Chapter 10
Chapter 11
Excerpts

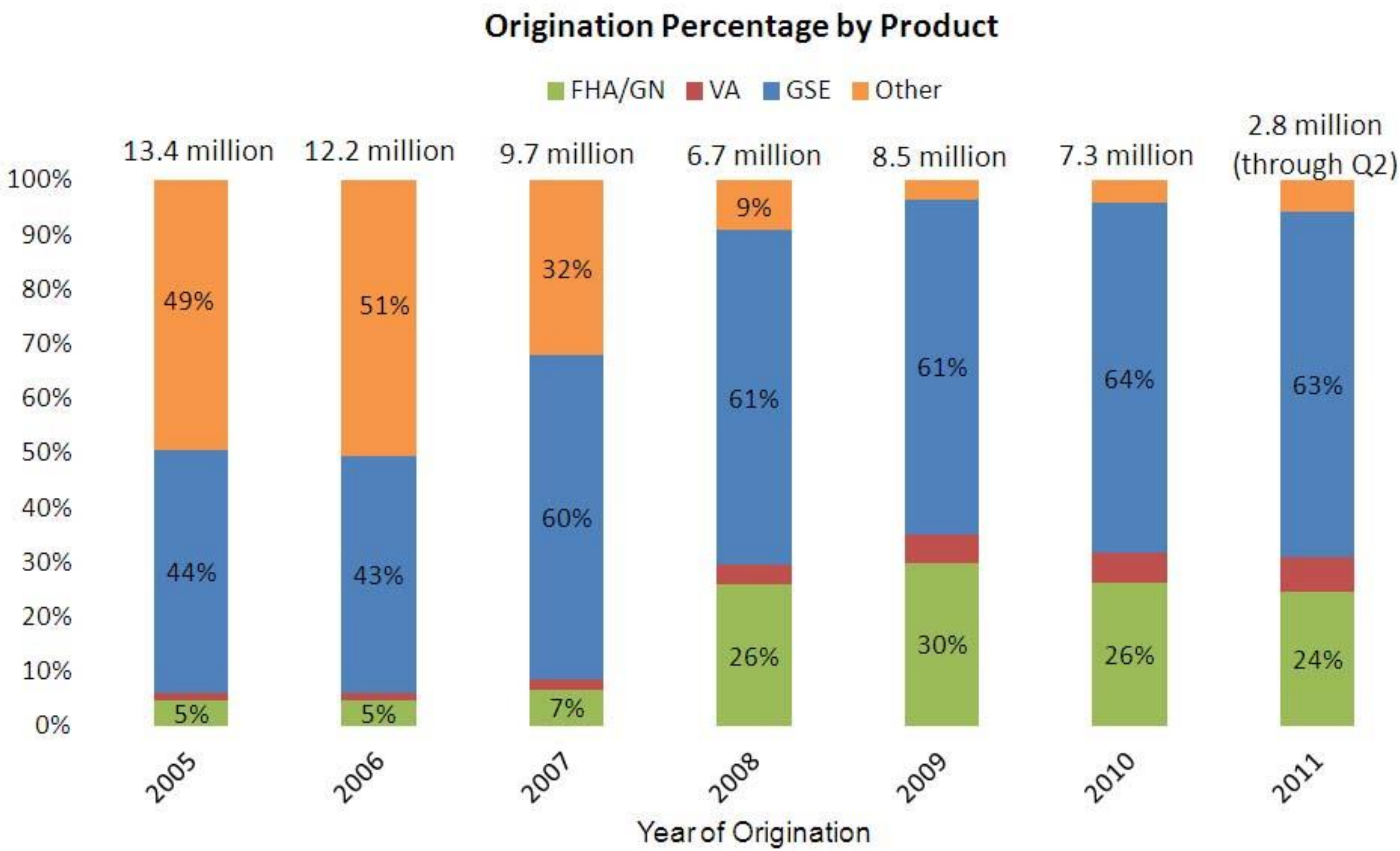
More on Mortgages

Conventional Mortgage Loans

- Oldest form
- Any standard home mortgage loan not insured by FHA or guaranteed by Department of Veterans Affairs
- Revolutionized in 1940s by private mortgage insurance

