

The Week that Was

Are all securitizations equal?

The difference between a medical doctor and bank portfolio manager is that a medical doctor can bury his mistakes ... or at least so goes the saying. However market events lead me to believe there is far more similarity between the two professions than conventional wisdom would imply. Recent articles in the press and dealer research suggest that most of the bad news surrounding the US mortgage market has by now been made public. As a result, asset prices seem to be stabilizing and, if we use the ABX as a proxy, some sectors are even improving. This news is being used to imply that bank mortgage portfolio related mark-to-market losses have been fully disclosed and that by extension financial asset prices are now attractive.

However it does not appear that the prognosticators are considering the effect of mortgages or securitization tranches kept in bank held-to-maturity portfolios or the costs of dealing with foreclosures and REO portfolios. They also don't seem to be factoring into their calculations retail or high net worth investor products based on US mortgage risk which, as rumours have it, are being quietly taken back on selling bank balance sheets in order to placate threatening investors.

These various problems are likely to be kept quiet and place a drain on bank earnings for years to come. Perhaps more importantly keeping these events quiet will mask the real cost of the US mortgage crisis. It would appear that the bank portfolio managers have taken a page out of medical school text books.

Considering the preceding, many traditional investors in securitized mortgage product are likely to be facing the need to deploy capital to enhance lagging earnings. However, at the same time they are experiencing a great deal of stress over how to differentiate which mortgage products are emanating a quiet tick tock like sound and which provide real value. This is also a recent theme in dealer research reports suggesting the key to investing today is differentiation of collateral.

Has it really taken an unprecedented bear market set off by excess capital chasing more and more marginal US borrowers for the market to realize that not all securitizations are equal? I don't think so but the dealer community seems to want to make this case. Of course dealers able to convince investors that their inventory has the best assets are helped out of potentially bad positions and definitively over extended trading books.

Identifying differences in assets and behaviour has always been the key to investing. Our sole purpose at SCR is identifying the existence of and reasons for these differences.



Mike Chacos
Managing Partner

Note: From time to time we will post these musings from various people within SCR. Feedback on these posts is encouraged and we'll look to place your comments in later issues in the hopes of stimulating some healthy debate.

ABX Commentary

The recent performance of ABX has been rather dull. The steep declines of March and subsequent rally through the April has been against a back-drop of extremely thin volume from both retail and the Street. In contrast to its recent history, ABX has been quite resilient to negative news with each of the indices seemingly finding a new equilibrium.

ABX HE AAA Performance



Certainly remittance reports which were released on Friday the 25th will be watched with interest but the actual impact of the results is likely to be minimal regardless of how bad the results are. We at SCR are still looking for an inflexion point in roll rates to 60 plus delinquencies and also looking to see how voluntary prepayment rates perform at loans in the 06-2 index experience their first rate reset.

In the News

Rating Agency Actions: Moody's- more aggressive than S&P by FAR

Moody's, which we noted had started aggressively downgrading previously highly rated subprime bonds in early April has not slowed in the past two weeks but rather accelerated. Since the 11th of April over 400 individual bonds have been downgraded or placed on negative watch. The average downgrade is to an A1 rating, or over 4 notches. Twenty-two bonds were downgraded below investment grade, worrying trend given that Moody's have given no indication that they have completed their review.

Although as we have mentioned previously, Fitch had led the way in downgrading AAA subprime mortgage bonds, the actions of Moody's have far more serious implications due to their far broader coverage of the subprime universe. Many institutional holders of AAA bonds will now be forced sellers which should place downward pressure on prices. We remind potential investors that although these bonds may no longer hold AAA ratings due to the poor performing collateral, structurally they still offer the same protections afforded to any AAA bonds. With such a wholesale move opportunities undoubtedly exist for the diligent investor.

