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"B" and "C" Borrowers: A New Frontier in the Nonagency Market

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Securities collateralized by "B" and "C" first mortgages are emerging as the fastest-growing sector of the nonagency mortgage-backed securities (MBS) market. The burgeoning supply of these mortgages, made to borrowers with poorer credit histories and/or higher debt-to-income ratios than traditional borrowers (commonly considered "A" quality), can be traced to several factors:

- A slowdown in refinancing has left traditional first-lien lenders with excess capacity;
- The points and servicing fees from B and C mortgages offer lenders higher margins; and
- Rising home prices outside of California, plus an economic turnaround inside California,[1] have positioned lenders, servicers and investors at a point in the residential credit cycle where tolerance for credit risk likely will increase.

Over the past few years, B and C MBS have come from two major sources: (1) about $3.5 billion from several California-based mortgage bankers concentrating on London Interbank Offered Rate- (LIBOR-) indexed adjustable-rate mortgages (ARMs); and (2) approximately $4.5 billion from traditional second-lien, finance companies shifting increasingly to 15-year, first-lien production. The mortgage bankers' securities have been sold as AAA-rated, mortgage pass-through structures, along with interest-only (IO) and lower-rated subordinate classes. In contrast, the finance companies have sold AAA-rated, short average life securities, structured more for the asset-backed market, with IOs used to accelerate the paydown of principal on the bonds.

To date, these two sectors of B and C MBS have evolved independently, but they should begin to converge as market participants recognize the similarities of the underlying collateral. Moreover, large national lender/conduits are planning to enter the fixed-rate, first-lien B and C market, promoting standardization and pricing efficiency. Consequently, investors should become familiar with the unique credit and prepayment characteristics of the B and C sector.

- A key feature of B and C loan origination is the use of borrower credit ratings, with riskier borrowers required to have lower loan-to-value (LTV) ratios and higher mortgage rates.
- Compared with traditional nonagency pools, recent B and C pools have featured lower LTVs, lower mortgage balances, higher proportions of equity takeout refinancings, and significantly greater credit enhancement.
- All four rating agencies have rated B and C pools using modified versions of their traditional methodologies, with an emphasis on the quality of servicing and collection operations.
- The use of prepayment penalties has had a significant impact on prepayment rates.

[1] See *California Has Turned,* David Hensley and Kathy Chin, Salomon Brothers Inc, April 7, 1994.

B and C lending is aimed at residential borrowers who are denied access to traditional first mortgage financing because of tarnished credit histories or higher debt-to-income ratios. As a result, B and C borrowers pay above-market mortgage rates to compensate for increased credit risk. However, most of these borrowers are homeowners who have sufficient equity in their properties to borrow at below-market loan-to-value (LTV) ratios. For example, the average LTV for a traditional, nonconforming ARM is about 75%, compared with 65% for recently securitized B and C ARMs. Therefore, with substantial equity at risk, these borrowers should have a powerful incentive to repay their mortgages to avoid forfeiting equity in a foreclosure proceeding. Lending that relies *strictly* on borrower equity is commonly known as equity-based lending. In contrast, current B and C programs rely *primarily* on borrower equity to minimize default risk, in conjunction with an underwriting process that categorizes and then prices the riskiness of each borrower.

First-Lien Mortgage Bankers

In this report, we focus mostly on three first-lien B and C mortgage bankers: Long Beach Federal Savings Bank, Quality Mortgage USA, Inc. and Option One Mortgage Corp.

Long Beach Federal Savings Bank

Long Beach Federal Savings Bank is a Federally chartered savings bank whose principal business is mortgage banking. Long Beach has been in the B and C lending business since the late 1980s. Since 1992, MBS totaling $1.7 billion have been issued with Long Beach acting as the primary and master servicer.

Quality Mortgage USA, Inc.

Quality Mortgage USA, Inc. is a California corporation acquired by CALMAC Funding (also a California corporation) in 1991 for the purpose of originating and selling B and C mortgages. In addition, DLJ Mortgage Capital has exercised an option to acquire a 49% interest in Quality Mortgage. Quality's loan originations began in January 1992 and have collateralized $1.4 billion of MBS. Lomas Mortgage USA, Inc. acts as primary and master servicer.

