

Pulte Homes and Risky Loans

The Hidden Cost of Selling New Homes

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A Report by Building Justice

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Pulte home in Palmdale, CA.

Since the boom began, no homebuilder has been more successful at building homes and originating loans than Pulte Homes.

From 2001-2006, the average price for a new home in the United States increased almost \$93,000, or 43%.¹ In the western U.S., new single-family home prices skyrocketed by \$156,000.² During this boom, developers were building homes around the clock in some markets and still couldn't satisfy demand.

While rising home prices certainly helped strengthen the home building industry's bottom line, they also priced more and more Americans out of the market. To make home ownership appear more affordable to the average buyer, Michigan-based Pulte Homes, Inc. and some of its peers began offering more non-traditional hybrid prime rate loans (as opposed to sub-prime rate loans) such as adjustable rate mortgages (ARMs) and loans with volatile interest rates.³



Pulte home in Henderson, NV.

Since the boom began, no homebuilder has been more successful at both building homes and originating loans to finance them than Pulte.⁴ From 2002 to 2005, the company's mortgage loan originations increased by 86%. By the end of 2006, more than nine out of every ten buyers who needed financing for a home built by Pulte or its main subsidiary Del Webb used Pulte Mortgage, the company's wholly-owned mortgage affiliate.⁵

In a typical scenario, a buyer qualified for a more expensive mortgage than the government would recommend because the initial interest rate on a hybrid loan is often well below market rates.⁶ This meant a smaller monthly mortgage

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payment compared to a standard fixed-rate product. But when the hybrid loan interest rate reset to a higher rate the payments doubled or tripled. The borrower experienced what the Federal Deposit Insurance Corporation calls "payment shock."⁷ If the borrower cannot afford the new higher payment, he or she will default on the loan.

However, long before the interest rates reset, the loans are sold, cut into tranches, and securitized on the secondary market. In other words, by the time the borrower defaults on the loan, the builder and its mortgage subsidiary are no longer liable.

Pulte home in Youngtown, AZ.



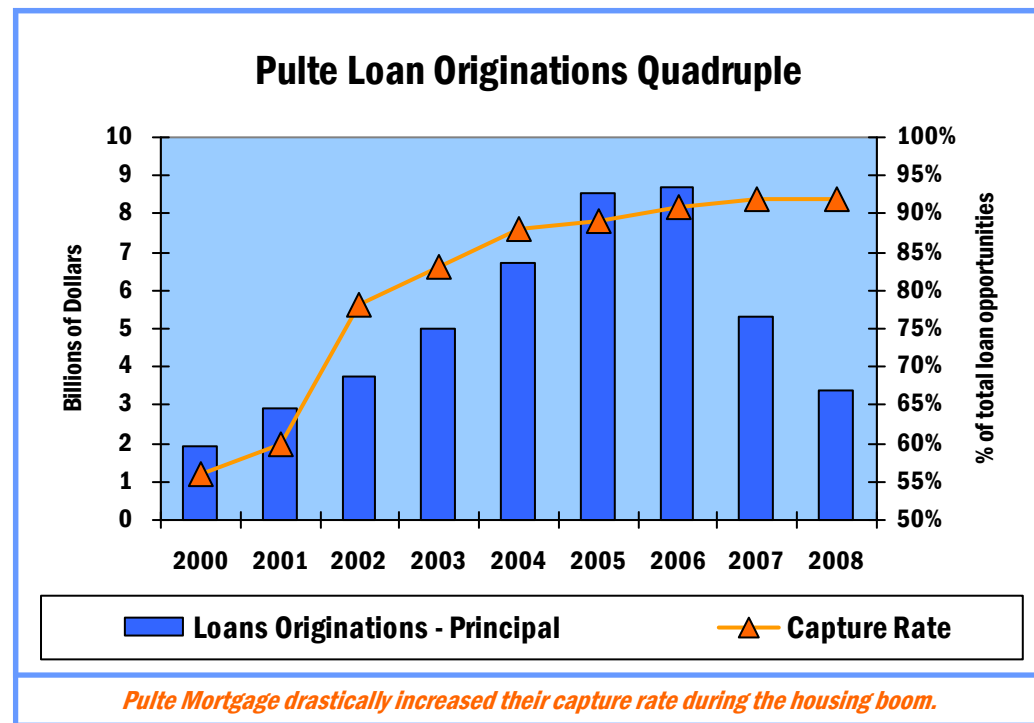
“...when we can control the financing side of the business, we have a much higher likelihood of getting the buyer to the closing table.”⁸
 - Bruce Orr, Pulte Vice President

