

Pushing the Edge on Alternative-A

In the last three years, some lenders have expanded the market for prime-credit, low-documentation mortgages by raising permissible loan-to-value (LTV) ratios and lowering credit score requirements. Now reports are surfacing that these loans are not performing well. Yet, some types of prime-credit, limited-doc loans outperform full-documentation loans.

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THE MORTGAGE MARKET IS INTENSELY COMPETITIVE, and companies battle it out fiercely over every nook and cranny in every niche the market has to offer. That means lenders will always be pushing to see what the limits might be for any given product to see if they can expand the market for that product or group of products. ∴ In the area of prime or A-credit, limited-documentation loans—the so-called alternative-A market—the innovators may have gone about as far as they can go. ∴ Some of the products offered in the market in the last three years in the 80 percent and higher loan-to-value (LTV) segment are starting to season enough to show seriously higher defaults, foreclosures and claims. Loan performance problems are, in fact, occurring for some products in the alt-A market at a pace four to five times greater than for full-documentation, prime-credit loans, according to mortgage insurers. ∴ One of the more troublesome loan types in the alt-A market is the no-income, no-asset (NINA) loan. With the NINA loan, borrowers do not have to state their income. Nor do borrowers have to state what their assets are. As a result, the borrower does not have to produce documents showing any income and/or assets. Usually, the borrower must state the name of an employer, the address of the employer and the type of job the borrower has—all subject to verification. Other than that, the decision to approve the mortgage rests almost entirely on the borrower's credit scores and the appraised value of the home.

Another niche loan program, the stated-income loan, also has run into some performance problems. For this loan, borrowers simply state their income, but do not have to provide verification of the income level. Usually, stated-income borrowers list assets, which can be verified by the mortgage lender.

The alt-A market is generally defined as loans made to borrowers who meet Fannie Mae and Freddie Mac underwriting standards for credit score, but that incorporate flexibility beyond agency guidelines for documentation requirements, property type, debt ratio or LTV ratio. These borrowers typically pay a small premium for that flexibility.

Alt-A loans with 80 percent and higher LTV ratios were widely available in the late 1980s and early 1990s, but those loans performed poorly in the early and mid-1990s. As a result, underwriting standards were tightened, product offerings were withdrawn and the market mostly evaporated. (This was not true of the segment of the alt-A market for loans with LTVs below 80 percent, which is discussed later. Low-LTV alt-A mortgages continued to perform well during the mortgage industry downturn of the early 1990s.)

The alt-A market for higher LTVs (above 80 percent) was reborn in 2001, and is now in the fourth year of strong origination growth. Unfortunately, there are no nationwide numbers on the size of this market, although mortgage insurers report it has remained strong and represents a significant segment of their business.

In an age of steadily rising house prices and extended refinancing booms, low-documentation loans offer more flexibility and less overall hassle for borrowers, who do not have to supply the verifications of income, employment and assets required with a full-documentation loan. On the other hand, some low-doc loans can carry a higher risk of delinquency, default and foreclosure.

Performance data

The evidence of poor performance is beginning to show up in analyses done by mortgage insurers, who cover a portion of the loan loss on defaults for loans above 80 percent of the original appraised value.

United Guaranty Corporation, a mortgage insurer based in Greensboro, North Carolina, reports that for a period of 2 3/4 years—from January 2001 to the end of September 2003—the default rate for NINA loans that it insures was 5.07 percent. That is sharply higher than the 1.59 percent default rate for full-doc loans.

Similarly, the claim rate for NINAs was 0.53 percent, compared with 0.12 percent for full-doc loans during the same period. United Guaranty has nearly 8,500 loans in its NINA portfolio, according to Kurt Smith, vice president for risk management at United Guaranty Residential Insurance

Co., the subsidiary at United Guaranty that offers mortgage insurance.

Higher defaults and claims on NINAs are not entirely unexpected, according to Smith. “NINA has always run ahead of other limited-doc in providing an early indication of problems,” he says. For example, in 2001, when the number of NINA loans began to be a significant part of United Guaranty’s low-doc business, delinquencies were running at 9.7 percent—twice the overall delinquency rate for the universe of loans with similar seasoning, Smith says.

NINAs now represent about 20 percent to 25 percent of what United Guaranty calls its limited-doc business, Smith says. (United Guaranty does not call this segment its alt-A business, as it does not include such products as very high LTV cash-out refis, which some lenders include in the broad definition of alt-A.)

By comparison, he adds, stated-income loans represent 60 percent to 65 percent of United Guaranty’s limited-doc business. Stated-income loans require the borrower to state his or her income level, but the borrower does not have to document that with pay stubs or, in the case of the self-employed, with tax forms. Usually, stated-income loan borrowers do report and often verify their assets.

For United Guaranty, the low-doc stated-income business has actually outperformed its prime-credit, full-documentation business. This is thanks to the fact that lenders have limited the loans to applicants with higher average FICO® scores than is the case for most A-credit loans.

