



**Understanding the  
PayOption ARM**

The Countrywide PayOption ARM (Adjustable Rate Mortgage) is an innovative loan program designed to provide greater flexibility than other loan types. As with all ARM loans, your interest rate moves with market rates. That is an obvious benefit when rates are falling, but during rising rate markets, you need to pay closer attention to an ARM loan. As its name suggests, the PayOption ARM offers you a choice of monthly payment options to help you manage your payments in rising rate markets and take advantage of falling interest rates. There are many benefits associated with this type of flexibility, and many informed borrowers find the program meets their financial needs. The keys to realizing those benefits are having a clear understanding of how the various payment options work and actively managing your home loan account on a monthly basis.

We hope that this brochure helps you understand the PayOption ARM and its features. We urge you to examine **all** of your home loan options and to understand fully the features and terms of the different loan types before choosing the one that is most appropriate for you. Don't hesitate to ask questions, and make sure you have the information you need to make an informed home financing decision.

# The Basics

The Countrywide PayOption ARM is very different from a traditional, fixed-rate, amortizing mortgage loan. A fixed-rate, amortizing loan provides for monthly payments that include both the interest you owe, based on the interest rate on the loan, and principal. This is known as an amortizing payment. As you make these monthly payments, the principal balance you owe goes down.

The PayOption ARM is a monthly adjustable rate mortgage. The interest rate you owe can change monthly—either up or down. However, the minimum monthly payment you are required to pay generally only changes once a year. If your interest rate increases in a given month, but you don't increase the amount of your monthly payment, then it is likely that the monthly payment will not be enough to pay all the interest due plus principal for that month. If this occurs, the principal balance you owe actually goes up. This means that your equity decreases due to what is known as negative amortization.

The PayOption ARM is designed to provide you with the ability to manage your monthly payment each month by offering up to four monthly payment options:

.....→ **PAYMENT OPTION 1**  
**Minimum Payment**

.....→ **PAYMENT OPTION 2**  
**Interest-Only Payment**

.....→ **PAYMENT OPTION 3**  
**Amortized Payment**  
(Based on the scheduled term of 30 or 40 years)

.....→ **PAYMENT OPTION 4**  
**15-Year Amortized Payment**

**It is important for you to understand when each of the monthly payment options is available, how each of the monthly payment options is calculated and how each of the monthly payment options impacts the future balance of your loan. It is also essential to note that paying less than the amortized payment (Payment Option 3) each month will result in future payments being higher, or potentially much higher.**

Please be sure to review the Consumer Handbook to Adjustable Rate Mortgages published by the Federal Reserve Board which we have also made available to you. Information about our other ARM loan programs is also available upon request. We urge you to call your mortgage professional if you still have questions after reading this brochure.

A summary of the risks of the PayOption ARM can be found on page 7.

# Important Terms to Understand

One of the most important things to understand about a PayOption ARM is the difference between the interest rate used to set the amount of the required minimum monthly payment and the monthly interest rate you are being charged on the loan.

## INTEREST ACCRUAL RATE

On a PayOption ARM, the rate you are being charged on the loan is the **interest accrual rate**. This interest accrual rate is a market-based rate determined each month by adding the margin on your loan to the index value for the month. Because this is a *monthly* adjustable rate mortgage, the interest accrual rate will change each month, either up or down—as the monthly index value changes. (See next page for the market indexes used.)

## INITIAL RATE

The **initial rate**—sometimes referred to as the start rate or payment rate—is a rate that is lower than the interest accrual rate. It is not based on the index and margin. It is a below-market rate used to calculate the lowest monthly mortgage payment you are *required* to pay during the first 12 months of your loan. This payment is referred to as the Minimum Payment (Payment Option 1) for the first year.

## INTRODUCTORY PERIOD

Some PayOption ARM loans have an **introductory period** of 1 or 3 months. During this introductory period, the initial rate and the interest accrual rate are the same, so the Minimum Payment (Payment Option 1) represents an amortizing payment. After the introductory period, the interest accrual rate begins to adjust monthly to the fully-indexed rate, but the required minimum monthly payment does not adjust until the beginning of the second year of the loan. If the interest accrual rate rises, then your minimum monthly payment will not be enough to pay all the interest you owe.

## NO INTRODUCTORY PERIOD

The PayOption ARM is also offered without an **introductory period**. In this case, an initial rate is still used to calculate your Minimum Payment (Payment Option 1) for the first 12 months of your loan. However, the interest accrual rate or fully-indexed rate is effective immediately. This means your Minimum Payment will not represent an amortizing payment at any time during the first year of your loan.

## INDEX

Lenders use a variety of indices (indexes) as the basis for setting the interest rate for an adjustable rate mortgage. The index choices for Countrywide's PayOption ARM are:

- .....▶ **COFI (11th District Cost of Funds Index)**—This index is based on the monthly weighted average cost of funds of the 11th District Savings Institutions (savings institutions in California, Arizona and Nevada). Index values are available from the Federal Home Loan Bank of San Francisco.
  
