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## U.S. 'not prepared' for option ARM flood

### Billions in loan 'recasts' expected in 2010-11

By Inman News Feed

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At the end of last summer, I was being interviewed by a radio commentator who at some point in the long Q-and-A asked me whether we should expect another wave of residential foreclosures -- or was the onslaught of busted mortgages over? Confidently, I assured him and my radio audience that the worst was over.

As it turned out, I wasn't completely in the right. There is one grouping of mortgage products that as early as next year will begin to wash through the lending markets in a second wave of damage. Although it's not a large sector, as we learned from the subprime blowout, even mortgage products that are just a small percentage of the total market can create havoc far beyond their initial volume.

This time the problem will come from option adjustable-rate mortgages (ARMs).

Here's the situation: Most option ARMs were written over the years 2005 and 2006 with five-year resets. That means in 2010 and 2011 these mortgages will reprice beyond the introductory bargain rates and most holders will not be able to afford the new payments.

Since the option ARM was negatively amortized, the loan balance actually grew to a balance cap of 100 percent to 125 percent of the original mortgage.

In what industry lingo calls a "recast," once the loan hits the balance cap, or 60 months in age, the borrower's monthly payment obligation increases from its minimum monthly payment to a fully amortizing principal and interest payment.

In an option ARM, you are initially paying out at a lower interest rate but actually accruing at the full interest rate for the life of the loan. In between is the rate at which you are negative on your loan, which is why the principal balance increases.

According to Fitch Ratings Inc., a fully amortizing principal and interest payment is on the average 63 percent higher than the original minimum monthly payment; it could be double depending on the loan attributes and

interest-rate behavior.

Not all, but many of the folks who opted for option ARMs back in 2005 and 2006 were borderline creditworthy, and when these things recast even those homeowners who managed to survive layoffs and a recession probably won't be able to pay the suddenly outsized mortgage payments.

Outstanding, securitized option ARMs (about 70 percent of all option ARMs are securitized) total \$189 billion - and of that, \$134 billion is going to recast over the next two years, says Alla Sirotic, a senior director at Fitch Ratings. "Definitely, this is a product that is going to see one of the highest default rates, probably close to subprime."

The reason is a combination of declining home prices since the original mortgage was created and the negative equity built up over time. About 94 percent of these loans have a higher balance today than they did at origination.

"The original loan-to-value averaged 79 percent at the time the loans closed, and it is approximately 126 percent today. And, that is just the effect of the declining home prices," says Sirotic. "On top of that, negative equity has built up. One hundred percent of these won't default, but it will be large percentage."

It's not as if lenders don't know this next wave is coming, but so many foreclosures and REOs have been washing through the pipeline that it's hard to start in on tomorrow's difficulties when you haven't yet gotten a handle on yesterday's problems.

Fitch Ratings estimates that 3.5 percent of the approximately 1 million 2004-07 vintage of securitized option ARM loans have been modified in an attempt to mitigate effects from payment shock. These efforts have included term extensions, conversion to interest-only loans, and interest-rate cuts.

The success of modifications has been, well, just moderate, with 24 percent of modified option ARM loans being 90-plus-days delinquent in comparison to overall option ARM exposure.

In the universe of loans reviewed by Fitch Ratings, which is non-agency, mortgage-backed securities, option ARMs represent only about 2 percent to 2.5 percent of the total market. Seemingly not a large percentage, but the market doesn't need another set of problems.

"This is unprecedented and we are not prepared. The market doesn't have the systems or methodology in place to handle the sheer volume," says Sylvia Alayon, vice president of Consumer Mortgage Audit Center in Fort Lauderdale, Fla.

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