Nomura Fixed Income Research

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A Journey to the Alt-A Zone

A Brief Primer on Alt-A Mortgage Loans

3 June 2003

It was 2:45pm on a regular Friday afternoon in the small seaside town of Oceanviewville. Sam Jones, a junior loan officer, was quietly sitting at his desk at First Oceanviewville Bank. He figured that he was just about done for the week and was looking forward to the weekend. Then, unexpectedly, a man entered the bank and walked up to his desk. The man said he was buying a vacation home in the town and wanted to take out a mortgage loan. The man gave Sam his social security number so that Sam could pull his credit report. Sam saw that that man had an impressive credit score of 725. The man explained that he planned to make a down payment of 5% on the $450,000 house and that he needed to act quickly. He explained that he was self-employed and a very private person. He strongly preferred not to discuss his assets or the source or nature of his income. Sam considered the situation. The man's situation did not fit the requirements of the regular loan programs with which Sam was familiar. On the other hand, because of his high credit score, the man clearly was not a sub-prime borrower. Sam didn't realize it, but he was about to take a journey…a journey to the alt-A zone.

I. Introduction

MBS backed by alt-A mortgage loans can be an attractive alternative to MBS backed by regular conforming or jumbo mortgage loans. Compared to regular mortgage loans, alt-A mortgage loans display greater resistance to prepayments during the first nine to twelve months following their origination. In the past, alt-A mortgage loans enjoyed an even greater prepayment advantage. However, the increasing efficiency of the primary mortgage market and the encroachment by the GSEs into the sector have caused the advantage to erode somewhat. Nonetheless, it persists for nearly a year following origination and, especially in an environment of falling interest rates, can create value for investors.

The alt-A prepayment advantage is tied to the characteristics that cause loans to be classified in the alt-A category. Those same characteristics make alt-A loans somewhat riskier from a credit perspective than regular loans. Thus, in broad terms, it is fair to describe the alt-A prepayment advantage as being tied to the degree of "credit impairment" in the loans. For the alt-A MBS investor, the incrementally higher credit risk of alt-A mortgage loans is counterbalanced by higher credit enhancement levels than those found in regular private-label MBS. However, the alt-A prepayment advantage carries through to the securities, giving investors an opportunity to moderate their exposure to prepayment risk.

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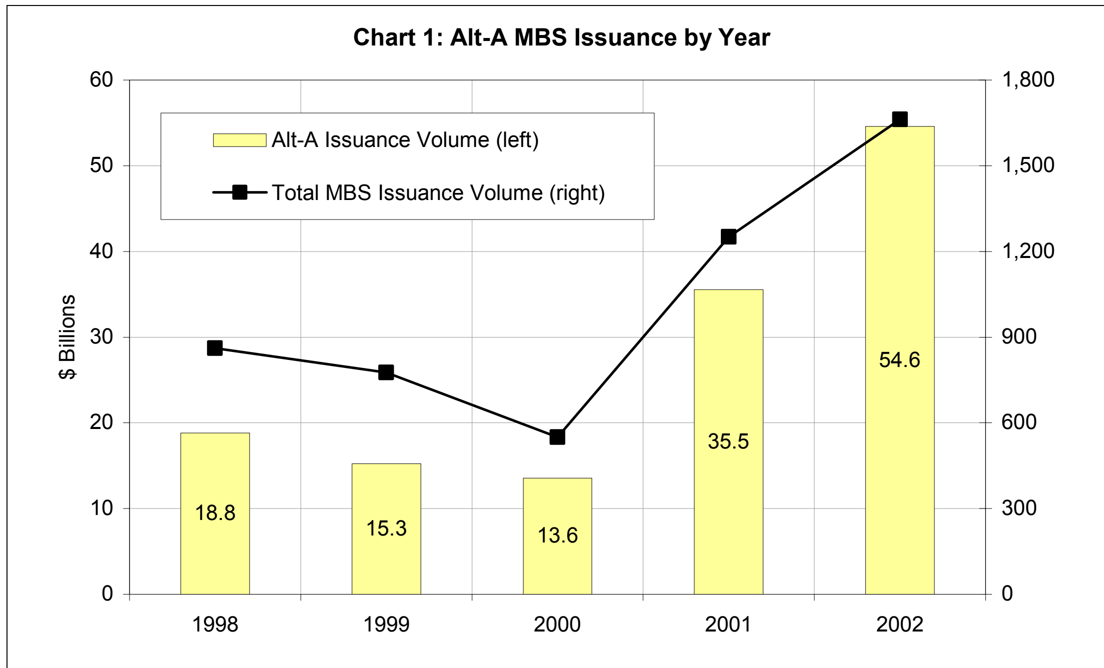
The alt-A MBS sector has grown gradually over the years. Although it represents only a small fraction of the whole MBS landscape, it produces enough volume to warrant consideration by most investors. The following chart shows the issuance volume of alt-A MBS over the past several years:



Source: Inside Mortgage Finance

II. Defining the Alt-A Sector

The alt-A mortgage sector has always been difficult to define. However, events of the past few years have made the task even more vexing. The boundaries of today's alt-A mortgage sector are faint and vague.

