THE BOTTOM LINE

Insights for Loan Portfolio and Information Services

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MORTGAGE MATTERS

THE YEAR AHEAD: PLENTY OF FINANCE OPTIONS, BUT INCREASED RATES MAY CHALLENGE LENDERS

Mortgage rates are at their lowest levels in more than 35 years and the refinance driven residential finance market shows no signs of slackening. The proof is in the numbers:

Â For the full year 2002, mortgage production may hit the $2.42 trillion mark, eclipsing last year's record of just over $2.0 trillion in originations.

Â Refinances accounted for more than half of this year's total output - 58 percent, according to Freddie Mac estimates, as homeowners rushed to lock in long-term mortgages at bargain finance costs.

In a year with generally spotty economic growth, housing finance stood out as one of the few bright spots on the landscape, filling origination pipelines and generating a flood of mortgage products in all categories - Prime, Alt-A, Jumbo Non-Conforming, Adjustable Rate and Subprime - for securitization conduits.

In the wake of two years of record volume for mortgage lenders, the inevitable questions are rising up about the year ahead. Can originators sustain this year's production volume without sacrificing credit quality? What happens if interest rates rise sharply in 2003? Will home values around the country hold up if the economy doesn't improve? Mortgage interest rates may have finally hit bottom or could be close to that point, following the Federal Reserve's surprise 50 basis point cut in the federal funds rate last month.

Refinance activity drove mortgage lending in 2002 to new heights and will continue to be a factor next year, even if loan production declines a bit. The Mortgage Bankers Association of America is forecasting 2003 originations of $1.77 trillion, a decline from this year's activity, to be sure, but still the third highest annual volume on record if it reaches that level.

Mortgage interest rates will probably increase over the next 18 months, but only moderately so, the MBA calculates. Doug Duncan, the Association's senior vice president and chief economist, estimates that 30-year fixed rate mortgages will average around 6.5 percent for most of 2003, before rising to around 6.8 to 7.0 percent a year from now. Duncan doesn't believe the Federal Reserve's interest rate cut will do much to reduce mortgage rates on longer maturity loans, which are priced off long-term Treasury securities.

The prospect of rising interest rates heading into 2003 could reduce the number of loans being refinanced and, at the same time, induce borrowers to get loans larger than their home value, taking out cash to meet household expenses. "Now that mortgage rates appear to be leveling off, we may see refinancing begin to slow down from the frantic pace of most of the year," says Frank Nothaft, Freddie Mac's chief economist, "If mortgage rates start to rise to slightly higher levels, we will see fewer refinances but most of those refinances will be taking cash out, since most homeowners will not be able to get a lower mortgage rate by refinanc-

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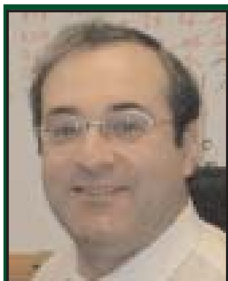
INSIDE THIS ISSUE

VIEWPOINT:

INTEREST RATE MODELING: A CONSCIENTIOUS CHOICE

By Alexander Levin, Senior Consultant for Andrew Davidson & Company



Alexander Levin

Intensive developments in interest rate modeling have delivered a bold, but confusing, model selection choice for financial engineers, risk managers, and investment analysts. Does this list of issues sound familiar?

Should a mortgage bank assess the interest rate risk using the lognormal Black-Karasinski (BK) model or using the normal Hull-White (HW) model?

Can a portfolio be hedged using different pricing models for assets and derivatives?

Is there any historical evidence that one model is better than another?

What does the market "think" about the interest rate distribution? It must "know" something - otherwise how would the rate options be traded?

In this article, we show that selecting the "best" term structure model is becoming more of a conscientious task than a matter of taste. We show that both recent historical rates and implied volatility skew for swaptions confirm rate "normalization" and reject the conjecture of lognormality. We propose valuing mortgages using the Hull-White model, which can be quickly and accurately calibrated to both the yield curve and the swaption volatility matrix.

Lognormality: the old days story

Those who read research on interest rates performed in the 1980s and early 1990s are accustomed to conjecture of lognormality. According to this theory, interest rates are lognormally distributed, i.e. their logarithm is normally distributed. The rates, therefore, cannot become negative, and their randomness should be naturally and steadily measured by relative volatility. This assumption had enforced the validity and applicability of the Black-Scholes pricing model to the interest rate option market.

Measuring volatility observed in the 1990s and 2000s does not confirm this conjecture. We computed daily deviations for the 10-year Treasury and 10-year swap rates and plotted them against the rate level. No proportionality was observed - not even a slight positive relationship. A weak or absent relation between absolute volatility and rate level is a sign of normality rather than lognormality. It also prompts using a different volatility standard, i.e. quoting rate uncertainty (and, therefore, option prices) in terms of absolute volatility (such as 110 basis points) rather than relative volatility (say, 20%). Recently, many brokers have started communicating exactly that way.

What does the swaption market think?

Can we recover the rate distribution from the way interest rate options trade? A simple way is to "measure" the implied volatility skew, i.e. dependence of the implied Black volatility on the strike level. If the market participants believed in lognormality, there would be little reason for the implied volatility to change with the option's strike price. Volatility skew testifies against lognormality by fact of its existence. Blyth and Uglum proposed a simple "skew measurement" method in "Rates of Skew" in the July 1999 issue of Risk.

Their model suggests that the volatility skew can be translated into "Constant Elasticity of Variance" parameter (CEV), which, in turn, allows specifying the best term structure model. For a lognormal model, CEV is equal to 1, and the skew does not exist. A normal model (HW) will have a zero CEV, and its implied skew has a shape of inverse square root. A popular family of "square root" models, such as the Squared Gaussian Model (SG), or the model of Cox, Ingersoll, and Ross (CIR), feature CEV equal to one-half. Their skew will have the shape of inverse fourth-degree root. Any "unnamed" values for the CEV are possible, including negative values ("hyper-normality") and values exceeding 1 ("hyper-lognormality").

