Subprime lending not main trigger of real estate bubble

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(PhysOrg.com) -- Critics often point to subprime mortgage lending – the funding of home loans to borrowers with less-than-perfect credit – as the culprit in the unsustainable boom in U.S. home prices that eventually derailed the real estate and mortgage markets.

But new research led by UC Irvine's Paul Merage School of Business Center for Real Estate suggests subprime loan products themselves may not be the primary cause of U.S. home prices' rise and fall.

Instead, the considerable 2003 pullback of government-sponsored financial service corporations Fannie Mae and Freddie Mac from the credit market and their replacement by aggressive, private mortgage securities issuers in late 2003 had a significant impact on home prices and was more responsible than subprime lending for the drastic price runup that peaked in early 2006.

"We were quite surprised to find the intensity of subprime lending was insignificant after controlling for all the other factors influencing the market, but we were really blown away when Fannie's and Freddie's continuing presence in the market was shown to be so important," said Kerry Vandell, UCI finance professor and Center for Real Estate director.

Vandell along with Major Coleman IV, finance doctoral student, and Michael LaCour-Little, Cal State Fullerton finance professor, used 1998-2006 housing and mortgage data from a variety of sources –

including First American LoanPerformance, the S&P/Case-Shiller Home Price Indices and the Federal Housing Finance Board – to analyze 20 U.S. metropolitan areas.

The researchers found that rising home prices up to 2003 could be explained by economic fundamentals, such as low unemployment rates, expanding household incomes and population growth. These factors fueled housing demand and, in turn, increased U.S. home prices. During this time, Fannie Mae and Freddie Mac actively issued and purchased conventional, conforming mortgage-backed securities.

But in 2003, political, regulatory and economic factors – including accounting irregularities that led to their senior officers' resignations and the capping of their retained loan portfolios – forced the two entities to significantly slow their lending volume. Private funding in the form of asset-backed securities and residential mortgage-backed securities replaced conventional, conforming mortgage-backed securities as the prevalent source of mortgage capital.

The new credit environment allowed looser underwriting standards and increased tolerance for riskier, high-yield loan products. Such products included adjustable-rate mortgages with low initial "teaser" rates, Alt-A loans that did not require income verification and nonowner-occupied investor products. This borrowing climate provided previously marginal borrowers with additional access to credit. The credit market shift led to a record increase in total mortgage volume and pushed up home prices with momentum characteristic of a bubble.

The researchers also determined that interest rates did not significantly affect house prices. The finding defied conventional wisdom that ties interest rates directly to the monthly cost of housing and assumes an effect on purchase prices.

“These findings help us understand that the government can have a major role in affecting the mortgage and housing markets,” Vandell said. “It’s important policymakers consider this influence when they attempt to shape the markets in the future.”

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