The dominant approach for defining the alt-A mortgage loans makes reference to the characteristics (or combinations of characteristics) that would have disqualified a loan from traditional conforming or jumbo loan programs. Perhaps the most important of such characteristics is "documentation." A substantial proportion of traditional alt-A loans were those where a borrower would not provide complete documentation of his assets or the amount or source of his income. As discussed below, a whole vocabulary has developed for describing loans with different levels of documentation.

Other characteristics that might cause a loan to fall into the alt-A classification include the following: (*i*) a loan-to-value ratio (LTV) in excess of 80% but lacking primary mortgage insurance, (*ii*) a borrower who is a temporary resident alien, (*iii*) secured by non-owner occupied property, (*iv*) a debt-to-income ratio above normal limits, (*v*) secured by a non-warrantable condominium unit or a condominium hotel, or (*vi*) an LTV above permitted thresholds in combination with other factors.[1]

The foregoing approach for defining alt-A loans is gradually becoming less useful. In large measure, the approach defines alt-A loans by what they are *not*; that is, *not* eligible for regular conforming or jumbo loan programs. However, in recent years, the regular programs have expanded the scope of

[1] For example, one lender's standard program allows for a maximum LTV of 75% on a $400,000 "stated income" loan to a top-tier borrower. The same lender's alt-A program allows such a loan to have an LTV as high as 95%. Another example: the same lender's regular program does not permit cash-out refinancing loans on properties that are second homes or vacation homes. The lender's alt-A program allows such loans. See https://www.gmacrfc.com/ClientGuide/At-A-Glances/At-A-Glance.pdf; or https://www.gmacrfc.com/ClientGuide/Newsletter/Archive/March03/03-G02_CG.pdf.

their offerings, with the result that many of the loans that would not have qualified several years ago would qualify today.

In addition to loans that possess "traditional" alt-A characteristics, today's alt-A loan pools often include a portion of loans from the strong end of the "sub-prime" range. Formerly, such loans were sometimes called "A-minus" loans. Such loans are especially likely to be classified in the alt-A category if they have less than full documentation. In broad terms, a "sub-prime mortgage loan" is a first-lien mortgage loan to a sub-prime borrower. There is no universally accepted definition of a sub-prime borrower. However, a borrower who has made all of his rent or mortgage payments on time during the preceding year and who has a FICO score above 620 generally can qualify for an ordinary (*i.e.*, "prime" or "A quality") conforming or jumbo mortgage loan. Thus, a typical sub-prime borrower either has been delinquent on his housing payments at least once during the preceding year or has a FICO score below 620.

Most recently, anecdotal evidence suggests that lenders sometimes classify loans as alt-A and include them in alt-A loan pools simply because they can. Such loans often have interest rates slightly higher than ordinary prime-quality loans, but they may be otherwise indistinguishable. In essence, this new species of alt-A loans includes whatever lenders – or issuers of alt-A MBS – choose to include in the category from time to time. Various companies have branded themselves as alt-A players either by issuing alt-A MBS or by highlighting alt-A loan products in their product line-ups. Examples include Wells Fargo, Countrywide, GMAC-RFC (RALI), Washington Mutual, Greenpoint Mortgage, and Impac Funding Corporation.[2] Such players can readily include a small proportion of regular loans in their alt-A pools, and they have an incentive to do so because of the favorable pricing that alt-A loans command. However, if they include too many regular loans in their alt-A pools, they will create visible performance distortions and lose their credibility as alt-A players. Thus, the majority of loans in virtually all alt-A pools either possess recognizable alt-A features or come from the A-minus genre.

