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Mortgage resets: a rude awakening

Ignorance may be bliss, but it could mean a lot of pain for all the players in the subprime crisis when a record number of adjustable rate mortgages reset.

By Les Christie, CNNMoney.com staff writer
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NEW YORK (CNNMoney.com) -- About $50 billion in adjustable rate mortgages reset this month, driving interest rates up for many borderline borrowers. And despite efforts to raise awareness, it doesn't look like anyone is really prepared for what's to come.

"I don't know if there's anything much [borrowers] can do," said Keith Gumbinger of HSH Associates, a publisher of mortgage related information. "Hopefully, they've been prudent about preparing for it, building a nest egg or refinancing the loan."

But most borrowers are likely to just scramble to pay the higher expenses - some of which will jump by 50 percent and come as a big surprise.

According to a survey conducted last month for the AFL-CIO by Peter D. Hart Research Associates, three quarters of borrowers have little clue about how much their payments will increase when their loans adjust. Nearly half don't know how their loans actually reset.

"This survey shows that many homeowners simply are not prepared for the steep rise in mortgage payments that this market inflicts on ARM holders," John Sweeney, president of the AFL-CIO, said in a press release.

When asked whether they were confident or worried about making their monthly mortgage payments over the next few years, 41 percent of homeowners whose adjustable rate mortgages (ARMs) had already reset said they were worried. Only 18 percent of pre-reset borrowers were concerned.

The record round of resets has been getting a lot of attention across the board. Congress, the Bush administration, government agencies, regulators and community groups and lenders all have their own ideas on how to offer relief. Mark Zandi, chief economist for Moody's Economy.com, believes that borrowers are more informed than in the past, but he doesn't see that knowledge translating into better results.

"The success rate for loan modifications is not improving much," said Zandi. "In September, defaults surged."

Zandi blamed the surge, in part, on the sheer number of borrowers seeking help; servicers who need to hire and train new loan counselors are unprepared for the volume.

And technical roadblocks to mortgage modifications are slow to being dismantled. Contractual obligations between servicers and investors who buy the loans can limit the options servicers may offer borrowers.

According to Michele Taylor, a community reinvestment organizer for the Chicago-based National Training and Information Center (NTIC), some investors stand to make less money if a loan is modified, so they're not playing ball.

"We're hearing from servicers, 'Nothing can be done because the investor won't allow it,'" she said. That occurs even when the same servicers have worked out favorable modifications for other borrowers.

Tax and accounting considerations are also hindering workouts. One initiative that could help is the Bush administration's proposal to forgive taxes when mortgage principals are lowered. But any relief action as a result is unlikely to take place before October's record round of resets.

There is a light at the end of the tunnel, however. "We may be approaching a tipping point after which we'll have more success with saving borrowers' homes," said Zandi.

He thinks servicers may move toward giving ARM borrowers an extra three to five years of payments at initial low "teaser rates," giving them a little breathing room until home prices rebound. Unpaid interest could then be folded back into principals and loans refinanced.

NTIC is pushing for a similar freeze as part of its "Save the American Dream" campaign. It's suggesting a two-year moratorium on resets.

But the mortgage situation can't hope to improve until banks tighten lending practices, and it doesn't look like they're quite on track. This past summer, the Mortgage Bankers Association revealed that delinquency rates for loans made in 2006 were rising.

And a new report from investment bank, Friedman, Billings, Ramsey, suggests that as conditions began to collapse during the first half of 2007, lenders still failed to vet borrowers carefully.

According to the report, lenders did not tighten underwriting standards until July or August, when the subprime crisis came to a head. As a result, delinquency rates for these most recent loans are even higher than those for 2005 and 2006.

With so many poorly underwritten loans, future delinquency rates and foreclosures could soar. And while October will be the peak year for resetting ARMs in 2007, new records will be set in early 2008; March will see more than $100 billion in resetting loans.

It could be a bumpy ride. ■

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