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Alternative Mortgage Products

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Agenda

- Introducing the alternative mortgage products
- Risk layering
- New wrinkles in the marketplace
- Concluding remarks

Interest-Only Loans

- How prevalent have they become?
  - In 2001, they constituted less than 2% of the market
  - By 2005, they were 23% of loans originated nationwide and 30% of subprime loans
  - Most prevalent in high-cost markets
  - 61% in California and 54% in the District of Columbia

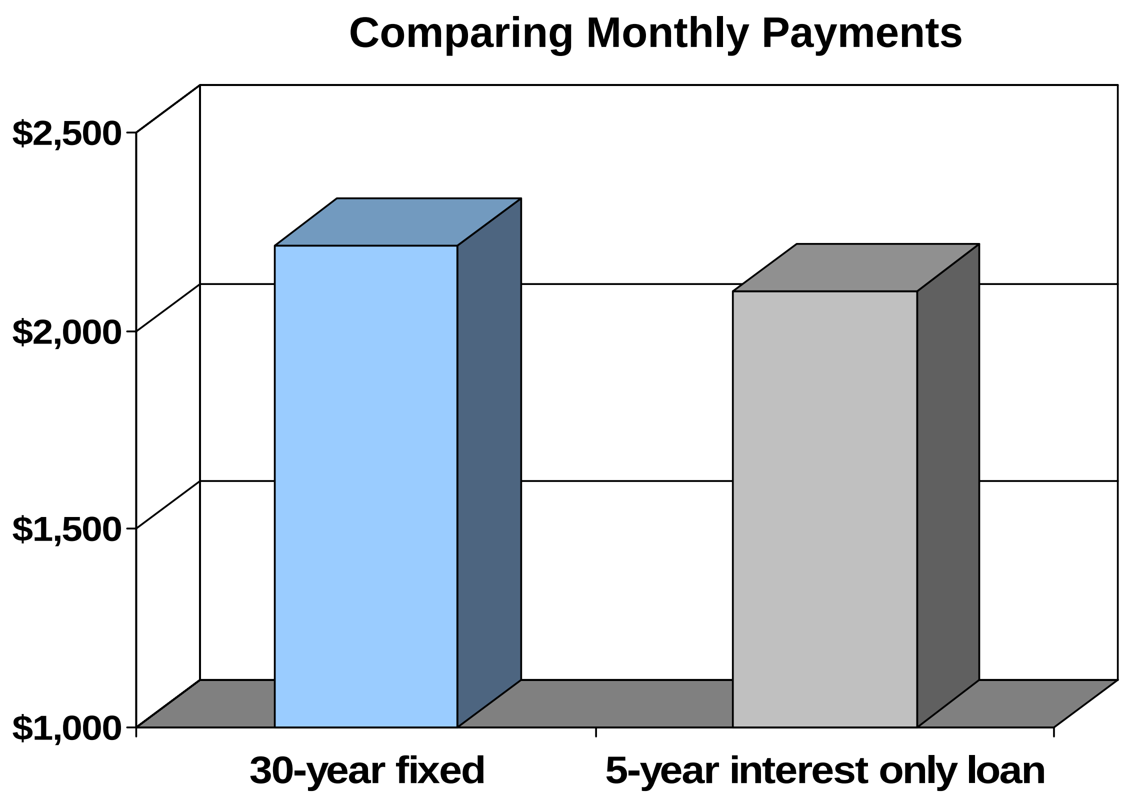
Sources: Mortgage Bankers Association, LoanPerformance

Who Should Consider an Interest-Only Loan?

