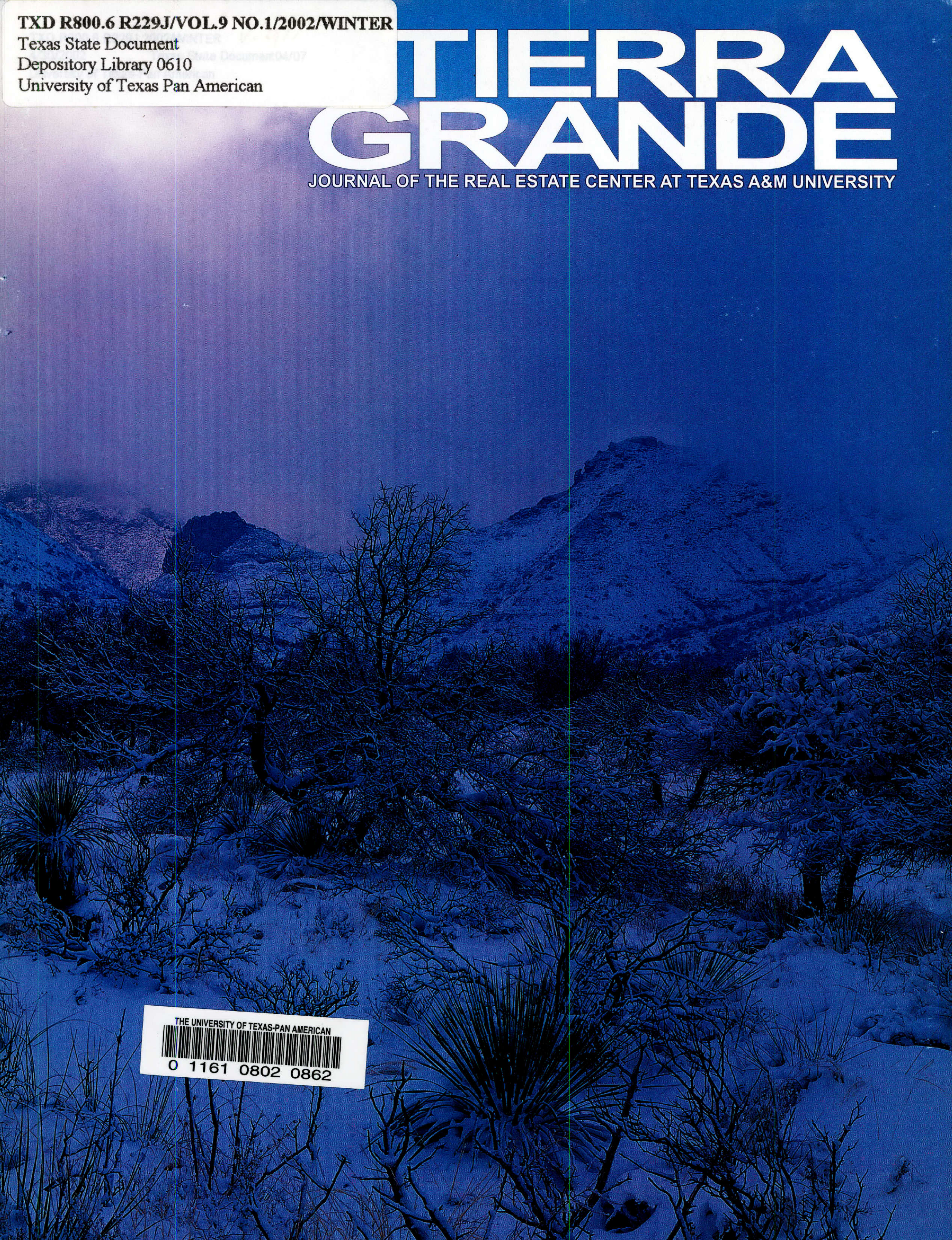
TIERRA GRANDE

JOURNAL OF THE REAL ESTATE CENTER AT TEXAS A&M UNIVERSITY



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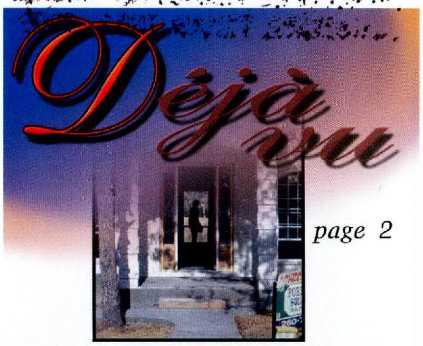

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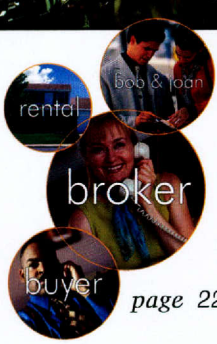

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On the Cover

Low-lying clouds envelop the rugged, snow-covered landscape of Pine Spring Canyon, Guadalupe Mountains National Park. **Photographer Laurence Parent**

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advisory committee

Gov. Rick Perry recently appointed three new members to the Real Estate Center's advisory committee. The ten-member committee provides research guidance and approves the Center's budget.

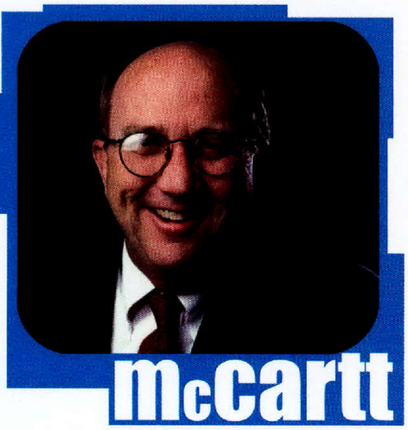
David E. Dalzell of Abilene is the owner of Dalzell Realtors. He replaces Gloria Van Zandt as a representative of real estate brokers on the committee. Dalzell is a graduate of Abilene Christian College. He is a member of the National Association of Realtors, the Texas Association of Realtors, the Abilene Board of Realtors and the Texas Real Estate Teachers Association.

Dalzell serves on the boards of the Abilene Chamber of Commerce, Meals on Wheels and the Abilene Housing Finance Corp. He is president of the West Texas Housing Finance Corp. and secretary of the Taylor County Housing Finance Corp. His term on the advisory committee expires in 2007.

Tom H. Gann is president of Gann Medford Real Estate, Inc., in Lufkin. He received his bachelor's and master's degrees in business administration from Baylor University. Gann has served as president of the Lufkin Association of Realtors and as a director of the Lufkin Board of Realtors. He served terms as president and as director of the Lufkin Homebuilders Association. He is a past director of the National Association of Home Builders and has been a director of the East Texas Housing Finance Corp. since 1992.

Gann is a member of the First Baptist Church of Lufkin and of the Lufkin Host Lions Club. He replaces Carlos Madrid of San Antonio on the committee, representing real estate owners or contractors. Gann's term expires in 2007.

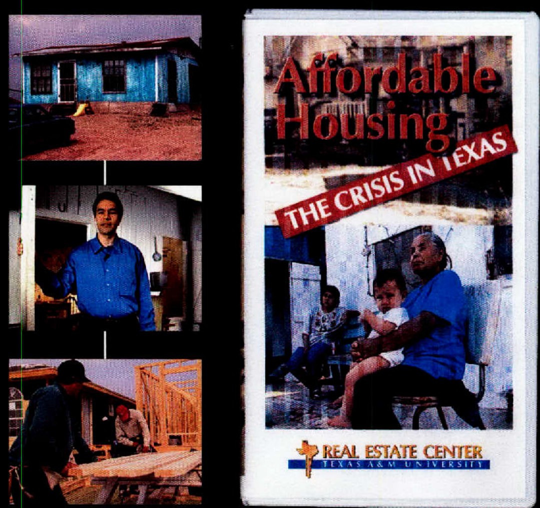
Joe Bob McCartt of Amarillo owns McCartt & Associates, Inc., a real estate development, investment and brokerage company.



McCartt earned a bachelor's degree in business administration from the University of Mississippi. His work includes renovations of the Paramount Building and the Atrium Plaza in Amarillo and development of Monigs Park Row Center in Arlington, Timbercreek Apartment Complex in Lewisville and Ridgeview Medical Center in Amarillo. In 1997, McCartt received the Certified Commercial Investment Member (CCIM) designation.

McCartt is a member of the National Association of Realtors, the Texas Association of Realtors, the North Texas Commercial Association of Realtors and the North Texas CCIM Chapter. His community involvement includes work with the Amarillo Council on Alcohol and Drug Abuse, the Amarillo Salvation Army and Center City. His term on the advisory committee expires in 2005.

McCartt replaces **Douglas A. Schwartz** of El Paso as the representative of owners, developers and managers of real estate. Schwartz, vice president and managing director of Southwest Land Development Services, Inc., remains on the committee but moves to the public-member position formerly held by Angela S. Myres of Kingwood. He will serve until 2007.



Déjà vu

High-Risk Loans Revive Specter of '80s Debacle

By Jack C. Harris

After declining through much of the 1980s, state and national homeownership rates are once again climbing, spurred by the federal government's drive to make more loans available to first-time homebuyers. But the push to boost homeownership may carry a high price tag. The mortgage industry has greatly increased the number of low down payment loans made. And studies have shown that a loan's default risk is directly tied to its loan-to-value ratio (LTV).

The last time so many high LTV loans were made was in the mid-1980s (Chart 1), a period noted for the demise of the savings and loan industry, reform of mortgage lending regulation and slow-moving Texas housing markets. Some are now wondering if rising loan risk could lead to a similar debacle.

Chart 1. Percentage of Loan Originated with High LTV

Source: Mortgage Bankers Association of America

A few alarms are sounding, triggered by slowing in the U.S. economy and high consumer debt of all types. The *New York Times* recently reported that delinquency rates (the percentage of loans held that are at least one month behind in payments) on loans insured through the Federal Housing Administration's (FHA's) 203(b) program are already higher than during the 1980s. The rise appears to be confined to FHA loans (Chart 2), which traditionally allow more risk than conventional loans. In recent years, however, conventional loans have begun to look a lot more like FHA loans (see "FHA: Timeworn or Timeless," *Tierra Grande* July 2001).

Foreboding signals are coming from some segments of the market. Easy credit policies aimed at boosting manufactured housing sales have backfired because of high defaults and repossessions. The "subprime" mortgage market, which caters to borrowers with damaged credit, is experiencing high default rates after years of aggressive expansion.

Lending Today vs. the 1980s

Today's lending environment differs in two key ways from the mid-1980s: the impetus driving lenders to take on riskier loans and the factors used to justify additional risk. In the 1980s, lenders (mostly savings and loans) sought more risky loans to cover the rising costs of deposits. Today, there are lenders chasing high yields in the subprime market. Subprime loans are inherently more risky but are also more lucrative because interest rates are 4 to 6 percentage points higher than the market. When the economy is doing well, jobs are more secure and the incentive to make more subprime loans is strong. However, defaults are already driving lenders out of this market.

Most lenders make loans according to the dictates of loan purchasers, largely the government-sponsored entities (GSEs), Fannie Mae and Freddie Mac. Both made major commitments to expand lending to previously underserved markets in the mid-1990s by creating loan programs designed for those who could not qualify under standard underwriting requirements. Fannie Mae's Community Homebuyers program and Freddie Mac's Affordable Gold program have lower down payment requirements and allow borrowers to take on a higher burden of debt service relative to their income.

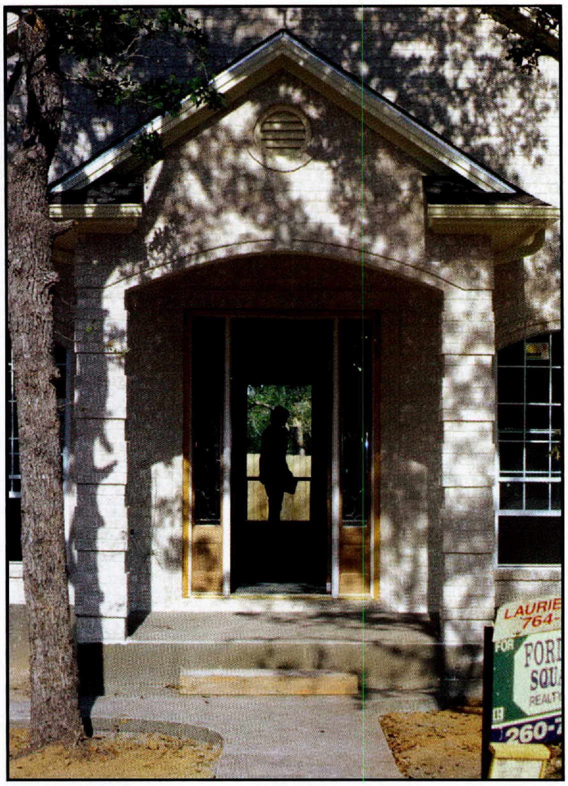
Meanwhile, community-based depository institutions (banks and thrifts) are under increasing pressure to make more loans to low-income borrowers in accordance with the Community Reinvestment Act. Armed with public information pinpointing where and to whom loans are being made, community activists vigorously challenge the charters of lenders who fail to comply.

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) mandates that district Home Loan Banks devote a fixed percentage of their revenues to affordable housing programs. The banks award grants to local lenders for special lending programs aimed at moderate-income homebuyers.

Another reason lenders have been willing to make low down payment loans is because of their confidence in "automated underwriting" techniques. The loan committee largely has been replaced by a computerized process that evaluates a borrower's ability to handle debt. Applicants are assigned scores (called "FICO" scores) based on their financial strength and how they have handled debt in the past.

These scores do not require any information that is illegally discriminatory, such as race, sex or marital status. They enable lenders to fine-tune the underwriting process, resulting in a higher statistical probability of making sound loans. Lenders can extend loans to borrowers with lower credit ratings at higher interest rates. By being better able to spot bad credit risks, lenders feel they can offset any increase in risk exposure.

To be eligible to receive low down payment loans, borrowers must attend counseling on financial responsibility. The counseling is aimed at reducing default caused by ignorance or bad financial habits. Borrowers learn that defaulting may mean losing their homes and may impair their ability to borrow in the future.



HOMEOWNERSHIP RATES *have increased as financing has become more accessible.*

So What's There to Worry About?

Although it would seem that lenders are better able to handle a higher level of risk in the current market, a few issues cause observers to worry.

