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Nightmare Mortgages - ARM Rates To Skyrocket

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For cash-strapped homeowners, it was a pitch they couldn't refuse: Refinance your mortgage at a bargain rate and cut your payments in half. New home buyers, stretching to afford something in a super-heated market, didn't even need to produce documentation, much less a downpayment.

Those who took the bait are in for a nasty surprise. While many Americans have started to worry about falling home prices, borrowers who jumped into so-called option ARM loans have another, more urgent problem: payments that are about to skyrocket.

Slide Show

The option adjustable rate mortgage (ARM) might be the riskiest and most complicated home loan product ever created. With its temptingly low minimum payments, the option ARM brought a whole new group of buyers into the housing market, extending the boom longer than it could have otherwise lasted, especially in the hottest markets. Suddenly, almost anyone could afford a home -- or so they thought. The option ARM's low payments are only temporary. And the less a borrower chooses to pay now, the more is tacked onto the balance.

The bill is coming due. Many of the option ARMs taken out in 2004 and 2005 are resetting at much higher payment schedules -- often to the astonishment of people who thought the low installments were fixed for at least five years. And because home prices have leveled off, borrowers can't count on rising equity to bail them out. What's more, steep penalties prevent them from refinancing. The most diligent

home buyers asked enough questions to know that option ARMs can be fraught with risk. But others, caught up in real estate mania, ignored or failed to appreciate the risk.

There was plenty more going on behind the scenes they didn't know about, either: that their broker was paid more to sell option ARMs than other mortgages; that their lender is allowed to claim the full monthly payment as revenue on its books even when borrowers choose to pay much less; that the loan's interest rates and up-front fees might not have been set by their bank but rather by a hedge fund; and that they'll soon be confronted with the choice of coughing up higher payments or coughing up their home. The option ARM is "like the neutron bomb," says George McCarthy, a housing economist at New York's Ford Foundation. "It's going to kill all the people but leave the houses standing."

Because banks don't have to report how many option ARMs they underwrite, few choose to do so. But the best available estimates show that option ARMs have soared in popularity. They accounted for as little as 0.5% of all mortgages written in 2003, but that shot up to at least 12.3% through the first five months of this year, according to FirstAmerican LoanPerformance, an industry tracker. And while they made up at least 40% of mortgages in Salinas, Calif., and 26% in Naples, Fla., they're not just found in overheated coastal markets: Through Mar. 31 of this year, at least 51% of mortgages in West Virginia and 26% in Wyoming were option ARMs. Stock and bond analysts estimate that as many as 1.3 million borrowers took out as much as \$389 billion in option ARMs in 2004 and 2005. And it's not letting up. Despite the housing slump, option ARMs totaling \$77.2 billion were written in the second quarter of this year, according to investment bank Keefe, Bruyette & Woods Inc.

The First Wave

After prolonging the boom, these exotic mortgages could worsen the bust. They also betray such a lack of due diligence on the part of lenders and borrowers that it raises questions of what other problems may be lurking. And most of the pain will be borne by ordinary people, not the lenders, brokers, or financiers who created the problem.

Gordon Burger is among the first wave of option ARM casualties. The 42-year-old police officer from a suburb of Sacramento, Calif., is stuck in a new mortgage that's

making him poorer by the month. Burger, a solid earner with clean credit, has bought and sold several houses in the past. In February he got a flyer from a broker advertising an interest rate of 2.2%. It was an unbeatable opportunity, he thought. If he refinanced the mortgage on his \$500,000 home into an option ARM, he could save \$14,000 in interest payments over three years. Burger quickly pulled the trigger, switching out of his 5.1% fixed-rate loan. "The payment schedule looked like what we talked about, so I just started signing away," says Burger. He didn't read the fine print.

