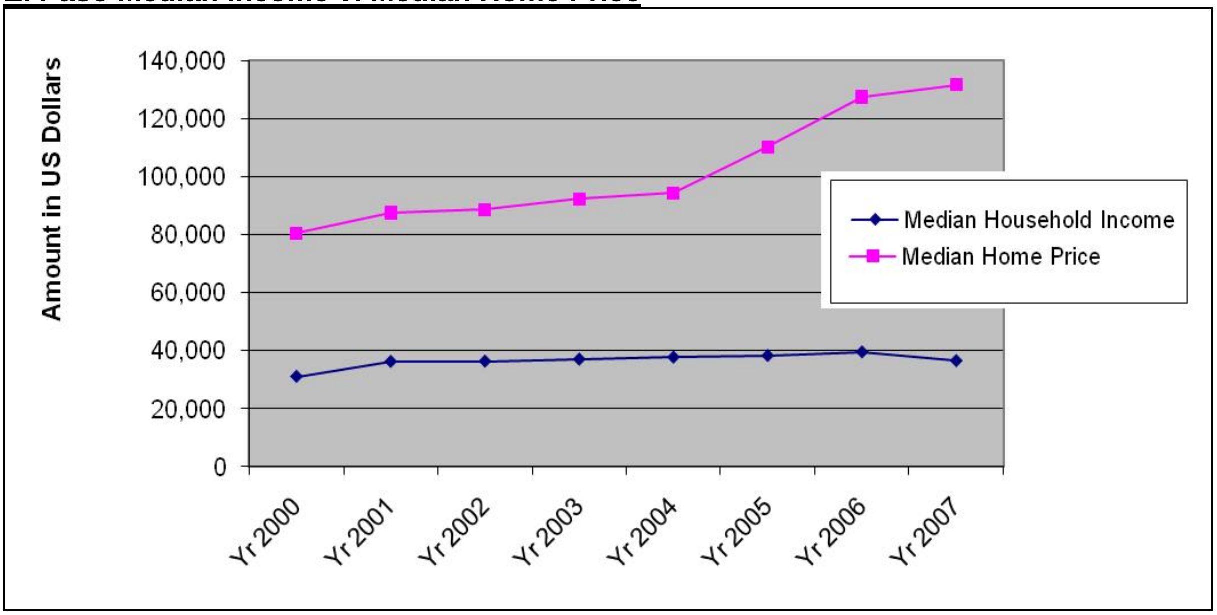
The data on both tables leads one to deduce that El Paso is somewhat shielded from the foreclosure crisis. But another thing to consider is if El Paso has found itself in an economic bubble, where “asset price inflation rises faster than what income can sustain.”[47] In this example, “asset price” refers to the cost of rising home prices. The following graph explores the relationship between El Paso’s median income and median home price.

[46] “El Paso Area Overview." No Date. www.dataplace.org. 25 June 2008 <http://www.dataplace.org/area_overview/index.html?place=x1203&replace_place=0&z=1>

[47] Martenson, Chris. 8 May 2008. "Chapter 15: Bubbles." Chrismartenson.Com. 7 July 2008 <http://www.chrismartenson.com/bubbles>.

Graph 3.1

El Paso Median Income v. Median Home Price



Source: Texas State Comptroller & Dataplace.org

The graph above suggests that El Paso's housing market is possibly in a bubble. The graph shows that while the median home price has increased since 2000, the median household income has not kept pace. In fact, the gap between median home prices and median incomes is increasing every year. If this trend continues, homes in El Paso could become unaffordable within the next few years.

Even though some evidence suggests that we are in fact headed for a housing crisis bubble, some experts argue that El Paso's housing market is insulated against it. There are several factors that contribute to El Paso's relative stability in the housing market. This next section will explore these "insulators."

El Paso's Insulating Factors

El Paso's insulating factors are its current and future economic drivers that fuel its housing market. El Paso's cultural influence also plays a part in its unique insulation.