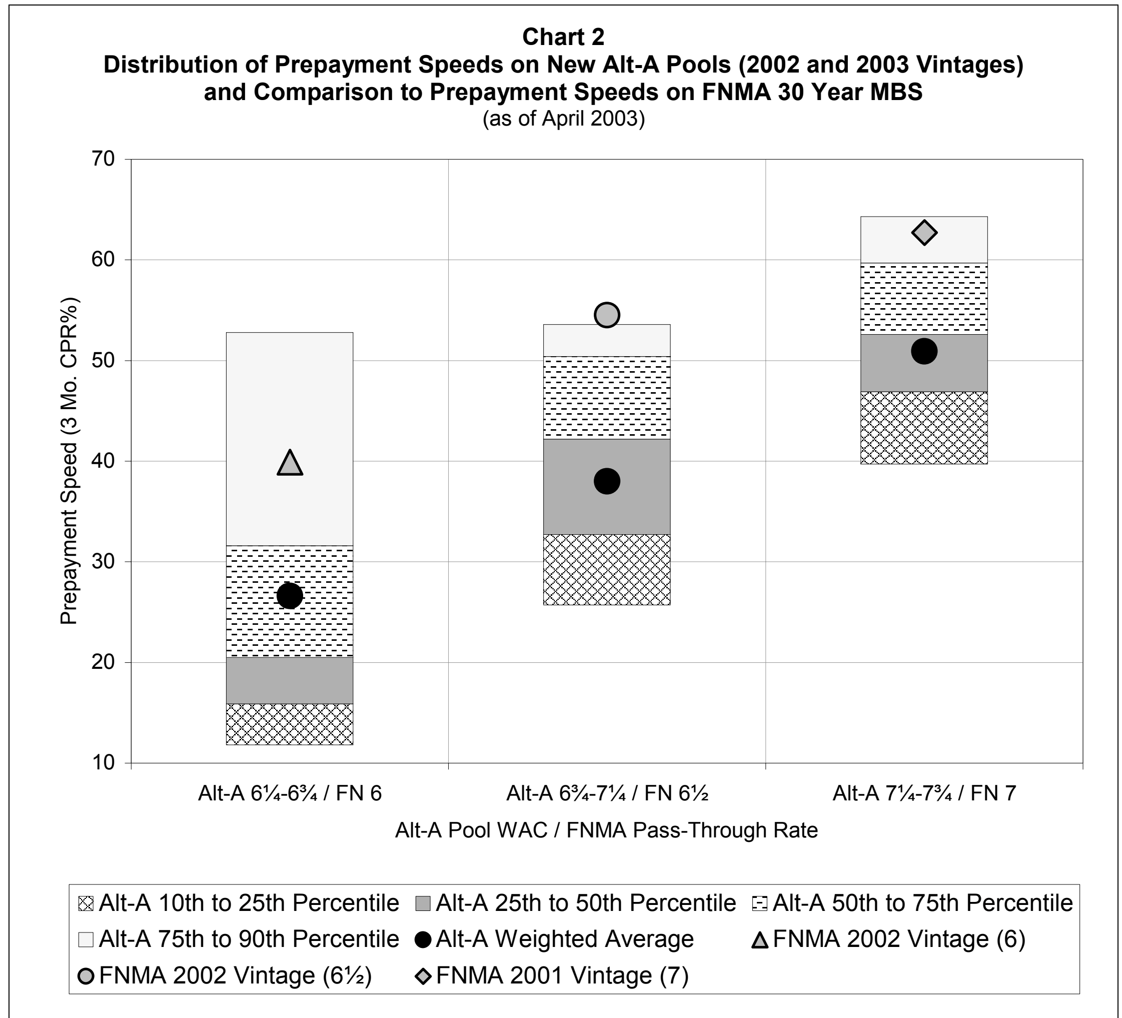
III. Appeal of Alt-A MBS

Alt-A MBS are appealing because they are perceived to offer temporary protection from prepayment risk. The degree of protection from prepayment risk has declined over time. Today, conventional wisdom is that alt-A loans are less likely to be prepaid in a falling interest rate environment than regular mortgage loans for the first nine to twelve months following their origination. For newly issued securities in a fast prepayment environment, the alt-A prepayment advantage can translate into substantial value. Chart 2 below illustrates the slower prepayment speeds that alt-A MBS have achieved relative to regular MBS. The data underlying the chart was compiled from a sampling of more than 50 alt-A MBS transactions from the 2002 and 2003 vintages.

[2] Bloomberg tickers for selected alt-A MBS issuers are as follows:

Selected Alt-A MBS Issuers		
Company	**Issuer (SPC)**	**Bloomberg**
Residential Funding Corporation	Residential Accredit Loans, Inc.	RALI
Wells Fargo Home Mortgage (f/k/a Norwest Mortgage)	Wells Fargo Alternative Loan Trust Norwest Integrated Structured Assets, Inc.	WFALT NISTR
IndyMac	Residential Asset Securitization Trusts	RAST
Greenpoint Mortgage (f/k/a Headlands Mortgage)	Headlands Mortgage Securities, Inc.	HMSI
Impac Funding Corporation (f/k/a ICI Funding Corporation)	Impac Secured Assets Corporation	IMSA
Lehman Brothers	Structured Asset Securities Corp	SASC
Countrywide	Countrywide Alternative Loan Trust	CWALT
Bank of America	Bank of America Alternative Loan Trust	BOAA
UBS Warburg	Mastr Alternative Loan Trust	MALT
Nomura	Nomura Asset Acceptance Corporation (also issues non-alt-A securities)	NAA

