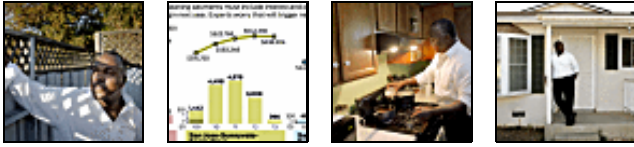


## \$30 billion home loan time bomb set for 2010

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Thousands of Bay Area homes have a ticking time bomb embedded in their mortgage. The homes were purchased with loans known as option ARMs, short for adjustable rate mortgages.

Next year, many option ARM payments will begin to readjust, slamming borrowers with dramatically higher monthly mortgage bills. Analysts say that could unleash the next big wave of foreclosures - and home-loan data show that the risky loans were heavily used in the Bay Area.

From 2004 to 2008, "one in five people who took out a mortgage loan (for both purchases and refinancing) in the San Francisco metropolitan region (San Francisco, Alameda, Contra Costa, Marin and San Mateo counties) got an option ARM," said Bob Visini, senior director of marketing in San Francisco at First American CoreLogic, a mortgage research firm. "That's more than twice the national average.

"People think option ARMs (will be) a national crisis," he said. "That's not really true. It's just in higher-cost areas like California where you see their prevalence."

Of the 10 metro areas nationwide with the most option ARMs, three are in the Bay Area, according to Fitch Ratings, a New York research firm. They are the East Bay counties of Alameda and Contra Costa, the South Bay area of Santa Clara and San Benito counties, and the counties of San Francisco, Marin and San Mateo.

Together, these areas account for the second-most option ARMs in the country, although they are still far behind the greater Los Angeles area (including Los Angeles, Riverside, San Bernardino and Orange counties), according to Fitch data.

### Understated data

First American shows more than 54,000 option ARMs issued here with a value of about \$30.9 billion. Fitch shows more than 47,000 option ARMs here with a value of about \$28 billion. Both say their data underestimate the totals.

Why are so many option ARMs clustered here?

"In markets where home prices were going up rapidly, more and more borrowers needed a product like this to afford something," said Alla Sirotic, senior director at Fitch Ratings. Option ARMs were designed for savvy real estate investors and people whose income fluctuates, such as those paid on commission. Instead, the loans became a tool for regular people to "stretch" to buy homes that were beyond their means.

That's because option ARMs let borrowers choose to make very low payments for the first five years. During that initial period, borrowers can pick their payment option - they can pay interest and principal, interest only, or a minimum monthly payment that doesn't even cover the interest.

Fitch said 94 percent of borrowers elected to make minimum payments only. The shortfall gets added to their loan balance, which is called negative amortization. The amount they owe can grow substantially.

### **The mortgages 'recast'**

After five years, or once the loan balance reaches a certain threshold above the original balance, the mortgages "recast" and borrowers must make full principal and interest payments spread over the loan's remaining life. Fitch said that new payments average 63 percent higher than the minimum payments, but could be more than double in some cases.

"When option ARMs recast, the payment shock is much more intense than we've seen (with other types of loans, such as subprime)," said Maeve Elise Brown, executive director of Housing and Economic Rights Advocates in Oakland, a consumer advocacy group. "That makes them potentially much more damaging."

Unlike subprime loans, which were more commonly used for entry-level homes, option ARMs started out with high balances. In the five-county San Francisco area, option ARMs average about \$584,000 and were used to buy homes averaging \$823,000, according to an analysis of First American data.

That means they'll spawn foreclosures among upper-end homes.

"The mid- to high-end real estate market is already stranded right now," said Mark Hanson, principal of Walnut Creek's the Field Check Group, a mortgage consultant. "Any sort of extra inventory is not going to be welcome for that market whatsoever."

Option ARMs became widespread starting in 2005, which is why the recasts and higher payments will hit starting in 2010, five years later.

Joey Amacker of Newark, who works as an account manager for a catering company, refinanced his home with an option ARM for \$624,000 so he could pull out money to build an addition. The friend who sold him the loan assured him that an option ARM was a safe and affordable product, he said.

