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Survey on the Use of Alternative Mortgage Instruments

by

Ronnie Starbow

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CENTER FOR REAL ESTATE AND URBAN ECONOMICS
UNIVERSITY OF CALIFORNIA, BERKELEY

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SURVEY ON THE USE OF ALTERNATIVE

MORTGAGE INSTRUMENTS

by

Ronnie Starbow

Center for Real Estate and
Urban Economics

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ABSTRACT

Major deregulation of the types of residential mortgage instruments lending institutions could offer to the consumers occurred in the early 1980s. The high and volatile interest rates and inflation of the late 1970s and early 1980s, which initiated the deregulation, created difficulties for both lending institutions and borrowers.

To ascertain what types of single-family mortgages were being offered in the home finance market, leading lenders of single-family residential mortgages in California were surveyed. The purpose of the survey was twofold: to determine the actual dollar volume of different mortgage instruments being offered to borrowers; and to obtain qualitative data on the advantages and disadvantages of each instrument.

The major quantitative findings of the survey are that sixty percent of single-family mortgages originated in California in 1982 were fixed rate loans; 1983 predictions are that fixed rate originations will continue to represent over 50 percent of these loans. Adjustable mortgages were 30 percent of all originations in 1982; in 1983 adjustable rate loans are predicted to increase to 36 percent of originations.

Qualitatively, the major finding of the survey is that consumers prefer fixed rate loans over all other types. Two
conclusions are drawn from the survey. The first is that due to consumer preference for fixed rate loans, the market-driven mortgage industry will provide fixed rate loans despite the risks of volatile interest rates. The second conclusion is that high interest rates indicate the proliferation of alternative mortgage instruments. As interest rates decline, it is likely that fixed rate loans will increase in volume.
Survey on the Use of Alternative Mortgage Instruments

In the past two years there has been a major deregulation of the type of mortgage instruments offered to the consumer by lending institutions. In March 1981, national banks were given authority by the Comptroller of the Currency to make a wide variety of adjustable rate mortgages (ARM). Several months later, The Federal Home Loan Bank allowed federally chartered savings and loans even more flexibility, with virtually any type of adjustable mortgage loans (AML) and graduated payment/adjustable mortgages (GPM/AM) authorized. In 1982, with the passage of the Garn St. Germain Act, all other lending institutions were deregulated in terms of the types of residential mortgages which could be offered.

This trend toward deregulation was motivated by the needs of lending institutions and borrowers, who were both experiencing severe difficulties from high and variable inflation and interest rates of the late 1970s through the early 1980s.

Lenders, to the late 1970s, could profitably fund long term fixed rate loans with low cost short term liabilities, since regulatory agencies maintained below market interest rates on depository liabilities. As interest rates were deregulated, depository institutions had to pay market rates for their liabilities. The high cost of funds created an increasingly disadvantageous mismatch between yields on short term funds and long term mortgages, to the point where some institutions faced
insolvency. Adjustable rate mortgages are viewed as the primary financing vehicle which will enable depository institutions to match their cost of funds with interest earned on assets.

The borrower, on the other hand, was faced with an affordability crisis. First time homebuyers were unable to purchase homes due to the high interest rates which increased the monthly carrying costs of a conventional fixed rate mortgage. Graduated payment mortgages, which provide reduced payments in the initial years of the loan, are viewed as a solution to the affordability issue.

Due to the increasing interest in alternative mortgages, the UC Berkeley Center for Real Estate and Urban Economics undertook a survey of leading lenders of single-family residential mortgages in California to ascertain what types of mortgages were offered the market. The purpose of the survey was twofold: to determine the actual dollar volume of different mortgage instruments being offered to borrowers; and to obtain qualitative data on the advantages and disadvantages of each instrument. (See Appendix I for copy of questionnaire.)

The largest ten savings and loans, commercial banks, and mortgage banks in California were contacted. Executives of institutions in the Bay Area were interviewed in person. The survey was mailed to institutions outside the Bay Area. Twenty-six institutions responded to the survey: 11 savings and loans; 9 commercial banks; and 6 mortgage banks. It was felt that the data from the responding institutions, since they were chosen on the basis of high mortgage dollar volume, would be an accurate
representation of what is being sold in the California residential mortgage marketplace.