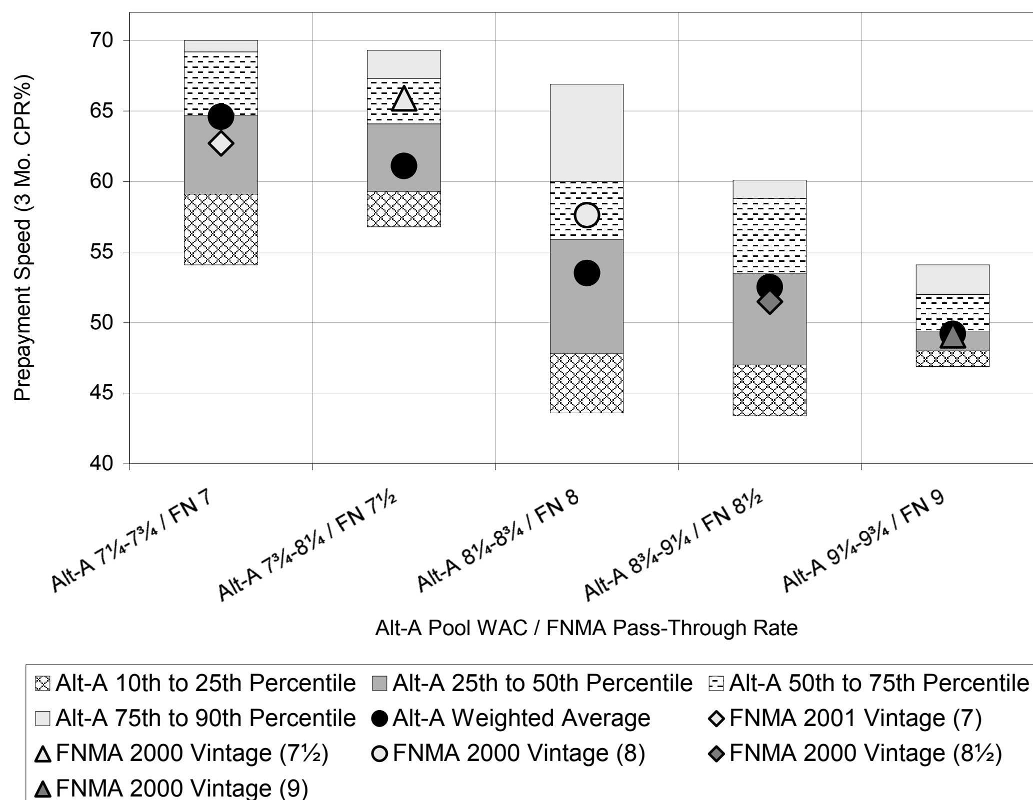
Each floating bar in Chart 2 shows the distribution of prepayment speeds for alt-A loan pools having weighted-average coupons in the corresponding range. Within each bar, the different segments (bands) correspond to different percentile ranges in the distribution. The circular black dots show the weighted-average prepayment speed for pools in the category. The grey-shaded dots show the weighted average prepayment speeds for FNMA MBS. We have compared each alt-A WAC range with what we believe to be the most reasonably comparable coupon and vintage (*i.e.*, the vintages from which an investor could expect delivery on a generic trade). As shown on the Chart 2, alt-A pools generally display prepayment rates that are more than 10% CPR slower than the comparable FNMA MBS.



Source: Bloomberg

Chart 3, below, shows how the alt-A prepayment advantage burns off after the loans have seasoned for more than a year. Chart 3 is organized in the same fashion as Chart 2 and reflects the prepayment speeds on more than 80 alt-A deals from the 2000 and 2001 vintage years. As shown on the chart, prepayment speeds on the older alt-A pools are nearly the same as the speeds on the most reasonably comparable FNMA coupons and vintages.

Chart 3
Distribution of Prepayment Speeds on Seasoned Alt-A Pools (2000 and 2001 Vintages) and Comparison to Prepayment Speeds on FNMA 30 Year MBS
(as of April 2003)



Source: Bloomberg

Understanding the alt-A prepayment advantage requires delving into the characteristics of the loans themselves. The characteristics associated with traditional alt-A loans are the ones that give them their prepayment advantage relative to ordinary conforming and jumbo loans. However, those characteristics also increase the credit risk of the loans. Compared to ordinary mortgage loans, alt-A mortgage loans often are described as being slightly "credit impaired." In broad terms, the prepayment advantage of an alt-A loan is proportional to its degree of credit impairment.

A. Documentation

One of the strongest factors driving the credit impairment – and the prepayment advantage – of alt-A loans is their documentation level. Loans with less than full documentation arguably are riskier from a credit standpoint than fully documented loans. The 1991 recession revealed a notable correlation between losses and reduced documentation in mortgage loans. For example, losses on PruHome deals from the late 1980s and early 1990s displayed a strong correlation to the proportion of reduced documentation loans included in the underlying pools.[3] Similarly, high levels of losses on RFC deals from the same vintages have been ascribed, in part, to large proportions of reduced documentation loans in the underlying pools.[4] It may be reasonable to expect a similar correlation in the future.

At the time of the last recession, alt-A mortgages were not separately labeled and segregated into pools of their own for securitizations. Accordingly, the connection between reduced documentation

[3] Diane Westerback, *Residential Mortgage Business Practices' Effect on Credit Quality: A PruHome Case Study*, Moody's Investors Service, 5 May 2000.

[4] Residential Funding Corporation, *Mortgage Data Report*, vol. 7, no. 12, p. 3, December 1998.

and losses was not specifically associated with alt-A pools. Since the early 1990s recession, the entire mortgage landscape, including documentation practices, has evolved substantially. In today's primary mortgage market, there is a spectrum of documentation options available to borrowers. The spectrum ranges from "full documentation" at one end to "no doc" loans at the other. In between, there are a nearly infinite variety of documentation options. It is worthwhile considering some of the more common ones:

Full Documentation: Full documentation loans refer to loans where the borrower documents his income, assets, and mortgage or rental history. The traditional device for documenting the income of an employed borrower is a written verification of employment (VOE). Various combinations of pay-stubs, W-2 statements (usually for two years), and tax returns also are considered full documentation. For self-employed borrowers, full documentation generally consists of tax returns and business financial statements.[5] Documentation of a borrower's assets generally consists of either (*i*) bank, mutual fund, and brokerage statements or (*ii*) a written "verification of deposit" (VOD) from the borrower's bank.[6] In some cases, full documentation standards also require written verification of the borrower's mortgage (VOM) or rental history (VOR).[7]

Alternative Documentation: The term "alternative documentation" is somewhat misleading. Alternative documentation refers primarily to the use of pay-stubs, W-2's, and bank statements instead of traditional VOEs and VODs. In today's primary mortgage market, pay-stubs, W-2s, and bank statements carry as much weight as VOEs and VODs and meet the requirements for full documentation loan programs.