Growing dominance of GSEs. Fannie Mae and Freddie Mac are not just large corporations; they are large corporations that have a special relationship with the federal government. Their boards of directors include government representation. They enjoy exemption from state taxation and lower-cost access to capital because investors assume they will be bailed out by the federal treasury if problems arise.

GSEs have used these advantages, along with ability to fill the void left when the savings and loan industry imploded, to dominate the home loan market. Today, the agencies hold 40 percent of all outstanding home mortgage debt.

The power of the GSEs has led to the creation of oversight organizations. Within the government, the Office of Federal Housing Enterprise Oversight oversees the agencies. FM Watch is a private watchdog group. The latter, created by mortgage bankers, sees disturbing signs not only in the move to higher-risk lending practices but in the increased purchasing of its own debt issues and moves to reduce mortgage insurance coverage.

Questions about the viability of automated underwriting. Freddie Mac and Fannie Mae encourage the use of their automated underwriting systems and their staffs feel that credit scoring accurately measures default risk. They point out that delinquencies

Chart 2. Delinquency Rate Trends

Source: Mortgage Bankers Association of America

Delinquencies on FHA loans are higher now than they were in the 1980s. Is that a sign of what's to come?

have not gotten out of hand despite a much larger proportion of low down payment loans.

Others note that the system really has not been tested under fire. All loans perform well when the economy is strong. What will happen when people start losing their jobs?

As credit scoring has become more common, so have efforts that could further compromise its effectiveness. The Department of Housing and Urban Development is probing the system for any bias that could lead to high rejection rates for minority loan applicants. Also, there is pressure to make the scoring criteria public, so that borrowers could do things to raise their scores, making the scores less reliable as predictors of borrowers' behavior.

Effect of crackdown on predatory lending. Efforts to serve new constituencies necessarily result in some new borrowers who are financially unsophisticated. Unscrupulous lenders, particularly some in the subprime market, have devised tactics to take advantage of borrower naiveté. The aim of such predatory lending (see What is Predatory Lending?) is to saddle the borrower with a high interest rate loan and high fees or induce foreclosure and confiscate the borrower's equity.

Both state and federal governments recognize that these reprehensible practices need to be stopped. The difficulty is identifying cases in which outright fraud is being perpetrated as opposed to those in which loan terms are unfavorable but appropriate for the lender's higher risk exposure. Putting an end to predatory lending with the blunt instrument of the law may severely stunt subprime lending with excessive red tape. Because subprime lending is often the only source of financing available to residents of inner cities, they may lose access to capital in these areas.

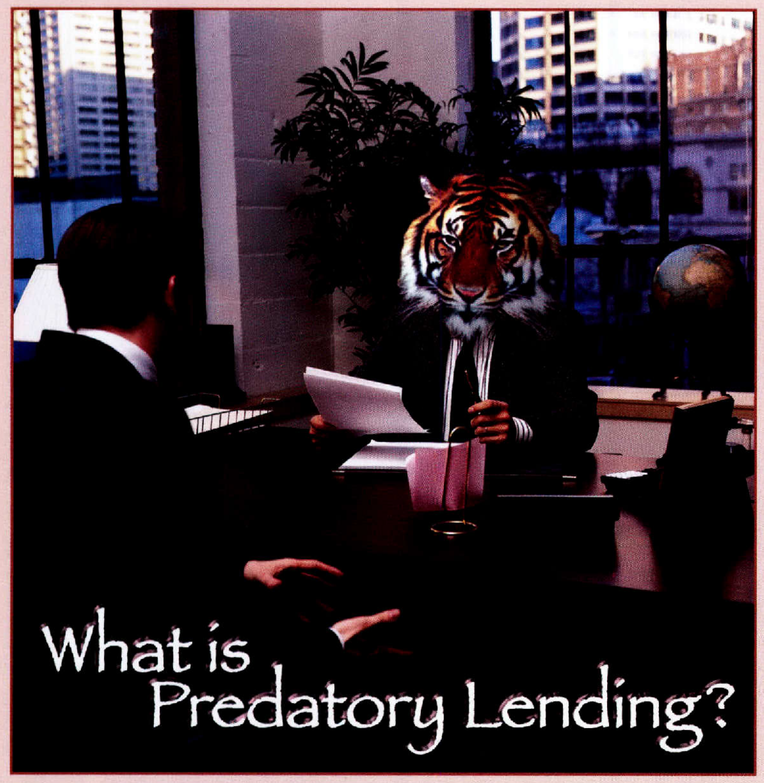
Helping Buyers Over Financial Hurdles

Expanding homeownership opportunities and broadening access to financing are worthy goals. But inducing people to take on financial burdens they can handle only under the best of economic conditions is not the way to pursue those goals.

One way to make mortgage financing more accessible is through subsidized programs that offer below-market interest rates and down payment assistance. Such programs already are available for some. Another way — liberalizing underwriting methods so that more people can qualify for loans with affordable terms — is an experiment being conducted in today's mortgage markets. Lenders are depending on scientific risk analysis and consumer education to make the strategy work.

Housing markets may soften a bit in coming years, but there is little prospect for the kind of market collapse suffered in the 1980s. As long as markets remain active, homebuyers who overcommit themselves financially need not lose their life savings and credit. And recent research shows that low-income borrowers are no more likely to default than other income groups, supporting the likelihood of the experiment's success.

Dr. Harris (j-harris@tamu.edu) is a research economist with the Real Estate Center at Texas A&M University.



Unscrupulous lenders who take advantage of borrowers with low incomes, credit problems and limited financial knowledge are referred to as "predatory lenders." Predatory lenders use various tricks to get higher than normal loan yields from borrowers. Professor Jack Guttentag of the Wharton School of Business describes three forms of predatory lending:

Equity grabs. The lender persuades the borrower to undertake a loan he or she cannot afford. When the borrower defaults, the lender confiscates the borrower's equity.

Contract knavery. The lender slips onerous, nonstandard provisions into a mortgage contract. The terms of the contract may be verbally described as more favorable than they actually are. The borrower later discovers a provision that prevents refinancing or paying off the loan without a large penalty.

Price gouging. The lender charges a much higher interest rate (often higher than the rate promised at the time of application), high fees or requires high-cost insurance on the loan. These costs are much higher than the borrower's credit rating would justify. In some cases, borrowers are given subprime loans when they qualify for better terms.

Reputable lenders could not write predatory contracts for long without losing customers. So how do predatory lenders get away with this? They exploit common beliefs and tendencies among inexperienced borrowers. Some borrowers believe they cannot get a loan from a reputable lender so they do not comparison shop for the best loan terms. The truth is that most people have difficulty understanding mortgage contracts and without counsel might agree to provisions they do not understand. Predatory lenders take advantage of this.

These scams are used mostly on borrowers seeking home equity loans and refinanced first mortgages. Laws being written to discourage predatory practices would apply to all mortgage loans.

GATEWAY TO THE PACIFIC

Por Harold D. Hunt

La Entrada al Pacifico

Growth in truck traffic between Texas and Mexico has been nothing short of phenomenal. About 12,000 trucks per day crossed between Texas and Mexico in 2001. Most trucks cross the Texas-Mexico border on highways routed through Laredo, El Paso or the Rio Grande Valley.

A proposed highway called La Entrada al Pacifico ("Gateway to the Pacific") from Mexico's Pacific coast through the City of Presidio to Lamesa, Texas, would offer an additional route for truck traffic that has increased more than 150 percent since the 1994 implementation of the North American Free Trade Agreement (NAFTA).

If constructed, La Entrada will provide a more direct link from Mexico's Pacific coast to cities in the northeastern United States, the primary destination for NAFTA traffic passing through Texas. It currently takes more than 20 hours to drive from Port Topolobampo, a deep-water port on the Pacific Ocean in the Mexican state of Sinaloa, to the bridge crossing at Ojinaga-Presidio on existing roads. La Entrada could cut that time in half.

Supporters argue that if La Entrada were built, Asian parts and components could be shipped more rapidly through Port Topolobampo to Mexican maquiladoras along the Texas border. They would then be assembled into finished products and sold in the United States. Asian companies are finding Mexican maquiladoras increasingly appealing for the production of goods sold in American markets.

Agricultural shipments could benefit from La Entrada as well. The bulk of winter produce sold in the United States is now shipped from west-central Mexico through Nogales, Arizona, because no alternative route through Texas exists. About 1,000 trucks per day cross the border at Nogales during the winter produce season. Much of this traffic could be diverted to the La Entrada route, significantly reducing produce shipping times to the heavily populated areas of the eastern United States.

Governor of Chihuahua Patricio Martinez has expressed a desire to complete the section of La Entrada from Chihuahua City to Ojinaga by the end of his term in 2004. A new section under construction (see map) between El Morrion and La Mula will skirt the Peguis Mountains, providing a better alternative to the narrow, mountainous road that now leads to Ojinaga. The governor believes that La Entrada could relieve some of the pressure on El Paso border crossings while increasing the potential for economic development in northeastern Chihuahua.

Private developers in Sinaloa have expressed an interest in seeing La Entrada completed. They believe a major highway from Presidio through Copper Canyon, one of the most scenic areas in Mexico, to the Pacific coast in Sinaloa could encourage more resort hotel development in the state. La Entrada could facilitate further maquiladora plant construction in Sinaloa as well. Generally seen as a border phenomenon, maquiladoras also are being located deeper within Mexico's interior to take advantage of lower labor costs.

On the U.S. side, a combination of cities, counties and private citizens in the Midland-Odessa area known as MOTRAN (Midland-Odessa Transportation Alliance) have been working since 1997 to promote the highway's construction. The group maintains that La Entrada will create economic benefits and expand trade opportunities throughout the Midland-Odessa region.

The idea for a trade route from Mexico's Pacific coast to the eastern United States through Texas is not new. However, a highway capable of handling heavy truck traffic has never been completed through this Mexican corridor because of several significant hurdles.

By far, the most daunting task will be constructing the 121-mile section of highway between the Mexican cities of Choix

La Entrada could facilitate maquiladora construction within Mexico's interior.

and San Rafael. This section crosses the Sierra Madres through Copper Canyon, which is actually a series of 20 canyons covering more than 20,000 square miles. No highway exists through this stretch of rough terrain. Plans call for the roadway to be constructed roughly parallel to an existing Chihuahua Pacifico railroad line, a line that required more than 40 bridges and 80 tunnels to cross Copper Canyon. This section of La Entrada is currently slated for completion by 2010.

Another limitation will be the Ojinaga-Presidio bridge crossing. Constructed in 1987, the bridge facilities can handle only a limited number of heavy trucks. About 9,000 northbound trucks will cross the Presidio bridge this year. By comparison, Laredo's bridges handle that many northbound crossings in two days. The facilities are being upgraded and within 18 months should be able to handle a maximum of 300 trucks per day, about ten times the traffic crossing there now. A second bridge has been discussed; however, it is unlikely that there will be sufficient need for it after the present commercial inspection facilities are upgraded.

Although most Texas cities along the La Entrada route view its development favorably, leaders of Alpine and Marfa do not. These two cities have no bypasses, so truck traffic travels directly through the town centers. The prospect of increased truck traffic prompted the formation of an activist group in Alpine known as TNT or "Tourists Not Trucks." State Representative Pete Gallego (D-Alpine) has asked the Texas Department of Transportation (TxDOT) to study alternative routes around both Alpine and Marfa. Preliminary estimates indicate about 1.5 miles of highway would be required for a loop around Marfa while an Alpine bypass might require as much as five miles with estimated construction time of five to eight years.

Other TxDOT activity involving the La Entrada route is under way as well. TxDOT recently committed funds to construct a Hwy. 349 reliever route around Midland to accommodate truck traffic destined for Lubbock and Amarillo. The 15-mile construction project is scheduled to open bids in mid-2002. TxDOT is conducting a study for a proposed bypass around Lamesa and the expansion of Hwy. 349 south of Lamesa to Midland.

Even if La Entrada is completed and trucking companies choose to use the route, economic activity in many of the Texas cities along the La Entrada corridor may not increase.

Proposed

Highway Route
Mexican Section
Port Topolobampo to San Blas
San Blas to Choix
Choix to San Rafael
San Rafael to San Pedro
San Pedro to Cuauhtemoc
Cuauhtemoc to Chihuauha City
Chihuahua City to Aldama
Aldama to El Morrion
El Morrion to La Mula
La Mula to Ojinaga (U.S./Mexico Border)
Total Mileage (approx.) to U.S. Border
Main U.S. Section
Presidio to Marfa via Hwy-67
Marfa to Alpine via Hwy-67
Alpine to I-10 via Hwy-67
I-10 to Fort Stockton
Fort Stockton to McCamey via Hwy-67 & 385
McCamey to Odessa via Hwy-385
Odessa to Midland via I-20
Total Mileage (approx.) Presidio to Midland
Alternative 1 Leaving Midland
Midland to Lamesa via Hwy-349
Lamesa to Lubbock via Hwy-87
Lubbock to Amarillo via I-27
Total Mileage (approx.) Midland to Amarillo
Alternative 2 Leaving Midland
Midland to Abilene via I-20
Abilene to Wichita Falls via Hwy-277
Total Mileage (approx.) Midland to Wichita Fall
Alternative 3 Leaving Midland
Midland to Fort Worth via I-20
Fort Worth to Dallas via I-20
Total Mileage (approx.) Midland to Dallas

oute of La Entrada al Pacifico

Approximate Distance (miles)	Current Status	Currently Planned Upgrades to Mexican Sections
38	4-lane divided highway	None
60	2-lane paved road	4-lane divided highway by 2005
121	no road	2-lane paved road by 2010
90	2-lane paved road	None
34	2-lane paved road	4-lane divided highway by 2005
58	4-lane divided highway	None
20	4-lane divided highway	None
31	2-lane paved road	4-lane divided highway by 2003
69	no road	2-lane paved road by 2002 & 4-lane divided highway by 2004
27	2-lane paved road	4-lane divided highway by 2003
548		
61	2-lane paved road	
26	2-lane paved road	
48	2-lane paved road	
10	4-lane divided highway	
46	2-lane paved road	
53	2-lane paved road	
20	4-lane divided highway	
264		
55	2-lane paved road	
62	2-lane paved road	
118	2-lane paved road	
235		
141	4-lane divided highway	
134	2-lane paved road	
275		
283	4-lane divided highway	
50	4-lane divided highway	
333		

Currently, trucks transporting goods from Mexico into the United States must stop at the border to be inspected by U.S. Customs and other government agencies. Because trucking companies typically expect long-haul drivers to cover about 600 miles per day before a layover, Texas cities along NAFTA routes but away from the border may not reap an economic benefit from La Entrada other than increased truck-stop activity.

