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Gauging the Effect of Automated Underwriting on Alternative-A Collateral Prepayments

The Alternative-A subsector. An alternative-A loan is typically a nonconforming mortgage with a conforming loan balance taken out by a borrower with an "A" credit rating.[12] **In the past, these loans had some features that made them ineligible for sale to the agencies. These features varied from issuer to issuer but usually included the following borrower characteristics:[13]**

• A preference for expanded criteria underwriting: alternative-A borrowers often utilize "Stated Income" and "No Ratio" underwriting.

• Debt-to-income ratios that exceed agency limits: alternative-A borrower debt-to-income ratios can average 38%-40% on the high end, whereas the maximum debt-to-income ratio permitted by Fannie Mae and Freddie Mac is 36%.

• A significant number of loans taken out on *investment properties*: Compared to the agencies, alternative-A lenders offer less stringent underwriting standards and competitive rates for *investor* loans.[14]

The borrower compensates the lender for taking on increased credit risk by paying a loan rate that is on average 50bp-100bp above prevailing conforming mortgage rates.

The alternative-A subsector of the nonagency mortgage market witnessed substantial growth this year with projected issuance estimates for 1997 ranging between $8 billion and $12 billion, an estimated 15%-25% of all private-label issuance. Significant issuers in the alternative-A subsector include: RFC through its RALI shelf, Indy Mac under the INMC and RAST labels, and more recently, Headlands Mortgage Company and ICI Funding.

Fannie Mae's New Automated Underwriting Guidelines. The advent of improved releases of the Loan Prospector (Freddie Mac) and Desktop Underwriter (Fannie Mae) automated underwriting systems has the potential to transform the dynamics of the traditional nonagency mortgage market. With their enhanced risk analysis abilities, these systems allow lenders to quickly and accurately assess the credit risk associated with a loan, and determine which underwriting guidelines may be relaxed. This in turn allows lenders to underwrite loans that might previously have been rejected.

In particular, with a scheduled release date of late October/early November, the latest version of Fannie Mae's Desktop Underwriter (DU 4.0) features enhancements that could have a strong impact on future underwriting of alternative-A collateral. The new features of DU 4.0 most likely to have a significant effect are:

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[12] FICO scores for such borrowers usually average between 680 and 700, with 620 being the minimum.

[13] For a detailed discussion of Alternative-A issuers and their program and issuance characteristics, see The *"Alternative-A" Nonagency Subsector: A Primer,* Peter DiMartino, June 3, 1997.

[14] An *investment property* is a residential unit financed with an *investor* loan. An *investor* loan is a mortgage on a one-unit to four-unit residential property that will be rented out by the owner to others.

(I) Limited Documentation underwriting — Loans with "low risk profiles" may be underwritten using the borrower's stated income and only a verbal verification of employment. While Fannie Mae did underwrite loans using streamline documentation before, DU 4.0 is apparently much more efficient and flexible in this regard.

(II) 80% cash-out refinances — Expanded cash-out refinances, with the maximum allowed LTV increased from 75% to 80% on fixed-rate mortgages, and with flexible mortgage insurance requirements for loans with "excellent risk profiles."

(III) Investor properties — Expanded LTVs from 70% to 80% for single-unit investor properties, and cash-out refinances on single-unit investor properties to 65% LTV, and two-unit investor properties to 60% LTV. Previously, cash-out refinances on investment properties were not permitted.

The Impact on Alternative-A borrowers. The relaxed guidelines described in (I) - (III) are significant because approximately 50%-60% of all alternative-A borrowers have alternative or limited documentation, 20%-25% are cash-out refinances, and 20%-35% take out investor loans. Of course, there is some overlap between these categories, and only borrowers with conforming loan balances would initially qualify under the new guidelines. We define non-overlapping categories as follows:

Category (I)

• Alternative or Limited Documentation

• Conforming loan balance

• Purchase/Refinance mortgages (excluding cash-outs)

• One- and two-unit mortgages

• Owner-occupied (not investment property)

• LTV <= 80%

Category (II)

• Cash-out refinances

• Conforming loan balance

• Single unit owner-occupied or second homes (not investment property)

• 75% <= LTV <= 80%

Category (III)

Loan (A):

• Single unit investment property

• Conforming loan balance

• 70% <= LTV <= 80%

• Purchase mortgages

Loan (B):

• Investment property

• Conforming loan balance

• Cash-out refinance

• One-unit property with LTV <= 65% or two-unit with LTV <= 60%

Figure 2 estimates the population of alternative-A loans affected by each feature.

Figure 2. Alternative-A Loans Affected by DU 4.0

	% of all loans		
	INMC	RAST	RAL
Category (I)	19	18	14
Category (II)	3	3	3
Category (IIIA)	3	2	3
Category(IIIB)	2	2	2
Totals:	27	25	22

Source: Salomon Brothers Inc.

The estimates indicate that roughly 20%-30% of all alternative-A borrowers fall under the new guidelines. These numbers may have to be taken with a grain of salt because of the difficulty in determining what Fannie Mae believes constitutes a loan with a "low risk profile," and numerous other factors including pricing, response by alternative-A issuers etc. To make matters even more hazy, Fannie Mae recently instituted a pilot program that will allow lenders to upgrade "refer" loans underwritten through DU to "accept" with the addition of 5% additional mortgage insurance.[15] This program would also give lenders the capability to underwrite alternative-A or even subprime loans with DU.

What the new guidelines do clearly indicate is that Fannie Mae is in the process of exploring the traditional nonconforming mortgage market, and initially wishes to retain the flexibility to tighten or further weaken its requirements as necessary.

The impact on Alternative-A prepayment speeds. Some alternative-A issuers believe that Fannie Mae's entry into their markets will have a marginal effect on their market share because they believe they can continue to offer a competitive advantage by offering a flexible range of mortgage products and competitive rates. However, they do predict that given the increased level of competition, the spread between conforming and alternative-A mortgage rates should compress by about 20bp over the next two years.

We simulate the effect of rate compression over a two year period on a selection of representative alternative-A deals to show how long term prepayment speeds could change under different interest rate scenarios. This is illustrated in Figure 3.

Figure 3. Projected Long-Term CPRs for Alternative-A deals, 10 Oct 97

			Decline in Alt-A Spreads Over Next Two Years (bp)					
Deal	WAC	WALA	-50	-40	-30	-20	-10	NC
INMC95-H	10.01%	30mo.	26.2%	25.0%	24.7%	24.1%	23.8%	22.3%
INMC95-N	9.46	26	26.8	25.4	24.8	23.9	23.1	22.3
RAST96.A9	9.07	11	24.5	23.1	22.3	21.2	20.3	19.5
RAST97.A3	8.63	7	20.3	18.8	17.9	16.8	15.9	15.1

Source: Salomon Brothers Inc.

Apart from decreasing rates, Fannie Mae's entry into the alternative-A market also implies that going forward, the estimated 20%-30% of current alternative-A borrowers that fall under the new guidelines will find it easier to refinance into a conforming loan as their documentation hurdles will have been removed or reduced. The next two years will also determine what role this factor will play in affecting alternative-A speeds.

[15] Automated underwriting systems divide loans into three risk categories: "accept", "refer", and "caution." An "accept" designation indicates that the loan is acceptable for purchase, a "refer" designation signals the need for further lender review and additional information, and a "caution" designation signifies that the loan carries substantial risk.