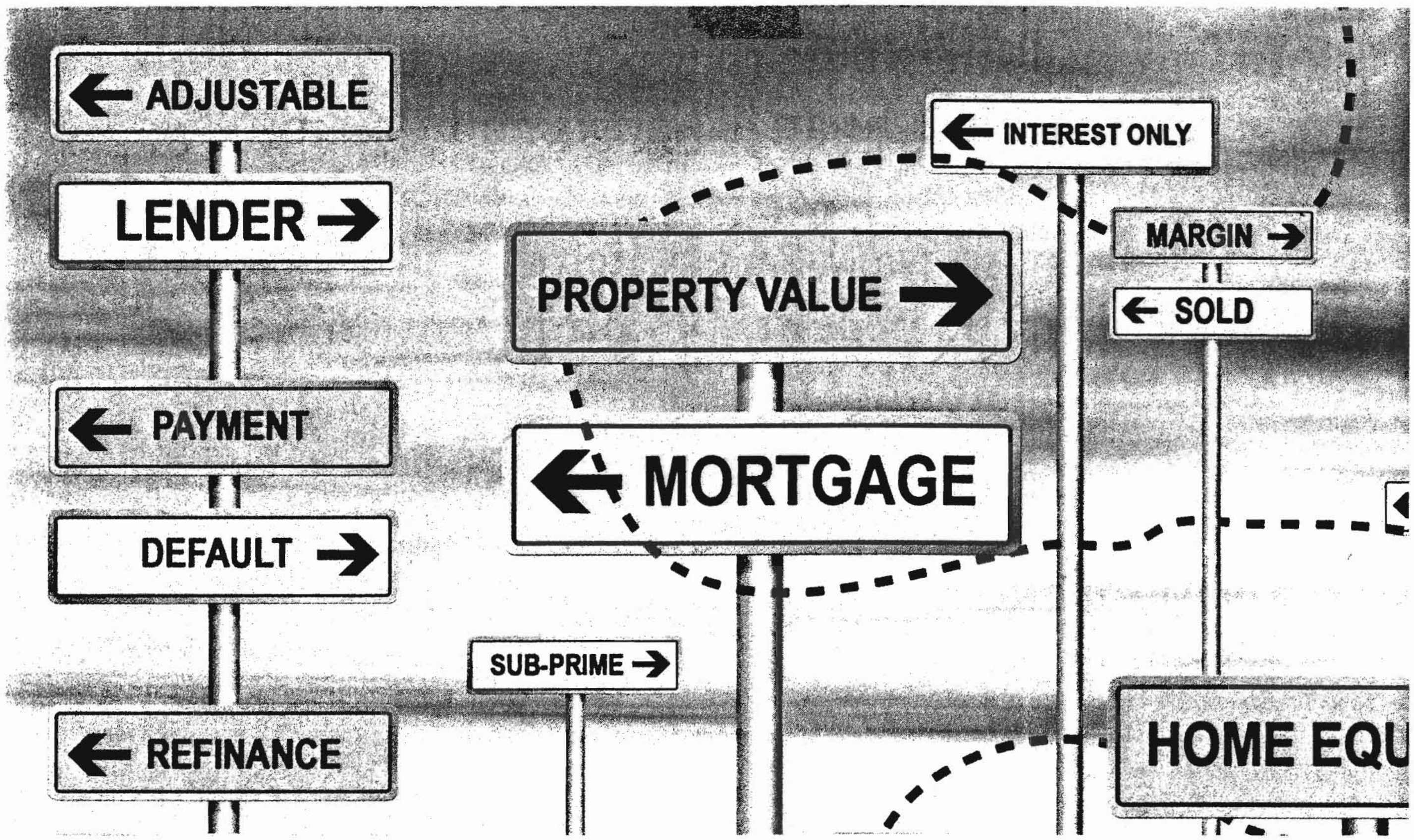
Guiding Clients Through the Mortgage Mess

by Ed McCarthy, CFP®



The bad news from the mortgage markets has been unceasing. First it was the collapse of the sub-prime market as defaults rose and financial services firms began to feel the impact. In early 2008, reports started coming in that delinquencies in prime mortgages were increasing; the evening news began to show vacated, high-end homes in upscale neighborhoods in which owners had simply walked away from properties where the mortgage balance exceeded the property's value. Princeton economist Paul Krugman forecasts that 20 million U.S. homeowners will have negative equity by year-end 2008 and the country will have seen a capital loss of $6 trillion to $7 trillion when the crisis ends in 2010.

Borrowers with solid payment histories and good credit have been feeling the pinch, too. Lenders are tightening standards for refinances and canceling home equity lines of credit even for these applicants, many of whom until recently would have been approved without difficulty. It's an unfolding disaster that will affect homeowners and borrowers for years to come.