In the future, if Mexican and American trucks are allowed to start from interior cities and cross the U.S.-Mexico border without stopping, a completely new set of cities could benefit from NAFTA traffic. Optimal destinations for economic development, such as factories or warehouse-distribution centers, could change. However, an open border for NAFTA truck-related traffic will not occur overnight. Pancho Benavides, an executive for trucking company M.S. Carriers, predicts that the transformation to an open border "will be more like an evolution than a revolution."

The director of highway planning for the Mexican state of Chihuahua asserts that in ten years 4,000 trucks per day could be using the La Entrada al Pacifico route. If La Entrada is in fact completed in ten years, it could enhance demand for warehouse-distribution real estate development in Texas cities located roughly 600 miles from the border.

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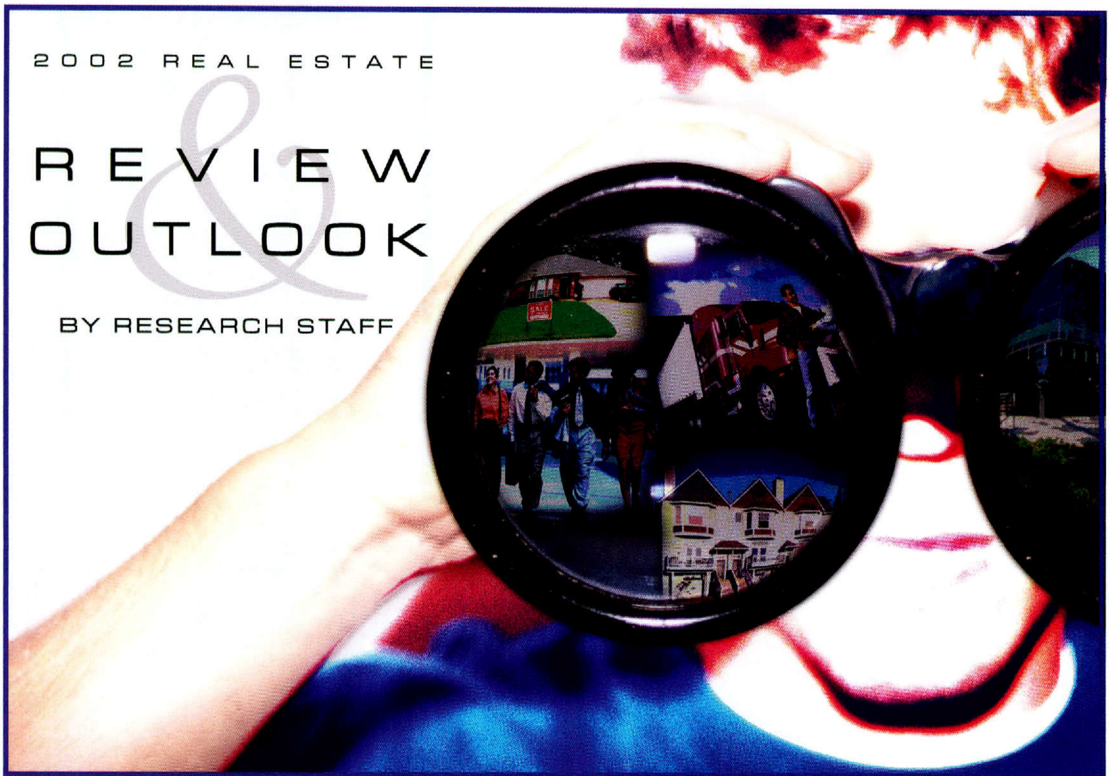
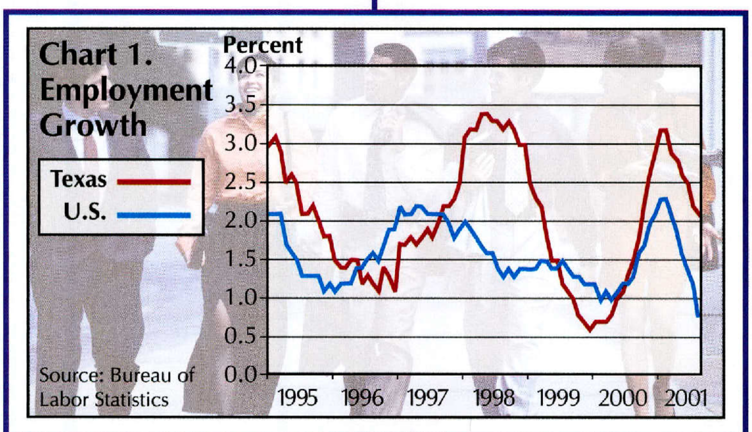


A disputed election. Terrorism. Tumbling stock markets. Recession. Recent times have provided an extraordinary stream of unsettling events. Such uncertainty has contributed to the fall of consumer confidence. Yet real estate markets, the housing market in particular, have held up surprisingly well. Will the industry continue to live a charmed life and escape major disruption?

Economy Pauses

In last year's spring forecast, the Texas Comptroller of Public Accounts projected employment growth in 2002 (2.4 percent) as only slightly lower than that for 2001 (2.5 percent). Of course, that was before the tragic events of last September and the resulting jolt to the national economy, as well as the revelation that the economy had been in recession since March. Consequently, the forecast may be too optimistic.

Even if employment grows this year, that does not rule out the possibility of a few negative quarters. Employment growth was 3.2 percent in January 2001 but only 2.1 percent by August. By the end of the year, growth may have ground to a halt. A better than 2 percent growth rate in 2002 may be achieved if a near standstill in the first half is followed by a vigorous recovery in the summer. Such growth would mean a short recession.



Texas employment has been growing at a rate about 1 percentage point more than the national rate (Chart 1). So, despite a contraction nationwide, the state may escape that fate. Texas has had only one year in the last 20 (1986) in which employment declined. If employment continues to decline, it may simply be a scaling back of the rapid growth in early 2001. Such growth surges are difficult to maintain even in buoyant economies.

Like the national economy, Texas should be positively affected by the federal tax rebates and interest rate cuts by the Federal Reserve Bank (Fed). The Fed is also increasing the supply of money at a rapid pace to re-ignite the economy. Increased defense spending should be stimulating as well. It will take some time for increased demand to absorb excess inventories and boost corporate profits needed for the creation of new jobs. Expect renewed growth in the latter half of 2002. However, the strength of the recovery could be dampened should the Fed need to raise interest rates.

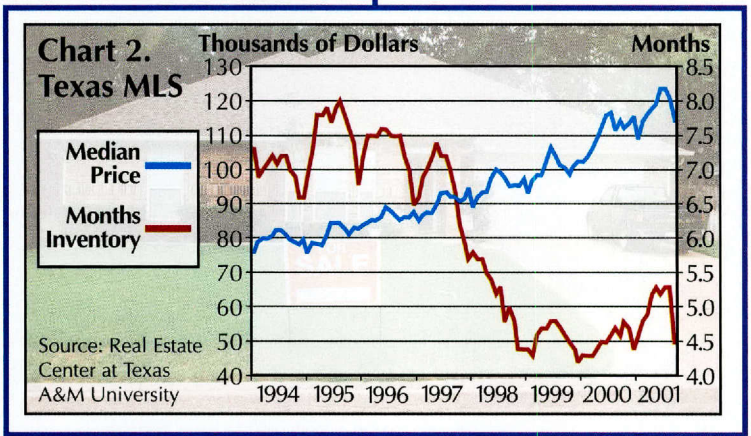
Before the Sept. 11 terrorist attacks, some questioned whether the U.S. economy would lapse into recession. A strong retail and homebuying sector was keeping the economy on a slightly positive path. The traditional manufacturing economic base was clearly in retreat. But consumers were badly shaken by events and retail sales dropped substantially. The Conference Board's Consumer Confidence Index last September dropped to its lowest level in ten years.

The attacks caused considerable damage to the U.S. economy. The people lost cannot be replaced, and the resources destroyed will be costly to replace. Security measures put in place to prevent future attacks will create inefficiencies. Some industries, such as the travel industry, will have difficulty dispelling fear among their customers. The global war on terrorism will not be cheap, so taxes may have to be raised once the economy is strong enough to support them.

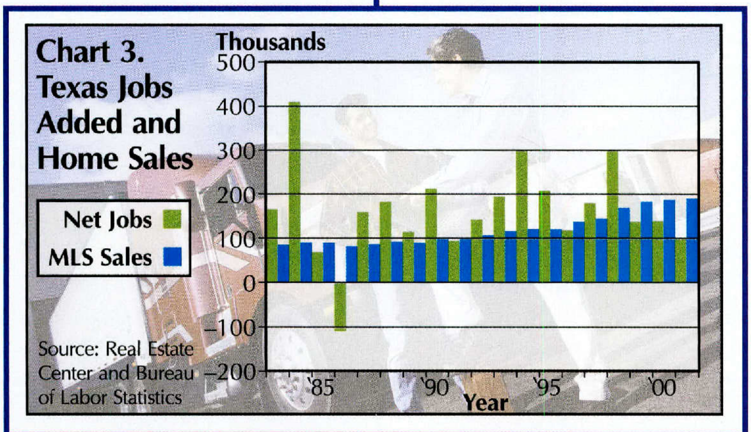
Some fear that the slowdown will drag out over several years because the growth phase was so long — beginning approximately in 1991. Long periods of no growth are caused by excesses during the preceding expansion. Often expansion is based on government spending rather than productivity gains. For example, prosperity in the 1960s was built on massive government spending on the War on Poverty and the Vietnam War. The result was runaway inflation in the 1970s and volatile interest rates.

In contrast, the 1990s were remarkable for government spending restraint and the Fed's commitment to a low-inflation policy. And unlike in the early 1980s, energy prices have been under control with market forces dampening price swings. Interestingly, the sense of unity engendered by the Sept. 11 attacks forged a consensus among political groups to rejuvenate the economy in defiance of the terrorists. In this way, the tragedy may have provided a catalyst to economic growth. So even with the additional problems caused by terrorists' actions, economic stagnation promises to be relatively short.

Texas is in a much better economic position than during the turbulent 1970s and 1980s. The state's economy is more diversified. In 2001, the majority of new jobs were created in the services sector, which has shown consistent growth. The impact of energy prices is hedged by the fact that Texas now is as much a consumer of oil as it is a producer. The decline in manufacturing employment may not be as bad as forecast; it was showing some moderation near the end of 2001. Mexico, which has an economic impact on a large part of the state, is committed to freer trade and a market-based economy.



On the other hand, industries with unexpectedly strong growth in 2001 may not be as fortunate this year. Mining sector employment got a boost from the oil and gas price spike early in 2001. Likewise, the construction sector benefited from the surprisingly strong demand for new homes. Both sectors are expected to slow or shrink during 2002. Real estate employment is expected to decline modestly. In the recent past, this decline has been based on higher productivity, leaving those in the business with higher incomes. This year, it may reflect lower demand, depending on how big a hit the housing market takes.



Unless there are big surprises, look for a slow first half in 2002, with a decent recovery later in the year. However, construction and real estate will be under pressure much of the year.

Resilient Housing Markets

A remarkable three-year period for Texas housing markets ended in 2001. More homes sold through Texas Multiple Listing Services (MLS) during each of those years than in any year since the Center began compiling statistics in 1979. Some increase is expected as the population keeps getting larger, giving the markets a larger base from which to draw. In the past three years, a combination of strong economic growth (including the creation of many high-paying jobs in the high-tech, medical and business services sectors), low interest rates and easy credit created an ideal environment for home sales.

It now looks like that period of booming markets is over. A slower, more cautious economy will mean fewer new households relocating to the state and reduced confidence among move-up and first-time buyers. To the extent that entry-level jobs become hard to come by, many would-be first-time buyers will lack the financial base to enter the market.

Home sales could be more adversely affected if an economic slump leads to disruption in the mortgage market. Those who qualified under the eased standards applied to low down payment, affordable housing programs are especially vulnerable. The proliferation of these loan programs is one reason homeownership rates climbed in recent years.

Indiscriminate credit extension and aggressive marketing already have wreaked havoc on manufactured housing markets. High default rates have driven several lenders out of the subprime loan market (subprime loans are high interest rate loans for borrowers with poor credit ratings).

If defaults, already at elevated levels for FHA-insured mortgages, get out of hand and lead to extensive foreclosures, interest rates could rise and qualifying standards may tighten (see "Déjà vu," page 2). In a worst-case scenario, the favorable credit conditions that expanded the housing market would be reversed. Higher foreclosure rates could lead to higher inventories of homes for sale in the lower price ranges.

Even if defaults and foreclosures do not get out of hand, look for interest rates to rise by the end of 2002. The drop in rates last year was foreshadowed by inversion of the yield curve in late 2000. An inverted yield curve occurs when short-term interest rates exceed long-term rates, indicating that financial markets expect lower interest rates, generally accompanied by recession, in the near future. The spread between the shortest- and longest-term treasury securities was almost 3 percentage points last September, the widest gap in years. Market analysts are anticipating higher rates, which could come as soon as the effect of the Fed's rate-cutting runs its course.

Strong sales numbers of recent years have been accompanied by rising property values. According to the repeat sales price index compiled by the Office of Federal Housing Enterprise Oversight, Texas homes improved in value by 7.7 percent in 2000 and 7.4 percent halfway through 2001. The main reason for such high rates of appreciation is short supply. Many MLS inventories fell to less than a three-month supply in 2001 (Chart 2).

Expect prices to soften in 2002 even if sales remain strong. There will be more supply for buyers to choose from and sellers will be more accommodating. Inventories of existing homes began rising in the second half of 2001. Single-family building permits have hit levels equaling or exceeding the early 1980s boom. While it may not be a buyers' market exactly, the sellers' market of recent years is probably over. It has been over for some time for the highest-priced homes.

The big question is how far activity will decline. To see how markets have reacted in the recent past, see Chart 3, which compares economic growth (reflected in net jobs added) and home sales for each year since the early 1980s.

The only time during this period that a war was being waged was in 1990 — the Gulf War. Sales were up that year, and it was a strong year for the economy as well. When the economy slumped in 1991, sales slipped a bit. However, values were up that year as mortgage rates tumbled.