Base Realignment and Closure Act

In 2005, the Base Realignment and Closure Act (BRAC) designated Fort Bliss to be one of four military bases in the United States to gain posts, along with Fort Knox, Fort Bragg, and Fort Riley. The Department of Defense used BRAC to strengthen the nation's military bases and ensure posts work as efficiently as possible.[48] After BRAC, the population of El Paso is expected to increase from 736,310 people in the year 2006 to 884,454 people by the year 2011.[49] There are 27,954 predicted soldiers along with incoming families coming to the Paso Del Norte region due to BRAC. The total number of families and troops will be an estimated total of 65,636 people.[50] In terms of the overall housing market, experts speculate

[48] Community Scholars, Inc. Breaking Down BRAC: An Analysis of Regional Preparedness for Military Transformation. 10 June 2008. El Paso: Community Scholars, 2005

[49] "Community Profile." No Date. Office of Economic Adjustment. 16 June 2008 <http://www.oea.gov/OEAWeb.nsf/70B0533B76ACB348852573AD0050A88 C/$File/

[50] City of El Paso. "Initiatives and Challenges in Growth, Economic Development, Education, Housing, Healthcare, Workforce and Infrastructure Needs." 18 July 2008. City of El Paso.

that as troops start to come in, home prices will continue to rise. This helps new and existing homebuyers because it means that their home values are likely to increase also, which increases the equity and resale value of their home. One problem this may cause later however, deals with affordability.

Medical Center of the America

The newest of El Paso's higher education facilities, opening to its first class in 2009, is the Paul L. Foster School of Medicine at Texas Tech. The Texas Tech Medical School has been predicated to have the biggest economic impact on El Paso in the long run.[51] With the expansion of the institution from a 2 year satellite school to a 4 year independent school of medicine, the city will attract more people and money into the region.[52] The school will hold upwards of 460 students and is expected to have a $1.3 billion impact on the economy by 2013. Most of the economic impact will come from approximately 5,000 new jobs that will be made directly through faculty, staff, and indirectly through local businesses brought by the medical center.[53]

Border Culture

Another insulating factor that is perhaps harder to quantify is El Paso's socioeconomic culture. El Paso is a predominately Hispanic community, and within this Hispanic culture families tend to stay close. For example, it is common that children live with their parents, or that older parents live with their children. The extended family structure allows for household expenses and the mortgage to be supported by more than one income.

The Looming Credit Crisis

As we have discussed, the subprime crisis is only one piece of what could be a more significant credit crisis , the effects of which may be felt worldwide. According to one more local mortgage expert, the current crisis we are in is not the biggest crisis that we will face in our lifetime. He believes that a credit crisis is looming and could create a major issue for the economy. The mortgage crisis is a large portion of our economic downturn, but it is a myopic view.[54]

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[51] Dodson, Kathryn. "Growing El Paso's Economy Through Job Creation and Revitalization." No Date. YISD Central Office. 27 May 2008.

[52] Community Scholars. Just What the Doctor Ordered: A Look at the Impact the Texas Tech School of Medicine Will Have on the Paso del Norte Region. 10 June 2008. El Paso: Community Scholars, 2007

[53] Shauer, David A., Dennis L. Soden, and David Coronado. "The Expansion of Texas Tech University." 2004. Digitalcommons. 17 June 2008 <http://digitalcommons.utep.edu/cgi/viewcontent.cgi?article=1036&context=iped_techrep>.

[54] Haddad, Gus. President of Haddad Mortgage Group. Personal Interview. 7 July 2008.

Appendix A:
Fannie Mae and Freddie Mac Background

The federal government originally created The Federal National Mortgage Association or Fannie Mae in 1938. Fannie Mae was given the task of stimulating a stagnant housing market in 1938 by allowing banks to fund inexpensive mortgage loans, as a part of President Roosevelt's New Deal Plan, which was created to help stimulate the economy after the Great Depression.[55] Thus, Fannie Mae was created during a period when millions of families across America were not able to become homeowners or ran the risk of losing their homes because of a short supply of mortgage funds throughout the nation. Instead Fannie Mae helped expand the flow of mortgage funds throughout communities at any given time despite the economic conditions. This had the overall effect lowering the cost of home buying.[56]

History

At first, Fannie Mae operated like a savings and loan institution permitting banks to charge a low interest rate on secondary mortgages, creating what today is known as the secondary market. In the secondary mortgage market, investors such as Fannie Mae and Freddie Mac purchase newly originated mortgages and package them into mortgage backed securities. They then sell these mortgage backed securities to other investors such as pension funds, insurance companies and hedge funds.[57]

