Querin Law: Real Estate Data Points for 2014

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As 2013 recedes in the rear-view mirror of memory, I thought it high time to ask what were some of the significant developments of the year, and what do they bode for the real estate industry in 2014? I've identified the following five data points I believe are most worthy of discussion. They are arranged in no particular order of importance. ~PCQ

1. The Portland-Metro Real Estate Market. Unless you've been on the Moon for the past 15 months, it's hard to ignore the pleasant truth – the market is much improved. But by no means is it fully recovered. It's off life support, but still recuperating. There are certain aspects of today's real estate market that continue to be in need of improvement.

For five years, 3Q 2007 to 3Q 2012, real estate was in the tank. Prices had plummeted 30%, 40%, and 50% in many parts of the state; the Realtor® industry locally had suffered attrition rates of 25% or more; buyers were mostly on the sidelines, and sellers were held hostage by homes awash in negative equity.

Beginning in September 2012, Portland-Metro home prices – *for the first time in 60 months* – began to inch up. From that point forward, the average and median price of properties began to improve, consistently better than the month before. In the late Spring of 2013, there was a cooling, but nevertheless, each month had numbers that were better than the same period a year earlier.

The Regional Multiple Listing Service (RMLS™) reports the housing stats on a monthly basis. They are provided to the Oregon Realtor® industry approximately two weeks after the close of the prior month. Overall, listing and selling activity in 2013 was consistently better than the same period in the prior year. Time on the market – i.e. how many days it took from the date of listing to the date the home went "pending" – was also consistently improving. *[For the January 2014 numbers and year-to-date comparisons, go to my post here.]*

There is little reason to believe the trend will not continue. The only question is will the rates of appreciation continue at the same torrid pace? From January to December 2013, the average priced home increased by approximately 12%, i.e. one-percent a month on average. That is not sustainable or healthy. It is reminiscent of 2005 – 2007, and we know how that story ended.

To be clear, I do not believe we are heading for another real estate "crash." Why? Because the conditions that precipitated the collapse in 2007/2008 do not exist today. During those "easy-money" days of lax or nonexistent underwriting, if you could fog a mirror, you could get a loan. This put homes within grasp of anyone – *even those who could not afford them.* As demand increased, so did prices. It became a "sellers' market" where demand outstripped supply, even though new construction was flying off the shelf. Since that time, the Big Banks and Wall Street have been chastened. No more free money! No more "liar loans," "no-doc loans," neg-ams, piggy-back loans for 100% financing,[1] and all the other gimmicks lenders used to snake-charm customers into believing it was OK to bite off more than they could chew.

[1] At the time, the term NINJA loans came into vogue: "No Income, No Job or Assets."

The appreciation we're seeing in the local Portland-Metro market today is not being driven by profligate lending. What is happening is the result of several dynamics: Increasing confidence, the gradual disappearance of negative equity, thus allowing home sellers to "trade in" their home for another, and perhaps most important, a whole new crop of first-time buyers. What is missing, however, is a dramatic improvement in the employment numbers. Also, with Congress in gridlock and an AWOL president, there is the continuing question of what lies over the horizon. As a result, homebuilding is still tepid, with the large national builders remaining cautious.

Perhaps the most disconcerting feature of the residential real estate market today is the lack of available inventory. There are many more buyers than sellers, reminiscent of 2005-2007/8. This is due to many factors, including those touched on above: Caution by sellers, buyers and builders and low employment figures. Plus, much of what might have been available in 2013 was gobbled up by investors who turned homes into rentals.

***The Take-Away*. Housing will continue to improve throughout 2014, though not at the torrid pace of 2013. As discussed below, with the new regulatory controls being implemented in 2014, more cautious financing will limit access to "easy" credit, which has a sobering affect on buyer aspirations. As inventory improves, there will be more equilibrium in the marketplace – meaning that buyers will have more to choose from, thus enabling them to walk away from sellers with unrealistic pricing. Once that happens, home prices will be negotiated on a more level playing field, thus keeping prices from escalating as fast as 2013.**

2. ***Distressed Housing*.** This is a term used to define all residential housing that, due to negative equity and other personal events, results in a loan modification, short sale, foreclosure, or a deed-in-lieu of foreclosure.