Texas has experienced a net loss in jobs only one year: 1986. That was the year of the great oil bust. Home sales fell by more than 7 percent, and property values fell by more than 5 percent. Consider that mortgage rates — around 10 percent — were much higher than they are today, and prices had been soaring in previous years. If the current market suffers a comparable drop, sales volume would still be higher than any year prior to 1999.

The economy and housing market are in many ways much stronger than they were in the mid-1980s. Though the tech manufacturing bubble has burst, it is not as important to the state's economy as oil was then. Home prices are elevated because of a shortage of inventory and low interest rates, not because of inflationary expectations. Mortgage lenders have their problems, but they are not as vulnerable fundamentally as they were in the 1980s (see "Déjà vu," page 2). Consequently, the contraction in sales should be milder. The key is how the mortgage market fares. If defaults build, credit will be tighter, and many first-time buyers may be shut out of the market. This would result in a much larger decline.

Slower economic growth will mean slower population growth and fewer new housing units needed in the near future. The latest Housing Needs Projection (see Statewide Housing Needs Assessment) indicates less home building in the next several years than during recent years. The pace should be comparable to that of the mid-1990s. Also look for some scaling back on multifamily production and shipments of manufactured homes.

Hottest Housing Markets

Rank	MSA	MLS Sales Per 1,000 Population*
1	Austin	13.2
2	Dallas	12.8
3	Houston	12.1
4	San Angelo	11.0
5	Odessa-Midland	10.9
6	Fort Worth	10.7
7	Tyler	10.6
8	Abilene	10.5
9	Wichita Falls	10.4
10	Lubbock	10.3

*projected from September year-to-date figures
Source: Real Estate Center at Texas A&M University

Commercial Markets Mixed

Income-producing property markets have been signaling the end of economic expansion for some time. According to a nationwide analysis published by Legg Mason Wood Walker, Inc., all commercial property sectors were in overbuilt situations by mid-2001. That assessment came prior to the terrorist attacks that caused property markets to retreat further.

Legg Mason analyst Glenn Mueller has developed methodologies that allow specific property markets to be evaluated according to their position on the classic real estate market cycle (see Real Estate Market Cycles). In the oversupply phase, a market is struggling to absorb a surge of new supply. Normally, these markets would proceed to the recession phase, which is characterized by falling rents and lack of construction activity.

Texas market cycle conditions vary by location and property type. In general, apartment markets are faring better than other types of property. However, multifamily construction has been on a downward trend since mid-1999, largely reflecting the decline in real estate investment trust (REIT) (companies that invest in real estate using funds raised in the stock market) market activity (Chart 4). Rents in most markets, except Austin, have been flat for more than a year. However, Legg Mason considers apartments in most Texas cities a better bet than other types of commercial property.

Austin, last year's star performer, has been tarnished by the high-tech bust and will have a hard time maintaining the rent and price premiums it currently enjoys. According to Legg Mason's analysis, the industrial and retail markets are in oversupply, and the office and apartment markets have advanced to the recession phase.

Houston's markets are nearing their peaks, but some opportunities may remain. The office market is the big story with

Fastest Growing Local Economies

Rank	MSA	Employment Growth Rate (percentage)*
1	Laredo	3.6
2	Dallas	3.3
3	McAllen-Edinburg-Mission	2.9
4	Brownsville	2.8
5	Houston	2.7
6	Fort Worth	2.6
7	Brazoria	2.6
8	Odessa-Midland	2.5
9	Lubbock	2.1
10	Texarkana	1.8

*August 2000 to August 2001
Source: Texas Workforce Commission

Fastest Growing Home Prices

Rank	MLS Area	Annual Percent Change in Median Price*
1	Bryan-College Station	18
2	McAllen-Edinburg-Mission	16
3	Lufkin	15
4	Garland	12
5	Sherman-Denison	12
6	Arlington	11
7	Irving	11
8	Fort Bend	9
9	Fort Worth	9
10	Houston	8

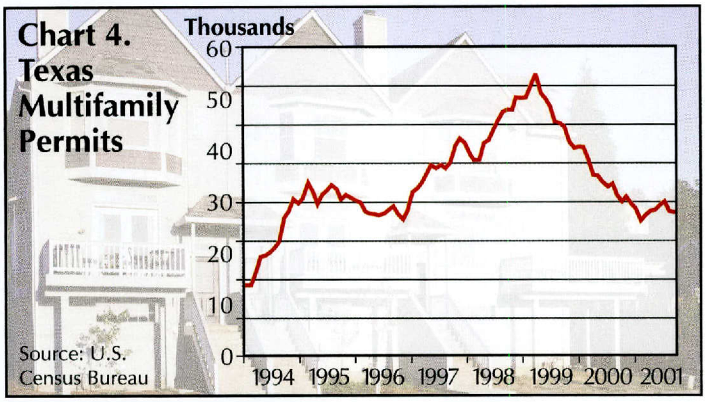
*September 2000 to September 2001
Source: Real Estate Center at Texas A&M University

rents exceeding $25 per square foot and valuations more than $150 per square foot. This market is supposedly near the end of its expansion phase, but there is not a lot of new supply in the pipeline. Therefore, an overbuilt situation may be avoided.

The Dallas-Fort Worth office market is at the other end of the scale. Although valuations remain high, prospects for the market were the lowest in the nation according to the National Real Estate Index Market Score survey. The industrial and retail markets have entered the overbuilt phase. Apartments offer some promise as rents and valuations are still rising.

San Antonio offers more opportunities for contrarian-minded investors. The apartment market is in recovery, meaning that there may be bargains for those with a long-term strategy. Retail is well into the over-supply phase and other sectors are holding near the peaks of their cycles.

All nonresidential sectors of real estate markets depend on economic growth. Even apartment markets need a level of prosperity to attract potential tenants into their market areas. As the economy slows, expect occupancy and rental rates to slip and construction and transaction activity to slacken. Apartments may get a temporary boost from those who might have purchased homes in a stronger economy.



Rural land markets follow the economy as closely as other real estate markets. Sales activity has slackened across the state. The one factor that had been driving much of the rural land market — recreational sales — appears to have taken a temporary hiatus.

What Industry Professionals Can Expect

Texas real estate markets are being and will continue to be influenced by the current economic lull. This phase is expected to be a pause in the market, however, not a crash.

Housing markets are entering a downward phase from an extremely high level of activity. While this will make it more difficult for sellers, it will help buyers and may even allow sales professionals to devote more time to each transaction. Selling a home will require more effort, so demand for professional assistance should strengthen. This may prove a real test of the Internet and other new ways of gaining market exposure.

For investors, this is a time for selective acquisition and long-term thinking. Those with attractive property presented in a professional manner will prevail.

For more information, contact info@recenter.tamu.edu.

Statewide Housing Needs Assessment

	Single-family units	Multifamily units	Manufactured homes
Housing stock			
1990	4,602,751	1,783,454	622,794
2000	5,200,500	2,049,700	907,500
2005 (est.)	5,506,800	2,147,100	1,039,200
Housing units produced 1990–2000	830,804	325,008	350,621
Annual average	75,528	29,546	31,875
Total housing needed 2001–2004	259,634	78,747	112,507
Housing needed per year 2001–2004 annual average	64,909	19,687	28,127

The Housing Needs Assessment is an estimate of future housing needs based on population projections prepared by the Texas State Data Center. Housing stock for 2000 is estimated based on 1990 and 2000 Census of Housing and building permit data. The stock for 2005 and production for 2000–2004 are estimated based on projections of population and characteristics of the housing stock. Among the key assumptions are:

2005 population: nearly 22.4 million (more than 20.8 million in 2000)
2005 homeownership rate: 64 percent (63.8 in 2000)
2005 average household size: 2.745 (2.74 in 2000)
2005 single-family vacancy rate: 3 percent (3.7 in 2000)
2005 multifamily vacancy rate: 8.5 percent (9.1 in 2000)

Real Estate Market Cycles

Because it is difficult to forecast future demand for commercial real estate space and because it takes a long time to bring new space onto the market, real estate markets tend to be highly cyclical. Surges in demand caused by economic expansion often cause space shortages in a market area, while a waning of demand may occur as new space comes on the market. Cycles generally have four distinct phases:

- Expansion — Rising demand and occupancies with a high level of construction.
- Oversupply — Rising vacancies as construction continues; rental rates grow at a slower rate.
- Recession — Demand and rental rates fall; vacancies rise but construction continues.
- Recovery — Construction stops as excess capacity is absorbed; decline in rents slows.

Identifying a local market's current phase is important to investors as market dynamics affect the success of the investment.

Markets tend to progress from one phase to the other, though not at uniform pace. Some markets can go backwards in the cycle or may skip a phase. In general, however, knowing which phase a market is in helps predict what the next phase will be.

Refinancing and the U.S. Economy

The recent surge in refinancing activity has raised issues regarding the costs and benefits of refinancing for homeowners as well as for the economy.

By M.A. Anari and Mark G. Dotzour

Yields on 30-year, fixed-rate mortgages (FRM) peaked at 8.51 percent in May 2000. Since then, the rate has been falling in response to the cooling U.S. economy. From May to December 2000, the rate fell from 8.51 to 7.38 percent, well before the Federal Reserve Board's (Fed's) interest rate reductions.

Since January 2001, the Fed has cut the federal funds rate 11 times in an effort to keep the U.S. economy from slipping into recession. The drop in the Fed funds rate from 6.5 percent in January 2001 to 1.75 percent has mostly influenced short-term interest rates. The 30-year FRM rate decreased to 6.82 percent in September 2001, the lowest rate since January 1999.

The 1.7 percentage point drop in mortgage rates since May 2000 has sparked a refinancing boom (Table 1 and Figure 1). The volume of refinancing originations increased 230 percent from fourth quarter 2000 to first quarter 2001. Refinancing volume climbed to $251 billion in second quarter 2001, the highest level since fourth quarter 1998 when it reached $263 billion. Refinancing originations increased from 25 percent of total originations in fourth quarter 2000 to 55 percent in first quarter 2001, dropping slightly to 50 percent in second quarter 2001.

Microeconomics of Refinancing

Homeowners can benefit from lower mortgage rates in one of two ways. They can get lower monthly payments on their existing mortgage balance, or they can increase the amount owed on their mortgages, thus increasing their monthly mortgage payments in return for a lump sum to be spent as they wish (the cash-out option). Refinancing allows homeowners to either spend or save more.

Table 1. Mortgage Originations on One-to-Four-Family Residences First Quarter 2000 through Second Quarter 2001

Period	Originations (in billion dollars) Total	Refinance	Purchase	Share of Originations (in percent) Refinance	Purchase
2000 Quarter 1	200	42	158	21	79
2000 Quarter 2	276	41	235	15	85
2000 Quarter 3	286	49	237	17	83
2000 Quarter 4	262	66	197	25	75
2001 Quarter 1	396	218	178	55	45
2001 Quarter 2	502	251	251	50	50

Source: Mortgage Bankers Association and Real Estate Center at Texas A&M University

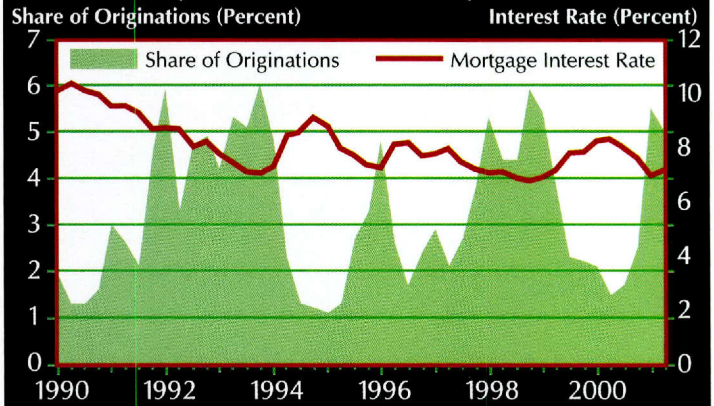
Mortgage refinancing is costly. Processing a new mortgage requires an origination fee, credit report, appraisal, hazard insurance, title insurance policy, closing fees and an escrow account. These costs may be paid in cash or added to the new loan balance. The number of months required to recoup these costs is an important component of a refinancing cost-benefit analysis.

In the past, refinancing was economically viable when the difference between old and new mortgage rates was about 2 percent (200 basis points). However, transaction costs of refinancing have been decreasing steadily since 1985. Monthly interest rate surveys by the Federal Housing Finance Board show that fees and initial charges on conventional fixed-rate mortgages have fallen from 2.56 percent (of the loan) in 1985 to 0.75 percent in 2000. The median balance of a single-family mortgage purchased by Freddie Mac in 2000 was $107,250. A 150-basis-point reduction in the mortgage rate thus results in an annual savings of $1,608.70 ($107,250 x .015) for a typical homeowner.

Mortgage interest rates are the key determinant of refinancing activity. As Figure 2 shows, higher levels of refinancing originations have been closely associated with lower mortgage interest rates, and lower refinancing volume with higher interest rates. For cash-out refinancing, house price appreciation is also an important factor because the maximum amount of the new mortgage is determined by the value of the home.

In the 1990s, refinancing accounted for an average of 31.9 percent of all loans originated and ranged on an annual basis from 11 percent to 60 percent of loans originated. Over the same period, the mean value of 30-year conventional mortgage rates was 8.11 percent, ranging from a high of 10.3 percent to a low of 6.7 percent. Since 1990, the median sales price of new privately owned single-family houses sold in the United States has increased from $122,900 to $168,000 (in 2000), an increase of 36.6 percent (U.S. Bureau of Census, Surveys of Construction). The median sales price of U.S. existing single-family homes increased from $92,000 in 1990 to $139,000 in 2000, an increase of 51 percent (National Association of Realtors, Home Sales Surveys).