From early 2001 to the end of September 2003, for example, stated-income loans insured by United Guaranty had a default rate of 1.20 percent, compared with 1.59 percent for full-doc loans, according to a company spokesperson. The claim rate for stated-income was 0.09 percent, compared with 0.12 percent for full-documentation loans. The FICO scores on these stated-income loans averaged 20 points higher than the scores for full-doc, prime-credit loans, the company reports.

United Guaranty does not insure no-documentation loans—loans where the borrower does not make a statement about employment or income. NINA loans, by contrast, require that the borrower state the name and address of the employer, but no income is stated. The borrower may have a statement or source of assets, but there is no verification of those assets.

A full menu of alt-A loans

Mortgage Guaranty Insurance Corporation (MGIC), Milwaukee, also reports emerging concerns with its limited-doc, prime-credit loans. NINAs, too, are among the problem product lines.

NINAs are classified by MGIC as one of five types of alt-A

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loans that the company insures. There are two stated-income loan categories: stated-income, verified-assets (SIVAs); and stated-income, stated-assets (SISAs). There are three no-income loans: no-ratio, no-income (NRNIs), where the employer is stated and sometimes verified; NINAs; and no-doc loans, which are NINA loans where no employer or employer's address is identified.

MGIC has done an analysis of all of its alt-A business for 2001 and 2002, and has found disturbing trends in loan performance that echo those found by United Guaranty. In its analysis, MGIC compared loans of a similar age and seasoning, similar credit scores and similar LTV. MGIC then compared the performance data on its alt-A loans at a similar age and with similar full-doc A loans. MGIC concluded: "It is our experience that reduced-documentation loans will result in a claims rate five times more frequent than other loans with similar age, seasoning, credit risk profile and loan to value," says David Greco, MGIC's vice president of credit policy.

One cannot generalize about all NINA loans from the experience tracked by mortgage insurance companies, because insured loans, by definition, involve loans with 80 percent or more LTV. Indeed, lenders who do a lot of alt-A or low-doc business—especially thrifts and savings banks that market to immigrant communities—have a long experience of successful lending in this area. One of the key differences, it would appear, is that for the savings and loans (S&Ls) and savings banks, these loans typically come with very large down payments, usually 25 percent or more. Such loans would not show up in the databases of mortgage insurers, since they do not require mortgage insurance.

The return of the alt-A market

Various limited-doc loans with LTVs of 80 percent or more came onto the scene in the late 1980s and early 1990s. "They were offered for the best of intentions"—to provide mortgages to people who had trouble meeting the criteria of the conventional conforming market, says Greco. The loans were targeted by early entrants into the market at self-employed people with very good credit, Greco says.

The limited-doc, 80-plus LTV business ran into trouble when borrowers were found to be misstating their income or borrowing beyond their means, recalls Smith. As a result, Freddie Mac, which entered the market with no-ratio and stated-income products, quickly withdrew from the market, and "the mainstream [of the mortgage business] fell back to full-doc or reduced-doc business," Smith says.

After being dormant for nearly a decade, a broad-based prime-credit, limited-doc business for loans with more than 80 percent LTV re-emerged in 2000 and has remained strong through early 2004.

Both Fannie Mae and Freddie Mac accept some types of limited-doc loans, according to company spokespersons, but neither was willing to discuss these programs beyond stating they constitute a small part of their business. There are no firm numbers on the size of the alt-A business or any of its product lines. According to Douglas Robinson, Freddie Mac's media relations director, the market for NINAs was bigger for Freddie Mac in 2003 than in 2002.

Many large mortgage lenders declined to discuss NINA or low-doc loans for this article. Julie Davis, vice president of corporate communications for Charlotte, North Carolina-based Bank of America, reports that the bank's mortgage company did not offer a NINA loan specifically, but it did offer loans with 80 percent less paperwork.

Mark Benhard, vice president for corporate public relations at Seattle-based Washington Mutual (WaMu), reports that WaMu does offer a NINA program, but it requires 25 percent down for a new home purchase and no more than 75 percent of the value of the house for refinancing. Calabasas, California-based Countrywide Financial Corporation could not be reached for comment on NINAs and other limited-doc loans.

One source in the mortgage industry was willing to talk about the trends that have affected alt-A loans, but not for attribution. "We thought it was a workable approach," the source says. Typically the program was not offered to anyone who had a bankruptcy or foreclosure in his or her history and it was offered to borrowers who had a FICO score of at least 700. Loans made on that basis "tended to work well," the source recalls.

Unfortunately, over time the LTV level began to creep upward, sometimes as high as 100 percent, the source says. At the same time, the minimum FICO score slipped down as low as 620.

"We've seen the market for low-doc loans expanded to accept, and then target, wage earners," the industry source says, which was a move away from the original market segment the loans were designed for: the self-employed. MB

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There are also concerns that alt-A loans are more easily subject to fraud.

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