



## **Bank Acquisitions Raise POA Stakes**

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1 November 2009

Washington-Existing payment-option ARMs (those that haven't been refinanced or already gone bust) are extremely risky loans to have on the books. Which lender/servicers might be on the hook for future POA losses and how did they get to this point? The answer is big commercial banks, and most of the worst trouble was brought into their shops through the acquisition of already troubled lenders.

According to survey figures collected by this publication, the POA business peaked in 2006 with \$348 billion in originations that year, but remained strong through the next year before petering out entirely in 2008.

Two years ago the top funders of POAs were Countrywide Home Loans (now the property of Bank of America), Wachovia Mortgage (bought by Wells Fargo last fall) and Washington Mutual, the failed mega-thrift (also a big player in subprime) that was sold, in a federally assisted merger, to JPMorgan Chase, a company whose former mortgage chief, Tom Wind, publicly lambasted POAs at the peak of the product's popularity.

Between 2005 and 2008 roughly \$830 billion in POAs were funded by lenders of all different stripes. The loan became very popular because it offered consumers four different payment options each month including the risky negative amortization choice.

The product was originated by companies like Countrywide, Wachovia and WaMu. (Wachovia's book of POAs includes billions funded by Golden West Financial, the Oakland-based thrift that first popularized the product in the expensive San Francisco market. Wachovia bought GWF in 2006.)

A recent report penned by Huxley Somerville, group managing director and head of the residential MBS group at Fitch Ratings, said \$134 billion of these securitized loans are set to recast over the next two years. Overall, there are \$189 billion in securitized POAs outstanding. But the Fitch number doesn't include whole loans that remained on the balance sheet of the originator. In total, up to \$400 billion in POAs are outstanding, according to research done by this publication.

Most of the top holders of POAs - BoA, Wells, JPM - would not confirm their current respective exposures to the product but are well aware of what might lie ahead.

Although JPMorgan would not provide current dollar figures, a February presentation by Charlie Scharf, its retail financial services CEO, said that at yearend the bank held \$50.6 billion in POAs - most of it coming from its acquisition of WaMu. Of these, only \$9 billion were categorized as noncredit impaired with JPM taking a 24% markdown on their credit-impaired unpaid principal balance.

A spokeswoman in JPM's Chicago office said the POAs, like all of the loans in the company's servicing portfolio, would be modified if possible through the federal HAMP program if they qualify.

Analysts say the biggest concern over POAs is from the negative amortization option. This feature allows for the loan balance to grow over time to upwards of 125% of the original mortgage amount. In an event known as recast, once the loan hits the balance cap or reaches 60 months in age, the borrower's monthly payment obligation increases from a minimum monthly payment to a fully amortizing principal and interest payment.

Having not demonstrated their ability to make payments at the full rate, option ARM borrowers are at the greatest risk of default resulting from payment shock, Mr. Somerville said, discussing his findings.

A key driver in the worsening severities is the fact that 75% of option ARMs are secured by properties located in California, Florida, Nevada and Arizona, which have experienced average home price declines of 48% from the second quarter of 2006 to the present. But even without further declines in home values, Fitch expects defaults on option ARMs to soar as loan recasts occur, as these borrowers are unable to effectively refinance into alternative mortgage product.

While mods may help somewhat, Fitch believes losses on the product will still be significant.

According to Fitch, so far 3.5% of the approximately one million 2004-2007 vintage securitized option ARM loans have been modified in an attempt to mitigate effects from the payment shock.

Modification types have included term extension, conversion to interest-only loans, interest rate cuts and others. These mods have been somewhat successful, with 24% of modified option ARM loans being 90-plus days delinquent, compared with 37% of the overall option ARM universe.

But because this product initially offers lower payments than would be available after recast, even with substantially favorable mod terms, there may still be material payment shock, according to Fitch. The rating agency expects a high default percentage for modified option ARMs.

Modifications should have some positive impact on the loans but because of their case-by-case nature they will be challenging to apply to the large volume of pay-option ARMs maturing, Sylvia Alayon, vice president of operations for the Consumer Mortgage Audit Center, Fort Lauderdale, Fla., told this publication.

The product has perhaps unfairly tarnished the reputation of ARMs in general, Ms. Alayon said. It's not an adjustable-rate factor [that is a problem], it's payment shock and lack of equity, she said.

Ms. Alayon said there was some logic to payment-option loans at the time they were first made, given they were designed to allow borrowers who were anticipating higher future incomes but were currently limited in resources to start by making small payments - but the poor economy, among the many other aforementioned concerns, has made them ill-suited to the recent economic downturn.

Few if any are originating the loans today. Ellen Bitton, CEO of Park Ave. Mortgage, New York, told this publication they are now considered verboten and she has not seen them used in a long time.

Shane Chalke, president of Tysons Corner, Va.-based Mortgage Harmony, told this publication that while option ARMs seem unlikely to make a comeback any time soon, the banks and credit unions he works with have shown potential interest in hybrid mortgages that shift from one rate to another in a new form modifiable loans that avoid payment shock by only adjusting downward at borrowers' request to match a competitive market rate similar to, but lower than, their current one. Financial institutions appear to have some interest in doing this in order to hang on to customers and manage prepayment risk.

James Comtois contributed to this story.