They're In -- but Not Home Free; Many Californians have 'interest- only' loans. They might be living on borrowed time.; [HOME EDITION]

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Abstract (Document Summary)

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It's good to be a homeowner. Herron knew that three years ago, when she saw a place she liked for $169,000. She could have gotten a mortgage, but this was before interest-only loans were widely available and she didn't think she could swing the payments. "I was being fiscally responsible," she said.

Risky debt; CREDIT: Los Angeles Times; GRAPHIC: More homeowners; CREDIT: Los Angeles Times; HOPEFUL: Rachael Herron with her cat Adah in her Oakland condominium, which she purchased with an "interest-only" loan.; PHOTOGRAPHER: Robert Durell Los Angeles Times

Full Text (2345 words)

Rachael Herron's new condo will ensure her financial salvation -- unless it provokes her ruin.

Herron put no money down for her tidy one-bedroom, borrowing the entire purchase price of $211,000. To keep her monthly payments as low as possible, she got an adjustable-rate mortgage that won't require her to pay any principal for three years.

Thanks to her "interest-only" loan, the 911 police dispatcher was able to afford, barely, her first home. She now has a stake in California's sizzling real estate market. As her home increases in value, she plans to use some of that equity to pay down her credit cards.

But Herron is also setting herself up for a day of reckoning: Nov. 1, 2007.

That's when she has to start paying off her loan principal. If interest rates are higher than when she bought her home last fall -- something many economists consider probable if not inevitable -- her monthly payment will increase by as much as a third.

"I don't know what I'll do," said Herron, 32. "I'm already working overtime to pay my bills."

Confronted with soaring home prices, Californians are adopting a "buy now, pay later" strategy on a massive scale. The boom in interest-only loans -- nearly half the state's home buyers used them last year, up from virtually none in 2001-- is the engine behind California's surging home prices.

But all that borrowed money might be living on borrowed time. When higher bills start coming due, Herron and hundreds of thousands of other homeowners in the state will have to find ways to cope -- or will have to sell.

In the most dire scenario, if they owe more on the home than it's worth, they'll simply walk away. Abundant foreclosures could spark a downturn in the entire housing market, leading to the long-feared bursting of what some call a housing bubble.

Interest-only loans, and other forms of so-called creative financing that are far riskier than the traditional 30-year fixed- rate mortgages, have allowed more people to afford homes in California even as prices have skyrocketed.

When the price of houses in California soared 17% in 2003 and 22% in 2004, a curious thing happened: Instead of home ownership decreasing because fewer people could afford houses, it rose to record levels.

During the last two years, according to U.S. Census Bureau data, home ownership in the state rose to 59.7% from 57.7%. The previous record was 58.4%, measured during the 1960 Census.

Although homeownership in California traditionally lags behind that in the rest of the nation -- the U.S. rate in 2004 was 69% -- the 2-percentage-point increase during the last two years was greater than in all but about a dozen states.

Rather than closing the door, lenders have apparently been opening it wider, inviting in people like Herron who would not have qualified for a mortgage under the more rigorous standards of an earlier generation.

"If you can fog a mirror, you can get a home loan," said mortgage analyst Ralph DeFranco.

An interest-only loan offers the ability to defer for three, five or seven years any payment for the house itself. That allows a potential buyer to stretch to afford a place that otherwise would be out of reach.

Of course, everyone else using an interest-only loan can stretch too. The result is that prices keep rising. That, in turn, encourages still more people to use interest-only mortgages, which fuels still more appreciation.

In 2001, as the current housing boom got underway, fewer than 2% of California homes were bought with interest-only loans, according to an analysis done for The Times by LoanPerformance, a San Francisco mortgage research firm.

By last year, the level had risen to 48%. Nationally, LoanPerformance says, interest-only loans were used in about a third of all purchases.

What's propelled the market up in California, some experts worry, could just as easily speed its descent.