Option One Mortgage Corp.

Option One Mortgage Corp. is a subsidiary of Plaza Home Mortgage, a holding company with subsidiaries that also include Plaza Home Mortgage Bank, a California savings and loan/mortgage banker, and Plaza Home Mortgage Servicing, a mortgage servicing company. Option One was founded in 1992 with a primary business line of B and C lending and originated its first loan in February 1993. To date, Salomon Brothers has underwritten two Option One MBS totaling $165 million. Plaza Home Mortgage Servicing acts as servicer for Option One originations.

Other B and C Lenders

Traditional second-lien lenders also are active in the B and C mortgage market. The major players include Advanta, Alliance Funding Corporation (AFC), Old Stone Credit Corporation (OSCC), and The Money Store (TMS). As a group, these issuers sold approximately $2.7 billion of B and C securities in 1993. Although these finance companies are thought of as home equity lenders and their securities are considered home equity asset backeds, in fact, first-lien mortgages comprise up to 90% of some pools.

The first step for investors when analyzing the credit quality of these mortgage pools is to understand the various standards for assigning borrower credit ratings. These credit ratings are expressed as letter designations, representing various credit guidelines, including the original LTV ratio, debt-to-income ratio, delinquency/default history, as well as other criteria. These guidelines are applied in conjunction with documentation guidelines. In general, borrowers with lower credit ratings must have lower LTVs and must pay higher mortgage rates.

Figure 1 presents a simplified comparison of the three mortgage bankers' guidelines for first-lien mortgages, along with the corresponding borrower credit ratings. We include Fitch's guidelines and borrower credit ratings for comparison.[2] The selected guidelines shown in this figure are not comprehensive, but rather, they represent guidelines that we believe are the most important when assessing overall credit risk.

As the table indicates, there are four major groupings of borrower credit risk with maximum debt-to-income ratio as the common denominator. In all cases, the two highest categories use various A and B designations. The two lowest categories use some form of C designation, with the exception of Long Beach's B- and Fitch's D. For example, Option One's A rating allows a maximum original LTV of 80% with full documentation, a maximum debt-to-income ratio of 45%, two 30-day delinquencies and no 60-day delinquencies within the past 12 months, and no defaults in the past five years. By comparison, Option One's C rating allows a maximum LTV of 70% with full documentation, a maximum debt-to-income ratio of 55%, six 30-day delinquencies and one 60-day delinquency in the past 12 months, and no notice of sale in the past 1.5 years. Typically, borrowers qualifying with limited documentation are subject to more restrictive guidelines than those shown in Figure 1.

Figure 1. Comparison of Borrower Credit Rating Guidelines

Originator/ Rating Agency	Borrower Credit Rating	Maximum LTV: Full Documentation[a]	Maximum Debt-to-Income	Maximum Delinquencies: No. 30-Day/No. Months	Maximum Delinquencies: No. 60-Day/No. Months	Maximum Defaults: No./No. Years
Fitch	A-	85%	45%	2/12	0/12	0/5
Option One[b]	A	80	45	2/12	0/12	0/5
Quality	A	75	45	2/12	0/12	N/A
Long Beach	A-	80	45	2/24	0/12	0/3
Fitch	B	70%	50%	4/12	0/12	0/3
Option One	B	75	50	4/12	0/12	0/2
Quality	B	75	50	4/12	0/12	>0
Long Beach	B+	80	50	4/24	0	0/3
Long Beach	B	80	50	6/24	0	0/2
Fitch	C	75%	55%	6/12	1/12	0/2
Option One	C	70	55	6/12	1/12	0[c]/1.5
Quality	C1	70	55	6/12	1/12	>0
Long Beach	B-	75	55	No Limit	1/24	0/2
Long Beach	C	70	55	No Limit	3/12	0/1
Fitch	D	75%	60%	No Limit	No Limit	0/1.5
Option One	CC	65	60	No Limit	No Limit	No Limit
Quality	C2	65	60	No Limit	No Limit	No Limit
Long Beach	C-	65	60	No Limit	6/24	No Limit

[a] Refers to first-lien LTVs only. [b] We have excluded Option One's AA borrower credit rating. Although similar to Option One's A guidelines, only 1.3% of securitized collateral has had a AA borrower credit rating. [c] Notice of sale.
Source: Prospectus.

