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The "Alternative-A" Nonagency Subsector: a Primer

"Alternative-A" mortgage collateral first appeared in the nonagency MBS market in mid-1994. Up to that time, most nonagency CMOs were backed by fully documented jumbo loans. Although alternative-A borrowers meet or exceed FHLMC/FNMA credit standards and have conforming loan balances, their loans do not fit FHLMC/FNMA program guidelines. Consequently, alternative-A loans (typically originated from a lender's "expanded criteria" guidelines) have become popular with borrowers that otherwise would not qualify for a conforming mortgage loan. At the same time, CMOs backed by this collateral have grown in popularity with investors because these loans are perceived to exhibit favorable convexity characteristics. Unlike standard nonagency transactions, there are substantial differences in collateral among alternative-A issuers. The purpose of this article is to familiarize investors with the major conduits and mortgage bankers in this subsector, review their issuance patterns, and explore the collateral (and program) characteristics of relevant transactions.

Issuer Overview: In this article, we focus on five organizations prominent in the origination and acquisition of "alternative-A" mortgages. They are: Headlands Mortgage Company, ICI Funding, North American Mortgage Company, Residential Funding Corporation, and Independent National Mortgage Corporation.

Headlands Mortgage Company (Headlands), a subchapter-S corporation, has originated, acquired, sold, and serviced residential mortgage loans for ten years. "Alternative-A" production in 1996 was $2 billion (95% from wholesale broker network). Headlands' first securitization closed in February 1997. Prior to that, Headlands sold their mortgage production to other mortgage conduits. Headlands is located in Larkspur, California.

ICI Funding (ICI) is a mortgage banking conduit that acquires residential mortgage loans nationwide. ICI is a subsidiary of Imperial Credit Mortgage Holdings, Incorporated, a publicly traded REIT. ICI's first securitization closed in March 1997. Prior to that, ICI sold their mortgage production to other mortgage conduits. ICI's executive offices are located in Santa Ana Heights, California.

North American Mortgage Company (NAMC) is one of the nation's largest independent mortgage bankers. They originate, acquire, sell, and service first-lien, single-family loans. Their first transaction was issued off the Financial Asset Securitization, Incorporated shelf. However, the company expects to issue off their own shelf by year end. NAMC operates 105 offices in 31 states and is headquartered in Santa Rosa, California.

Residential Accredit Loan, Incorporated (RALI) is a shelf registration in the Residential Funding Corporation (RFC) family. RFC, a subsidiary of GMAC, is a mortgage conduit, and a major issuer of standard nonagencies, alternative-A, and home equity loans (each on their respective shelf registrations). RFC first securitized alternative-A CMOs on the RALI shelf in September 1995, and has issued over $2.5 billion to date. RFC is located in Bloomington, Minnesota.

Residential Asset Securitization Trust (RAST) and INMC represent mortgage transactions by Independent National Mortgage Corporation (Indy Mac), a subsidiary of CWM Mortgage Holdings — a publicly traded REIT. In mid-1994, Indy Mac issued the first alternative-A transaction. Indy Mac is a mortgage conduit and has issued $10 billion in fixed-rate and adjustable-rate transactions under the RAST and INMC labels. Indy Mac is headquartered in Pasadena, California.

RAST and RALI have the longest issuance histories and the highest mortgage production in our survey.

Issuance and Production Volume: Issuance and production volume varies greatly for the five originators. As shown in Figure 2, Headlands and ICI had their inaugural securitizations earlier this year. Under their individual shelf registrations, they have issued just over $1 billion, and have quarterly production of $375 million and $300 million, respectively, as shown in the figure. NAMC recently issued their first transaction, containing a mixture of alternative-A (60%) and standard jumbo loans (40%). (NAMC expects to issue securities backed by a similar collateral mixture for the remainder of the year.) Their alternative-A production averages about $160 million quarterly, as shown. RALI and RAST have the longest issuance history. As shown in Figure 2, RALI and RAST acquire and securitize $400 million and $700 million on average each quarter, respectively. The alternative-A business is dominated by wholesale originations (including broker and correspondent lending).

Norwest Mortgage, not shown, is also planning to securitize alternative-A collateral before year end on their NISTAR (Norwest Integrated Structured Assets Incorporated) shelf. NISTAR will likely include higher percentages of retail originations. Overall, we anticipate that alternative-A issuance will comprise 25-35% of the total nonagency volume in 1997, approximately double that of 1996.