Figure 2. Refinancing First Quarter 1990–Second Quarter 2001



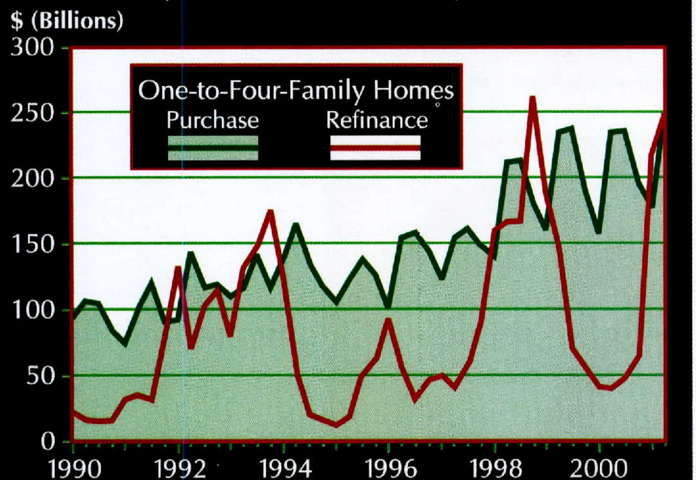
Source: Mortgage Bankers Association and Real Estate Center

Macroeconomics of Refinancing

Total refinancing originations in the first six months of 2001 stood at $442 billion. It is reasonable to assume that mortgagors who refinanced realized savings equal to at least 1 percent of refinancing originations; otherwise they would not have undertaken the refinancing process. Thus, in the first half of 2001, refinancing mortgages provided consumers with about $4.4 billion to spend.

If a cash-out refinancing is assumed to be equivalent to ten times the annual savings from refinancing, consumers may have gained $44 billion to spend. This represents about 0.6 percent of annual personal consumption expenditures and helps the U.S. economy at a time when businesses have cut investment expenditures, leaving consumers to become the saviors of the economy.

Figure 1. Mortgage Originations, First Quarter 1990–Second Quarter 2001



Source: Mortgage Bankers Association and Real Estate Center

Dr. Anari (m-anari@cgsb.tamu.edu) is a research economist and Dr. Dotzour (dotzour@tamu.edu) is chief economist with the Real Estate Center at Texas A&M University.

msa market profiles

By Harold D. Hunt and Laura K. Nobles

Abilene

McMurry University completed a $25 million capital campaign, renovation of the Cooke Classroom Building (below left) and Radford Auditorium (below center and right), and groundbreaking on a student apartment complex. An aluminum smelting facility opened in the Sweetwater Industrial Park. Road work continues in the 13-county Abilene district, which has $80.1 million in ongoing construction projects.

Amarillo

The Texas A&M University System Agricultural Research and Extension Center added a $630,000, 5,800-square-foot wing to the facility (below). Harrington Medical Center has $43 million in construction under way including a pair of four-story office buildings. The City of Amarillo and the Amarillo Independent School District will build a baseball park as a joint-use project.

Austin

Austin ranked 11th on a survey listing the most popular U.S. destinations for people who move. Hard Rock Café will open after restoring the building at 222 East Sixth Street. Horseshoe Bay plans its first new development in a decade—a new Marriott Hotel and Conference Center (below left), 600 homes and a Jack Nicklaus golf course (below right).

Beaumont

At least 100 homes for low-to-moderate income families will be built on land donated to the city. BASF Corporation has a $1 billion steam cracker operating at Atofina's Port Arthur refinery. Cardinal Village Complex (below), a new dorm, opened on the Lamar University campus. A $300 million electric generating plant is planned for Newton County.

Brazoria

To boost industry, Pearland designated a foreign trade zone (FTZ) offering both local and federal tax breaks for businesses and industry. The city gained trade zones through expansion of the Port Freeport FTZ (below left), which also included expansions in Alvin and at Brazoria County Airport (below right). Rollac Shutter of Texas has moved its headquarters from Houston to Pearland.

Brownsville-Harlingen

A new Border Patrol facility will replace the Port Isabel station. Panasonic built a new shipping and receiving warehouse near the Free Trade Bridge (below left). Rio Grande Valley Multibank will provide $10.8 million for affordable housing to more than 400 Valley families. A new upscale subdivision, Los Lagos Golf Club, will add about 400 homes to the area (below right).

Bryan-College Station

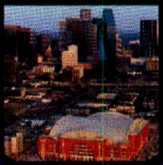
The Miramont golf course resort and residential development's first phase is nearing completion (below left). MeriStar Hotels and Resorts, Inc., the largest independent hotel operator in the United States, will manage the Traditions Golf and Country Club at University Ranch. College Main Parking Garage (below center) opened along with the Tradition (below right) at Northgate dormitory.

Corpus Christi

The city was chosen as a site for two world championship sailing events in 2002, and the city council approved a new $35 million downtown arena. Three Rivers Rialto Theater (below) was refurbished and reopened after being closed 20 years. A $5 million La Raza school will accommodate approximately 500 students.

Dallas

The American Airlines Center and complex (below left) opened in summer 2001. The City of Frisco will build a $22 million minor league ballpark and a $20 million Dallas Stars training facility. The Shops at Willow Bend (below right) opened 1.5 million square feet on Plano Parkway at the North Dallas Tollway. A performance hall, expected to open in February, is under construction at I-30 and Belt Line next to Lone Star Park.



El Paso

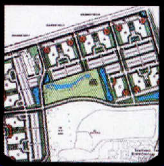
Southwestern Bell opened a 93,000-square-foot call center. The University of Texas-El Paso unveiled its $15 million, 13-building student housing unit (below left and center). El Paso Water Utilities wants to construct a $52 million desalination plant to produce 20 million gallons of drinkable water a day. The El Paso Downtown Partnership continues its efforts to revitalize the central city (below right).



Houston

Construction began on Houston's 7.5-mile, $300 million light rail line (below left). The $700 million hotel and convention center expansion next to the George R. Brown Convention Center (below center) will double the number of hotel rooms and convention meeting space downtown. Texas Medical Center plans the Southeast Texas Biotechnology Park (below right) that will eventually cover 64 acres and cost $633 million. A master-planned community is under development in northwest Harris County on Katy-Hockley Road.





Fort Worth

Wal-Mart plans a massive, 888,000-square-foot food distribution center in Cleburne. A $70 million renovation and expansion is planned for the Medical Center of Arlington. The City of Fort Worth chose Portman Holding to develop the new convention center hotel on Houston Street (below left). Robson Ranch began development of the 2,700-acre site that will have more than 6,000 homes, three golf courses, tennis courts and other facilities (below right).


Laredo

Laredo is the fastest growing city east of the Rocky Mountains. The city launched a $15 million program to assist first-time homebuyers. A 171,466-square-foot arena is under construction at Loop 20 north of the Laredo International Airport (below left). La Bota Ranch will soon have a new golf course (below right).


Galveston

Construction began on a community center in Carbide Park that will house a senior citizens center and county beach and parks department offices. Texas A&M University-Galveston (below) plans the state's first Wetlands Study Center, a walking nature trail around the Mitchell Campus to educate the public and serve as an outreach program for the university. Plans are under way in League City to develop the 900-acre second phase of the River Market project.

Longview-Marshall

Longview Regional Medical Center completed a $3.7 million enlargement and renovation of its emergency room. Two new hotels will add 170 rooms for Longview travelers. Dana Corp., an automotive component manufacturer, plans a $59 million, 200,000-plus-square-foot facility in Longview Business Park (below).

Lubbock

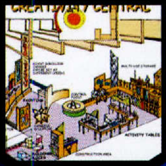
Wells Fargo & Co. plans a $12.7 million customer care center in west Lubbock. Texas Tech will build the first parking garage on campus (below) and an 18-hole golf course that meets NCAA standards. Construction began on SunCrest, a new development expected to have 329 homes on Quaker Avenue.

San Angelo

San Angelo has committed $1 million toward implementation of a master plan for parks. San Angelo Health Foundation gave $1.5 million to the YMCA to build a new $4.76 million facility on Concho River near Park Drive. Ground was broken on a proposed 400-acre industrial park. Plans continue for the construction of the estimated 83,370-square-foot, air-conditioned, dirt-floor Spur Arena (below) and an accompanying 38,304-square-foot bar.

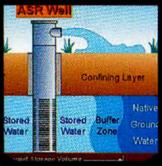
McAllen

The Chamber of Commerce (below left) has a new $1.8 million home that is twice as big as the former location. McAllen International Museum (below right) continues to expand. Hunter Douglas Wood Products moved its vertical blinds, mini-blinds, shutters and other window coverings division to Weslaco Industrial Park from Casa Grande, Arizona. Development began on an upscale subdivision at the Los Lagos Golf Club.



San Antonio

Plans for a massive expansion of terminals, part of a $350 million program to overhaul and enlarge the San Antonio International Airport, are under way (below left). A three-block, $100 million extension will be added to the current "U-shaped" Riverwalk to allow tourists to walk a complete circle (below center). The San Antonio Water System plans a $215.8 million aquifer storage and recovery program (below right).

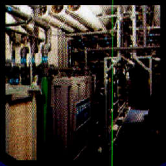


Odessa-Midland

The University of Texas-Permian Basin library and lecture center was dedicated (below left). The building includes 87,000 square feet, houses more than 200,000 books and has seating for 300 in the lecture halls. The $45 million Scharbauer Sports Complex on Loop 250 and State Highway 191 will consist of a baseball stadium and a football-soccer stadium (below center and right). Fairfield Inn is the first new hotel to be constructed in Odessa since the early 1980s.

Sherman-Denison

The Sherman Economic Development Council has teamed with Grayson County College, Workforce Texoma and Sherman ISD to develop a new technical training center. The Greater Texoma Utility Authority issued $1.8 million for utilities for Denison and Pottsboro, including a water line running between the cities and water storage (below) in Lake Texoma.



Temple-Killeen

University of Mary Hardin-Baylor began construction on the $4.5 million Parker Academic Center (below left) that will house the business and education schools. An $11.5 million, 57,000-square-foot research building is under way and will house 200 researchers, staff and graduate students along with ten laboratories (below center and right). The Cardiovascular Research Institute will occupy space in the new building. Scott & White Hospital also plans an eight-story addition.



Victoria

Chandler Elementary School (below left) at Guy Grant and Salem roads replaced the aging Stanly Elementary School. The first of three new plants in Formosa Plastic Corp.'s $750 million expansion project began operation in Point Comfort. Citizens Medical Center (below center and right) opened a $10.5 million, 72,000-square-foot Healthplex on Zac Lentz Parkway.

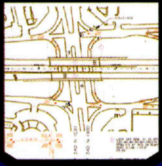


Texarkana

Texarkana National, an 18-hole golf course, is expected to open in fall 2002. The Federal Highway Administration approved a $93 million construction project to improve Highway 71 from Fouke to Doddridge. Texas A&M-Texarkana (below left) began offering a bachelor's degree in nursing in fall 2001. The Queen City school district (below right) received a grant from Texas Parks and Wildlife to build an outdoor classroom.


Waco

Construction is under way on a $12.2 million, 160-unit, mixed-income, low-rent apartment complex on Lake Shore Drive. Waco established a free trade zone allowing companies to use material received from outside the United States to make products for export that are exempt from customs duty. A $70 million retail and restaurant complex is planned at the northwest corner of I-35 and Loop 340 (below).



Tyler

The Northwestside Group plans a $1.5 million water park in Seven Points. University of Texas Health Center at Tyler plans to spend $15 million to expand the Biomedical Research Building (below left). Tyler Pounds Field Airport continues construction on the new 38,000-square-foot terminal building set to open early in 2002. Mother of Frances Hospital (below right) will add 152 patient rooms and a new Heart Institute by 2003 with a $50 million, four-floor expansion to the $27 million surgical wing.


Wichita Falls

A $17.5 million project will extend Kell Freeway west from Kemp Street through Fairway Boulevard (below left). A new multipurpose events center coliseum with a 10,000-seat building and ten proposed luxury skyboxes is under construction. A $6 million expansion will double the size of Kell West Regional Hospital (below right), adding 28 patient suites and eight special-care rooms with high-tech monitoring equipment.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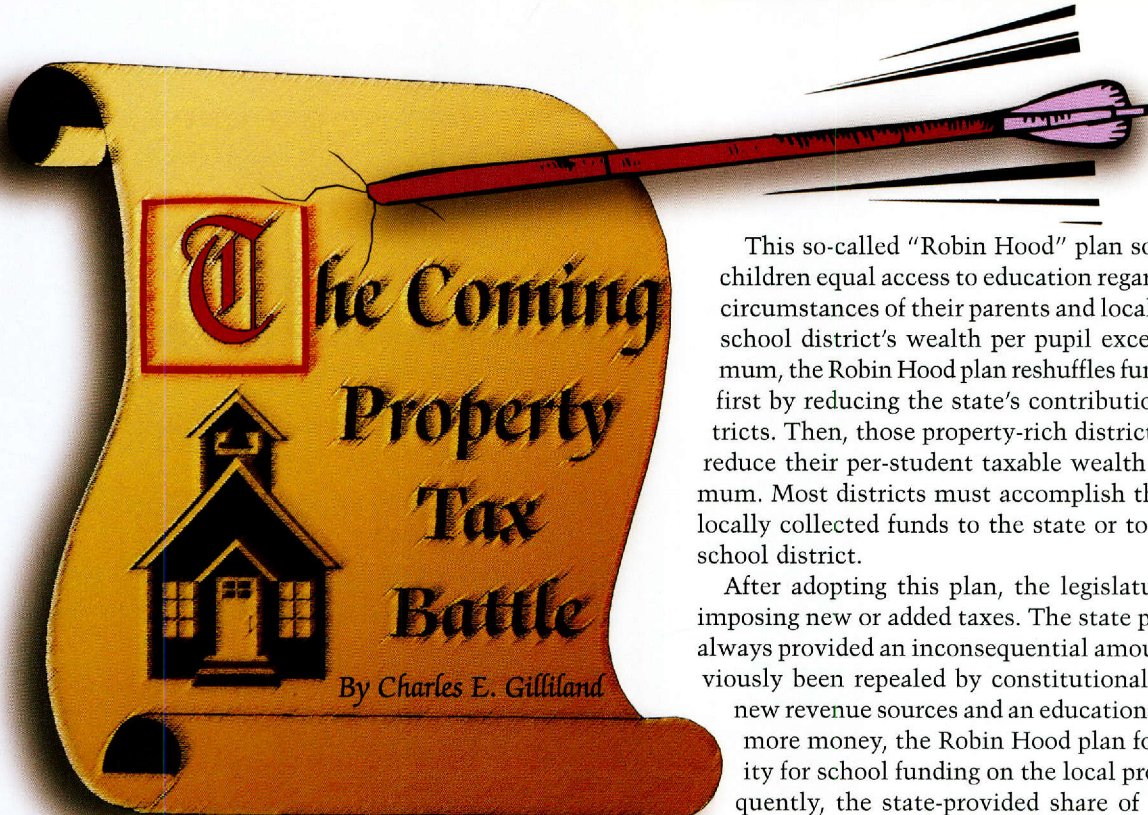


The Coming Property Tax Battle

By Charles E. Gilliland

Texas faces a crisis in financing public schools. Beginning in the 1970s and continuing through the 1980s, school districts with low levels of taxable wealth pursued litigation designed to equalize per-pupil funding of public schools. The legislature's various attempts to address the situation were deemed unconstitutional by the Texas Supreme Court. Finally, in 1995, the legislature passed a plan designed to shift funds from so-called affluent districts to poor districts. The plan also limited school districts' local tax rate for maintenance and operation.