When the foreclosure crisis was in full steam, *circa* 2008-2009[2], approximately a third of all listings were for short sales. Foreclosure companies sprouted up *[some affiliated with the very banks who were owed the loans]*, specializing in churning out non-judicial foreclosure documents like pizzas on a food line. Then, in July, 2012, when the Oregon Supreme Court ruled that non-judicial foreclosures were being illegally processed, banks and servicers began hiring foreclosure-mill law firms to process the paperwork. One had only to count the monthly court filings in the Tri-County area to know that the foreclosure business was booming. The filings climbed during most of 2013 until the very end of the year. For the past two months *[December 2013 and January 2014]* they appear to have fallen precipitously. That's a good thing on a couple of levels.

[2] Clearly, foreclosures were occurring for a couple of years before that, but these were primarily the "sub-prime" loans made to folks who should never have received them. These loans fell into default almost immediately, and were foreclosed in due course. It was not until approximately 2009, when folks who were legitimate buyers and borrowers, began to question their wisdom, willingness and ability to continue making payments on a home that was now 30% -50%+ underwater. It did not take a graduate degree from the London School of Economics to do the numbers; owning a home worth $200,000 and paying on a mortgage of $300,000, meant that there would be no equity appreciation for years, if things continued as they were. The result was that, compliments of the Great Recession, many families ultimately fell victim to one of the 3-Ds: death, divorce, and debt. This, coupled with negative equity, caused many folks to give up, stopping their payments, and disposing of their homes through short sale, deed-in-lieu, or foreclosure. Thus, what started out as a "sub-prime crisis," ended up infecting the entire marketplace, from starter homes to stately mansions.

First, it's good that folks are getting the unpleasantness of negative equity behind them. Only when the home is sold, transferred, or foreclosed, can a borrower begin improving their credit rating. One could have perfect credit, but with a late-payment entry on their report every thirty days, it was impossible to improve one's FICO score.

Secondly, for every home foreclosed or taken back in lieu of foreclosure, it means an increase in the available housing stock. Only when normalcy returns to the marketplace, i.e. where available homes are sold in arms-length transactions, will pricing be driven by economics, rather than a distressed housing event that does not reflect fair market value.

The big unknown is "shadow inventory." This is the unknown number of folks 90-120 days or more delinquent, but still not formally in foreclosure, which might be six to eight more months. And once served with the summons and complaint, it could take 8+ months for the process to be completed. Then, since the foreclosure is "judicial," i.e. in court, Oregon law requires that the high bidder at the auction sale only gets a "sheriff's certificate," and cannot get a "sheriff's deed" to the property for another six months. This is known as the "right of redemption" which exists so the defaulting buyer has an opportunity to re-purchase the property. Since almost all foreclosures have been against borrower-owners with negative equity, there is little or no incentive for them to exercise their right of redemption.

We simply don't know how many homes are still in some stage of pre-foreclosure status. Nor do we know how many banks, afraid to flood the market, may be holding onto post-foreclosure homes, rather than putting them up for sale.

***The Take-Away*. Unquestionably, the worst of the foreclosure crisis is behind us; it is safe to assume that available housing inventory should improve into 2014 as a result. How quickly the improvement will come, is a matter of debate. My take is that it will be slow, since confidence is still tepid, due to the sluggish employment figures and contrarian economic predictions. By June the picture should become clearer as we hit the home-selling season.**

3. Today's Regulatory Environment: The CFPB, QM & ATR. The 2010 Dodd-Frank Act *[2,300 pages]* spawned perhaps the country's biggest regulatory overhaul in banking and finance, including the creation of the Consumer Finance Protection Bureau, or "CFPB," *[900 pages and untold thousands of pages of administrative regulations, which are still not close to completion[3]]*.