Although mortgages are grabbing headlines, as more financial advisors have moved to an assets-under-management model, there is a risk that clients' mortgages will receive less attention than under a traditional financial planning model. That's not to imply that advisors overlook mortgages and debt management—many cover those areas with every client. But advising on mortgages doesn't pay the bills: have you ever heard an advisor cite statistics on clients' mortgages to describe the size of his business?

The shift toward focusing exclusively on wealthier clients also changes the practice of advising on mortgages. Those clients usually have sufficient assets to avoid the problems cropping up for lower- and middle-income homeowners. They also receive professional advice on debt-funding options and avoiding excessive borrowing. Wealthy clients aren't immune from the current crisis, of course, as evidenced by problems in the jumbo loan market. Frequently, however, mortgages and other debts have a less prominent role in these clients' finances than they do for the less affluent.

Over Their Heads in a Changing Environment

In early 1998, I wrote the following about the Federal Housing Administration's mortgage-debt regulations for a book on personal finance: "According to these formulas, buyers with other debts (car and student loans, for example) can afford to spend up to 29 percent of their gross monthly income on housing, and debt-free borrowers can budget as much as 41 percent."

The mortgage world was much simpler then. My list of mortgage types included fixed-rate, plain-vanilla adjustable rate (ARMs), hybrids that started as fixed and switched to ARMs at some point between three and ten years, and government-backed loans (FHA, VHA, and VA, for example).

Fast forward to September 2006, when the practice of underwriting NINJA (no income, no job, no assets) mortgages was raising concern. A *Business Week* article describes the problems emerging with option ARMs, a popular type of mortgage: "The option adjustable rate mortgage (ARM) might be the riskiest and most complicated home loan product ever created. With its temptingly low minimum payments, the option ARM brought a whole new group of buyers into the housing market, extending the boom longer than it could have otherwise lasted, especially in the hottest markets. Suddenly, almost anyone could afford a home—or so they thought" ("Nightmare Mortgages," by Mara Der Hovanesian, September 11, 2006).

The drama played out as the story predicted. Many homeowners were shocked when the ARMs they had taken out in 2004 and 2005 reset with much higher payments. Housing markets in many parts of the country had cooled, so the anticipated appreciation was not there to support higher debt levels. Contract penalties made refinancing costly, and it soon became obvious that many borrowers were either clueless or hopelessly optimistic when they took out their mortgages. One analyst described the option ARMs as a neutron bomb that would "kill all the people but leave the houses standing."

That comment was accurate. Randall S. Guttery, Ph.D., CLU, ChFC, is a professor of real estate finance and associate dean at the University of North Texas College of Business in Denton, Texas, where he also serves as director of the CFP professional education program. He says the problem with the sub-prime borrowers compared with prime borrowers is that a prime borrower's margin over the ARM index is historically about 2.75 percent. With sub-prime borrowers, the average margin is 6 percent over the index, which translates to a rate that is 3¼ percent higher for the sub-prime borrowers. Consequently, he says, the rate readjustment might increase the rate from 4 percent to 9½ or 10 percent, and borrowers can't handle the higher payments.

It is beyond this article's scope to analyze the crisis's cause beyond the examples cited. Instead, we will share advisors' insights into the role of mortgages in clients' finances by asking financial planners and mortgage brokers what they are telling clients in today's environment. Are they urging clients to pay off their mortgages ahead of schedule and cut back on debt? Or are they telling them it makes more sense to carry a large mortgage and invest funds elsewhere? Not surprisingly, sources expressed a range of opinions.

Pay Off or Invest Elsewhere?

Guttery's approach to real estate financing is conservative. He paid off his personal mortgage ahead of schedule and he urges his students to be cautious when borrowing. "I'm a firm believer in a long-term financial plan that will have you out of debt," he says. "I've been telling my students for over ten years to get a fixed-rate mortgage," he says. "Right now, a 30-year mortgage is hovering around 6 percent. Historically, that is a phenomenally low rate. Why would you take on the risk of paying increasing interest when you can lock in at 6 percent? It just doesn't make any sense."

There are several counter-arguments to the conservative financing approach. The first is that rising property values provide leveraged owners with a higher return than what unleveraged owners earn. That's true, provided the property appreciates as projected.

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But Guttery notes that leverage is a double-edged sword, as many property owners are learning.

"What if I get 100 percent financing?" he asks. "The argument was that my house would appreciate 15 percent a year, so my $100,000 house is now worth $115,000 after the first year. If I had $2,000 in negative amortization—that is, the loan payment is less than the interest charged—I owe $102,000 on a house that's worth $115,000. That sounds great, but what happens when that $100,000 house, a year later, is worth $90,000? You now owe $102,000 on a house worth $90,000, and if I owe far more than the asset is worth, default risk is going to go through the ceiling."

