

Credit Trends in Subprime Mortgage Lending — Case Review

The liquidity crisis of 1998 reduced the presence of lower-credit borrowers in securitized real estate ABS transactions. Many of the companies that financed loans to such borrowers — for example, UCFC and Conti — exited the business, leaving the issuance and loan origination in the hands of well-capitalized players, whose primary focus was on the upper end of the borrower credit scale.

In 1999 and 2000 some market leaders expanded the lending opportunities for lower-credit borrowers.

As business conditions in subprime lending improved in 1999 and 2000, many of the new market leaders felt confident enough to explore opportunities at the lower end of the credit spectrum. Some expanded the underwriting criteria in a limited fashion, in what amounted to little more than a fine-tuning of the business model. Others pursued lower-credit borrowers more aggressively, leading to significantly lower FICO scores on the more recent originations.

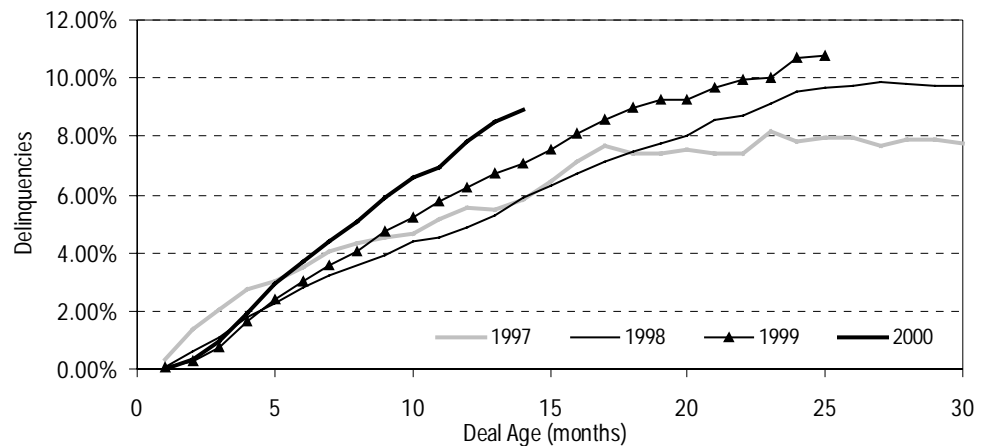
Changes in the underwriting standards were taking place while consumer leverage was increasing.

The changes in the underwriting standards were taking place against the backdrop of increasing consumer leverage. Although the strong economy and rising home prices kept this leverage in check through 1999 and 2000, the recent economic slowdown appears to have triggered an increase in the number of delinquencies in the mortgage sector, amplifying the impact of new underwriting standards on credit performance. In this article we review the recent credit performance at two issuers: RFC (the RASC shelf) and Saxon. Both issuers are viewed as top-tier by the ABS market. However, their approaches to the expansion of underwriting criteria were different. At RFC the changes in borrower credit, as reflected in FICO scores, for example, were small. At Saxon the changes were more significant.

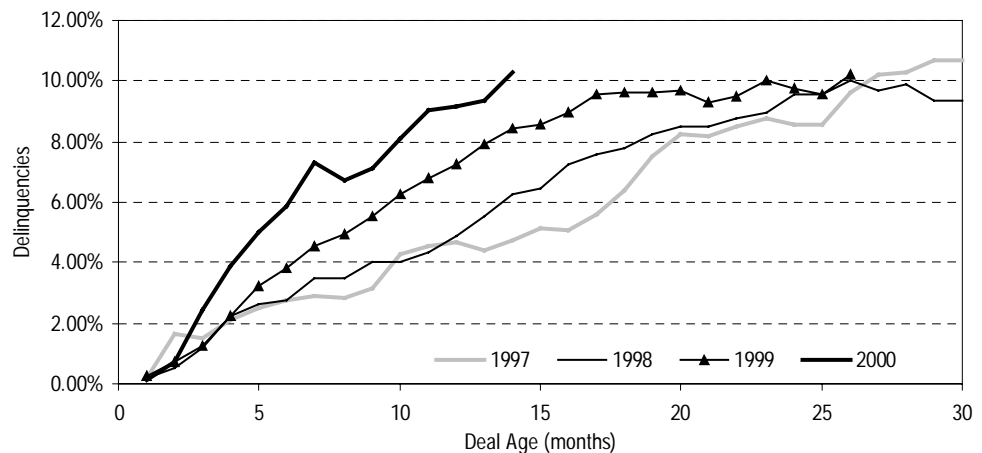
Credit Performance

Serious delinquencies on 1999 and 2000 originations are higher than on 1997 and 1998 originations.

