VANDERBILT Ave.
ASSET MANAGEMENT

Emad A. Zikry, President and Chief Executive Officer

PRIVATE LABEL MORTGAGE SECURITIES

The largest issuers of mortgage securities are, by far, the government agencies: GNMA, FNMA, and FHLMC. Securities backed by these agencies enjoy the explicit or implicit guarantee of the US government. The first level of credit quality on these securities, however, is the high quality of the assets securitized, first mortgages on single family residences. Even without government guarantees, it is possible to create very high quality securities from mortgages. Because FNMA and FHLMC place limitations on the mortgages they will purchase, mainly in respect to size or documentation requirements, many mortgages are originated which do not qualify for the agency securitization programs. These loans can be, and often are, securitized and issued by non-government entities, usually special purpose subsidiaries of mortgage bankers, savings and loans, or investment banks. A new entry in this field, and soon to be the dominant issuer, is the Resolution Trust Corporation (RTC), which owns the assets of failed S&L's. It is issuing mortgage securities, dubbed Ritzy Mae's, which have no recourse to the government, and no government guarantees. Ritzy Mae and the special purpose subsidiaries are known as private label issuers, and the securities are referred to as being backed by whole loans.

The credit quality of a pool of whole loans is determined by many factors.

- Most importantly is the average loan-to-value ratio (LTV) of the loans. The lower the LTV, the more equity the homeowner has in the property, and the less likely they are to default. Lower LTV's also make full recovery of any defaulted loans more likely. Typically, on any loan with an LTV above 80%, private mortgage insurance is required to reduce the LTV to 75%.

- Secondly is the geographic diversity of the pool, and the economic diversity of any geographic concentrations. The greater the geographic dispersion of a pool, the less susceptible the pool would be to a localized downturn in the economy and housing prices, such as occurred in the oil-patch states in the mid-1980's. Because of high property prices, and therefore mortgage balances in excess of FNMA/FHLMC limits, a high proportion of whole loans are now originated in California, and on the East Coast, and so broad geographic diversity is hard to achieve, but the economic diversity of these areas makes up for the concentration.

- Single family, detached, owner occupied residences generally provide the highest collateral value backing loans. Condominiums or investor-owned properties are less preferable. The loan purpose (purchase, refinance for rate, or refinance for equity takeout) should also be considered.

- The mortgage type is important, as loans that subject the homeowner to variable payments, such as ARM's or GPM's, or loans that allow negative amortization, have higher incidences of default than fixed rate mortgages.

- The greater the number of loans in a pool, and the lower the number of very large loans, the higher the credit quality, as the pool is less impacted by any single default.

In evaluating these pools of mortgage securities, the ratings agencies (Moody's, Standard and Poor's, or Fitch) perform stress tests simulating a Depression-era economic scenario. The forecast foreclosure rates, housing price depreciation and foreclosure costs based on the pool characteristics described above, and combine the three to determine the loss severity of the pool. To gain the desired AAA rating, some form of credit enhancement is required to cover this degree of loss.

Credit enhancement is typically achieved in one of three ways:

- Third Party Guarantees: A letter of credit from a AAA rated bank, or a pool insurance policy from a top rated insurance company is issued in the amount of the required loss coverage. This method was the dominant form of credit enhancement until the last few years. Under this method, the pool of mortgages is susceptible to event risk, the downgrading of the credit enhancement provider. The downgrading of several large providers, as well as investors getting full on a name, made it more difficult to use third party guarantees.

- Senior/Subordinated Structure: The loss coverage is built into the structure by creating a class whose claims on principal payments are subordinate to the senior class. The percentage of the subordinate class or "B" piece, is set equal to the loss severity. Losses, are absorbed by this subordinate class, in that its share of principal paydowns are used first to cover any shortfalls on the senior class. Senior/Sub structures are now the dominant form of credit enhancement used in the marketplace.

- Cash collateral: Cash and short-term eligible investments are held in trust to cover the expected losses. An initial cash deposit is augmented by the excess cash flow until it reaches a certain percentage of the pool. Typically, the dollar amount then remains constant for a period of years (five to ten), then is allowed to decline, keeping the percentage constant.

These pools of whole loan mortgages can be securitized into either pass-through securities, or multi-class REMIC structures (CMO's). To compensate for the reduced liquidity and slightly lower credit quality, the structures can offer yield spreads to comparable FNMA securities of 20 to 50 basis points. Issuance has accelerated in recent years, especially with the advent of the RTC now securitizing approximately $1 billion of product per month. As investors search for higher yields in high quality investments, more have become comfortable with the inherent credit protection of whole loan structures. This increased demand has met the increased issuance, and liquidity has improved dramatically.

Vanderbilt Research Team