The Language of Conventional Mortgage Loans

- Conforming conventional home loan: Meets the requirements for purchase by Freddie Mac or Fannie Mae:
  - Standard note
  - Standard mortgage
  - Standard appraisal
  - Standard Underwriting
  - Size limit: Currently $417,000 (higher for high cost areas)
  - Interest rate advantage due to liquidity (at least .25%, over 1.00 percent since mid-2007)



Origination Percentage by Product
FHA/GN
VA
GSE
Other
13.4 million
12.2 million
9.7 million
6.7 million
8.5 million
7.3 million
2.8 million (through Q2)
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
49%
44%
5%
51%
43%
5%
32%
60%
7%
9%
61%
26%
61%
30%
64%
26%
63%
24%
2005
2006
2007
2008
2009
2010
2011
Year of Origination

The Language of Conventional Mortgage Loans

- Nonconforming loan: Does not meet GSE requirements in some respect
  - Jumbo
  - Subprime

Private Mortgage Insurance (PMI)

- Protects lender against losses due to default
- Generally required for loans over 80% of value
- Protects lender for losses up to 25% - 35% of loan
- Example terms:
  - 2.5 percent of loan in single up-front premium, or
  - No up-front premium and 0.5 percent annual premium (0.041 per month)
  - See MGIC website for variation in PMI programs and terms: http://www.mgic.com/rates/index.html

Private Mortgage Insurance (continued)

- Insurer may allow termination if:
  - Loan falls below 80% of current value
  - And borrower is in good standing
- Must allow termination when:
  - loan falls to 80% of original value (Homeowner's Insurance Act of 1999)
  - And borrower is in good standing
- Must terminate when:
  - loan falls to 78% of original value
  - And borrower is in good standing

Private Mortgage Insurance: Example

- House price: $200,000
- Loan amount: $190,000
- PMI, insuring "top 30%": First $57,000 in losses
- Borrower pays down loan to $188,000
- Defaults: Foreclosure sale at $180,000
- Lender's loss: $188,000 – $180,000 = $8,000
- With loss less than $57,000, PMI covers it completely

FHA Mortgages (Federal Housing Administration)

- Goals of the National Housing Act of 1949:
  - Decent home and suitable living environment
    - Implemented mainly through mortgage markets
- FHA is strictly a loan insurance program
  - Loans are from private lenders
  - FHA has had positive cash flow in most years
  - Through 2012 has never needed government funding
  - Set the precedent for PMI

How FHA Insurance Works

- Insures 100% of loan
- After foreclosure, title is transferred to Housing and Urban Development (HUD)

How FHA Insurance Works

- Premiums (as of end of 2012):
  - Up-front premium: 1.75%, which can be included in loan
  - Annual premium based on average balance:
    - 0.60% for loans of 15 years or less and under 95% of value
    - 0.55% for loans of 15 years or less and 95% of value
    - 1.20% for loans over 15 years but under 95% of value
    - **1.25% for loans over 15 years and 95% of value**

Premium

FHA Insurance

- Many FHA insurance programs
  - 203b: Standard LPM insurance
  - 245: Insurance for graduated payment mortgages
  - ARM insurance (“1 and 3” caps required)
  - 203k Rehab program for single family houses
  - Home equity conversion mortgage (HECM)
- Importance of FHA
  - Created the level payment mortgage
  - Influenced housing and subdivision standards
  - Continues to innovate: HECM program