This so-called "Robin Hood" plan sought to offer all Texas children equal access to education regardless of the wealth and circumstances of their parents and local communities. When a school district's wealth per pupil exceeds the allowed maximum, the Robin Hood plan reshuffles funding for public schools, first by reducing the state's contribution to property-rich districts. Then, those property-rich districts must adopt a plan to reduce their per-student taxable wealth to the specified maximum. Most districts must accomplish this by actually sending locally collected funds to the state or to another property-poor school district.

After adopting this plan, the legislature steadfastly avoided imposing new or added taxes. The state property tax, which had always provided an inconsequential amount of revenue, had previously been repealed by constitutional amendment. With no new revenue sources and an educational system clamoring for more money, the Robin Hood plan forced more responsibility for school funding on the local property tax base. Consequently, the state-provided share of local schools' revenue steadily eroded.

The U.S. Bureau of the Census estimated that in 1998–1999 Texas provided approximately 42 percent of local school funding versus the national average of approximately 50 percent. Local property taxes provided 50 percent of per-pupil funds compared with the national average of 44 percent.

As the state's educational needs expand in the future, property tax rates may have to climb to support current levels of per-pupil funding. However, the Robin Hood plan places a cap on the revenue school districts may raise through property taxes. Currently, that cap imposes a maximum maintenance and operation tax rate of $1.50 per $100 of assessed value. Those opposing the Robin Hood plan argue that this state-imposed rate cap essentially creates a state ad valorem property tax, which is prohibited by the Constitution. The Texas Supreme Court ruled in 1995 that if the cap became

Per Pupil Expenditures 1998–99

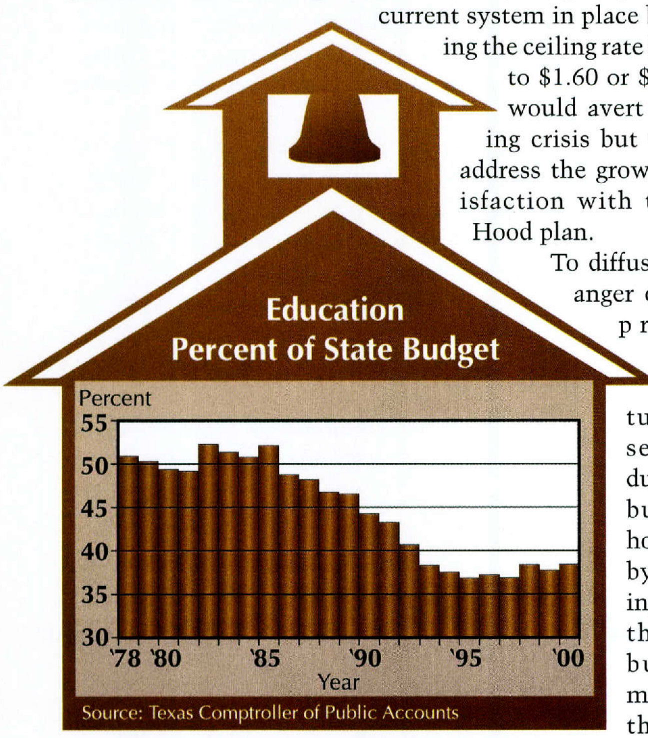
	Rank	Dollars Per Student
New Jersey	1	11,430
Wyoming	13	8,181
U.S. Average		7,504
Florida	25	7,312
Texas	36	6,595
Mississippi	51	5,034

Source: U.S. Census Bureau

binding, acting as both a floor and ceiling, the measure would be an illegal state property tax. As long as schools are not forced to tax at the cap, however, the plan is not unconstitutional.

Officials estimate that as many as 37.4 percent of Texas school districts have maintenance and operation tax rates that have reached the limit or will soon, effectively barring further tax increases. In April 2001, a number of these districts filed suit against the commissioner of education, arguing that too many districts had reached the $1.50 cap, rendering the Robin Hood plan an unconstitutional state property tax. It appeared that without legislative action those districts would likely face budgetary shortfalls. Recently, however, the court ruled that as long as those districts offer an optional homestead exemption for homeowners, they have not technically reached the limit of their ability to raise revenue at a rate less than the $1.50 cap. That decision is now being appealed. While the issue does not appear to be ripe for a constitutional challenge now, it will surely come to crisis in the future.

In the meantime, the legislature has created a Joint Committee on Public School Finance to plan for the next session. Legislators will likely investigate a series of options for resolving public school financing issues. They may simply opt to keep the current system in place by increasing the ceiling rate from $1.50 to $1.60 or $1.75. That would avert the looming crisis but would not address the growing dissatisfaction with the Robin Hood plan.



To diffuse taxpayer anger over rising property taxes, the legislature could seek to reduce the tax burden on homeowners by considering a system that taxes businesses more heavily than homeowners. This might allow for meaningful relief without imposing another tax. Such a program would likely include measures designed to access currently untaxed assets by expanding reporting requirements for property owners, especially businesses. Another method of shifting more of the tax burden to business property is to adopt a system in which businesses pay tax at a higher rate than homeowners. As another option, the state could tax all business and commercial property at the state level, using the proceeds for funding equalization.

Undoubtedly, a host of potential solutions will surface as legislative discussions continue. Ultimately, Texas property owners and the real estate industry face the prospect of substantial changes in the property tax system in the years ahead.

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Land Locked

Controversial Conservation Easements Last Forever

By Charles E. Gilliland

The expanding economy and the rising popularity of rural land as a recreational asset is changing landscapes across the state as landowners accommodate eager buyers. Even in remote areas, large land holdings are being broken up, transforming pastoral vistas into patchworks of housing developments and ranchettes. Landowners, environmentalists and wildlife officials alike are viewing changes in land uses as a threat to wildlife and the rural way of life. Many view ownership fragmentation as an unfortunate trend eroding the character of the Texas countryside.

To reduce fragmentation, environmentalists have urged landowners to consider voluntarily creating land-use restrictions known as *conservation easements*. These easements generally prohibit any activity deemed to be at odds with preserving the current land use, most frequently some form of ranching. The easement is granted to a trustee who assumes a legal obligation to ensure that landowners comply with the restrictions in the easement.

In essence, the easement transfers control of a portion of the owner's rights to the trustee. In addition, the trustee asks the landowner to donate funds to cover the cost of managing the easement. Owners can continue operating the ranch as long as their activities do not stray beyond uses allowed by the easement.

Conservation easements thwart development pressures that drive the fragmentation process. Ranch owners who hope to preserve their ranches for future generations often find the idea of banning development appealing. When ranch ownership passes to younger generations, the heirs often feel pressured to convert land-based wealth to cash by breaking up the property into smaller parcels. Some landowners see conservation easements as a means to ensure that the family ranch does not end up as a golf course or ranchette development.

Proponents contend that conservation easements let current owners "lock up" their land and provide financial benefits as well. Critics deride them as tax breaks for the rich that threaten to lock land into inferior uses and deprive future generations of freedom to control properties and living arrangements.

In most cases, landowners who surrender some of their property rights by creating a conservation easement are compensated through income tax savings. By pledging a permanent conservation easement that is binding for all future landowners, owners are eligible for a deduction equal to the difference between the ranch's value before severing the rights and its value after imposing the easement. Ideally, that difference should reflect the value of the rights surrendered through the easement.

Properties with unique qualities may be sought after by groups wishing to purchase conservation easements. Owners of such properties can bargain for compensation to cover the rights surrendered. Because all terms of the easement are negotiable, owners may attempt to obtain specific desired terms from the group purchasing the easement. Purchased easements can even be temporary if the owner foregoes the income tax benefit.

Although conservation easements have become more prevalent in rural Texas, many landowners regard them with skepticism. Several issues cause owners concern. First, for a tax deduction to offer significant benefits, owners must have sizeable taxable incomes. Many long-time Texas ranch owners have limited income and few assets other than their land. For them, a tax deduction has little or no value. Further, establishing a management fund may require more cash than they can afford. Without an organization offering to purchase the easement, these owners have little incentive to grant one.

Second, many owners suspect that the trustee's role in managing the easement may intrude on their use of the land. The trustee must see that activities on the land do not transgress the limits imposed by the easement. In practice, the trustee may be able to veto plans to construct new buildings, clear land and conduct a variety of other activities. Many landowners see this as an unacceptable intrusion on their authority.

As time passes and personnel of the trustee organization change, differences could emerge regarding what constitutes acceptable management practices. Unless otherwise specified in the easement agreement, the trustee could transfer the easement to another group without the landowner's approval. Faced with this loss of control, some owners are reluctant to grant easements.

Finally, the benefits received for granting the easement depend on the estimated value lost to the easement. Many tax professionals routinely look for a 50 percent reduction in value from the appraisal. However, some appraisers contend that value effects often amount to much less than half of the property value, especially if there was little prospect of immediate development. Further, before-and-after appraisals are difficult when appraisers are faced with complicated loss-of-control issues with little empirical evidence to establish the value effects. In some cases, ensuring that no development will occur enhances market acceptability, leaving owners who were expecting large value losses disappointed when an appraisal indicates a much lower reduction in value.

Conservation easements remain controversial among landowners. Many hesitate to lock up land forever, depriving future generations of control over how their land is used. Landowners considering imposing an easement would do well to consider all sides of the issue carefully. If an easement accomplishes the end they desire and affords sufficient benefits, and if the legal document establishing the easement clearly describes restrictions, it can serve as a helpful management tool.

CONSERVATION EASEMENTS *reduce breakup of family farms and ranches by preserving the current land use. Opponents argue they deprive generations to come of the freedom to control their properties.*

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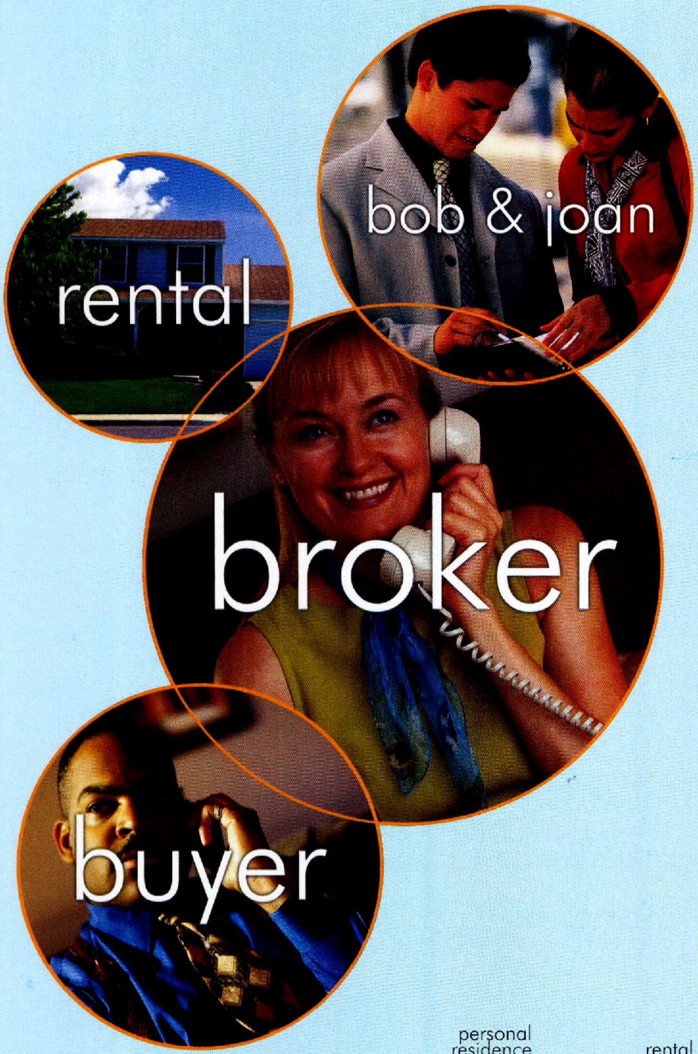
TAX-FREE EXCHANGES AND SALES OF RESIDENCES

BY JERROLD J. STERN



	total	personal residence portion	rental portion
land cost	$33,000	$16,500	$16,500
structure cost	220,000	110,000	110,000
total cost	253,000	126,500	126,500
depreciation on structure [$4,000 x 10 years]	40,000		40,000
tax basis at sale	213,000	126,500	86,500
sale price received	300,000	150,000 cash	150,000 rental property
gain on sale	$87,000	$23,500	$63,500
tax treatment of gain		excluded	postponed

When homeowners sell their homes, they typically avoid tax on the gain. When an investor trades one piece of investment real estate for another, tax is either postponed or avoided if all criteria for a tax-free, like-kind exchange are met. These results can be combined if an owner-investor lives in one unit of a duplex or other multifamily dwelling and rents out the other unit(s). Tax on the personal residence portion of the property can be avoided under the sale of principal residence rules, and the rental portion can be exchanged, with tax on the gain postponed or avoided under the like-kind exchange rules.

In the example (see table), Bob and Joan purchase a duplex for $253,000. The land value is $33,000, and the cost basis of the structure is $220,000. They live in one unit and rent out the other. For tax purposes, they have two separate assets — a principal residence and a rental property.

The rental half of the structure can be depreciated for tax purposes over 27.5 years using the straight-line method because it is residential rental property. Annual depreciation deductions are $4,000 (one-half of $220,000 divided by 27.5 years). Each year, the couple computes net rental income or loss by subtracting total rental property deductions ($4,000 depreciation plus operating expenses associated with the rental half of the property) from rent received.