Risky Loans at Pulte Mortgage

Pulte Mortgage, LLC is a wholly-owned subsidiary of Pulte Homes. Its operations – and its affiliates – cover markets where Pulte Homes conducts business. As of year-end 2008, Pulte Mortgage was originating loans to 92% of Pulte Homes’ customers seeking mortgages, an increase of 65% from 2000. This is the highest “capture rate” in the business.⁹

Because of its extremely high capture rate, Pulte Mortgage originated more loans per home sold annually than all its peers, thereby helping its parent company sell more Pulte and Del Webb homes. In 2005 these “captured” loans topped out at almost 43,000, with a total principal value of \$8.5 billion – more than a 125% increase from 2002.

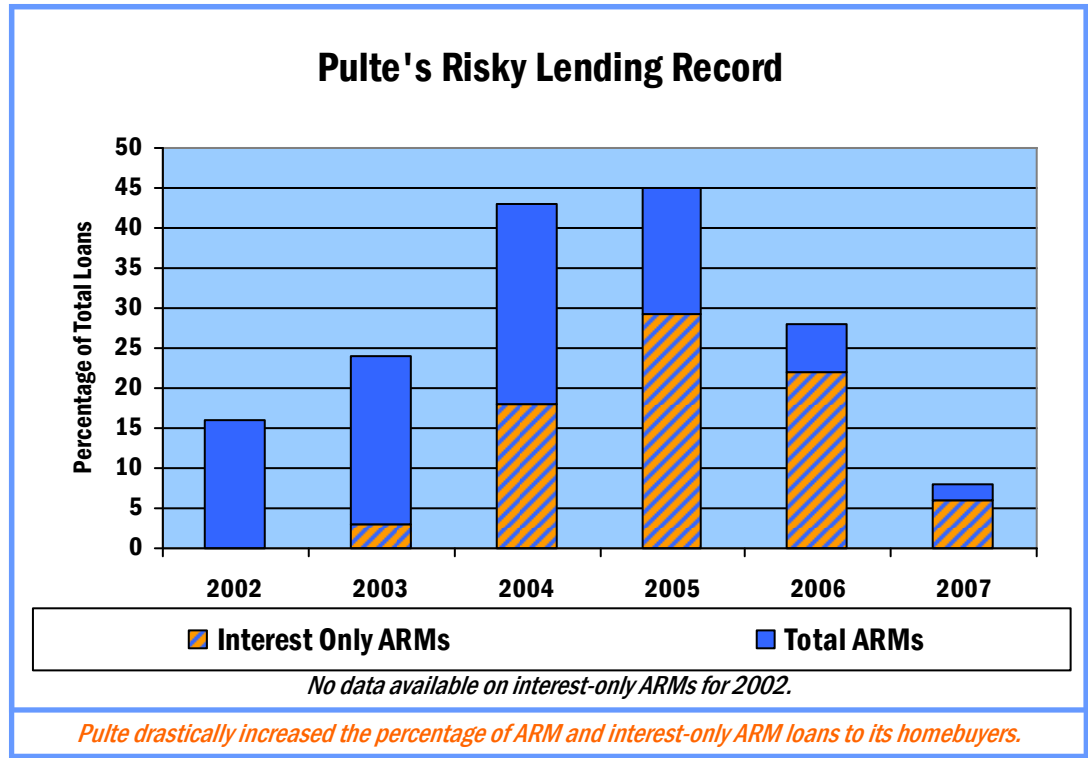
A review of Pulte’s financial statements from 2000-2006 reveals that growth in its annual capture rate coincided with a time of record profits and sales. But these sales decisions ultimately produced catastrophic economic consequences for homeowners and our economy.



