Foreclosures may jump as ARMs reset

NEW YORK (AP) - In 2003, Anita Britten refinanced her two-story brick cottage in Lithonia, Ga., using a hybrid adjustable rate mortgage or ARM. Her lender reassured her that she could refinance out of the riskier loan into a traditional one when her interest rate started to reset.

Three years later, Britten can't get a new mortgage and her monthly payment has jumped by a third in six months. She can't afford her payments and may face foreclosure if her financial situation doesn't change.

As more ARMs adjust upward and housing prices begin to dip, many Americans like Britten can't refinance and are finding themselves trapped in too-high monthly payments. For those who can't make their payments, foreclosure — the legal process by which the lender repossesses the house because the owner has defaulted on payments — is the only way out.

Foreclosure figures just released by the Mortgage Bankers Association show that foreclosure activity fell in the first quarter of 2006 over the first quarter of 2005 for all loan categories except subprime loans. The MBA didn't specify how many subprime loans were adjustable rate mortgages.

But while a strong economy helped hold down the foreclosure rate in the first quarter, homeowners and experts fear the market has turned and numbers are headed upward.

In the last several years, millions of Americans took equity out of their houses and refinanced when interest rates were at historical lows and housing prices were at record highs.

Many of them chose to refinance into hybrid ARMs that lenders were aggressively pushing. ARMs, which featured a low introductory interest rate that resets upward after a set period of time, were easier to qualify for than traditional fixed-rate loans.

ARMs are now starting to fall by the wayside as the difference in interest rates narrows. The average rate on a 30-year fixed rate loan in May was 6.60 percent compared to 5.63 percent on a one-year ARM, according to Freddie Mac. In 2003, rates on a 30-year fixed were at 6.54 percent, while ARMs carried a 3.76 percent rate.

This year, more than $300 billion worth of hybrid ARMs will readjust for the first time. That number will jump to approximately $1 trillion in 2007, according to the MBA. Monthly payments will leap too, many beyond what homeowners can afford.

For example, Britten's monthly payment jumped from $1,079 to $1,340 at the beginning of this year. It rose again on June 1 by another $104 and is scheduled to increase again in December. Britten, who is also paying off student loans, went to a credit counseling service to help her avoid foreclosure.

"I've gotten rid of all my credit cards and I'm not supposed to refinance for another year," she said. "All I can do is tread water right now."

"ARMs are a ticking time bomb," said Brad Geisen, president and chief executive of property tracker Foreclosure.com. "Through 2006 and 2007, I'm pretty sure we'll see a high volume of foreclosures."

Last year, foreclosures hit a historical low nationwide at about 50,000. But that number has more than doubled since then, according to Foreclosure.com.

And delinquency rates appear to be rising, as well. While delinquency rates fell for most types of loans from the fourth quarter of 2005 because of a stronger economy, delinquencies for both prime and subprime ARM loans increased year-over-year in the first quarter, according to the MBA.

The hardest hit states so far are those that have experienced the roughest times economically. Michigan, Texas and Georgia lead the pack, specifically around Detroit, Dallas and Atlanta, whose major employers have run into strikes, bankruptcies and industry downturns.

But as the housing market slows, experts expect foreclosures to skyrocket in those areas that have experienced the highest appreciation rate — like California, Florida, Virginia and Washington, D.C.

"There is a direct correlation between foreclosure sales and market activity," said Dr. James Gaines, a research economist at The Real Estate Center at Texas A&M University. "If the rate of appreciation is not there, then there is an increase in foreclosure sales."

Gaines pointed out that although California's default notices are rising by the thousands, actual foreclosure sales remain in the hundreds. Because of California's still-active housing market, homeowners there can sell their properties before going into foreclosure.

Anita Britten sits in front of her home in Lithonia, Ga.

On the flip side, in less active markets like Texas and Georgia, homeowners can't find a buyer in time and are forced into foreclosure.

But as the housing cools in these once hot markets at the same time that ARMs reset, many homeowners may be unable to dump their properties before going into foreclosure, Gaines predicts.

Additionally, Gaines pointed out that these same real estate markets also boasted a higher percentage of ARM originations, because most buyers could only get into their homes using an unconventional loan.

California, where the median home price reached $468,000 in April, leads the nation in the percentage of homes purchased with adjustable rate mortgages. Nationwide, ARMs account for 24 percent of all home loans.

"In our zeal to make mortgage lending more available to a greater number of people, it's normal to expect the foreclosure rate to go up," Gaines said.

Even investors in foreclosures are having a harder time finding good deals, as the housing market cools. Many homes that do end up in foreclosure auctions are saddled with more than one mortgage and have little or no equity — so the investors take a pass.

Falling home values are also affecting homeowners' ability to refinance into a traditional 30-year fixed rate loan to avoid foreclosure.

In 2002, Christopher Jones, 32, refinanced into a hybrid ARM with plans to refinance again when the rate started to readjust. At the time, his downtown Atlanta house appraised for $108,000.

Now, his monthly payments have shot up, but Jones can't sell his house for more than $84,000 and he can't get an appraisal for more than $85,000.

The appraisal firm told Jones that the value of houses in his neighborhood have fallen victim to a cooling market. With no other options left, Jones has decided to pack it in and foreclose on the house.

"I'm just going to take the loss," he said. "That's all I can do."

Some homebuyers, especially first-time buyers, may not have fully understood the risk of ARMs. In the rush to close on a house sale, especially in the frenzied market of the past few years, many first-time buyers often failed to get the full details of their loan from their mortgage broker.

"Sometimes buyers are very optimistic of how much mortgage they can handle, especially in a strong housing market with aggressive marketing of riskier mortgages," said Suzanne Boas, president of Consumer Credit Counseling Services of Greater Atlanta.

When Dora Angel of DeSoto, Texas, bought her first home in 2003, she paid $141,000 for the brand new three-bedroom, two-bath home. At the time, her mortgage payment was $1,400 a month.

DeSoto originally thought that she had a fixed-rate loan. But about five months ago, she noticed that her monthly payment kicked up to $1,900. She only made the monthly payments by sacrificing payments on her credit cards, which pulled down her credit rating.

Now, DeSoto can't continue paying $1,900 each month, but, because of her credit ranking, she doesn't qualify for a fixed-rate mortgage.

"I was a first-time buyer. I was blind. I didn't know what questions to ask," she said. "And the mortgage brokers are there telling you what you want to hear just to get you in the mortgage."

Unfortunately, during a runaway market, many buyers, sellers and mortgage brokers were more excited about making deals than making smart deals, and the fallout has just begun.

"We are on the front of this ARM problem. It will roll out over the next several years," Boas said. "Owning a home is the American dream, but losing one is the ultimate nightmare."