

## Goodbye Amortization?

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A new crop of mortgage products surging in popularity-especially option ARMs and interest-only loans-may raise some interesting long-term questions for the mortgage industry. They are part of a number of product trends moving the industry into unexplored territory.

NON-AMORTIZING MORTGAGES REACHED A peak in 2004, while negative-amortization mortgages have been surging this year. These products begin with low payments but are subject to big jumps in payments down the road. Some suggest they are contributing to a spike in house prices in some overheated markets, and some are forecasting an increase in defaults for borrowers who have chosen these instruments-unless they can refinance out of them before they experience payment shock. \* It's hard to imagine "non-amortizing mortgages" becoming a household word. Yet, in recent years consumers have increasingly flocked to new types of non-amortizing mortgage products that allow them to have initial lower monthly payments, which adjust higher in ensuing years. These products allow consumers to afford homes they might not otherwise be able to buy. They also provide borrowers who could otherwise qualify for a fixed-rate mortgage (FRM) a way to manage their cash flow by controlling the amount of amortization of the principal they will pay in any given month. \* While these new hybrid products occupied a market niche five years ago, consumers have been flocking to them, driving up their share of originations in 2004 to 23 percent-with 31 percent of home-purchase mortgages, according to LoanPerformance, a San Francisco-based mortgage data research company and subsidiary of First American Real Estate Solutions. \* "It's a significant chunk of the market," says Frank Nothaft, chief economist with Freddie Mac. \* For the first half of 2005 the share of origination volume for these products fell to 19 percent of the market. The decline in overall share came entirely from a sharp decline in purchase mortgages, which fell from 31 percent to 23 percent, during that period, according to LoanPerformance. The share of mortgage originations for borrowers who were refinancing with non-amortizing mortgages held at 16 percent, according to LoanPerformance.

Even as the market share for non-amortizing mortgages as a group stabilized, it was rising for a group of mortgage products that provide not just deferred amortization, but which give customers a payment choice that allows for negative amortization.

When a customer makes the minimum payment using an option adjustable-rate mortgage (ARM) and it does not cover the interest charge, the total mortgage balance owed on the house will rise. Consumers have been turning to payment option ARMs in greater numbers, particularly buyers in markets where real estate prices have jumped the most.

There is another popular hybrid called the interest-only (IO) ARM. These three-year, five-year, seven-year and even 10-year ARMs offer a lower interest-only payment in the initial years of the mortgage. After the initial period expires, the mortgage switches to a payment that starts to amortize the principal. The monthly payment at that time can rise sharply as the loan both adjusts its underlying interest rate-it adjusts to a one-year ARM that is calculated by adding a set percentage margin to the index on which the loan is based-and also kicks in a principal payment that amortizes the full principal over the remaining life of the loan.

The option ARM, by contrast, provides borrowers with a range of payment options that includes a minimum payment that, as interest rates rise, can allow borrowers to make a payment that is below the monthly interest charge on the outstanding mortgage. The option ARM, typically based on the index for the monthly Treasury average (MTA) for one-year Treasuries-known as MTA option ARMs-also offers an interest-only payment option, a 30-year amortization payment and a 15-year payment. There are option ARMs based on other indexes, including the London interbank offered rate (LIBOR).

Most option ARMs limit the annual increase in the minimum payment to 7.5 percent. There is also a cap on the amount of negative amortization allowed, usually preventing the balance from going higher than either no percent or 125 percent of the original mortgage balance.

A cipher in the market as recently as 1999, option ARMs may have as much as a quarter of the non-agency market that is, prime jumbo and alternative-? loans bundled by Wall Street firms and funded by investors in residential mortgage-back securities (MBS).

As option ARMs have made the transition from serving a savvy borrower to the broader mainstream, they have generated some concern about the risks to unsophisticated borrowers. Others are monitoring possible risks to MBS investors. Still others wonder whether or not such products are contributing to excess home appreciation.

A chief concern is that more and more borrowers using these loans may not fully understand the potential for payment shock, and many of them may not be able to manage the higher payments when they come.

"The product was developed for a specific market niche a sophisticated borrower looking for cash-flow management," says Mark Milner, chief risk officer at PMI Mortgage Insurance Co., Walnut Creek, California. "Now it's migrating into a section of borrowers it was not intended for."

There is also concern among the credit-rating agencies that the credit quality of the average borrower for these loans is declining to the lower edge of the near-prime market, and that competitive pressures could push lenders further down the credit quality scale.

