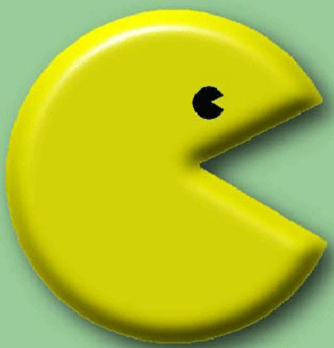

Newsletter - Vol. 4 Issue 5

May 2007

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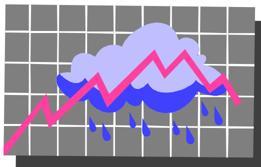
30 Yr. Fixed Conform. & Jumbo	6 & 6.25%
5/1 ARM Conform. & Jumbo	5.75 & 6%
Prime Rate	8.25%
MTA Index	5.027%
COFI Index	4.376%
Home Ownership Accelerator Index	5.32%

Morty's Bench Marks - 4/27/07

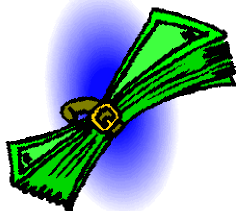
Above rates assume 30 day locks priced at par, that is, at wholesale with no rebate.

CURRENT EVENTS



During the past few months the media have been reporting on the failings of various sub-prime lender's—both their lending standards and their viability. While there is a measure of truth in aforesaid, on the whole, the sub-prime "meltdown" (as some have referred to it) has been overblown and misrepresented. While it is true that the programs were intended to increase home ownership and there were borrowers who relied too heavily upon home appreciation to make up for their lack of equity, it's not as simple as all that. It's also true that given the lax underwriting guidelines and the double-digit gains in 2002 & 2003 many buyers jumped into the market in 2004 & 2005 without considering that appreciation would ease at some point or that home values might decline. As we all know, nothing lasts forever. Now the twin bugaboos of easing home appreciation and even declines have come to fruition. In response, credit and lender guidelines have tightened considerably. So, where does this leave the average homeowner and how is it likely to affect home appreciation?

With the Fed remaining fairly steadfast in its commitment to check inflation, a rate cut before the third quarter seems as unlikely as ever. Without a rate cut, the pressure is not going to ease for these borrowers any time soon and for a number of them it will mean not being able to afford their resetting mortgages. The subsequent rise in delinquency and foreclosure rates will add to the bloated inventories of unsold homes thereby generating additional downward pressure on prices. Additionally, with the tighter lending standards now in place, this will make it harder for new buyers to qualify for loans and further serve to keep a lid on prices, at least for the next several quarters.



THE BEST LAID PLANS OF MICE AND MEN….

This month's topic was slated to be "The Top 10 Mistakes Borrowers Make When Refinancing" but, with the newspapers full of scare stories about the sub-prime fiasco I thought a 1-month moratorium was warranted. I assure you that a "white paper" on the whys and wherefores of sub-prime lending, explaining what (and not who) the true culprit is in this debacle was not something I had envisioned for the May issue. Above, in **Current Events,** I gave a brief synopsis of the situation and its likely impact on borrowers and prices. But, the substitute topic for discussion in this issue is to explain what sub-prime loans are, how underlying economic events have led to the present debacle, as well as, to identify the true problem (Hint: despite what you may have read or heard, the problem is not strictly with the sub-prime market). As a result, you may end up knowing more about this situation than you ever wanted to.

THE BACKSTORY ON SUB-PRIME LENDING

Owning one's home has long been regarded as having a piece of the American Dream. For years, the homeownership rate in the United States has ranged from 60 to 65 percent of the total population. Studies have shown that society in general benefits where there is a higher rate of homeownership because it generates financial wealth for borrowers, reduces crime and stimulates economic growth. To enable more Americans to experience it, the Department of Housing and Urban Development (HUD) worked with the housing industry, nonprofit groups and other government officials to develop the National Homeownership Strategy. The group drew up a list of initiatives. Among them were ways to make home financing more affordable, accessible and flexible. In the past 35 years, lenders have introduced a host of new mortgage products--from adjustable-rate mortgages to home equity lines of credit to no-money-down mortgages, which have served to expand the number of people who qualify for loans. But the major thing that the mortgage markets have done over the past 35 years is to be more inclusive. Formerly, the young, the credit challenged, and the low-income earners without a lot of money in the bank to use for a down payment would have been turned away.