Veterans Affairs Guarantees

- Limited to qualified veterans of military service.
- Guarantee:
  - Loans under $45,000: 50 percent
  - Loans over $144,000: 25 percent
  - Maximum guarantee: One-fourth of the GSE loan limit.
- Loan can be up to 100% of value
- Funding Fee is based on loan-to-value ratio and service:
  - Over 95% LTV: 2.15% for active duty, 2.4% for other
  - Over 90% - 95% LTV: 1.5% for active duty, 1.75% for other
  - Up to 90% LTV: 1.25% for active duty, 1.5% for other
- Loan covers funding fee, but not closing costs

Other Mortgage Types

- Purchase money mortgage: Mortgage given by a property buyer simultaneous with receipt of title
  - Among real estate brokers: refers to a second mortgage loan from a seller to reduce the buyer's down payment
  - Among government agencies: any loan that finances a purchase
- Piggyback loan: A second mortgage paired with an underlying 1st mortgage to keep the 1st at or below 80 percent LTV, thus avoiding required mortgage insurance. Example

Other Mortgage Types: Home Equity Loans

- Some home equity loans are closed-end, fixed-term loans
- Mostly open-end or line-of-credit loans (HELOC)
- Tax deductible interest
- Strength of the house as security provides favorable rate and longer term
- Usually limited to total mortgage debt (sum of all mortgage loans) of 75% to 80% of value

Other Mortgage Types: Reverse Mortgage

- Many older households are income constrained
- Over 80% own their home
- Most have little or no mortgage debt
- Most do not want to sell

Recent Mortgage Forms

- Interest-only Mortgage
  - *I-O with balloon* has interest-only payments for five to seven years, ending with a full repayment of principal.
  - *I-O amortizing* has interest-only payments for up to fifteen years, then converts to a fully amortizing payment for the remainder of the term.

Recent Mortgage Forms

- Hybrid ARM
  - Interest rate is fixed for some years, then becomes adjustable
  - Payment is set to be fully amortizing
  - Fixed rate period ranges from two to ten years
  - Fixed rate increases as the fixed portion term lengthens
  - Successfully blends
    - Need of borrowers for predictable payments
    - Need of lenders for market level interest rates

Recent Mortgage Forms

- Options ARM Example
  - Borrower could select among three types of payments: fully amortizing, interest-only, and minimum
  - Minimum payment based on a very low rate: say, 1.5 percent
  - Minimum payment increases 7.5 percent per year
  - Interest rate charged was adjustable, usually deeply reduced for the first few months
  - With minimum payment, the loan balance grew due to "negative amortization"
  - At the end of five years, or when the balance reaches 125 percent of the original loan, the payment is recast to fully amortize the loan over its remaining term.
  - Most borrowers, unfortunately, chose the minimum payment