In 2013, the CFPB created two sets of banking regulations known as the "Qualified Mortgage" ("QM") and the "Ability to Repay" ("ATR") rules. For a discussion of these rules, go to my post here. A QM loan contains none of the risky features we saw during the easy money days of 2005 – 2007/8, such as negative amortizations, interest only, and terms over 30 years. QM loans have "safe-harbor" protections for the lender against borrower suits. The ATR rules define the underwriting steps lenders must take in order to have this QM protection. Riskier loans *[e.g. with balloon payments or adjustable rates]* will - assuming they comply with the ATR rules - have a rebuttable presumption of compliance. Violations of the ATR rules can be harsh: A borrower has the ability to recover back all of the finance charges and fees

[3] According to the progress report of the Davis Polk law firm, here: "As of February 3, 2014, a total of 280 Dodd-Frank rulemaking requirement deadlines have passed. Of these 280 passed deadlines, 132 (47.1%) have been missed and 148 (52.9%) have been met with finalized rules. In addition, 201 (50.5%) of the 398 total required rulemakings have been finalized, while 110 (27.6%) rulemaking requirements have not yet been proposed."

paid, plus actual damages, statutory damages, attorney fees and court costs. There is a three year statute of limitations from the date the violation occurred.

The QM and ATR rules went into effect on January 10, 2014. So the question going forward is, will lenders refuse to make housing loans *unless* they conform to the QM model? If so, this will surely mean that many borrowers will be unable to qualify, thus closing them out of the housing market. If only the most highly qualified borrowers can qualify for loans, it does not bode well for the rest of the marketplace.

Although certain commentators feared this result in 2013, the dire predictions are not likely to be seen in 2014. Why? There are several factors. First, with interest rates so low, we've seen a refinance boom over the past several years. Banks made money hand over fist, and to their delight, they discovered they could do so the old fashioned way – legally. Today, now that refi income is slowing, a major source of revenue for banks has been in purchase money financing, i.e. loans to home buyers.[4]

Secondly, thanks to Dodd-Frank's many regulations, including the recently passed Volker Rule,[5] banks are finding themselves having to spin off profit centers that are deemed either a violation of the new laws, or too risky in today's tight regulatory environment.[6] This means that an important source of revenue is disappearing. Again, banks are looking to focus more on the lending side of their business to boost revenues.

Today, there are stories in the financial papers indicating that Big Banks are relaxing some of their lending requirements in order to attract new borrowers. Here's the catch: Fannie and Freddie will only buy QM loans – i.e. those plain vanilla loans with 30-year amortizations, fixed rate interest, and 5% - 20% down.[7] This means that a non-QM loan, with riskier features, would have to become a "portfolio loan," i.e. retained by the bank in its own portfolio. This is beginning to occur – with Wells Fargo, the nation's largest lender, leading the pack. Additionally, Wells Fargo has recently announced that it is lowering its credit score bar from 640 to 600 for FHA and federal VA loans. Others are likely to follow Wells' lead.

Thirdly, one of the anticipated major sources of financing is going to be first-time buyers. The Internet is crowded with advertisements for first-time buyer programs. These were the folks that have been ignored for the last five years of the housing crisis, since they were not in the market for a home. But as they aged, formed families, and solidified their balance sheets, they have now become attractive candidates for residential loans.

***The Take-Away*. Lenders are beginning to realize that they can still make money on lending by simply controlling their underwriting risks. This applies to non-QM loans (e.g. ARMS and interest only) today as well – banks will still be doing them – but with better underwriting. Just because a borrower had a**

[4] However, recently, JPMorgan has recently announced major layoffs on their lending side, and Big Banks are sure to follow suit. This may be good news for the local and regional banks.

[5] The Volker Rule prohibits Big Banks from engaging in certain risky trading activity – not for the account of their clients, but for their own account *[known as "proprietary trading"]*. The theory is that if the banks are permitted to engage in excessive risk-taking, even on their own account, a large loss could bring down a bank and endanger its depositors. Ironically, it was *not* risky proprietary trading that caused the 2007-2008 financial crisis. For more on this issue, see my post here.

[6] The CFPB has been flexing its muscles in 2013, now that it is up and running with a full-time regulator.

