

# The Rise of Private Label

**T**he mortgage industry—today more than ever—has become dynamic, fast-changing and unpredictable. Like New York City, it has become the market that never sleeps. Industry structure and arrangements that seem permanent one year, can be washed away by the tides of change the next. Overnight, dominant players can see their dominance undermined by market forces barely visible a year or so prior. ■ A perfect example of this is what has taken place in the secondary mortgage market. A change in the mortgage-backed securities (MBS) market that began more than two years ago appears to have completely reshuffled the industry's deck of cards. Now, issuers of private-label residential MBS are holding the aces that were once held by the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac. ■ Once a junior—but powerful—player in the market, private-label residential mortgage-backed securities (RMBS) are now the leading force driving product innovation and the net overall volume of mortgage origination. Further, it appears that the new dominant role for private-label RMBS may be here to stay. ■ “I do believe it is a permanent change,” says Alec Crawford, managing director and head of agency MBS strategy at Greenwich Capital Markets, Greenwich, Connecticut. “There may continue to be a tug-of-war back and forth between agency mortgages and non-agency mortgages, but at this point what’s happened is innovation on the non-agency side has accelerated to such a point that it’s going to take the agencies a while to catch up.”

BY ROBERT STOWE ENGLAND

**Innovative mortgage products, enthusiastic investor support and consumer demand for new affordable loans have all come together to give extraordinary new power to the private mortgage-backed securities market. This has left the private sector setting the rules once largely dictated by Fannie Mae, Freddie Mac and FHA.**

Product innovation has resulted from two developments, the first is mortgage consumers looking for new low-payment mortgages to help them afford rising home prices. The other is the growing willingness of investors to fund the new types of mortgage products that lenders have developed to meet this need.

Mortgages that offer low monthly payment options often do not amortize the principal balance on the loan, and may even negatively amortize. These products—interest-only (IO) mortgages and option adjustable-rate mortgages (option ARMs)—are the primary generators of gains in market share for private-label issuers.

There are also new nontraditional mortgage products that amortize, but extend the amortization term from the current 30 years to 40 and even 50 years in an effort to bring down the monthly payment.

The expectation that private-label issuers are likely to retain their dominant position was the consensus view of the Council to Shape Change, a blue-ribbon mortgage industry panel of 19 experts that published its findings in August. The council was created last December by former Mortgage Bankers Association (MBA) Chairman Regina M. Lowrie, CMB, founder of Gateway Funding Diversified Mortgage Services, Horsham, Pennsylvania, and president and chief executive officer of

RML Investments Inc., Blue Bell, Pennsylvania. The panel was headed by Andrew Woodward, retired chairman of Columbia, South Carolina-based Bank of America Mortgage and a former MBA president.

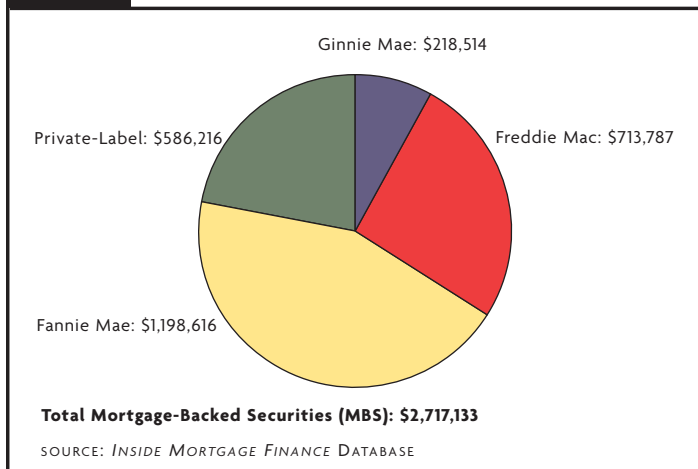
The council's report, *Outlook for the Real Estate Finance Industry*, clearly articulated its view on these secondary mortgage market developments. "It is unlikely that Freddie Mac and Fannie Mae will return to their former position of dominance within the industry," the report states. Both Fannie Mae and Freddie Mac were asked to comment for this article on the market-share gains of private-label securitizers, but declined.

The council, echoing what other market observers have said, cited the lag in product innovation as "the most important factor" holding the agencies back. "Most of the business now considered alt-A used to be prime business and would have fallen in the GSEs' sweet spot," the report states.