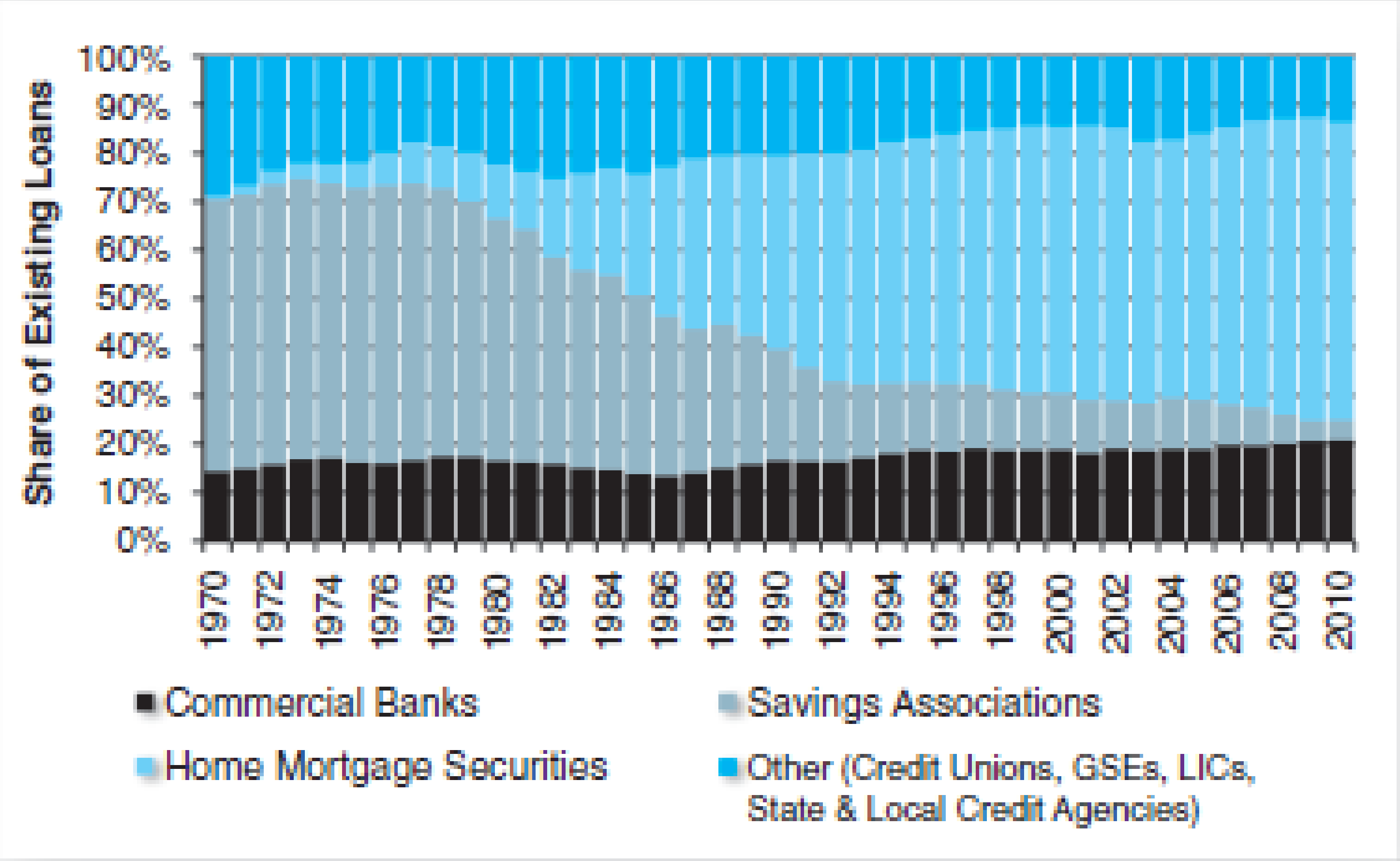
Subprime Loans

- Not a unique design, but a high-risk use
- Mostly 2-28 hybrid, I-O, or option ARM
- Almost all were adjustable rate
- Low initial payment, large negative amortization
- Started at very high loan-to-value ratio
- Designed so that refinancing would become necessary due to severe payment increases
- Often had prepayment penalty to recoup upfront teaser
- Wide-spread abandonment of prudent underwriting

Chapter 11

Sources of Funds for Residential Mortgages

Traditional and Modern Housing Finance



Source: Flows of Funds Accounts of the United States.

Portfolio and Non-Portfolio Mortgage Lenders

- Portfolio Lenders (depository institutions)
  - Banks
  - Thrifts
  - Large credit unions
- Non-portfolio lenders
  - Mortgage bankers
  - Mortgage brokers
    - May include credit unions and small banks

Fannie Mae

- Original mission: Secondary market for FHA/VA
- Became privately owned but still U.S. chartered
  - Public mission for housing
  - U.S. Treasury financial credit line available
- Surpasses Freddie Mac in buying conventional loans
- Funded through both debt issues and mortgage securitization
- Has securitized and sold, or owns, about 23% of outstanding home loans
- Taken into conservatorship by U.S. in 2008

Freddie Mac

- Chartered by Congress
- Deals exclusively in conventional loans
- Securitized all loans purchased until recent years
- Financially similar to Fannie Mae
- Has securitized and sold, or owns, about 15% of outstanding home loans
- Taken into conservatorship by U.S. in 2008