Assume the property is worth $300,000 ten years later. Bob and Joan want to sell the personal residence portion for cash and trade the rental portion for another rental property without incurring taxes. They can accomplish this using a three-cornered exchange. A like-kind exchange intermediary (a broker specializing in three-cornered exchanges) finds a buyer who wants to purchase the duplex. The broker sells the duplex for $300,000 and then uses one-half of the cash to purchase a rental property chosen by Bob and Joan. The couple exchanges the duplex for the cash and rental property. All the sales contracts specify that the rental properties are being exchanged for each other, and the personal residence portion of the duplex is being exchanged for cash.

Under current tax law, as much as $500,000 of gain from the sale or exchange of a principal residence can be excluded by married taxpayers filing a joint tax return. Thus, the $23,500 gain from the sale of the residence portion of the duplex is excluded from income for tax purposes.

Gain from the exchange of the rental portion of the duplex, $63,500, is not taxed currently. Instead, the tax basis of the newly received rental property is set equal to the tax basis of the property exchanged, or $86,500. If the rental property is later sold for its $150,000 fair market value, the $63,500 "postponed gain" would then be recognized for tax purposes. However, if the value of the rental property declines over time, part or all of the postponed gain could escape income tax.

The like-kind exchange criteria must be met to secure tax-free treatment on the rental property exchange. The newly received rental property must be identified within 45 days and received within 180 days of the sale of the duplex.

The tax rules and computations for three-cornered exchanges are complex. Consultation with an accountant, attorney or real estate professional is recommended.

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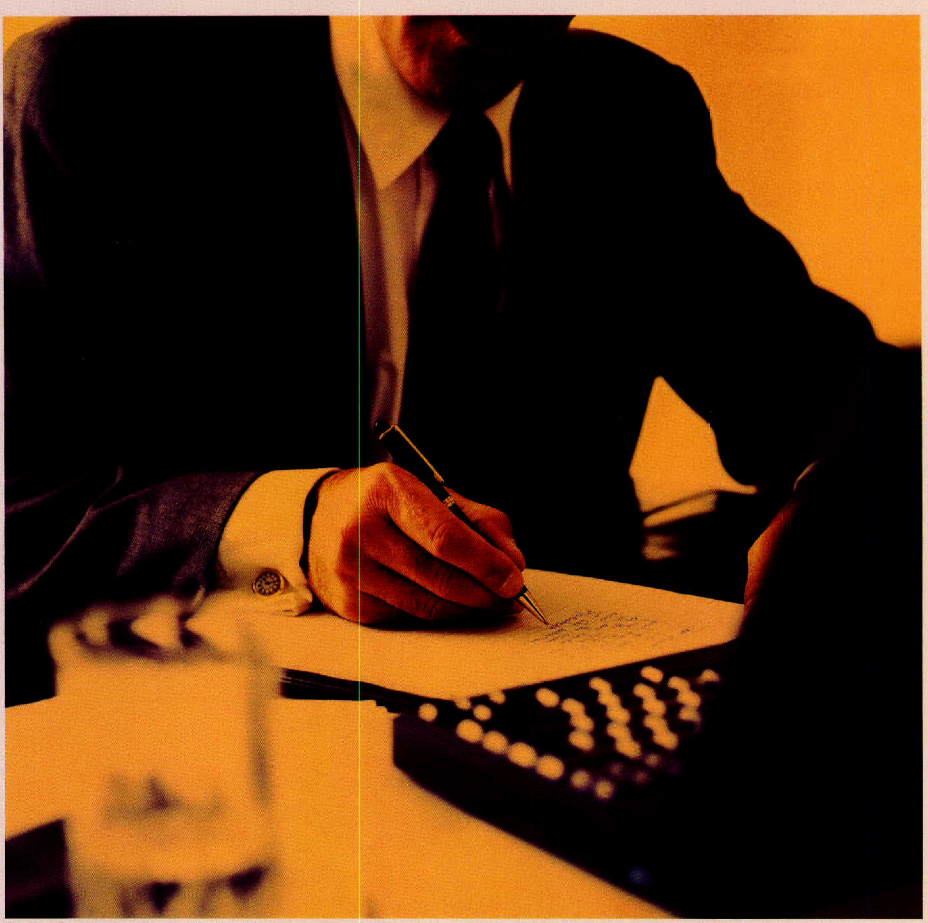
BY JUDON FAMBROUGH

NEW RULES

GOVERN CONTRACTS FOR DEED



Effective Sept. 1, 2001, new rules govern both existing and newly executed contracts for deed, which place greater burdens on residential lenders and brokers. Failure to comply with the new provisions subjects sellers who finance residential loans, lenders and brokers to a Deceptive Trade Practices Act (DTPA) violation and in some cases as much as $500 per day in damages.

Two Types of Financial Arrangements

Owners or lenders can finance the sale of real estate and retain a security interest two ways. The most common is a real estate lien note secured by a deed of trust. The other is a promissory note secured by a contract for deed. Both methods have advantages and disadvantages for lenders and buyers.

Buyers prefer the deed of trust. At closing, the buyer receives both title and possession of the property. If a default occurs, the lender may foreclose under strict statutory guidelines to divest the buyer of both title and possession. If the foreclosure sale generates a surplus, the excess goes to the buyer.

In the past, lenders preferred the contract for deed, sometimes referred to as a *contract of sale* or an *executory contract for conveyance,* which was used frequently with seller financing. At closing, the buyer took possession but not title to the property. The seller retained title until all or part of the promissory note was paid. If the buyer defaulted, the lender accelerated the promissory note, terminated the contract, regained possession and retained all payments made by the buyer. Nothing resembling a foreclosure sale, in which excess proceeds go to the buyer, took place.

By making changes to the Texas Property Code (TPC), Texas legislators came to the aid of buyers who purchase a home using a contract for deed. For this reason, after Sept. 1, 2001, lenders, sellers and brokers may prefer deeds of trust over contracts for deed. However, lenders and sellers should be aware that the law changes the rules for existing contracts for deed, too.

Application of New Law

The new rules apply only to transactions using a contract for deed to purchase residential property (lots of one acre or less are presumed to be residential). Not covered are land sales by the State of Texas, by the Texas Veteran's Land Board or transactions in which the deed is delivered within 180 days. The rules apply to sales between closely related individuals as long as the buyer does not waive the statutory requirements in writing.

The language requirement under the new law for contracts negotiated on or after Sept. 1, 2001, may prove formidable for some sellers and brokers. The law states, "If the negotiations that precede the execution of an executory contract are conducted primarily in a language *other than English,* the seller (or broker) shall provide a copy *in that language* of all written documents relating to the transaction . . ." This means that precontractual notices, the contracts and all post-contractual notices, *et cetera* may need to be drafted in Spanish, Vietnamese, Chinese, Hindi, Arabic, Korean or other languages.

Precontractual Notices

The new rules burden the seller (or broker) with many precontractual disclosures and documentations not required under deeds of trust. These notices apply to contracts negotiated and some contracts entered on or after Sept. 1, 2001. Noncompliance subjects the seller and possibly the broker to a private or public DTPA violation and allows the purchaser to cancel and rescind the contract. A rescission entitles the buyer to a full refund of all payments made pursuant to the contract. The seller or broker must provide the buyer with the following disclosures under the contract for deed.

- A survey less than a year old or a plat of a current survey of the property.
- A list of all transactions in the chain of title affecting the property, including all encumbrances, restrictive covenants and other claims.
- A Seller's Disclosure of Property Condition Form with the heading, "WARNING, IF ANY OF THE ITEMS BELOW

HAVE NOT BEEN CHECKED, YOU MAY NOT BE ABLE TO LIVE ON THE PROPERTY." The form covers items such as the availability of potable water, sewers, electrical service and septic tanks. Other disclosures include the maintenance of roads, locations in floodplains, liens on title, whether other individuals besides the seller own an interest in the property and whether restrictions prohibit the construction of a home.

- A Seller's Disclosure of Tax Payments and Insurance Coverage Form containing a tax certificate from the tax collector's office for the property plus a legible copy of any insurance policy or binder.
- A Seller's Disclosure of Financing Terms Form, similar to a truth-in-lending statement, indicating the purchase price, the interest rate of the promissory note, the total dollar amount of interest charged throughout the term of the contract, the total amount of both the principal and interest to be paid under the contract and the amount of any late-payment fees that can be assessed. No prepayment penalties can be charged under the contract for deed.
- An Oral Agreements Prohibited Statement stating in 14-point uppercase, boldface type that the contract cannot be modified by oral agreements of the parties. This notice can be a part of the precontractual notices or a part of the contract.
- If the property is not in a recorded subdivision, the seller must provide the purchaser with a separate disclosure form stating that utilities may not be available until the subdivision is recorded as required by law. Any advertisements of the property must disclose the availability of water, sewage and electrical service.

UNDER THE NEW LAW, *if negotiations are conducted primarily in a language other than English, all documents must be drafted in that language.*

Contractual Requirements

In addition to precontractual disclosures, the statute describes three provisions that must be included in the contract for deed. Again, these requirements apply to contracts on which negotiations began on or after Sept. 1, 2001.

- Notice of buyer's right to cancel contract within 14 days. To ensure buyers are aware of the right to cancel, the contract for deed must contain a notice in 14-point boldface type or in 14-point uppercase typewritten letters.

  The notice, placed near the purchaser's signature, must contain the following language: "YOU, THE PURCHASER, MAY CANCEL THIS CONTRACT AT ANY TIME DURING THE NEXT TWO WEEKS. THE DEADLINE FOR CANCELING THE CONTRACT IS (DATE). THE ATTACHED NOTICE OF CANCELLATION EXPLAINS THIS RIGHT." The buyer may cancel the contract by signing and sending the notice to the seller by telegram, certified or registered mail or personal delivery.
- To reinforce the buyer's right to cancel, a "Notice of Cancellation" form must be provided to the buyer when the contract is signed. The buyer need only sign this form and deliver or send it to the seller to cancel the contract during the 14-day period.
- If not in the precontractual notices, an Oral Agreements Prohibited Statement as described earlier must be in the contract.

Just as certain items must be placed in the contracts, the statute limits or prohibits the inclusion of others. For example, if late payment fees are included in the contract, they may not exceed the lesser of 8 percent of the monthly payment or the actual administrative cost of processing the late payment.

Likewise, the contract cannot prohibit the purchaser from pledging the buyer's interest as security for utility improvements or fire protection improvements. For contracts entered before Sept. 1, 2001, the purchaser could pledge the property only to obtain a loan to improve the property or to improve the safety of the property. Finally, the contract may not impose prepayment penalties or any similar fee if the buyer elects to pay the entire amount before the maturity date.

Contractual Maintenance

After the contract is signed, the law imposes four more requirements on the seller during the term of the contract.

- If the contract is terminated for any reason during the 14-day cooling-off period, the seller must record the instrument terminating the contract. The seller also must return the executed contract to the buyer along with any property or payments received at the inception of the contract. Likewise, the seller must cancel any security interest arising out of the contract within ten days after receiving the cancellation notice.
- If the contract was entered after Sept. 1, 2001, and not cancelled during the 14-day period, the seller must record the contract for deed along with all the precontractual disclosures within 30 days from the date the contract was executed.
- Effective Sept. 1, 2001, all sellers and lenders under contracts for deed are required to send an "Annual Accounting Statement" to the buyers disclosing the amount paid under the contract, the remaining unpaid balance of the note, the remaining number of payments, the taxes paid on the purchaser's behalf, the amount paid to insure the property, any insurance proceeds received during the year if the property was damaged and evidence of any change in insurance coverage for the property. If the notice is mailed, it must be postmarked no later than January 31. This accounting statement will most likely need to be written in the language used to negotiate the contract.

  Although annual accounting statements are required for all contracts for deed, the penalties apply only to contracts entered on or after Sept. 1, 2001. For these contracts, a violation entitles the buyer to $250 in daily damages until the accounting statement is provided. Also, the buyer can recover reasonable attorney fees needed to collect the damages. This requirement, perhaps the most burdensome, may cause sellers and lenders to avoid the use of contracts for deed.

- The seller must promptly inform the insurer (the company issuing any insurance coverage on the property) of the name and address of the purchaser and the terms of the contract for deed. The insurer must be informed within ten days after either the coverage is obtained or the contract for deed is entered. For existing contracts for deed, lenders and sellers must notify the insurer no later than Jan. 1, 2002, to be in compliance and avoid a DTPA action. Any disbursements of insurance proceeds under the insurance policy must be issued jointly to the purchaser and seller and be used for repairs.

Remedies in Event of Default

The law defines a default under a contract for deed as the failure to make a timely payment or a failure to comply with terms of the contract. Placement of a lien on the property for utility service does not constitute a default. The new law dictates what the lender may do in the event of a default. The following provisions apply to all contracts for deed on which a default occurs on or after Sept. 1, 2001.

On default, the buyer no longer automatically forfeits all prior payments. The seller's remedies depend on whether the buyer has tendered 40 percent or the equivalent of 48 monthly payments. If less than 40 percent has been paid, the seller must send a notice by registered or certified mail, return receipt requested, to the purchaser's residence or place of business. The notice must be written in conspicuous 14-point boldface type or in 14-point uppercase typed letters that includes on a separate page the following statement:

NOTICE

YOU ARE NOT COMPLYING WITH THE TERMS OF THE CONTRACT TO BUY YOUR PROPERTY. UNLESS YOU TAKE THE ACTION SPECIFIED IN THIS NOTICE BY (DATE), THE SELLER HAS THE RIGHT TO TAKE POSSESSION OF YOUR PROPERTY.

The notice must:

- Identify and explain the remedy the seller intends to enforce (this can be either rescission of the contract or acceleration and forfeiture).
- Specify in detail the amount in delinquency (itemized by principal and interest), any additional charges caused by the delinquency, such as late payments, and the period to which the delinquency and late charges relate.
- Specify the exact terms of the contract the buyer has breached if the default was caused by something other than failing to meet a payment.

After receiving the notice, the buyer has 60 days to pay the amount in default or to remedy the breach of the contract specified in the notice. If the buyer does not comply within the 60-day period, the seller may either rescind the contract by returning all the payments made by the buyer or accelerate the note and cause a forfeiture of all the buyer's prior payments. Nothing similar to a foreclosure sale occurs. The seller selects which remedy to pursue in the default notice.