[2] See *Mortgage Criteria for B and C Loans*, Jill M. Guido, Mary Sue Lundy and Michele J. Loesch, Fitch Investors Service, Inc., January 3, 1994.

Although these pools exclude second-lien mortgages, each originator has specific guidelines with respect to the existence of second liens on the properties that collateralize their first liens. None of these originators will underwrite both a first and second lien for the same borrower. However, second-lien financing is permitted from other lenders, as long as the combined loan-to-value (CLTV) ratio does not exceed 90%. As a result, small percentages of securitized first liens likely will have second liens outside of their respective pools. In these instances, a pool's reported LTV distribution will reflect CLTVs.

Figure 2 introduces the mortgage bankers' documentation program names and compares their basic requirements. Although the program names differ, all three lenders have documentation guidelines that fall into three tiers. All programs require appraisal, credit check and verification of employment. Acceptable forms of documentation and look-back period (usually 12 or 24 months) may vary when verifying income (VOI). For example, Option One's "limited income" program accepts one form of verifiable income documentation for a 12-month period, whereas "full documentation" requires two forms covering 24 months, as well as a verification of deposit. However, the VOI may be waived if the property is single family, owner occupied and the borrower can satisfy a lower LTV ratio.

Figure 3 presents a comparison of recent B and C MBS in terms of credit structure, credit rating and rating agency. Long Beach and Quality issues have used straight subordination to achieve AAA-rated seniors, whereas Option One's senior classes were rated AAA/Aaa with a combination of subordination and a Financial Security Assurance Inc. (FSA) guarantee. Consistent with the borrower profile, the percentage subordination needed to receive a AAA rating — about 16% for the straight subordination structures — is about double that of traditional FRM pools and about 50% greater than that for traditional ARM pools. In addition, all four rating agencies have rated B and C securities. (Although not shown in Figure 2, Fitch rated a previous DLJ issue.)

Figure 2. Comparison of Documentation Programs of Selected B and C Originators

	Lenders' Documentation Programs		
Documentation Requirements[a]	Option One	Quality	Long Beach
Written Verification of Deposit Written Verification of Income (Two Forms Representing 24 Months) Telephone Verification of Employment	Full	Full	B-1st
Verification of Income (One Form Representing 12 Months) Telephone Verification of Employment	Limited Income[b]	Quick Qualifier[b] Quick Qualifier Plus[b]	B-1st Fast Trac
Telephone Verification of Employment	Stated Income	Quick Qualifier[b] Quick Qualifier Plus[b]	B-1st Quick Credit B-1st Quick Credit Fast Trac

[a] Appraisal and credit check are included in all documentation programs. [b] Under "Limited Income," "Quick Qualifier" or "Quick Qualifier Plus" programs, verification of income may be waived if property is single family, owner occupied.
Source: Prospectus.

Figure 3. Indicative Characteristics of Recent B and C Mortgage-Backed Securities

	SBMSI VII 1994-2	DLJ 1993-Q16	GCAP 1993-LB3
Originator	Option One	Quality	Long Beach
Senior Credit Enhancement	100%	16%	15.75%
Credit Enhancement Type	Subordination[a] FSA[b]	Subordination	Subordination
Senior Credit Rating	AAA/Aaa	AAA/Aaa	AAA/Aaa
Rating Agency	Moody's Standard & Poor's	Moody's Standard & Poor's Duff & Phelps	Moody's Standard & Poor's Duff & Phelps

[a] Subordination in two pools represents 6.25% and 5%, respectively. [b] Financial Security Assurance Inc. (FSA) issued a financial guaranty insurance policy to cover any losses in excess of subordination. FSA's claims-paying ability is rated AAA by Standard & Poor's and Aaa by Moody's.
Source: Prospectus.