Importance of Fannie Mae and Freddie Mac

- Have brought about standardization in:
  - Mortgages and mortgage notes
  - Appraisal forms and practices
  - Underwriting procedures and standards
  - Also, influence practices and standards in nonconforming mortgage markets

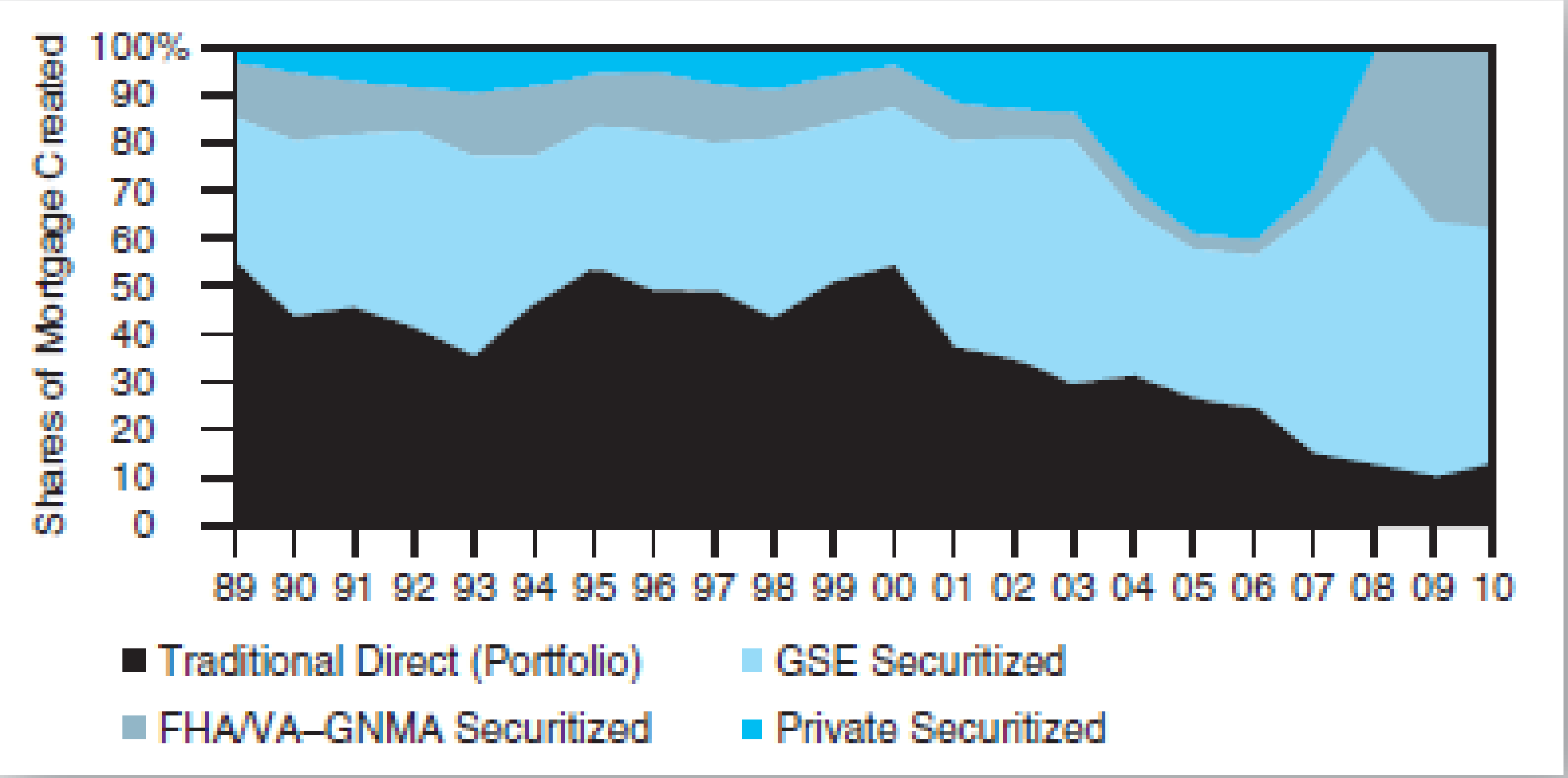
Importance of Fannie Mae and Freddie Mac