The object of our study - the 5-into-10 swaption - was selected with modeling volatility of mortgage rates and valuation of the prepayment option in mind. Since the beginning of 1998, the best CEV value (0.23) was generally between the normal case and the square-root case and nowhere close to the lognormal case. In addition, the swaption market has been "normalized" lately (close-to-zero CEV since the beginning of 2001). Because of its analytical tractability and the recent CEV trend, we recommend using the HW model as the chief alternative to the traditional lognormal models.

Volatility calibration

Dislocation of Treasuries from all other fixed-income sectors triggered by the series of crises in 1998 has made them a poor MBS/ABS pricing benchmark. Instead, the swap market has been widely recognized and employed for mortgage valuation and hedging. Calibration to swap rates and swaption volatility (including its dependency on the strike level) seems a highly desirable function for any contemporary option-adjusted valuation system.

As explained above, the observed skew can be measured and matched by a model selection itself. Having chosen a model, we are now left to match the at-the-money (ATM) volatility. Andrew Davidson & Company has developed analytical tools that allow for quick and accurate ATM volatility calibration. We employ a widely available 2-dimensional matrix ("surface") of swaption volatility as the input. The math "translates" this matrix into the model's internal parameters. For example, we can find best short-rate volatility and mean reversion used by the HW model. We get an even better match with the market data if we think of the short-rate volatility as a time dependent function. In short, we can replicate absolute volatility with accuracy of 3-4 basis points measured across expirations and swaps, allowing us to value the prepayment option quite accu-

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INTEREST RATE MODELING...

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rately.

Model change: valuation and risk management implications

If we employ the ATM swaption market as our volatility guide, we should expect the process of pricing an "ATM" mortgage to be free from interest rate model selection. This conclusion follows directly from the difference in volatility specifications: an "up" rate scenario hurts an MBS more under the lognormal model due to the absolute volatility boost. Transitioning from a lognormal model to a normal one will reduce effective duration by an estimated 0.4 year for the current coupon MBS, making it closer to the way the market actually trades. Needless to say, it will reduce hedging needs for mortgage bankers and secondary marketers. Interestingly enough, stripped derivatives, including MSRs, are exceptions; they may look shorter or longer - depending on the pool's coupon. Ė

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Editor's Note: The Bottom Line welcomes letters to the editor. Responses will be edited for length and published the following month. Please send all comments to tfitch@claytongroup.com, or call 203.378.0033.

THE YEAR AHEAD...

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ing. Therefore the incentive to refinance becomes that of taking some equity "out of the house" via a cashout refi. If rates rise, Nothaft says, refis in 2003 will probably fall to around 54 percent of mortgage applications compared to this year's 58 percent.

Credit Concerns

Following on the heels of two years of extraordinary mortgage production, next year could be a challenging one for originators even if rates remain within a narrow range for much of the year. Rating agency analysts worry about lenders easing up on underwriting standards to maintain market share in a very crowded field.

With robust originator pipelines through late December and into January 2003, it may be too early to worry about easing of underwriting guidelines. But the rating agencies are keeping a watchful eye, just in case, and they are ready to take corrective action on residential loans submitted for review. If any easing in underwriting standards is detected, says Terry Osterweil, a director at Standard & Poor's, "We will take appropriate action such as adding to their credit enhancement, or whatever the case may be to maintain credit quality." But he adds, "So far we haven't seen that."

The single family housing sector, the star performer in the current economic environment, faces some risk in the months ahead, according to Mark Zandi, chief economist at Mortgage.com, who says "low rates and aggressive lending have really juiced up the market," leaving several regional housing markets at risk to price declines if the economy fails to improve. He says more federal aid to states and tax cuts may be needed to keep the recovery on track.

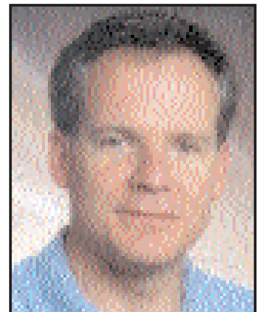
New Mortgage Products

Low interest rates are fueling mortgage production across the board, but most notably in Alt-A issuance. Alt-A loans are mortgages made to A-quality borrowers which have characteristics that make them non-conforming under Fannie Mae or Freddie Mac underwriting guidelines. Alt-A securitizations should reach a record-breaking $41 billion by the end of 2002, according to Moody's Investors Service, a 50 percent gain over 2001 volume. These loans may have higher LTV ratios, limited documentation, or the houses may be vacation homes or investment properties.

Another sector experiencing rapid growth is the short-term adjustable rate mortgage. One year, Treasury-indexed ARMs averaged 4.15 percent in early November, an eight-year low. Hybrid ARMs, which are issued as fixed-rate loans convertible to a floating rate after a specified period, have become very popular this year. "The volume in hybrid ARMs has definitely increased throughout this year," says Christine Brunei, a director at Fitch Ratings. "Lots of issuers are offering the hybrid ARM that have not in the past. One thing we're seeing more of recently is short-term ARMs, one-month to six-month LIBOR ARMs with rates pegged to the London Interbank Offered Rate." Ė

UPFRONT WITH AN INDUSTRY LEADER: WILLIAM O'NEIL, OPTION ONE MORTGAGE

THE KEYS TO SUCCESS IN THE SUBPRIME MARKET: KNOW YOUR RISKS AND MAINTAIN FREQUENT CUSTOMER CONTACT



William O'Neil

From a risk management standpoint, subprime lending has its advantages over the prime mortgage sector: a fairly predictable prepayment rate regardless of flutuations in the interest rate cycle. That's a plus in today's refinance driven origination market. But the non-conforming B-C-D sector is not without its risks. Top originators like Option One Mortgage Corporation, an Irvine, California, subsidiary of H & R Block, put far more attention on customer service and hand holding than prime lenders typically do. That's one reason the company was awarded a rating of RPS-1 from Fitch Ratings, the highest possible rating assigned to residential primary servicers. Option One, formally organized in 1992, today has annual production exceeding $12 billion and a servicing portfolio of more than $25 billion.