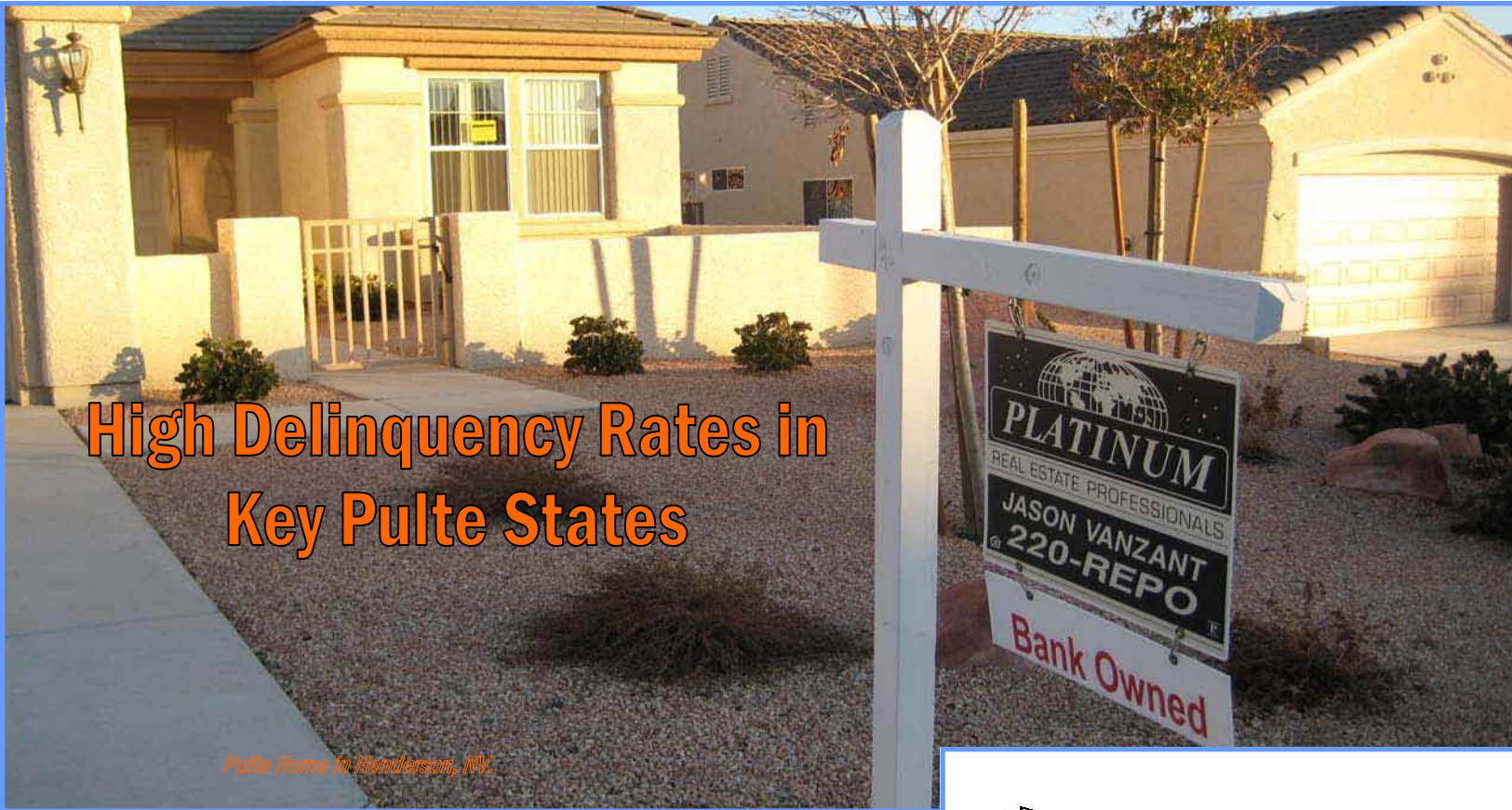
As Pulte's financial services operation originated more mortgages, it also began to significantly increase the varieties and volume of hybrid mortgages it provided. In 2002, when Pulte Homes sold just over 23,000 homes, only 16% of the customers to whom it originated mortgages received an ARM loan. By the peak of the boom in 2005, Pulte sold nearly 43,000 homes (118 per day) and recorded over \$1.4 billion in profits while its use of ARM loan products nearly tripled. These changes occurred simultaneously with the average sales price of its homes jumping by more than 30% - almost four times the increase in average hourly earnings for most of its customer base.¹⁰ Many mortgage professionals describe ARM loans as risky because borrowers can be exposed to rising mortgage rates when market rates increase.

