



Foolish Mortgages

By Lauren E. Willis

Americans are foolish when it comes to money, whether a borrower or an investor they be. No mortgage is too expensive or too creative, so long as the first monthly payment can be met.

Careless borrowers. As the President pointed out last week, they do not read their mortgage loan documents, and certainly not the fine print.

On more complicated loans, such as adjustable rate mortgages (ARMs), borrowers do not even try to calculate whether they will be able to afford their future monthly payments. According to data obtained by the Federal Reserve, interest rates on more than 9 out of 10 ARMs can adjust upwards by 5 to 12 points or more. But most homeowners with ARMs think their own rates could not possibly increase this much, and nearly all the rest admit they do not know what they can be charged.

Overoptimistic borrowers. They are overconfident about increases in their future income and are in denial about how much their future expenses will rise.

A recent article in *The Review of Economics and Statistics* found that over a third of workers who lost their jobs had predicted just one year earlier that there was no chance of this happening. Borrowers reckon they can control their finances by working more hours, making more commissions, or tightening their spending. But when the children are sick they must stay home, when the customers do not buy there are no commissions, and when an emergency strikes—the car breaks down, the hospitalization is not covered, or the roof leaks—these bills must be paid.

Trusting borrowers. They believe no lender would give them a loan they could not afford. Most have no idea that the lender is paid by investors today, regardless of whether the loan forecloses after the monthly payments go up. Borrowers do not realize that if the interest rates are high enough, the investors who funded their loans do not need every one to succeed.

Borrowers know foreclosure happens, but never expect their own loan to fail. The payments might make their budgets tight, but they

trust “their” loan officer’s assurance that after a year of timely payments, they can refinance at a lower rate.

RealtyTrac reports that over half a million homes have gone into foreclosure this year, about the number of households (renter and homeowner) in New Hampshire. The trend is not slowing, meaning that about 1.2 million U.S. households are likely to enter foreclosure this year. Imagine every homeowner in New York City’s five boroughs facing foreclosure.

Within a year, the monthly payments on about \$1 trillion worth of ARMs will increase. These include “option” ARMs, loans that allow borrowers to pay less than the interest due by adding the amount unpaid each month to the loan principal. Over 70% of homeowners with these loans have opted to pay the minimum, and when these loans reset based on their new balances, the payments can double.

But none of this should be a surprise. Prospectuses for mortgage backed securities on the Securities and Exchange Commission’s public “EDGAR” website have been making default and foreclosure risk clear for years.

A 2001 prospectus for one \$325 million offering acknowledges that loans in its pool “include a teaser rate, i.e., an initial interest rate significantly below the fully indexed interest rate at origination.” As these loans “are underwritten at the teaser rate,” the document warns, “[h]igher risks of delinquency may result” because borrowers who could manage payments at the teaser rate “may not be able to afford the monthly payments when the payment amount increases.”

Even this year, after foreclosure rates zoomed high, subprime lenders have been originating loans without full documentation of the borrower’s income, a Center for Responsible Lending investigation found.

A 2007 prospectus for over \$550 million of securities backed by these loans is explicit:

“There has recently been an increasing number of mortgage loans originated under ‘stated income’ programs, which permit an applicant to qualify for a mortgage loan based upon monthly income as stated on the mortgage loan application....Typically no verification of monthly income is required..., which in-

creases the risk that these borrowers... may not have sufficient income to make their monthly mortgage loan payments. You should consider the risk that a higher number of mortgage loans originated under stated income programs may result in increased delinquencies and defaults....”

But maybe investors carelessly fail to read their securities disclosures; they certainly do not read the fine print. On more complicated products, such as collateralized debt obligations (CDOs), investors might not even try to calculate the expected value of the underlying mortgage assets.

Maybe investors are overoptimistic, predicting that housing prices will not fall and loan payment losses will be recouped at foreclosure sales. They know that foreclosure rates are rising, but never expect their own portfolios to take the hit.

Perhaps investors trust the rating agencies that give these securities an investment grade. They forget that the agencies are paid to rate the securities at issuance, regardless of whether the agencies announce a downgrade after the securities are bought.

The President suggested that financial education is what we need. But the MBAs of CDO investors have not much helped.

The federal banking regulators have issued warnings about risky mortgages, but the music of potential homeownership for borrowers and potential profits for lenders and investors drowns out the government’s advice.

How should we protect our communities and our economy? Prohibiting:

- lending to consumers at teaser rates,
- originating mortgages without full income documentation, and
- rating securities backed by unseasoned nonprime mortgages at investment grade, would be a good start.

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