- .....▶ **MTA (Monthly Treasury Average)**—This index is the twelve-month average of the annual yields on actively traded United States Treasury Securities adjusted to a constant maturity of one year. The monthly yields for the most recent twelve months, as published by the Federal Reserve Board in the Federal Reserve Statistical Release entitled Selected Interest Rates (H.15), are added together and divided by 12 to get the 12-month average.
  
- .....▶ **LIBOR (London Interbank Offered Rate)**—This index is the average of interbank offered rates for one-month U.S. dollar-denominated deposits in the London market, as published by the Wall Street Journal.

## NEGATIVE AMORTIZATION

**Negative amortization** occurs when the monthly payment is not enough to pay the amount of interest due for the month. This happens when the interest accrual rate is higher than the rate used to set your monthly payment. Consequently, any unpaid interest for the month is deferred and added to the principal balance of the loan. This **deferred interest** results in negative amortization, which means your loan balance increases rather than decreases. Negative amortization reduces the amount of equity you have in your home, and increases the amount of the monthly payment that will be needed to pay off your loan. You need to monitor negative amortization closely by reviewing your Countrywide home loan statement.

## PAYMENT CHANGE CAP

Even though your interest accrual rate may change monthly, the monthly payment amount you're required to make—your Minimum Payment—generally only changes annually and is subject to a **payment change cap** of 7.5%. This cap means that your *required* minimum monthly payment can increase no more than 7.5% at each payment change date. This payment cap acts to cushion the amount of increase in your required monthly payment from year to year. There are times when this payment cap is not in effect, and they are described more fully in the recasting section of this brochure. It is important to note that the payment change cap is tied to your Minimum Payment only and has no impact on the interest accrual rate used to calculate your other monthly payment options. In a rising rate market, if you pay only the Minimum Payment, your negative amortization will increase and the size of the payments needed to amortize your loan will increase.

# Monthly Payment Options

Now, let's look at the monthly payment options in more detail. The PayOption ARM offers you a choice of monthly payment options to help you manage your payments in rising rate markets and take advantage of lower rates in a declining market. It's important to note:

- .....> During any Introductory Period, you are only required to make the Minimum Payment (Payment Option 1).
- .....> After any Introductory Period (or starting immediately if there is no introductory period), you may choose from the available Payment Options explained below to make the monthly payment on your loan.
- .....> If any Payment Option is less than the Minimum Payment in a particular month, that Payment Option **will not** be available as an option that month.

## PAYMENT OPTION 1

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- Minimum Payment** .....> The Minimum Payment is the lowest payment amount required each month and will remain unchanged for the first 12 months of the loan.
- .....> During any Introductory Period, the Minimum Payment represents an amortizing payment (pays both principal and accrued interest) based on the initial rate and your original principal balance. After the introductory period, if the interest accrual rate increases, the Minimum Payment will remain the same, but a larger portion or even all of it will be required to pay interest, and the Minimum Payment may no longer amortize your loan.
  - .....> If the loan does not have an introductory period, the minimum monthly payment is set based on an initial rate that is lower than the fully-indexed rate, and that payment will typically not be enough to pay both principal and interest.
  - .....> Depending on the amount of the difference between the interest accrual rate and the initial interest rate, the Minimum Payment will most likely not be enough to pay the accrued amount of interest you owe. When this happens, the accrued, but unpaid, interest will be deferred and added to the principal balance of the loan, resulting in negative amortization.
  - .....> After the first 12 scheduled payments on your loan and every year thereafter, the Minimum Payment will be recalculated to a fully amortizing payment (based on the loan balance at that time, the interest rate in effect during the preceding month and the remaining loan term), subject to the 7.5% payment cap. The payment cap is to prevent your payment from increasing too much at one time. However, the new Minimum Payment may not be enough to pay all the interest you owe or to amortize the loan because of the cap.
  - .....> The new Minimum Payment remains in effect for a 12-month period, unless the loan requires a **Recast** (see "Recasting (Reamortizing) the Loan" on page 6).
  - .....> When the loan is recast (reamortized), the 7.5% Payment Cap is not used.

## PAYMENT OPTION 2

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### Interest-Only Payment

- .....> As suggested by the name of this option, the Interest-Only Payment is a payment that covers only the accruing interest.
- .....> With this payment option, you will not pay down any of the principal balance on your loan, but you will avoid deferred interest for that month.
- .....> The Interest-Only Payment adjusts each month based on changes in the fully indexed rate and the then-current principal balance.