A comparison of the data with known market share percentages of savings and loans, commercial banks, and mortgage banks, has led to the conclusion that the data is representative of savings and loans and mortgage banks, but not of commercial bank lending activity. Specifically, the data indicates the proportionate volume of loans originated by commercial banks is smaller than the known market share of the commercial bank industry. A possible explanation for this is the interaction between commercial banks and their subsidiary mortgage banks in accounting for loans originated. A list of institutions that participated in the survey appears on Table III (A) (B) and (C).

The first section of this paper briefly summarizes the different versions of alternative mortgages found in the California market. The second section reviews the quantitative results of the survey. The last section presents the qualitative results of the survey.

ALTERNATIVE MORTGAGE DEFINITIONS

The typical fixed rate mortgage (FRM) has a fixed interest rate, fixed monthly payments, fixed date of maturity and zero debt at maturity. The length of the loan is usually thirty years, although some loans are amortized over fifteen years. Short-term fixed rate mortgages (STFRM) are amortized over thirty years, and
payable in five to ten years. Because of the early due date, the principal of the loan is not substantially reduced by amortization, and a balloon payment almost equal to the amount of the loan must be paid by the borrower.

The adjustable rate mortgage (ARM) and the adjustable mortgage loan (AML) have interest rates that vary in accordance with changes in a predetermined money market index. ARMs, which are authorized by the Comptroller of the Currency for use by national banks, can vary with one of three market interest rate indices: the Federal Home Loan Bank Board's national mortgage rate closing index; the three-year Treasury note rate; or the six-month Treasury bill rate. Interest rates can increase only one percent every six months. The maturity of the loan is fixed, usually for thirty years.

AMLs are authorized by the Federal Home Loan Bank Board for use by savings and loans. Interest rates and payments have no adjustment ceilings set by the FHLBB. Savings and loans have developed different AML plans that offer various interest rate and payment adjustments and various ceilings on interest rate and payment increases. Negative amortization can occur if the monthly payments are not large enough to cover interest payments due, in which case the unpaid interest is added to the loan principal outstanding.

Graduated payment mortgages/fixed (GPMs/Fixed) begin with reduced initial monthly payments. Payments increase gradually over the first five or ten years of the loan. Monthly payments can increase 2 1/2 percent, 5 percent, or 7 1/2 percent over the first
five years, or 2 percent or 3 percent over the first ten year period. The interest rate is fixed and payments vary in accordance with a predetermined schedule. Negative amortization is possible. The maturity date is fixed, usually at thirty years.

Graduated payment mortgages/adjustable (GPM/AML) use two interest rates. One rate is adjustable and is the rate at which the borrower is charged interest. The second is a fixed rate which is used to compute payments on a graduated schedule. During the early years of the loan there is usually negative amortization since the low payments often do not cover the total interest charged. The maturity of the loan is fixed, in most cases to thirty years.

Growing equity mortgages (GEM) are thirty-year amortizing fixed rate loans, with payments increasing yearly at a predetermined rate. Some plans call for a payment increase based upon an inflation rate index. The increase in payments is used to repay the principal of the loan more rapidly, thus shortening the life of the loan.

Several parameters characterize adjustable mortgage loans. These are: interest rate index to which mortgage interest rates are pegged; payment adjustment period; rate adjustment period; interest rate caps. An overview of how these characteristics vary with the three types of lending institutions is presented in Table I. The vast majority of savings and loans use the FHLB cost of funds index for the 11th district. The other most commonly used index by lenders is a six-month to one-year Treasury bill index.
QUANTITATIVE FINDINGS

The aggregate volume of single-family mortgage originations, by type of loan, is shown in Table II.

