

Housing and the Economy

ARM Survey Reveals Trend Toward Tighter Underwriting

Lenders appear to have tightened ARM underwriting standards by reducing initial-period discounts and qualifying more borrowers at the fully indexed rate.

Those are just some of the findings in Freddie Mac's third annual survey of one-year ARM characteristics. (See accompanying table for more complete comparison.) The survey, run in conjunction with Freddie Mac's weekly Primary Mortgage Market Survey (PMMS), revealed that nearly 25 percent of the lending programs qualified applicants based on the fully indexed rate, compared with only 10 percent in late 1985. In addition, some lenders used an alternative requirement—the initial rate plus the annual rate cap (200 basis points)—which often is more stringent than the fully indexed rate.

Vary with Downpayment

Although the survey responses refer to ARMs with an 80 percent loan-to-value ratio, several lenders noted that the interest rate used to qualify borrowers varied with the amount of the downpayment. These lenders typically apply the initial interest rate when underwriting loans with loan-to-value ratios of 90 percent or less, but use the fully indexed rate when the ratio exceeds 90 percent. This procedure satisfies the underwriting criteria for Freddie Mac's ARM purchase programs.

Pricing Changes

The PMMS results also reveal a striking change in the pricing characteristics of new one-year ARMs compared with a year ago. Since late 1985, the fully indexed rate on one-year adjustables has fallen by more than the initial interest rate. As a consequence, the average first-period discount (the difference between the fully indexed rate

Characteristics of New Commitments for One-Year ARMS

(a) Qualification Standards

	November ¹ 1985	December ² 1986
Percent Distribution		
Initial Rate	82%	64%
Fully Indexed Rate	10	24
Initial Rate Plus 2 Percent	n.a.	6
Other	6	6

(b) Interest Rates

	November ¹ 1985	December ² 1986	Difference
Initial Rate	9.42%	7.77%	-1.65%
Index Rate	8.18	5.78	-2.40
Margin	2.55	2.60	.05
Fully Indexed Rate	10.73	8.38	-2.35
Initial Period Discount	1.31	.61	-.70

¹—84 percent of the programs used the one-year Treasury as index, and 10 percent used the cost-of-funds.

²—Sample limited to ARM programs indexed to the one-year Treasury (Survey conducted during week ending December 5).

³—In the December 1986 survey, this category refers to a qualification rate that generally lies between the initial and fully indexed rate.

n.a.—Not available.

Source: Freddie Mac Primary Mortgage Market Survey

and the initial rate) has narrowed from 131 to 61 basis points. By making ARMs more expensive relative to fixed-rate credit, the smaller discounts have contributed to the falloff in the ARM share of originations during the past year.

Readers should note that this analysis is based on a survey of commitment programs rather than loan closings; therefore, programs which are relatively inactive are given the same weight as plans which generate a high volume of ARMs. As a result, the characteristics of actual recent originations may differ somewhat from the conclusions.

by Frank Nothaft