Since 1995, as an example, even though roughly 45% of the loans made to African-Americans and Hispanics were sub-prime loans, home-ownership has nearly doubled among the respective households for these same groups. Moreover, the vast majority of even sub-prime borrowers have been making their payments. Indeed, 87% of borrowers in this most risky group have not even been delinquent on a payment, much less defaulted. In 2004, the homeownership in the U.S. reached 69.2 percent, a record.

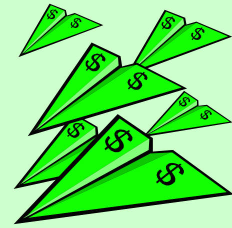
THESE LOANS HAVE BEEN AROUND FOR YEARS— SO WHY ALL THE DRAMA NOW?

So why have TV and newspapers concentrated their coverage on calamities in this housing segment? To answer this it's important to understand what constitutes sub-prime. A "sub-prime" home loan is one where the client has some significant credit issues, or was otherwise unable to qualify for a standard, conventional loan. Incidentally, some lenders have taken to referring to these borrowers as Non-Prime borrowers in an effort to de-stigmatize this category. An easy, numerical way of identifying members of this group is one whose FICO score is below 660 [the threshold for Alt-A or qualifying for a Home Equity Line Of Credit (HELOC)]. Due to the fact that these loans are riskier for the lender, their interest rates are higher. These loans are most often adjustable hybrids.

What is meant by this is that they are both fixed and adjustable, with the first 2 or 3 years being at a fixed rate of interest and the balance of a 30 year term (the typical mortgage length) being at a variable rate of interest for 28 or 27 years, respectively. On sub-primes, the rates that are fixed during the first 2 or 3 years are often called introductory rates; they are lower than what the adjustable rates will subsequently be. These rates are low for borrowers in the first few years for a variety of reasons: to enable the borrower to get into a home by qualifying at the relatively low rate, to give them time to adjust to the expenses that come with home ownership (like taxes, insurance, repairs, etc.) and to give them time to do some financial planning like replenishing savings that may have been depleted by their paying the closing costs on the new home. A mortgage with an adjustable rate is comprised of two components: the margin (or lender's profit) which is fixed and the indexed portion which is the variable. When added together it yields the actual note rate (a.k.a. fully-indexed rate). So, if the index is today at 5% and the margin was 5% the actual note rate would be 10% = (5% + 5%). Margins of 5% (or more) are often the norm with sub-prime loans, over twice as high as prime loan margins at 2.25%. Sub-prime loans are also referred to as "band-aid loans" because it is expected that borrowers will refinance out of them once they've repaired their credit in 2-3 years. This is another reason for the higher margins.

Sub-prime Adjustable Rate Mortgages (ARMs) are tied to short-term interest rates, which, more or less coincide with the terminus of the fixed interest rate period. Sub-primes and other adjustable home loan rates have moved sharply higher, due in part to the Federal Reserve

Board's 17 consecutive quarter-point rate hikes which began in July of '04. Initially, buyers did not feel the impact because their fixed interest rate periods were still in effect and the rates had yet to reset. But, as these fixed-rate periods ended, along with overall increases of more than 4% in the Prime Rate by July of '06, many adjustable rate borrowers began experiencing "payment shock" when the new, adjustable-rate phase of their mortgage reset. On top of this, the rate resets for sub-primes in the adjustable rate phase occur every 6 months; for standard adjustables, like a 5/1, 7/1 or 10/1, the reset period is ordinarily once a year.



Note: Short term rates have been dropping since last summer. The 6-month LIBOR Index, among the most volatile, peaked in June of 2006 at 5.63. It now stands at 5.37%.

Of necessity, low- to moderate-income families and the sub-prime borrowers have historically relied heavily on short-term borrowing because it was usually the most affordable. A typical subprime loan might have been issued in early 2005 at 7% or so. Today, with its fixed rate expiring, that loan might be resetting to 10%.

