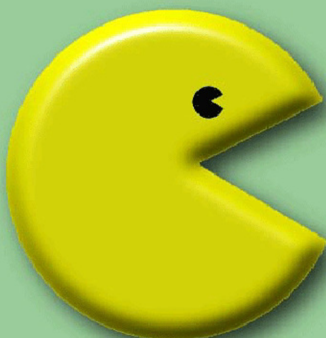

Newsletter - Vol. 4 Issue 9

September 2007

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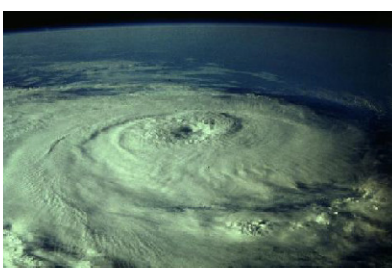
30 Yr. Fixed Conform. & Jumbo	6.125 & 7.5%
5/1 ARM Conform. & Jumbo	6.125 & 7%
Prime Rate	8.25%
MTA Index	4.983%
COFI Index	4.283%
Home Ownership Accelerator Index	5.32%

Morty's Bench Marks - 8/31/07

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

CURRENT EVENTS



I am the eye of the hurricane.

All around me is chaos.

Frustration and annoyance are lessons.

All obstacles are tools for learning.

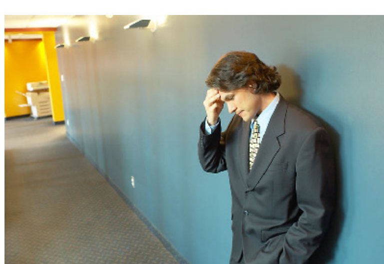
--Anonymous

THE GATHERING STORM

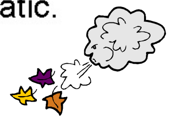
In last month's issue, I opined that we had perhaps entered the "dog days of summer", with nothing much going on. To say I spoke too soon would be an understatement. Only later, what I mistook for the summer doldrums was actually the calm before the storm.

Winds of change were in the air on July 20th when the Dow Jones Averages breezed to a close above 14,000, an all-time high. A week later (but too late for inclusion in the August newsletter) the first bellwether that something was amiss came in the form of 6% drop in the market between 7/24 and 7/27, some 434 points. As I noted back in January about my prognostications for the year, there were conditions present that could make for very volatile market swings.

Currents began eddying about more forcefully on the 25th when Countrywide Financial, the nation's largest mortgage lender, announced that due to an increasing number of their home equity and sub-prime loans going bad they expected a sharp decline in second-quarter profits. This was the first tacit acknowledgment that the problems in the mortgage industry were not contained and had spread beyond the sub-prime sector.



By month's end, 6 more major mortgage lenders had collapsed. That same day, Mortgage Guaranty Insurance Corporation, or as it's more commonly known, M.G.I.C., said it would write down its half-billion dollar investment in Credit-Based Asset Servicing and Securitization, or C-BASS, to possibly zero. Moody's and Standard & Poor's admitted that their grading of mortgage-backed securities was problematic.



"IT IS AN ILL WIND THAT BLOWS NO ONE ANY GOOD."

August 1st, the start of a new month, was the day that the industry felt the initial brunt of the ensuing financial hurricane. No longer comfortable with tightening their underwriting guidelines as they had for months, lenders en masse inaugurated a new approach: they simply dropped or suspended their Non-Conforming loans (above $417,000) Alt-A programs (LTVs above 80%),

Stated Income products, HELOCs and fixed rate seconds because they couldn't find investors to buy them. A few lenders re-priced their Non-Conforming products to the point where essentially there were no takers. For example, borrowers with 720+ FICO scores (A paper) saw their 100% financed jumbo purchase with lender paid MI (mortgage insurance) skyrocket from 7.875% to 9.625%, literally overnight. In the span of 24 hours Non-Conforming rates jumped a full point.

THE EYE

A week-long lull followed as we entered the eye of the hurricane. The European Central Bank, the equivalent of our Fed, announced that it would raise interest rates a quarter of a percentage point, to 4.25 percent, at its September policy meeting, to curb inflation amid an expanding economy. Meanwhile, the Federal Open Market Committee (FOMC) acknowledged that its favorite inflation measure, the core PCE (Personal Consumption Expenditure) remained at 1.9% for the second straight month—right in the Feds' target zone.