In other words, the price increase of Pulte and Del Webb homes far outpaced the ability of most customers to afford them, if their only financing option had been a traditional fixed rate mortgage.

By the end of 2005, 65% of the ARM loans Pulte provided to customers were interest-only, in which borrowers' monthly payments had no principal component, i.e., their payments did not lower the total amount they owed on their mortgage. The US Department of Housing and Urban Development (HUD) lists interest-only loans as predatory.¹¹ But, while the number of ARM loans the company originated in 2006 and 2007 declined, the percentage of interest-only ARM loans jumped to 79%, and then 74%, respectively.



In addition, an even riskier type of mortgage product, the sub-prime loan became more popular. From 2005 and 2006, six of the top developers in the country, including Pulte, increased their subprime lending between 59% and 400%. Over this period, Pulte more than doubled the number of subprime loans it originated.¹²

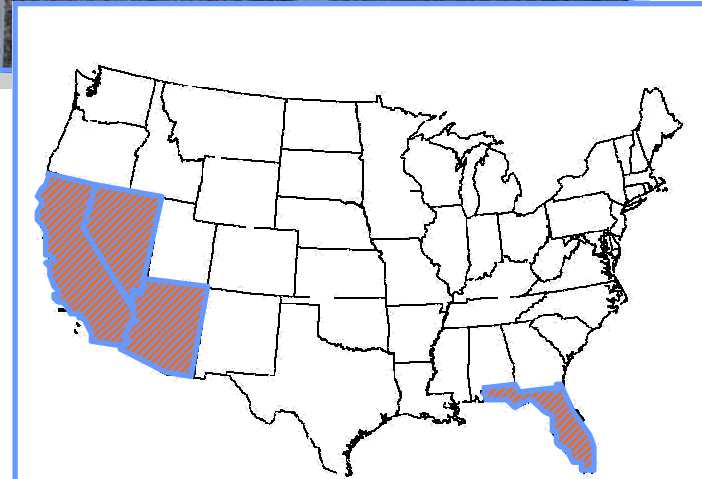


High Delinquency Rates in Key Pulte States

Pulte Home In Henderson, NV.

Pulte, and its active-adult subsidiary, Del Webb, were extremely profitable during the boom years, booking more than \$4.25 billion in net income on sales exceeding \$55 billion from 2002-2006.¹³ But while Pulte Homes is a national company, its sales have been fairly concentrated. By 2005, the percentage of its total sales in just four states – Arizona, Florida, California and Nevada – exceeded 60% of total annual sales.¹⁴

These states rate as the top four in the U.S. in foreclosure activity.¹⁵ These states also ranked well above the national average for delinquency rates at the end of the fourth-quarter 2008 according to the Mortgage Bankers Association.



Over 60% of Pulte's sales were concentrated in Arizona, California, Florida, and Nevada in 2005

