February 21, 2007

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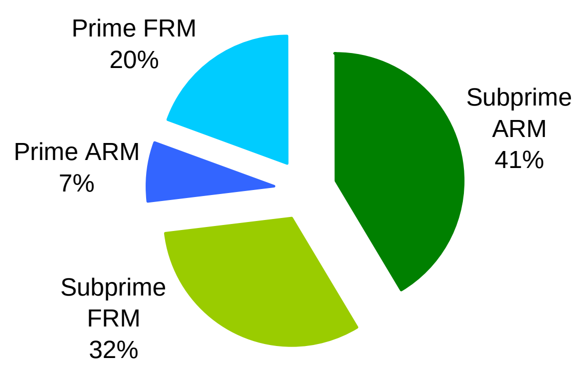
Case Study in Subprime Hybrid ARM Refinance Outcomes

This brief case study describes the outcomes of 106 subprime hybrid adjustable-rate mortgages (ARMs) made by Option One Mortgage Corporation to borrowers in Charlotte, North Carolina in the first three quarters of 2004. According to a Westlaw database, these 106 loans accounted for all ARMs made by Option One in Charlotte during this time. As shown in the pie chart detailing outcomes among loans in this 2004 sample that refinanced by February 2007, **three-in-four subprime ARMs refinanced into another subprime loan. Only one-in-four refinanced into a lower-cost prime loan.**

Subprime ARM Refinance Outcomes



Background: Subprime ARMs are commonly sold as debt consolidation loans that can lower monthly mortgage payments, but these loans come with substantial scheduled payment increases (commonly in the 30-40% range) that take effect just two-to-three years into the loan. Since borrowers in the subprime market are routinely approved even if the initial payment amounts to 50% or more of their pre-tax income, the dramatic payment increases that follow rate resets means that many homeowners must either sell their property, find a way to refinance, or face foreclosure.

Option One Loans: The Option One loans examined here exhibited traits typical of subprime ARMs. These loans carried initial rates averaging 7.5% for a period of two years, followed by a period of 28 years during which an average margin of 5.4% would be added to an index (currently at 5.4%) for a typical fully-indexed rate of 10.8%.

Analysis: As of February 2007, each loan we examined had four possible outcomes: (1) homeowners ended the loan by selling the home or, less likely, paying off the loan in cash; (2) the homeowner was foreclosed; (3) the homeowner remained in the original loan; or (4) the homeowner refinanced. Outcomes for the loans were tracked through records from the Mecklenburg County Register of Deed's office. The loans that refinanced Option One loans were first coded as fixed-rate mortgages (FRMs) or ARMs depending on information in the courthouse records. Since ARM loans are not required to be explicitly identified as such in courthouse filings under North Carolina law, this analysis likely over-counts FRMs and under-counts ARMs. Next, subsequent ARM loans were sorted into subprime and prime categories based on their initial interest rates and margins. Subsequent FRMs were labeled subprime if a majority of loans reported in the county by the new lender in 2005 Home Mortgage Disclosure Act (HMDA) data were higher-cost. If this was not the case, the new FRM was designated as prime. The table below shows all outcomes. In some instances "sold" outcomes may represent a sale to avoid foreclosure.

Outcome	Proportion of All	Proportion of New Loans
Sold / Paid In Cash	15.1%	-
Active in Original Loan	37.7%	-
Foreclosed	8.5%	-
Subprime ARM	16.0%	41.5%
Subprime FRM	12.3%	31.7%
Prime ARM	2.8%	7.3%
Prime FRM	7.5%	19.5%