FORCE-FIVE FINANCIAL DEVASTATION

The financial storm gained renewed strength on the 9th starting in France, after BNP Paribas, the largest publicly traded bank there, suspended investors' ability to remove money from three funds that had invested in American mortgage securities. Turmoil in the home loan market ricocheted from France to the United States to Europe and back again as stocks on Wall Street suffered their biggest one-day decline since February, plummeting 387 points and reflecting growing concerns about tightening credit worldwide. Central banks around the globe—including the U.S., Europe, Australia, Canada, and Japan—dumped over $300 billion into their banking systems, in an attempt to ease market tensions. After the market closed, Countrywide Financial stated that the mortgage markets were "experiencing unprecedented disruptions" that could hurt its profits and financial health. The company said it planned to hold more loans on its own books because investors were not willing to buy them. But it noted that its capacity to do so was "not unlimited."

The next day, the market opened down and plummeted an additional 200 points before the Fed intervened by injecting $38 billion of liquidity into our own banking system. The Fed's intervention calmed the nervous credit markets by restoring confidence, and allowing the markets to continue to trade in an orderly fashion and stocks recovered and closed essentially flat for the day on Wall Street.

The Federal Reserve injected an additional $2 billion into the banking system on the 13th. Foreign banks took a similar action, with the European Central Bank (ECB) adding another $65 billion into the European banking system, the third infusion in as many days. The Bank of Japan also added $5 billion.

The 15th saw the shares of Countrywide Financial Corp., the biggest U.S. mortgage lender, fall for the fifth consecutive day on the New York Stock Exchange after Merrill Lynch & Co. raised the possibility of its bankruptcy. CountryWide acknowledged that it was forced to tap an emergency $11.5 billion line of credit to run its business during the credit crunch. The Dow, at one point, was down 341 points before the NYSE instituted trading curbs and Federal Reserve Bank of New York pumped another 17 billion into the system to shore up the ailing mortgage market. The session closed with the Dow down only 15 points for the day.

The morning of the 17th, The Fed cut the Discount Rate from 6.25% to 5.75%. TheDiscount Rate is the rate at which the Fed lends money directly to commercial banks, credit unions and savings and loans including large lenders. It differs from the Fed Funds Rate, the overnight rate at which banks lend money to otherbanks. The Discount rate is usually held 1% above the Fed Funds Rate, which makes the Fed a last resort for lending institutions to borrow from—they would generally of course rather borrow from other banks at a lower rate—but with the current liquidity crisis making that difficult, this move was made to provide some liquidity at more desirable rates in the short term.

More importantly, the Fed extended the borrowing period from overnight to 30 days, which could allow some lenders to use the discount window for loan fundings prior to sale in the secondary market. The 30 day extension allows time for the credit markets to settle a bit so that buyers of mortgage-backed securities can come back into the market. Additionally,it is highly likely that the Fed will cut the Fed Funds rate on or even before the next Fed Meeting on Sept 18th. It is important to note the Discount Rate is different from, the Fed Funds Rate, which impacts interest rates you pay for Home Equity lines of Credit, credit cards, and automobile loans.

This year, as of 8/29, 142 major U.S. lenders have “imploded”, meaning they have ceased operations permanently, filed for bankruptcy protection temporarily halting major operations, or have been acquired by another lender at fire-sale prices. Amid all of this decimation, the yield on the 10-year Treasury note, the domestic benchmark against which long term interest rates are measured, had dropped 78 basis points (bps) from a high of 5.29% in mid-June to 4.51% on August 29th. Ordinarily, market dips are good for mortgage-backed securities but there has been a huge discrepancy between the 10-year Treasury yield and mortgage-backed securities during this period of uncertainty, with mortgage bonds running counter to the norm. Although the bad news in the sub-prime market began surfacing as early as February, the defaults in this sector were projected to be little more than 2% of the overall market and confined to the sub-prime sector. So, their impact was deemed to be slight. Areas of far greater concern were the mortgage-backed securities comprised of Option ARMs with pending resets amid slumping real estate values which comprised a far larger segment of the mortgage market. (See Morty’s Mailbag, this month, for a detailed example).

GONE WITH THE WIND

We’re in the current liquidity crisis for one underlying reason--GREED. The primary reasons are several: Mortgage lenders competed against each other for sales to the point of imprudence. Lenders were eager to make sub-prime loans because they were so lucrative. These loans bore pre-payment penalties right up to the day of the payment reset and when the payment reset, the increases were substantial because the sub-prime margins were twice that of “A paper” loans. Like a game of “Musical Chairs”, as long as the music played and housing prices kept rising, everyone was okay. But when the music stopped and prices began to fall, borrowers who had put no money down and/or had Interest Only loans could not refinance as many owed more than their homes were worth. Lenders were certainly aware that prices couldn’t rise endlessly, but, again, the profits relative to the forecasted rate of foreclosure looked small and contained.