The second argument against using a conservative approach to financing focuses on the drawbacks to tying up wealth in home equity. Sean Sebold, CFP®, CFA, president of Sebold Capital in Naperville, Illinois, states the theme for this perspective: Is it good to pay off your house? From a strict finance perspective, he says, the answer is no. Sebold points to a home's investment characteristics using the perspective of a salesperson pitching a stock: "I've got a stock. It's highly illiquid—you can't get rid of this thing in a very short period of time. The transaction costs are really high—somewhere between 6 and 8 percent—and it's going to appreciate at roughly 4 percent a year. Would you want to buy it?"

Peter Mitchell, president of Capital Republic Financial Group, a California-registered RIA in Long Beach, agrees with this argument. He co-authored *The New Mortgage Investment Advisor: Structuring Your Mortgage to Work as a Financial Planning Tool.* The book's central theme is that homeowners can increase their long-term wealth by minimizing their monthly mortgage payments and maximizing their funding of equity indexed universal life insurance contracts with the money that otherwise would have gone to amortize the mortgage balance. Mitchell recommends equity indexed policies because of their combination of downside protection for returns, tax-deferred accumulation, and tax-free policy loans. The scenarios illustrated in his book assume that home values will increase by either 3 percent or 5 percent annually, invested funds will grow by 4, 6, or 8 percent, and the insurance contract's value will grow by an assumed 8 percent.

I told Mitchell that many readers would view his approach as nothing more than a sophisticated way to sell life insurance. He agreed that it does generate insurance sales, but says it was the emergence of the equity indexed policies that led him to the strategy. He says the strategy does not work for all clients, and he maintains that "if you're really doing what's in the client's best interest, it doesn't matter what kind of product you're using."

My initial impression of the book is that it presents overly simplified scenarios to support its propositions. As a reader, I wanted to see worst-case scenarios in which the strategy gets stress-tested for extended periods, not just positive outcomes. It's also difficult to justify a life contract's insurance and administrative costs if the client does not need the coverage. In fairness, though, it's not possible to illustrate every scenario in a book, and of course, there is always the *caveat emptor* assumption that an author advocating a position will select scenarios that support his case.

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Mitchell does caution readers that they should not consider the strategy if they are unable to make the fully amortized 30-year payment at the outset or if they fail to save the difference between the minimum monthly payment and the 30-year amortized payment. He also acknowledges that managing an adjustable mortgage and funding an ARM and an insurance policy with substantial values is a challenge that homeowners and advisors can mismanage. "This is a complex strategy," he says. "It's not simple. You've got to know what you're doing and the client needs to understand what you're doing. And it's a long process to actually get one of these things started, to make sure that it's built correctly, to make sure the client understands it every step of the way, and then you've got to get together with them at least annually."

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The strategy of tapping home equity to fund an investment has surfaced periodically over the past 20 years. This writer recalls analyses supporting the use of home equity for real estate limited partnership investments—before they tanked—and in mutual funds—before the dot-com crash. In each case, the recommended investment was being sold as a can't-miss wealth builder, but the scenarios did not play out as projected. The advisors selling the strategy and the investment sponsors profited, but the investors did not. "Where are the customers' yachts?" as the visitor to Wall Street once asked.

Nonetheless, a case can be made for using home equity, if it fits the client's circumstances and tolerance for risk. Sebold, a fee-only planner, cites an example of a wealthy client who requested a $250,000 distribution from his brokerage account because he was tired of paying a mortgage and wanted to pay off the balance. The client had more than sufficient funds for his financial goals and Sebold believed it was an appropriate request. In other cases, though, he believes clients can benefit from using home equity to increase their leverage, liquidity, and likelihood of achieving their financial goals. But he's not attached to any particular product as the ideal investment for the released equity, provided the client can maintain adequate liquidity and diversity, and tolerate investment performance swings.

"I don't care what the product is but you'd have to look at the long-term performance," Sebold says. "As long as you've got your rate of return and you have liquidity, those are the issues when it comes to the investment component of it. Because what you're looking to do is to pull home equity out and get liquidity."

A Broker's Perspective

Mortgage brokers have received much of the blame for the current sub-prime debacle. They are often accused of convincing clients to take on high-risk mortgages without clearly explaining the loans' risks. Michael Waitt, CFP®, a principal with mortgage broker Vertex Financial Group Inc. in Highlands Ranch, Colorado, knows that his industry is under attack. Waitt has worked in the mortgage business for about nine years and understands that many financial planners view the mortgage industry as being primarily transactional. He and his partner, also a CFP certificant, started Vertex to fill a perceived need for a more advisory role with mortgage applicants.