[7] Loans with less than 20% down typically require mortgage insurance, paid for by the borrower.

distressed housing event, such as a short sale or foreclosure in their past, does not mean they should not qualify for another loan. In most cases, many folks emerging from a distressed housing event had stellar credit in all other respects. Also, first-time buyers looking to enter the housing market, and empty nesters looking to downsize, will be a fertile source of financing. Additionally, over the past several years, most banks have dramatically improved their balance sheets. The number of "troubled banks" - as they have been euphemistically referred to - is nothing compared to the past five years.[8] Those having difficulty in competing for business in today's lending environment will likely be absorbed rather than fail. In short, lending will not dry up for housing – banks are just going back to basics, which is a good sign.

4. ***QE3 & Interest Rate Uncertainty.*** ***"***Quantitative Easing" or "QM," is a fiscal policy whereby the Federal Reserve purchases large quantities of long-term securities from Big Banks. The Fed prints money to make these asset purchases. The goal is to keep long term interest rates low and release more money into the market place, thereby increasing the money supply. Until recently, the Fed was buying $45 billion in treasury bills ("T-Bills") and $40 billion of mortgage-backed securities a month. When interest rates went down – which they did - the hope was that the construction and housing industries would rebound, businesses would increase capital investment, and employment would increase. *[For a cynical, but very funny explanation of Quantitative Easing, see cartoon here.]*

As we know, interest rates today are at historic lows, and the Big Banks who sold the Fed treasuries, are awash in cash. Unfortunately, although QE may have produced some incremental benefits, on the whole, it has been underwhelming. In fact, today the Fed is taking its third run at QE, called "QE3." QE1 occurred shortly after the credit markets crashed following the Bear Stearns collapse and the Lehman bankruptcy in the fall of 2008. QE2 occurred in 2010; QE3 was initiated in 2011.

Since mortgage interest rates track the long term T-Bill rates, as QE keeps these rates low, it also keeps mortgage interest rates low. As we know, however, QE1 and QE2 did little to lure home buyers from the sidelines. The result was that the housing industry continued in the doldrums and foreclosures surged as borrowers became trapped by loans that exceeded the falling value of their homes. Big banks, the primary beneficiaries of QE, held on to their money rather than lending it out. This increased their capital risk reserves and improved their balance sheet picture. And no thanks to Dodd-Frank, many potential home purchasers found that tight lender underwriting had locked them out of the marketplace for an affordable loan.

Now that Janet Yellen has taken over as the Fed Chair, what is happening? Well, in a continuation of her predecessor's attempt to slow down the bond purchases, the Fed is reducing them by $10 billion a month (a.k.a. "tapering"). This will continue unless or until the economy has a relapse. She has also reiterated Ben Bernanke's vow to continue keeping interest rates at historic lows. Initially, he had said low rates would continue until unemployment dropped to 6.5%. But as we slowly approach that figure, it appears that Ms. Yellen intends to keep interest rates down even if unemployment drops below that.[9]

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[8] Per Bankrate.com the number of bank failures and cost to the FDIC were the following: **2014** (2) $0.071B (estimated); **2013** (24) $1.165B (estimated); **2012** (51) $2.785B (official); **2011** (92) $7.945B (official); **2010** (157) $22.904B (official); **2009 (**140) $38.732B (official).

[9] Here is the Fed's official position as of the date of this article: "To support continued progress toward maximum employment and price stability, the Federal Open Market Committee expects that a highly accommodative stance

How successful she will be depends on the economy and her ability as the Fed Chair to persuade the other members to follow her lead. For an interesting article on her prescience, go to a recent New York Times article here.

The Take-Away*. As long as the economy lumbers along on its slow, ambulatory, road to improvement, we should expect rates to remain low, thus permitting housing to gradually improve. This is good news for the real estate and construction industries. However, there is one factor that acts as a restraining negative influence on full economic recovery – unemployment. The recession devastated major sectors of the workforce, and for some, the blow was one from which they still have not recovered. For most folks who take what our government reports with a grain of salt the size of a horse pill, there is a strong suspicion that the official unemployment numbers are grossly understated, and overlooked by a press with the collective attention span of a 6-year old on a sugar high. This problem is exacerbated by a White House that spends its time denigrating the very employers who could help, and stoking the fires of class envy, all for political points.

