FINANCIAL FAQs

How Dangerous Are the "Hybrid" Mortgages?

Fed Chairman Greenspan warned Congress in his Midyear Monetary Policy Report on July 6. "The apparent froth in housing markets appears to have interacted with evolving practices in mortgage markets," he said then. "The increase in the prevalence of interest-only loans and the introduction of more exotic forms of adjustable-rate mortgages (ARMSs) are developments of particular concern. To be sure, these financing vehicles have their appropriate uses. But some households may be employing these instruments to purchase homes that would otherwise be unaffordable, and consequently their use could be adding to pressures in the housing market."

How dangerous are such hybrid mortgages? Loans that require interest-only monthly payments for the first few years have zoomed from nowhere 10 years ago to one-third of all new mortgages. These loans account for more than half of both jumbo mortgages (those above $360,000) and "alternative-A" (or "alt-A") loans (those that are not conforming, jumbo, or subprime, often for investment properties and second homes). Jumbo mortgages are concentrated in California and a sprinkling of major metro areas, including New York, Washington, and Boston. Anecdotally, most of the increase in alt-A mortgages is for second homes rather than investment properties, but the data to prove this are not available.

But interest-only (and 40-year amortization) mortgages are probably less a problem for lenders than many people think: Even the slight buy-down of principal provides mortgagors some extra cushion, especially beyond the first two years. Yet, lenders are making what in the past would have been considered a dangerously risky bet when they use these instruments to sell houses to people who otherwise couldn't (and maybe shouldn't) buy them. Lenders are willing to go out on such a limb in search of higher yields in this low-interest-rate environment.

ARMs—which include most interest-only loans—are becoming more popular as well. About 35% of new mortgages are adjustable, but only 12% of these adjust in two years or less. The rise in ARMs is unusual, since they're normally most popular when interest rates are high instead of at historical lows. And in fact, it turns out that most of the increase reflects the popularity of the new "hybrid" mortgages, which have fixed rates for three to 10 years, and for most homeowners are essentially fixed, since most mortgages last less than seven years before sale or refinancing.

If mortgage rates rise slowly and moderately, even consumers with interest-only and adjustable mortgages should be able to manage their monthly payments. However, if rates jump more sharply than expected, they could cause problems. A wave of adjustments will come in the first half of 2006, the first for the two-year refinancings of early 2004. The reaction of households to these may tell us what to expect ahead.

Be that as it may, the affordability index from the National Association of Realtors, which measures median income relative to the monthly payment needed to buy the median house (including interest, taxes, and insurance), is at its highest level since the early 1970s. Home ownership, at 64% of households in 1994, has thus climbed to its highest level in history—69.4%.

That said, we assume that home price appreciation will slow sharply enough over the next five years to return the ratio of average home price to average (after tax) income to its historical level of 2.6. In this scenario, there's a sharp drop in housing starts, from an estimated 2.02 million this year to 1.70 million in 2008. Yet home equity continues to rise, albeit sluggishly, and there is little impact on consumer spending. The saving rate holds near 1%, the unemployment rate near 5%, and the economy continues to grow by 3%-3.5% a year, near its potential trend.

Could a sharper home-price decline hurt the economy? It depends. If instead of stabilizing, home prices drop an average 20% over the next two years, the ratio of the average house price to income would fall to 2.5, below its historical average. That would take more than $2 trillion out of household wealth and about $100 billion out of consumer spending—cutting GDP by less than 1%.

A collapse of the housing business—which we define as starts falling more than 50% from current levels—could have a larger effect. The resulting severe recession in the home building business, plus an associated drop in consumer spending as cash from refinancings dries up, would further slow the U.S. economy.

However, a collapse in home prices probably would persuade the Fed to lower interest rates to shore up the economy. Should prices drop 20% nationwide and new home starts fall 30%, we would expect about a one-percentage-point drop in the federal funds rate, which would restore about half the GDP losses within two years. The net result would be 1.2% real GDP growth in 2006 versus the 3% expected in our baseline forecast. In such an event, the economy would recover in 2008 and 2009 (see Table 2).

But if the past is a guide, home prices are less likely to crash nationwide than to stop accelerating and then stabilize until incomes catch up with unsustainably high mortgage debt. This happened after home price spikes in the late 1970s, and again in the late 1980s. The coming rebalancing period could last half a decade, because it will take a 20% correction nationally to restore the normal ratio of home prices to incomes.

For now, in fact, there are few real signs of stress in the housing market. Delinquency rates (the percentage of loans more than 30 days overdue) have dropped to 1.40%, after peaking at 2.39% in the spring of 2001: In a period of rising home prices, defaults are rare because it's easy to sell a house for enough to cover the mortgage. Even in a default, moreover, the collateral will cover the loss to the lender. That explains why bank mortgage-related losses remain negligible, at 0.08% of outstanding balances.

It is not easy to read future tea leaves, nor the direction of oil prices, nor future fiscal and monetary policies, nor the reaction to all of these by financial markets. So we won't. We are still in the conundrum of low fixed interest rates occurring as our economy nears its full production capacity. Suffice to say, that in such a fast changing world, we must be prepared for catastrophic economic events as well as hurricanes and tsunamis.

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