Federal Reserve Chairman Alan Greenspan weighed in on the growing use of non-amortizing mortgages in his testimony before Congress in July, and tied them to a portion of the "apparent froth in the housing markets."

"[S]ome households may be employing these instruments to purchase homes that would otherwise be unaffordable, and consequently their use could be adding to pressures in the housing market," he stated. Greenspan also sounded a caution to the mortgage industry. "[T]hese contracts may leave some mortgagors vulnerable to adverse events. It is important that lenders fully appreciate that some households may have trouble meeting monthly payments as interest rates and the macroeconomic climate change."

Some insight into the size of the non-amortizing market can be garnered from a report from Deutsche Bank's Global Markets Research, which calculates that more than \$1 trillion of hybrid non-amortizing loans will hit their first reset date in 2007. "This could result in a significant uptick in refinancing activity in that year, and may have implications for delinquency levels as well," states a white paper issued by the Mortgage Bankers Association (MBA) in August (Housing and Mortgage Markets: An Analysis).

Indeed, as the use of option ARMs and IOs has spread, there is evidence that, at loan application, the typical borrower has lower FICO® scores, is providing less loan documentation of income and assets, and is more likely to put down less than 20 percent. These borrowers are sometimes relying on piggyback second mortgages to complete the home purchase. All these factors layer additional risks that are troubling, according to PMI's Milner.

Are option ARMs and IOs in "hot" real estate markets fueling some of the home-price appreciation? "It certainly does contribute to a bubble," says Mike McMahon, a managing director at Sandier O'Neill & Partners LP, San Francisco.

"Marginal borrowers are putting down less than 20 percent at the top of the market, hoping to refi before the payment resets," he adds.

Other observers believe that borrowers are struggling to buy the same home they would have bought a few years ago, but can no longer afford with traditional financing because of rising home prices and rising interest rates. "It's a chicken-and-egg thing," says Milner. "Home prices are up because demand is high. People bid up the prices."

There are already signs of slowing home-price gains in some of the hottest markets. In San Diego, one of the markets that led the boom in home prices, price gains slowed significantly to a 2.1

percent year-over-year increase in August, according to DataQuick Information Services, La Jolla, California. PMI, for one, is predicting prices will stagnate across the country over the next few years because home prices have outstripped median incomes, reducing the pool of eligible buyers who can afford to buy at ever-higher prices.

#### Payment shock

While nearly everyone understands that payments could rise in the future for borrowers with these unique adjustable products, fewer people have taken the time to figure out just how high payments could go. New York-based Standard & Poor's (S&P) took on that task. Based on its outlook for interest rates and terms and conditions of most of the option ARMs in the market, S&P calculated that payments on an option ARM are likely to rise 80 percent in the fourth year—a far higher jump than probably most expected.

This occurs under a scenario where there is an option ARM with a 110 percent cap on negative amortization and a 7.5 percent cap on annual increases in the payment. The mortgage reaches the neg-am cap at the beginning of the fourth year and resets at a higher interest rate and loan balance, and with a fully amortized payment.

S&P's concern was bolstered by the fact that it was seeing 75 percent of borrowers with option ARM mortgages choosing to make only the minimum payment. This payment pattern means that the great majority of option ARMs are, to borrow a phrase in the mortgage industry, "neg-amming"—or, experiencing negative amortization.

These loans can, in fact, expect to encounter the payment spikes S&P calculated in its simulation. As S&P put in a report titled Increasing U.S. Option ARM Credit Support to Address the Probability of Default, "Because these loans have the potential to negatively amortize, which results in a higher loan balance upon foreclosure, they are subject to a higher loss severity."

Option ARMs and other hybrid products, Standard & Poor's found, are also subject to a higher foreclosure frequency than 30-year FRMs. For this reason, S&P decided to require additional credit enhancement for option ARMs, IOs and 40-year mortgages.

While 40-year mortgages are amortizing mortgages, they spread the amortization over a longer period, so that in the initial years the portion of the payment dedicated to principal is lower than it would be with a 30-year mortgage. At a time when some local markets are seeing dramatic price increases and may experience a correction in the future, the 40-year mortgage may not amortize fast enough to ensure that lenders and investors in mortgage securities are fully protected if there is a default.