Figure 4 shows a comparison of selected collateral characteristics.

As the figure indicates, 75%-85% of the Quality and Option One collateral is in either A or B categories. (Percentages were not disclosed for the Long Beach collateral.) In addition, there is a relatively small percentage in the lowest rating category, 1.6% in Quality's C2 rating and 4.7% in Option One's CC rating. Thus, the major credit risk in these securities is high debt-to-income ratios, as opposed to significantly impaired credit histories.

Figure 4. Collateral Characteristics of Recent B and C Mortgage-Backed Securities[a]

	SBMSI VII 1994-2	DLJ 1993-Q16	GCAP 1993-LB3
Originator	Option One	Quality	Long Beach
Borrower Credit Rating/ Pool Percentage	AA/1.7% A/40.8 B/32.5 C/20.3 CC/4.7	A/50.4% B/35.4 C1/12.6 C2/1.6	Not Disclosed
Average Loan Balance	$116,465	$106,385	$110,828
LTV	66.4%	64.6%	66.3%
Single-Family Detached	83.8	80.5	86.9
Owner Occupied	87.9	87.0	91.5
Refinance	87.5	83.8	89.7
Full Documentation	39.2	64.2	77.8
California Concentration	93.6	80.1	99.4
Servicing Fee	50bp	40bp	52bp

[a] All figures are shown as a percentage of principal balance, except where noted. bp Basis points.
Source: Prospectus.

Some of the characteristics shown in Figure 4 are significantly different for traditional MBS. For example, weighted-average LTVs of around 65% are about 10% and 7% lower than traditional ARM and 30-year FRM pools, respectively. Furthermore, maximum LTVs (see Figure 1) are 80%, in contrast to most traditional FRM and ARM pools, which allow up to 90% LTVs. Average loan balances are significantly below traditional nonconforming pools — $105,000-$115,000 versus $250,000-$300,000 — which suggests property values at the lower end of the spectrum. The percentage of California mortgages ranges from 80%-99% — higher than traditional nonagency FRM pools but comparable to many traditional nonagency ARM pools. Finally, servicing fees range from 40 basis points to 52 basis points, as much as 33%-100% higher than traditional nonagency MBS.

Refinancings constitute about 80% of these pools, most of which are equity take-out refinancings. Borrowers may be extracting equity from the property to pay off second mortgages or home equity loans, or to consolidate other debts with a tax-deductible mortgage loan. This high proportion of refinancings likely will continue, as B and C lenders tap into borrowers passed over during the recent refinancing wave.

Other B and C Issuers

B and C mortgages securitized by the traditional home equity issuers, such as Advanta, differ from the mortgages described above in several important respects.

- Mortgages are predominantly fixed rate with 15-year maturities.
- California is *not* the dominant geographic area.
- Average loan balances are low at $40,000-$90,000.

In addition to collateral differences, structures used by the traditional home equity issuers also differ from those of the first-lien mortgage bankers. First, credit enhancement is provided routinely by guaranty insurance from providers such as FGIC and MBIA. However, the issuer often retains some first loss exposure, typically in the form of overcollateralization. In addition, the entire balance of mortgage collateral may not be available at closing. In this case, cash is deposited into a "pre-funding" account equal to the amount of collateral shortfall. The prefunding account subsequently purchases additional collateral.

Another structural difference is the substantial amount of excess interest cash flow represented by the difference between borrowers' mortgage rates and the security's pass-through rate. This rate difference, or spread, can be as wide as 300-500 basis points. The resulting excess interest cash flows are used to accelerate the paydown of senior securities, shortening and stabilizing average lives.

All four rating agencies have developed methodologies for rating B and C pools. Both Fitch[3] and Duff & Phelp's[4] have published reports outlining their techniques.