Alternative documentation slightly increases the risk of fraud. Using a computer and a laser printer, a clever borrower can fabricate reasonably convincing pay-stubs, W-2s, and bank statements. However, the incremental fraud risk associated with alternative documentation is quite small. A borrower inclined to commit fraud might just as easily opt for a "reduced documentation" loan.

Reduced Documentation: "Reduced documentation" refers to situations where either a borrower's income or his assets are not fully documented. For example in a "stated income" loan, the borrower discloses his income. However, the lender does not verify the amount of income, though the lender might verify the source. In a stated income loan, the lender would verify the borrower's assets and would use the stated (unverified) income amount to calculate qualifying ratios. The following table summarizes some of the frequent permutations for reduced documentation loans.

Loan Documentation – Common Permutations

		Reduced Documentation						
Documentation Type	Full or Alternative Documentation	Stated Income	Stated Assets	Stated Income/ Stated Assets	No Income	No Asset	No Ratio	No Doc (NINA)
Income Disclosed	✓	✓	✓	✓		✓		
Source of Income Verified	✓	✓	✓	✓	✓[1]	✓	✓[2]	
Amount of Income Verified	✓		✓			✓		
Qualifying Ratios Calculated Based on Income	✓	✓	✓	✓		✓		
Assets Disclosed	✓	✓	✓	✓	✓		✓	
Assets Verified	✓	✓			✓		✓	

[1] "No Income" loans usually have a verbal verification of employment (VVOE)
[2] "No Ratio" loans rarely (but sometimes) have a VVOE

[5] Fannie Mae Single Family Selling Guide, Part X, § 101; Freddie Mac Single Family Seller/Servicer Guide, Volume 1, § 37.23(a).

[6] Fannie Mae Single Family Selling Guide, Part X, § 102; Freddie Mac Single Family Seller/Servicer Guide, Volume 1, § 37.23(b).

[7] Fannie Mae Single Family Selling Guide, Part X, § 104.

Some of today's reduced documentation loans are less risky than those of the late 1980s and early 1990s. The key difference is the selection process. Many of today's reduced documentation loans result from a *lender-driven* process rather than a *borrower-driven* one. Some of today's loan underwriting processes automatically offer reduced documentation to the most credit-worthy borrowers. Even though a high-quality borrower never requests reduced documentation standards, he may receive them in order to expedite the processing of his loan application.

In contrast, only borrowers who specifically sought reduced documentation loans received them in the borrower-driven process that dominated the late 1980s and early 1990s. A borrower-driven process still accounts for some portion of today's reduced documentation loans. Reduced documentation loans produced through a borrower-driven process arguably are riskier than other reduced documentation loans. We believe that alt-A pools contain a somewhat higher proportion of borrower-driven reduced documentation loans than do regular loan pools.

The incremental risk of borrower-driven reduced documentation loans stems from the possibility that a borrower has something to hide. A fairly common situation is one in which a borrower has substantial cash income that he does not report on his tax returns. However, such a borrower's true income can support a larger loan than could the level of income reported on his tax filings. The borrower's general lack of integrity is one factor that likely increases risk. A second factor is the possibility that the borrower's tax evasion or other illegal activity comes to light. In such a case, government action could impair the borrower's ability to make payments on his mortgage loan.

Borrower-driven reduced documentation loan programs arguably raise public policy issues. Such programs can be seen as encouraging or facilitating tax evasion by dishonest borrowers. If all borrowers were subjected to full income verification, certain borrowers would have an additional incentive not to cheat on their taxes. Although there are legitimate reasons why a borrower might seek a reduced documentation loan (*e.g.*, speed of processing, privacy, lost financial records, etc.), it is debatable whether those reasons would be sufficiently compelling to counterbalance the government's interest in properly administering the tax system. We are not aware of any proposed legislation to curtail borrower-driven reduced documentation lending, but we would not be surprised to see such legislation eventually surface.

No Ratio: A "no ratio" loan is one in which the borrower's assets are fully disclosed and verified. However, the neither the amount nor the source of the borrower's income is disclosed,[8] and the credit approval process for such a loan does not rely on qualifying ratios. Thus, in a no ratio loan program, a borrower can borrow more than he might otherwise be able to. No ratio loans are somewhat riskier than regular loans because the borrowers tend to be more financially stretched.

In contrast to a no ratio loan program, traditional lending guidelines use a borrower's debt-to-income ratio (DTI) as a measure of his capacity to repay a loan. Traditional guidelines for conforming loans specified that a borrower's monthly mortgage payment should not be more than 28% of his gross monthly income and that all the borrower's total monthly debt service (including mortgage, auto loans, credit cards, student loans and all other debt) should not be more than 36% of his gross monthly income. Although the traditional guidelines have declined in importance, they still have a role in underwriting many residential mortgage loans.[9]

No Doc (NINA): A "no doc" loan is one in which the borrower discloses neither his income nor his assets. Such loans are sometimes called "no income/no asset" loans or NINAs. No doc loans are the riskiest of all. No doc loans can be viewed as a natural and logical extension of reduced documentation loan programs. However, it is not appropriate to describe a no doc loan as simply a sub-category of the reduced documentation sector because documentation is entirely *eliminated*. A

[8] In a small minority of "no ratio" loan programs, the lender verbally verifies the source of a borrower's income. Such programs are essentially identical to "no income" programs.