Figure 2. Issuance and Production Volume for Alternative-A Issuers (dollars in millions), 15 May 97

	Headlands	ICI	NAMC	RALI	RAST (INMC)
First Securitization	Feb 1997	Mar 1997	Apr 1997	Sep 1995	Jun 1994
Issuance-to-Date	$540	$575	$175	$2,550	$7,630
Quarterly Production	375	300	$160	400	700

Source: Headlands, ICI Funding, Indy MAC, North American Mortgage, RFC, Bloomberg, Salomon Brothers.

Alternative-A loans originate from a lender's expanded criteria underwriting and generally do not conform to agency standards.

Collateral and Program Characteristics: Alternative-A loans generally do not conform to agency underwriting guidelines. The market niche exists because a segment of the mortgage borrower community, those with high-quality credit histories, desire non-traditional lending programs. Alternative-A loans originate from a lender's expanded criteria underwriting guidelines. For example, borrowers can qualify without income verification. In some programs, borrowers are not required to disclose their income on the loan applications. Typically, expanded criteria also allow for higher debt-to-income ratios with higher accompanying LTVs than otherwise permissible in conforming mortgage programs. Alternative-A programs are also a haven for investor properties, because these lenders offer competitive pricing.

Rate premiums are lower today because of increased competition and lower credit enhancement requirements.

For the convenience of qualifying under expanded criteria guidelines, borrowers pay an above-market mortgage rate. As a result, gross WACs (GWACs) for alternative-A transactions are higher than those for conforming transactions. Figure 3 shows representative collateral characteristics for alternative-A issuers (1997 year-to-date issuance only). Substantially all loans are 30-year, fixed-rate. Some 15-year and balloon mortgages appear in selected transactions. GWACs in our survey range from 8.60-8.90%, as shown in Figure 3, representing a 70bp-100bp rate premium when compared to the average FHLMC survey rate during the first quarter of 1997. When we made the same comparison in March 1996, we found that the rate premiums ranged from 60bp-130bp. We attribute the lower maximum rate premiums to: (1) increased competition among lenders in this market niche; and (2) lower credit enhancement levels required by the rating agencies.

Alternative-A loans with high LTVs usually have PMI.

LTVs average 75%, 2-5% less than average LTVs in standard nonagency transactions. At the same time, high LTV loans (loans with LTVs greater than 80%) range from 5-35%, on average, as shown in Figure 3. High LTV lending often results in higher credit enhancement levels because of their potential for increased foreclosure frequency. Most alternative-A loans with high LTVs have private mortgage insurance, which serves to reduce loss severity (a key component in ratings criteria). Maximum LTVs in full documentation underwriting usually do not exceed 90% (in some programs, maximum combined LTVs are 95%).

RALI collateral has the lowest average loan balance and the lowest percentage of loans from California.

The alternative-A sector became popular with investors, in part, because average loan balances resemble those in conforming lending, thereby reducing interest-rate sensitivity relative to traditional jumbo mortgages. In our survey, average loan balances are as low as $105,000 in RALI transactions, and as high as $165,000 in Headlands transactions (as shown), with ICI, NAMC, and RAST closer to the average at $145,000. As shown in Figure 3, just 12% of RALI's loans are greater than the conforming maximum. Headlands and RAST, by contrast, have more than double that amount (NAMC's jumbo loan percentage is not applicable because their transactions mix "alternative-A" loans with standard jumbo originations). Not surprisingly, the programs with higher average loan sizes also have higher concentrations of loans from California. Figure 3 shows that the California concentration ranges from 20% for RALI to 65% for Headlands.

Debt-to-Income ratios in alternative-A lending can exceed the FNMA/FHLMC guideline limit.

Alternative-A collateral has significant percentages of limited documentation loans, mostly comprised of borrowers seeking to qualify without verification of income (including "stated income" and "no-ratio" programs). Limited documentation underwriting ranges from 45-65% (Figure 3). No-ratio loans (whereby prospective borrowers do not disclose income, thus, debt-to-income ratios cannot be calculated) typically do not exceed 20% of the pool's original balance (not shown). Underwriting guidelines for stated income or no-ratio programs typically allow a maximum LTV of 80% for high-quality credits. Under these programs, emphasis is placed on the collateral and credit history rather than the verified income of the borrower (lenders usually require additional reserves as well). Debt-to-income ratios in alternative-A lending (when disclosed by the borrower) typically do not exceed 38-40% (whereas FNMA/FHLMC guidelines permit a maximum debt-to-income ratio of 36%).