Sixty percent of all single-family first mortgages originated in California in 1982 were fixed rate loans; 1983 forecasts predict that the percentage of fixed rate originations will continue to represent over 50 percent of all loans made. In 1982 adjustable mortgages comprised 30 percent of all originations; 1983 projections are for an increase in adjustables to 36 percent of total originations. In 1982 GPM/Fixed were 2.6 percent of originations, GPM/AMs were slightly higher at 3.1 percent, and GEMs were a low 0.1 percent of originations. Projections for 1983 show an increase in GPM/AMs and a decrease in GPMs/Fixed.

Each of the three types of lending institution has originated different percentages of alternative and fixed mortgages. These findings are presented in Table III.

In 1982, 61.3 percent of all mortgages originated by savings and loans were fixed rate loans. Of this 61.3 percent, 51.3 percent were resold in the secondary mortgage market. Adjustable comprised 34.0 percent of all savings and loan 1982 originations; GPM/Fixed were 1.0 percent and GPM/AMs were 3.0 percent of originations. GEMs were a low 0.2 percent.
**TABLE I (A)**

**MARKET INTEREST RATE INDICES**

<table>
<thead>
<tr>
<th>INDEX</th>
<th>S &amp; L</th>
<th>CB</th>
<th>MB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monthly T Bill Average</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6-Month Moving Average of 6-Month T Bill Weekly Average</td>
<td></td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Weekly Avg of 3-Month T Bill Rate</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>26-Week T Bill Rate</td>
<td>2</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>One-Year T Bill Rate</td>
<td></td>
<td></td>
<td>4</td>
</tr>
<tr>
<td>Monthly Yield of Treasury Securities Adjusted to Constant Maturity of</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 years</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FHA 30-Year Mortgage Rate</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5-Year T Note Rate</td>
<td>2</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>FHLBB Cost of Funds for 11th District</td>
<td></td>
<td>13</td>
<td></td>
</tr>
<tr>
<td>Weekly Average Yield on US Treasury Securities Adjusted to Constant</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maturity of:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 year</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 years</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 years</td>
<td>1</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>6 months</td>
<td>1</td>
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<td></td>
</tr>
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</table>


<table>
<thead>
<tr>
<th>TABLE I (B)</th>
</tr>
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**INTEREST RATE CAP ON EACH ADJUSTMENT**

<table>
<thead>
<tr>
<th>Rate</th>
<th>S 6</th>
<th>L 1</th>
<th>CB</th>
<th>MB</th>
</tr>
</thead>
<tbody>
<tr>
<td>No cap</td>
<td>18</td>
<td>2</td>
<td>6</td>
<td></td>
</tr>
<tr>
<td>0.5%</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.0%</td>
<td>1</td>
<td></td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>2.0%</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.0%</td>
<td>3</td>
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**INTEREST RATE CAP OVER THE LIFE OF THE LOAN**

<table>
<thead>
<tr>
<th>Rate</th>
<th>S 6</th>
<th>L 1</th>
<th>MB</th>
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</thead>
<tbody>
<tr>
<td>No cap</td>
<td>9</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>3.0%</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>5.0%</td>
<td>14</td>
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**FREQUENCY OF RATE ADJUSTMENT**

<table>
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<tr>
<th>Frequency</th>
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<th>L 1</th>
<th>MB</th>
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</thead>
<tbody>
<tr>
<td>1 month</td>
<td>5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 months</td>
<td>10</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>1 year</td>
<td>4</td>
<td></td>
<td>4</td>
</tr>
<tr>
<td>30 months</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 years</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 years</td>
<td>3</td>
<td>1</td>
<td>2</td>
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</table>