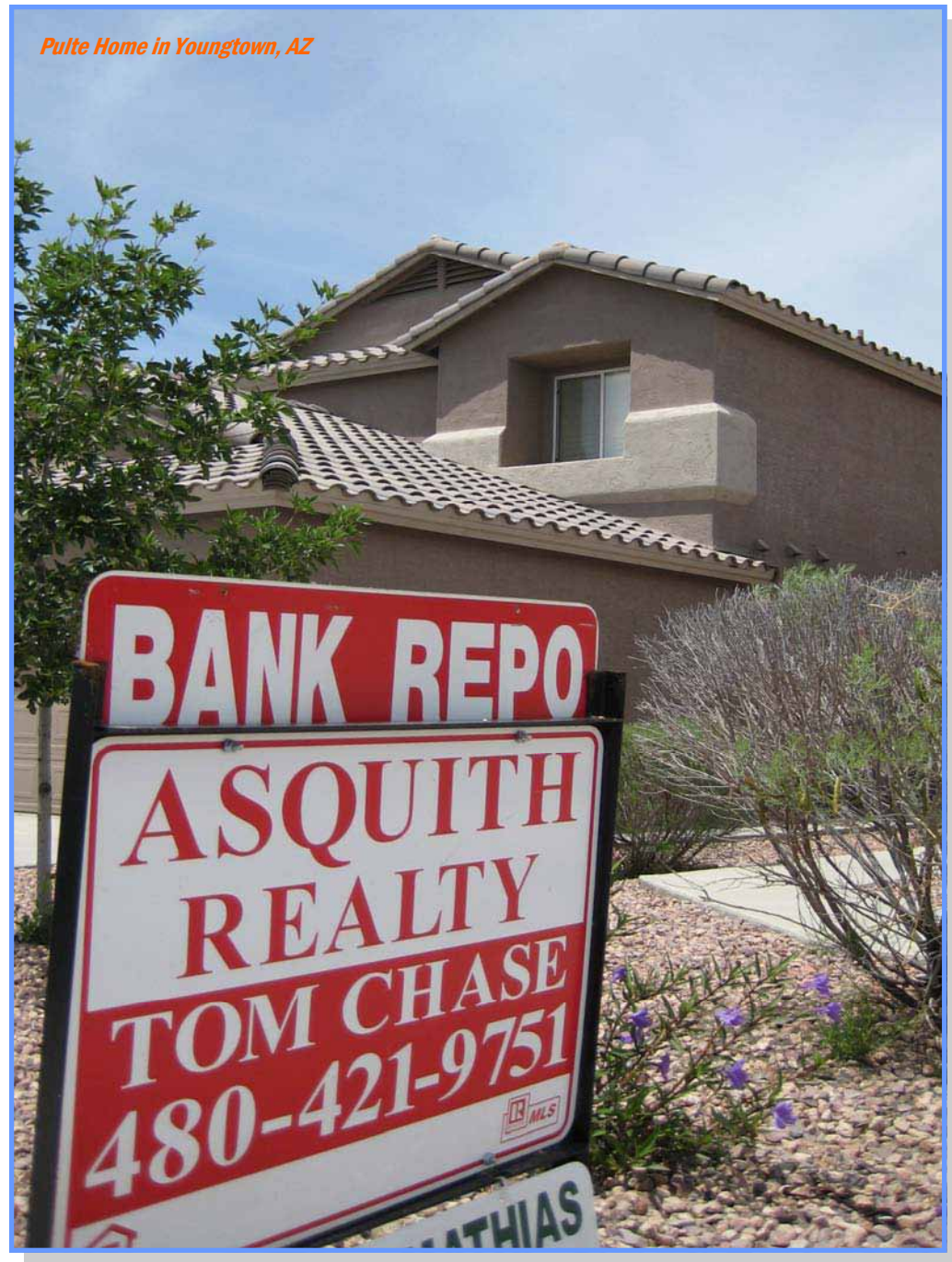
This trend continues to persist and intensify as our economic crisis worsens. According to RealtyTrac, the 26 cities with the highest foreclosure rates in the first quarter of this year are all located in Arizona, Nevada, California and Florida. The Las Vegas market tops the list and the Phoenix Valley placed at number nine.¹⁶

These mortgage delinquencies rates are cause for serious concern, but the numbers become even more alarming when prime-rate ARM loans are examined. Pulte's biggest markets for sales all fall in the top ten in the country for the highest percentage of past-due prime-ARM loans, with Nevada and California second and third, respectively. Moreover, Arizona, California, Florida, and Nevada account for 46% of all past due prime ARM loans for the entire country – more than 2.6 million loans.¹⁷

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A contributing factor to these high delinquency rates are hybrid prime-ARM loans resetting after a fixed introductory rate period. The numbers tell the story here: in 2006, only 2.3% of prime ARM loans were past due. But at the end of 2008, when many boom-period ARM loans saw their interest rates reset, this percent increased more than four-fold to 9.7%.¹⁸

The delinquency rate of subprime ARM loans has been a major factor in the recession. The media has focused much of its attention on these loans, but there is an equally important story should not be lost: that non-traditional/hybrid prime loans also played a significant role in fueling the mortgage crisis.