To capture an even larger market share of the Prime and Alt-A market, lenders had not only relaxed their underwriting guidelines, they created a welter of programs of dubious merit like or Stated Income Loans for Wage Earners (a.k.a. "liar loans"), 103% and 125% financing. Interest Only & Option ARMs and various Option hybrids were marketed on the basis of their low payments without sufficiently educating borrowers to their downsides. The low payments often enabled borrowers to buy more expensive homes that they could ill afford. To obtain a loan, it got to the point where little more was needed than a valid Social Security Number and a heartbeat!

To counteract this, the Fed tightened credit with 17 successive ¼ point bumps to the Fed Funds rate between 2004 and 2006. But Wall Street devised new ways of blunting the impact of these measures. It diluted the pools of securitized mortgages by inserting "tranches" or slices of riskier but higher yielding bonds to create a new security called a Collateralized Debt Obligation or CDO for short. Because most investors don't fully research bond risks, a costly and complex task, they rely instead on ratings agencies or mathematical risk models. Despite the dilution, Moody's & Standard & Poor's continued to assign AAA ratings to these CDOs even though they were composed of AA, A, & BBB rated mortgage bonds, as well. As the defaults mounted, questions arose about how these AAA rated mortgage backed securities and CDOs could be affected, given their stellar credit rating.

When the market became aware of what truly comprised many of these holdings, investors, uncertain as to the actual risk factor, backed away. The few that would buy them, now, required a significantly higher return. A number of hedge funds which were heavily invested in these risky securities discovered that because of their highly leveraged positions their losses were magnified, with as much as 90% of their value being wiped out. Further, because the funds were often unable to discern the extent of their losses they were unable to value their holdings. Consequently, as investors headed for the exits, the funds were forced to suspend redemptions which in turn further panicked shareholders and credit seized up.

The media also needs to take its lumps to for sensationalizing the sub-prime mess; it was always much smaller than the media let on. Panic occurs when fear outruns fact and the media certainly fed the ensuing panic. The credit markets have a herd mentality and those that spook the herd and cause them to stampede have to accept a measure of blame.

THE FUTURE

The first line of defense for dealing with a liquidity problem is to make sure the system has enough reserves, so there can be an adequate amount of lending. The next line of defense, if market jitters persist and a recession appears imminent, would be to cut interest rates. Some on Wall Street want Mr. Bernanke to do that now. I believed that the Fed would not lower the Fed Funds rate this year. But, conditions have deteriorated so dramatically that the Fed may need to lower rates to head off a major recession. Traders have gone from predicting that an interest rate cut was unlikely to forecasting that it's all but certain by September 18th. Some speculate that by the end of the year, the Fed will have cut the Federal Funds rate by half a percentage point.

Within the year, the present pandemonium will have abated and some semblance of normalcy will have been restored. The insurance companies and pension funds that are the traditional buyers of bonds always have money coming in, from interest payments and bond maturities, as well as from new business, and they will have to put it to work. So, is the crisis over? Not even close. In the next ninety days trillions of dollars of commercial paper will come due. There will be no relaxing until the market sees how that evolves. Until then, short-term borrowing will be difficult and likely lead to more turmoil.

History has shown that lenders, move like a pendulum between two extreme points—stringency and accommodation. Lenders will swing back toward accommodation one day, but for now, it appears that borrowers looking for Non-Conforming loans, LTVs in excess of 80% or Stated Income loans will find, at least for the time being, that it will be much more difficult to find someone to lend them money and/or that there is a significantly higher premium to be paid.

On 8/27, CNN reported that the glut of homes on the market hit a 16-year high, with 9.6 months of inventory. For the first time since the Depression real estate prices have dropped for the 12th straight month and until this surfeit of inventory is reduced, the downward pressure on prices will remain extant. San Diego has been hard hit with a 7.3% decline in home prices.