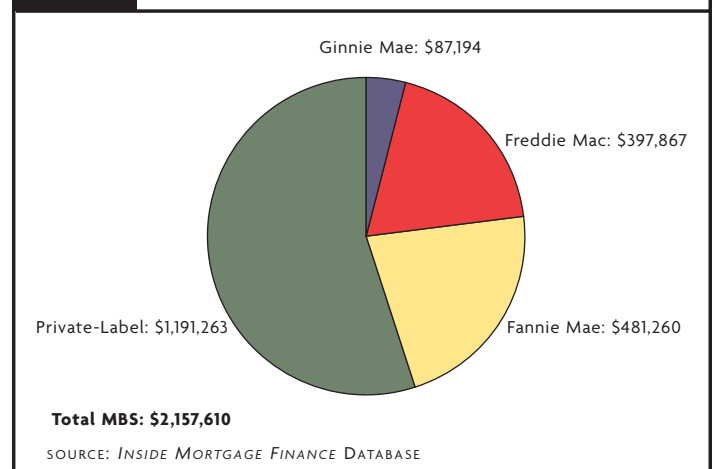
Another factor in the market shift has been the ability of mortgage originators to increasingly securitize their own production. With this new capability, originators have been able to "adversely select the GSEs, feeding only product that lenders cannot advantageously securitize themselves," the council's report notes.

Also, due to sharply rising home prices and the limits on the

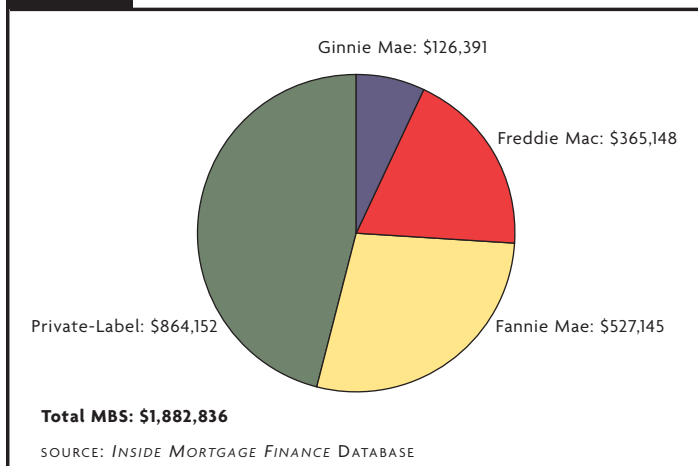
**Figure 1 Mortgage and Asset Security Issuance—2003 (\$ millions)**



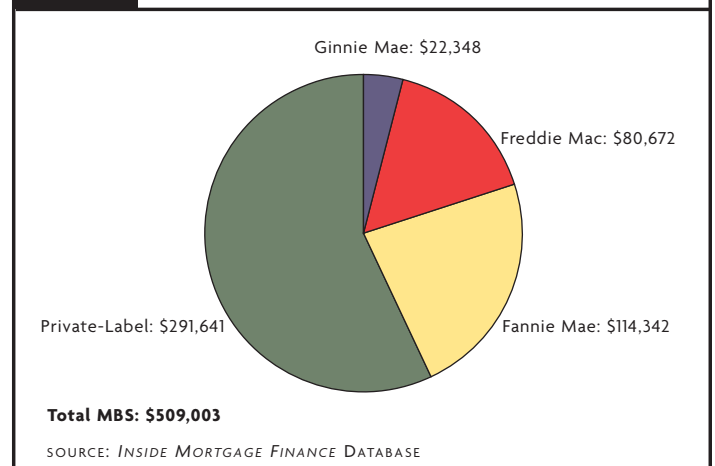
**Figure 3 Mortgage and Asset Security Issuance—2005 (\$ millions)**



**Figure 2 Mortgage and Asset Security Issuance—2004 (\$ millions)**



**Figure 4 Mortgage and Asset Security Issuance—2006 2Q (\$ millions)**



**M**any  
observers  
contend that  
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credit risk.

size of loans they can purchase, Fannie Mae and Freddie Mac are a minimal presence in states such as California, the nation's largest mortgage market.

To get a sense of the dramatic nature of the shift in market share, a few numbers help tell the story. As recently as 2003, the agencies issued 76 percent or \$2.13 trillion of the year's \$2.72 trillion in mortgage-backed securities, according to data compiled by *Inside Mortgage Finance* (see Figure 1). These numbers include Fannie

Mae, Freddie Mac and Ginnie Mae securitizations.

In 2003, the non-agency or private-label RMBS was only 24 percent or \$586 billion. Most of these were jumbo prime mortgages. The ground began to shift in the second half of 2004 as the refi boom subsided and interest rates began to rise, and home-price appreciation raced ahead at double-digit rates—prompting the introduction of a flurry of new affordability products.

By year-end 2004, agency RMBS issuance represented \$1.02 trillion, while the non-agency piece had risen to \$864 billion out of a total of \$1.88 trillion, according to *Inside Mortgage Finance* (see Figure 2).

In 2005, the private-label RMBS surged into the dominant position, with \$1.19 trillion or 55 percent of the \$2.16 trillion in securities issued, while the agencies issued \$966 billion (see Figure 3).

By the first half of 2006, the private-label share has strengthened still more to 57 percent or \$577 billion, according to *Inside Mortgage Finance*. Agency issues totaled \$439 billion of the \$1.12 trillion market.