S&P's additional requirements for IOs reflect the fact that the potential for payment shock is also built into IO ARMs. Borrowers are typically qualified at the initial interest-only rate, and monthly payments can rise at a steeper pace than even for option ARMs, according to Cyan Sinha, senior managing director at Bear Stearns SL Co. Inc., New York. Sinha acknowledged that option ARMs have a much steeper payment shock than IOs, when one looks at the teaser rate and the rate at which future payments will be calculated. However, if one uses the qualifying interest rate for the baseline for modeling how option ARMs will behave instead of the teaser rate, the payment shock is higher for both three-year and five-year IOs.

S&P required an increase of collateral to cover an additional 20 percent in foreclosure frequency for option ARMs with a neg-am cap of no percent to 125 percent, according to Brian D. Grow, associate director at Standard & Poor's. At the same time, S&P required an increase of collateral for interest-only ARMs for consumers who have lower FICO scores. For those with at least a FICO score above 695, there is no adjustment. However, for borrowers with FICO scores between 660 and 695, bond dealers must set aside more collateral to cover an additional 10 percent in foreclosure frequency, according to Grow. For FICO scores below 640, deals will need additional collateral to cover a 20 percent higher foreclosure frequency. S&P also began requiring additional collateral on 40-year mortgages to cover a 5 percent higher foreclosure frequency, according to Grow.

S&P's tiering of risk for hybrid IOs based on FICO scores reflects its concern that FICO scores for borrowers using non-amortizing loans are declining to a range of 680 to 700. In the early years, the FICO scores for borrowers getting non-amortizing loans typically exceeded 740. FICO scores in the 680 to 700 range are still considered prime, according to Michael Stock, a mortgage bond analyst at

S&P. But the overall decline shows that the use of non-amortizing loans has moved from "the crème de la crème to the general public."

While LoanPerformance has good numbers for the size of the overall non-amortizing loan market, hard numbers on its individual sub-sectors-especially the option-ARM market-are difficult to come by. LoanPerformance, for example, separately compiles for option ARMs and IOs, but also reports that participating lenders that send them data do not always report the type of mortgage to the firm, according to Robert W. Visini, LoanPerformance's vice president of marketing. LoanPerformance has estimated that option ARMs represent 9 percent of originations for the first half of this year.

Within the non-agency market, however, option ARMs have a sharply higher share of the overall market. S&P's Grow reported that the option-ARM share has risen from \$3.3 billion or 3 percent of the \$110 billion market for prime jumbo and alt-? in the first five months of 2004 to \$42.5 billion or 24 percent of a \$170 billion market for these mortgage products for the same period in 2005.

Grow provided these numbers at a presentation he gave on option ARMs at a mortgage roundtable hosted by Bear Stearns & Co. Inc. in August. By contrast, in 1999 the size of the S&P-rated market for jumbo and alt-? option ARMs was a tiny \$8 million-the equivalent of a couple of homes in Laguna Beach, California.

The key issue for S&P in deciding whether to increase credit-enhancement levels was whether or not borrowers could afford to make the higher payments and, thus, ride out any potential downturn in home prices.

S&P looked at how rising payments would affect the debt-to-income (DTI) ratio of borrowers and, thus, determine what the potential burden might be. To be sure, it is important to note that option ARMs, unlike IO hybrids, do not qualify borrowers on the basis of the minimum payment, but on the basis of a fully indexed rate and amortized payment. In his presentation to the Bear Stearns mortgage roundtable, Grow cited six examples of originators and the qualifying rates they use. Only one used the initial teaser rate to qualify buyers. All the rest used the fully indexed rate, and one used the fully indexed rate plus a margin of two percentage points.

Grow has identified some of the trends S&P found with option ARMs that go to the question of whether borrowers will be able to manage the payment shock. In the early years of emerging popularity for option ARMs, more borrowers had full documentation on their loan applications (more than 30 percent in the years 2000, 2001 and 2002). More recently, the portion of borrowers with full documentation fell below 20 percent just as the product's popularity soared in 2003, 2004 and 2005.

Only 16 percent of option ARMs in residential mortgagebacked securities (RMBS) deals rated by S&P in the first part of 2005 had full documentation, according to Grow. At the same time, S&P found another potentially worrisome trend in the form of a rising percentage of cash-outs from option ARMs after 2004.

The increase in the share of borrowers without full documentation means more of the borrowers were in the stated-income or the stated-income/stated-assets category. Thus, even though they may be qualified at a fully amortizing payment based on the fully indexed rate, some doubt still remains about the ability of borrowers to pay because their income is simply stated and not documented.

To shed further light on potential risks surrounding the ability of the borrower to repay at higher monthly payments, S&P simulated just how high the DTI could go over a period of eight years if borrowers make only the minimum payments on option ARMs. S&P did a second simulation based on a slower-than-average gain in income.

