From the Editor

Take three disparate topics, shake madly, bake at 500 degrees and await the outcome. That's pretty much what went into concocting this *SMM*. Happily, the final product turned out just right.

Consider the three topics featured: Lending to the underserved that ostensibly is dogged by high defaults. Loan swindles. A mortgage designed to right a market imbalance.

Yet a central theme recurs. Each article presents a prickly problem. The players involved nonetheless persevere and produce more palatable prospects than first seemed possible.

First, Freddie Mac's chief credit officer, Mike Stamper, presents new research proving that affordable loans perform as well as other mortgage types, early evidence to the contrary.

Mortgage fraud is another sensitive topic. Yet, as *SMM* Managing Editor Michele Walczak recounts, the lending community has decided to declare war.

Borrowers, some say, are indifferent to the business side of mortgages. The backers of the prepayment-protection mortgage, however, are convinced that borrowers are ready to decide whether to share in the risk for part of the reward. Authors Jim Cotton and Susan Mudry explain.

So a few eggs did break to produce this issue, but I believe it serves up an omelet both wholesome and filling. My compliments to the many chefs involved.

H. Jane Lehman
Editor

Payment Options Proliferate Among ARMs

Borrowers who wish to defer the interest-rate uncertainty of an adjustable-rate mortgage (ARM) to seven or even 10 years now can find many more lenders willing to postpone the first payment adjustment that far into the future.

EXHIBIT 1: ARM Product Features

	1-Year ARMs		3-Year		5-Year
	Conforming	Jumbo	3/1	3/3	5/1
1. Index	5.58%	5.58%	5.58%	6.08%	5.58%
2. Margin	2.79	2.80	2.80	2.79	2.79
3. Fully Indexed Rate *(rows 1+2)*	8.37	8.38	8.38	8.87	8.37
4. Starting Rate	5.58	5.64	6.78	6.91	7.11
5. Initial Discount[1] *(rows 3 – 4)*	2.79	2.74	1.60	1.96	1.26
6. Points	1.4	1.4	1.3	1.4	1.2
7. FRM–ARM Spread[2]	1.95	1.89	0.75	0.62	0.42
8. Product Penetration	100	96	81	44	77

Note: The sample is limited to ARMs indexed to either the 1-year or the 3-year Constant Maturity Treasury (CMT) yield. Data were collected from 117 ARM lenders during the week of September 5, 1997. The 3-year and 5-year ARM results are limited to conforming loans.

[1]Based on the value of the weekly average 1-year or 3-year CMT yield for the week ending September 5, 1997.

[2]Based on the average 30-year conforming fixed-rate mortgage (FRM) commitment rate of 7.53 percent from Freddie Mac's Primary Mortgage Market Survey for the week ending September 5, 1997.

Source: Freddie Mac

Although the annually adjusting 1/1 ARM remains the most popular of the ARM payment options, the availability of ARMs that delay the first rate adjustment for seven years or longer has gained ground over the past year, a nationwide survey of lenders shows.

Sixty-four percent of the lenders participating in Freddie Mac's 14th annual ARM survey report that they are offering a 7/1 ARM. That's up 16 percent from the previous year, when only 55 percent were prepared to originate the product, which locks in an **initial interest rate** for seven years and adjusts annually thereafter.

Likewise, the 10/1 ARM now is finding an outlet through 52 percent of the respondents compared to 45 percent in 1996. The interest rate on a 10/1 ARM remains constant for the first 10 years and then adjusts each year.

The 1/1 ARM, however, has proven the most ubiquitous. Of the 117 lenders selected to participate in this year's survey because they offer a 1/1 ARM as part of their **conforming mortgage** product line, 96 percent also originate the mortgage as a **jumbo** product (*Exhibit 1*). As of early September, when the research was conducted, lenders were charging an average initial interest rate of 5.6 percent during the first year of the loan. Beginning in September 1998, then, the rate on these 1/1 ARMs will reset annually in line with the prevailing one-year Treasury rate plus a **margin**, which in this year's survey averaged 2.8 percent, subject to a cap which limits the maximum rate change.

Approximately 81 percent of lenders are offering 3/1 ARMs at an additional cost of 1.2 percentage points above the rate charged on the one-year ARM. Similarly, 77 percent of these lenders are marketing a 5/1 ARM for an extra 1.5 percentage points above the 1/1 ARM starting rate.

Less popular is the 3/3 ARM, available through only 44 percent of the

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alone, residents lost more than $183 million to mortgage swindles in 1993 and 1994, according to the San Francisco branch of Consumers Union. To help provide relief, Freddie Mac and the Mortgage Insurance Companies of America (MICA) gave the Los Angeles District Attorney's office a $500,000 grant in July 1994 to fund a new unit dedicated to investigating and prosecuting cases of real-estate fraud. A law passed in 1996 has since given all California counties the option of assessing a $2 recording fee on real-estate trust filings to fund similar investigation units.

Fighting the Good Fight

Given the lack of a foolproof system to prevent the dishonest, the unscrupulous and the greedy from targeting the industry, the complete eradication of mortgage fraud is close to impossible.

Nonetheless, expanded efforts by the housing-finance community to thwart fraud crimes are yielding encouraging results. As the industry continues to tighten its ranks, arm its personnel with information to mitigate fraud and aggressively pursue scam artists, the message it is sending is clear: Fraud perpetrators beware; we are watching. SMM

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respondents. Even though the interest rate on the 3/3 ARM changes every three years, lenders are not charging borrowers much of a premium for the extra certainty. The average starting rate of 6.9 percent on a 3/3 ARM exceeded the 3/1 ARM start rate by a mere 0.1 percentage point.

Despite the widespread supply of ARMs, demand has waned in the face of historically low interest rates on fixed-rate mortgages. In August, ARMs accounted for only 20 percent of total mortgage financing, according to the Federal Housing Finance Board.

To make ARMs more attractive to consumers, lenders typically offer these products with a starting rate discounted below the **fully indexed rate**. On a conforming, one-year ARM, lenders were giving up 2.8 percentage points of interest during the first year, coincidentally an amount equal to the margin. Consequently, borrowers were paying about the same interest rate as the U.S. Treasury for the first year.

Since Freddie Mac's last ARM survey, the average discount has increased by 0.1 percentage point to 0.2 percentage point for ARMs that at some point adjust annually and by a heftier 0.4 percentage point for the 3/3 ARM. (See "ARM Lenders Compete on Introductory Rates," *SMM*, December 1996.) As Exhibit 1 also shows, lenders are shaving off successively less from the introductory rate as the duration of the initial-payment period lengthens. Likewise, the interest-rate spread between adjustable-rate and fixed-rate mortgages narrows as the initial-rate period extends.

Additional calculations indicate much less deviance in the prices charged for fixed-rate mortgages. The interest rates quoted within ARM-product categories varied across lenders by up to three times that cited for fixed-rate mortgages, leaving a diligent ARM shopper a wide range of price points from which to select.

—Michael Schoenbeck, financial analyst