### Gauging the level of risk

Many observers contend that the transformed mortgage market carries greater credit risk. Delinquencies and defaults, already rising this year from very low levels, are expected to rise even more. There are a lot of unanswered questions about the future performance of these loans.

How will the performance of the newer low-payment and subprime mortgages affect the real estate and mortgage industries? How will mortgages and mortgage bonds perform in a rising rate environment or an economic downturn? Have market players taken the steps necessary to make the new structure of the industry strong enough to hold up to a shock, such as the one that knocked out Long-Term Capital Management (LTCM) in the late 1990s?

And then there's the question of how low-payment mortgages and related mortgage bonds will hold up to a downturn in home prices. Will the growing number of new alternative-A and subprime mortgages and bonds actually aggravate a potential downturn in home prices?

"We're somewhat in uncharted waters here," notes Mike

McMahon, research analyst in the San Francisco office of New York-based Sandler O'Neill & Partners LP. "I've been an observer of the market for 20 years, and I don't recall a period of time when we've had so many new products broadly embraced. It's not clear whether or not there will be massive problems down the road."

A closer look at the mix of securitized mortgage products being generated can help assess the potential risk the industry has taken on.

According to data collected by *Inside Mortgage Finance*, the mix of mortgage products has dramatically shifted since 2003. That year, 62 percent of originations were conventional, conforming loans underwritten to Fannie Mae or Freddie Mac guidelines. By contrast, in the first half of 2006, only 35 percent of mortgages were conventional, conforming loans.

Subprime loans are taking a bigger share of originations, too, rising from 8.5 percent of originations in 2003 to 22 percent in the first quarter of 2006, according to *Inside Mortgage Finance* (see Figure 5).

Likewise, alt-A lending has gained share in overall originations, rising from 2.2 percent in 2003 to 14 percent in the second quarter of 2006. Alt-A's share of private-label originations has soared from 12 percent in the first quarter of 2003 to 34 percent in the second quarter of 2006, according to *Inside Mortgage Finance*.

The combined volume for subprime and alt-A originations rose from just under 11 percent to 37 percent between 2003 and the first quarter of 2006, making this segment larger than the share of originations of conventional, conforming loans. As a share of the private-label securitizations, however, the combined subprime and alt-A mortgages rose from 41 percent to 76 percent of the total, according to *Inside Mortgage Finance*.

Other types of loans also have been in decline. For example, FHA and VA loans, which represented 6 percent of originations in 2003, fell to 2.8 percent in the first half of 2006, according to *Inside Mortgage Finance*. Originations of jumbo prime mortgages fell modestly, from 18 percent to 15 percent.

The gains in market share for subprime and alt-A loans have been driven primarily by an increase in funding from investors in private-label MBS. Put another way, the growth in private-label MBS issuance over the past three years has come almost entirely from a sharp increase in the volume of securitized subprime and alt-A loans.

Private-label subprime issues, for example, rose from \$37 billion in the first quarter of 2003 to \$127 billion in the second quarter of 2006, according to *Inside Mortgage Finance*.

**Figure 5 Private-Label MBS Issuance by Type (\$ millions)**

	Prime	Subprime	Alternative-A	Grand Total
2003 1Q	\$57,562.7	\$37,438.2	\$15,836.9	\$130,975.5
2006 1Q	\$67,185.5	\$114,277.6	\$76,505.2	\$284,891.9

Note: Scratch-and-dent (S&D) transactions include reperforming FHA/VA and conventional loans, resecuritized loans from existing MBS and conduit fallout loans. S&D and second-lien transactions backed by subprime loans are not included in the subprime category. Besides the categories for S&D and seconds, there are other small categories of private-label issuance that are not listed separately in this chart but are reflected in the grand total

SOURCE: INSIDE MORTGAGE FINANCE DATABASE

Subprime's share of the overall private-label MBS issuance market rose from 26 percent to a substantial 42 percent during the same period.

The growth in private-label funding for subprime has contributed to a steep decline in market share for Ginnie Mae, which guarantees securities backed by pools of FHA and VA loans. Ginnie Mae's slice of the market fell from \$230 billion in 2003 to just \$19 billion in the first quarter of 2006.

Private-label alt-A rose from \$16 billion in the first quarter of 2003 to \$104 billion in the second quarter of 2006. Alt-A issues rose from 12 percent to 34 percent of all private-label RMBS, according to *Inside Mortgage Finance*.

Since early 2003, the volume of jumbo prime private-label RMBS issuance first rose slightly and then declined. However, its share of overall private-label MBS issuance has fallen sharply from 44 percent in the first quarter of 2003 to 16 percent in the second quarter of 2006.