- Have increased liquidity of mortgage markets
  - No interstate differentials in mortgage interest rates
  - No home lending disruptions when interest rates rise
  - New sources of mortgage funds in security investors
- Heavily influence what type loans lenders make

The U.S. Home Mortgage System Today – Four Channels

- Local depository lending (very limited)
  - Home Equity loans via credit unions
- FHA/VA – GNMA securitization process
- Conforming conventional – GSE process
- Non-conforming conventional – private security process

Market Shares of the Four Channels of Home Mortgage Lending



Where Do You Get a Mortgage Loan in Today's Complex System?

- No simple answer, except to shop aggressively
- Portfolio lenders may offer cost and interest rate advantage
- Brokers may offer service and down payment advantage
- Depository lenders may have best ARM offers
- Non-depositories may have best fixed-rate offers
- SHOP!

Lenders' Underwriting Decisions

- Underwriting: Process of determining whether the risks of a loan are acceptable
- Three "Cs" of traditional underwriting:
  - Collateral: URAR appraisal
  - Creditworthiness: Credit report
  - Capacity: Ability to pay (payment ratios)

Traditional Payment Ratios for Mortgage Underwriting

- Housing expense ratio = *PITI/GMI*
  - *PITI* is principal, interest, (property) taxes and insurance
  - *GMI* is gross monthly income
  - Recent convention set maximum at:
    - 28% for conventional loans
    - 29% for FHA
  - Known as "front-end" ratio