S&P's calculations were based on an example involving a \$372,821 MTA option ARM. S&P calculated that total annual payments on this loan would rise from \$13,667 in the first year to \$34,244 in the eighth year. The coupon rate on the mortgage, initially 4.5 percent (but qualified at 6.7 percent), would rise to 7.9 percent in the eighth year. Meanwhile, household income would rise from \$90,179 to \$111,300 in year eight.

S&P found that DTI in this test case would rise from 29.8 percent to 52.6 percent in the fourth year, before falling back to 47.5 percent in the eighth year. After eight years, the balance on the mortgage would be \$386,691. «i.

While these calculations assume all borrowers remain with their mortgage, LoanPerformance has looked at the behavior of early borrowers who chose non-amortizing loans in the period from 2001 to 2003. According to Visini, less than 10 percent of the borrowers from that period actually remained with their loans to the point where they reset. Fully 90 percent of those borrowers had refinanced out of their loans when it came time to reset.

This suggests "a lot of homebuyers have used these products as a transitional borrowing tool," he says. Visini says the question for current holders of non-amortizing loans are these: Where will interest rates be when it comes time to reset or refinance? What will be the market value of the home at that point? Will the borrower still be gainfully employed at an income level that would justify a refinancing?

#### Refinance restrictions

The potential to refi might also be affected by the fact that some option-ARM loans have prepayment penalties that lock borrowers into the loans for the first three years, according to Grow. Penalties can be as high as 3 percent of the mortgage in the first year, 2 percent in the second year and 1 percent in the third. In such cases, borrowers would have to wait until the first payment in the fourth year before they could refinance without prepayment penalty.

If, however, borrowers assume they will refinance when the loan starts to amortize, they may still be in for a shock, according to Jef Kinney, vice president for business development at Fannie Mae. "The concern is that we will be in a rate environment where, even going into the same loan product, the rate could be higher," he says.

Some worry there may be longerterm industrywide consequences as a result of more borrowers choosing riskier loans. George Yacik, vice president of SMR Research Corporation, Hackettstown, New Jersey, is concerned with the surge in non-amortizing mortgages. SMR also sees the rising loan-to-value (LTV) ratio in mortgages, as well as piggybacking, as worrisome. "The prospects are not good for credit quality," Yacik says.

SMR has identified markets where there is a chance for home-price declines, and higher delinquencies and defaults. In a proprietary study released to clients in March, SMR identifies which markets have the greatest risk for home-price declines, based on the gap between income and housing prices. While Flint, Michigan, headed the list, a number of metro areas, not surprisingly, are in California. Interestingly, however, San Diego is not on the list-partly due to recently moderating house prices and partly due to the high incomes in that area.

Moody's Investor Service, New York, has also seen risks associated with option ARMs. Two years ago, Moody's changed its methodology for assessing the risk. "Obviously, along the way there have been adjustments," notes Amita Shrivastava, an analyst with Moody's. In November 2004 Moody's analysts noted at an investor briefing that option ARMs were likely to have 315 percent to 20 percent greater risk due to higher foreclosure frequency and severity than do 30-year amortizing ARMs. Moody's assessment is similar to the one that has emerged at S&P.

So far this year, Moody's has not seen anything in the more recent trends in deals with option ARMs it rates to indicate it should require added credit enhancement. For example, the rating agency has not seen the drop in FICO scores, decline in documentation and increase in cash-outs reported by S&P, according to Shrivastava. There have, however, been anecdotal reports of declining FICO scores and other potential credit-quality issues, she says.

Given the intense competitive pressures in the mortgage industry, "one would expect it to happen in the future, but we have not seen [any dramatic shift] yet," says Shrivastava.

For the last few years major players in the market have held their FICO scores relatively constant, with Washington Mutual generally securitizing option-ARM mortgages with aggregate FICO scores in the 7305 or higher, while two other major lenders who entered the market in a big way in recent years are more typically in the 700 to 710 range-all considered good prime and near-prime credits, Shrivastava says. In the future, however, "based on originators' desire to keep up volume, they

may go for the teaser rate or for more stated-income borrowers," she adds. "Our biggest worry is that they will go down the credit spectrum," Shrivastava says. Moody's will be monitoring the credit quality for any potential trends that might indicate the quality is weakening, she says.

