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REAL ESTATE FirstFed Grapples With Payment-Option Mortgages

Loans Could Be Next Nightmare For Banking Sector

By RUTH SIMON
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LOS ANGELES -- Like many mortgage lenders, FirstFed Financial Corp. is struggling with rising losses. The bank posted a loss of nearly \$70 million in the first quarter -- reversing years of profit. Forty percent of its borrowers became at least 30 days delinquent after the payments on their adjustable-rate mortgages were recast. The number of foreclosed homes held by the bank doubled in the second quarter from the first quarter.

But FirstFed isn't another bank grappling with the fallout from subprime mortgages that went to less-creditworthy borrowers. In fact, FirstFed was ranked last year as one of the top five banks in the nation by a trade publication, partly because it appeared to have pared back on risky mortgage loans. Yet this year, the Los Angeles bank is on the front lines of what could be the next big mortgage debacle: payment option mortgages. These loans went mainly to people with good credit, but they are likely to experience defaults that are nearly as high as -- in some cases higher than -- those for subprime.



Babette Heimbuch

Barclays Capital estimates that as many as 45% of option ARMs, as they are often called, originated in 2006 and 2007 could wind up in default. Another analysis, by UBS AG, suggests that defaults on option ARMs originated in 2006 could be as high as 48%, slightly higher than its estimate for defaults on subprime loans. Both studies looked at loans that were packaged into securities.

Option ARMs typically carry a low introductory rate and give borrowers multiple payment choices, including a minimum payment that may not even cover the interest due. Borrowers who make the minimum payment on a regular basis -- as many do -- can see their loan balance rise, known as negative amortization. Monthly payments can increase by 60% or more once borrowers begin making payments of principal and full interest. That typically happens after five years or earlier if the amount owed reaches a preset amount, typically 110% to 125% of the original loan balance.

FirstFed's experience highlights the challenges lenders face as option ARMs recast. That is happening earlier at FirstFed than at some other banks because it set a 110% cap on many of its option ARMs, while many other lenders have higher caps.

FirstFed is a relatively small lender, with just \$7.2 billion in assets. Babette Heimbuch, FirstFed's chief executive, says that option ARMs were "a very good loan for the borrower and the bank" for more than 20 years. But that changed, she said, when investment-banking firms entered the industry and set lower lending standards, which FirstFed and others followed.

For most of the product's history, Ms. Heimbuch says, the introductory rate on an option ARM was one to two percentage points below the actual interest rate on the loan. As long as interest rates were flat or falling, the minimum payment was enough to cover the interest due, making the option ARM equivalent to an interest-only loan in the early years of the mortgage.

But around 2003, as home prices accelerated, lenders began pushing mortgages that made payments more affordable. As competition increased, lenders dropped the introductory rate on option ARMs to 1% or even lower and made more loans to borrowers who didn't fully document their income or assets. FirstFed was initially reluctant to follow the crowd. But as mortgage brokers took their business to other lenders with easier terms, FirstFed's mortgage originations declined to \$366 million in the second quarter of 2003, from \$389 million a quarter earlier. At the same time, its existing borrowers refinanced into new loans at other banks that offered easier terms. "The fear was that at the rate loans were paying off we were going to have to close the company down," says FirstFed President James Giralдин.

Rather than shut its doors, FirstFed joined the crowd and business boomed. But as the Federal Reserve boosted short-term rates, the gap between the introductory rate, used to set the minimum payment, and actual rates swelled to as many as 7.5

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percentage points. That meant that borrowers making the minimum payment weren't covering even the interest due.

FirstFed started to pull back in mid-2005 and, as a result, didn't see a big jump in delinquencies until loans began recasting in the second half of 2007. Others lenders are seeing borrowers fall behind even before recasts.

Now, as loans are recasting, FirstFed is scrambling to modify the loans of borrowers who can't afford the higher payments. As of the end of June, nonperforming assets climbed to 8.2% of total assets, compared with 0.85% a year earlier.

Instead of waiting for borrowers to fall behind, the company sends borrowers letters as their loan balances swell, offering them a chance to modify their mortgages. From January through June, the company had modified 705 loans totaling \$345 million.

There have been unexpected hurdles. Many borrowers took out home-equity loans with other lenders after getting an option ARM from FirstFed. These borrowers account for 25% of FirstFed's mortgage loans but represented nearly 50% of its delinquencies in the third quarter of 2007, the company says. It is harder to modify the terms of these loans because FirstFed often needs the approval of the holder of the home-equity loan.

In addition, many borrowers submitted loan applications that overstated their financial condition, making it more likely that they won't be able to afford even a modified loan. FirstFed figured that some borrowers had fudged their incomes and tried to protect itself with tighter credit standards. "But we were shocked by the magnitude of the lies," Ms. Heimbuch says. "You expect a 20% fudge. You don't expect 500%."

Dien Truong, a 35-year-old, water deliveryman, pulled out \$156,000 in cash when FirstFed refinanced the \$628,000 mortgage on his Richmond, Calif., home in 2005. Mr. Truong used the money as a down payment on another home and turned the FirstFed home into a rental property. But the \$2,500 a month he collects in rent is no longer enough to cover his mortgage payments, which have climbed to roughly \$5,100 from \$1,618.

FirstFed offered to refinance him into a new loan with payments of roughly \$4,250 for the first five years, but Mr. Truong says he can afford only to pay the \$2,500 in rental income. Because he has been making the minimum payment, his loan balance has climbed to more than \$690,000, which is more than the home is worth.

"I've been a good customer," says Mr. Truong, who hasn't made a loan payment since March. "This time my credit will be screwed up for good." His loan application shows that Mr. Truong and his wife earn \$165,000 a year, more than double their actual income, says Katrina Vizinou, a housing counselor with Community Housing Development Corp. of North Richmond. Like Mr. Truong, she says, many borrowers say they didn't read the application until later.

Frederick Cannon, an analyst with Keefe, Bruyette & Woods, believes the company should be "well enough capitalized" to absorb the losses.

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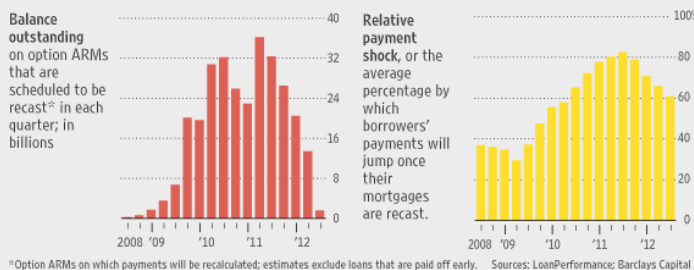
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The next blow to the housing market could come from 'option ARMs.' Borrowers who opted to make a minimum payment on these loans could see their monthly payments jump when they begin to make full payments. Many of them now owe more than their homes are worth.



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