William O'Neil, senior vice president and chief financial officer at Option One, has been with the firm since 1994, long enough to have witnessed the effects of rising interest rates twice in the last decade. A 15-year veteran of the non-prime lending industry, O'Neil is responsible for Option One's accounting, finance, secondary marketing and capital market operations.

Cashout refinance is the bread and butter of Option One's mortgage lending, which O'Neil says is a key difference between prime and non-prime lending. "We're really different from the prime business," he stresses. "Our borrowers use their home to obtain liquidity."

Q. What is your origination volume year-to-date?

A. Our business has never been better. We're funding over $1 billion a month in the non-prime business, and that's about a 50 percent increase over the prior year. The majority of our business is, and always has been, cashout refinances, and our borrowers are not heavily influenced by interest rates. Cashout refis are about 62 percent of our total originations versus about 54 percent last year. Purchase money, which is what someone needs to buy a new home, is about 30 percent this year, down a little bit from 35 percent last year. And refinances that are just to reduce the rate or to obtain a better term are about eight percent this year, versus 10.5 percent last year.

With interest rates probably increasing a bit in 2003, what's your outlook for production in the next year?

We don't expect to grow our business at 50 percent a year. We don't think that's sustainable, but even in light of where interest rates will be headed next year, we still think we can grow the business 10 to 15 percent. We think that's a reasonable expectation.

What's the biggest challenge for an originator in the non-conforming or non-prime market?

The inevitable rise in interest rates six to nine months from now is certainly going to be a challenge to us and the industry. Typically, in a rising rate environment a lot of our competitors are reluctant to raise rates. They want to hang on to market share and are less concerned about profit margins. We've been through a rapidly rising rate scenario twice, once in 1994 and once in 1999 and 2000. We've been through the cycle before, but it is a challenging time. Another (challenge) is the temptation to lower credit standards to continue to grow loan production. Some of our competitors seem to be getting looser with their underwriting standards.

The Bottom Line:

"We don't hedge because the prepayment behavior is very predictable."

- Bill O'Neil, Option One

Let's talk about the regulatory front. The issue of predatory lending has been in the news lately. Are there states where you'd rather not do business?

We've only exited one state, West Virginia. More recently, Georgia has passed a very restrictive predatory lending law, covering two things: high cost loans and covered loans. We're not going to do high-cost loans. We don't do high-cost loans in any of the states, but we're going to do what they call covered loans. We're going to stay in the state and we're going to continue to originate, but it will be more challenging for us, certainly.

There's a lot of customer contact and hand holding in the non-conforming market. Let's talk about your approach to loan servicing.

Everybody gets a welcome call 10 days before their first payment is due. If you are delinquent on your first payment we're a lot more stringent than if you're delinquent on your seventh, eighth, or ninth payment. If you're a first payment default, we'll call you as soon as the second day of the month. But it is really more of a counseling approach. We call our collectors loan counselors because that's really what they are. Their job is to ask a series of questions to determine if the borrower has the capacity or the ability to repay. You're right - it's a high touch business. Seventy-five percent of the people in our servicing unit are in collection or loss mitigation activities, which is probably just the inverse of what happens in the prime market.

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THE KEYS TO SUCCESS...

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Has that worked out in practice - keeping delinquencies in line with your target?
Up until December of last year delinquencies had continued to rise. Since December we have seen a flattening or a gentle falling of delinquency rates.

You have used a variety of credit enhancement techniques in secondary market securitizations. How do you decide which ones to use? Is it done on a case-by-case basis?
Every time we go out to market we work with two primary investment banks. They put all of the alternatives together for how we can structure our transactions, and generally speaking, we're seeking the best overall sale price and cash execution that we can get. Each quarter when we go to sell loans we look at what the whole loan buyers are willing to pay, and sometimes they are willing to pay in excess of what we can get in a securitization. More often, they are paying slightly less than that. I'm not sure we have any real definitive strategy for credit enhancement. We employ various financial guarantors, and various bond structures that achieve the best overall price, while at the same time assuring that any bond structure can withstand reasonable financial stresses and can meet the investor's performance expectations - Because we don't want to push the envelope so hard that we create a bond that doesn't perform.

Do you have a preference for whole loan sales versus securitization?
We don't really have a preference, other than I can say that over the last 120 days we've been selling a lot more whole loans. There have been a lot of people paying very rich premiums for our loans, so we've been selling more whole loans than we have been securitizing. Even if we were able to sell everything in a quarter in a whole loan sale, we will still do a securitization, albeit a smaller one for two reasons. For us, being out there regularly issuing securitizations helps the liquidity of the bonds. There are more people making markets in our bonds. But at the same time we have to stay sharp here. If we skipped a quarter and didn't do a securitization, that would basically mean there would be a six month time frame between when we did one deal and when we did another deal, and you kind of get rusty. We're committed to doing a securitization every month. It may be a $2-3 billion deal or it could be as small as $500 million, depending on what the whole loan market is doing.

What do you think your total securitization volume for 2002 will be like?
I know we did $8.4 billion last year. I think through July we were probably around $4-5 billion. We've done more whole loan sales, so I would say we're probably going to end up somewhere around where we were last year for the full calendar year.