THIS ISSUE'S TOPIC: LOAN RATE LOCKS

The topic this month's issue was originally to be on "Short Sales", but given what's transpired I wanted the Current Events section to render an explanation of some depth and perspective. (The topic of "Short Sales" will be featured in next month's issue). Had I stuck to the original topic, I fear that the length would have worn out my welcome with some readers as a few have commented that recent issues have been too long or technical. I try to avoid this, but it's often difficult to provide meaningful explanations without going into some detail. This month's topic is one that has a special poignancy for realtors, mortgage brokers and buyers who were in the middle of deals last month but didn't have them locked. The topic, is a minor one, so it shouldn't be too "heavy" for anyone. Mortgage rate locks are confusing to many consumers though I'm not sure why.

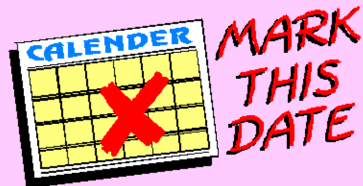
An interest rate lock-in is simply a lender's promise to hold a certain rate for a specified period of time, while the loan application is being processed. The length of a rate lock varies from 15 to 75 days, though the norms that appear on most wholesale rate sheets are 15, 30, 45, & 60-day locks. There are some lenders who have rate lock terms like 20, 35 and 50-day locks but they're in the minority.

Contrary to what some people believe, it costs a broker nothing to lock a rate. (This is not to suggest that one can lock with impunity—if done frequently the lender will disapprove the broker). The fee for a rate lock is assessed **only if and when** the deal closes. Then, the fee is either charged to the borrower or borne by the broker if he or she is receiving a rebate.

The longer the term of the interest rate lock, the higher the cost. Hence, a 15-day lock will be the least expensive and a 75-day lock, the most. The actual cost between terms amounts to a percentage of a point, usually an eighth of a percent. When the mortgage markets

are stable the variance between say a 15-day lock and a 30-day lock may be as little as a sixteenth and when they're in turmoil the difference may be as great as three-eighths because financial markets abhor uncertainty.

Generally, lenders are very good about honoring rate locks on their programs, but there are exceptions, as evidenced by what happened last month. In instances where lenders have elected to discontinue loan programs with files already in process, they simply deny loan approvals. In cases where the approval has been granted but the rate hasn't been locked, they will usually announce a deadline by which locks will be honored and/or at a revised price. If the loan has been approved and locked, but the lender doesn't have investors to buy the loans they simply won't fund the loan. "You can lead a horse to water," as the saying goes, "but you can't make him drink," or for that matter, a lender, fund. But, this is a rarity.



The interest rate lock-in period should be long enough to cover the average time for processing loans in the local area. Also any special factors that might delay the settlement of the loan should be considered e.g., doing credit repair like a "rapid rescore" to obtain a better rate. If the lock-in period is exceeded, rate lock extensions can be obtained but they can be costly. Lenders may grant a brief extension of 2 or 3 days for gratis. On the other hand, an extension of a week or two may cost the borrower or the broker anywhere from a quarter, to a half or even a whole point. It depends on the state of the credit markets.

The lock-in is important to the consumer because it provides assurance that the interest rate will not increase while the loan application is being processed and while work is underway to prepare, document and evaluate the loan application. When applying for a mortgage loan and determining the timing and length of a rate lock-in period, there are many personal factors that should be considered. It's important to discuss it in detail with a loan officer because should rates drop, there's no re-locking at a lower rate once the rate has been locked.

MORTY'S MAILBAG

Q. In your May issue, the one about the sub-prime fiasco, you referred to teaser rate loans and mentioned that if a borrower were to make only the minimum payment they would end up with their payment more than doubling in time. We have one of those so-called option ARM loans and I'm still not clear why that would happen. Could you provide some real world numbers by way of explanation? Our loan amount when we took it out was $400,000 and we've had it about 33 months. Our minimum payment was based on a rate of 1% but our loan agreement says our interest rate is 7.5%. I'm confused by this, is our rate 1% or 7.5%? Our mortgage note said that the loan would recast after 5 years or when our balance got to 115% of the original amount.

A. Your loan goes by a variety of names: option ARMS, Pick-A-Pays, neg-ams, and deferred interest loans. The problem is not with the loans, per se, but with borrowers not fully understanding what they signed up for. Not to mince words, it sounds as though you're one of these borrowers. These loans were popular because they were marketed to buyers based on low (minimum) payments, so it is not surprising that many, if not most, buyers chose the lowest payment option.