With the creation of a secondary market, Fannie Mae was able to borrow money from foreign investors at low interest rates since they received financial support from their governments. In 1968, financial pressures created by the Vietnam War lead President Lyndon B. Johnson to privatize Fannie Mae, removing it from the nation's budget. When Fannie Mae was privatized, it then became a Government Sponsored Enterprise as it is known as today. Basically a GSE means that the organization was chartered by the government but is not currently a federal entity. For the first thirty years since Fannie's formation, it monopolized the secondary market. In 1970, in order to prevent Fannie Mae from monopolizing the secondary market, Freddie Mac was created.[58]

With their combination of private enterprises, Fannie Mae and Freddie Mac have seen a period of unprecedented financial growth over the past few decades. Furthermore, Fannie Mae and Freddie Mac are the only two Fortune 500 companies that are not required to inform the public if they are having any financial problems. If there was ever a time that some sort of financial collapse happened within either company, the U.S. taxpayers could be saddled with hundreds of billions of dollars in outstanding debts.[59]

Freddie Mac and Fannie Mae are the largest sources of housing finance in the United States. As set forth in their charters, they are each required as a corporation to achieve and accomplish public goals and purposes. There are three goals and their purpose is to provide stability and liquidity. Liquidity, refers to, easily allowing assets such as a house, to convert into cash in the secondary mortgage market, while at the same time offering stability and security, as well as provides secondary mortgage assistance for low-income and moderate-income families and promotes access to mortgage credit nation wide, including underserved

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[55] Brock, Catherine. "Government-Sponsored Enterprises: an Overview." 6 June 2008. Mortgage loan. 24 June 2008 <http://www.mortgageloan.com/governmentsponsored-enterprises-an-overview-1930>.

[56] "About Fannie Mae." 28 Apr. 2008. Fannie Mae. 24 June 2008 <http://www.fanniemae.com/aboutfm/index.jhtml>.

[57] "Secondary Mortgage Market." No Date. Investopedia. 22 July 2008 <http://www.investopedia.com/terms/s/secondary_mortgage_market.asp>.

[58] Alford, Rob. "What are the Origins of Freddie Mac and Fannie Mae?" 8 Dec 03. HNN: History News Network. George Mason University. 21 July 2008 <http://hnn.us/articles/1849.html>.

[59] Alford, Rob. "What are the Origins of Freddie Mac and Fannie Mae?" 8 Dec 03. HNN: History News Network. George Mason University. 21 July 2008 <http://hnn.us/articles/1849.html>.

areas with insufficient services.[60] They both fund residential mortgages by buying loans directly from lenders, such as mortgage bankers and depository institutions. They also hold loans in a portfolio (a collection of loans), or issue mortgage-backed securities (MBS). Mortgage-backed securities are mortgages in the secondary market used as collateral, to insure securities.[61] Examples of securities are loans, notes, bonds, and stocks.[62] Together, Fannie Mae and Freddie Mac currently guarantee over $5 trillion.[63] This makes these organizations two of the largest house market players in the world.

Fannie Mae and Freddie Mac Now

There has been a growing fear surrounding the status of Fannie Mae and Freddie Mac. Since they guarantee over $5 trillion in home mortgages, they are key players in the housing market and have played an important part during this crisis to keep home mortgages afloat.[64] With this in mind, people fear that if one or both of these giant secondary market companies fail, it will bring havoc to the housing market and the broader economy. If Fannie Mae and Freddie Mac's guarantees become value-less, then this would result in tremendous losses for all investors and companies that have bought securities with their guarantees.[65]

With foreclosure becoming more common in the housing market, these mortgage giants have to make good on their guarantees to the investors they have sold mortgage-backed securities to. Together, these two companies have reported a total of $11 billion in losses, and investors worry that there is still more losses to come.[66] The Office of Federal Housing Enterprise Oversight states that the companies currently do have enough money to continue to do business.[67] There is a proposed accounting rule change that would require both Fannie Mae and Freddie Mac to maintain a certain amount of capital, which would require that they would have to add $46 billion and $29 billion to their reserves respectively.[68] This caused Fannie Mae and Freddie Mac would not be able to raise that amount of required capital during this credit crunch and have begun to sell their shares rapidly, resulting in declines in both companies stocks of over 80%.[69] It is unlikely, however, that the government would allow these two entities to fail because of the devastating effects failure would have throughout the economy. Both the White House and the Federal Reserve have asked Congress to authorize government loans to Fannie Mae and Freddie Mac and to also purchase equity shares from them in order to increase their capital.[70]

GSE Act and Regulation

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[60] "HUD's Regulation of Fannie Mae and Freddie Mac." No Date. Homes & Communities: U.S. Department of Housing and Urban Development. 24 June 2008

[61] "About Ginnie Mae." No Date. Ginnie Mae: Government Guaranteed. 24 June 2008 <http://www.ginniemae.gov/about/about.asp?Section=About>.