5. Is The Real Estate Market Fundamentally Changed? Is This The "New Normal?" In a word "Yes." How do I know? Does this make me a modern day Nostradamus? No, nada, nyet! It just happens that I've experienced and observed the real estate marketplace over the last four decades. Right or wrong, here's my take:

First, the level of regulation of the market is light years beyond what it was 40 years ago. When I first began practicing real estate law, the residential sale agreement was a single page. The sale of a home consisted of little more than a wink and a promise. Today, the same agreement is 10 pages. Each year brings new rules, and with those rules come changes in practices.

Interestingly, during the 5+ years, *circa* 2007 – 2012/13, the dynamics of real estate transactions were altered dramatically. Banks became the alter ego for sellers of short sales and buyers purchasing REOs, those formerly foreclosed homes the bank was re-selling. In both cases, the banks made the rules – regardless of contract terms, convention, or custom. It was their way or the highway. As a result, many things occurred – or didn't occur – during this time.

- Since a sizeable percentage of the entire marketplace was either short sales or REOs, all controlled by the banks, many buyer protocols, such as comprehensive testing and other due diligence, fell away. Banks were generally non-negotiable, and if one party walked away, another was found. Real estate brokers were little more than order-takers. The art of negotiation and strategizing waned.

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of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens. In its December 2013 statement, the Committee reaffirmed its expectation that the current exceptionally low target range for the federal funds rate of 0 to 1/4 percent will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than half a percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored. In addition, at its December 2013 meeting, the Committee indicated that, based on its assessment of measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments, it will likely be appropriate to maintain the current target range for the federal funds rate well past the time that the unemployment rate declines below 6-1/2 percent, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal."

- Since there were so few buyers for equity sales, they controlled the market price and terms. Sellers could not afford to walk away in the hopes of finding another buyer. The result was that there were very few disputes in the Portland-Metro residential marketplace.
- Even Realtor® vs. Realtor® disputes fell off, as did homeowner vs. Realtor® ethics cases, as well.
- The Realtor® industry in the Portland-Metro area lost about 25% of its members.
- Many homeowners with equity waited on the sidelines for the market to improve and equity to return.
- Most homeowners without equity either short sold, got foreclosed, or suffered in silence, waiting for the process server to knock on their door.
- Those Realtors® who survived the Recession were, in a Darwinian sense, the "fittest." But only now are they being required to sharpen the skills that fell dormant over the last several years. And it appears they are. To that extent, the Recession had a sobering effect on many brokers, who probably worked harder during that time than ever before.
- Moreover, those folks coming into the industry are doing so with few misconceptions. After meeting and speaking with hundreds in 2013, many of whom have come from prior careers, it is clear that they are older, wiser, and ready to learn the business from the ground up. That's a good sign.

Conclusion. The stars are slowly coming into alignment. But as long as inventory remains critically low, there cannot be true "balance" in the marketplace. Moreover, since the "pie" is smaller, it still means that real estate brokers must forage. Listings and sales do not just materialize. They have to be worked, coaxed, teased, and earned.

But much of the lender handwringing of the past appears to be for naught. Banks will continue to loan to folks across the economic spectrum. And yes, they are over-regulated – but they invited it on themselves, so they'll have to live with it. But it should not prevent them from making loans to most folks who want them. However, "sub-prime," "no-doc" and "liar-loans" have become dinosaur-extinct. The new lender focus will be on better ATR underwriting. And yes, there *will* be non-QM loans available in the lending marketplace.

The Realtor® industry, leaner and wiser, will have to keep pace with more sophisticated techno-savvy sellers and buyers. It is a challenge they appear to be meeting head-on. 2013 was the first year in five that steady improvement occurred in almost all statistical sectors of the Portland-Metro residential market. And while the road ahead is not without its unknowns, 2014 appears to be *The Year* we can finally begin to shake off the doldrums of the past, and focus on returning the industry to a vibrant business. It's about time!