On the servicing side, do you have an active hedging strategy to maintain the value of the servicing portfolio?
We don't hedge our mortgage servicing rights. And the reason we don't is that there isn't a close correlation between interest rates and prepayments. Typically, in the prime market there's a very close correlation. In our business, because the borrower is driven less by interest rates and more by the need to obtain liquidity, our prepayments are amazingly consistent year over year in different interest rate cycles. A high percentage of our loans, about 80 percent, have prepayment penalties that are in effect for two to three years so that helps make the prepayment behavior very predictable. We don't hedge for two reasons: we don't need to because the prepayment behavior is very predictable, and secondly, there probably isn't a hedge we could employ even if we thought we needed to use one. It's very different from the prime market.

The Bottom Line:

"There have been a lot of people paying very rich premiums...so we've been selling more whole loans than we've been securitizing."

\- Bill O'Neil, Option One

Are your prepayments more sensitive to changes in the economy, such as wages and employment?
We have not really seen that. But obviously, as the economy has gotten softer in the last couple of years, we've seen an increase in delinquencies. We've also seen a little bit of an increase in prepays because rates have dropped so much. If the economy got really soft you'd see an increase in defaults, which is a prepayment also, but we just haven't seen that.

Do you have any new projects scheduled for next year?
We're developing an automated pre-qualification tool, which is the first step toward a fully automated underwriting engine. Automated underwriting is something that's becoming widely accepted in the mortgage business. In our business, the fact that we don't have one out there, and some of our competitors do, has not really put us at a competitive disadvantage, but we think that over the next couple of years AU will be very widely accepted and widely used.

Are you going to build your own AU system or buy it from a vendor?
It's a little bit of both. We're buying some of the black box tools. We're going to buy them off the shelf and add enhancements to them, so when all is said and done I'm not sure how much is purchased and how much is developed. We will try to purchase as much as we can. Ė

STANDARD & POOR'S SEEKS ASSURANCES ON LOAN DOCUMENTATION

Rating agency Standard & Poor's has been asking mortgage originators to give assurances that loan records submitted for rating review accurately describe their loan underwriting standards. At issue is the practice of substituting alternative documentation, for example, an automated valuation model in place of a standard appraisal, and then coding the data tapes to imply that full, walk-through, appraisals were used in loan underwriting.

The practice isn't widespread, says Frank Raiter, S&P's managing director of global residential mortgage-backed securities, and it appears to be limited to only two or three originators. Nevertheless, S&P analysts are sufficiently concerned about the issue that the rating agency wants each of its mortgage originators to submit a "comfort letter" affirming that they will provide accurate loan-level documentation when submitting loans for rating agency review. In some situations, an originator's automated underwriting system allows user over-rides of system defaults - for example entering a loan on the originator's records as a full-documentation loan even though it may have been written as a low-documentation loan or the appraisal was generated from an AVM model.

S&P expects to have a revised warranty document ready after January 1, 2003, but in the interim the agency is asking originators to submit comfort letters. "After October 15, transactions that get rated in the Prime and Alt-A markets need to have a comfort letter from the issuer or we will not rate the transaction," Raiter says.

He further explains: "To be provided with incorrect information makes rating agency analysis somewhat suspect. When this was brought to our attention, we started asking participants to give us some assurance that this wasn't happening. We initially suggested that we would have a requirement for a new representation and warranty." But it will take some time for the rating agency's data processing staff to produce a revised documentation standard. "So we've come out in the interim with this comfort letter which asks the players who are providing tapes to provide a comfort letter basically to just affirm that they agree to use their best efforts to provide accurate loan level information." Ė

HUD WAIVES TERRORISM INSURANCE ON FHA-INSURED MULTI-FAMILY PROJECTS

In response to industry requests, the Department of Housing and Urban Development announced it will not require insurance coverage against acts of terrorism as a condition of its multi-family mortgage insurance. If purchased commercially, this insurance coverage could cost a typical 100-unit, FHA-insured, project an additional $5,000 a year in insurance costs. The added cost to project owners imposes financial strains on existing projects and might even discourage construction of new properties.

Following the attacks of September 11, 2001, primary insurance companies have been excluding or limiting coverage for catastrophic losses resulting from acts of terrorism, including policies covering multifamily projects. HUD secretary Mel Martinez, announcing the new policy at the MBA Annual Convention in Chicago, said FHA would pay the full or partial claim to the lender in the event an FHA-insured property was damaged or destroyed by an act of terrorism. In fiscal year 2001, FHA committed $1.5 billion toward insuring multi-family programs for construction and rehabilitation. In 2002, the agency raised its commitment to $2.8 billion.

This latest bit of regulatory relief may be welcomed by multi-family market participants. The latest survey by the National Multi-Housing Council of the Mortgage Bankers Association reports rising vacancies and lower rent increases in the quarter ending in October, even while debt and equity financing were more widely available. Two-thirds of firms responding said credit was more easily obtainable.

These results were in line with expectations, says NMHC chief economist Mark Obrinsky, adding: "The economy has not improved appreciably in the last three months. In particular, the current recovery is looking more like the previous one, widely known as the 'jobless recovery.' Without sustained job growth, any increase in apartment demand is likely to be muted." Ė

In Next Month's Issue:

The Bottom Line on Commercial MBS

Amid economic uncertainties, the commercial mortgage sector is turning in its best performance in years. What is the outlook for next year? Which sectors in this diverse industry are attracting investor interest? And which ones are they avoiding?

Plus ... An update on proprietary mortgage scoring, operational risk reviews, and much more...