**FREQUENCY OF PAYMENT ADJUSTMENT**

<table>
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<tr>
<th>Frequency</th>
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<th>L 1</th>
<th>MB</th>
</tr>
</thead>
<tbody>
<tr>
<td>6 months</td>
<td></td>
<td></td>
<td>4</td>
</tr>
<tr>
<td>1 year</td>
<td>18</td>
<td></td>
<td>4</td>
</tr>
<tr>
<td>30 months</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 years</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 years</td>
<td>3</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td></td>
<td>1982</td>
<td></td>
<td>1983</td>
</tr>
<tr>
<td>--------</td>
<td>------------</td>
<td>--------</td>
<td>------------</td>
</tr>
<tr>
<td></td>
<td>Volume</td>
<td>Percent</td>
<td>Volume</td>
</tr>
<tr>
<td>FRM/STFRM</td>
<td>4,265.5</td>
<td>61.3</td>
<td>8,691.0</td>
</tr>
<tr>
<td>AML/ARM</td>
<td>2,076.45</td>
<td>30.0</td>
<td>5,861.5</td>
</tr>
<tr>
<td>GPM/Fixed</td>
<td>184.0</td>
<td>2.6</td>
<td>295.0</td>
</tr>
<tr>
<td>GPM/AM</td>
<td>217.4</td>
<td>3.1</td>
<td>783.0</td>
</tr>
<tr>
<td>GEM</td>
<td>9.4</td>
<td>.13</td>
<td>41.25</td>
</tr>
<tr>
<td>Other</td>
<td>202.0</td>
<td>2.9</td>
<td>357.0</td>
</tr>
<tr>
<td>Total</td>
<td>6,954.7</td>
<td>2.9</td>
<td>16,029.0</td>
</tr>
</tbody>
</table>
Mortgage banks had the highest percent, 77.3 percent of their 1982 originations, in fixed instruments. Three percent of originations were adjustable loans; GPM fixed and adjustable comprised 11.3 percent and 8.1 percent of originations, respectively. GEMs were 0.1 percent of originations.

Commercial banks in 1982 sold 47.8 percent of their originations as fixed rate loans and 51.2 percent as adjustables; 1.0 percent of loan originations were GPM/Fixed.

For savings and loans, 1983 projections estimate fixed loans will decrease to 46.0 percent of originations, while adjustables will increase to 47 percent.

Mortgage banks in 1983 forecast a slight increase in fixed and adjustables with a decrease in GPMs. GEMs are predicted to increase to 0.9 percent of 1983 originations.

Commercial banks' originations in 1983 are forecast to consist of 80.0 percent fixed rate loans. Adjustables will decrease to 17.8 percent of originations.

The trends are: savings and loans will reduce their volume of fixed loans while increasing adjustables; commercial banks will increase fixed loan originations while decreasing adjustables; mortgage banks will maintain the majority of originations in fixed rate loans. In 1983, all institutions will resell a higher proportion of loans in the secondary mortgage market than they did in 1982.
**TABLE III (A)**

**ORIGIANATIONS BY LENDERS SURVEYED***

(in millions)

**SAVINGS AND LOANS**

<table>
<thead>
<tr>
<th></th>
<th>1982</th>
<th></th>
<th>1983</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>VOLUME</td>
<td>PERCENT</td>
<td>VOLUME</td>
<td>PERCENT</td>
</tr>
<tr>
<td>FIXED</td>
<td>$2,844.5</td>
<td>61.3%</td>
<td>$5,594.0</td>
<td>46.0%</td>
</tr>
<tr>
<td>ARM/AML</td>
<td>1,577.0</td>
<td>34.0%</td>
<td>5,730.0</td>
<td>47.0%</td>
</tr>
<tr>
<td>GPM/FIXED</td>
<td>52.0</td>
<td>1.0%</td>
<td>90.0</td>
<td>0.7%</td>
</tr>
<tr>
<td>GPM/AM</td>
<td>131.0</td>
<td>3.0%</td>
<td>700.0</td>
<td>5.7%</td>
</tr>
<tr>
<td>GEM</td>
<td>8.0</td>
<td>0.2%</td>
<td>24.0</td>
<td>0.2%</td>
</tr>
<tr>
<td>OTHER</td>
<td>27.0</td>
<td>0.5%</td>
<td>47.0</td>
<td>0.4%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$4,640.0</td>
<td></td>
<td>$12,185.0</td>
<td></td>
</tr>
</tbody>
</table>