But the next time the loan resets--in six months--if the Fed increased the Prime Rate or were the indexed rate to rise, the rate could go up again. At the same time, households with better credit could easily have switched to long-term loans where rates have barely budged over the past three years. Unfortunately, here too, the sub-prime borrower is locked in because sub-prime loans typically have pre-pay penalties that coincide with the length of their fixed rate periods of 2 or 3 years. The pre-pays amount to 6 months of mortgage payments, so they're not insignificant amounts.

When these loans were first being made back in 2004, people didn't pay much attention to the issue of the rate resets because, historically, 70% to 80% of two-year hybrids were paid off in the first two years. Rising home values would reduce the loan-to-value ratio, qualifying the borrowers to refinance at lower rates. Or they would repair their credit and get a better loan. Or they would sell and move: homeowners in this situation would simply throw the house on the market, realize enough of a profit to cover sales expenses, and literally move on. But, with the soft real estate market this is no longer a viable option—houses are not selling, and home values have moderated in vibrant markets and even declined in others.

As for the escape route of refinancing at long-term rates, it's pretty much sealed off for sub-prime borrowers. The reason is simple: They can't qualify for a 30-year fixed-rate loan. Bloodied sub-prime lenders have belatedly tightened their lending standards. What's more, the rate on a fixed sub-prime loan is around 8.75%, which is higher than the introductory rate they've been paying. Though it's less than what they will soon be paying for their ARM, they would have to apply to get a new fixed-rate loan and most couldn't demonstrate the ability to pay 8.75%. Consequently, they're forced to stay with the adjusting portion of the loan. It's going to be a real challenge to a lot of borrowers. Ironically, many overextended sub-prime mortgagors may soon be paying 10% or more on their mortgages, while everyone else can get 30-year fixed-rate loans at a little over 6%.

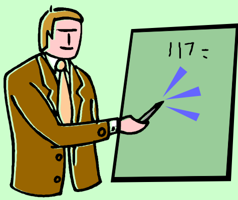
Unfortunately, a number of homeowners are paying a very steep price for what may have been imprudent advice and counsel given them at the time of their home purchase or refinance. In other cases, the advice and loan strategy given to clients was perfectly appropriate for them at the time they took out the loan....

but because of the confluence of colliding economic events in the form of relatively short term fixed-interest rate periods, continuing rate hikes by the Fed and cooling appreciation, they may end up with essentially the same result.

Now more than ever before, it is clear that it pays to work with a true professional, especially when your home is on the line. If you've ever thought it's too expensive to work with a real professional.... just wait until you work with an amateur. The price paid is often very dear and painful.

While many sub-prime borrowers may have found it onerous to keep up with the substantial increases in payments, others have become delinquent and have gone into foreclosure. The **traditional causes of foreclosure,** even before there was sub-prime lending, were **job loss, divorce and major medical expenses**. And the national foreclosure **data seem to suggest that little has changed in this regard.** The latest numbers show that foreclosures have been concentrated not in places where real estate bubbles have supposedly been popping, but rather in places whose economies have stagnated--the hurricane-torn communities on the Gulf of Mexico and the industrial Midwest states like Ohio, Michigan and Indiana, where the domestic auto industry has suffered.

The current sub-prime woes have captured the media's attention because it's the nature of mainstream reporting. As one observer put it, "traffic reports report the accidents—they don't report the normal traffic." Moreover, the media loves to deplore the hapless state of victims.



PUTTING IT IN PERSPECTIVE

According to a study commissioned First American Core Logic and written by *Christopher Cagan* titled "Mortgage Payment Reset, The Issue and the Impact" it is forecast that about 1.1 million homeowners will lose their homes to foreclosure because of a mortgage resetting to a higher rate over the next six years resulting in $112 billion in losses. Despite what you may have seen on TV and read in the newspapers, the situation is not as grievous as has been portrayed because sub-prime loans comprise only about 18% of the mortgage market, the losses from sub-prime foreclosures will amount to less than 1% of the $2 trillion total that the U.S. residential mortgage industry loans out each year. Consequently, the defaults don't appear to pose a significant threat to the economy and will account for about 0.36% of U.S. Gross Domestic Product.

WHAT DOES ALL THIS BODE FOR THE AVERAGE BORROWER?