When viewed as a function of deal age, serious delinquencies on 1999 and 2000 RFC and Saxon fixed-rate originations are higher than serious delinquencies on 1997 and 1998 originations. In addition to higher levels, the delinquencies on the recent deals increase more steeply from month to month, for almost all deal ages available to date. This pattern of rising delinquencies is shown in Figure 33 for RFC fixed-rate pools and in Figure 34 for Saxon pools. The graphs show 90-plus day delinquencies, which include foreclosures, bankruptcies, and REOs.

Figure 33. Ninety-Plus Day Delinquencies on RASC Fixed-Rate Loans

Source: Salomon Smith Barney.

Figure 34. Ninety-Plus Day Delinquencies on Saxon Fixed-Rate Loans

Source: Salomon Smith Barney.

Weakening of credit performance is issuer-specific.

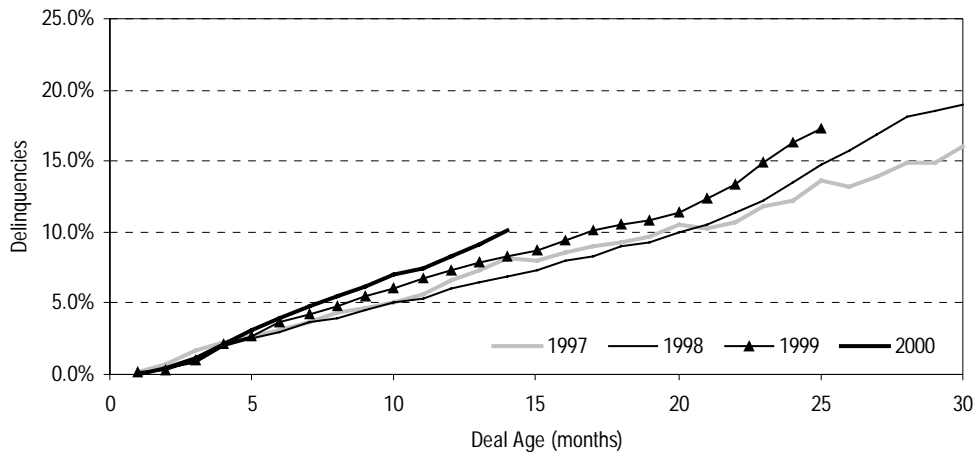
Although serious delinquencies increased for both issuers, the deterioration of credit performance is stronger for Saxon originations. For example, at the deal age of six months, delinquencies on the RFC's 2000 vintage were about the same as on the 1997 vintage, while at the deal age of 12 months they were 2.2% higher.²⁷ For Saxon, by contrast, at the deal age of six months, serious delinquencies on the 2000 vintage were 3.1% higher than on the 1997 vintage, while at 12 months they were 4.4% higher. Most of the differences in trends between the two issuers can be traced to differences in the evolution of the collateral composition, as we will discuss. Other features of the graphs in Figures 33 and 34 — such as the rather sharp decline in delinquencies after seven months for the Saxon 2000 deals — can also be accounted for by changes in the collateral.

Delinquencies on floating-rate loans exhibit the same trends as delinquencies on fixed-rate loans, although the variation from vintage to vintage is less pronounced.

²⁷ As a percentage of the outstanding balance.

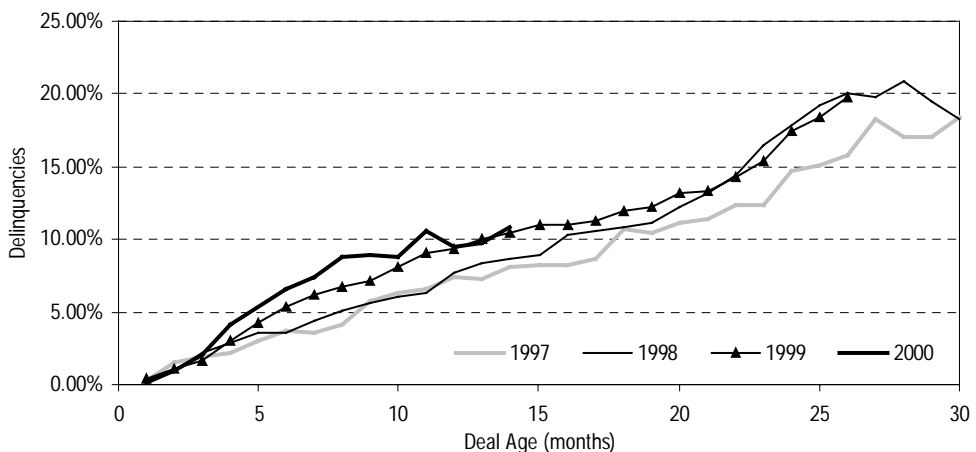
Figures 35 and 36 show the 90-plus day delinquencies on RFC and Saxon floating-rate pools originated since 1997.

