



Unraveling the Subprime Mess by Robert Freedman

At 85, Harry Teague had every reason to be satisfied with the way his golden years were playing out. Although he was living on a fixed income, he had a solid pension; and he had money coming in from a single-family rental he owned in Trenton, N.J., and from renters sharing an Atlanta duplex he owns and lives in.

But he made the mistake of refinancing the mortgage on his duplex in 2005. The refinancing itself wasn't a mistake — millions were doing it during the boom to take advantage of historically low rates.

The mistake was taking out a loan that's become the poster child for today's subprime mess: a "2/28," sometimes known as an "exploding ARM," in which the borrower enjoys two years of low monthly payments before the rate begins to reset at six-month intervals. There's also a 3/27 version of the loan. In many cases such loans are made using undocumented "stated income," even though those loans were never intended to be widely used.

Some credit blemishes had put Teague into this subprime world, and the loan originator — acting on common industry practices — underwrote the loan based on Teague's ability to make payments only during the introductory period.

The thinking of lenders relying on such loose standards goes like this: As long as home prices head up and interest rates stay down, borrowers can refinance the loan before the rate resets. Thus, long-term ability to pay isn't necessary. And in any case, the lender is far removed from repayment risk since the lion's share of these loans get traded on Wall Street. The ultimate risk holders are often global investors far removed from the action.

But stalled home values in many markets and short-term interest rate hikes intervened in 2006, crippling the ability of borrowers like Teague to refinance. He was stuck with mortgage financing on his duplex that shot up to 12.99 percent in October 2006 from 9.99 percent, and faced an additional increase to 15.99 percent in June. Teague would have been in line to be one of the more than 2 million subprime borrowers who the Center for Responsible Lending estimates will lose their home over the next few years in what's shaping up to be the greatest subprime loan challenge in the country's history.

For Teague, the story has a happy ending because of the intervention of Barbara Williams, a REALTOR® who used to sell real estate but today works on the loan side of the business as an originator for a company called The Mortgage Division in Atlanta.

Williams spent months negotiating on Teague's behalf, and eventually the lender took action on the case. Today Teague has a 27-year fixed-rate loan at a rate he can afford.

Millions More to Go

Not all subprime borrowers — many of whom are low-income seniors and minorities with little experience in navigating today's complicated mortgage choices — will be as lucky.

Although the universe of subprime borrowers in default remains a small segment of the overall market — about half a percent of all loans, NAR says — shaky borrowers still number in the millions. CRL estimates that \$164 billion worth of equity is at stake over the next couple of years, turning the homeownership dreams of moderate-income households into a nightmare.

And the devastation doesn't just hit borrowers; entire communities are hurt. Households near foreclosed homes face declines in the value of their home; tax revenues to local government shrink; public services wane; and a cycle of disinvestment — particularly in communities with clusters of problem houses — takes hold.

To be sure, some hard-hit households will eventually get back on their feet, and for financially sound households and investors, short sales on foreclosed homes provide some buying opportunities.

But the long-term damage has been done. Even households who escaped trouble by staying away from risky subprime loans and sat out the boom are harmed, as lenders tighten their underwriting standards. NAR estimates that new rules by lenders will push home ownership out of reach for as many as 250,000 households a year over the next two years, delaying to 2008 a housing recovery that NAR last year expected by the middle of this year.

Taking Action

Some lenders with big exposure in the market, including HSBC Bank, are trying to head off mass foreclosures by initiating workouts with shaky borrowers. They're getting help from a lot of players, including the two secondary mortgage market giants. Freddie Mac has unveiled a \$20 billion plan to help make sure lenders can offer fair and affordable financing to home owners seeking to refinance problematic loans. Fannie Mae is taking its own steps.

State housing finance agencies, tapping low-cost funds through taxable bond issuances, are making similar offers, as are some nonprofit groups, including NeighborWorks America.

NAR has stepped up to the plate, too, with a widely applauded proposal it sent in April to the U.S. Department of Housing and Urban Development. The proposal would modify FHA rules to allow borrowers delinquent on their mortgage to refinance into safe and affordable FHA-backed financing. At a House Financial Services Committee hearing in April, FHA Commissioner Brian Montgomery said it was well within the FHA's authority to make such a change on its own. The key, he said, is whether it can make the change in an actuarially sound way, which his department is reviewing.