- Households with variable income (salespeople, small business owners) that have the discipline to pay down principal when income permits
- Wealthy homeowners or investors looking to maximize cash flow
- Upwardly mobile that expect significant increase in income (new doctors or attorneys)
- The potential problem: borrowers may use this as a way to combat affordability concerns

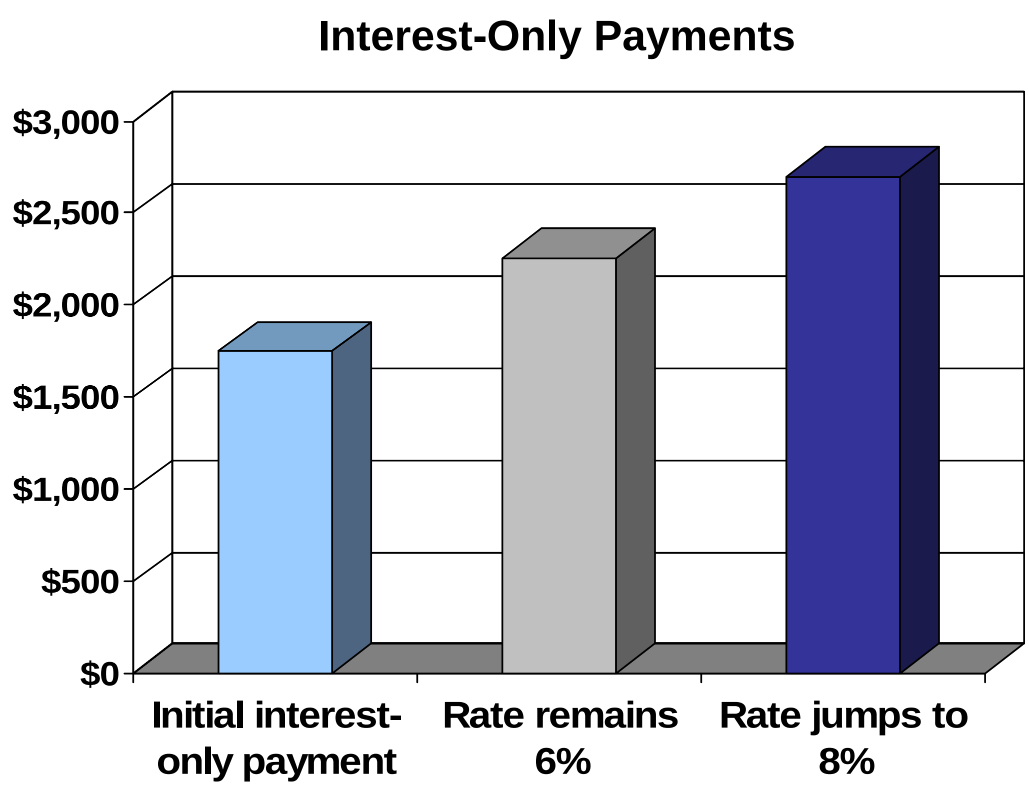
What Makes Interest-Only Loans Attractive to so Many Borrowers?

- Scenario: $350,000 loan
- 30-year fixed rate mortgage at 6.5% carries a payment of $2,212
- But a 5-year interest-only loan at 6% has a monthly payment of $1,750



But What Happens to the Monthly Payments?

- Here is what happens after five years:
  - Even if the rate remains at 6%, the payment jumps to $2,255…an increase of more than $500 per month!
  - If the rate jumps to 8% instead, the payment jumps to $2,701…a jump of $951 per month!



Option ARMs

- Several payment choices each month (payment examples also for a $350,000 loan with a loan rate of 6.5% and a pay rate of 1.5%):
  - Traditional 30-year amortization ($2,212)
  - Accelerated 15-year amortization ($3,049)
  - Interest-only payment ($1,896)
  - Minimum payment ($1,208)
- Payment flexibility is the primary selling point…

