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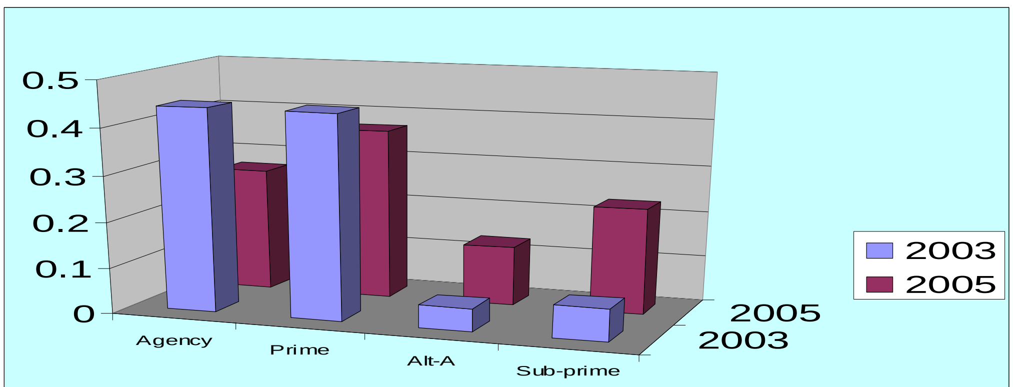
Topic of the Month: Shrinking A Credit Production

Excerpt from Compass Analytics July 2006 *Month in Review*

The mortgage industry has witnessed a dramatic decrease in A-Credit market share over the last several years. As the graph below illustrates, Agency production lost 17 points (or a whopping 38%) and Prime 7 points (or 16%) from 2003 to 2005:



	Agency	Prime	Alt-A	Sub-prime
2003	0.44	0.44	0.05	0.07
2005	0.27	0.37	0.13	0.23

Source: Lehman Brothers, Compass Analytics
How do we explain such market share decline?

- Are Non-Prime rates lower than Prime?
- Are Agency loan limits not keeping pace with housing values?
- Are recent borrowers less creditworthy – investors less risk adverse?
- Is it the interrelation between “affordability” programs and recent HPA (House Price Appreciation)?
- Are Non-Prime loans easier to originate and/or more profitable for lenders and LOs?
- Is it a combination of the above?

First, are Non-Prime rate lower than Prime? No! Although Subprime 2/28 – Alt-A 3/6 rate spreads are at historic lows – lower credit quality still commands higher yields.

Next, when we look at average loan sizes for Alt-A and Subprime production, although average loan amounts have crept up, both averages are still well south of current Agency maximums (SFR 417K).

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Next, are recent borrowers simply less creditworthy? In other words, are droves of borrowers buying houses/borrowing money that in previous years would not have had access to loan programs meeting their credit scenario? If that was the case wouldn't we expect to see newer Non-Prime production credit statistics suffer? First blush data belies the hypothesis:

	2003	2005	Change	Creditworthiness
FICO	686	684	-2	Less - Minor
% < 660	35	36	1	Less - Minor
LTV[1]	73	76	3	Less
% > 80%	20	16	-4	More[1]
DTI[2]	37	38	1	Less - Minor
% > 45%	12	9	-3	More[2]
Lim/No Docs	33	48	15	Less

1. Does not capture impact of 2nds on CLTV
2. DTI based off of initial payments (including IO, Neg Am)

Source: Lehman Brothers - Includes Jumbo, Alt-A and Subprime

A second look at the same data with special emphasis on affordability programs paints a little different picture.

	2003	2005	Chg Pts	Chg %	
Simultaneous 2nds	6	27	21	350	
Interest Only	16	34	18	112	
Negative Amort.		1	26	25	2500
Investor		10	15	5	50
ARMs	21	48	27	129	
2/10 Slope (bps)		230	20	-210	

Source: Lehman Brothers

When we look at affordability programs, e.g. Simultaneous Seconds, Interest Only, Negative Amortization, Option ARMs, ARMs in general, and 40-year loans, we see that these types of programs have indeed grown dramatically. Simultaneous 2nds do point to a worsening in credit as LTV statistics above do not consider CLTV credit impact. Interest Only and Neg-Am loan programs promote front-end affordability at the expense of payment resets at a later date. Investor loans reflect a loan production by-product of favorable HPA and ARMs and have more than doubled market share even though the yield curve flattened 210 bps during the same period! So these loan features, more widely available and/or marketed in Non-Prime loan products have exploded in market share and contributed significantly to Prime/Non-Prime market share shifts. The question remains to what extent the popularity of affordability programs and current Prime/Non-Prime market shares are dependent on HPA assumptions.

Finally, one additional explanation provides some understanding to market share shifts - profit margins. Despite sharp contraction in profit margins from 2003 to 2005 across Agency, Prime, Alt-A and Subprime loan production, Agency/Prime profit margins were and remain 1/3 of Alt-A/Subprime profit margins. *–Rob Kessel*