CHASEN ENTERPRISES ROLLS OUT WHOLE LOAN CMO LIBRARY

Investors looking for pricing data on whole loan CMOs can now turn to Chasen Enterprises, which recently introduced its much anticipated whole loan database covering more than 1,500 whole loan CMOs. Chasen, based in Peekskill, New York, has "reverse engineered" the deal structure on more than 7,000 agency CMOs and a broad selection of home equity and asset-backed deals. The firm expects to have databases of home equity and asset-backed deals available for investors in 2003.

Commercial banks, active buyers of Agency paper issued by Fannie Mae or Freddie Mac, have increased their purchases of non-Agency issues in 2003 for the extra yield these securities offer versus comparable Agency paper. "Banks have always been big buyers of Agency CMOs. Now that the capital reserve requirements have been reduced for AAA and AA-rated securities, the higher-rated tranches of whole loan CMOs have become attractive investments for banks," says Scott Sprouse, Chasen director of marketing and sales. Under current banking regulations, the capital reserves required for AA-rated non-agency mortgage securities are identical with those on Agency securities.

More information is available through www.chasen.com. Ė

SUBPRIME LENDING

NHEMA TARGETS MORTGAGE FRAUD, ENDORSING MORTGAGE INDUSTRY DATA EXCHANGE

The National Home Equity Mortgage Association, taking the initiative in dealing with mortgage fraud, has reached an agreement with the Mortgage Asset Research Institute (MARI) to endorse the organization's Mortgage Industry Data Exchange.

"We believe our members and all other lenders will benefit by exchanging information about incidents of mortgage fraud with one another through the MIDEX cooperative system," says NHEMA executive director Jeffrey Zeltzer.

MARI, founded in 1990, provides reports on alleged incidents of misrepresentation or misconduct, drawing from public and non-public information contributed by MIDEX subscribers. The public reports in MIDEX describe enforcement actions against both companies and individuals in the mortgage, finance and real estate industries. Jim Croft, MARI's executive director, says wholesale lenders can perform due diligence on their brokers from the MIDEX website, checking enforcement actions by more than 160
regulatory agencies.

While many large NHEMA members are already MIDEX subscribers, Zeltzer says the association's endorsement should encourage more small and medium size firms to join this cooperative effort, adding "the reports they will be contributing are going to make the database richer and more valuable for everyone." Ė

NORTH CAROLINA PREDATORY LENDING LAW HURTS LOW INCOME BORROWERS: STUDY FINDS

New data from Georgetown University's Credit Research Center, probing the relationship between North Carolina's strict anti-predatory lending law and credit availability, suggests that low-income borrowers were severely impacted by North Carolina's law - the first predatory lending law enacted in the nation. The Georgetown researchers found that subprime loan originations declined by 14 percent since the law took effect in July 1999.

Georgetown researchers Gregory Elliehausen and Michael Staten reported that reductions in predatory lending came as a result of a fall off in applications, not by a change in loan turndown rates. Their conclusions are dramatically different from a report from the Center for Responsible Lending, a North Carolina advocacy group that claimed the state's tough anti-predatory lending law saved borrowers $100 million in loan costs and that low-income borrowers continued to have a wide range of home finance options.

The Georgetown researchers uncovered what they said were flaws in the Home Mortgage Disclosure Act, which they said resulted in inaccurate data. They noted that lending activities of non-bank institutions are not covered by HMDA, nor does the federal law provide any information on the risk characteristics of subprime-eligible borrowers. Ė

REGULATORY COMPLIANCE

QUALIFIED BACKING ON RESPA REFORM, BUT WITH RESERVATIONS

A sampling of comment letters reveals tentative support for key aspects of the mortgage reforms proposed by the Department of Housing and Urban Development, but with cautionary flags. The Mortgage Bankers Association threw its support behind HUD Secretary Mel Martinez's plan, announced last July, to overhaul the Real Estate Settlement Procedures Act - although the association expressed concerns about the effects of some of the proposed modifications.

HUD's goal in proposing these revisions is to encourage comparative mortgage shopping and decrease the borrower's cost of searching for a loan, while in the process encouraging more competition among mortgage originators.

Guaranteed Mortgage Package

In a comment letter to the Federal housing agency, the MBA said the association supports the pro-consumer objectives of the draft proposal, for example the concept of a guaranteed mortgage package (GMPA), but recommended further study before a final rule is issued. Specifically, the inclusion of an interest rate "guarantee" in a mortgage commitment would give consumers better information about their loan, making it more difficult for lenders or brokers to use "bait and switch" tactics, but the concept needs to be examined closely and possibly revised if necessary.

MBA also suggested that the open-offer period in the GMPA be limited to five days, instead of 30 days as originally proposed, and these contracts should remain valid for at least 30 days. After the 30-day period ends, lenders would have the option of setting their own expiration date.

Good Faith Closing Estimate

On the more controversial topic of closing costs, the MBA urged HUD to consider delaying implementation of the revised Good Faith Estimate until some time after the introduction of a guaranteed mortgage package, citing the potentially high cost of implementing this regulation at the same time as a guaranteed mortgage package. Introducing both provisions simultaneously would have the effect of increasing lenders' origination costs "exponentially," the MBA warned. A key provision of the revised Good Faith Estimate is the disclosure of Yield Spread Premiums, or broker commissions paid by the lender, in the statement of estimated loan closing costs.

The Federal Trade Commission's Bureau of Consumer Protection also filed a comment letter expressing its support for the HMDA revisions, but urged further study and consumer research to determine whether mortgage applicants would really benefit from the proposed changes.

"We very much support HUD's proposal to improve RESPA disclosures. Consumers benefit from clear, understandable disclosures, and careful consumer research is the best way to ensure that those disclosures get the job done," says J. Howard Beales III, Director of the FTC's Bureau of Consumer Protection.

