Mortgage lenders loosen standards despite risks

By Ruth Simon, The Wall Street Journal, Tuesday, July 26, 2005

Mortgage lenders are continuing to loosen their standards, despite growing fears that relaxed lending practices could increase risks for borrowers and lenders in overheated housing markets.

Novel loan products have helped fuel much of the run-up, which continues to defy expectations, as reflected in home-sales data released Monday. Existing-home sales hit another record in June, up 2.7 percent from May's heated levels, according to the National Association of Realtors. Median home prices rose 14.7 percent from June 2004.

But lenders are making it still easier for borrowers to qualify for a loan. They are lowering the credit scores needed to qualify for certain loans, increasing the debt loads borrowers can carry and easing the way for borrowers to get loans while providing little documentation. In some cases, lenders are easing standards not only for homeowners, but also for the growing number of people buying residential real estate as an investment.

In one recent move, Chase Home Finance, a unit of J.P. Morgan Chase & Co., this spring began allowing some of its customers to take out home-equity loans and lines of credit without having their incomes verified. Under the new program, income verification isn't required for home-equity loans of up to $200,000, provided that the borrower's total mortgage debt doesn't exceed 90 percent of the property's value or $1.5 million. The change "is not for all customers -- it's only for customers with the very highest credit rating," a company spokeswoman says. Loans with little or no documentation have grown in popularity industry-wide.

Last month, Wells Fargo & Co. began allowing buyers of investment properties in some parts of the country to take out interest-only mortgages, which let borrowers pay interest and no principal in the loan's early years. Another recent change in some markets boosts the standard for how much total debt and housing expenses certain borrowers can carry to 45 percent of their income from 38 percent.

A Wells Fargo spokesman says the company doesn't discuss specific changes, but that it consistently monitors economic conditions in its major markets and will at times "modify our lending guidelines in a specific market." He added, "On a national basis, we have made no substantive changes to our lending policies and practices."

Banking regulators, meanwhile, are paying closer attention to mortgage lending practices. "Lending standards are continuing to ease," says Barbara Grunkemeyer, deputy comptroller for credit risk at the Office of the Comptroller of the Currency, which is putting the finishing touches on its annual survey of bank underwriting standards. Federal Reserve surveys of bank loan officers show that lenders have tended to loosen standards since early 2004, following a period of relative tightening.

In some cases, lenders have tweaked their offerings by reducing the minimum credit scores needed to qualify for certain loans. Countrywide Financial Corp., for instance, recently cut by 20 points the minimum credit score borrowers with bigger loan amounts need to qualify for one of its popular loan programs. A Countrywide spokeswoman says the change was designed to make the terms of this loan consistent with its other offers.

The continuing loosening of lending standards has helped push the home ownership rate to a record 69 percent of U.S. households. Mortgage delinquencies, meanwhile, have remained low, with just 1.08 percent of residential mortgages in foreclosure proceedings at the end of the first quarter, down from 1.17 percent five years earlier, according to the Mortgage Bankers Association. Low interest rates and rising home prices have helped keep delinquencies down by keeping monthly payments in check and making it easy for borrowers who run into trouble to refinance or sell their homes at a profit.

But the lowering of standards has also raised concerns that some borrowers may run into trouble making their payments, and that defaults could rise. In May, in response to concerns about looser underwriting standards, bank regulators issued their first-ever guidelines for credit-risk management for home-equity lending. Regulators are working on new guidelines for mortgage lenders.

In addition, bank examiners "are looking more at how banks originate first mortgages today than they were a year ago," says Ms. Grunkemeyer of the Office of the Comptroller of the Currency. "The reason they are doing it is because the mortgage products (lenders) are originating are higher risk." Washington Mutual Inc. says it's loosening its guidelines on some products while tightening them on others. In June, it began offering home-equity lines of credit to borrowers who buy condominium units as an investment or as a second home. Another recent change lets borrowers who buy a second home or investment property finance as much as 90 percent of the home's value, up from 75 percent. Sales of investment properties have surged recently, adding fuel to the heated housing market.