In the short term, home loan rates have improved, as the stock market has been taking its lumps, causing money to flow into Bonds and Mortgage Backed Securities, which have benefited home loan rates. But the longer term picture may spell higher interest rates ahead, as lenders have to absorb the cost of the loans that went belly-up, combined with the cost of increased compliance and accountability standards.

"IT'S TEASERS WITH A CAPITAL T… AND THAT SPELLS TROUBLE"

Now for the bad news! Though the prospect of sub-prime borrowers losing their homes to foreclosures because of resetting rates is nothing to feel sanguine about, a far greater risk of being blind-sided by the resets lies with borrowers who have mortgages with low, teaser rates. In fact, in the same study by *Cagan*, the "teaser" loan group is expected to register a default rate of 32 percent due to resetting, followed by 12-13 percent of sub-prime loans, while only about a distant 7 percent of market-rate adjustable loans are forecast to default through resetting.

SO WHAT'S A TEASER?

Teaser rate loans are A and Alt-A paper loans where the initial interest rate is extremely low (usually in the range of 1.25% to 2.25%) which rises to market rates later. The length of the teaser rate of interest can vary from one month, to 1 year, to 5 years, depending on the specific loan. The loans that most often have these teaser rates are known by a variety of names: option ARMs, deferred interest loans or

These loans are very flexible in that they allow borrowers to adjust their payments in accordance with their cash flows. Typically, they have 4 payment options each month: a minimum payment, an interest only payment, an amortized payment (over 30 years) and an amortized payment over 15 years). Though the minimum payments are often based on a 1 to 2% start rate, borrowers still have to qualify at the Fully Indexed Rate (FIR) = Margin + Index, typically in the area of 7-8%.

Option ARMs are popular because they are marketed to buyers based on low payments or housing affordability, so it is not surprising that many if not most buyers will choose the lowest payment option. The thing that is most often the source of borrowers' undoing is that when they make the minimum payment it does not fully cover the interest on principal so the amount of unpaid interest (or deferred interest) is added to the loan balance. When the loan balance exceeds 115% - 125% (depending on the program) of the original loan balance the loan "recasts" such that the new loan balance will be paid off by the remainder of the loan term in amortized payment amounts. At this point, the minimum and interest only payment options no longer apply. These borrowers are likely to face a substantial reset impact, with mortgage payments likely to double.

CONGRESS TO THE RESCUE?

Even though the biggest problem lies not in the sub-prime arena and despite sub-prime lenders having tightened their lending guidelines considerably, Congress is contemplating calling for further restrictions on issuing loans to people with low incomes and weak credit. While senators in Congress pontificate about the rise of "risky, exotic and sub-prime mortgages," as we've seen the problem lies not with the sub-prime market but with teaser rates and borrower inattention. Another study conducted by the Federal Reserve Bank of Boston confirms as much. It re-iterates how inaccurate the claim of those in Congress that allege lenders have been responsible for harming consumers and deluding them into thinking they can afford homes when they can not. As usual, Congress is "a day late and a dollar short" and further legislation is apt to prove misguided and exacerbate the problem. When contemplating ways to minimize sub-prime borrowers whose loans are predicted to default, legislators must be careful that they do not wreck the ability of the other 87% to obtain mortgages. Let the markets correct themselves as they ALWAYS manage to do and let us leave the regulating to the regulators, not the legislators.

FOR THOSE OF YOU FACING A MORTGAGE RESET WHO CAN'T MAKE THE PAYMENT… SEE PLAN B… IN NEXT MONTH'S ISSUE.

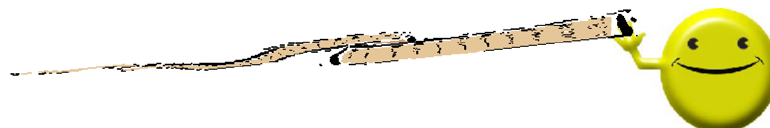
COMMENTS AND COMPLIMENTS

In the past month or two I've been in touch with most of you to solicit ways to improve this newsletter and make it more relevant for you, the readership. I'd like to thank you for your comments and compliments. The suggestion I heard most frequently, by far, was about the heavy card stock that we print the newsletter on (for recipients of print copies as opposed to the email version). Many of you pointed out that if we were to use a cheaper and thinner bond paper it would be doubly advantageous because it would also lessen our postage. The reason we use the card stock is because of "bleed through" since we print on both sides of the page. This begs the question why not print on just one side? We've considered that, but the cost savings of using two pages in lieu of one is negligible and they tend to look better and last longer on the card stock. (Some of you actually save them, although there's little need since all of the back issues are available on the web-site). As we shift away from our ink-jet printers and go to laser printers we will be going to a thinner and glossier paper which should diminish the printing and postage while preserving the look and quality of issues.