Traditional Payment Ratios for Mortgage Underwriting

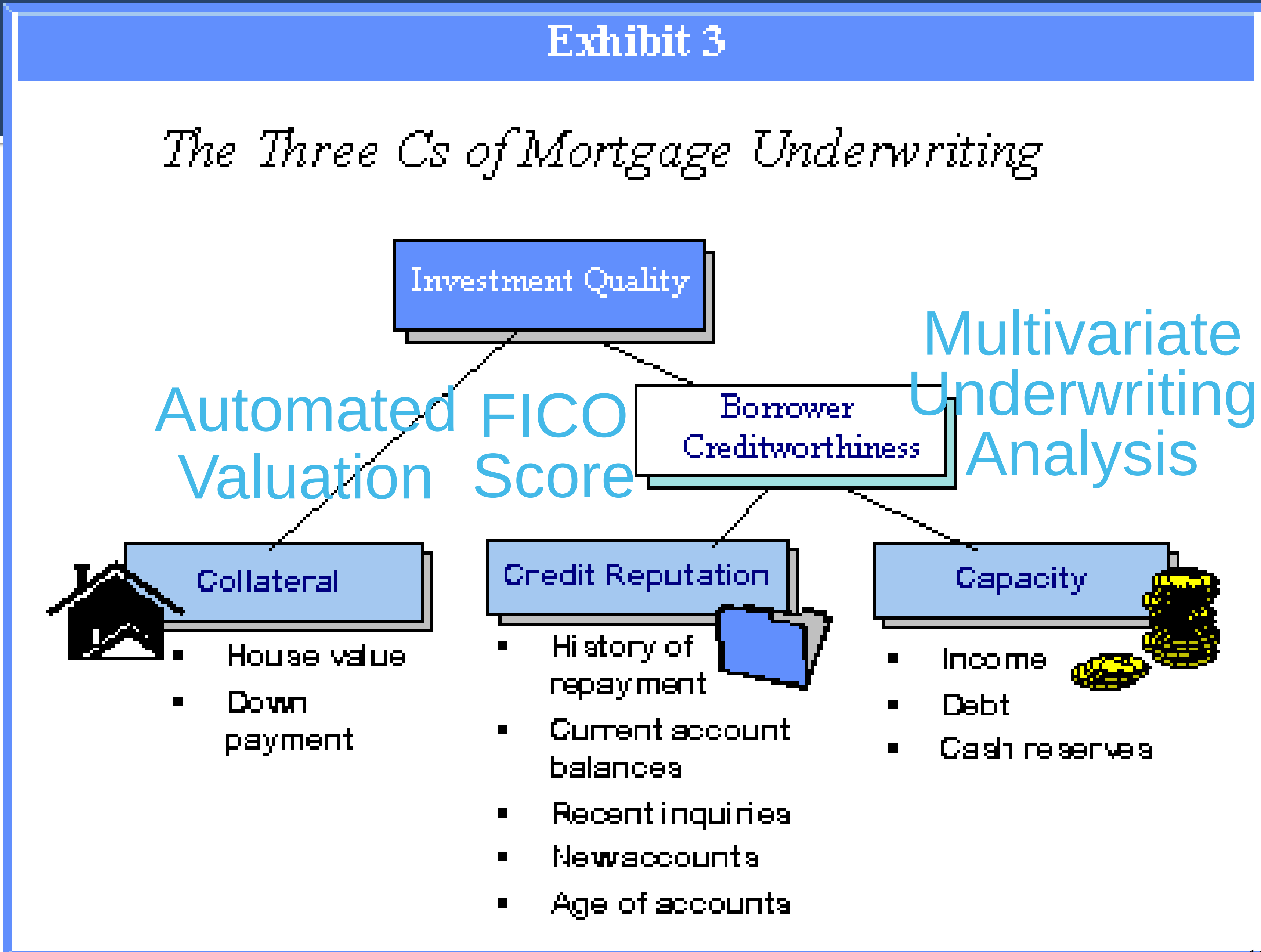
- Total debt ratio = ($PITI$ + LTO) ÷ GMI
  - *LTO* is long-term obligation
  - Recent convention set maximum at:
    - 36% for conventional loans
    - 43% for FHA
  - Known as "back-end" ratio
- Note: GMI is critical. Its computation is closely regulated by ECOA

Thinking about buying a house?

- Keep your LTO as low as possible if you want to maximize the amount of your mortgage

Modern Home Loan Underwriting

- Automated underwriting is dominant
  - Creation of single statistical score
  - URAR appraisal for to "automated valuation"
  - Credit report displaced by credit score
- Single underwriting index incorporates: house value, credit score, income and obligation data



Automated Valuation

FICO Score

Multivariate Underwriting Analysis

Subprime Lending

- Many households unable to qualify for "affordable" home loans
- Subprime originally targeted three borrower deficiencies:
  - Lack of income documentation
  - Weak credit
  - Seeking financing for 100% LTV or higher

Subprime Lending (continued)

- More expensive than standard home loans
- Polar views of subprime lending:
  - Fills compelling, legitimate need (beats credit cards)
  - Hunting ground of predatory lenders
- In any case, spun out of control, and to disaster

Qualified Mortgages

- In response to the "mortgage meltdown" following the 2008-2012 house price declines, mortgage credit has been tightened
- Top quality applicants have no problems getting loans, and interest rates are very low by historical standards
- The required documentation for borrowers has increased significantly
- The Consumer Financial Protection Bureau (created by congress) has defined a type of mortgage known as a Qualified Mortgage (as of January 1, 2014)

Qualified Mortgage

- No negative amortization allowed
- No IO payments allowed
- The points and fees on a mortgage over 100,000 can not exceed 3%
- Limits the fees that someone can earn for steering you to a QM (cannot earn more on a non-QM)
- All FHA/VA and conforming loans must be QM (for next 7 years)
- Must show a borrower can afford the loan over the life of the loan (cannot be qualified on the Teaser Rate).
- Back end ratio cannot exceed 43%

End of Chapter 11