A handful of issuers are emerging as the dominant players in the private-label RMBS, led by pace-setter Countrywide Financial Corporation, Calabasas, California. Countrywide issued \$75.8 billion in private-label securities the first half of 2006—far ahead of No. 2, Seattle-based Washington Mutual, at \$38.9 billion (see Figure 6). Countrywide Financial is the largest issuer of mortgage-backed securities in each of the following categories: jumbo prime, alt-A and home-equity loans. Countrywide, however, ranks fourth in subprime RMBS issuance, behind subprime specialists Irvine, California-based Option One and Irvine, California-based New Century, followed by Washington Mutual (see Figure 7). As a giant in a fast-growing RMBS sector that is now dominating the mortgage industry, "Countrywide is emerging as the private-sector alternative to Fannie Mae and Freddie Mac," says McMahon.

Some of the remaining slots in the top 10 are occupied by large mortgage originators (Washington Mutual; GMAC-RFC, Minneapolis; Wells Fargo Home Mortgage, Des Moines, Iowa; Indymac, Pasadena, California), while Wall Street investment banking firms (Bear Stearns & Co., Lehman Brothers, Goldman

Sachs) occupy most of the remaining positions. The Wall Street firms are acquiring mortgage origination and servicing platforms to become vertically integrated, just as Countrywide and other mortgage lenders have vertically integrated from the other end of the process by adding an ability to issue and underwrite mortgage-backed securities.

And just who is buying all these private-label mortgage-backed securities? The answer is: just about every institutional

**Figure 6 Top Private-Label Residential Mortgage-Backed Securities (RMBS) Issuers, First-Half 2006**

Total RMBS Issuance		
Rank	Issuer	Issuance (\$ thousands)
1	Countrywide Financial Corp.	\$75,838.8
2	Washington Mutual	\$38,904.3
3	GMAC-RFC	\$32,856.1
4	Bear Stearns & Co.	\$32,850.2
5	Lehman Brothers	\$31,971.7
6	Wells Fargo	\$29,257.7
7	Goldman Sachs	\$26,406.2
8	Option One	\$23,052.8
9	New Century	\$22,368.3
10	Indymac	\$22,157.9

SOURCE: INSIDE MORTGAGE FINANCE DATABASE

**Figure 7 Top Private-Label RMBS Issuer Breakdown, First-Half 2006**

Top Jumbo Prime RMBS Issuance		
Rank	Issuer	Issuance (\$ thousands)
1	Countrywide Financial Corp.	\$22,470.0
2	Wells Fargo	\$18,340.0
3	Washington Mutual	\$14,469.0
4	Lehman Brothers	\$12,234.0
5	Bear Stearns & Co.	\$12,121.0
6	JP Morgan	\$9,921.0
7	Goldman Sachs	\$8,777.0
8	GMAC-RFC	\$8,318.0
9	Bank of America	\$7,785.0
10	Indymac	\$7,777.0
Top Subprime RMBS Issuance		
Rank	Issuer	Issuance (\$ thousands)
1	Option One	\$23,052.8
2	New Century	\$21,411.1
3	Washington Mutual	\$18,698.9
4	Countrywide Financial Corp.	\$16,245.7
5	GMAC-RFC	\$16,140.7
6	Ameriquest Mortgage	\$14,533.8
7	Morgan Stanley	\$13,886.3
8	WMC Mortgage	\$11,813.6
9	Fremont	\$11,766.4
10	First Franklin	\$9,710.9
Top Alternative-A RMBS Issuance		
Rank	Issuer	Issuance (\$ thousands)
1	Countrywide Financial Corp.	\$34,023.7
2	Bear Stearns & Co.	\$20,994.9
3	Indymac	\$16,998.9
4	GMAC-RFC	\$12,914.2
5	Lehman Brothers	\$11,090.3
6	Goldman Sachs	\$10,250.3
7	Washington Mutual	\$8,440.2
8	GreenPoint Mortgage	\$7,890.8
9	RBS Greenwich Capital	\$7,182.5
10	JP Morgan	\$5,641.2

SOURCE: INSIDE MORTGAGE FINANCE DATABASE

investor group in America, and many overseas.

In the subprime RMBS category, for example, Fannie Mae and Freddie Mac are big buyers of AAA-rated floating-rate securities. Indeed, Fannie and Freddie are by far the biggest purchasers of subprime RMBS.

Last year, Fannie purchased \$179.9 billion while Freddie purchased \$41.3 billion, according to data from the agencies and the Office of Federal Housing Enterprise Oversight (OFHEO) compiled by Michael D. Youngblood, managing director of asset-backed securities research for Friedman, Billings, Ramsey & Co. Inc. (FBR), Arlington, Virginia. Freddie's investment in 2005 was sharply lower than its \$90.7 billion purchases of subprime RMBS in 2004.

Money managers are another big buyer of subprime private-label MBS across all rating categories, according to Youngblood. In addition, asset-backed commercial paper (ABCP) conduits and structured investment vehicles (SIVs) buy AAA floating subprime RMBS. The list of investors also includes domestic U.S. banks, which invest in AAA floating and fixed, as well as foreign banks, which invest in those credit classes plus AA floating.