[9] Fannie Mae Single Family Selling Guide, Part X, § 703; Freddie Mac Single Family Seller/Servicer Guide, Volume 1, §§ 37.15, 37.16; GMAC-RFC Client Guide, ver. 1-03-G02, Chap. 6A, § A602(F)(5).

lender making a no doc loan must rely entirely on the borrower's credit report and the value of the mortgaged property for underwriting the loan.

B. Occupancy Type

A second factor contributing to the credit impairment of many alt-A loans is the occupancy status of the mortgaged properties. A moderate proportion of alt-A mortgage loans are used to finance second homes (*i.e.*, vacation homes) or investment properties. Such loans are somewhat riskier than mortgage loans secured by borrowers' primary residences. A borrower in financial distress is more likely to default on a mortgage secured by a vacation home or investment property than he is to default on a loan secured by his primary residence. Foreclosure of a non-primary residence loan can hurt a borrower's credit rating and disrupt his life. However, the disruption would probably be much less severe than if the foreclosure is on his primary home.

Loans secured by vacation homes arguably are somewhat less risky than loans secured by investor properties. A borrower uses a vacation home himself. He has a natural incentive to maintain it so that he can enjoy it. He is also likely to develop a psychological attachment to the property and will endeavor to keep it even if his financial situation deteriorates. On the other hand, a vacation home is a luxury item, like a yacht or a fancy sports car. A borrower in severe financial distress naturally will sacrifice luxuries before necessities (such as his primary residence).

A typical borrower is likely to view an investment property in purely economic terms. His objective is to maximize the return on his investment. The borrower often will seek the greatest degree of leverage that he can get (*i.e.*, he will shop for a loan that permits the highest possible LTV) and he will spend as little as possible to maintain or improve the property. Accordingly, a borrower is not likely to maintain an investment property as well as he would maintain his primary or secondary residence. Additionally, the borrower's decision regarding whether or not to default on a loan secured by an investment property often is based on purely economic considerations. If the income from the property is not sufficient to cover the expenses of ownership (debt service, taxes, insurance, depreciation, etc.), the borrower is likely to strongly consider his option to default on the loan. Laws in some states limit a lender's ability to seek a deficiency judgment against the borrower. In such states, a borrower's decision regarding whether or not to default on a loan secured by an investment property is likely to be entirely cold blooded.

C. Other Alt-A Loan Features

Most fundamentally, pools of alt-A mortgage loans tend to have somewhat higher weighted-average LTVs and somewhat lower weighted-average FICO scores than contemporaneous pools of regular mortgage loans. The table below illustrates those relationships:

Comparison of Key Loan Characteristics, Alt-A vs. Prime

Vintage Year	**1998**	**1999**	**2000**	**2001**	**2002**
Alt-A Loans - Wtd. Avg. LTV	74.5	76.7	79.3	76.9	76.2
Prime Loans - Wtd. Avg. LTV	73.5	73.6	75.8	71.2	68.0
Alt-A Loans, Purchase - W.A. LTV	76.2	78.1	82.3	80.6	81.9
Prime Loans, Purchase - W.A. LTV	74.5	74.8	77.4	75.3	75.5
Alt-A Loans, Refinance - W.A. LTV		74.0	73.7	70.1	69.9
Prime Loans, Refinance - W.A. LTV		70.5	71.0	67.7	63.9
Alt-A Loans, Cashout - W.A. LTV	69.5	71.1	72.6	70.7	71.7
Prime Loans, Cashout - W.A. LTV	68.6	67.4	68.3	65.3	63.6
Alt-A Loans - Wtd. Avg. FICO	714	703	697	700	705
Prime Loans - Wtd. Avg. FICO	718	721	721	727	733
Alt-A Loans - Wtd. Avg. Coupon	7.92	8.12	9.07	8.26	7.47
Prime Loans - Wtd. Avg. Coupon	7.47	7.29	8.36	7.38	6.75
Source: Standard & Poor's					

Similarly, as shown in the last two lines of the table, pools of alt-A loans tend to have somewhat higher weighted-average mortgage interest rates than contemporaneous pools of regular mortgage

loans. Conventional wisdom used to hold that the interest rate on alt-A loans tended to be 0.75 to 2.00 percentage points higher than the prevailing rate on regular loans. Over time, the "alt-A premium" has declined. Today it is fair to characterize the alt-A premium as being in the range of 0.50 to 1.50 percentage points.

It is tempting, but ultimately futile, to frame a definition of alt-A mortgage loans based on their interest rate relative to contemporaneous conforming loans. The problem is origination points. At any time, the range of mortgage interest rates on newly originated conforming loans can span several hundred basis points. Some borrowers pay points to get lower interest rates on their loans. Conversely, a borrower may accept an above-market interest rate in order to receive "negative points" at the closing of his loan.[10] The same options are available to borrowers on alt-A loans. Thus, while it is fair to conclude that pools of alt-A loans generally have higher weighted-average mortgage interest rates than pools of conforming or jumbo loans, it is impractical to classify any particular loan solely based on its interest rate. However, it might be possible to identify an alt-A loan by capturing information about points or about the "annual percentage rate" (APR) disclosed to the borrower. For now, such approaches are impractical because the data is absent from most loan pool data files (tapes).