"In the last few years, rates went down and values went up. It's like you were paid to live in California," said analyst DeFranco, who works for LoanPerformance. "People got so used to refinancing. They'd think, 'No problem. My house will be worth twice what I paid, and I'll refinance my way out of trouble.' That's not going to be a good approach going forward."

Here's how he thinks a collapse could occur: Rising interest rates put a brake on price appreciation and refinancings. People realize their interest-only period is coming to an end, raising their monthly payments substantially. Since they have no equity in the house, they choose to default.

"If housing prices go down or even are flat, heaven help us," said DeFranco.

The notion of prices falling in California goes so contrary to the current environment it's almost laughable. In the San Francisco Bay Area, probably the state's strongest market, it's routine for houses to get more than a dozen bids. To win a house, a buyer often needs to pay a third over the asking price. A four-bedroom Berkeley house went on the market in February for $985,000 and promptly sold for $1.5 million.

The last statewide downturn in housing came 15 years ago, sparked by large job losses in Southern California's defense and aerospace industries. Nothing like that is happening now. Many experts forecast prices to continue to rise, but more moderately.

Federal Reserve Chairman Alan Greenspan has a different point of view. "I do believe it is conceivable we will get some reduction in prices, as we've had in the past," he told a House of Representatives hearing in February. But he added that this wouldn't be a problem, because housing prices had gone up so much, providing homeowners with "a fairly large buffer."

People who buy at the peak, however, aren't going to have that buffer -- or, if they have an interest-only loan, much room to maneuver.

The number of buyers falling into this category in any given month is unclear. But a California home builder recently got a sense when he sought to answer this question: How many of the potential buyers of his houses could still afford them if interest rates went up even a little?

To find out, the builder conducted a little experiment.

His firm's preferred lender had pre-qualified 90 potential buyers for a group of new houses. Since the houses wouldn't be ready for another six months, the builder tightened the loan criteria. He didn't want buyers to sign up for a house and then get frightened into canceling by rising rates.

He raised the threshold from a fully variable loan, the easiest to get since it immediately moves upward when rates increase, to a mortgage that was fixed for the first three years. That would shield buyers from rate jumps for at least a little while, but it's also more expensive.

Under the higher threshold, only about 15 of the buyers still qualified.

"People are really pushing to borrow as much as they can, and the lenders are right there," said the builder, who declined to be identified. "There's apparently not much of a cushion."

The Federal Reserve regularly queries banks about whether they're tightening or loosening credit standards for home mortgages. In four of the last five quarters, standards were loosened. The combined drop was the biggest in more than a decade.

Meanwhile, the range of home mortgage products keeps expanding. Some lenders offer mortgages that are spread over four decades rather than three. Others extend the interest-only period to 10 or 15 years, or offer programs allowing those who have what is called "difficult to document" incomes to put only 5% down.

"A few years ago, you would have had to go to an infomercial to get the kind of deals we're offering now," Wells Fargo home mortgage consultant Jimmy Kang told a group of new real estate agents last week.

Two weeks ago, the Fed raised short-term interest rates, which caused adjustable rates to spurt. But that only increased their popularity. The Mortgage Bankers Assn. said adjustables rose last week to a record high of 36.6% of all mortgages nationwide, exceeding earlier peaks in 1995 and 2000.

In California, the traditional fixed-rate loan is in danger of becoming extinct. According to recent LoanPerformance data, the percentage of new loans that are adjustable in Santa Cruz and San Diego was 85%; in Oakland 84%; in Santa Rosa 81%; in Los Angeles 74%.

Many of these loans are also interest-only, compounding the borrowers' risk of what the mortgage industry calls "payment shock."

Owning real estate in California has always been a matter of hope -- that ground zero of the next big earthquake won't be under the kitchen floor, that the house won't slip downhill in a mudslide or combust in a wildfire. Real estate agents around the state say their clients are equally optimistic that payment shock will never arrive.