The FTC staff recommended additional research to determine whether the planned revisions will actually improve consumer understanding of mortgage originations in three key areas: the disclosure of broker compensation, including yield spread premiums; the revision of loan settlement forms; and the reliability of settlement costs.

"If the additional information or the revised format confuses consumers," the FTC comment letter states, "the proposed changes may not increase consumer welfare as much as HUD intends, and, in the worst case, may actually result in consumer harm." Ė

Housing Discrimination Declining in Metropolitan Markets, HUD Study Reports

The gap between minorities and non-minorities in realizing the dream of homeownership has declined significantly in the last decade, according to a recently released HUD study. According to the study, *Discrimination in Metropolitan Housing Markets: Phase 1*, housing discrimination against African Americans and Hispanics looking to buy a home in 20 major metropolitan markets declined by more than 25 percent since 1989. For those seeking to rent, housing discrimination against African Americans is down 18 percent, but is unchanged for Hispanics.

"These results illustrate that we are making efforts but there is still work to be done," says HUD Secretary Mel Martinez. The downward trend since 1989 and a more targeted enforcement effort by federal agencies will help achieve the Bush Administration's goal of 5.5 million new minority homeowners by the end of the decade, he adds.

HUD said it plans to use the research, conducted by the Urban Institute, to document the nation's progress in reducing housing discrimination. Since 1989, HUD has awarded grants to public and private fair housing groups under the Fair Housing Initiatives Program (FHIP). Initially funded at $5 million, HUD this year is awarding $20 million in FHIP grants.

The minority housing study is the first of four housing discrimination reports undertaken by HUD. Future studies will provide a national estimate of discrimination against Asians, statewide estimates of discrimination against Native Americans, and metropolitan estimates of discrimination against persons with disabilities.

The study was performed using a “paired testing” technique. Two mortgage applicants, one minority and one non-Hispanic white, respond to the same mortgage advertisement. Their experiences are later compared to determine if either applicant was treated adversely while applying for a loan.

SERVICING

LOSS MITIGATION PROGRAMS ASSIST HOMEOWNERS IN A BIND

With little fanfare, mortgage servicers are making headway in tackling one of the costliest servicing issues facing the industry today: dealing with borrowers who fall behind in their mortgage payments. Last month all three of the industry's top players, Fannie Mae, Freddie Mac and the Federal Housing Administration, managed to keep most of their seriously delinquent borrowers in their houses by agreeing to "work out" problems with them, rather than initiating foreclosure action.

During the last 12 months, both Fannie Mae and Freddie Mac have set up counseling or loan modification programs to help servicers deal with financially challenged borrowers. Fannie Mae's Home Save Solutions program offers several creative approaches to handling borrowers in a financial bind - repayment plans, loan modification, deeds in lieu and pre-foreclosure sales. From 1997 to 200, loan workouts rose dramatically, Fannie Mae reports, from 35 percent of problem loans in 1997 to 52 percent in 2001.

Earlier this year, Freddie Mac introduced a Web-based version of its Early-Resolutions counseling service for delinquent borrowers. First announced in 2000, Early Resolutions is designed to help loan counselors get better information from borrowers over the telephone and use that information to figure out workout strategies that avoid foreclosure. According to Freddie Mac, the counseling service is an enhanced version of one that was first developed by Wells Fargo Home Mortgage. The GSE reports that foreclosures have declined 60 percent since it began using the technology.

The FHA, working under a mandate from Congress to reach out to borrowers with financial problems, recently recorded a milestone of its own. For the first time in its 60-year history, the agency paid out more in insurance claims during the fiscal year ending September 30 than claims associated with residential foreclosures. FHA offers borrowers several alternatives under its loss mitigation strategy: Special Forebearance, or lower payments for several months; Loan Modifications, or alterations in the original loan documentation when the financial problem is longer term; and Partial Claims, a policy under which the FHA pays itself through an insurance claim, later collecting from the borrower when the property is sold. The FHA’s loss mitigation strategy is outlined in the agency’s Mortgagee Letter 2002-17, issued August 29, 2002.

TECHNOLOGY

MISMO WORKING ON VERSION 3.0 OF XML DATA STANDARD

In the evolution of electronic commerce, newer, more feature-rich systems set the standard for functionality and ease of use. The Mortgage Industry Standards Maintenance Organization, which sets computer language standards for mortgage lending, has begun work on a new computer language benchmark. The new standard, version 3.0 of the MISMO computer language architecture, utilizes Extensible Markup Language (XML), a computer-readable version of the HTML and is expected to be ready for release next year.

MISMO was established in 2000 by the Mortgage Bankers Association to coordinate the development and maintenance of XML specifications for commercial and residential real estate finance. XML enables software from many different computer platforms to communicate with each other via a set of pre-established terms.

"Not every company uses MISMO specifications, but they are more inclined since Fannie and Freddie agreed to use it last year," said Gabe Minton, senior director of industry technology at the MBA, who heads the MISMO effort. "Over eight major lenders attended our last meeting. I think the general feedback from the industry has been very positive."

XML derived specifications have been developed for a number of mortgage industry applications, including property appraisals, insurance, loan pricing, credit reporting and underwriting. An example is Connect2Data(tm)XML, a full-featured XML product from First American Real Estate Solutions. "MISMO's XML standards benefit the entire mortgage industry," said George Livermore, president of First American RES. "With Connect2Data XML, our customers will have the scalability and flexibility needed to update their programs any time, without the need for custom development."