[62] "Glossary of Governmental Budgeting and Accounting Terms and Definitions." No Date. Michigan State Senate: Senate Fiscal Agency. 22 July 2008. <http://www.senate.michigan.gov/sfa/StateBudget/glossary.html>.

[63] "Why Fears About Fannie and Freddie are Growing." 11 July 2008. National Public Radio. 18 July 2008 <http://www.npr.org/templates/story/story.php?storyId=92456286>.

[64] "Why Fears About Fannie and Freddie are Growing." 11 July 2008. National Public Radio. 18 July 2008 <http://www.npr.org/templates/story/story.php?storyId=92456286>.

[65] "Why Fears About Fannie and Freddie are Growing." 11 July 2008. National Public Radio. 18 July 2008 <http://www.npr.org/templates/story/story.php?storyId=92456286>.

[66] "Why Fears About Fannie and Freddie are Growing." 11 July 2008. National Public Radio. 18 July 2008 <http://www.npr.org/templates/story/story.php?storyId=92456286>.

[67] "Why Fears About Fannie and Freddie are Growing." 11 July 2008. National Public Radio. 18 July 2008 <http://www.npr.org/templates/story/story.php?storyId=92456286>.

[68] "Why Fears About Fannie and Freddie are Growing." 11 July 2008. National Public Radio. 18 July 2008 <http://www.npr.org/templates/story/story.php?storyId=92456286>.

[69] "Why Fears About Fannie and Freddie are Growing." 11 July 2008. National Public Radio. 18 July 2008 <http://www.npr.org/templates/story/story.php?storyId=92456286>.

[70] Meyers, Mike. "Fannie, Freddie Bailout: a Lifeline to the Mortgage Market." 17 July 2008. StarTribune.Com. 22 July 2008 <http://www.startribune.com/business/25451609.html>.

The Federal Housing Enterprise Financial Safety and Soundness Act of 1992 (GSE Act) established the current regulatory structure for GSEs. Legislation split the regulatory responsibilities over Fannie Mae and Freddie Mac between the Secretary of the U.S Department of Housing and Urban Development (HUD) and the Director of an independent office of HUD, the Office of Federal Housing Enterprise Oversight (OFHEO). The secretary of HUD serves as the mission regulator ensuring both Fannie Mae and Freddie Mac comply with the public purposes created by the government in their charters, with the exception of looking after the GSEs financial safety and soundness.[71]

The HUD Secretary specifically sets the bar and enforces the fulfillment of the three housing goals, monitors and complies with fair lending practices, and collects loan-level data. Loan-level data is a report with data relating to specific loans that are backed by Fannie Mae's outstanding MBS on mortgage purchase activities from GSEs.[72] The data is then made public on a database made for viewing non-proprietary, and not trademarked protected GSE loan purchase data. Duties also include, reviewing and approving new GSE programs with the authority to deny any program the Secretary feels is not authorized with the terms of the GSE's charter.[73]

[71] "HUD's Regulation of Fannie Mae and Freddie Mac." No Date. Homes & Communities: U.S. Department of Housing and Urban Development. 24 June 2008

[72] "Monthly Reporting Data: Loan Level Detail." No Date Fannie Mae. 25 June 2008 <http://www.fanniemae.com/mbs/data/multifamily/loanleveldetail.jhtml;jsessionid=VYXUPLSFGHJ1JJ2FQSHSFGI?p=Mortgage-Backed+Securities&s=Monthly+Reporting+Data&t=Multifamily&q=Loan+Level+Detail>.

[73] "HUD's Regulation of Fannie Mae and Freddie Mac." No Date Homes & Communities: U.S. Department of Housing and Urban Development. 24 June 2008

Appendix B Creative Products
"Creative Products"

"Creative products" were aimed at making loans more attractive to potential purchasers. These creative products were designed to combine some of the characteristics of the loans described above and mesh them together to create something new. There are now many creative products in the mortgage finance arena but some are used more commonly than others. While these products helped some homebuyers who wouldn't have otherwise been able to afford a home, they put others in risky situations when interest rates reset.[74] Some of the more popular creative products will be discussed next.