A variety of other features also contribute to the credit impairment and prepayment advantage of alt-A loans. As noted above, some of the loans permitted in alt-A programs are essentially the same loans that a lender would make through its regular programs, but with higher LTVs. The higher LTV loans naturally are riskier and harder to refinance than their lower-LTV counterparts. For example, one lender's regular loan program limits LTVs to 70% on conforming balance, cash out loans secured by non-owner occupied properties. The same lender's alt-A program permits LTVs of up to 95% on such loans.[11]

Taken together, all the foregoing factors represent, to greater or lesser degrees, barriers that inhibit the ability of alt-A borrowers to refinance their loans. Alt-A MBS counterbalance the increased credit risk of their underlying loans by having higher credit enhancement than regular MBS. The result is that alt-A MBS can have at least a temporary prepayment advantage without additional credit risk to investors.

IV. Alt-A Loans in the Larger Context

We can observe one dimension of the difference between alt-A mortgage loans and other mortgage loans by comparing the percentage levels of cumulative losses incurred on vintages of each type. The following table details cumulative loss levels reported by S&P:

Cumulative Losses Over Time (%)
for Alt-A, Prime, and Sub-Prime Mortgage Loans of Different Vintages

Performance Year	**1998**	**1999**	**2000**	**2001**	**2002**
1998 Alt-A 30-yr losses	0.0000	0.0040	0.0317	0.0809	0.1334
1998 Prime 30-yr losses	0.0021	0.0024	0.0064	0.0140	0.0238
1998 Sub-prime (fixed) losses	0.0100	0.2843	1.3605	2.2841	3.0891
1999 Alt-A 30-yr losses		0.0003	0.0208	0.1126	0.2397
1999 Prime 30-yr losses		0.0000	0.0014	0.0115	0.0273
1999 Sub-prime (fixed) losses		0.0036	0.3219	1.0952	2.0727
2000 Alt-A 30-yr losses			0.0017	0.0772	0.2521
2000 Prime 30-yr losses			0.0000	0.0097	0.0333
2000 Sub-prime (fixed) losses			0.0244	0.4633	1.6144

Source: Standard & Poor's

[10] A lender may induce a borrower to accept an above-market rate of interest by paying points to the borrower at the closing of a loan.

[11] Pacific Northwest Mortgage Corporation, Underwriting Matrix, http://www.loans2000.com/banking/matrix.pdf.

As shown in the table, at each point in time cumulative losses for each alt-A vintage are slightly higher than the losses for contemporaneous vintage of regular (prime) loans, but still much lower than the losses on the contemporaneous vintage of sub-prime loans. The natural result is that credit enhancement levels are higher for alt-A MBS than for regular jumbo MBS, but not nearly as high as for securities backed by sub-prime mortgage loans.

Alt-A MBS structures generally are modeled after those of ordinary jumbo MBS. Accordingly, subordination is the primary (and usually the only) form of credit enhancement in alt-A mortgage securitizations. However, a modest proportion of alt-A deals use lender-paid mortgage insurance policies as an additional form of credit enhancement. The use of such insurance causes a deal to have lower subordination levels than would otherwise be the case. Alt-A deals that use such insurance have the effect of "pulling down" the visible average subordination levels on alt-A deals. Even so, it is worthwhile comparing the average subordination levels for alt-A deals with those of jumbo deals. As shown in the following table, subordination levels for AAA-rated alt-A MBS tend to be nearly twice what they are for recent AAA-rated jumbo MBS:

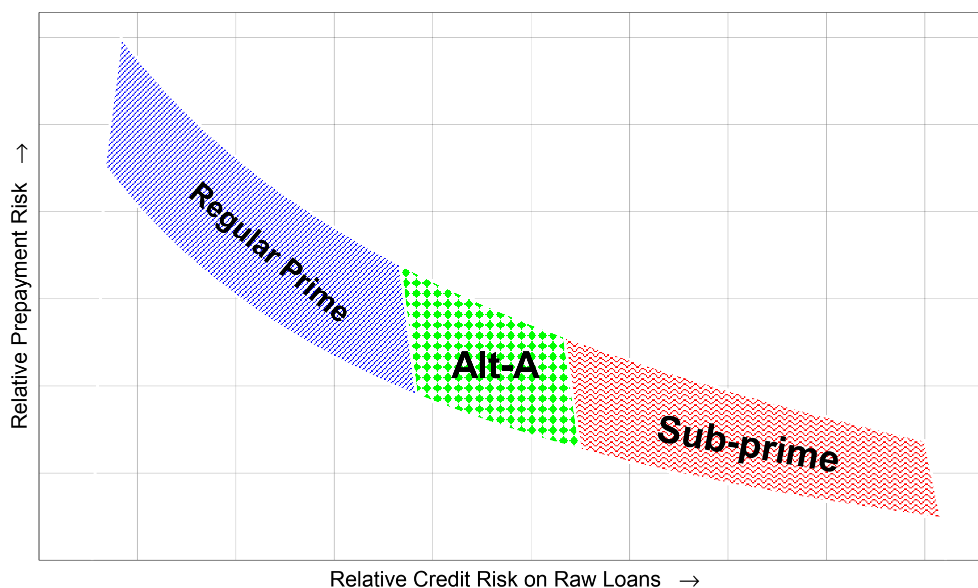
Avg. Subordination Levels for Alt-A and Jumbo MBS