*Institutions Participating*

Home Savings of America  
Western Savings and Loan  
American Federal Savings and Loan  
World Savings and Loan  
First Nationwide Savings and Loan  
Home Savings and Loan  
State Savings and Loan  
Imperial Savings and Loan  
Gibraltar Savings and Loan  
Coast Savings and Loan  
Allstate Savings and Loan

*Institutions Contributing Qualitative Data Only*

California Federal Savings and Loan  
Glendale Federal Savings and Loan
TABLE III (B)*

ORIGINATIONS BY LENDERS SURVEYED
(in millions)

COMMERCIAL BANKS

<table>
<thead>
<tr>
<th></th>
<th>1982</th>
<th></th>
<th>1983</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>VOLUME</td>
<td>PERCENT</td>
<td>VOLUME</td>
<td>PERCENT</td>
</tr>
<tr>
<td>FIXED</td>
<td>$599.0</td>
<td>47.8%</td>
<td>66.0%</td>
<td>$1,605.0</td>
</tr>
<tr>
<td>ARM/AM</td>
<td>641.2</td>
<td>51.2%</td>
<td>0.1%</td>
<td>352.5</td>
</tr>
<tr>
<td>GPM/FIXED</td>
<td>12.0</td>
<td>1.0%</td>
<td>0.0%</td>
<td>15.0</td>
</tr>
<tr>
<td>GPM/AM</td>
<td>0.0</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>GEM</td>
<td>0.0</td>
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</tr>
<tr>
<td>TOTAL</td>
<td>$1,252.5</td>
<td></td>
<td></td>
<td>$1,970.0</td>
</tr>
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</table>

*Institutions Participating

Bank of America
Security Pacific Bank
Wells Fargo Bank
Crocker Bank
California First Bank
Bank of California
Lloyds Bank
Sumitomo Bank
Imperial Bank
### TABLE III (E)

**ORIGINATIONS BY LENDERS SURVEYED**

(in millions)

**MORTGAGE BANKS**

<table>
<thead>
<tr>
<th></th>
<th>1982</th>
<th>1983</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>VOLUME</td>
<td>PERCENT VOLUME</td>
</tr>
<tr>
<td>FIXED</td>
<td>$822.0</td>
<td>77.3%</td>
</tr>
<tr>
<td>ARM/AML</td>
<td>33.3</td>
<td>3.1%</td>
</tr>
<tr>
<td>GPM/FIXED</td>
<td>120.0</td>
<td>11.3%</td>
</tr>
<tr>
<td>GPM/AM</td>
<td>86.4</td>
<td>8.1%</td>
</tr>
<tr>
<td>GEM</td>
<td>1.4</td>
<td>0.1%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$1,063.1</td>
<td></td>
</tr>
</tbody>
</table>

*Institutions Participating*

- Transamerica Mortgage Company
- Wells Fargo Mortgage Company
- First Interstate Mortgage Company
- Mason McDuffie Mortgage Company
- Lomas and Nettleton Mortgage Company
- Weyerhaeuser Mortgage Company
QUALITATIVE FINDINGS

Each institution surveyed was asked to list the advantages and disadvantages of each type of mortgage instrument offered. The following is a condensation of the responses.

FIXED RATE LOANS

Problems: To Lender

- There are no problems.
- Interest rate risk is a hazard.
- When rates are high, many consumers cannot qualify.
- Limitation of the maximum amount of the loan to $108,300.
- Dwindling investor acceptance in the secondary market with the exception of FNMA and FHLMC.
- The early call dates on some fixed rate loans may become a problem in the future when the loans are called.

Problems: To Borrower

- When rates are high, many borrowers cannot qualify.
- Borrower can become locked into rates that are higher than market rates, when interest rates are declining.
Advantages: To Lender

- Lower servicing costs—easy for the accounting department to keep track of.
- Can resell loans up to $108,300 in the secondary market.
- High degree of consumer acceptance.
- Easy to explain to consumer.

Advantages: To Borrower

- Provides greatest security since payments are constant; easy to budget money in advance.
- Can lock in a favorable interest rate and refinance if interest rates fall.