Pension funds prefer the AAA fixed securities, while insurance companies buy AAA fixed and both AA and A floating securities. Collateralized debt obligation (CDO) managers are also big buyers of AA, A and BBB floating securities. Hedge funds buy BBB and BB floating, while high-yield funds buy the BB floating, according to Youngblood.

### Payment shock

One of the big worries associated with the market shift to the newer mortgage instruments is what will happen to the IOs and option ARMs originated in the last few years when they have to reset in the current higher interest-rate environment.

"A sizable population of mortgages will have to be reset by midyear 2007," says Kurt Smith, senior vice president of risk management at United Guaranty Corporation's Domestic Residential Group in Greensboro, North Carolina. Borrowers who are not able to refinance because of static or falling home-price values are likely to see jumps of 50 percent to 60 percent in their payments, he predicts.

"We're starting to see an increase in delinquency rates in our IO book of business," Smith says, and the delinquency rates are rising faster than for the fixed-rate, 30-year amortizing mortgages. United Guaranty does not insure option ARMs. Smith estimates that between 5 percent and 7 percent of United Guaranty's overall population of insured borrowers will experience "a payment event" in 2007. That includes those with three-year ARMs from 2004 and those with one-year ARMs from both 2005 and 2006. The "good news" for United Guaranty, says Smith, is that the level of IO loans has reached



a plateau and even declined slightly after it surged to 6 percent of United Guaranty's annual insured volume in 2004.

### Credit quality

The sheer size of the gains in the private-label subprime and alt-A markets, combined with the decline in the share of loans in the jumbo prime category, suggests that the overall credit quality of newly originated mortgages has grown somewhat weaker over the last three years. If one also considers the decline in the share represented by conventional, conforming loans, it's easy to see why some are worried about potential increases in delinquencies and defaults.

So far, the credit quality of private-label MBS remains acceptable. New York-based Standard & Poor's (S&P) reports, for example, that more than 91 percent of the credit-rating classes in the transactions it rated by the beginning of 2005 maintained their credit rating based on the performance of the underlying loans. Among those 1,567 classes where the credit rating was changed, the vast majority—1,417—were upgrades, while 150 were downgrades.

During the first half of 2006, the ratio of upgrades to downgrades in private label RMBS compressed, however, according to Robert B. Pollsen, director at S&P. During that time, there were 435 upgrades and 147 downgrades. This means that while upgrades are still by far the more common change in rated classes, there are relatively more downgrades than in prior years.

But some market experts are predicting that higher delinquency and default rates are here to stay. That's the view of the Council to Shape Change, which stated in its report that the industry should expect "a secular increase in aggregate delinquency and default rates due to the net effect of changes in market conditions, borrower attitudes and behaviors."

Because home prices are expected to remain high relative to average family incomes—even if prices appreciate slower or decline—there will continue to be borrower need for affordability or low-payment interest-only and option ARM products, the council concluded. "Borrowers will increasingly want a 'right to use' property, but may have no real intention of ever owning their home free and clear of any debt," the council's report states.

Some market observers are concerned about the significant rise in subprime as a share of overall lending. "Everybody knows subprime has been booming for many years," says Stuart Feldstein, president of SMR Research Inc., Hackensack, New Jersey. "It gets harder to believe that credit quality is consistently improving when people with troubled credit histories are a growing part of the market," he adds.

Daniel Mudd, chief executive of Fannie Mae, told *National Mortgage News* in July that the credit quality of many of the nontraditional loans "have risks that are difficult to quantify." In particular, he was concerned about teaser rates, low-documentation and high loan-to-value (LTV) loans. While such loans might be appropriate for sophisticated buyers, Mudd questions whether they should be provided to borrowers with lower credit scores.

Last December federal banking regulators weighed in on their concerns about layering of risk in proposed regulatory guidance on nontraditional mortgage products. The guidance

said that when risks are layered, lenders should “compensate for this increased risk with mitigating factors that support the underwriting decisions and the borrower’s repayment capacity.”

The proposed guidance identified higher credit scores, as well as lower LTV and debt-to-income (DTI) ratios, as possible mitigating factors to nontraditional loans with lower documentation and simultaneous second liens. The regulators stated they do not think that higher pricing of the mortgage would necessarily address the increased risks associated with risk layering.

The guidance further challenged bank holding companies, thrifts and credit unions to “fully consider” the effects of layering risk on credit losses when establishing an allowance for loan-loss reserves. The feds were particularly adamant about layering risk for subprime borrowers, stating that such a practice would “significantly increase the risk to both the institution and the borrower.”

### Whither home prices?

A key worry relevant to this loan performance debate is whether home prices will hold up. If they do, increases in defaults will be less likely to lead to actual losses for lenders and investors. After years of double-digit increases, price appreciation has slowed or stalled in many markets and declined in some.

Month-to-month or year-to-year comparisons of average sales prices from multiple listing services (MLSes) do not necessarily reveal true price changes, because they cannot account for a different mix of houses, townhouses and apartments that make up each month’s averages, according to Friedman, Billings, Ramsey’s Youngblood. The data do not make an adjustment for the size of the average home sold or the amenities of the house, he adds. Neither do they adjust for whether the home is owner-occupied. The OFHEO House Price Index, however, controls for all such factors and is therefore more reliable, he says.

