

NATION'S HOUSING

Default rate of 'piggyback' loans spurs Wall Street to action

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WASHINGTON — Wall Street is sounding the alarm: on one of the most popular ways to buy a house in many high-cost areas around the country — so-called “piggyback” programs that mesh first mortgages with second-lien credit lines or mortgages.

As of July 1, the most influential ratings agency in the mortgage arena, Standard & Poor's Corp., has upped the ante for lenders who fund piggyback deals. The move is likely to raise interest rates and fees for some home purchasers this summer, say mortgage experts, and could reduce the volume and availability of piggyback programs overall.

The reason for the change, according to Standard & Poor's credit analyst Kyle Beauchamp, is that an exhaustive study of piggyback loans found them anywhere from 43% to 50% more likely to go into default than comparable stand-alone first-lien purchase transactions.

Piggyback plans were developed as a creative response to soaring home prices and borrowers' desires to stretch their down-payment cash while avoiding private mortgage insurance premiums. In traditional financings, a borrower with less than a 20% down payment typically must pay for mortgage insurance premiums. In piggyback arrangements, by contrast, the borrower takes out a traditional mortgage for 80% of the property value, but simultaneously obtains a second lien for a portion or all of the balance — and avoids PMI payments.

Banks and other lenders offer a wide variety of piggyback options. For example, an “80-20” piggyback would require zero down payment — an 80% standard first mortgage and a credit line or second mortgage covering the 20% balance. An “80-10-10” would involve a 10% down payment; an “80-15-5,” just 5% down.

With their low cash requirements and often-generous credit standards, piggybacks have been wildly popular among home purchasers during the last several years. According to a study by SMR Research Corp., piggybacks quadrupled their market share from 2001 to 2004. In a sample of loans in California markets, according to the SMR

study, the percentage of piggybacks exceeded 60% in some cases.

Standard & Poor's policy change effectively requires lenders selling piggyback loans into secondary-mortgage-market bond pools to purchase substantial, additional credit enhancements — added protection for bond investors against the higher expected default rates.

Ted Durant, vice president of analytic services for MGIC, a large Milwaukee-based private mortgage insurer, was not surprised by Standard & Poor's action. “The securities market has recognized the risk” that piggybacks entail for some time. Essentially they are low- or no-down-payment loans — which always carry higher default risk than loans with conventional

20% down payments — but with no insurance to handle that elevated risk.

One reason for the higher defaults: Though the interest rate on the first-lien mortgage may be fixed, many of the second liens in piggybacks have been floating-rate home equity credit lines. They are tied to short-term interest-rate movements, especially the prime rate, and are exposed to frequent payment increases as short-term rates rise. The Federal Reserve's steady drumbeat of quarter-point increases over the last year has weighed heavily on buyers who took out piggybacks in 2003 and 2004, when short-term rates were at near-record lows. They have been forced to refinance their loans or find the extra monthly income to pay for the

rising costs on their credit lines.

With low equity and home price appreciation flattening in once-zesty markets, many piggyback borrowers are being squeezed financially.

A second reason for the defaults: Significant numbers of piggybacks have been made to buyers who were financially stretched to begin with and had marginal credit scores.

In Standard & Poor's analysis of nearly 640,000 piggyback transactions, borrowers with FICO scores below 660 were 50% more likely to become delinquent than a traditional single-lien mortgage borrower with the identical credit score. The extra variable-rate and rising monthly cost factor associated with the piggyback apparently was too

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Be mindful of 'piggyback' risks

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much to handle for buyers who were financially challenged to begin with.

More ominous still for the piggyback market: Federal financial regulators are expected to issue guidelines for lenders within the next few months that will force them to throttle back on piggybacks, payment-option loans and interest-only loans to borrowers with marginal credit scores and incomes.

The bottom line for borrowers: Recognize the heightened risks associated with piggybacks and make sure your loan officer discusses them in detail. Ask about alternatives that might be more appropriate.

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