Amacker said he initially made only the minimum monthly payment of \$1,800, which covered part of his interest and none of the principal. The amount he owed grew to \$660,000 by November 2008, according to loan documents.

Meanwhile, payments that would cover both interest and principal also escalated above his reach, said Amacker, a single father of twin teenage boys. Although he wanted to pay more than the minimum, "it was a struggle, borrowing from Peter to pay Paul," he said. His 21-year-old daughter moved in to help out, and he rented out the addition he'd built. But he couldn't keep up with the payments. He's been trying to get his bank to modify the loan, but says it doesn't get back to him. The bank did not respond to a request for comment.

Between the negative amortization and his missed payment and penalties, Amacker's total debt has ballooned to \$725,000, while the house is probably worth about \$500,000, he said.

"I feel so ashamed of how I could have gotten myself in such a bad situation," he said.

Like Amacker, most option ARM borrowers owe much more than their homes are worth, so they cannot refinance their way out of trouble.

### **'Significantly underwater'**

"The average option ARM borrower is significantly underwater, so much that they don't think they'll get out," Sirotic said. On average nationwide, option ARM borrowers started out with loans for about 79 percent of their home's value (the other 21 percent may have been covered through a down payment, a second loan or a combination of the two). But now, on average, the amount these borrowers owe is 126 percent of their home's value, based on depreciation and not including the effects of negative amortization, Sirotic said. That means, for instance, someone with a \$600,000 mortgage might have a home now worth only \$476,000.

That could explain the ominously high default rates. Even though most option ARMs have not yet adjusted higher, 27 percent of option ARM loans in the five-county San Francisco metro area are at least 90 days past due or in foreclosure, First American said.

The option ARM scenario will unfold over several years, which offers some hope that there may be time to avert a deluge of foreclosures. The bulk of option ARMs recast dates are spread out from 2010 through 2012. Especially for the loans that recast later, it's possible that a solution will arise, either through rising home prices allowing them to refinance, or through extra intervention from the government or lenders to help these borrowers.

"This will be another factor keeping home prices from recovering," said Cynthia Kroll, senior regional economist with the Fisher Center for Real Estate and Urban Economics at UC Berkeley's Haas School of Business. "It should be a message to policymakers in Washington that there is a big group out there that falls outside the parameters of what's being addressed by current policy."

### **Bay area option arms**

From 2004 to 2008, almost one-fifth of all mortgages, for both home purchases and refinancing, in the San Francisco and San Jose metro areas were option ARMs - more than double the national average. Option ARMs were even more common in the suburban counties of Sonoma (25% of home loans) and

Solano (28%). Though most option ARMs have not yet recast and hit borrowers with higher payments, they are going into default at extremely high rates. One quarter or more of all option ARMs in the regional areas are more than 60 days delinquent or already in foreclosure. Analysts say option ARM borrowers are so underwater that they may be choosing to walk away.

Metropolitan statistical area	% of all home loans originated 2004-08 that were option ARMs	% of 2004-08 option ARMs that are 60-plus days delinquent or in foreclosure
San Francisco-Oakland-Fremont (San Francisco, Alameda, Contra Costa, Marin, San Mateo counties)	19.52%	27.23%
San Jose-Sunnyvale-Santa Clara (Santa Clara and San Benito counties)	19.32%	28.36%
Santa Rosa-Petaluma (Sonoma County)	25.31%	24.94%
Vallejo-Fairfield (Solano County)	28.12%	36.91%

\$584,000

Average option ARM loan in 5-county S.F. metro region

54,000

Number of option ARMs in Bay Area

\$30.9 billion

Bay Area option ARM loan balance

Source: First American CoreLogic

94%

Borrowers who make minimum monthly payments

79%

Average loan-to-value ratio when loans were made

126%

Average loan-to-value ratio now

39.3%

Option ARM borrowers who are 60+ days delinquent

Source: First American CoreLogic and Fitch Ratings

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<http://sfgate.com/cgi-bin/article.cgi?f=/c/a/2009/09/20/MNOR19N2B1.DTL>

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