The OFHEO House Price Index showed home prices rose 12.5 percent in the four quarters of 2005. In the first quarter of 2006, however, the 2.03 percent quarterly growth rate represents a slower annual rate of 8.12 percent. For the second quarter, OFHEO had revised upward its first-quarter number to 2.2 percent, yet reported 1.17 percent for second-quarter home-price growth, for an annualized rate of just 4.68 percent. Nevertheless, the year-to-year gain in second-quarter 2006 was 10.2 percent.

Despite all the doom and gloom about a housing bubble, Youngblood insists that comprehensive data on house pricing, employment and income suggest that “the outlook for a soft landing is, so far, intact.” That could change if there are any surprises in state-level data on income from the Bureau of Economic Analysis released in late September, he adds.

Friedman, Billings, Ramsey is forecasting a continued slowing of home-price appreciation over the next few quarters. However, FBR does not use the OFHEO average house prices across the nation, but computes the median for each metropolitan area in the OFHEO data and computes an average median price from those numbers. Youngblood explains there is “no such thing” as a national housing market, but a collection of local markets.

Using this approach, FBR forecasts year-over-year house-

price gains at 5.7 percent for the third quarter, 4.4 percent for the fourth quarter and 3.5 percent for the first quarter of 2007.

While acknowledging that the supply of houses on the market has risen, Youngblood says, “It remains to be seen if that has an influence on house prices.” He says that some of the inventory could be from speculators “heading for the doors,” while some of it might be from homeowners opportunistically listing their homes for sale. Those sellers could rather quickly withdraw those properties if they cannot be sold at the asking price the homeowners want, he says.

### Market-by-market survey of credit quality

FBR does an annual detailed analysis of credit performance in local markets across the nation, relying on default data on loans from LoanPerformance, San Francisco, a subsidiary of Anaheim, California-based First American Real Estate Solutions LP. LoanPerformance has a large sample of non-agency mortgages. FBR’s May 2006 survey found that default rates for private-label prime mortgages rose to 0.22 percent from 0.15 percent a year. For private-label securitized alt-A, defaults edged up to 0.91 percent from 0.90 percent. For private-label subprime, it rose from 5.37 percent to 6.72 percent.

The findings were published in August in a report titled *Credit Performance for Non-Agency Mortgage Loans and Securities in May 2006 with Forecasts for May 2007*.

Loan performance and default rates in the FBR analysis closely track employment conditions. “Borrowers gainfully employed will pay obligations on time,” Youngblood says, noting the sharp contrast between the May 2006 default rates in Cleveland (20 percent) and those in Los Angeles (3 percent).

The FBR report attributes the rise in default rates to the natural aging of the private-label prime, alt-A and subprime book of business that grew at record rates in 2004 and 2005. “The aging of subprime loans is especially brisk,” the authors state.

The subprime ARM default rate rises to 3.1 percent 12 months after origination, 6.8 percent 24 months after origination and 11.6 percent 36 months after origination. Fixed-rate subprime defaults do not rise as rapidly, but still have a steep upward slope: 2.1 percent after 12 months, 4.1 percent after 24 months and 8.4 percent after 36 months.

### Forecast of a decline in default rates

Surprisingly, Friedman, Billings, Ramsey is forecasting a decline in default rates for subprime loans for May 2007, falling from 6.72 percent to 6.37 percent across the 331 metropolitan statistical areas (MSAs) in the United States. This forecast reflects “vigorous and widespread growth in payroll employment” and the “striking declines in default rates in the 12 MSAs hardest-hit by Hurricanes Katrina and Rita,” the report states.

As long as employment is expected to remain strong, the focus shifts to the quality of the underwriting on the innovative loan products. Youngblood is upbeat on this score. “There is no evidence these loans have been underwritten less than prudently,” he says. He contends that the evidence suggests that the growth in subprime lending has been for the most creditworthy borrowers within the category.

The May 2006 Friedman, Billings, Ramsey analysis, *Layering of Risk in Subprime Mortgage Loans*, found that borrowers with securitized subprime interest-only mortgages in February

2006 had an average FICO® score of 656, based on data from 331 MSAs across the nation collected by LoanPerformance. “For most lenders, that is an A-minus credit,” Youngblood says. By comparison, the average credit score for a subprime fully amortizing loan was 618, a B credit, he adds.

The FBR analysis set out to determine the extent subprime IO loans are associated with layering of risk. The FBR analysis found that 83.4 percent of the subprime IOs did not have additional layers of risk beyond being an IO. Only 10.5 percent of the subprime loans had two layers of risk, while 4.9 percent had three layers, 0.8 percent had four layers and 0.5 percent had five layers.