The other comment that was most often voiced was "Where did I think home

values were headed in the next year or so". "Your guess is as good as mine," was often my ingenuous response, "I'm a mortgage broker, not a realtor."

"But we figure you're privy to all kinds of 'inside information'," one reader opined. [Were it only true]. On the one hand, I do talk to realtors daily and I have made a mental note to query them on what they see as possible trends and I promise to include some of their observations in future issues. One disclaimer I feel is incumbent: my readership is rather diverse geographically. Though my readership is predominantly confined to So. Calif., it ranges from as far east as New Jersey to as far north as Washington State. Even so, the price of real estate is very much a local phenomenon and my comments could hardly be relevant for such a diverse geography. (See this issue's Current Events section for a macroeconomic view of the housing market). I will be incorporating and acknowledging more on your feedback in future issues.



TA…DAH! INTRODUCING MORTY'S LIST

Exclusive to my web site is a list of real estate professionals (Realtors, Appraisers, Title Reps, and Escrow Agents) that I can wholeheartedly endorse. I know that many of you are thinking this a rip-off of *Craig Newmark's* idea (of Craig's List fame). Well, it is and it isn't. Craig's List was "there" first. But, a good idea is a good idea—no matter whose name is attached to it.

The primary difference between Craig's List and Morty's List is that anyone can advertise on Craig's List, such is not the case on Morty's List. The names that appear on Morty's List appear solely because I've personally dealt with them and can attest to their expertise and professionalism.

To view the list, simply click on www.mortgagestraightTalk.com. Then, go to the menu button labeled "Promotions" that appears in the upper right hand corner of the web page. Open it up and as you scroll down you should see Morty's List and names, numbers and email addresses for the afore-mentioned professionals.

<u>Note:</u> if you don't see the Promotions button it's probably because your browser's platform is different from the majority. Simply move your cursor to the white horizontal line very slowly in an up and down fashion and the double sided arrows should appear allowing you to lengthen the header tabs and the Promotions button should appear.

MORTY'S MAILBAG

Q. I recall you touting the advantages of using the services of a mortgage broker by saying: WHY PAY RETAIL, WHEN YOU CAN BUY AT WHOLESALE. Yet, last month you referenced in your column entitle CORRECTION that a borrower got a better rate through a lender's retail division than what you could get them through their wholesale lending side. It seems that you're contradicting yourself. Please explain.

A. My what sharp eyes you have and a doubly good memory! You are right, however. As the saying goes, "There are exceptions to every rule," and this was one of them. The lender (in this particular case) Bank of America, has a special program for doctors that is available only through their Retail division. Although I represent their Wholesale division, a comparable program does not exist. The reason that they give the doctors preferential treatment in this regard is because medical practices have tremendous cash flows and B of A is hoping to retain these business accounts by offering the medics unbeatable rates. Coincidentally, one of our principals has a wife that works for Bank of America and she admits that the program is a loss leader for them—they make no money on doing these loans. The doctors often get their mortgages through them but use other banks for their business accounts.

MORTGAGE MIRTH

A man was in his front yard mowing grass when his attractive blond female neighbor came out of the house and went straight to the mailbox. She opened it then slammed it shut and stormed back in the house. A little later, she came out of her house again, went to the mail box again, opened it, slammed it shut again. Angrily, back into the house she went. As the man was getting ready to edge the lawn, here she came again, marched to the mail box, opened it and then slammed it closed, harder than ever. Puzzled by her actions the man asked her, "Is something wrong?"

To which she replied, "There certainly is! My stupid computer keeps saying, "YOU'VE GOT MAIL."

If you'd care to share one that you've heard, please email it to me at.... **rod@mortgagestraightTalk.com**

NEXT ISSUE'S TOPIC: THE TOP 10 MISTAKES BORRROWERS MAKE WHEN REFINANCING