Consumer Reaction

- Excellent; good; they love it; the most popular instrument.
FIXED RATE LOANS WITH CALL PROVISIONS

Problems: To Lender

- None.
- Borrower's preference for straight thirty-year fixed rate.
- Customer hesitation because of balloons.
- Some banks cannot refinance when the loan is called.

Problems: To Borrower

- May have difficulty refinancing loan when it is called.

Advantages: To Lender

- Strong secondary market exists for loans with call provisions.
- Provides lenders with money for new loans at the expiration of the call period.

Advantages: To Borrower

- Loans with call provisions can be made for amounts up to $200,000. Generally fixed rate loans have a cap of $108,300.
- Interest rates are below market.
- Paid off sooner.
- Assumable.
Consumer Reaction

- Apprehension regarding financing availability when the call period expires.
- Upscale borrowers who want a larger mortgage respond favorably.
- Acceptable to many borrowers.

ADJUSTABLE MORTGAGES

Problems: To Lender

- None.
- Borrower finds frequent rate adjustments unacceptable.
- Difficult for consumers to understand. Must educate the marketplace.
- Each type of loan requires a different set of documents and its own computer program. Administering the loans is difficult.
- Difficult to properly disclose all factors to the borrower.
- Potential delinquency from payment shock, depending upon where rates are at the time of the loan readjustment.
- Some market interest rate indices move more slowly than the cost of funds.
Problems: To Borrower

- Frequent rate adjustments makes budgeting difficult.
- May not be able to make higher payments if rates increase.

Advantages: To Lender

- Immediate increase in income as base index rises.
- Allows lending institution to move with the cost of funds; reduces interest rate risk borne by lender.

Advantages: To Borrower

- Possible decrease in payments should base index decline.
- No prepayment charge.
- Assumable.
- Initial interest rate is lower than rate on fixed instruments.
- No floor on rate reductions.
- If the market rate moves slowly from the lender's perspective, it is advantageous from the borrower's perspective.
Consumer Reaction

- Cautious.
- Borrowers prefer fixed rates.
- Where the product has been adequately explained to consumers, the response is good.
- Consumers worry about large interest increases, especially with loans with no caps.
- Consumers who think rates will drop will chose this loan.
- Confused.

GPM/FIXED

Problems: To Lender

- None.
- Marketing to consumer.
- Acceptance by consumer.
- Difficult to explain.
- Payment shock potential when payments increase. Less potential for shock with this instrument than with the adjustable loans, since payment increases are scheduled in advance.

Problems: To Borrower

- None.
Advantages: To Lender

- Can qualify more buyers when interest rates are high.
  (Assumes income will increase as payments increase)
- Knows what payments will be.
- Easy to explain and to service. Payments and rate changes are specified at the time the loan is closed.

Advantages: To Borrower

- Low initial payments allow consumers to qualify more easily.
- Fixed rate.
- No prepayment penalties.

Consumer Reaction

- Fair.
- Good.
- Favorable when unable to obtain thirty year fixed financing.
GPM/Adjustable

Problems: To Lender

- Complicated and difficult to explain to borrowers.
- Difficult to service.
- Payment shock.
- If interest rates increase, negative amortization may drive payments above the market value of the house. The owner, then, may not make payments and the lender will be forced to foreclose.

Problems: To Borrower

- Difficult to understand.
- May not be able to pay increased payments.

Advantages: To Lender

- More borrowers can qualify.
- Yield increases as cost of funds goes up.
- Reduces interest rate risk with adjustable accrual rate.
**Advantages: To Borrower**

- Qualifies people who would not be eligible with fixed rates.
- If interest rates decline, payments will decrease.

**Consumer Reaction**

- Very good, especially during high interest rate times.
- Apprehensive--concerned about negative amortization and owing more in the future than the present.
- Consumers like it better than the regular adjustable loans.

**GRM**

**Problems: To Lender**

- High capital expenditure is required to develop computer system software for servicing.
- Poor marketing. Not many people know about this loan.