The FBR analysis of subprime IOs also found that they were broadly dispersed across 331 MSAs in the United States, with concentrations in only five MSAs, representing about 1 percent of all IO loans. Further, there was no concentration of IO loans in MSAs with weak labor markets.

The securitized subprime IO loans had a default rate of 2.93 percent, well below the 7.25 percent for securitized subprime fully amortizing loans. What do these findings tell us? According to the report, “It seems that subprime lenders have allowed borrowers with higher credit scores to obtain interest-only loans but have steered borrowers with lower credit scores to fully amortizing loans, sheltering them from potential payment shock when the interest-only period ends five years after origination.”

Greenwich Capital Markets’ Crawford makes another point: The entire subprime market still remains a small portion of the overall mortgage market. “The vast, vast majority of loans are prime,” he notes. The credit protection required by rating agencies for subprime deals is “huge,” he adds.

### Option ARMs

Alt-A option ARM mortgages represent another area of concern for those who worry that the surge in private-label issuance increases the level of risk in the nation’s mortgage portfolio.

Once a cipher in the private-label securitization business, option ARMs began to take off in 2004, when they accounted for \$217 billion of RMBS issuance, according to a January 2006 report by New York-based Moody’s Investor Service titled *2005 Review and 2006 Outlook: Alternative-A RMBS*.

In 2005, securitized alt-A more than doubled to \$425 billion. According to Moody’s January 2006 analysis, the surge occurred because as prime jumbo originations slowed, lenders began to target borrowers with relatively weaker credit scores and originate loans with either reduced or no documentation. These trends have continued into 2006.

According to *Inside Mortgage Finance*, securitized alt-A volume surged to \$104 billion in the second quarter of 2006—a big jump from the first quarter issuance of \$76.5 billion. At the same time, private-label jumbo prime issuance in the second quarter fell to \$48.7 billion from \$67 billion in the first quarter.

In 2005, ARMs and hybrid ARMs became the dominant product in alt-A lending, according to Moody’s analysis of 500 alt-A deals it reviewed. In 2004, option ARMs represented 12 percent of issuance, but rose to 36 percent in 2005.

Moody’s, again based on an analysis of the 500 deals it reviewed, found that 35 percent of private-label securitized alt-

A loans had a simultaneous second mortgage. The weighted combined LTV ratio of all 2005 securitized pools was 79 percent—about 5 percentage points higher than the weighted average for all mortgages, according to Moody’s.

The alt-A borrower’s credit, as one would expect, is below that for borrowers of prime mortgages in 2005. The weighted average credit score was 711 for all alt-A borrowers, and scores fell within a range of 645 to 740. Fixed-rate alt-A mortgages had borrowers with a slightly higher weighted average credit score of 715, while option-ARM borrowers were slightly lower at 705.

The average loan balance for all alt-A borrowers was \$330,000, a level well below the maximum conforming loan amount for Fannie Mae and Freddie Mac. Fixed-rate alt-A borrowers had smaller average balances of \$250,000, while option-ARM borrowers had average balances of \$403,000.

Moody’s expects option ARMs to have higher default rates, and has identified option ARMs with teaser rates as among the more troubling products. Many of these were introduced late in 2005, as short-term interest rates rose. Most of them likely began to immediately negatively amortize for the majority of borrowers making the minimum payment.

### More layering of risk

While the overall level of layered risk may not yet be substantial in mortgages backing private-label securities, it is growing and is a matter of concern, according to Mark DiRienz, managing director at Moody’s. “Our assessment is that the expected loss on pools [of mortgages] has increased over the last three years,” he says.

Moody’s has raised its expected losses from subprime home-equity loans by 30 percent to 35 percent, DiRienz says, based on the early poor performance of some of those loans originated in 2005. Based on the early rates of delinquencies and defaults, Moody’s expects losses to be higher than originally assumed.

Joseph Grohotolski, Moody’s vice president, says that Moody’s looked at the early-term performance of home-equity delinquencies to get a pulse on what was happening with subprime lending. The 2005 vintage subprime loans are having delinquencies close to those from 2002, a year when credit was weaker. By contrast, vintage 2003 and 2004 home-equity loans have performed well.

DiRienz says it is more difficult to pinpoint what will happen with losses for alt-A, partly because of the increasingly blurred lines between alt-A and subprime categories. On the one hand, more of the borrowers who might have chosen a jumbo prime mortgage are taking out alt-A loans, which pushes up the credit quality of the alt-A group. On the other hand, some of the best credits that have until recently been rated subprime are being pushed up into the alt-A category by lenders, he says.

Typically, alt-A borrowers have had relatively high FICO scores and clean credit histories, and are qualified to pay a fully amortized payment.

DiRienz says, there is no large database of historical performance data for new mortgage products such as option ARMs. “We may have to make more assumptions,” he says. “We may have to analyze how an IO will perform, especially in the subprime arena, based on what we’ve seen in higher-LTV loans.”

