

Loan by Loan, the Making of a Credit Squeeze

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THREE years ago, Martin and Jennifer Cossette bought into the dream of homeownership -- the quintessentially American ideal of personal striving and family stability celebrated by politicians, promoted by Madison Avenue and financed by Wall Street.

The modest Cape Cod-style house, in Meriden, Conn., had three bedrooms, and a backyard for their young son, Steven. Like so many families, they stretched to buy their first home. In the red-hot housing market at the time, they put no money down and got a mortgage for its entire \$180,000 price tag. They had qualms but too few, as reassuring lenders spoke of rising housing prices, falling interest rates and easy access to future loans.

None of it turned out that way. There were unforeseen expenses: a new furnace, stove and garage door. Bills mounted and credit card debt got out of hand. They refinanced in late 2005, folding other debts into the mortgage, but that proved to be only a stopgap.

Earlier this year, the Cossettes filed for bankruptcy under Chapter 13, used by wage earners who want to hold onto their homes. But the monthly payments on the \$230,000 mortgage were \$1,800, 40 percent higher than the first mortgage, and headed even higher. So they decided to let the house go. "We were totally naïve," said Mr. Cossette, a purchasing agent for a warehouse company.

Families like the Cossettes are the individual faces of the American credit crunch of 2007. The economic bite of the credit squeeze, which began with troubles in the market for higher-risk home loans, like the one made to the Cossettes, continued to intensify last week. Stock markets around the globe were pummeled by worries about the squeeze's ripple effect. Businesses and savers far removed from the housing fallout, from the shares of industrial companies to 401(k) retirement accounts, suffered losses.

Consumer confidence is slipping. Countrywide Financial, the nation's largest mortgage lender, was forced Thursday to tap \$11.5 billion in emergency loans from 40 of the world's largest banks. The Federal Reserve took a dramatic step on Friday, cutting the rate it charges banks for loans to add liquidity and steady the financial markets. The Fed explained its move by saying that the risk to the economy from the credit squeeze had increased "appreciably."

The fallout extends from hedge fund managers to rank-and-file investors, but the most personally punishing setback is a family losing its home.

About 1.7 million households will lose their homes to foreclosure this year and next, according to estimates by Moody'sEconomy.com. That would be nearly double the number of the previous two years.

Looking at foreclosure warning signs like loan delinquency and default rates, which are spiking, Mark Zandi, chief economist of Economy.com, said the outlook was "very dark," largely because of the current "self-reinforcing downward cycle" of falling house prices, loan defaults and credit tightening that pushes house prices down further.

There are regional and local differences, to be sure. Problems tend to be more pronounced in a few Midwestern states with weak economies, like Michigan and Ohio, and states with the greatest concentration of subprime loans, like California, Florida and Nevada. "But the trouble is not just a few places. It's coast to coast now," Mr. Zandi said.

As the squeeze on homeowners becomes worse, the political debate over how to address the problem will intensify. Earlier this month, Senator Hillary Rodham Clinton, Democrat of New York, called for a crackdown on mortgage brokers who engage in so-called predatory lending, and a \$1 billion federal fund to help families avoid foreclosure.

Senators Christopher J. Dodd of Connecticut and Charles E. Schumer of New York, both Democrats, recently urged federal regulators to ease restrictions so that Fannie Mae and Freddie Mac, the two giant mortgage agencies, could buy more mortgages and mortgage-backed securities from lenders to add fresh capital to the home credit markets. The lenders, then, would presumably have to use the new capital to refinance loans for borrowers facing default and foreclosure.

Congress is looking hard at changing the bankruptcy law so courts can restructure home loans as they do other personal loans like credit card debt. The goal, proponents say, would be to update the bankruptcy code in line with realities of the modern mortgage market.

In Chapter 13, a borrower's mortgage obligation remains intact. The most that a person gets is extra time to catch up on payments in arrears, but every nickel on the mortgage must be paid.

The bankruptcy code went through a major revision two years ago, in what was seen as a triumph for banks and other lenders. The revision made it harder for people to declare bankruptcy, especially a Chapter 7, or "straight bankruptcy," in which everything is liquidated, by setting tighter income and means tests to qualify. The 2005 amendments also set more stringent rules for writing down unsecured debt, notably credit card debt.

PROTECTION for the mortgage lender has been unchanged since the Bankruptcy Reform Act of 1978. At the time, first-time home buyers paid about 20 percent of the value of the houses upfront, got fixed-rate mortgages, and the lenders were local bankers -- serious, skeptical types who scrutinized borrowers. Homeowners agreed to mortgages they could afford. When they ran into financial troubles, it was typically because of some unforeseen event in their lives like the loss of a job, an illness or a divorce. The mortgage was rarely the problem.

Yet the mortgage often is the financial culprit these days. That is particularly true of lending in the subprime market of zero-down loans with terms fixed for two years and then floating rates, arranged by aggressive national mortgage brokers and bankers who earn lucrative fees.

"The bankruptcy law was written for a different world, and we want to give the bankruptcy courts, and creditors, more flexible tools to work with borrowers to save their homes," said Senator Richard J. Durbin of Illinois.