## PAYMENT OPTION 3

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### Amortized Payment (Based on the scheduled term of 30 or 40 years)

- .....> If you select this payment option, you will be paying the principal and interest due for that month, calculated at the then-current interest rate and principal balance and remaining loan term.
- .....> Selecting this option **each month** during the entire life of your loan ensures that the loan will be paid in full and on schedule based on the term of the loan.
- .....> The amortized payment, or principal and interest payment, adjusts each month that there are changes in the interest rate.

## PAYMENT OPTION 4

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### 15-Year Amortized Payment

- .....> The 15-Year amortized payment is calculated using the then-current interest rate and principal balance and the remaining term of an assumed original loan term of 15 years from the first payment due date.
- .....> If this payment option is selected **each month**, a larger amount of principal, plus the interest due on the loan will be paid and the payoff of the loan could actually accelerate.
- .....> Unless this payment option is selected **each month**, the principal balance may not be paid off within a 15-year term.

Remember: Payment Options 2, 3 and 4 are only available if they are **greater** than Option 1.

### TRACKING DEFERRED INTEREST

Your Countrywide home loan statement will help you keep track of your current principal balance, including any increases that result from deferred interest. We urge you to pay close attention to this activity so you will always know what you owe on your mortgage loan. Although deferred interest is added to your principal loan balance, you may choose to pay down any amount of deferred interest at any time during the life of the loan. There may be tax benefits associated with paying down the deferred interest. Consult a tax advisor.

# Important Additional Information

## RECASTING (REAMORTIZING) THE LOAN

When a PayOption ARM loan is recast (also known as reamortized), a new Minimum Payment is calculated based on the then-current principal loan balance, the applicable fully indexed rate and the remaining loan term. The new Minimum Payment is the amount that would “amortize,” or pay off, the principal balance by the end of the scheduled loan term if there were no more changes in the interest rate. PayOption ARM loans are recast:

- .....▶ Usually after the tenth year and every fifth year thereafter (these will be specified in your note); and
- .....▶ If negative amortization would cause the principal loan balance to reach a certain level as specified in your note—for example, 115% (110% in New York) of the amount you originally borrowed.

When the loan is recast, **the 7.5% payment cap is not applied. This means the Minimum Payment could increase by more than the 7.5% payment cap.**

If negative amortization would cause the principal balance to reach the limit specified in your note, recasting before the next annual Minimum Payment adjustment will be required. Therefore, the Minimum Payment could possibly change more frequently than once a year.

Depending on the amount of negative amortization and increases in the interest rate that have occurred, your new Minimum Payment could increase substantially. This is sometimes referred to as “payment shock.”

## INTEREST RATE CEILING

Like other adjustable rate mortgages, the Countrywide PayOption ARM offers interest rate protection in the form of a maximum interest rate ceiling. This ceiling limits how high the Fully Indexed Rate on the loan can go. The interest rate ceiling is set at the beginning of the loan and does not change over the life of the loan.

## PREPAYMENT PENALTIES

Countrywide makes the PayOption ARM loan available both with and without a prepayment penalty. If you choose a PayOption ARM with a prepayment penalty, the margin and/or points for your loan will be lower, and a lower margin can result in a lower interest rate when your interest rate adjusts. Prepayment penalty amounts vary by state, but the typical penalty is six months interest (at the then-current interest rate) on the amount of your original principal balance that you pay off early that exceeds 20% of the original principal balance.

## REDUCED DOCUMENTATION

Countrywide makes the PayOption ARM loan available on both a “full” and “reduced” documentation basis. The cost to you for a “reduced doc” loan will be somewhat higher.


# Understanding The Risks

While many informed borrowers may find the PayOption ARM to be a versatile financial tool, this loan program may not be right for everyone. There are many benefits associated with this loan, but it is very important that you understand the risks as well.

- .....▶ An obvious advantage of the PayOption ARM is that your monthly payments are lower because the required Minimum Payment is based on an interest rate that is less than the fully-indexed market rate during the first year of your loan.
- .....▶ However, you need to think carefully about always selecting the Minimum Payment (Payment Option 1) since it will almost always result in **deferred interest** or **negative amortization**.
- .....▶ Negative amortization will cause your **principal loan balance** to **increase**.
- .....▶ Paying less than the Amortized Payment (Payment Option 3) each month (resulting in deferred interest) will cause your **future payments** to **increase** or to substantially increase causing what is referred to as “payment shock.” You may not be able to afford these higher payments.
- .....▶ Negative amortization results in a **reduction** of the **equity** you have in your home unless the value of your home appreciates enough to offset that reduction. If your home does not appreciate in value, the higher principal balance caused by negative amortization could affect your ability to sell or refinance your home.
- .....▶ **Rising interest rate markets** increase these risks.
- .....▶ By reviewing your Countrywide home loan statement each month, you will be able to closely monitor any deferred interest activity and choose a Payment Option that makes the most sense for you.



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221-1402 (09/06)