Figure 35. Ninety-Plus Day Delinquencies on RASC Floating-Rate Loans



Source: Salomon Smith Barney.

Figure 36. Ninety-Plus Day Delinquencies on Saxon Floating-Rate Loans



Source: Salomon Smith Barney.

Collateral

Several key collateral characteristics for fixed-rate and floating-rate RFC and Saxon deals are displayed in Figures 37 and 38.

Figure 37. Select Collateral Characteristics of RFC and Saxon Fixed-Rate Subprime Deals

Deal	Issue Date	Original			Current ^a			FICO
		Bal (\$MM)	WAC (%)	Term (Months)	Purchase (% of Deal)	LTV (%)	Avq. Bal (\$000)	
RASC 97.KS1	Mar 97	121.7	11.05	282	28	71	76	NA
RASC 97.KS3	Aug 97	200.0	10.84	284	35	71	74	NA
RASC 97.KS4	Nov 97	200.1	10.49	296	35	73	75	623
RASC 98.KS1	Mar 98	380.4	10.11	303	33	73	78	621
RASC 98.KS2	Jun 98	401.8	10.23	278	24	74	72	617
RASC 98.KS3	Sep 98	450.1	10.07	277	27	77	70	617
RASC 98.KS4	Dec 98	350.0	10.12	287	27	77	67	612
RASC 99.KS1	Mar 99	650.0	10.06	302	31	77	73	613
RASC 99.KS2	Jun 99	650.0	9.98	300	33	78	78	613
RASC 99.KS3	Sep 99	700.0	10.21	304	36	77	73	607
RASC 99.KS4	Nov 99	350.0	10.45	300	38	79	75	604
RASC 00.KS1	Feb 00	650.0	10.44	302	34	78	73	609
RASC 00.KS2	Mar 00	300.0	10.57	298	26	77	72	601
RASC 00.KS3	Jun 00	500.0	10.82	297	34	77	71	607
RASC 00.KS4	Sep 00	500.0	11.00	307	37	76	73	605
RASC 00.KS5	Dec 00	500.0	11.07	306	33	77	73	601
SAST 97.1	Mar 97	106.6	10.10	282	20	74	83	635
SAST 97.2	Jun 97	119.5	10.22	304	25	75	82	630
SAST 97.3	Nov 97	234.1	10.09	311	26	75	79	631
SAST 98.1	Feb 98	344.9	10.00	304	24	76	78	617
SAST 98.2	Jun 98	233.8	9.78	285	21	76	83	618
SAST 98.3	Sep 98	259.5	9.59	284	28	76	89	629
SAST 98.4	Nov 98	304.5	9.62	273	28	78	86	620
SAST 99.1	Feb 99	257.8	9.82	266	23	76	84	614
SAST 99.2	May 99	249.0	9.98	253	26	77	84	607
SAST 99.3	Aug 99	492.8	10.08	247	28	77	81	604
SAST 99.5	Nov 99	300.0	10.35	323	24	78	76	601
SAST 00.1	Feb 00	298.8	10.46	343	21	76	86	599
SAST 00.2	Jun 00	490.0	10.65	314	24	76	81	595
SAST 00.3	Sep 00	340.3	11.30	230	26	75	77	584
SAST 00.4	Dec 00	180.0	11.30	228	24	74	78	584

^a Current values refer to the original values of the variables for the loans currently in the pool.

Source: Salomon Smith Barney.

