The AZ Real Estate Boom & Bust

(7/11/2014 AZ Republic by Dr. Harold Wong)

This summer, I will be writing about a number of topics about how people view money, manage their money, and the consequences. The same cycle of greed and fear occurs in every market, whether it is real estate, stocks or gold. Of these two emotions, normally greed is dominant and let me prove it. Even the most degenerate gambler knows that when you enter a casino, the odds favor the house in every game. However, that does not prevent millions of Americans from entering casinos.

Among other things, I was in the mortgage industry from 2001 through 2007, and so saw the rise and fall of the AZ real estate market. In 2001 we still had a fairly normal mortgage market, where those applying for a mortgage loan had to prove income with paystubs and also the last 2 years' tax returns if self-employed. One had to prove sufficient asset reserves with bank and other financial statements. One had to have a sufficiently high credit score, or the loan officer would not even fill out your loan application. Finally, there was the debt-to-income ratio (DTI).

The typical DTI limit in the 1970s was that monthly housing expense should be less than 25 percent of monthly income and there was no codified limit for the back-end ratio (which includes housing and all other debt). The back-end ratio limit was left to the discretion of lenders on a case-by-case basis. The rule of thumb was that one should not spend more than one week's pay on total housing expense. Over time, this DTI ratio allowed by lenders increased.

On April 13, 2005, HUD (Housing Urban Development, a government agency) increased the allowable DTI for manually underwritten loans to 31/43. The first number, 31, is the front-end ratio and represents the percentage of the borrower's income that will go to his new housing expense of principal, interest, taxes, insurance, and homeowner association dues. The 43 is the back-end ratio, which is the percentage of total monthly income that goes to total debt, including all housing, credit card, car, student loans and alimony and child support payments. With the use of automated system underwriting approvals, a borrower's debt-to-income (DTI) ratios can exceed the guidelines and may go as high as 50 percent of more.

Around 2002, innovative products led to totally relaxed mortgage underwriting standards. If one had a very high credit score, one did not have to prove one had a job or a specific amount of income or assets. This was called a NINJA loan (No Income, No Job, and No Assets). There were even popular negative amortization mortgages, where the true rate of interest might be 7 percent, but you only had to pay 2 percent for the first 5 years. The extra 5 percent interest that you owed, but did not pay, was added to your loan balance every month. So, at the end of 5 years, your initial $400,000 mortgage loan would now have a balance of over $500,000.

The relaxed mortgage underwriting standards gave homebuyers this choice: I can buy my $450,000 brand-new dream home in a gated community, with 3,000 square feet, 5 bedrooms, 3 baths, 3 car garage, and swimming pool; OR I can buy the 30-year-old $225,000 home that has 3 bedrooms, 2 baths, and no pool. Investors jumped in and bought houses with hopes of quick and big profits. Greed won out and led to the big housing boom. When the value of homes started dropping in 2006, it led to massive foreclosures and over 500 banks going under. All of this eventually led to the 2008 stock market crash and The Great Recession, where 10 million jobs were lost. Excessive greed always has consequences.

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