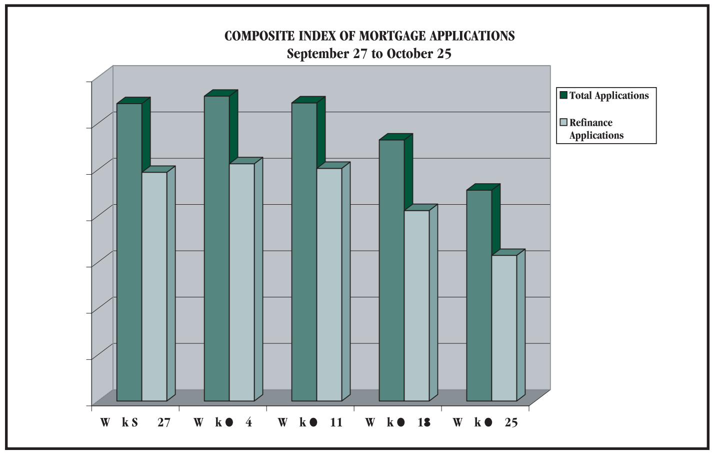
RES introduced its first XML offering in 1999. Its latest innovation leverages the fast-growing acceptance of XML within the mortgage industry. "MISMO saw the need for a standard protocol for communications between systems involved in processing mortgage transactions," said Minton. "XML was a natural choice because of its simplicity, widespread adoption as the Internet data standard and most importantly, its open versus proprietary nature."

MISMO currently has more than 90 subscriber organizations and over 500 people participating. "MISMO standards will further accelerate the adoption process beyond its already rapid pace," said Doug Lamb, IT project manager at First American and a member of MISMO's appraisal committee. "Using XML really gave us the opportunity to provide a flexible way to share common information formats via the Internet, intranets and elsewhere. It opens up a world of possibilities and brings together the different process areas in the lending transaction like credit, collateral assessment, flood and title."

FACTS & STATS

LOAN REFINANCINGS LEAD OCTOBER MORTGAGE APPLICATIONS AS RATES RISE

Mortgage loan applications soared to near-record heights in October, as interest rates hovered around the 6.0 percent level. The market composite index, a measure of loan applications for home purchase and refinance, decreased 19.3 percent to 911.0 on a seasonally adjusted basis from 1128.3 according to the Weekly Mortgage Applications Survey of the Mortgage Bankers Association of America. On an unadjusted basis, the Index decreased 10.6 percent but was up 7.7 percent compared to the same week a year earlier.



Refinance activity declined to 69.2 percent of loan applications in the week ending October 25, a decrease from 73.4 percent the previous week. This was also the lowest ratio of refis to total applications in more than eight weeks. The seasonally adjusted Refinance Index decreased to 4240.4 from 5588.7 the previous week. Through the month of October, the Index was above 4000 for 14 consecutive weeks.

The average contract interest rate for 30-year fixed-rate mortgages decreased to 6.01 percent from 6.21 percent the week, with points increasing to 1.55 from 1.37 (including origination fees) for 80 percent LTV loans. The average contract rate for 15-year fixed-rate loans decreased to 5.39 from 5.63 percent the previous week, with points remaining the same as the previous week at 1.36. The average contract rate for one-year ARMs was 4.01 percent, decreasing from 4.16 percent. Points for ARMs increased to 1.10 from 1.09. The share of adjustable rate loan applications increased to 15.2 percent from 13.9 percent the previous week. The MBA survey covers approximately 40 percent of all U.S. residential mortgage originations and has been conducted weekly since 1990.Ė

BORROWERS REFINANCE TO ADD TO SAVINGS, PAY DOWN DEBT

Nearly one-third of American homeowners that have refinanced mortgages in the past two years or plan to do so in the next year expect to use the extra cash to increase their savings, according to a nationwide survey by the Cambridge Consumer Credit Index. Thirty-one percent of borrowers surveyed planned to add to savings, while 23 percent said they would pay off non-credit card debt such as car loans or college loans. Another 20 percent would spend the extra cash on home remodeling or vehicle purchase. The survey, conducted monthly by ICR/International Communications Research, said that 24 percent of homeowners have refinanced mortgages since 2000, while 16 percent expect to refinance next year.

The prospect of higher mortgage rates heading into 2003 seems to have triggered a wave of cashout refinances. Forty-five percent of homeowners refinancing during the third quarter took out loans at least five percent larger than the original loan, according to Freddie Mac's Quarterly Refinance Review.Ė

CMBS DELINQUENCIES TAKE A BREATHER IN THIRD QUARTER

Delinquency rates on commercial mortgage-backed securities improved in the third quarter, according to Standard & Poor's CMBS Quarterly Review. The relative stability of delinquency rates was largely the result of continued low interest rates, which softened the impact of declining property cash flow.

After the second quarter's flat delinquency rate of 2.05 percent, the third quarter's rate declined to 1.9 percent, approaching 2001 levels, the review said. Overall, healthcare and office delinquencies declined, while retail and multi-family delinquencies increased. In the third quarter of 2001, delinquency rates for pooled commercial mortgage-backed security transactions increased by 12 percent from the previous quarter, attributed to the effects of several large loan delinquencies carried over from previous quarters. But delinquencies for most sectors remained below 1.5 percent on average.

Investment grade commercial mortgage securities have been some of the best performing securities in the U.S. bond market through the first three quarters of 2002. As of September 30, high-grade CMBS issues earned a year-to-date investment return of 13.1 percent, outperforming all other types of bonds with the exception of long-dated Treasury issues and federal agency bonds, according to an analysis by Lehman Brothers.Ė

INDUSTRY PULSE

MBA ELECTS NEW CHAIRMAN, OFFICERS; FREDDIE MAC PROMOTION

Recent industry promotions and appointments include:

Â John A. Courson, president and CEO of Central Pacific Mortgage Company in California, has been elected chairman of the Mortgage Bankers Association of America at the Association's recent Annual Convention in Chicago. Robert M. Couch, president of New South Federal Savings Bank in Birmingham, Alabama, and Michael Petrie, president of P/RMIC in Indianapolis, Indiana, were named as chairman-elect and vice-chairman, respectively.

