History of the Option ARM;
Structural Features of the Golden West Option ARM

History of the Option ARM

Late in the first phase of the savings and loan debacle in May 1981, Federal Home Loan Bank Board Chairman Richard Pratt authorized federal thrifts to originate a mortgage product other than a fixed-rate mortgage for the first time, namely the adjustable rate mortgage (ARM). Academics, lenders and others had been urging regulators to permit ARM lending for several years prior, particularly given the significant interest rate risks associated with "borrowing short and lending long" (e.g. borrowing short-term money at low interest rates from savings products and making fixed-rate mortgages that were stuck at high rates for 30 years). Since thrifts had historically been the most important provider of credit to the residential mortgage market, the regulators needed to allow ARM lending to help thrifts (most of which were portfolio lenders) avoid interest rate risk that had contributed to the savings and loan crisis that cost taxpayers $140 billion (before interest). In the wake of the savings and loan crisis, bank regulators aggressively discouraged fixed-rate lending and strongly encouraged the industry to shift to originating ARMs.

For some time before 1981, Golden West and other major financial institutions in California and throughout the country, together with trade groups and others, began to study the various forms of ARMs. The research led to Great Britain and other parts of Europe where adjustable rate residential mortgages had been in use for many years. At the end of the day, there were essentially two alternate structures: the Option ARM that includes protections against payment shock such as annual payment caps and a borrower's ability to defer interest, and the "No Neg" ARM that is more likely to result in payment shock as interest rates rise.

Major U.S. financial institutions heavily involved in mortgage lending did an enormous amount of analysis and ran innumerable simulations. Golden West alone ran several thousand simulations, analyzing the various alternative forms of ARMs under a large variety of stress situations. The No Neg ARM was adopted by many companies in the East, primarily smaller institutions. All the major thrifts on the West Coast, and various others throughout the country, chose the Option ARM. Golden West's and others' simulations demonstrated that the No Neg ARM posed significant concerns about early, and continuing, payment shock to the borrower as rates increase. Experienced lenders were concerned that by using the No Neg ARM, they might be exchanging interest rate risk protection for serious potential credit risk problems. For portfolio lenders – that is, those who originated loans and held them in their portfolios – it was imperative that the loan work for borrowers and at the same time not present inappropriate risks to portfolio lenders.

For the first two-plus decades after the Option ARM was authorized, the loan was originated principally by portfolio lenders who needed a loan product they could keep in portfolio without significant interest rate or credit risk. During that time, the Option ARM had little appeal to lenders who were not going to hold it in portfolio because the Option ARM was only a tiny portion of the total mortgage market, and the loans required a significant investment in personnel

and sophisticated systems to service the loans effectively. Portfolio lenders all understood the dangers of sacrificing quality for volume, and knew that appropriate loan structures and effective underwriting, appraisal and other risk management practices were critical to managing a portfolio of Option ARM loans. With their risk-averse orientation, portfolio lenders were not interested in exchanging interest rate risk for credit risk.

Around 2003, investment banks and mortgage banks saw an opportunity to use the securitization market to originate a large volume of Option ARMs. These new participants lacked a sophisticated understanding of the Option ARM loan and did not know anything about its history or its purpose in relation to portfolio lending. Instead, mortgage banks focused on generating volume with more aggressive pricing (lower minimum payment rates), diluted underwriting standards (including higher loan-to-value ratios), and the elimination of structural features that had been used for decades by Option ARM portfolio lenders to limit the risk the loan would recast and cause payment shock to borrowers. The introduction of FICO scoring also facilitated differentiated pricing based on a borrower's risk profile (risk-based pricing). Risk-based pricing enabled the explosion in volume of high-yield subprime ARM lending and securitization.

Structural Features of the Golden West Option ARM. The Option ARMs that Golden West originated from 1981 to 2006 had the following structural features:

1. **Interest Rate that Changes Monthly**. The Option ARMs Golden West originated had interest rates that changed monthly based on an index plus a fixed margin that was set at the time the loan was made.

2. **Payment Options**. The Golden West Option ARM provided borrowers with up to four payment options. These payment options included a minimum payment, an interest-only payment, a payment that enabled the loan to pay off over its original term, and a payment that enabled the loan to pay off 15 years from origination. In addition to these four specified payment options, borrowers could elect a payment of any amount above the minimum payment.

   Substantially all of the ARMs Golden West originated allowed the borrower to select an initial monthly payment for the first year of the loan. The initial monthly payment selected by the borrower was limited by a floor that Golden West set. If the initial monthly payment selected by the borrower was less than the amount of interest due on the loan, then deferred interest occured, as described below under "Deferred Interest." The minimum monthly payment for substantially all Golden West's ARMs was reset annually. The new minimum monthly payment amount generally could not exceed the prior year's minimum monthly payment amount by more than 7.5%. Periodically, this 7.5% cap would not apply. For example, for almost all of Golden West's loans, the 7.5% cap did not apply on the 10th annual payment change of the loan and every fifth annual payment change thereafter. The 10-year period had been selected by Golden West after careful analysis, because it provided plenty of cushion for lenders and borrowers throughout interest rate cycles. Mortgage bankers significantly reduced the loan's risk by reducing the structure to 5 years.

3. **Deferred Interest**. Deferred interest (also known as negative amortization) refers to interest that is added to the outstanding loan principal balance when the payment a borrower makes is less than the monthly interest due on the loan. Golden West's loans had this deferred interest feature for almost a quarter of a century. Borrowers could always make a high enough monthly payment to avoid deferred interest, and many borrowers did so. Borrowers could also pay down the balance of deferred interest in whole or in part at any time without a prepayment fee.

   Golden West's loans provided that deferred interest could occur as long as the loan balance remained below a cap based on a percentage of the original mortgage amount. A 125% cap on the loan balance applied to loans with original loan-to-value ratios at or below 85%, which included almost all of the loans Golden West originated. If the loan balance reached the applicable limit, additional deferred interest may not have been allowed to occur and Golden West could increase the minimum monthly payment to an amount that would amortize the loan over its remaining term. In this case, the new minimum monthly payment amount could increase beyond the 7.5% annual payment cap described above, and continue to increase each month thereafter, if the applicable loan balance cap was still being reached and the current minimum monthly payment amount would not be enough to fully amortize the loan by the scheduled maturity date. Most mortgage banks reduced the loan balance cap from 125% to 110% when they started securitizing and selling their Option ARM.

   The amount of deferred interest a loan incurred depended on a number of factors outside the lender's control, including changes in the underlying index and the borrower's payment behavior. If a loan's index were to increase and remain at relatively high levels, the amount of deferred interest on the loan would be expected to trend higher, absent other mitigating factors such as monthly payments that met or exceeded the amount of interest then due. Similarly, if the index were to decline and remain at relatively low levels, the amount of deferred interest on the loan would be expected to trend lower. Simulations run by Golden West predicted that the amount of deferred interest in the portfolio would trend up and down throughout the interest rate cycle; this is in fact what occurred during the company's 25 year history with the Option ARM loan.

4. **Lifetime Caps and Floors.** During the life of a typical ARM loan, the interest rate could not be raised above a lifetime cap which was set at the time of origination or assumption. Virtually all of Golden West's ARMs were subject to a lifetime cap.