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Fixing Troubled Mortgages for the Elderly

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Santa Maria, Calif. A year ago, Pedro Garcia and his terminally ill wife, Julia, were about to be evicted from their home of nearly 40 years after their mortgage lender foreclosed on the loan.

Today, Mr. Garcia is living in his Southern California home nearly payment free. The turn of events came after the lender, Bank of America Corp., employed an unusual tactic that is being used on occasion to help some debt-strapped seniors locked into exotic mortgages known as option ARMs from losing their homes.

"There are a lot of people who lost their houses [in the recession], so I'm fortunate," says Mr. Garcia, a 69-year-old retired corrections officer. "We lived in this house since 1970 and this was our dream." Mrs. Garcia died last November.

Mr. Garcia owed about $490,000 on his home, which a recent appraisal said is now worth only about $150,000. Bank of America wrote down about $405,000 of the loan. To account for the rest, the bank then issued a reverse mortgage for about $85,000. But instead of paying that amount to Mr. Garcia, as is usual with a reverse mortgage, the bank paid the proceeds to itself. A reverse mortgage is a form of equity loan available to older homeowners that generally doesn't need to be repaid until after the homeowner dies.

That means Mr. Garcia can remain in his home without having to make mortgage payments to Bank of America. (Mr. Garcia is making small monthly payments on a second mortgage that was modified by another lender.) When he dies, the house reverts to Bank of America, and his heirs can choose to buy it back for the $85,000 plus interest and fees. Or, if the heirs choose to walk away, the bank can sell the house, and any proceeds above the loan amount would go to Mr. Garcia's family.

Under pressure from the government, banks in general have been stepping up efforts to work with financially troubled homeowners. The Treasury Department this month said it had met its goal of beginning trial loan modifications by Nov. 1 for 500,000 borrowers as part of the Obama administration's $75 billion foreclosure-prevention plan. But many stretched borrowers complain it's still hard to get help from lenders, and economists expect foreclosures to continue to increase.

In Mr. Garcia's case, the big write-down Bank of America was willing to take highlights the controversy surrounding pay-option adjustable-rate mortgages. Option ARMS, as they're known, have become the focus of investigations and a spate of lawsuits by borrowers who believe they were misinformed about the loans' complicated structure. It also follows the bank's settlement last fall of predatory-lending charges brought by several state attorneys general against Countrywide Financial Corp., which Bank of America acquired last year. Under the settlement, in which the bank neither admitted nor denied guilt, the bank agreed to, where possible, modify the terms of certain subprime mortgages and option ARMs serviced by Countrywide.

Michael Drawdy, Bank of America's senior vice president for home retention, says the bank has issued approximately 20 reverse mortgages with write-downs to borrowers like Mr. Garcia who have "dire circumstances." He says that though the bank loses money in this process, it would lose nearly as much by foreclosing on the home and selling it in today's market.

Option ARMS are turning out to be nearly as toxic as subprime loans. According to Lender Processing Services Inc., 32% of option ARMs were delinquent or in foreclosure as of Aug. 31, compared with 48% of subprime loans. But unlike subprime loans, which typically went to people who had weak credit, option ARMs were generally given to borrowers with good credit, including many seniors who had significant equity in their homes and wanted to refinance to take money out to pay bills. They were lured partly by "teaser" interest rates—sometimes as low as 1.5%.

One feature of option ARMS is that borrowers can select among three or four different payment choices. Many borrowers opted for the minimum payment, not realizing that by doing so, their loan balances and payments could jump over time because the payments didn't even cover the monthly interest. Most elderly borrowers who were put into option ARMs "didn't understand how it worked," says Jennifer Sinton, deputy director of the Foreclosure Prevention Project at South Brooklyn Legal Services. "They're some of the most abusive loans out there."

Difficult to Modify

Option ARMs are proving difficult to modify. The most common way that banks modify troubled mortgages is to reduce the interest rate on the loan. But many option ARMs already have low rates, so there isn't much room to reduce them further. And with home prices having plunged in California, Florida and many other markets where option ARMs were popular, a growing number of borrowers with these loans owe more on their mortgages than the homes are worth, even as principal payments keep rising.

Housing counselors say Bank of America is playing a leading role in dealing with option ARMs, since its settlement with state attorneys general last fall. And a key tool the bank is using, at least for seniors, is the reverse mortgage. To qualify for such a mortgage, a homeowner must be at least 62 years old.

Mr. Garcia decided to refinance his home in early 2006 and use the proceeds to renovate his three-bedroom house, which was purchased in 1970 for $23,000. At the time of the refinancing, the house was appraised at $465,000, with the mortgage broker recommending that Mr. Garcia take out $400,000. He used $70,000 on renovations and much of the rest to pay his wife's medical bills. After he quit a post-retirement job as a construction worker to care for Mrs. Garcia, he dipped into those funds for day-to-day living expenses as well.

Mr. Garcia said he initially sought a fixed-rate mortgage, but agreed to take an option ARM because the broker convinced him the payments would be low for a long period of time. "He said it would go up only $100 per year for five years," Mr. Garcia says. That turned out to be untrue, as the rate immediately began to adjust, based on market interest-rate benchmarks.

The mortgage, which was originated by a third-party lender and sold to Countrywide, offered four payment choices. The lowest of them, the only one Mr. Garcia says he could afford, was less than the interest on the loan, meaning the principal grew even as he made payments. After struggling to stay current, Mr. Garcia finally quit paying when the mortgage payment eclipsed the $2,600 a month he was receiving from California Public Employees' Retirement System and Social Security.

Eviction Stayed

When a judge granted an eviction order in October of last year, Mr. Garcia contacted California Senior Legal Hotline in Sacramento. Lawyers for the group persuaded the judge to stay the eviction, basing their argument in part on the settlement agreement reached between Countrywide and several state attorneys general. Mr. Garcia's case wasn't subject to that settlement, however, because his home was already in foreclosure proceedings. Still, Bank of America's Mr. Drawdy says the bank agreed to grant the reverse mortgage and write down the difference after hearing from the legal hotline group.