Within just the past few weeks almost every investor has become aware of the fact that something very risky has been going on in the U.S. housing market. That has been a wide-spread use of adjustable –rate mortgages to finance home purchases. I have written about adjustable-rate mortgages over many years. In my February 3, 2007 column in this paper I said, "Once again, the adjustable rate mortgage has been rolled out because by starting off at a rate well under market, many more people can qualify for loans. But now, even if interest rates remain stable, the increase in the mortgage rate in just a few years, which translates to higher monthly payments, will put great financial strain on many home buyers." And this is not the first time I have written about adjustable rate risks. That was in the January, 1982 edition of "Mortgage Banking" magazine in which I described the problem and offered a solution.

In 1982, mortgage rates were north of 10% for fixed-rate 30-year loans and almost no one could qualify because the monthly payments were so high. To illustrate, a $400,000 home financed today for 30 years at 6% would have a monthly payment of $2,398. If the rate was 12% as in 1982, the monthly payment would be $4,114. This is why adjustable-rate mortgages were invented. If the lender could lower the rate, even temporarily, then more borrowers could qualify for loans. The great unaddressed problem was how to confront the fact that each borrower was certain to see their payment increase much faster than their income could.

The idea I put forth in 1982 was called a Growing Equity Mortgage, or GEM. This idea recognized that from a lender's standpoint, where "lender" can be a bank or an investor, a fixed-rate loan is risky. If interest rates rise sharply the value of the loan falls and can put stress on the lender. The adjustable rate mortgage was conceived as an answer to this but the idea had a serious flaw. Mortgage borrowers are working people and their ability to increase payments is limited by the rate at which their incomes rise. I suspected they could not withstand huge increases in payments caused by large increases in interest rates. This appears to be exactly what we are now seeing.

The idea of the GEM recognized most of these thoughts. There are circumstances where lenders need to receive more cash on their loans. One of my ideas was that lenders won't care if that cash is principal or interest. The key is more money to invest at higher rates. The flip side of that idea is that, while the borrowers must pay more, they get something in return. Instead of just paying interest, they are paying off their loan and building equity. And finally, if payments on a 30-year fixed-rate mortgage are increased just 4% a year, the loan will be paid off in about 12 years. This idea was brought to market by Merrill Lynch, Salomon Bros. and Freddie Mac.

Today's market is different from the early '80s. As I've noted, we now have adjustable-rate mortgages because of the price of houses; not high interest rates. Nevertheless, those adjustable-rate loans are as bad an idea now as they were in 1982. We need to understand that the only way someone should buy a house is if they can qualify for a fixed-rate, 30-year mortgage. And they should understand, for their own good, that if they cannot qualify, then they must work and save until they can.