Calendar Quarter	Alt-A Average "AAA" Subordination (%)	Jumbo MBS Average "AAA" Subordination (%)	Alt-A ÷ Jumbo
2001Q1	5.84	3.35	1.7
2001Q2	4.80	3.44	1.4
2001Q3	5.37	3.26	1.6
2001Q4	6.53	3.16	2.1
2002Q1	5.17	3.10	1.7
2002Q2	5.63	2.92	1.9
2002Q3	5.77	2.87	2.0
2002Q4	5.83	2.55	2.3
2003Q1	5.99	2.85	2.1

Source: Standard & Poor's

Based on their relative characteristics, historical performance, and credit enhancement levels, it is fair to conclude that alt-A mortgage loans occupy an area "in between" regular (prime quality) mortgage loans and sub-prime loans. However, the whole story is not so simple. The attributes of each product area place it in a distinct zone representing a combination of credit risk and prepayment risk. The essential appeal of alt-A loans is that they arguably represent a desirable locus in the area between the prime and sub-prime zones. The following chart illustrates the idea:

Chart 4: The Alt-A Sweet Spot in Credit-Prepayment Risk Space



V. Segmentation of Alt-A Pools

A recent development on the alt-A MBS landscape is the segmentation of loan pools into groups that emphasize particular loan attributes. For example, some deals have included loan groups that segment loans by original balance and by interest rate. Segmentation potentially could subdivide alt-A loan pools by documentation type, geographic concentration, and FICO scores.

Segmentation offers an investor the opportunity to purchase a security backed by loans that possess characteristics that the investor prefers. Investors with differing preferences can express those preferences by purchasing MBS backed by loan groups that feature different loan attributes.

The opportunity for investors to target specific alt-A attributes through segmented loan groups is reminiscent of specified pool trading in the agency MBS sector. There, investors can express preferences for low loan balance pools and for pools with concentrations of loans secured by properties in "slow refinancing" states.

So far, the only apparent disadvantage of segmented alt-A loan groups is that groups may be composed of small numbers of loans. For example, one recent alt-A deal was backed by slightly fewer than 1,000 loans and was divided into more than half a dozen groups. The groups ranged in size from more than 400 loans to fewer than 60 loans. Three groups had fewer than 100 loans. Investors who purchase securities backed by small numbers of loans should expect to experience prepayment volatility. If two or more loans are prepaid in a single month, the one-month CPR of such a pool can be extreme.

However, an investor can effectively diversify his exposure to prepayment risk across deals. By investing in securities from multiple deals, the overall prepayment speed that the investor experiences on his alt-A MBS holdings will be simply the weighted average of the speeds across all positions. In contrast to credit risk, which cannot be fully diversified across deals (because credit enhancement protection does not flow from one deal to the next), prepayment risk can spread across multiple deals without hindrance, producing a beneficial averaging and smoothing.

VI. The Future of Alt-A

The future of the alt-A sector is unclear. The GSEs have made major inroads by means of their automated underwriting systems: DU (Desktop Underwriter) and LP (Loan Prospector). Already, the GSE "encroachments" into the alt-A sector have severely blurred the once-sharp line that divided "conforming" mortgage loans from all others.

If the GSEs continue to expand their appetites for alt-A production, the impact would likely be felt most sharply in the area of conforming-balance loans at the high-credit-quality end of the alt-A spectrum. The remaining/surviving portions of the alt-A sector would be the alt-A jumbo area and the near-sub-prime area. While such developments might curtail the overall volume of alt-A-branded production, they could offer opportunities to investors. For example, Alt-A production that borders on sub-prime arguably has the greatest degree of prepayment protection.

VII. Conclusion

We have concluded our journey through the alt-A zone and returned safely. As it turns out, it really is not that mysterious or exotic. It is, however, a zone where credit risk and prepayment risk combine in a special way. Although the alt-A sector is hard to define, we identified a few key factors that appear in many alt-A loans: (*i*) less than full documentation and (*ii*) non-owner occupied properties. We saw that reduced documentation can take many forms, and we observed that today's lender-driven reduced-documentation process is likely to produce less-risky loans (from a credit perspective) than did the borrower-driven environment of the late 1980s and early 1990s. We compared some characteristics of alt-A pools to those of other pools and found that alt-A pools were positioned right where they ought to be: in-between pools of regular loans and pools of sub-prime loans.

The basic alt-A advantage is a temporary suppression of refinancing activity by the borrowers. On top of that, the relatively new practice of segmenting alt-A loan pools into groups that feature specific loan attributes offers investors the opportunity to fine-tune their strategy in using alt-A MBS to moderate prepayment risk in their portfolios. The incrementally higher credit risk of alt-A loans – that is, their credit impairment – is the key to their prepayment advantage. Higher credit enhancement levels in alt-A deals counterbalance the higher credit risk while allowing investors to seize the prepayment advantage.

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