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Evaluating Mortgage Security Risks: A Primer For Today's Market

Times have changed, and there is an immediate need for a new game plan when approaching securitization.

By Nick Krsnich

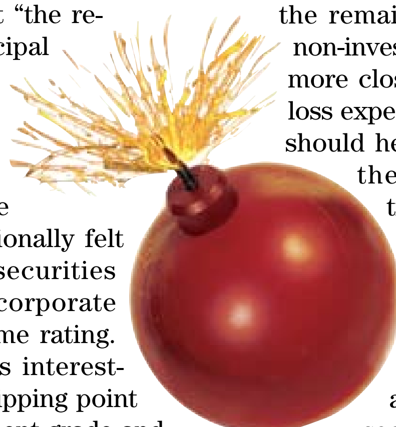
Most third-party mortgage pool and security valuation methods involve the gathering of historical prepayment information, followed by consideration of recent performance and the economic environment, and then an analysis considering various stress scenarios. Usually, the emphasis is on past performance rather than on the actions of issuers or sellers that contribute to future performance. But that is the weakness in our current system.

Certainly, there are issues regarding motivations in how rating agencies are compensated or which buyer or research firm has the most experienced talent, but in my mind, the evaluation process could be different. For years, sellers have "arbitraged" ratings by determining which loans could be packaged in a security to achieve a certain rating.

Of course, most times, this means putting loans into transactions that meet, but do not significantly exceed, ratings thresholds. In evaluating new issues, due diligence on recent changes in product and underwriting guidelines, current methods of producing loans, and risk and monitoring practices specific to target products are the "devils in the details" musts.

On secondary transactions in which the pools are finalized, the stress tests to determine return of principal need to be more granular than those of the rating agencies, yet easily understood by mortgage-bond purchasers.

Structured finance ratings are, unfortunately, a decedent of corporate ratings, while mortgage buyers are more concerned about "the return of my principal than the return on my principal," to quote Will Rogers.



The mortgage buyer has traditionally felt that mortgage securities are safer than corporate issues of the same rating. The BBB case is interesting, as it is the tipping point between investment grade and non-investment status, yet the BBB credit spreads for mortgage securities during most periods were considerably tighter than their corporate counterparts.

Expectations of mortgage investors were different from the onset - the secondary market for residential mortgage products started with the forming of the government-sponsored enterprises that expressed a government backing. That initial guarantee market set the expectation for structured mortgage products to be higher in safety than their corporate counterparts.

This situation changed in 2008-2009, when nearly all security classes in structured mortgage products faced potential principal write-downs. Going forward, there has to be the prevailing belief that investment-grade structured bonds, specifically AAA and AA, need to be more granular in terms of the probability of principal return, while the remaining investment-grade and non-investment-grade bonds need to more closely approximate corporate loss expectancy. This type of analysis should help renew buyer interest in the non-agency structured transactions.

New issue transactions

A stronger emphasis needs to be put on the issuer/seller's origination and packaging of loans into securities in terms of due diligence on recent product and underwriting changes, sales methods and risk monitoring. Unfortunately, delinquencies and ultimate defaults are much like the lagging unemployment rate when used as a measure to predict economic cycles. As product and underwriting guidelines "widen," the loan and subsequent pool characteristics suffer.

Combined loan-to-value ratios, credit scores and documentation, if relaxed, change a loan product's risk. That was never more evident than from 2004 to 2007. As production declined, underwriting guidelines were relaxed. Buyers bought into the notion of layered risk, or the concept that multiple combinations of high-risk attributes will not necessarily result in multiplicative risk. That notion was obviously wrong.

Enhanced front-end due diligence allows a buyer to better determine if recent loans still should be grouped as prime, Alt-A or subprime. That brings up another issue: Why bother grouping securities into broad product groups? The more important issue is the attributes of the pool in question rather than categorizing according to currently favored market segments. In fact, who knows if the future non-agency market will be Alt-A, subprime or some other product grouping, so why categorize at all?

In 2004-2007, the attributes of subprime mortgages looked very similar to past Ginnie Mae production. But 50% of the loans had reduced documentation, and Ginnie Mae's past delinquencies have always been in the 20% to 30% range. As a result, should we be surprised that subprime products have 30% to 40% delinquencies?

Alt-A mortgages, which are characterized by reduced documentation, are nothing new. In the early 1990s, bank originators struggled with this product, and they didn't attach second liens or qualify borrowers at low interest rates like in 2004-2007. Does that mean you don't originate these products? Maybe so, but if they are produced, you need to make sure you are getting paid for the expected risk, and the expected risk includes all known origination practices.

Secondary-market securities

We can now look back and ask, what did AAA mean from 2004-2007? Ratings should be viewed as guidelines; buyers need to perform bond analysis that best quantifies their risk appetite. This means updating all loan data to the current market, running scenarios assuming full default and full severity, and evaluating structure, insurance, origination and loan servicing.

When we look at non-agency residential mortgage-backed securities and collateralized debt obligation securities, we focus first on likely return of principal and second on expected rate of return. While we don't categorize our findings in terms of ratings, here is what it might look like:

Rank 1 - There is no chance of principal loss as a government guarantee is implied. Acts of war or nature are not considered in any of our ranks. We also assume that contract law will not be violated.

Rank 2 - The security structure is such that 100% default and 100% severity conditions will not result in a principal loss.

Rank 3 - In considering the worst economic scenarios to date, there is a high probability that principal will be returned. This category assumes no credit for market diversification or non-correlation in that all markets deteriorate in unison.

Rank 4 - In considering the worst economic scenarios to date, there is a high probability that principal will be returned. Credit is given for non-correlated markets and diversified asset pools.

Rank 5 - In considering the worst economic scenarios to date, there is a zero to 10% chance of principal loss.

Rank 6 - In considering the worst economic scenarios to date, there is a 10% to 20% chance of principal loss.

Rank 7 - In considering the worst economic scenarios to date, there is a 20% to 50% chance of principal loss.

Rank 8 - In considering the worst economic scenarios to date, there is a 50% to 100% chance of principal loss.

Rank 9 - An investor can only expect to collect accrued interest.

Rank 10 - An investor should expect no cash return.

There is a significant need to better address the concerns of the mortgage buyer who seeks more detail in the upper categories. Hopefully, this situation will be addressed in 2010. SME

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