**Problems: To Borrower**

- Prepayment charge, not assumable.
- Less tax deductions due to decreased interest payments--must consult a tax expert to discuss tax consequences.
Advantages: To Lender

- Accelerated amortization increases cash flow.
- Easy to administer and to explain.
- The shorter term of this instrument should bring a lower yield requirement in the secondary market.

Advantages: To Borrower

- Rapid equity buildup.
- Decreased amount of interest paid.
- Fixed rate.

Consumer Reaction

- Some interest, though not widespread.
CONCLUSIONS

Two conclusions can be drawn from this survey. The first is that fixed rate mortgages will not disappear from the mortgage marketplace. Consumers prefer fixed rate loans, and since the mortgage industry is market-driven, many lenders are willing to cater to this preference.

The second conclusion is that high interest rates motivate the proliferation of alternative instruments. As interest rates decline, it is likely that fixed rate loans will increase in volume. Although interest rates are presently stable, by making long-term fixed loans, lenders still face the danger of mismatched yields on assets and liabilities should short-term interest rates increase. Mortgage banks, by selling 100 percent of their originations in the secondary market, bear none of the interest rate risk engendered in maintaining long-term fixed instruments in a mortgage portfolio. Commercial banks also plan to reduce interest rate risk by selling a high percentage of their increased volume of 1983 fixed loans in the secondary market. The thrust for the continued strong presence of adjustable loans comes from savings and loans, which must maintain an ongoing residential mortgage portfolio, and therefore, must guard against an asset/liability imbalance.

At the time of this survey, several lenders had only recently begun to offer alternative instruments. Therefore, some types of mortgages had not been offered for a full year. Some institutions were in a stage of experimenting, trying some loans, and
eliminating others that had not been attractive to consumers. At present, the mortgage finance industry can be characterized as being in a transitional stage of development. It is recommended that a similar survey be conducted next year, when the housing finance industry has had a longer period to become thoroughly familiar with alternative instruments and their ramifications for lenders and consumers.
APPENDIX

Alternative Mortgage Instrument Questionnaire

This survey is concerned with first mortgage originations on single family residences. Please fill out this first page and one of the following pages for each mortgage instrument specified.

Name of Institution_____________________________________

Name and Title of individual completing questionnaire.

_____________________________________________________

Phone Number_____________________________________

Specify which of the following alternative mortgage instruments is offered by your institution.

Conventional Fixed Rate Mortgage_____________________

Adjustable Mortgage Loan____________________________

Adjustable Rate Mortgage____________________________

Dual Interest Rate Mortgage__________________________

Flexible Payment Plan_______________________________

Graduated Payment Mortgage__________________________

Growing Equity Mortgage____________________________

Renegotiable Rate Mortgage__________________________

Other 1.___________________________________________

2.________________________________________________

3.________________________________________________

Total volume, in dollars, of your institution's first mortgage loan originations in 1982_____________________

Predicted dollar volume of first mortgage originations for 1983______________________________
Alternative Mortgage Instrument Questionnaire

Type of Mortgage ____________________________

Dollar volume of this type of mortgage origination 1/82-12/82. ____________________________

Dollar volume of this type of mortgage origination projected for 1983. ____________________________

Dollar volume of this type of mortgage sold in the secondary market, 1982. ____________________________

Dollar volume of this type of mortgage planned to be sold in the secondary market, 1983 ____________________________

Index used for interest rate adjustments. ____________________________

Frequency of interest rate adjustments. ____________________________

Maximum interest rate adjustment allowed with each change. ____________________________

Maximum interest rate adjustment allowed over life of loan ____________________________

Frequency of payment adjustment. ____________________________

Is negative amortization permitted. ____________________________

Maximum amount of negative amortization allowed. ____________________________

Average loan to value ratio. ____________________________

Problems you have experienced with this instrument.

1. ____________________________

2. ____________________________

3. ____________________________

Advantages of this instrument for lender.

1. ____________________________

2. ____________________________

3. ____________________________

Advantages of this instrument for borrower.

1. ____________________________

2. ____________________________

3. ____________________________

Consumer reaction to this instrument.
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-1-


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