Homebuyers Hurt by Bad Business Practices

The home buying process can be intimidating and overwhelming for many consumers. When agents of a homebuilder are responsible for selling and financing a house the process may appear to be streamlined and simplified. But when builders offer loan terms that are complex, buyers are putting themselves at a disadvantage without having a buyer's agent to represent them.

At present, there is a loophole in the law, the Real Estate Settlement Procedures Act (RESPA) that allows a sales employee of a builder to receive a commission for referring a customer to its own mortgage settlement service provider.¹⁹ For example, a sales agent from Pulte Homes could receive a bonus for referring a customer to Pulte Mortgage. The law allows for sales employees to be viewed separately from those directly working for the settlement service provider, so they are not included in conflict-of-interest restrictions.

Employees of both companies technically work to promote the same parent corporation. At present, prospective new

homebuyers may not be aware that the builders' sales agent could very well have a financial incentive to sell them a loan.

This is not the only incentive that gives builders the upper hand when selling homes. At present, builders are allowed to offer "contingent incentives" to buyers – such as a \$25,000 closing cost credit and a 15%-off voucher to the base price of the house – but only if the buyer uses the builder's mortgage provider. For example, if a buyer chose to secure a loan through his or her credit union, then any incentive offered would be withdrawn.

This "required use" provision does not foster free and open competition.²⁰ HUD felt the same way and proposed a rule change in 2008 that would have made it illegal for homebuilders to steer business towards their own mortgage affiliates. The rule change would have prevented builders from enticing consumers to take a higher interest or non-traditional loan they may not fully understand, or be able to afford.

The new proposed rule stemmed from consumer complaints

A sales employee of a builder can receive a commission for referring a customer to its own mortgage settlement service provider.



Pulte Home in Palmdale, CA.

alleging that rates and fees charged by homebuilders' settlement service providers were higher than buyers would have been charged by an unaffiliated provider. Consumers also complained to HUD of being lured to builders' mortgage affiliates by advertised incentives and discounts that had been built into the sales price of the home.²¹ Homebuyers who did choose an unaffiliated mortgage provider were then penalized with a higher home price.

Home builders, including Pulte, vigorously lobbied against HUD's proposed rule change. The president and CEO of its mortgage affiliate, Debra Still, testified before Congress on September 16, 2008, arguing against the proposed rule. She said it "would result in significant increases in home purchase costs and undermine critical financing support at a time of severe mortgage and housing market turbulence."²²

After a lawsuit was filed by the National Association of Homebuilders, HUD moved to reconsider the rule change. Pulte and many other national builders are very active within the association.

HUD had it right the first time. As its Office of RESPA and Interstate Land Sales deputy director Barton Shapiro stated, "What goes on currently with these incentives is that they are tying the sale of the house to the use of affiliates so people will be dazzled and won't look elsewhere." He continued, "There's no real way to see if there is a benefit."²³



Notice on a Pulte home in Palmdale, CA.

The use of contingent incentives deserves rigorous debate in Congress. The issue is much too important for the government to bow to pressure from the homebuilding industry. Consumers should be confident that HUD is providing the necessary guidelines to ensure that the home buying process is both fair and sustainable.

Pulte Homes' pending merger with Dallas-based Centex homes would make Pulte the biggest homebuilder in the country. If the merger is consummated, and the newly formed company is able to continue selling mortgages to its customers without full transparency, buyers need to beware of sales practices and mortgage products that may not be consistent with their own long term interests.



Pulte home in Buckeye, AZ.