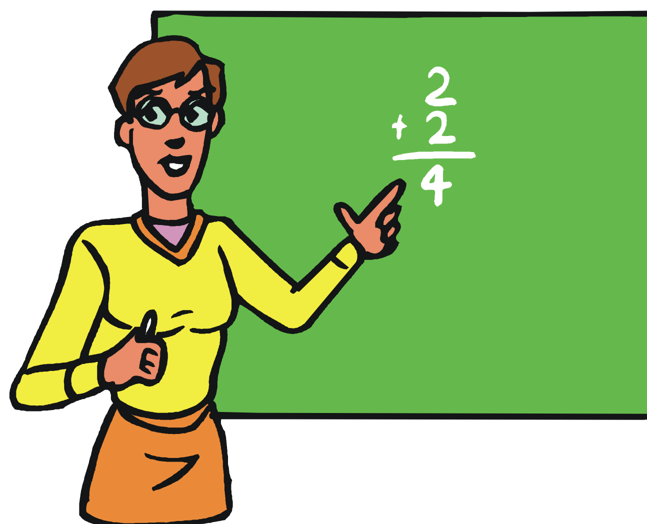
The thing that is most often the source of borrowers' undoing is that the minimum payment does not cover the interest on the principal so the amount of

unpaid interest (or deferred interest) is added to the loan balance (principal). When the loan balance exceeds 110% to 125% (depending on the lender and loan program) of the original loan balance, the loan "recasts" such that the new loan balance will be paid off within the remaining years of the loan term in amortized payments. Then, the minimum and interest only "options" are no longer available.

An option ARM loan of $400,000 @ 7.5%, the true note rate (or contract rate), would have a minimum monthly payment of $1286 (the minimum payment is arrived at by using an amortized rate of 1%--this does not mean any of the payment is going toward principal reduction, it is only a way of calculating the minimum payment). The interest only payment would be $2500 and the fully amortized payment on a 30 year term would be $2796. In your case since the recast limit is 115% of the original loan amount, then, when your loan balance reaches $460,000, it will recast. If you have been making only the minimum payment, your negative amortization is ($2796 – 1286) = $1510 is added monthly to the loan balance and will hit the $460,000 recast point in your 39th month (460,000/ 1,510).

This will leave only 321 months remaining in which to pay off the loan (30 years x 12 months = 360 -39 = 321). **After the recast, minimum and interest only options no longer exist and the amortized payment will be 258% higher than the $1286 you have been accustomed to paying and the new payment will be $3324.** By my calculations your new loan balance is (33 x 1510 = 49,830 + 400,000) = 449,830. Since you have approximately 27 months left on your mortgage before it will recast, providing your loan balance does not hit $460,000 first, I would begin increasing my minimum mortgage payments in the neighborhood of $838 so as to get the most mileage out of the remaining 27 months of your mortgage before it recasts at the 5 year mark. I arrived at this number by subtracting $449,830 from $460,000 leaving 10,170 then dividing this by the 27 months left on a five year term (5 x 12 =60 -33 = 27) and dividing this gives 10,170/27 = 376, then, $2500 (interest only payment) - 376 = $2124. Or, 1286 + 838 = $2124.

Incidentally, you didn't mention if your option ARM loan was a traditional Option ARM (where the annual payments increase 7.5% per annum) or a 5 year hybrid (where the payments remain fixed for 5 years, providing the recast limit is not reached so I assumed the latter. If you had the former, you would have slightly more cushion at $13,122 before you reached the $60,000 recast point and you would only have to increase your payment to $728. In case that's the situation, here's the math $13,122/27 = 486 amount of negative amortization that could be added monthly and still not trigger the recast. $2500 (amount of interest only payment) minus the $486 = $2014.



You didn't ask it, but sometime prior to the 60th month, you should arrange to refinance and it might not even be a bad idea to choose an Option ARM loan again, if real estate prices are rising faster than your loan is negatively amortizing and if they're still available. Just be sure you know what you're getting yourself into.

Recipients of the newsletter are invited to Ask Morty any real estate or financing questions. The answer to the question will be answered in the next issue for the benefit of all. Questions may be forwarded via mail phone or fax. (See front of issue for phone and fax numbers). Morty's email address is.... **Morty@MortgageStraightTalk.com**

NEXT ISSUE'S TOPIC: THE SHORT SALE

MORTGAGE MIRTH

The classified ad said, "Wanted: a very experienced lumberjack".

A man answered the ad and was asked to describe his experience.

"I've worked at the Sahara Forest."

"You mean the Sahara Desert," said the interviewer.

The man laughed and answered, "Oh sure, that's what they call it now."

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