Interest-only Mortgages

Interest-only mortgages allow the borrowers to only pay the interest for a certain amount of time (normally between 5-10 years). Many borrowers apply for this type of mortgage because of the lower monthly payments, since principal is excluded during the initial interest only period. When the period of time the borrower can pay interest only ends, the borrower would then proceed to pay off the principal amount of the loan and interest. Although interest only payments seem attractive at first, the total amount of money the borrower ends up paying is more than what they would pay using a traditional loan.[75]

Pick a Payment loans

There are also the "Pick a payment" loans: These are loans that allow the borrowers to choose what they pay for a month. They can choose to pay enough to cover the interest plus the principal, interest only, or less than the interest. For the latter choice the unpaid interest would be tacked on to the principal, meaning that the borrower would end up owing more than the amount of the original loan.[76] While this type of loan is initially an attractive option because this allows the borrower to choose what they pay, the borrower will eventually end up paying much more than the term of the loan, versus using a traditional mortgage product.

Initial Fixed-rate Mortgages

Another common product is the Initial Fixed-Rate mortgages. T hese include some of the most common hybrid loans such as the 2/28, 3/27, and 5/25 ARMs.[77] These mortgages are appealing because they offer lower interest rates and give the borrowers the hope that interest rates will continue to stay low at the fixed rate long enough so that they can build equity in their houses and refinance before the interest rate adjusts.

Teaser rates

Teaser rates are what some lenders use to hook unsuspecting homebuyers with very low mortgage rates. These low rates however, are only valid for a short period of time (anywhere between 1 month to 6 months), before the contract mortgage rate takes effect. Most borrowers who start out with these teaser rates are taken by surprise when their interest

[74] Byron, William. "Roots, Consequences of Subprime Woes Go Deep." 16 Aug. 2007. The Huffington Post. 20 June 2008 <http://www.huffingtonpost.com/byron-williams/roots-consequences-of-su_b_60696.html>.

[75] "Subprime Lending." No Date. Answers.Com. 19 June 2008 <http://www.answers.com/topic/subprime-lending?cat=biz-fin>.

[76] Trehan, Veena. "The Mortgage Market: What Happened?" 27 Apr. 2007. National Public Radio. 19 June 2008 <http://www.npr.org/templates/story/story.php?storyId=12561184>.

[77] "Subprime Lending." No Date. Answers.Com. 19 June 2008 <http://www.answers.com/topic/subprime-lending?cat=biz-fin>.

rates reset, and their required monthly payment increases significantly. As a result of this, many homes are foreclosed.[78]

NINJA Loans

NINJA is what lenders call the No Income, No Job or Assets loan. These loans are meant for the borrowers who are not qualified – meaning they don't have the proper credit or income they need–to buy a home. Although these borrowers weren't qualified for a good prime loan, the lenders, using a NINJA loan, lent money to them anyway. NINJA loans help the borrowers who wouldn't otherwise be able to receive a loan.[79]

Liar Loans

Typically, when getting a loan, a borrower is limited to using only 30% of their gross income for a home mortgage payment. When getting a liar loan, the borrower would say that they make whatever income they would need to support the size of the loan that they wanted for their homes. In such a case, the lender would not verify that the borrower does indeed make the income stated. The lender would not go through the proper underwriting process of a loan and lend the money to the borrower even though they cannot support it.[80]

Negative Amortization Loans

With a negative amortization loan, the borrower pays a low monthly payment. However, the monthly payments are too low to actually reduce the balance owed on the loan. In the end, the loan amount actually increases over time instead of decreasing.[81] To borrowers, low monthly payments are attractive and welcomed. Not all borrowers realize, however, that these negative amortization loans are significantly more expensive in the long run.

[78] Latour, Louie. "Mortgage Refinancing - Watch Out for Teaser Interest Rates." 9 Mar 2007. EzineArticles.com. 20 June 2008 <http://ezinearticles.com/?Mortgage-Refinancing---Watch-Out-for-Teaser-Interest-Rates&id=483423>.

[79] Sapp Gary. President of Southwest Division of Hunt Development Group. Personal Interview. June 24, 2008.

[80] Sapp Gary. President of Southwest Division of Hunt Development Group. Personal Interview. June 24, 2008.

[81] Sapp Gary. President of Southwest Division of Hunt Development Group. Personal Interview. June 24, 2008.

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