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Affordability Over Sustainability - A Cause of the Mortgage Crisis

by: Markham Lee

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On a fairly regular basis, we hear about companies that are in trouble due to a “failed product launch”, a “faulty product”, or just bad products in general. As these companies struggle to get back on track, commentators, analysts and pundits will criticize the company for designing and selling products that are behind the times, aren’t on par with competitors, etc. The company’s executives will talk about a “renewed commitment to innovation”, tout the virtues of the new products, etc. No matter how you slice it, the company (or in some cases, an entire industry) is in trouble due to producing a series of bad products.

When it comes to mortgage lenders, I think we can say pretty much the same thing: various companies are in trouble due to the production, marketing and sale of a lot of bad “financial products”. Whilst much of the talk around the mortgage crisis has revolved around “bad lending standards”, “toxic waste ARMs”, “Alt-A loans with false information”, etc, not enough talk has focused on the fact that many of these loan products were simply bad ideas in the first place, due to the fact that they put the customer in a precarious and unsustainable financial situation.

I listen to local radio stations on a fairly regular basis with my tastes ranging from the Classical Music, Jazz, Classic Rock, NPR, and the drive-time talk shows aimed at the “football watching, maxim reading, rock listening, 18-35/yr old male” crowd. One commercial is a constant on nearly every station, a commercial from a local mortgage firm that advertises a “flex-30 mortgage” which provides you with a fixed interest rate, but also gives you the option of paying a lower minimum payment when necessary. The loan is touted as a way to “save the consumer money” and “increase your monthly cash flow”.

I’ll turn on the television and often see commercials (albeit not as many as last year) touting interest-only mortgages, mortgages with flexible terms, etc – all marketed as loan products that will “save the consumer money”. In the days prior to the mortgage crisis, I saw commercials touting ARMs in a similar manner: “A loan product that will make home ownership more affordable”.

I recently browsed the web sites of various lenders and reviewed their ARM, interest only and flexible payment/negative amortization loan offerings, and found they were ALL positioned as tools to help you “afford more house”. It’s almost mind boggling when you think about it, the bank has designed and positioned a product where the borrower isn’t likely to be able to pay back the loan over the long-term. The teaser rate payment is often near the max of what the buyer can afford, so once the ARM, flex-payment or interest only mortgage recasts or resets, the buyer has a payment they can’t afford.

The problem with these products (as many are now well aware) is that they don’t in fact make home ownership more affordable, and over the long-term, put the borrower into a financial situation that is unsustainable. Better put, some of these loans are just bad ideas in the first place:

- A customer who takes on a “minimum payment negative amortization loan” is effectively agreeing to have their initial loan amount increased by 10-15% (or more), on top of the interest expense of the minimum payments. This loan may be touted as “cheaper” or “putting more cash in the borrower’s pocket”, but over the medium to long term, we know that just isn’t the case.
- Let’s say a borrower in the 28% tax bracket borrows \$300k via a 5-year interest-only loan that later converts to a mortgage with a fixed prime rate of 6.75%. This borrower will pay the bank \$85,438.80 in interest, then pay off the \$300k loan balance via a regular fixed rate mortgage, effectively agreeing on a \$385,438.80 mortgage and that’s before the interest expense incurred whilst paying the \$300k.
- ARMs have been covered to death, so we know the story here; even if your ARM resets to a prime low rate mortgage, the payment jumps significantly. A borrower with a \$300k loan and a 4% teaser rate that has their ARM loan reset to a prime rate of 6.75% sees their payment jump from \$1,485.64 to \$1989.68. The lender allowed the borrower to take on an ARM where they could only really afford the teaser

payment, so when the real payment kicks in (even at prime) the borrower winds up in default.

Now, some of these issues can be cleared up by better lending standards, namely by limiting the borrower to a monthly payment that he/she can afford AFTER the ARM/interest-only/negative amortization loan resets, recasts, etc. However, it doesn't change the fact that in many cases, even under the best of circumstances, the borrower has made a bad decision and is only increasing their borrowing costs and total purchase cost of the home. Considering that many lenders built a business around borrowers making bad decisions for the largest purchase of their lives, is it no wonder that many are in trouble right now?

With financial stocks so beaten down right now, many analysts are touting various financial stocks as buys due to the "relatively" low price. Instead, I think investors need to be asking the hard questions:

- Are the "specialty loan products" of a particular bank positioned as tools to help the borrower afford "more house" even though they'll inevitably result in more expense for the buyer?
- What % of the bank's loan portfolio is made up of "specialty" or "exotic" loan products?
- Looking through the bank's web site, marketing materials, talking with their loan officers, etc., has the bank really stopped originating various exotic loans? Is the bank positioning them properly?
- After reading through the terms of the bank or lenders various loan products, do they seem like wise choices to you?

What impact will a significantly more educated consumer have on the lender?

On a near weekly basis when the stock of a lender or bank takes a nose dive, sometimes the stock of another company is pulled down with it. This company nearly always issues a statement noting that they're not a subprime lender, touting the FICO scores of its borrowers. However, if you ask me that's not even the point. By now, we know that prime borrowers who took on questionable loan products, Alt-A loans, etc, are probably going to be a bigger problem. Instead, the statement from a lender that would give me confidence would be for them to note having a very small % of exotic mortgages in their overall portfolio, and that they're implementing plans to either phase out or greatly reduce the number of exotic mortgages they originate in the future.

A bad product is a bad product, if you want to make bets on lenders, banks, financial firms, etc. that are going to emerge victorious from the current credit crisis, look towards lenders that are shying away from exotic mortgages or never really played in that sandbox in the first place. Looking at the loan offerings of many lenders, (even those in trouble) it appears that many are choosing to stick with these faulty products, and instead believe their troubles are the result of needing to merely "tweak" their lending standards, get cheaper funding, improve liquidity, "fear" within the credit markets, etc. Instead, these lenders should be saying to themselves: "would I take on this kind of loan, is this type of loan even a good idea in the first place?"

Disclosure: The Author doesn't own shares in any of the companies listed in this article.

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