To be sure, there's only so much lenders can do, given the big role Wall Street has taken in spreading the risk to global investors. There's no doubt that the dispersal of investors has curtailed lenders' ability to do workouts.

Self-Correction Sought

In taking the aggressive actions that they have, lenders are aiming to save themselves huge amounts of money by avoiding short sales on hundreds of thousands of houses.

But they're also trying to show federal financial services regulators like the Federal Reserve and members of Congress that draconian steps in the form of new laws and regulations aren't needed. Indeed, should the federal government overreach in an effort to help borrowers, housing could get hit with an even tougher problem: a credit crunch, as liquidity for mortgages dries up.

"Careful consideration of the macroeconomic impacts of new laws or regulator guidance is required so that we avoid making the current subprime issues even worse," Sandor Samuels, executive managing director of lending giant Countrywide Financial Corp., told the Senate Banking Committee in late March. Although some proposals on Capitol Hill are under discussion — Sen. Hillary Clinton (D-N.Y.) has proposed a "foreclosure time-out," and Sen. Charles Schumer (D-N.Y.) wants to make federal funds available to help nonprofit groups provide replacement financing — lawmakers largely appear content to point fingers of blame rather than step in with a legislative remedy.

At a hearing in March, Senate Banking Committee Chairman Christopher Dodd (D-Conn.) took federal banking regulators to task for proposing subprime lending guidelines only this spring, long after the first

wave of troubled borrowers broke.

"Our nation's financial regulators were supposed to be cops on the beat," Dodd said. "Yet they were spectators for far too long. How many home owners were sold loans they couldn't afford in the time that the regulators delayed?"

As it is, the guidelines are voluntary, and in their prescriptions, they scarcely rise above the level of normal business prudence, critics say. In a key provision, for example, lenders are directed to take into account borrowers' ability to repay the loan beyond the introductory period — something that critics say lenders should have been doing all along. "Why would lenders ever make such loans?" says Rep. Barney Frank (D-Mass.), chair of the House Financial Services Committee.

Looking Ahead

Although no big push to provide assistance for today's troubled borrowers is in the works, Dodd and Frank, the chairs of committees with jurisdiction over the issue, are gathering ideas from regulators, lenders, industry groups, and consumer advocates for preventing a recurrence of trouble.

The principles Dodd and Frank have laid out center on enforcement against deceptive and abusive predatory lending practices while maintaining liquidity for all types of mortgages. REALTORS® are helping to shape the legislative and regulatory debate. In testimony on Capitol Hill throughout the spring, REALTORS® have made headway with their long-sought call to make the FHA more competitive against subprime lenders by increasing its loan limits, allowing risk-based pricing, and eliminating the minimum down payment requirement.

At a mid-April hearing on the issue, lawmakers on both sides of the aisle agreed on all of these basic reform measures, positioning the legislation for victory once issues not tied to reform — including the use of FHA proceeds to capitalize a housing trust fund — are resolved.

Also enjoying success is legislation backed by REALTORS® to eliminate the tax burden on hard-hit households who've had mortgage debt forgiven by lenders after foreclosure or a short sale. The IRS counts the forgiven debt as taxable income. Reps. Rob Andrews (D-N.J.) and Ron Lewis (R-Ky.) introduced the "Mortgage Cancellation Relief Act" (H.R. 1876) in April, and by the end of April two dozen lawmakers had signed on as cosponsors.

More initiatives from REALTORS® are in the works, but the focus won't just be legislative. Building on a series of popular brochures it's published over the last two years about mortgage financing, including Specialty Mortgages: What are the Risks and Advantages?, NAR is planning beefed-up educational outreach to members and consumers that will include information on working with trusted lenders to safely restructure troubled mortgage debt.

And on the regulatory side, NAR is submitting comments to the Federal Reserve and other agencies on their proposed subprime lending guidelines.

"As the nation's leading advocate for home ownership, NAR believes that all avenues to help consumers should be explored," says NAR President Pat Vredevoogd Combs. "The goal for all — government, lenders, banks, individuals, and REALTORS® — should be to help keep people in their homes."



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