  …and the biggest pitfall

The Risks of Option ARMs

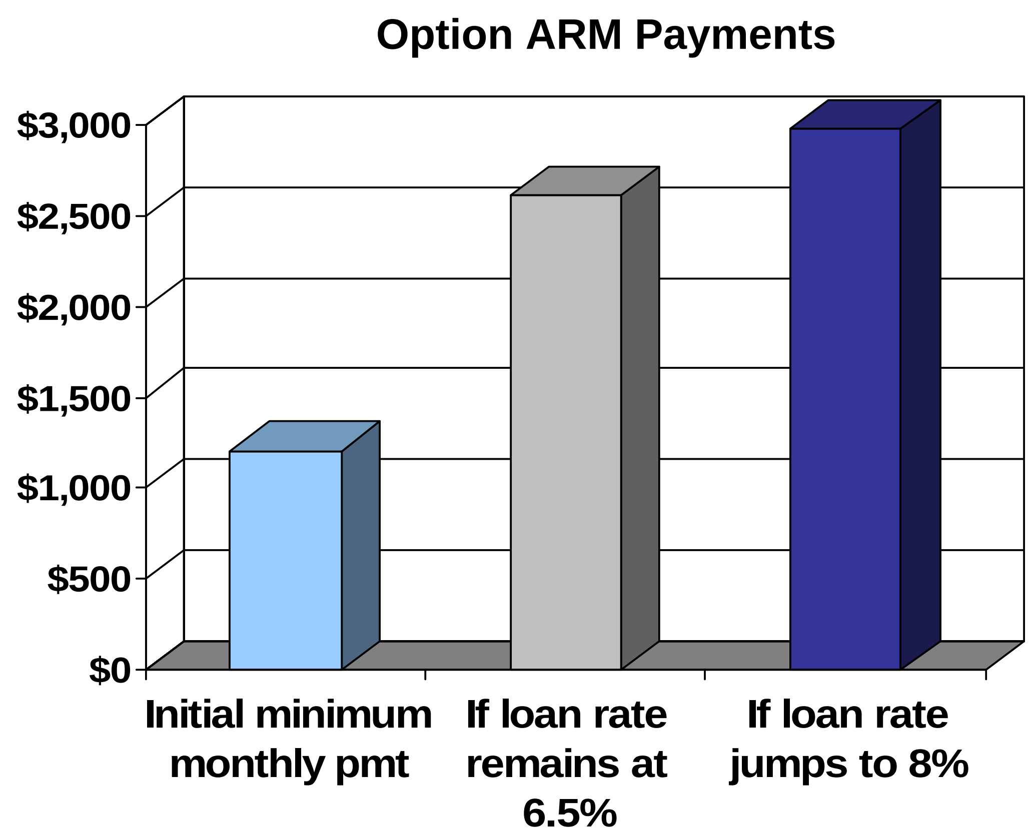
- Interest-only isn't even the riskiest choice
- Temptation of minimum payment leads to negative amortization
- Still subjected to rising rates…often, as soon as the first month!

Benefits of Option ARMs

- Payment flexibility for households with widely variable income
- Purchase a larger home sooner

Consider This Scenario

- Here is what happens after five years of minimum payments:
  - If the loan rate remains at 6.5%, the payments jumps to $2,611
  - If the loan rate rises to 8%, the payment jumps to $2,984



Do Borrowers Understand the Risks?

- Borrowers don't have a good understanding of adjustable rate loans:
  - 41% don't know the maximum rate that can be charged
  - 35% don't know the maximum amount the rate can rise at one time
  - 17% don't know how often the rate can change

Source: Federal Reserve

Risk Layering

- In 2005, 42% of first-time home buyers made no down payment
- No down payment coupled with no repayment of principal
- Combining a piggyback loan arrangement with an interest-only first mortgage (increasing payments on both loans and still, no principal repayment)

Source: National Association of Realtors

New Wrinkles in the Marketplace

- Fixed rate interest-only mortgages
  - Removes any interest rate uncertainty but future payment shock still possible
  - Example: $350,000 loan at 6.75%
  - Interest-only payment = $1,969
  - Principal and interest payment after 10 years is $2,661…because the loan balance is now repaid over the remaining 20 years

New Wrinkles in the Marketplace

- 40-year fixed rate mortgages
  - Advantage: predictable payment for buyers concerned with affordability
  - Disadvantage: modest difference in payments and the loan balance declines at a snail's pace
  - On a $350,000 loan, the difference in monthly payments is just $100 by stretching out to 40 years
- And now…..50-year mortgages

Thank you!

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