After two months Burger noticed that the minimum payment of \$1,697 was actually adding \$1,000 to his balance every month. "I'm not making any ground on this house; it's a loss every month," he says. He says he was told by his lender, Minneapolis-based Homecoming Financial, a unit of Residential Capital, the nation's fifth-largest mortgage shop, that he'd have to pay more than \$10,000 in prepayment penalties to refinance out of the loan. If he's unhappy, he should take it up with his broker, the bank said. "They know they're selling crap, and they're doing it in a way that's very deceiving," he says. "Unfortunately, I got sucked into it." In a written statement, Residential said it couldn't comment on Burger's loan but that "each mortgage is designed to meet the specific financial needs of a consumer."

The loans certainly meet the needs of banks. Option ARMs offer several payment choices each month. Among Burger's alternatives were one for \$2,524, about what a standard fixed-rate mortgage would be on the new amount, and the \$1,697 he pays. Why would his bank make the minimum so low? Thanks to a perfectly legal accounting practice, no matter how little Burger pays each month, the bank gets to record the full amount.

Option ARMs were created in 1981 and for years were marketed to well-heeled home buyers who wanted the option of making low payments most months and then paying off a big chunk all at once. For them, option ARMs offered flexibility.

So how did these unusual loans get into the hands of so many ordinary folks? The sequence of events was orderly and even rational, at least within a flawed system. In the early years of the housing boom, falling interest rates made safe fixed-rate loans attractive to borrowers. As home prices soared, banks pushed adjustable-rate loans with lower initial payments. When those got too pricey, banks hawked loans that required only interest payments for the first few years. And then they flogged option ARMs -- not as financial-planning tools for the wealthy but as affordability tools for

the masses. Banks tapped an army of unregulated mortgage brokers to do what needed to be done to keep the money flowing, even if it meant putting dangerous loans in the hands of people who couldn't handle or didn't understand the risk. And Wall Street greased the skids by taking on much of the new risk banks were creating.

Now the signs of excess are crystal clear. Up to 80% of all option ARM borrowers make only the minimum payment each month, according to Fitch Ratings. The rest of the money gets added to the balance of the mortgage, a situation known as negative amortization. And once balances grow to a certain amount, the loans automatically reset at far higher payments. Most of these borrowers aren't paying down their loans; they're underpaying them up.

Yet the banking system has insulated itself reasonably well from the thousands of personal catastrophes to come. For one thing, banks can sell some of their option ARMs off to Wall Street, where they're packaged with other, better loans and re-sold in chunks to investors. Some \$182 billion of the option ARMs written in 2004 and 2005 and an additional \$83 billion this year have been sold, repackaged, rated by debt-rating agencies, and marketed to investors as mortgage-backed securities, says Bear, Stearns & Co. (NYSE:BSC - News) Banks also sell an unknown amount of them directly to hedge funds and other big investors with appetites for risk.

The rest of the option ARMs remain on lenders' books, where for now they're generating huge phantom profits for some lenders. That's because, according to generally accepted accounting principles, or GAAP, banks can count as revenue the highest amount of an option ARM payment -- the so-called fully amortized amount -- even when borrowers make only the minimum payment. In other words, banks can claim future revenue now, inflating earnings per share.

For many industries, so-called accrual accounting, which lets companies book sales when they contract for them rather than when they receive the cash, makes sense. The revenues will eventually come. But accrual accounting doesn't apply well to option ARMs, since it's more difficult to know if unpaid interest will ever cross a banker's desk. "This is basically an IOU that may never get paid," says Robert Lacoursiere, an analyst at Banc of America Securities. James Grant of Grant's Interest Rate Observer recently wrote that negative-amortization accounting is "frankly a fraudulent gambit. But what it lacks in morality, it compensates for in ingenuity." The Financial Accounting Standards Board, which is responsible for

keeping GAAP up to date, stands by its standard but told BusinessWeek in a written statement that it is "concerned that the disclosures associated with these types of loans (are) not providing enough transparency relative to their associated risks."

