May 2007

Mortgage Minute

The shake-up in the subprime market.

Reflecting in the aftermath of the subprime mortgage fallout.

In recent financial news there have been numerous headlines and stories regarding the state of affairs of the subprime mortgage market. This month I'll be looking at what types of borrowers and loan programs fall into the subprime category and how the changes in this sector have impacted the mortgage industry, for both subprime and prime borrowers. We'll discuss enough of the basics so you can sound informed in conversations around the office water cooler.

It begins with credit. If a borrower has one, or a combination of, negative aspects to their credit they will only qualify for loans with rates and terms that reflect this higher risk, i.e. higher rates and often variable rates with prepayment penalties.

Negative credit aspects might include:

- Low credit scores
- A recent bankruptcy or foreclosure
- Unpaid collections
- A 30-day late payment on a mortgage
- Non-traditional credit

When we say "subprime loans" many initially think interest only. Interest only however is an option utilized on many conforming or prime loans as well. Borrowers who only qualify for subprime loans often have at least one but often a combination of the following: a higher rate, a variable rate with a short fixed period like 2 or 3 years, a prepayment penalty or a longer amortization like 40 or 50 years.

The variable rate loan has been the biggest culprit in the subprime fallout, especially when it is paired with an option payment, called an Option ARM. It gives the borrower the option of making the minimum payment, which usually doesn't cover the full interest payment. These are the types of loans Alan Greenspan referred to as "exotic."

Here is an example of how it plays out. A few years ago when rates were at historic lows, people in high cost living areas used option ARM loans to buy homes because they could afford the minimum, less than interest only, payment. After 3 years, when the rate started to adjust, payments increased dramatically, while at the same time home values were depreciating. Borrowers couldn't sell their homes for what they owed, and they couldn't afford to keep making payments.

While at the same time during these 3 years, lenders wanted to capitalize, my pc way of saying people got greedy, on the historic low rates by getting more and more people into homes. They lowered standards and many new "subprime" lenders were born. Subprime borrowers began defaulting on their loans, as you might expect, especially as the rates on their loans began to adjust. Foreclosure havoc ensued and so began the subprime implosion.

Many wholesale lenders, both subprime and prime, have had to close their doors because of it. Others have adjusted how they do business, tightening requirements on many loan products and raising standards to qualify for products, which is probably healthy for our industry. Subprime options are diminishing more each day. But, for good credit borrowers, the options for loans are still plentiful.

Today's Rates at a Glance

30-year fixed
5.875%
(APR 6.066%)

15-year fixed
5.500%
(APR 5.816%)

3/1 ARM
5.375%
(APR 7.004%)

Calculations based on a purchase loan amount of $150,000 and an 80% loan to value. Rates assume a 1% origination fee and are as of 5-1-07 and are subject to change.

Identity Theft Tip of the Month

Write "SEE ID" next to your signature on the back of credit cards. The back of the card states "not valid unless signed" and some merchants will not process it without a signature, so don't write just "SEE ID". You probably won't get asked often for ID, but every little can help.

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