Â Linda Holmes, multi-family director of marketing and support at Freddie Mac, was promoted to vice president of customer management and communications in Freddie Mac's multi-family division.

INDUSTRY BRIEFS

HOME IMPROVEMENTS TRENDING UPWARD

With mortgage rates at record lows, homeowners are once again investing in home remodeling, the Joint Center for Housing Studies at Harvard University reports. Despite a volatile stock market, homeowners spent an estimated $115.6 billion on remodeling from the fourth quarter of 2001 through the third quarter 2002, a 3.3 percent increase in remodeling activity. The National Association of the Remodeling Industry says consumers will spend $163 billion on remodeling projects this year, compared to $157.5 billion in 2001 and $150 billion in 2000.

Growth in home improvement spending is closely linked to mortgage refinancing, a trend expected to continue into 2003. About 45 percent of homeowners refinancing mortgages in the third quarter took out extra cash for remodeling, or for other purposes, according to Freddie Mac's Quarterly Refinance Review. "Home improvement expenditures appear to have stabilized and begun a modest recovery," comments Joint Center director Nicolas P. Retsinas. "Recognizing strong home price appreciation, homeowners are making improvements in their most stable asset - their home."

HOME SALES AND HOUSING STARTS ON RECORD PACE

Sales of existing homes will increase 3.2 percent for the year, setting a new record of 5.47 million units, the National Association of Realtors predicts. New home sales are projected to rise 2.2 percent to 929,000, also a record, the association said.

Housing starts are expected to rise 3.1 percent to 1.65 million units for the full year, with the same production expected next year. Mortgage giant Freddie Mac has raised its forecast for housing starts in 2002 to 1.66 million units, a 3.75 percent increase from 2001 starts. Meanwhile, housing values are expected to grow from 6 to 6.5 percent for the year, according to Freddie Mac, even though home price appreciation has begun to slow in some regions.

SPANISH LANGUAGE PROGRAM TARGETS PREDATORY LENDING

The Mortgage Bankers Association of America has launched a Spanish language version of its anti-predatory lending campaign "Stop Mortgage Fraud." The campaign was launched in English at the MBA's Second Annual National Housing Summit last March.

This consumer education campaign is one part of MBA's commitment to the Department of Housing and Urban Development's "Blueprint for the American Dream," a public/private partnership to create 5.5 million new minority homeowners by the end of the decade. The Research Institute for Housing in America, in a study revealing an upsurge in legal immigration from Latin America over the past two decades, predicts that demand for foreign-born homeownership will increase dramatically in the next 20 years.

THREE MILLION U.S. HOMEOWNERS MISSED CHANCE TO REFINANCE

The financial incentives to refinance a home mortgage are undeniable strong, with interest rates near a 40-year low. But at least three million homeowners who could refinance and reduce their mortgage payments have not done so, according to mortgage industry analysts.

Refinancing a longer-term loan doesn’t make sense if the homeowner is planning to move within five years. Some homeowners may no longer be creditworthy, while others have not refinanced due to inertia or fear of dealing with the mortgage application process.

This year’s refinancing will total about 7.2 million loans, according to Mortgage Bankers Association economist Phil Colling. The average loan amount for refinanced mortgages is about $195,000.

INDUSTRY BRIEFS

MISMO AWARDED STEVE FRASER AWARD

The Mortgage Industry Standards Maintenance Organization (MISMO) is the 2002 recipient of Mortgage Technology magazine's Steve Fraser Award. This is the first year that an industry organization, rather than an outstanding individual, was selected for promotion of innovative technologies.

The prize recognizes MISMO's many achievements, including its work in advancing the Extensible Markup Language (XML), currently used by both Fannie Mae and Freddie Mac in their automated underwriting systems, and the SMART Doc standard created for the purpose of capturing paper documents and storing them electronically.

MISMO professionals named in the Steve Fraser announcement are Gabe Minton, senior director of technology at the Mortgage Bankers Association, David Barkley of Freddie Mac, Mark Oliphant of Fannie Mae, Lisa Bolelli of First American, and Roger Gudobba of VMP Mortgage Forms.

CONSUMER CREDIT OUTSTANDINGS INCREASED IN SEPTEMBER

Consumers stepped up their borrowing in September at an annual rate of 7 percent, according to data released by the Federal Reserve Board. Consumer credit outstandings, which do not include residential mortgages, increased $9.9 billion in September to $1.732 trillion.

This is an increase from the $1.67 trillion outstanding at the end of 2001, and the $1.56 trillion at the end of 2000. Market analysts had only expected a $5.6 billion increase in September's consumer credit data.

LOOKING AHEAD

January 12-14, 2003
CMBS INVESTORS CONFERENCE
Commercial Mortgage Securities Association
Loews Miami Beach Hotel
Miami, Florida
212.509.3282 / www.cssambs.org

January 27-30, 2003
REGULATORY COMPLIANCE INSTITUTE
Mortgage Bankers Association of America
Embassy Suites Hotel
Orlando, Florida
800.793.6222 / www.mbaa.org

February 2-5, 2003
COMMERCIAL REAL ESTATE FINANCE CONVENTION
Mortgage Bankers Association of America
San Diego Convention Center
San Diego, California
800.793.6222 / www.mbaa.org

February 5-8, 2003
ABS WEST 2003
Information Management Network
Arizona Biltmore
Phoenix, Arizona
212-768-2800 / www.imn.org

February 9-12, 2003
NATIONAL REAL ESTATE LENDING CONFERENCE
America's Community Bankers
Sheraton El Conquistador Resort
Tucson, Arizona
202.857.3146 /
www.americascommunitybankers.org