The Seattle-based lender says it has also moved to toughen some standards. Earlier this year, Washington Mutual began setting stricter limits on the size and loan-to-value ratios for loans above $7 million. It is also reassessing its credit standards for investment properties and second homes, says Jim Vanasek, the company's chief enterprise risk-management officer.

"There's been a growing awareness over the past six to nine months that the risks are starting to increase with the very, very rapid price escalation we have seen," Mr. Vanasek says. "I would be surprised if mortgage lenders don't do some degree of reining in or tightening over the next several months."

So far, evidence of tightening has been hard to detect. "The trend toward relaxing standards is still relatively strong," says Gibran Nicholas, a mortgage broker in Ann Arbor, Mich. Mr. Nicholas expects this pattern to continue as long as foreclosure rates remain low and demand remains high from investors who buy bonds backed by pools of mortgages.
Some lenders say they are being forced to relax their standards to remain competitive. U.S. Bank Home Mortgage, a unit of U.S. Bancorp, says interest-only mortgages and loans with less-than-full documentation now account for about 10 percent of its business, up from just 4 percent a year ago.

"We're just offering the product that a lot of our competitors have offered," says U.S. Bank President Dan Arrigoni. "If anything, we have to think about loosening them if we want to compete." But, he says, U.S. Bank has resisted pressures to offer increasingly popular option adjustable-rate mortgages -- which carry starting rates as low as 1 percent and give borrowers multiple payment choices -- because the bank considers them too risky.
Lenders also say that advances in technology and data analysis enable them to do a better job of determining who is a good credit risk. "One of the things that is often missed is that we've become much better predictors of loan performance with automated underwriting systems and appraisal practices," says Jerry Baker, president and chief executive of First Horizon Home Loan Corp., a unit of First Horizon National Corp.

First Horizon recently reduced the credit scores and boosted the loan-to-value ratio allowed on limited and no-documentation loans that it sells to investors through Wall Street. The bank says such loans represent a tiny portion of First Horizon's volume.

The loosening of standards also shows up as products that were initially geared toward the most sophisticated borrowers -- such as option ARMs and interest-only loans -- have become more mainstream. A recent analysis by

UBS AG shows that the average credit scores for borrowers with option ARMs has declined over the past three years. In addition, more than 22 percent of the borrowers who took out option ARMs this year financed more than 80 percent of the purchase price, up from 12 percent of borrowers in 2004 and less than 2 percent in 2002, according to the UBS analysis, which looked at loans sold to investors.

Similarly, interest-only mortgages, which were first aimed at wealthy borrowers, are increasingly being offered to people with poor credit. Interest-only mortgages accounted for 30 percent of the subprime loans originated in April, according to UBS, up from 14 percent in all of 2004. Average credit scores and other measures of credit quality have also been declining, according to UBS.

Easing Up
Here's how mortgage lenders are loosening their standards:

- Reducing the minimum credit score borrowers need to qualify for certain loans.
- Allowing borrowers to finance more of a home's value or carry a higher debt load.
- Introducing new products designed to lower borrowers' monthly payments for an initial period.
- Letting borrowers take out loans with little, if any, documentation of income and assets.

A Field Guide to Innovative Mortgages
Here are some of the novel loan products that have been gaining popularity and helping fuel the housing boom:

- LOAN PRODUCT: Interest-only mortgages
  COMMENT: These allow borrowers to pay interest and no principal in the loan's early years, which keeps payments low for a time.

- LOAN PRODUCT: Option adjustable-mortgages
  COMMENT: These loans carry introductory rates of as low as 1 percent and give borrowers multiple payment choices. But borrowers who elect the minimum payment can see their loan balance rise.

- LOAN PRODUCT: Piggyback loans
  COMMENT: These combine a mortgage with a home-equity loan or line of credit, allowing borrowers to finance more than 80 percent of the home's value without paying for private mortgage insurance.

- LOAN PRODUCT: No-documentation and low-documentation loans
  COMMENT: Under these programs, borrowers can take out a loan while providing little if any documentation of their income or assets.