

Dispelling Some Common MBS Myths

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Some participants in today's secondary mortgage market have fallen victim to believing in several false and dangerous myths. This report addresses a few of the more perilous myths and explains why they are false. The three critical points discussed below are:

- Computer models alone can *not* determine the appropriate levels of credit enhancement for mortgage securitizations.
- Traditional, prime-quality mortgage loans are about as risky today as they were in the past.
- Automation and computers will not by themselves reduce risk in mortgage lending unless a lender's business strategy is to originate loans of higher credit quality.

Myth No. 1: Computer models alone can accurately and reliably determine credit enhancement levels for residential MBS deals.

Computer models alone cannot reliably determine appropriate credit enhancement levels for residential mortgage loan securitizations. Although computer models have a place in the credit analysis of residential mortgage loan securitizations, the models fail to capture all the relevant factors that drive credit quality.

As a general matter, even the most sophisticated computer models are based on simplified assumptions about the real world. Although this fact is well appreciated in many circles, it is sometimes forgotten by the financial community. Thus, as recently as October 1997, Federal Reserve Board Chairman Alan Greenspan felt compelled to warn banks that they "should not rely on computer models alone to manage risk."¹

On their face, two pools of mortgage loans from two different companies may appear to be of equivalent credit quality because the companies report them as having the same "quantitative" characteristics. But each company's practices in originating and servicing mortgage loans can influence the credit enhancement needs of a pool being securitized. "Pool data" may not fully capture the idiosyncratic effects of origination and servicing practices. Nevertheless, those practices can have a considerable impact on the credit enhancement levels needed to achieve target rating levels.

Critical quantitative characteristics may contain biases introduced by a company's loan origination practices. For example, appraisal practices can strongly influence reported loan-to-value ratios (LTVs). Prudent appraisal practices are likely to yield reliable LTVs. Conversely, loose or sloppy appraisals may over-value properties and hence understate LTVs. The result is understatement of the actual risk of the mortgage loans.

¹ J. Seiberg, "Greenspan: Computer Models Insufficient for Managing Risk," *American Banker*, October 15, 1997.



Or consider the ranking systems used by lenders to classify borrowers. The mortgage lending industry lacks standardized borrower quality classifications (e.g., A, A-, alt-A, B, C, D, etc.). A given symbol may denote materially different risk levels at different companies. In addition, even if two lenders' classification schemes are very similar on paper, one may allow more "exceptions" than the other (i.e., one may adhere more strictly to its own classification system than the other). The real distribution of borrower credit quality – based on a company's actual practices – is what influences credit enhancement levels for MBS. Internal quality symbols used by a company are not the driving force.

A further example of distinctive practices is in the area of loan documentation standards. Some lenders classify loans in the "full documentation" category even though the loans may have been originated without traditional verification of income. Naturally, "pool data" may not capture these variations in practice that translate into differences in risk.

Like origination practices, idiosyncratic servicing methods can influence risk in ways that are not readily apparent from mortgage pool data. If a company's unique practices make it a below-average servicer of mortgage loans, it is reasonable to expect that any given pool of mortgage loans will perform worse if serviced by that company than by an "average" servicer. Unless the loans are sold on a servicing-released basis (or unless there is a strong likelihood that the servicing would be transferred within a short time), the presence of a weak servicer will increase risk and push up credit enhancement levels.

Ironically, above-average servicers create two different kinds of potential problems: First, unless there is a very strong likelihood that the company will remain the servicer of a mortgage pool for its entire lifetime, the benefit of superior servicing might be lost through an unanticipated transfer of servicing responsibilities. Second, if a company is an above-average servicer, the benefit of its superior servicing may be impossible to separate from its origination activities. This reduces the reliability and precision of estimates concerning the "intrinsic" riskiness of the company's loans.

In the end, qualitative factors not reflected in "pool data" often influence credit enhancement levels by as much as 30%.

Myth No. 2: Prime-quality mortgage loans originated this year are less risky overall than loans originated during the late 1980s and early 1990s.

Various evolutionary changes in the prime-quality sector of the mortgage market have had both positive and negative effects on the riskiness of mortgage pools. All told, the positive and negative effects roughly balance each other out, making overall riskiness about the same.²

Changes that reduce risk include: (i) the introduction and widespread use of deep PMI, (ii) higher geographic diversity in many pools, and (iii) the proliferation of "best practices" in both origination and servicing. Deep PMI has the effect of reducing the severity of loss when a borrower defaults. Higher geographic diversity reduces the exposure of a mortgage pool to regional economic downturns. The proliferation of best practices enables more originators and servicers to achieve superior results with a given population of applicants and borrowers.

On the other hand, examples of changes that have had a risk increasing effect include (i) more originations of high-LTV loans, (ii) increased use of "low documentation" or "alternative documentation" programs, (iii) increased use of old appraisals, and (iv) over-reliance on automation. High LTV loans may experience both higher frequency of default and higher severity of default than low LTV loans. The performance of loans originated through "low doc" programs is more variable and less predictable than that of loans originated through "standard doc" programs. This is because the source and amount of a low doc borrower's income are not fully verified.

² Even though prime-quality mortgage loans are about as risky today as they were in the past, credit enhancement levels for many highly rated securitizations backed by such loans are lower today than they were before. This development reflects the ongoing evolution of Moody's rating methodologies. In particular, the methodology for rating residential mortgage pass-throughs evolved over time from being driven primarily by collateral coverage (LTV) to being driven principally by a combination of borrower credit quality, issuer practices, and collateral coverage. See, "Moody's Approach to Rating Residential Mortgage Pass-Through Securities," *Moody's Structured Finance*, November 8, 1996. It also reflects issuers' efforts to better segregate pools by collateral risk.

Old appraisals render LTV a less reliable measure of collateral coverage for a loan and thus increase risk by reducing the certainty of predictions about future performance. Over-reliance on automated systems ignores the fact that experienced judgment can be a strongly beneficial element in the credit decision-making process.

From a broader perspective, it is perhaps not surprising that the overall riskiness of prime-quality mortgage loans has not changed. Prime borrowers, in general, are not fundamentally different today than they were in the past. The population of homeowners includes households from a wide range along the economic spectrum. Moreover, despite the introduction of diverse new mortgage products, the two major determinants of mortgage loan credit risk have remained collateral coverage (LTV) and borrower quality.

During the recent six-year period of economic expansion, the overall credit performance of prime quality mortgage loans has been extremely good. This is to be expected; during good times, loans of any given quality ought to perform better than during bad times. However, some market participants have misconstrued the recently observed good performance during a period of economic expansion as an indication that mortgage loan performance will permanently remain good through varying economic conditions. This is a dangerous mistake.

Myth No. 3: Credit scoring and automated underwriting systems have eliminated the impact of originator practices on the riskiness of mortgage pools.

Computerized credit scoring systems and automated underwriting systems do not (and never will) eliminate the impact of a company's business practices and strategies on the riskiness of its mortgage loan originations. This is because computers and automation cannot dictate homogeneity and uniform quality if the competitive business environment drives lenders to make loans to ever riskier borrowers. Computers and automation, if properly used and maintained, can help lenders to measure and monitor changes in the riskiness of new loans being originated. However, it is unrealistic to believe that computers and automation alone will maintain a constant level of risk in new loan originations even when a company embarks on a strategy of making riskier loans in a highly competitive environment.

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