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Reducing the Risk of Default

By BOB TEDESCHI

BECAUSE of new policies from Freddie Mac, some, if not many, of the millions of borrowers with poor credit could be shut out of home mortgages. But Freddie Mac also says that it is planning new mortgage products in an attempt to reduce the risk of default.

Freddie Mac, which buys loans from lenders and, in doing so, sets underwriting standards for many lenders, said late last month that it would stop buying certain “2/28” and “3/27” loans, or those on which interest rates are fixed for only the first two years or three years of a 30-year loan. The change was prompted by an increasing number of defaults on such loans because of rising rates and falling real estate prices.

Interest rates on these loans can start in the 6 percent range but rise to their maximum rates of around 12 percent within four years.

Freddie Mac said that in September, it would buy only those loans made to borrowers who proved they could pay the highest interest rates, not the initial rates. It also said that lenders would be required to be more careful in verifying incomes of applicants for such loans and that lenders would be strongly encouraged to collect tax and insurance payments and hold them in escrow accounts.

“It’s a straightforward attempt to make sure the borrower can afford the payments,” said Frank Nothaft, the chief economist for Freddie Mac.

The 2/28 and 3/27 loans have been marketed heavily to subprime borrowers whose credit scores are so low they cannot qualify for mortgages with longer fixed-rate periods. Mr. Nothaft said that a typical subprime borrower, with a credit score of 550, might qualify for a 2/28 loan with a teaser rate of 5.9 percent. But interest rates on 2/28s rise more sharply than adjustable-rate mortgages given to prime borrowers.

Those with 2/28s may have their rates rise by three percentage points after two years, then another percentage point every six months thereafter. Borrowers could reach the typical lifetime interest rate cap of 11.9 percent within 42 months.

In contrast, prime borrowers with adjustable-rate mortgages enjoy fixed rates for five or seven years, with interest rates raised at longer intervals after that.

Freddie Mac said it would create “model subprime mortgages” for lenders to market. The new mortgages will include smaller “margins,” or incremental interest rate increases once

the fixed-rate period ends, and longer intervals between those increases. They will also include longer fixed-rate periods.

The Federal National Mortgage Association, the government-backed company known as Fannie Mae, which has the same mission as Freddie Mac, would not comment directly on Freddie Mac's initiative. But it said it was developing new "rescue mortgage" products to help subprime borrowers in difficulty.

The Mortgage Bankers Association criticized Freddie Mac's new standards. John M. Robbins, the group's chairman, said that the new policies would "limit the product options and the access to credit for those individuals most in need, many of whom are first-time, underserved or minority home buyers."

But many minority and consumer advocates expressed support for the new standards, including the [AARP](#), the [N.A.A.C.P.](#) and the Consumer Federation of America.

Freddie Mac's new loan standards will not dictate lending methods all by themselves, since Fannie Mae has not joined in. Lenders who sell loans to hedge funds and other investors also need not follow suit.

Jeffrey Guarino, the managing director of Gotham Capital Mortgage, a broker based in New York, said the regulations would be felt most fully outside [Manhattan](#), because Manhattan has fewer subprime borrowers.

The new policies "are generally speaking smart," Mr. Guarino said, "although with fewer people getting loans, that could lower housing prices."

Mr. Nothaft of Freddie Mac said that for subprime borrowers who keep current at the outset, "odds are that your credit scores will have improved, too — you might even qualify for a prime product."