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Borrower Grades and Doc Standards: Distinguishing the "Stellar" and the "Full" in RMBS, Part 1

Two subjective characteristics affect default rates in RMBS: borrower grades and documentation programs. Although objectively created by the application of rules within a lending institution, these variables are subjective in use. Each is open to interpretation because each condenses a complex set of rules into a single statistic used outside of the lending institution by users without first hand knowledge of the rules by which and the "credit culture" under which it was determined. "Non-lender" users of these codes (among them, conduit, insurer, investor, and rating agency) use the codes to understand default risk. In practice, one lender's "Stellar" borrower and another lender's "B" may represent the same default risk under different labels.

It is cumbersome to compare across many programs and lenders. To cope, non-lenders have established translations, but defining a robust map is not an easy task for two reasons. First, performance data is noisy. Today's "Stellar" borrower will not necessarily resemble last year's if underwriting guidelines change. Second, equating guidelines (so that similar guidelines carry the same label) requires an understanding of how much data granularity matters (or exists). With doc standards, for example, is a program that requires six bank statements to provide proof of income marginally or fundamentally less risky than a program that requires four? A statistical study of this magnitude, with a large enough sample of mortgages and individual component data (e.g., number and type of delinquencies for borrower grade analysis or number of weeks covered by pay stubs for doc analysis), is not feasible because this level of detail has never been routinely or extensively collected.

Despite noisiness of and gaps in the data, borrower grade and doc type are useful in predicting default rates and DBRS has included both in its RMBS model. The question now becomes, what is a reasonable map with which to equate borrower grades and doc codes for all originators? The remainder of this article (given space limitations) will focus on borrower grades. Next week's will address doc types.

DBRS generally uses the following rules to standardize borrower grades. An "A" borrower has been not more than 1 x 30 days delinquent within the past year and has no bankruptcy or foreclosure within the past seven years. An "A-" borrower has been perhaps as much as 2 x 30 days delinquent but not 60 days delinquent and has no bankruptcy or foreclosure within five years. A "B" borrower may have been 1 x 60 days delinquent and has no bankruptcy or foreclosure within two years. A "C" borrower is a borrower who has been more than 1 x 60 days delinquent and who may have declared bankruptcy or suffered a foreclosure within the past year.

Informed judgment is required to analyze program differences. To the extent that guidelines offer different mixes of allowable delinquencies, recency of bankruptcy, or other features, an analyst must review available performance data or, if there is no reliable data, make a thoughtful judgment based on performance that is known. Should one lender's "A-" program with 2 x 30 days permitted but a max allowable DTI ratio of 28% equate to another lender's "A-" program with only 1 x 30 days but a max 35% DTI? The answer lies in analysis of what is permitted, what is actually underwritten, and how the collateral performs.