Figure 38. Select Collateral Characteristics of RFC and Saxon Floating-Rate Subprime Deals

Deal	Issue Date	Original			Current ^a			FICO
		Bal (\$MM)	WAC (%)	Term (Months)	Purchase (% of Deal)	LTV (%)	Avq. Bal (\$000)	
RASC 97.KS1	Mar 97	151.9	9.57	360	46	76	106	NA
RASC 97.KS2	Jun 97	365.3	9.79	360	41	77	100	NA
RASC 97.KS3	Aug 97	250.0	9.79	360	49	78	93	NA
RASC 97.KS4	Nov 97	200.1	9.97	360	46	76	78	604
RASC 97.KS4	Nov 97	200.0	9.88	360	49	77	98	599
RASC 98.KS1	Mar 98	150.0	9.77	360	41	76	70	598
RASC 98.KS1	Mar 98	325.0	9.90	360	54	80	99	605
RASC 98.KS2	Jun 98	370.0	9.81	360	49	79	95	596
RASC 98.KS2	Jun 98	75.0	9.84	360	62	81	96	604
RASC 98.KS3	Sep 98	425.0	9.84	360	56	82	99	598
RASC 98.KS4	Dec 98	475.0	9.78	355	54	81	104	601
RASC 99.KS1	Mar 99	650.0	10.02	360	51	80	89	592
RASC 99.KS2	Jun 99	575.0	10.02	360	49	81	97	591
RASC 99.KS3	Sep 99	750.0	10.08	360	53	81	99	591
RASC 99.KS4	Nov 99	500.0	10.24	360	51	81	88	589
RASC 00.KS1	Feb 00	750.0	10.33	360	47	82	97	587
RASC 00.KS2	Mar 00	575.0	10.30	360	43	81	102	589
RASC 00.KS3	Jun 00	750.0	10.63	360	48	81	98	587
RASC 00.KS4	Sep 00	925.0	10.82	360	55	81	105	591
RASC 00.KS5	Dec 00	850.0	10.92	360	51	81	105	591
SAST 97.1	Mar 97	357.5	9.70	360	20	74	81	588
SAST 97.2	Jun 97	347.4	9.68	360	20	75	81	589
SAST 97.3	Nov 97	366.2	9.51	360	35	78	117	603
SAST 98.1	Feb 98	140.9	9.48	360	22	74	105	604
SAST 98.2	Jun 98	224.0	9.54	360	28	76	91	594
SAST 98.3	Sep 98	235.7	9.38	360	30	78	119	591
SAST 98.4	Nov 98	220.3	9.72	360	36	78	107	581
SAST 99.1	Feb 99	251.2	9.74	360	33	79	97	581
SAST 99.2	May 99	225.1	9.90	360	29	78	106	577
SAST 99.3	Aug 99	357.2	9.96	357	40	79	110	577
SAST 99.4	Nov99	370.0	10.03	360	40	80	112	586
SAST 00.1	Feb 00	160.0	10.21	360	39	79	111	582
SAST 00.2	Jun 00	250.0	10.52	360	38	78	111	578
SAST 00.3	Sep 00	334.7	10.79	360	40	78	119	580
SAST 00.4	Dec 00	280.0	10.77	360	37	78	120	578

^a Current values refer to the original values of the variables for the loans currently in the pool.

Source: Salomon Smith Barney.

Some of the loan features shown in the tables are effective determinants of delinquency and default behavior. We review them in detail.

Variation of loan terms from deal to deal is higher than the trend . . .

Loan Term. Longer-term loans become delinquent at higher rates than shorter-term loans, all other variables being equal. On the fixed-rate side, RFC's average loan terms have extended slightly since 1997, although the variation from deal to deal is higher than the average extension from 1998 to 2000. Saxon's average loan terms also vary significantly from deal to deal, with the overall trend toward shortening.

. . . except for the last two Saxon deals.

The last two Saxon deals in 2000 stand apart from the other deals. Average loan terms are more than 80 months shorter compared to the preceding deals, the WACs are sharply higher (even though the conforming rates declined by more than 100bp during the second half of 2000), and FICO scores are lower by 15 points. These features point to a significant and abrupt change in the underwriting standards.

On the floating-rate side, virtually all collateral has been originated as 30-year loans over the full period shown.

Purchase Money Loans. Loans taken out for the purchase of a home, rather than to consolidate debt, tend to carry less credit risk. Little trend is evident either in RFC of Saxon fixed-rate originations, except during the refinancing wave of 1998, when the fraction of refinancing loans increased in fixed-rate RFC pools. Apart from the general observation that RFC deals generally have 10%–15% more purchase money loans than Saxon deals, this characteristic of the loans does not account for the observed trend of increasing delinquencies.

Trends in LTV do not explain the observed pattern of delinquencies.