RALI collateral contains the highest percentage of investor properties and requires the most subordination as well.

Another interesting feature of alternative-A collateral is the substantial concentration of investor properties. However, not all lenders compete for non-owner occupants. In our survey, investor properties range from 5% (for ICI Funding) to 35% (for RALI) of collateral. All other things being equal, the more investor properties, the higher the subordination requirement. This relationship is evident in our survey, as ICI's subordination is 1.75% less than RALI's. Investor properties typically do not exceed $200,000 original loan balance and 90% LTV (most underwriting standards, however, permit larger loan sizes with an offsetting reduction in LTV).

Figure 3. 1997 Representative Alternative-A Collateral Characteristics by Issuer, 15 May 97

	Headlands	ICI	NAMC	RALI	RAST (INMC)
30-year amortization	90%	95%	100%	100%	100%
GWAC	8.60	8.90	8.72	8.80	8.65
Average LTV	75	75	75	77	73
LTV > 80%	5	35	13	35	12
Loan Balance	$165,000	$145,000	$150,000	$105,000	$140,000
Jumbo Loans	25%	20%	NA	12%	25%
California Concentration	65	35	35	20	35
Limited Documentation	65	65	50	45	60
Investor	18	5	27	35	18
Average Credit Score	700	680	700	680	700
Triple-A Subordination	7.25%	6.75%	6.00%[a]	8.50%	7.75%

[a] Subordination reflects pool containing a mixture of "Alternative-A" and standard nonagency collateral.
Source: Headlands, ICI Funding, INDY MAC, North American Mortgage, RFC, Bloomberg, DCR, Fitch, Salomon Brothers.

Credit Scoring: In the first quarter of 1997, credit scores made their debut in the prospectuses of several nonagency transactions. Credit scores are now captured on 75-90% of new alternative-A mortgage originations. Credit scores are typically shown in ranges, as well as a weighted average for the pool, in the prospectus. A credit score is a quantitative evaluation of past and present credit accounts on the borrower's credit bureau report. It includes (among other items) the following:

- Payment history
- Account delinquencies
- Levels of outstanding indebtedness
- Length of credit history
- Types of credit
- Bankruptcy experience

Credit scores can be viewed as a measure of relative risk and assesses a borrower's willingness and ability to repay.

In short, the credit score assesses a borrower's willingness and ability to repay the mortgage loan obligation. The most frequently cited credit score is the "FICO" score, developed by the Fair, Isaac Company, Incorporated, of San Rafael, California. FICO scores range from 250 to approximately 900, with the higher scores implying a more favorable credit history compared to an individual with a lower score. Therefore, a FICO score can be viewed as a measure of relative risk that a borrower represents to the holder/servicer of the mortgage.

Some underwriting programs are geared specifically for the use of credit scores. For example, if a borrower is deemed to be a good credit risk (via credit scoring), the originator may underwrite that loan to streamlined underwriting standards. Conversely, if a borrower has a more negative credit profile, the lender will resort to full documentation guidelines. In fact, high FICO scores allow lenders to expedite the origination process. Loans can be approved and closed quickly on the basis of the score. In addition, credit scores provide the rating agencies with incremental borrower credit information, enabling them to more accurately access the default risk of a mortgage transaction when scores are supplied.

FICO scores for our issuers generally range from 680 to 700, presenting relatively low default probability.

Generally, the minimum allowable FICO score is 620 in alternative-A lending. As seen in Figure 3, the weighted-average credit scores for these issuers range from 680 to 700. On this basis, alternative-A borrowers (as a group) may present a relatively low probability of default. Furthermore, a portion of the collateral is backed by loans whose borrowers exceed a 700 FICO score. These borrowers are considered to be "A+" credits. However, on a limited case-by-case basis, and with significant compensating factors (like additional reserve requirements and LTV ratio restrictions), FICO scores below 620 may be permitted. There is also evidence that a small percentage of borrowers in alternative-A transactions have creditworthiness and credit histories more consistent with a typical "B&C" credit designation. Clearly, these loans would not qualify under FNMA/FHLMC standard underwriting guidelines, and bear higher interest than mortgage loans made to alternative-A borrowers.