Camouflaged Losses

Risks or not, the accounting treatment is boosting reported profits sharply. At Santa Monica (Calif.)-based FirstFed Financial Corp. (NYSE:FED - News), "deferred interest" -- what an outsider might call phantom income -- made up 67% of second-quarter pretax profits. FirstFed did not respond to requests for comment. At Oakland (Calif.)-based Golden West Financial Corp. (NYSE:GDW - News), which has been selling option ARMs for two decades, deferred interest made up about 59.6% of the bank's earnings in the first half of 2006. "It's not the loan that's the problem," says Herbert M. Sandler, CEO of World Savings Bank, parent of Golden West. "The problem is with the quality of the underwriting."

In the middle of one of the hottest U.S. markets, Coral Gables (Fla.)-based BankUnited Financial Corp. (NASDAQ:BKUNA - News) posted a \$14.8 million loss for the quarter ended June, 2005. Yet it reported record profits of \$23.8 million for the quarter ended in June of this year -- \$20.9 million of which was earned in deferred interest. Some 92% of its new loans were option ARMs. Humberto L. Lopez, chief financial officer, insists the bank underwrites carefully. "The option ARMs have gotten a bit of a raised eyebrow because we generate and book noncash earnings. But...it's our money, and we do feel comfortable we'll get it back."

Even the loans that blow up can be hidden with fancy bookkeeping. David Hendler of New York-based CreditSights, a bond research shop, predicts that banks in coming quarters will increasingly move weak loans into so-called held-for-sale accounts. There the loans will sit, sequestered from the rest of the portfolio, until they're sold to collection agencies or to investors. In the latter case, a transaction on an ailing loan registers on the books as a trading loss, gets mixed up with other trading activities and -- presto! -- it vanishes from shareholders' sight. "There are a lot of ways to camouflage the actual experience," says Hendler.

There's no way to camouflage what Harold, a former computer technician who asked BusinessWeek not to publish his last name, is about to face. He's disabled and has one source of income: the \$1,600 per month he receives in Social Security disability payments. In September, 2005, Harold refinanced out of a

fixed-rate mortgage and into an option ARM for his \$150,000 home in Chicago. The minimum monthly payment for the first year is \$899, which he can afford. The interest-only payment is \$1,329, which he can't. The fully amortized payment is \$1,454, which his lender, Washington Mutual (NYSE:WM - News), gets to count on its books. WaMu, no fly-by-night operation, said it couldn't comment on Harold's case, citing confidentiality issues. A spokesman says the bank "accounts for its option ARM product in accordance with generally accepted accounting principles." WaMu has about \$12 billion in loans negatively amortizing right now, up from \$2.5 billion in 2005, estimates CreditSights' Henderson. In a written statement, WaMu said "borrowers who request an adjustable loan with payment options should understand those options and potential adjustments throughout the life of the loan. We make detailed disclosures to customers that are designed to develop a more informed consumer of mortgage products and ensure that our customers are comfortable with the loan products they select."

Hard Sell

To get the deals done, banks have turned increasingly to unregulated mortgage brokers, who now account for 80% of all mortgage originations, double what it was 10 years ago, according to the National Association of Mortgage Brokers. In 2004 banks began offering fatter sales commissions on option ARMs to encourage brokers to push them, says Gail McKenzie, assistant U.S. attorney in Atlanta, who is investigating mortgage brokers for improper practices.

The problem, of course, is that many brokers care more about commissions than customers. They use aggressive sales tactics, harping on the minimum payment on an option ARM and neglecting to mention the future implications. Some even imply verbally that temporary teaser rates of 1% to 2% are permanent, even though the fine print says otherwise. It's easy to confuse borrowers with option ARM numbers.

A recent

Federal Reserve study showed that one in four homeowners is mystified by basic adjustable-rate loans. Add multiple payment options into the mix, and the mortgage game can be utterly baffling.