As Moody's has raised the level of losses it expects for some mortgage products, it has required Wall Street to beef up the credit-enhancement levels for various classes of securities. S&P also reports it is requiring more loss coverage to gain a given credit rating, says Pollsen.

Greenwich's Crawford is not concerned about the increase in risk represented by IOs and option ARMs, including negative amortization. "The risk is broadly distributed, and investors are cognizant of potential declines in housing prices," he says. "In the riskier tranches, which are often purchased by hedge funds, investors are looking at every loan in every deal," Crawford says.

### Changing product mix

During the first half of 2006, all mortgages classified as "low-payment" have continued to take a larger share of the market, according to an analysis of the data by SMR Research's Feldstein.

By Feldstein's calculations, during the first six months of 2006, 32 percent of all loans by volume can be classified as low-payment mortgages. That includes all agency, private-label and portfolio loans. This share of the market represents a significant gain over the 28 percent share for all of 2005.

The majority of the growth in the low-payment mortgages—eight percentage points of the 32 percent—has not come from option ARMs or from IOs, but from 40-year and higher-term amortizing mortgages, according to Feldstein.

Both lender and borrower preferences are pushing the market toward long-term amortizing mortgages, says Feldstein. "Borrowers are reading articles like the one in *BusinessWeek* [titled "Nightmare Mortgages" by George McCarthy, housing economist with the Ford Foundation], and people are getting queasy about IOs and option ARMs," Feldstein says.

As for option ARMs, lenders are moving toward a five-year or 10-year fixed rate at the beginning before the loan adjusts, as consumers steer away from ARMs that adjust monthly or yearly.

At the same time, the December 2005 guidance from federal regulators on nontraditional mortgages, including IOs and option ARMs, could become effective soon. The guidance was critical of negative amortization, a feature offered with option ARMs. Forty-year loans, for example, do not have the problem of resetting payments after the initial interest-only term. "There's a belief in the industry that if the guidance is implemented, it will not affect fully amortizing 40-year loans," says Feldstein.

On its Web site, Fannie Mae describes 40-year loans as "ideal for borrowers who face affordability issues and think homeownership is beyond their reach."

Financial institutions that hold any loans carrying deferred interest due to negative amortization will face dramatically higher costs for foreclosures and loan-loss reserves. That's because the deferred interest is booked as income, even though borrowers are making a minimum payment. In a period of rising foreclosures, the lending institution will have to raise loan-loss reserves higher than the original mortgage to include the deferred interest that is now being subtracted from income.

Feldstein calls the deferred interest income "a real wild card in terms of the income statement" for those who own the loan or sold it with recourse.

### Implicit recourse

Lenders that securitize their loans and have stipulated zero recourse for those deals may, however, find that there is implicit recourse, according to the federal regulators' guidance. The guidance notes that an institution continues to be exposed to "reputation risk" that would arise if credit losses on sold or securitized loans exceed expected losses.

"In order to protect its reputation in the market, an institution may determine that it is necessary to repurchase defaulted mortgages," the guidance notes. "It should be noted that the repurchase of mortgage loans beyond the selling institution's contractual obligations is . . . implicit recourse."

Implicit recourse comes with a price, as one might expect. Under the federal regulators' risk-based capital standards, the repurchase of mortgage loans from a sold or securitized portfolio would require that risk-based capital be maintained against the entire sold portfolio or securitization.

Finally, to add one more component of uncertainty, one of the conclusions of the Council to Shape Change was that the mortgage industry should be aware of the potential for a financial shock over the next five to 10 years.

"I want to be real careful, because we're not predicting doom and gloom," says Woodward. "We've been [going] for a long period of time here with very stable markets, and we've enjoyed the best of times with free-flowing global capital," he adds. The council's intent in bringing up the potential for a shock to the system was to convince mortgage market players of the importance of stress-testing their business models, Woodward says, "to see how they perform in different situations where the market is in disruption."

With the mortgage markets increasingly being dominated by private-sector players in the global capital markets, it is important for these players to consider possible sources of market disruption. Woodward identifies as potential stresses a credit shock, a big spike in interest rates or the failure of a third party on the other side of one of the complicated hedge instruments, such as occurred with Long-Term Capital Mortgage in the late 1990s.

The council concluded that mortgage lenders without a portfolio-lending capability are likely to be at greater risk if a financial crisis led to a sharp decline in investor interest in non-agency RMBS. There could be potentially sharp declines in demand from investors in RMBS—especially for lenders whose mortgages suffered greater-than-expected losses.

Federal regulators may still crack down on nontraditional mortgage products if they believe the private markets have allowed underwriting that is overly lax or detrimental to borrowers. Yet not everyone is convinced that regulators can effectively put an end to product innovations such as IOs and option ARMs.

"It's very hard to put the innovation genie back in the bottle once a product is out there and has a willing investor base, especially outside the banking industry," says Crawford. "The mortgage market is made of up so many players and places, if a product pops up in one state, it can usually be originated in other states," he says. **MB**

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