Ticking time bomb

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A nasty mortgage product promises yet more misery

OPTIMISTS, look away now. Prices in America's housing market may have slumped, but the pain for a significant subset of homeowners has barely begun. Even at Barclays Capital there is still concern. The bank's Nicholas Strand says that roughly 1.4m households, most of them in California, hold a particularly nasty type of adjustable-rate mortgage called the "option ARM". Although the overall value of option ARMs is lower than that of subprime loans—some $500 billion, according to Mr Strand, compared with about $1 trillion in subprime loans—their sting is more venomous.

The option ARM allows borrowers to pay less interest than the formal rate for a limited period (the vast majority of customers choose this option). In return, the unpaid interest is added to the original loan, a process soothingly called "negative amortisation". While house prices are rising, the product just about makes sense. If borrowers do get into trouble when they start paying off the loan in full, higher property values offer some wiggle-room. But when house prices are falling and refinancing is difficult, as is now the case, the option ARM is the financial equivalent of a bikini in winter. Homeowners end up owing more on a property that is worth less.

Delinquencies are already rising fast. Write-offs for option ARMs at Washington Mutual, a stumbling thrift, have zoomed from 0.49% in the last quarter of 2007 to 3.91% in the second quarter. But the real crunch will come when the mortgages "recast", forcing borrowers to start making full payments. The loans recast after a set period (typically some five years after origination) or when the principal hits a predetermined ceiling. The biggest wave of recasts is due to happen in 2010 and 2011. By some estimates, borrowers' monthly payments will then surge by 60-80%, at a time when property values may still be at, or close to, their trough.