LTV. Original loan-to-value ratio (LTV) is a key loan determinant of credit behavior. The trends in LTV shown in Figures 37 and 38, however, do not explain the observed pattern of delinquencies. LTVs on RFC fixed- and floating-rate deals increased by 4%–6% from 1997 through the second half of 1998, but have remained nearly constant since that time. With the exception of the last two fixed-rate deals, LTVs on Saxon transactions show little directionality from vintage to vintage.

FICO score. Consumer credit is by far the best predictor of credit performance of a loan. Although FICO scores are not necessarily the best measure of consumer credit for mortgage transactions, they provide a simple and unambiguous way of comparing the credit composition of different pools.

A sharp drop in FICO scores for fixed-rate Saxon deals explains the observed performance.

A sharp drop in FICO scores for fixed-rate Saxon deals between 1997 and 2000 offers a clear explanation for the observed deterioration of credit performance. The FICO scores declined by more than 45 points between 1997 and the end of 2000, and by 35–40 points between 1998 and 2000. By comparison, between 1998 and 2000 the FICO scores on RASC fixed-rate deals dropped by a far more modest ten–15 points. This difference is consistent with a more dramatic deterioration of credit performance for fixed-rate Saxon deals.

The drop in FICO scores for the last two fixed-rate Saxon deals in 2000 compared to earlier 2000 deals also accounts for the drop in 90-plus day delinquencies that are evident in Figure 34 at seven months. The average FICO score for deals originated in 2000 and aged by more than seven months is 597, compared to 591 for all 2000 deals.

On the floating-rate side, the FICO scores changed by only a few points for RFC deals between 1998 and 2000. For Saxon deals they declined by about ten points over the same period, consistent with a slightly more pronounced deterioration of credit performance for floating-rate Saxon deals.

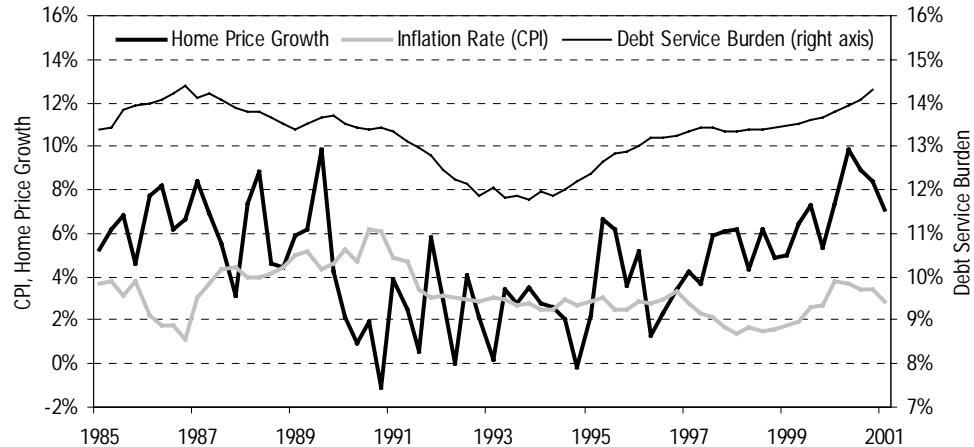
Economic Environment

Although the downward trend of FICO scores with vintage accounts well for the observed pattern of weakening credit performance, the collateral characteristics alone likely cannot provide a full explanation. For example, delinquencies on floating-rate RASC deals were higher for 1999 and 2000 vintages compared to the earlier ones, even though little trend is evident over that time period in any of the collateral characteristics shown in Figures 37 and 38. Increasing overall consumer leverage most likely played a part.

Increasing consumer leverage likely contributed to rising delinquencies.

Consumer leverage can be measured either as a total indebtedness per capita or as a fraction of monthly cashflows that the consumer expends to service his debt. By either measure, consumer leverage has grown steadily during the last decade and is currently at or near an all-time high. Since the consumer debt load is a relevant determinant of credit performance, it may be assumed that the increase in consumer leverage is partly responsible for the increasing trend of delinquencies seen in Figures 33–36.²⁸ The effect of consumer indebtedness may be expected to become more pronounced going forward, as the weakening economy and a slowdown of home price appreciation begin to strain the consumer’s ability to service debt. Figure 39 shows the history of debt service burden, the national average of home price growth (quarterly, annualized), and the CPI index.

Figure 39. Home Price Growth, Inflation, and Debt Service Burden



Source: Salomon Smith Barney.