"They say they'll worry about tomorrow when tomorrow comes," said Glendora agent Steve Robinson, who says half his clients use interest-only loans. "Right now their worry is, 'How can I get into this house as cheaply as possible?' "

Christopher Stafford, a San Francisco agent who says nearly two- thirds of his clients use interest-only loans, said prices had risen so much for so long that clients had a hard time conceiving of anything bad happening.

"In 12 years of selling real estate, I've never heard anyone tell me they wished they had purchased a smaller house," said Stafford. "They always say, 'If I'd known what was going on, I should have stretched further.' "

If disaster does strike, he believes, the housing market will be propped up. "The real estate economy is too important to the country and the state," Stafford said. "Lenders don't want foreclosures. They'll introduce new loan products that will allow people to stay in their properties."

The California Housing Finance Agency, which helps first-time home buyers, announced Friday that it too will be offering an interest-only loan. Its version is less risky, because the loan is fixed for its entire life, which is 35 years instead of the standard 30.

But it still bumps up after five years, when repayment of the principal starts. On a $300,000 loan, it moves up about $340, to $1,657 a month.

"We had great debates whether we should be doing this or not," said the agency's executive director, Theresa Parker. "What happens to people in five years if they can't make these larger payments?"

In the end, she said, they decided not to be "paternalistic," especially since the customers wanted and needed this type of loan.

Proponents of interest-only loans like to note that Californians tend to move every couple of years and that therefore many will escape payment shock. On the other hand, many people move to get into a better house, something that will be less attractive if interest rates keep going up.

Amy Matzenbacher and her fiance, Chris, a restaurant manager, are closing this month on their first house, a three-bedroom in Palm Springs that cost $495,000. They're borrowing $60,000 from their parents for a down payment, and financing the rest with an adjustable-rate loan that is interest-only for the first three years.

"We will be extremely nervous if we decide to stay longer than three years in that house and interest rates skyrocket," said Matzenbacher, a cocktail waitress in Del Mar. "We are just banking on the hope that the home will gain enough equity by the time we sell."

It's not just first-time buyers who are at risk of payment shock. Miseon and T.G. Kang just sold their town house in San Jose for $625,000 and bought a new home for $1.21 million.

"We paid a premium. We wanted this house. Without an interest- only loan, we couldn't have afforded it," said Miseon Kang, a pharmacist. "For five years, our payments will be OK. But after that, they'll be a problem. My husband and I are concerned."

Rachael Herron is concerned too, but mostly she's just exultant to have a home of her very own. It's only about 540 square feet, but it has a claw foot bathtub, space to store a voluminous amount of yarn (her passion is knitting) and a porch where she likes to watch the cars on the freeway, which is about 10 feet away.

Even better, she pays a few dollars less each month than she did for her last rental.

It's good to be a homeowner. Herron knew that three years ago, when she saw a place she liked for $169,000. She could have gotten a mortgage, but this was before interest-only loans were widely available and she didn't think she could swing the payments. "I was being fiscally responsible," she said.

She kept an eye on that condo, and says it's now worth $250,000. Something that seemed incredibly risky would have made her solvent.

Last fall, Herron decided to take the plunge. With the first four places she found, she was outbid. Then a bottom unit in a fourplex became available, and she got it. She's still amazed.

"I have $40,000 in student loans from my master's degree," Herron said. "I have high credit card debt. I'm a typical American. And yet they wanted to give me more debt to buy a house."

She wonders sometimes if she'll end up in foreclosure, if the bank will take her beloved home away from her when she can no longer pay her bills. Maybe it was a mistake to give her this money, maybe it was a mistake for her to take it. But she wasn't about to protest.

"If you're like me, you're so incredulous that anyone would give you any money whatsoever, you just close your eyes and sign the papers," Herron said. "I would have signed anything."

[Illustration]
Caption: GRAPHIC: Risky debt; CREDIT: Los Angeles Times; GRAPHIC: More homeowners; CREDIT: Los Angeles Times; PHOTO: HOPEFUL: Rachael Herron with her cat Adah in her Oakland condominium, which she purchased with an "interest-only" loan.; PHOTOGRAPHER: Robert Durell Los Angeles

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