Real Estate Owners Feel Pinch Of Adjustable-Rate Loans

by Emmet Pierce and David Washbur

A recent spike in default notices may be a sign that some homeowners are struggling to pay the adjustable-rate mortgages that now dominate lending in many residential real estate markets, analysts warn.

While the spike doesn't threaten most homeowners, many of whom have little or no mortgage debt, default activity has captured the attention of economists and researchers who view the San Diego region, for instance, as a bellwether for national housing trends. Those at greatest risk of default are recent buyers who used adjustable-rate mortgage products to buy properties that otherwise would have been beyond their financial reach.

CNS Photo by Charlie NeumanNotices of default - the first step toward mortgage foreclosure - jumped 60 percent in the San Diego region in the first three months of this year, compared with the first quarter of last year DataQuick analyst John Karevoll characterizes the increase, the largest since 1992, as "a potential blinking yellow light on the dashboard."

The 1,533 notices issued during the first quarter of 2006 are below the quarterly average of 2,149 over the past 14 years and account for only a fraction of the region's homes. Typically, about 5 percent of those who receive default notices end up losing their dwellings.

"Right now, we are not seeing anything dangerous, but we are watching carefully," Karevoll said. "We know that is a definite possibility down the line."

In contrast, Nicolas Retsinas of Harvard's Center for Joint Housing Studies says the increase in default activity coming during a time of economic growth is a sign that many adjustable-rate mortgages, or ARMs, carry too much risk for borrowers. Millions of households across the country are at risk of "payment shock" when mortgage payments adjust upward over the next two years, Retsinas said."They are in for a bumpy ride and some of them will fall off the tracks," he said. "I think we should be concerned."

David Berson, chief economist for mortgage-investment giant Fannie Mae, is troubled that foreclosure activity is rising during a period of economic growth. "Normally this is a situation in which housing problems tend to go down, not up," Berson said. "If it continues, it could be a sign that borrowers are in financial distress."

Brad Geisen, the head of foreclosure.com, a default-tracking company, said the increase in default notices here should be taken seriously. The nation's housing boom has been driven by adjustable loans with low "teaser" rates, Geisen said. The most risky, such as negative-amortization loans, sometimes are called "exotic."

Because of lowered underwriting standards, many buyers since 2003 "have been able to qualify for more house than they can afford," he said.

The trend toward highly leveraged loans began when middle-wage consumers in escalating housing markets no longer could qualify for fixed, 30-year mortgages, Geisen said.

In December, five institutions, including the Federal Reserve Board and the Office of the Comptroller of the Currency, voiced their concern by issuing a "guidance" to lenders. Citing "a significant risk of payment shock and negative amortization," the regulators urged them to exercise greater caution.

On May 1, the comptroller's office announced a consumer-education drive to prevent foreclosures, citing "a potential downside to this homeownership boom" as ARM payments rise.

Lenders around the nation have seen an increase in foreclosure activity. Nationally, 323,102 properties entered some stage of foreclosure in the first quarter of 2006, a 38 percent increase from the previous quarter and a 72 percent year-over-year increase from the first quarter of 2005, according to the U.S. Foreclosure Market Report.

Most ARM holders shouldn't feel threatened by the rise, but any interruption in income flow, such as a death, divorce or the loss of a job, can push financially stretched households quickly into default, critics of the loans say. Many buyers who entered the market when prices were rising rapidly didn't anticipate the current cooling trend that has brought home price appreciation down from heady double-digit increases.

"I think we have seen the best of times," said Zoltan Pozsar, an economist for Moody's economy.com. "From here forward, we will see a deterioration in mortgage credit quality. Delinquencies will start going up. Those will lead to foreclosures for some people, primarily those who hold exotic mortgage loans."

The rising number of default notices is not surprising to longtime San Diego mortgage broker Ed Smith Jr. Smith has seen too many people who are willing to take financial risks for their slice of the American Dream.

"You have a hardworking family trying to buy home in a market where a starter home costs $500,000 to $550,000," said Smith, who is the San Diego chapter president of the California Association of Mortgage Brokers. "They are all looking for the lowest monthly payment. They don't plan for when the freight comes due on that ticket."

Smith said ARMs, which vary greatly in risk, can't increase beyond agreed-upon caps. Adjustments generally range between 1 percent and 2 percent, Smith said. They typically have lifetime caps of 6 percent. Unlike traditional fixed-rate 30-year loans, these mortgages often are viewed as short-term vehicles for attaining homeownership.

A very popular choice is the pay-option or flex-payment ARM. The borrower can decide how much to pay every month, a 30- or 15-year fully amortized payment, just the interest or minimum payments that don't cover the interest, Smith said. If borrowers aren't careful, they may wind up owing more money than their home is worth, he said. "A day of reckoning is coming."

In La Mesa, Calif., Erik Weichelt, a real estate agent who specializes in marketing REOs, or real estate owned properties acquired through foreclosure, said business is good.

"We have more REOs now than we have in the past three years," Weichelt said. Until recently, "there was no need for the foreclosure process; appreciation was so strong. People were able to refinance or sell the property and get a fresh start. Now, because of limited appreciation and some stagnation in the market, that is just not available."

Sometimes holding down a job isn't enough to keep your home, said David Michael, Money Management International's director of consumer counseling for the West Coast. High gas prices, for instance, make default much more likely for households struggling to cope with higher mortgage payments and long-distance commuting costs. Some families will see mortgage payments rise by hundreds of dollars each month when their loans adjust, Michael said.

Union Bank of California Senior Economist Keitaro Matsuda said a sharp rise in home foreclosures would have a ripple effect.

"The entire economy starts to slow down," Matsuda said. "But that is a pretty extreme scenario."

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