In September, Mr. Durbin, the Democratic whip, plans to propose amendments to the bankruptcy code, in a bill called the Helping Families Avoid Foreclosure Act. It would, among other things, permit writing down loans and stretching out payment terms.

Some bankruptcy experts agree that it is time to change the law. "Our bankruptcy laws are not well designed to deal with a massive wave of mortgage foreclosures," said Elizabeth Warren, a professor at the Harvard Law School. In particular, Ms. Warren said, bankruptcy courts should be able to rewrite mortgages in line with market conditions.

The banking industry, which pushed hard for the tougher bankruptcy law in 2005, wants no easing up now.

For people struggling to hold onto their homes, the path to financial peril usually began with bad loans. Bad choices often made matters worse.

That is the story Neil Crane hears and sees every day in Connecticut, a state that closely tracks the national trends in mortgage loan delinquencies and defaults. Mr. Crane, a lawyer in Hamden, Conn., has been handling personal bankruptcies for 25 years. Business is brisk. His office takes on 30 new cases a month, a 50 percent increase in the last year and a half.

His clients, including the Cossettes, are families typically with household incomes of \$65,000 to \$90,000 a year. In the past, Mr. Crane said, it was usually the loss of a job, a lengthy illness or another unexpected setback that pushed people into bankruptcy.

"But what we see now are people who refinanced to pay existing bills, with the encouragement of lenders, on very poor terms that only worsened their problems," he said. "If you sat in at the mortgage closing, you could have predicted the bankruptcy."

Joseph and Lu-Ann Horn bought their 1,200-square-foot, three-bedroom home in South Windsor, Conn., in 2002, paying for nearly all of it with a \$150,000 loan. The mortgage was a 30-year loan with a fixed rate of 7.5 percent. Two years later, they decided to refinance to pay off their truck and their credit card debt and to buy a \$4,000 motorcycle.

The new mortgage was for \$198,000, at a fixed rate of about 8 percent for two years and variable rates afterward. The monthly payment was about \$1,600. The mortgage broker, Mr. Horn said, told them not to worry about the variable rate because they could refinance in two years and lock in a fixed rate again.

"They basically put us in a loan that they knew we couldn't pay," Mr. Horn said. "We never should have done it."

When the fixed rate expired last year, the Horns found no willing lenders. The interest rate has jumped and the monthly payments rose to nearly \$2,200, Ms. Horn said. "It just goes up and up," she said.

Mr. Horn, 34, is a truck driver and Ms. Horn, 39, is an assistant manager in a fast-food restaurant. They make about \$70,000 a year, but with two children and other expenses they fell behind on the mortgage. They have been served with foreclosure papers, and have filed for Chapter 13. "We're fighting to hold onto the house now," Ms. Horn said.

For Sue Ellis, 47, a nurse in Northford, Conn., the road to bankruptcy began with a home improvement project six years ago. "If I had it to do over again, I never would have redone my kitchen," she said.

The first refinancing added \$40,000 to her original mortgage of \$140,000 on the small ranch house she bought in 1997. She was a single parent and wanted to have a backyard for her two children. The monthly payment on the original mortgage was about \$850.

Ms. Ellis has since remarried, and she and her husband, Robert, a salesman at an industrial equipment company, make about \$85,000 a year. But the higher mortgage and other bills led to two more refinancings, in 2003 and 2005, each to pay off about \$40,000 in credit card debt. "We were using credit cards to pay the bills and then we refinanced to pay off the credit cards," she said. "It's a vicious cycle."

Today, her mortgage debt is \$260,000, and her monthly payments are \$2,400. The value of her house, said Mr. Crane, her lawyer, is about \$200,000. Ms. Ellis is a month behind in her mortgage payment and is not in foreclosure yet. But she has also accumulated more than \$20,000 in credit card debt, and she is filing for Chapter 13 bankruptcy.

FOR people in Chapter 13 and facing foreclosure, the struggle to hold onto a home will be an uphill battle. Bankruptcy buys a few months of relief from creditors. Mr. Crane urges his clients to use the breathing room to build up a small cushion of savings and to pare back all expenses. Life's small frills -- restaurant meals, movies, Starbucks coffee -- are jettisoned. Brown-bag lunches can save a few dollars a day.

The goal, Mr. Crane said, is to establish 12 months of timely mortgage payments and then, with court approval, refinance into a lower-interest, fixed-rate mortgage -- and to take advantage of any new federal or state programs to help homeowners.

For Mr. Cossette, 37, who is now a renter, homeownership no longer has much allure. "You put your life's sweat into a piece of real estate that may or may not go up in value," he said. "So I don't have a house. That's O.K. with me."

Mr. Cossette said he may never again own a house. He would not consider buying, unless he could put 20 percent down, he said. His experience with the home lending system has left him understandably jaded, and he has a suggestion for policy makers.

"Hopefully, they will make it harder for people to buy houses in the long run," Mr. Cossette said. "Maybe others can learn from this."