If more than 40 percent has been paid, the seller has only one option: to appoint a trustee to sell the property. However, the notice of default is not the same. The seller must send a 60-day notice worded as follows:

NOTICE

YOU ARE NOT COMPLYING WITH THE TERMS OF THE CONTRACT TO BUY YOUR PROPERTY. UNLESS YOU TAKE THE ACTION SPECIFIED IN THIS NOTICE BY (DATE), A TRUSTEE DESIGNATED BY THE SELLER HAS THE RIGHT TO SELL YOUR PROPERTY AT A PUBLIC AUCTION.

The statute requires all notices to be written and sent in the language in which the negotiations were conducted.

The procedure for conducting the sale must comply with Section 51.002 of the TPC, the same law that governs foreclosure sales under deeds of trust. Among other things, the trustee must post, file and serve notice of the sale in the county where the property is located at least 21 days before the sale is conducted. The sale is conducted on the first Tuesday of the month after the 21-day period. For more information on foreclosure procedure see *A Homeowner's Rights Under Foreclosure* (technical report No. 825).

At the sale, the trustee conveys title to the purchaser and warrants that the property is free from encumbrance. Any proceeds that exceed the debt go to the buyer-in-default. Unless the contract for deed states otherwise, the purchaser-in-default is subject to the same collection procedures specified in Sections 51.003–51.005 of the TPC for any deficiencies resulting from the sale.

Precontractual, contractual and postcontractual requirements are extensive, and penalties for breaching them are severe.

Postcontractual Procedures

Sellers and lenders are required to convey legal title to the buyer and record the deed within 30 days after receiving the final payment. This requirement applies to all contracts. However, the following penalties apply only to contracts entered on or after Sept. 1, 2001. For these contracts, a violation entitles the buyer to $250 per day starting on the 31st day and continuing until the 90th day. After that, daily damages rise to $500 until compliance occurs. The purchaser is entitled to reasonable attorney's fees needed to collect the damages and to secure title to the property. The daily penalties are suspended in instances in which title is being adjudicated following the seller's death.

Sellers or lenders who have used and who contemplate using contracts for deed to finance residential sales face tougher rules. The precontractual, contractual and postcontractual requirements are extensive and penalties for breaching them are severe. Buyers no longer forfeit past payments automatically on default. For these reasons, sellers and lenders may wish to use deeds of trust instead of contracts for deeds for financing sales of residential property.

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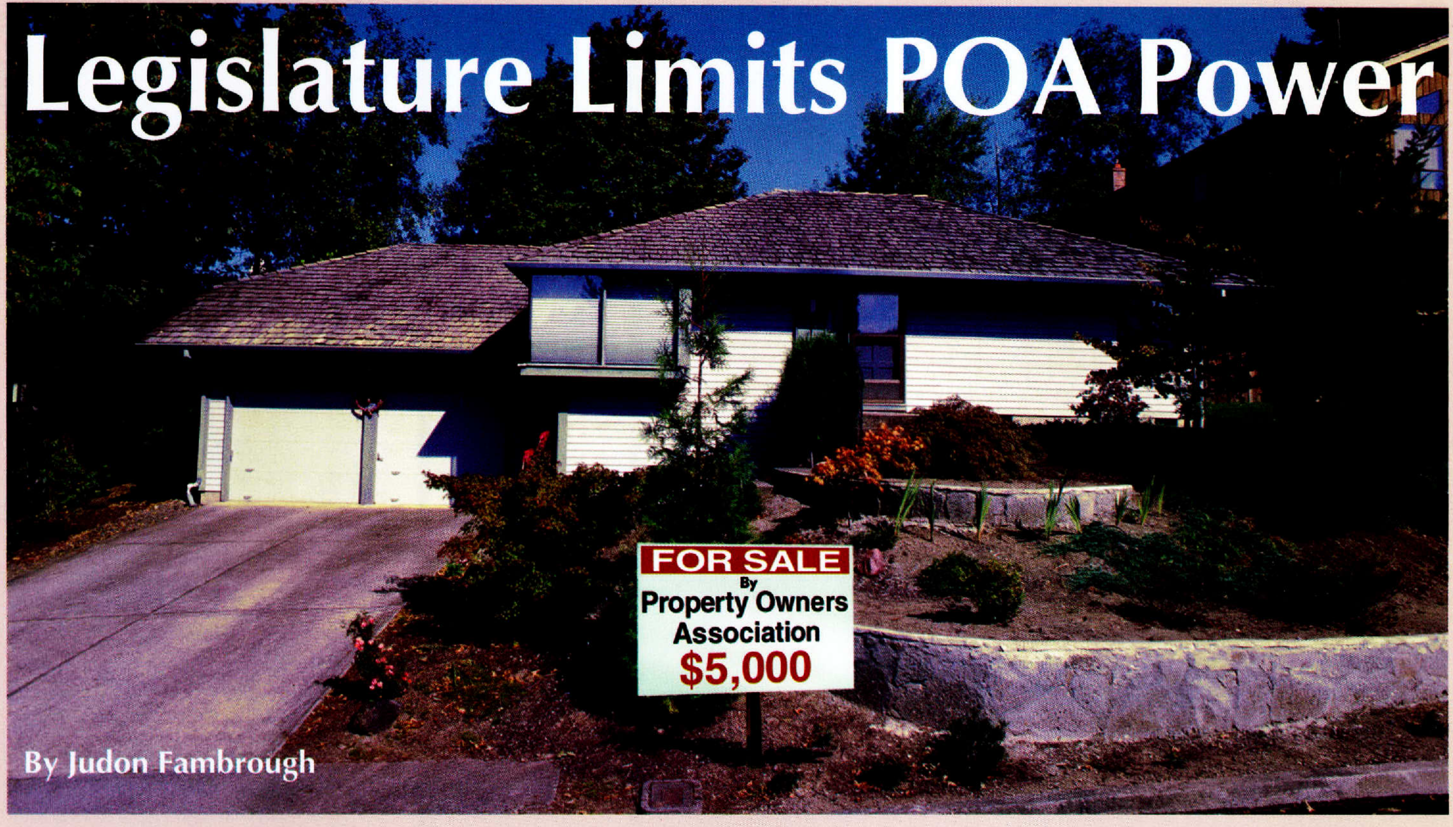
Legislature Limits POA Power



By Judon Fambrough

It's no longer business as usual for Texas property owner associations (POAs). Effective Jan. 1, 2002, new rules govern how associations conduct business. Legislators hope the law eliminates much of the criticism and charges leveled at POAs regarding rule enforcement, collecting attorney fees and foreclosure procedures.

The seeds for the new law were planted last year during a highly publicized foreclosure sale when a $180,000 home was sold for $5,000 to pay assessments. Its name, the Texas Residential Property Owners Protection Act, speaks for itself. Here are some of the changes and requirements imposed by the new law.

The law (SB 507) implements sweeping reforms affecting all residential POAs regardless of what they are called as long as they:

- represent, manage or regulate the subdivision on behalf of the owners,
- require mandatory membership for all or a majority of the property owners and
- collect regular or special assessments from all or a majority of the owners.

Required Notices

POAs may no longer take quick, unilateral action to resolve problems involving homeowners without first sending notices and, in some cases, giving the homeowners an opportunity for a hearing. Notices must be sent before a POA may:

- suspend an owner's right to use a common area,
- file a suit against the owners for other than failing to pay a regular or special assessment,
- foreclose on an association's lien against the homeowner,
- charge an owner for property damage or
- levy a fine for violating a restriction, the bylaws or a rule of the association.

The notice must be sent by certified mail, return receipt requested, detailing the violation or the property damage and stating the amount of damages due the association. The owner must be given a reasonable time to cure the violation and be informed of the right to a hearing if requested within 30 days after receiving the notice.

The Hearing

If the owner opts for a hearing, the board must convene one within 30 days after receiving the request. The board must give the owner at least ten days prior notice of the scheduled date, time and place. The owner's presence is not required. Either party may ask for a postponement of not more than ten days. Either party may make an audio recording. The statute does not address the use of videotapes.

In lieu of a hearing, either party may use alternative dispute resolution services.

The statute describes three situations in which the owner does **not** have a right to receive notice to cure or the right to a hearing. These occur when:

- the owner received a notice and opportunity to cure a similar violation within the previous six months,
- the association files a lawsuit for a temporary restraining order, a temporary injunction or a foreclosure or
- the owner's right to use common areas have been suspended because of a significant and immediate risk of harm to others.

When a lawsuit has been filed for a temporary restraining order, a temporary injunction or a foreclosure, the owner has the right to file a motion to compel mediation.

Attorney Fees

One of the greatest criticisms of POAs related to the way attorney fees were imposed on homeowners. If a homeowner was delinquent in payment of an assessment or fine, no matter how short the period or how small the amount, some POAs hired an attorney to send a collection letter. The attorney fees for drafting and sending the letter (generally a form letter) at times far exceeded the amount in default. If the homeowner protested, attorney fees increased drastically.

The new law still allows associations to collect reimbursements for reasonable attorney fees and other reasonable costs for enforcing restrictions, rules or bylaws or for collecting amounts due the association. However, the POA must send the owner prior written notice that attorney fees and costs will be charged if the delinquency or violation continues beyond a certain date.

A homeowner is **never** liable for attorney fees in two circumstances. Both are tied to the required notice and right to cure discussed earlier. First, if a notice is required and the owner requests a hearing, the owner is not liable for any attorney fees incurred by the association before the conclusion of the hearing. Second, if a hearing is not requested, the owner is not liable for any attorney fees incurred during the 30 days following the receipt of the notice.

The statute absolutely forbids foreclosure to collect attorney fees associated with fines assessed by the association. The statute limits attorney fees when the POA pursues nonjudicial foreclosure for nonpayment of assessments. If the documents or restrictions governing the establishment, maintenance or operation of the subdivision permit nonjudicial foreclosure, then the association may include, as part of the POA's proceeds from the foreclosure sale, the greater of $2,500 or one-third of the actual costs and assessments, excluding attorney fees. Actual costs may include court costs and interest if the law or restrictive covenants permit. Excess proceeds from a foreclosure sale are refunded to the owner.

If the association pursues the collection of attorney fees, it must provide a copy of all invoices and other costs related to the matter when requested by the owner. If attorney fees, costs and other amounts are collected, they must be deposited into an account maintained at a financial institution in the name of the association or its managing agent. Only members of the board or its managing agent may be signatories on the account.

Right of Redemption

POAs may foreclose for unpaid assessments, but owners now have the right to repurchase their homes. Formerly, this right of redemption, as it is sometimes called, was limited to tax foreclosure sales in Texas.

The association must send written notice informing the owners of their redemption rights within 30 days following the sale. The notice must be sent by certified mail, return receipt requested, to the last known address in the POA's records.

The POA must file an affidavit in the public deed records stating the date the notice was mailed along with a legal description of the property. The affidavit must be filed within 30 days after the notice is sent to the homeowner.

Owners must be given reasonable time to cure violations and must be informed of their right to a hearing if requested within 30 days of being notified of violations.

The owner has 180 days after the association mails the notice to redeem the property. The statute prohibits the buyer at the foreclosure sale from transferring title during this period. The price the original owner must pay to redeem the property depends on whether the POA or a third party purchases the property at the foreclosure sale.

If the purchaser rents the property during the redemption period, all rent collected is credited toward the redemption price. Leases entered by the purchaser are subject to the owner's right of redemption. This means the renter must surrender possession immediately if the owner redeems.

If the redemption price is paid, the purchaser at the foreclosure sale must immediately execute and deliver a deed transferring the property to the original property owner. Failure to do so means the original owner may sue the purchaser and recover reasonable attorney fees.

The redeeming property owner must do one of two things during or at the end of the 180-day redemption period to keep the purchaser from selling the property to a third party. The owner must either record the deed from the purchaser or an affidavit stating the redemption has occurred along with the legal description of the property. If the original owner does not file either document during the redemption period, the owner's right to redeem expires at the end of the 180 days unless an extension occurs.

The original owner may extend the redemption period by sending the purchaser at the foreclosure sale a written request to redeem the property. If the request is sent by certified mail, return receipt requested, on or before the end of the redemption period, the period is automatically extended until the tenth day after the purchaser at the foreclosure sale responds in writing with the amount needed to redeem the property.

Foreclosure by the POA and redemption by the owner does not affect existing liens or encumbrances on the property. Installment payments on mortgages or other liens must be paid on time to prevent their foreclosures.

The statute allows the owner to redeem the property from the POA by making partial payments. But all payments must be tendered on or before the redemption period ends. If not, the association must mail the amounts received, within 30 days after the redemption period expires, to the owner's last known address according to the association's records.

If the property is not redeemed and the redemption period is not extended, the purchaser at the foreclosure sale may file an affidavit in the real property deed records stating this fact. The property is then no longer bound by the right of redemption, and the purchaser is free to sell.

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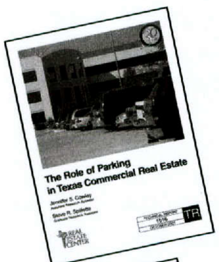

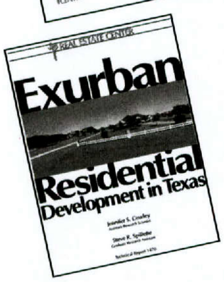

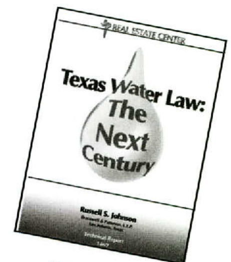

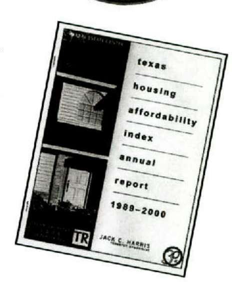

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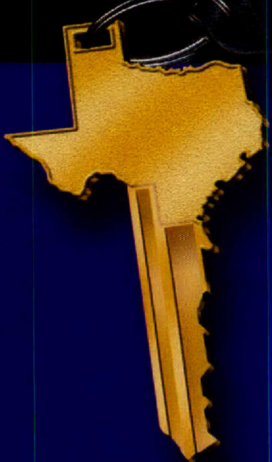

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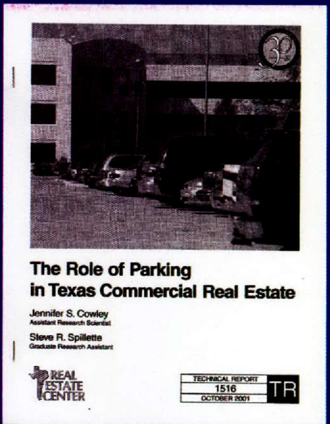
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