Billy and Carolyn Shaw are among the growing ranks of borrowers who have taken out loans they say they didn't understand. The retired couple from the Salinas (Calif.) area needed to tap about \$50,000 in equity from their \$385,000 home to cover mounting expenses. Billy, 66, a retired mechanic, has diabetes. Carolyn, 61,

has been caring for her grandchildren, 10-year-old twins, since her daughter's death in 2000. The Shaws have a fixed income of \$3,000 a month that will fall by about \$1,000 in November after Billy's disability benefits run out. Their new loan's minimum payment of about \$1,413 is manageable so far, but the fully amortized amount of about \$3,329 is out of the question. In a little over a year, they've added some \$8,500 to their loan balance and now face a big reset if they continue to pay only the minimum. "We didn't totally understand what was taking place," says Carolyn. "You have to pay attention. We didn't, and we're really stuck here." The Shaws' lender, Golden West, says it routinely calls customers to ask them if they are happy and understand their mortgage loan.

Then there's the illegal stuff. Mortgage fraud is one of the fastest-growing white-collar crimes in the nation, costing \$1 billion in 2005, double the year before. A slower housing market could foster more wrongdoing. "With a tighter market, you are going to find there is more incentive to manipulate," says Tim Irvin of Irvin Investigations & Research Services in Spring, Texas. "Brokers are having a harder time getting business, so they're getting creative."

Concerns like these haven't curbed Wall Street's hunger for option ARMS. "At a price, you can originate or sell anything," says Thomas F. Marano, global head of mortgage and asset-backed securities at Bear Stearns. Hedge funds have been particularly active, buying risky loans directly from banks and cutting out the bundlers in the middle. Kathleen C. Engel, an associate professor of law at Cleveland-Marshall College of Law at Cleveland State University, says Wall Street and hedge fund money has helped to finance widespread lending abuses, particularly among the most vulnerable borrowers.

Pros Go Unscathed

Why are hedge funds willing to buy risky loans directly? Because they can demand terms that help insulate them from losses. And banks, knowing what the hedge funds want in advance, simply take it out of the hides of borrowers, many of whom qualify for lower rates based on their credit histories. "Even if the loan goes bad, (the hedge funds are) still making money hand over fist," says Engel.

Eventually, some of it will go sour. But the Wall Street pros who buy option ARMs are in the business of managing risk, and no one expects widespread losses. They've taken on billions in iffy option ARMs, but the loans are no shakier than the billions

in emerging market debt or derivatives they buy and sell all the time. Blowups are factored into the investing decision.

Banks that hold lots of option ARMs on their books will surely be hit by loan defaults in coming years. "It's certainly reasonable to expect to see some excesses wrung out," says Brad A. Morrice, president and CEO of New Century Financial Corp. But even here the damage will likely be limited. Banks use insurance and other financial instruments to protect their portfolios, and they hold real assets -- homes -- as collateral. Christopher L. Cagan, director of research and analytics at First American Real Estate Solutions, a researcher and unit of title insurer First American, forecasts total defaults of \$300 billion across all types of loans, not just option ARMs, over the next five years -- less than 1% of total homeowner equity. (In comparison, JPMorgan Chase & Co. alone has a mortgage portfolio of \$182.8 billion.) Cagan estimates that banks will end up losing only \$100 billion of it all told.

Most of the pain will be born by ordinary people. And it's already happening. More than a fifth of option ARM loans in 2004 and 2005 are upside down -- meaning borrowers' homes are worth less than their debt. If home prices fall 10%, that number would double. "The number of houses for sale is tripling in some markets, so people are not going to get out of their debt," says the Ford Foundation's McCarthy. "A lot are going to walk."