Footnotes

1. US Census Bureau, *Median and Average Sales Prices of New Homes Sold in United States*, <http://www.census.gov/const/uspriceann.pdf> [date?]
2. US Census Bureau, *Median and Average Sales Price of Houses Sold by Region*, <http://www.census.gov/const/pricerega.pdf> [date?]
3. A prime rate loan is the interest rate banks charge to preferred customers. Sub-prime loans are used to describe loans with less stringent lending and underwriting terms and conditions. Due to the higher risk, sub-prime loans charge higher interest rates and fees. <http://www.hud.gov/offices/hsg/sfh/buying/glossary.cfm>
4. This is based on the capture rate for Pulte Homes compared to its peers. See note 9 for definition.
5. Pulte Homes, Inc. Form 10-K, for the fiscal year ended Dec. 31, 2006 <http://www.sec.gov/Archives/edgar/data/822416/000095012407001049/k12634e10vk.htm>
6. Ginnie Mae, Homeownership Guide and Calculators http://www.ginniemae.gov/2_prequal/intro_questions.asp?Section=YPTH
7. Federal Deposit Insurance Corporation, *Interest-Only Mortgage Payments and Payment Option ARMs*, October 2006, http://www.fdic.gov/consumers/consumer/interest-only/mortgage_interestonly.pdf
8. New York Times, *Incentives to Fight the Doldrums*, November 4, 2007, <http://www.nytimes.com/2007/11/04/realestate/04lizo.html?fta=y>
9. Capture rate represents loan originations from a homebuilding company's business as a percentage of total loan opportunities excluding cash settlements.
10. US Department of Labor, Bureau of Labor Statistics, Establishment Data, Historical Hours and Earnings, 1964-2008. <ftp://ftp.bls.gov/pub/suppl/empsit.ceseeb2.txt>
11. US Department of Housing and Urban Development, *Don't be a Victim of Loan Fraud*, Oct. 1, 2003, <http://www.hud.gov/offices/hsg/sfh/buying/loanfraudfaq.pdf>
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14. Pulte Homes, Form 10-K, year ended Dec. 31, 2005. <http://www.sec.gov/Archives/edgar/data/822416/000095012406001106/k02502e10vk.htm>
15. National Real Estate Trends, March 2009 Foreclosure Rate Heat Map, <http://www.realtytrac.com/trendcenter/default.aspx>
16. RealtyTrac, Sun Belt Cities Top List of Nation's Metro Foreclosure Rates in the First Quarter, April 22, 2009, <http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=6203&acct=64847>
17. Ibid
18. Ibid.
19. RESPA is a consumer protection statute first passed in 1974. Its purposes are to help consumers become better shoppers for settlement services and to eliminate kickbacks and referral fees that unnecessarily increase the costs of certain settlement services, <http://www.hud.gov/offices/hsg/ramh/res/respamor.cfm>.
20. The term "required use" is currently defined in § 3500.2 of HUD's regulations to mean a situation in which a person must use a particular provider of a settlement service in order to have access to some distinct service or property. <http://edocket.access.gpo.gov/2008/pdf/08-1015.pdf>, p. 14053.
21. Federal Register, Real Estate Settlement Procedures Act (RESPA): "Proposed Rule To Simplify and Improve the Process of Obtaining Mortgages and Reduce Consumer Settlement Costs," March 14, 2008, p. 14053.
22. Federal Register, Real Estate Settlement Procedures Act (RESPA): Proposed Rule To Simplify and Improve the Process of Obtaining Mortgages and Reduce Consumer Settlement Costs; March 14, 2008
23. Testimony of Debra Still on behalf of the National Association of Home Builders, Before the Committee on Financial Services, Subcommittee on Oversight and Investigations, US House of Representatives, September 16, 2008, <http://www.house.gov/financialservices/hearing110/still091608.pdf>
24. Builder, New for 2009: HUD Bans Incentives for Using Affiliated Lenders, Dec. 17, 2008, <http://www.builderonline.com/mortgages-and-banking/new-for-2009-hud-bans-incentives-for-using-affiliated-lenders.aspx?printerfriendly=true>

All photographs taken by the Building Justice Coalition.



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