### Piggybacking

The incidence of piggybacking-like the use of non-amortizing loans-has been rising, and is concentrated in markets where prices have gone up the most. These 80-10-10 loans include either a closed-end loan or an open-ended home-equity line of credit with an adjustable rate. A study commissioned by PMI and prepared by economist Charles A. Calhoun, titled *The Hidden Risks of Piggyback Lending*, examines the potential risk of this trend to the industry.

The use of piggybacking rose to 42 percent of home-purchase mortgage loan dollars in the first half of 2004, compared with 20 percent in 2001, according to Calhoun's study. The study also ranked the market by a risk factor for the potential for home-price declines. This factor was based on the size of the gap between median income and the median price of a home. Boston ranked at the top of the list, followed by the combined Nassau County-Suffolk County area of Long Island, New York.

California, however, held the honor for the most at-risk markets for being overpriced and relying on piggyback mortgages. The following markets were among the top 10 in the PMI risk index, based on several factors, including having home prices out of line with household incomes and a heavy reliance on piggyback lending for home-purchase mortgages: Oakland-Fremont-Hayward (62 percent piggyback purchase); San Jose-Sunnyvale-Santa Clara (62 percent) and San Diego-Carlsbad-San Marcos (62 percent); Santa Ana-Anaheim-Irvine (54 percent); Los Angeles-Long Beach-Glendale (59 percent); Sacramento-Arden-Arcade-Roseville (54 percent); and San Francisco-San Mateo-Redwood City (60 percent).

### Specific markets to watch

Data from LoanPerformance show a continued heavy reliance on non-amortizing originations in California, although at a lower level than in 2004. For the Golden State, 30 percent of all originations in the first half of 2005 are non-amortizing loans. This compares with 33 percent in 2004. For home purchases in California, the use of non-amortizing loans was still high at 39 percent for the first half of 2005, but below the 46 percent of 2004.

Arizona, too, continued to originate a high level of nonamortizing loans-34 percent in the first half of 2005, compared with 35 percent in 2004, ranking it as the state with the highest share of non-amortizing originations.

Within California, some metropolitan areas remained near their record use of non-amortizing loans, while housing consumers were less likely to use them in other areas. In San Francisco, for example, non-amortizing loans represented 57 percent of purchase mortgages in the first half of the year, only slightly below the 58 percent level of 2004.

San Diego, by contrast, saw a significant decline that parallels the slowdown in home-price appreciation. In 2004, 63 percent of new-home purchases were financed by a nonamortizing loan. In the first half of this year, however, it was 45 percent. There have been similar declines in San Jose and Orange County, California.

Not everyone is pessimistic about the future of option ARMs. Bear Stearns analyzed a subset of 19,000 individual option-ARM loans backing mortgage securities it has issued. It found the typical borrower who chooses an option ARM is not "someone buying a home with their backs to the wall," according to Bear Stearns' Sinha. Indeed, because these borrowers qualified at interest rates substantially higher than the initial teaser rates offered with option ARMs, "They could afford a higher payment [of a fixed-rate loan], but chose a lower payment to afford their continued level of discretionary consumption," Sinha stated at the August 19 Bear Stearns mortgage roundtable.

Furthermore, even if these borrowers cannot refinance out of their loans, past experience suggests every effort will be made by these homeowners to avoid losing their homes. When California suffered significant declines in homeprice values in the early 1990s, "people didn't walk away from houses," says Sandier O'Neill's McMahon. "They just stayed 10 years, and the prices came back."

Furthermore, there are signs that borrowers' loan preferences may be switching back to 30-year FRMs, as the yield curve has flattened. With long-term interest rates remaining remarkably low and short-term rates continuing to rise, the attraction of the fixed-rate mortgage has showed new vigor since August, when it began to take market share from the ARM market.

Competitive pressures, however, might tempt lenders to lower their underwriting standards, warns SMR's Yacik. "If a lender feels compelled to keep origination volume flowing," that may weaken underwriting, he says-especially if three lenders down the street are more than willing to do so. "A minority of lenders will say no" when those pressures come, says Yacik.

There are other voices of caution. Freddie Mac's Nothaft suggests lenders may want to be careful with their underwriting of IOs and option ARMs, both of which have a higher default probability than a fixed-rate mortgage-holding all else equal for similar houses, down payments and borrower credit profiles. If, however, IOs and option ARMs require a higher FICO, for instance, it could offset that higher default probability. Or, he adds, lenders might charge an appropriate premium for the higher default probability.

Finally, Nothaft thinks lenders should make it clear to borrowers that there is the risk of payment shock. It would also help to remember that "these products are not for everyone," he says.

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