Fed's actions prove calming to rate resets; Sub-prime home loan payments are going up modestly -- by just 1% on average in March, a study shows.

Los Angeles Times
April 26, 2008 Saturday
Home Edition
BYLINE: *E. Scott Reckard, Times Staff Writer*
SECTION: BUSINESS; Business Desk; Part C; Pg. 1

The great mortgage reset of 2008 isn't turning out quite as advertised.

Thanks to interest rate cuts by the Federal Reserve, payments on sub-prime loans with expiring "teaser" rates are going up only modestly when the loans start adjusting -- by just 1% on average last month, one study found.

A payment that would have risen by $450 in December is currently going up by no more than $100 and often much less, according to Tom Deutsch, an industry expert who testified recently to a housing panel of Congress.

Last fall, consumer advocates and government officials had raised concerns that increases of several hundred dollars in monthly payments were in store for about 2 million sub-prime loans made to high-risk borrowers at the height of the housing boom.

Defaults and foreclosures are still rising, however -- it's just that the culprit isn't solely the payment shocks once feared.

Instead, industry experts put most of the blame on tumbling housing prices, which have left many borrowers owing more than their homes are worth after making little or no down payment, taking on second mortgages or sucking their equity dry through refinancings.

"Every single borrower with a resetting loan has gotten effectively a mortgage modification in the sense that they are paying significantly less every month than they would have just last December," said Deutsch, deputy executive director of the American Securitization Forum, a trade group for the companies involved in creating mortgage bonds.

Consumer advocates say Deutsch understates the problem of resets. Bruce Marks, chief executive of Neighborhood Assistance Corp. of America, said the troubled borrowers who ask his organization for help often stretched to qualify for start rates of 5% on their loans, not the 7.5% or 8% that the industry says was typical.

That means their loans become unaffordable even if the rate rises just 1.5 percentage points at the first adjustment, as often occurs, Marks said. What's more, he noted, sub-prime adjustable loans are set up so the initial rate can never go down, unlike traditional adjustable-rate loans.

"Payments on sub-prime loans are still going up, just not as much," Marks said.

Even so, without the recent reduction in interest rates, "things would have been worse," said economist Peter Morici of the University of Maryland. "The fact that it is down has made resets easier to swallow and has reduced the level of foreclosures."

Lower short-term interest rates also help certain other adjustable-rate borrowers, including people with home equity lines of credit, which have interest rates at or close to the prime rate. The prime rate, which was 8.25% a year ago, was at 5.25% this week.

Holders of controversial "pay option" mortgages, which allow borrowers to pay so little that the balance rises, also will benefit.

Facing what was shaping up to be the worst wave of foreclosures since the 1930s, the Fed lowered its benchmark rate for short-term loans between banks by 1.25 percentage points in January and by an additional 0.75 of a percentage point March 18.

In response, the index for most sub-prime loans -- a European inter-bank lending rate known as six-month U.S. LIBOR -- fell to 2.4% on March 18, the lowest level in more than three years, a recent Standard & Poor's study noted.

The Federal Reserve cuts were aimed in part at stemming foreclosures and propping up the slumping housing market, which many economists believe has tilted the economy into recession.

But the reduction in interest rates hasn't revived the moribund sub-prime lending market, economist Morici said.

Big investors such as pension funds, burned on mortgage investments, now will buy only those mortgage bonds backed by the safest prime loans or guaranteed by government-sponsored entities. And that, Morici said, has cut off sub-prime lending to potentially worthy borrowers with some credit dings and also loans for self-employed people and others in the "alt-A" loan category between prime and sub-prime.

"That's one reason the housing markets are tanking so badly, especially new-home sales," Morici said.

The Fed also has little control over long-term fixed mortgage interest rates. The average rate on a 30-year fixed-rate mortgage rose to 6.1% after the Fed reduced short-term rates in January because investors feared that the stimulus to the economy might fuel inflation. The rate had moved back down to 5.8% as of Thursday.

Consumer advocates said lower resets were no substitute for the five-year rate freeze that Treasury Secretary Henry M. Paulson Jr. had promoted back in December. Under that plan, many lenders had pledged to leave unchanged the teaser rates for sub-prime borrowers if their payments would become unaffordable because they were rising by 10% or more.

"The important thing for a family getting a [rate freeze] loan modification is that it provides long-term stability," said Kevin Stein, associate director of the California Reinvestment Coalition, who testified last week before the same House subcommittee as Deutsch. "Getting a temporary small increase based on a LIBOR index that can go back up in a few months is not going to do that."

Still, the lower resets are very real for what the industry describes as typical sub-prime borrowers. Their loans might start with an 8% rate for two years, the S&Pstudy noted, then start adjusting twice a year to six-month LIBOR plus 6 percentage points. If LIBOR was 5%, the borrower would pay 11% interest on the loan.

Borrowers who got a loan like that in January 2005 would have paid $734 a month for two years on a $100,000 mortgage, S&P said. The payment would have jumped to $945 a month -- a 29% increase -- in January 2007, when six-month LIBOR was at 5.4%. The borrowers would have been paying even more at that point if not for restrictions on interest-rate increases built into the loan to reduce the payment shocks, S&P noted.

But as of March 18, payment shocks were only about 1%, S&Psaid, compared with 19% at the end of December, before the Fed started cutting rates.

After recent news articles questioned whether banks were properly reporting the interest rates used to calculate LIBOR, it crept back up a bit, to just over 3% last week.

But most sub-prime loans adjust by adding 5.5 or 6 percentage points to the index, meaning adjusted rates would be in the 8.5% to 9% range, not the double digits that had been feared last year when Paulson was promoting a "streamlined modification plan" to freeze the initial interest rates.