

From the Editor

What passes for today's conventional wisdom may sound a bit off-base once tomorrow arrives. Trouble is, we never know which ideas will fade until the passage of time sets us straight. In the fourth and final issue of *Secondary Mortgage Markets* for the year, we view two such cases through the clarity of 20/20 hindsight.

First, authors Jeff Green and Jan Luytjes tackle the puzzle posed by derivatives: how could something so roundly castigated in the popular media and business press prove so popular with the very investors who supposedly should know better? At least part of the answer is that the financial instrument is no more responsible for the heavy losses blamed on it than is the oft-maligned bearer of bad news; in fact, derivatives are thriving.

Next, the head of Freddie Mac's servicing division, Paul Peterson, chronicles recent shifts in the mortgage-servicing landscape. In 1990, servicing operations proliferated yet received little industry attention. Now a handful of mega-servicers commands nearly half the market, and servicing has landed a marquee role as rainmaker.

In 1997, *SMM* will continue to not only present the latest industry thinking but later report back on its staying power.

H. Jane Lehman
Editor

ARM Lenders Compete on Introductory Rates

Pricing differences among competing adjustable-rate mortgages (ARMs) are captured primarily in the introductory, discounted interest rates characteristic of these loans, according to the latest Freddie Mac

annual survey of ARM-lending practices. Correspondingly, the November survey found little difference in the average number of points charged or in the average margin built into the loans. (The margin, when added to the underlying index value to which the loan is tied, establishes the fully indexed rate paid after the introductory rate expires.)

At the same time, introductory ARM rates quoted among the 121 lenders surveyed varied by more than three times the spread among rates offered for fixed mortgages. Together, these findings suggest that ARM borrowers in particular stand to benefit from comparison shopping among lenders.

The ARM survey, in conjunction with other research undertaken by Freddie Mac, also finds a mortgage marketplace where:

- ARMs have regained ground over the course of 1996, constituting nearly one-third of mortgage originations in September. That represents a doubling in market share from January, when only 16 percent of borrowers chose ARMs over fixed-rate loans. ARM share, which at times has commanded two-thirds of the

EXHIBIT 1: ARM Lending Practices

	1-Year ARMs		3-Year ARMs		5-Year ARMs
	Conforming	Jumbo	3/3	3/1	5/1
Initial-Period Rate	5.56%	5.70%	7.06%	6.76%	7.13%
Points	1.4	1.4	1.3	1.4	1.4
Margin	2.78	2.80	2.76	2.78	2.77
Fully Indexed Rate	8.22	8.24	8.65	8.22	8.21
Initial-Period Discount	2.66	2.54	1.59	1.46	1.08
FRM-ARM Spread ¹	2.11	1.97	0.61	0.91	0.54
Percent of ARM Lenders Offering	100	95	44	83	79

Note: The sample is limited to ARMs indexed to either the 1-year or 3-year Constant Maturity Treasury notes. Data represent survey responses by 121 ARM lenders during the week of November 8, 1996.
¹Based on the average 30-year conforming fixed-rate mortgage (FRM) commitment rate of 7.67 percent from Freddie Mac's Primary Mortgage Market Survey.
 Source: Freddie Mac

market, generally grows in relation to rising interest rates for fixed-rate loans.

- The interest-rate differential between 30-year, fixed-rate conforming mortgages and one-year ARMs increased sharply during the year, widening to 2.3 percentage points in October from 1.6 percentage points in January. The fixed rate stood at 7.67 percent in early November.

- The starting interest rate on jumbo ARMs—those loans larger than the 1996 conforming loan limit of \$207,000—carried a small 0.14 percentage-point premium over conforming ARMs in November. The comparison is based on comparable one-year, Treasury-indexed ARMs.

- Although one-year ARMs remain the most prevalent, adjustable loans with an initial three-year rate lock (3/1 ARM) and a five-year rate lock (5/1 ARM) appear on about 80 percent of lender menus. Both products carry higher premiums of at least one percentage point over one-year ARM rates. The higher premiums serve as lender compensation for the greater interest-rate risk associated with the longer periods during which the interest rate is frozen.

—Michael A. Schoenbeck, financial analyst