In general, all four rating agencies' approach to collateral credit risk has been to modify existing rating methodologies, given the relative lack of historical performance data on B and C first mortgages. Considering the credit risk of the collateral — past delinquencies and/or debt-to-income ratios significantly above the traditional 28%-36% — the rating agencies anticipate higher levels of delinquency and foreclosure in B and C pools than in traditional pools. For example, Fitch increases its traditional AAA default assumption by factors of two, three, four, and five for A-, B, C, and D quality loans, respectively. The relative risk assigned to the lower-rated borrowers highlights the importance of understanding both the borrower rating process and the proportion of borrowers in each rating category.

Future losses should be mitigated by the use of conservative LTVs. Although delinquency and foreclosure levels could be higher as a function of borrower quality, losses will be related primarily to the direction of home prices. Thus, a sharp decline in home prices, similar to that in Southern California over the past four years, will result in higher loss levels. At the triple A level, however, the rating agencies set the amount of credit enhancement to be able to withstand severe economic stress and market value declines.

The underwriting process is critical to the rating agencies, particularly the quality of appraisals. Given the high proportion of equity take-out refinancings, investors are exposed to appraisals as the "true" measure of a pool's LTV distribution. For this reason, the rating agencies scrutinize each originator's appraisal standards and internal review process. Typically, B and C originators use outside appraisers with an internal chief appraiser to ensure quality control.

Aside from collateral characteristics, servicing is the most important credit element and, hence, receives close scrutiny from the rating agencies. In particular, the rating agencies prefer servicing/collections personnel with experience in the B and C arena. Furthermore, given that some of the borrowers have a history of delinquency or default, the rating agencies prefer the "aggressive" servicing that existing B and C originators generally employ. Aggressive servicing includes tactics such as phone contact within days of a missed payment or the prompt initiation of foreclosure proceedings.

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[3] See *Mortgage Criteria for B and C Loans*.

[4] See *Special Report on the Securitization of B & C Quality Loans*, Andrew Jones, Duff & Phelps Credit Rating Co., June 1993.

In contrast to traditional A quality pools, a significant percentage of B and C mortgages has prepayment penalties that vary in strictness and timing. Consequently, investors should understand these penalties, particularly for such prepayment-sensitive classes as IOs.

Quality and Option One have prepayment penalties on some portion of their mortgage collateral. Although prepayment penalty terms can vary within the same pool, the most common penalty requires the payment of six months' advance interest on the amount of any prepayment that exceeds 20% of the original principal amount of the mortgage. Long Beach has added prepayment penalties only recently.

Prepayment penalties appear to have had a major impact on prepayment rates, based on a comparison of prepayment speeds of five Long Beach pools (GCAP; no penalties) versus five Quality pools (DLJ; penalties). To avoid differences in seasoning, the pools chosen all were issued in 1992. Since issue, Long Beach collateral has prepaid 70% faster than Quality collateral: 14.6% constant prepayment rate (CPR) versus 8.6% CPR. As shown in Figure 5, the Long Beach life CPRs are consistently faster across all transactions.

Figure 5. Historical Prepayment Rates for Long Beach and Quality Mortgage Transactions Issued in 1992, Mar 94 (Dollars in Thousands)

Issue	Closing Date	Original Balance	Current Balance[a]	Life CPR
GCAP 92-LB2	Mar 92	$94,982	$71,664	12.0%
GCAP 92-LB4	Apr 92	39,933	25,563	15.4
GCAP 92-LB5	Jun 92	236,671	177,672	14.5
GCAP 92-LB6	Sep 92	246,361	188,013	15.1
GCAP 92-LB8	Dec 92	205,013	163,137	15.2
DLJ 92-Q2	Apr 92	74,949	62,706	8.1
DLJ 92-Q4	Jun 92	92,244	75,531	9.7
DLJ 92-Q7	Aug 92	158,047	130,368	10.3
DLJ 92-Q8	Oct 92	146,799	128,018	7.6
DLJ 92-Q11	Dec 92	151,240	134,547	7.2

[a] March 25, 1994. CPR Constant Prepayment Rate.