Jennifer and Eric Hinz of Somerset, Wis., are feeling the squeeze. They refinanced out of a 5.25% fixed-rate, 30-year loan in June, 2005, and into an option ARM with a 1% teaser rate from Indymac Bank. The \$1,483 payment for their original mortgage dropped to as low as \$747 with the new option ARM. They say they had no idea when they signed up, however, that the low payment adds \$600 in deferred interest to their balance every month. Worse, they thought the 1% would last three years, but they're already paying 7.68%. "What reasonable human being would ever knowingly give up a 5.25% fixed-rate for what we're getting now?" says Eric, 36, who works in commercial construction. Refinancing is out because they can't afford the \$15,000 or so in fees. "I'm paying more, and the interest is just going up and up and up," says Jennifer, 34, a stay-at-home mom. "I feel like we got totally screwed." They say their mortgage broker has stopped returning their phone calls. Indymac declined to comment on the loan's specifics.

Stories like these can be found across the socioeconomic spectrum, says Allen J.

Fishbein, director of Housing & Credit Policy for the Consumer Federation of America. In a May focus group, the CFA found that option ARM customers at all income levels said the loans were the only way they could afford their homes. While many recognized that their mortgages could increase, "they professed complete surprise that they could increase as much as they could," says Fishbein. That lack of diligence will cost them over time.

Not that all option ARM holders go in blindly. While the loans are marketed aggressively, plenty of holders know exactly what they're getting into. Jon and Meghan Bachman of Portland, Ore., consider them wealth-building tools. "We want to own a bunch of houses," says Meghan. "We're hoping for early retirement."

So far they have stayed out of the fire. The couple, who are in their 30s, bought their first home, a 100-year-old farm house in Portland, Ore., in October, 2005, with a no-money-down loan for \$200,000 from GreenPoint Mortgage, a unit of NorthFork Bancorporation Inc. By May, the value of the house had soared to \$275,000. Rather than sit tight as their grandparents might have, the Bachmans, with an annual household income of \$70,000, took out a home equity loan to put a \$30,000 downpayment on an investment property in an up-and-coming neighborhood nearby. They pay a minimum of just \$825 on their new \$191,000 mortgage, and rent the house out for \$100 more than that. Sooner or later, the payment will rise. Then they'll have to raise the rent to stay in the black. If the still-strong Portland housing market tanks, they could find themselves in deep trouble. It's a risk they say they're willing to take.

Public policy has yet to catch up with the new complexities of the lending industry. Comptroller of the Currency John C. Dugan, the banking industry's main regulator, wants banks to clean up their act. A source inside the federal Office of the Comptroller says Dugan intends to raise lending standards, as he did last year on credit cards, where super-low minimum payments made it improbable that cardholders would ever pay down debts. New guidelines are expected this fall.

Fair-housing pundits suggest that mortgage lenders follow the lead of the securities industry and require that mortgage borrowers be not only eligible for a product but also suitable -- meaning the loan won't impose hardship. Says Consumer Federation of America's Fishbein: Buyers have to have a "reasonable prospect of being able to handle the payments, not at the initial rate, but (assuming) the worst-case scenario."

So far, banks have shown little desire to raise their standards. In February, Golden West announced it would raise its minimum option ARM payment to 2.6% of the loan. In March, Golden West's Sandler wrote a nine-page letter to the Office of Thrift Supervision decrying the lax lending standards he was seeing. "Foolish lenders who eventually stumble under the weight of their missteps will bring down innocent borrowers with them and leave the rest of us to clean up the mess," he wrote. But on May 7, Golden West announced it was selling out to Charlotte (N.C.)-based Wachovia Corp. (NYSE:WB - News). By June it had dropped its option ARM rate back down to 1.50%. Sandler says the rates were changed according to the bank's interest rate outlook.

Analyst Frederick Cannon of Keefe Bruyette & Woods says most banks don't apologize for their option ARM businesses. "Almost without exception everyone says (the option ARM) is a great loan, it's plenty regulated, and don't bug us," he says. In an April letter to regulators, Cindy Manzettie, chief credit officer for Fifth Third Bank in Cincinnati, said it's not the "lender's responsibility to help the consumer determine the appropriate payment option each month.... Paternalistic regulations that underestimate the intelligence of the American public do not work."

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