Waitt has clients in 16 states and works with over 50 lending firms. He says that matching mortgage applicants with the right type of mortgage requires an evaluation of multiple factors. The first factor he considers is the borrower's financial acumen. Seasoned homeowners, he says, are usually more knowledgeable and willing to consider the range of alternatives. The owner's time horizon is another important factor. If a person moves frequently or plans to live in the home for a relatively short time, Waitt would be more likely to recommend an ARM where the length of time that rate is locked in is commensurate with the time horizon the person intends to hold that property. "Someone who says—and we get this occasionally—'I'm going to live in this home until I die and I don't want anything that has any risk at all'—that's usually a fairly easy analysis that the person typically would be best suited for a 30-year fixed-rate," says Waitt.

Different age cohorts also have different attitudes toward mortgages. Waitt notes that his parents and their peers have exhibited a greater tendency to stay in their homes for longer durations, while younger people tend to move more frequently. Consequently, he says, the older generation tends to believe that 30-year fixed mortgages are the best solution.

The mortgage payment is usually the last item Waitt considers. He cites an example where a couple has found their ideal house and wants to buy it but have a maximum affordable payment. That situation can dictate the type of mortgage, Waitt says, because an interest-only loan has a payment that would be lower than a fixed-rate loan that would have a principal and interest element to it. "The goals the client has are the biggest factors," he says. "I almost never walk into a situation with my mind set on a recommendation. It's not a product-oriented approach. It's definitely more of a goals-and-objectives, risk-reward element, as well as a time-horizon element."

A Balanced Approach

Mark Laspisa, CFP®, president of Vermillion Financial Advisors Inc. in South Barrington, Illinois, describes his firm as a "a throwback to the old days of comprehensive financial planning, where clients come to us for everything," including advice on mortgages. He estimates that 80 to 85 percent of the mortgages he recommends to clients are of the fixed type, but he will recommend ARMs when appropriate. He starts the analysis with a consideration of how long the client anticipates owning the home. The second factor he considers is the client's desire for "peace of mind" with their mortgage payments. Those responses give Laspisa a sense of the client's suitability for a fixed-rate mortgage or an ARM. "We also look into cash flow issues," he says. "Do they have other outstanding debt? Are we trying to minimize the payment? We'll look at their tax picture and their saving habits."

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Another critical factor Laspisa considers is mortgage affordability. Before the mortgage market deteriorated, aggressive lenders often qualified borrowers for more than they could genuinely afford. Laspisa helps clients determine how much house they truly can afford rather than how much they might qualify for. Once he understands the client's mortgage situation, Laspisa suggests which product they should consider when approaching lenders. "Every single financial product that has ever been designed was designed for a reason," he says. "If you use that product for the appropriate reason for which it was designed, it's a good thing. If you try to use a product for a reason for which it was not designed, and it's the silver bullet or solution for all financial issues in the world, then you've got problems."

Phil Storms, founder of the Westmont Companies, a real estate consulting firm in Denver, Colorado, has advised numerous financial planners' clients on mortgages over the years. (Storms is a former CFP licensee and contributor to this journal.) He believes that recommending only fixed mortgages to clients is not a viable solution, and cites the example of a doctor halfway through his residence and earning $40,000 a year. The doctor knows his income will increase, and that factor makes him a viable candidate for an interest-only loan in the interim. Storms uses an analogy to illustrate his point. "I have a pick-axe in my tool shed and I can do all kinds of good things with it, but it bears some risk because you can hurt somebody with it," he says. "Mortgages are a tool. They all bear a risk and we have to make sure clients understand those risks and are able to bear those risks. I don't think I've done very many fixed-rate mortgages for clients in the last ten years, and I don't think any of my clients are disappointed with that."

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The Planner's Role

Although firms like Vertex are introducing a consultative role with mortgagees, that's not the typical model. Most borrowers shop for a broker and lender that can give them the best deal in the shortest time frame—there is usually no contact between transactions. As a result, borrowers are frequently left on their own to manage mortgage decisions unless their financial planner can fill that role. Storms estimates that roughly 80 percent of his mortgage brokerage business resulted from referrals from planners and other financial professionals, and he filled the role of mortgage consultant in those cases. He suspects that many borrowers now facing mortgage problems are in that situation because no one was advising them. "That's the thing about financial planners and their clients' mortgages," he says. "If they don't advise them, there's no one else. If you look at the real estate agent, his job is to help those clients get into the house that fits their lifestyle. The mortgage broker's job is to get that client qualified to buy that house and to use those financial instruments that work."

Mortgages lack the appeal and income-generation potential of investment management, and it takes an ongoing effort to stay current with the mortgage market's developments. But the growth in mortgage delinquencies and foreclosures illustrates borrowers' need for objective advice outside the traditional channels, and for some planners, at least, this could be a business and service opportunity.

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