S&P also released a report on the 24th of April updating their loss projections for bonds issued in the first half of 2007 from 17.30% to 23%. This brings S&P's estimates for 2007 more into line with Fitch who in March stated that they expected losses of 23% and 28% for the first two quarters of 2007.

Remit Reports Released

Remit reports in April provided increasing evidence that the Fed rate cuts together with anticipation of Bush's emergency tax rebate have had an impact on borrower delinquencies. All indices experienced a deceleration in 60+ delinquencies. The WALA on ABX 06-2 has reached 28 meaning we should expect voluntary prepayments to have peaked (absent any wholesale refinancing plans discussed below) at around 18 CPR. Accelerating liquidations have meant that involuntary prepayments have started to play an increasing role in overall prepayments contributing between 5 and 10 CPR. Severity was also steady at or around 50% for 06-1, 06-2 and 07-1 and 57% for 07-2. From our perspective the net impact is a slight positive and should provide some support for the recent price stabilization we have seen in ABX.

H.R. 5830 Housing Stabilization and Homeownership Retention Act of 2008

Debate began last week in the House Financial Services Committee around Democrat Barney Frank's \$300 billion program to refinance troubled borrowers. The Bush administration has come out strongly against the plan saying it would weaken the FHA's underwriting criteria and force the agency to take on more risk. House Republicans also strongly opposed the bill, calling it a bailout at homeowner's expense. The bill is expected to go to vote this week. Even if it does pass, successful implementation is a significant challenge for legislators. Hope Now has been a definite failure which doesn't bode well for Frank's plan.

Case-Shiller Down 12.7% YOY

House price depreciation accelerated in February according to the S&P/Case-Shiller Index which announced on Tuesday (30th April) the largest monthly decline on record. Prices were down 2.7% in February, up from 2.4% in January leading to year on year change on 12.7%, 0.7% worse than a Bloomberg survey which had predicted a decline of 12%. The worst areas were Las Vegas, down 23% and Miami, down 22%. Charlotte, NC was the only city out of the 19 comprising the index showing a gain.

RealtyTrac also released a report Tuesday detailing nationwide foreclosure rates. Year-on-year foreclosure rates more than doubled with Nevada having one in every 54 households in default or foreclosure. California was second but had the most filings as well as 6 of the worst 10 metropolitan areas.

Lastly, the U.S. Census Bureau reported a homeowner vacancy rate 2.9% for the first quarter of 2008, an all-time high (records began being kept in 1956). The rental vacancy rate reached 10.1%, up from 9.6% in the previous quarter.

Macro Picture

New Home Sales

New home sales dropped by 8.5% in March, falling to an annual pace of 526,000. Economists surveyed by Bloomberg had predicted a smaller drop to an annual pace of 580,000 with the minimum forecast of 560,000. The median price of a new home dropped by over 13% year-on-year. This was the biggest decline since July 1970 and means that at current prices the supply of unsold homes is now 11 months, the most since September 1981.

These are by far the worst housing data we have seen since the beginning of the current

housing crisis. It appears there is still a long way to go before this market finds a bottom.

U.S. Unemployment and Durable Goods

In contrast to the awful housing data, U.S. unemployment and durable goods data was marginally positive. Initial jobless claims unexpectedly fell to 342,000 for the week ended April 19. Payrolls were negative but only marginally worse than January or February at a loss of 80,000 workers.

Orders for durable goods also increased by more than forecast last month as the weakening dollar appeared to stimulate demand from overseas. In contrast to the housing market, the manufacturing sector is holding up reasonably well which may explain why we haven't seen the unemployment rate spike as has been observed in previous recessions.

U.S. Consumer Confidence Falls to 26 Year Low

U.S Consumer Confidence fell last month to 62.6 down from 69.5 in March and an early forecast level of 63.2 from April 11. With oil prices reaching new highs at over \$120/barrel and keeping inflation elevated at 4% year-on-year, a housing market which shows no signs of bottoming out and unemployment rising the concern of consumers appears well founded.

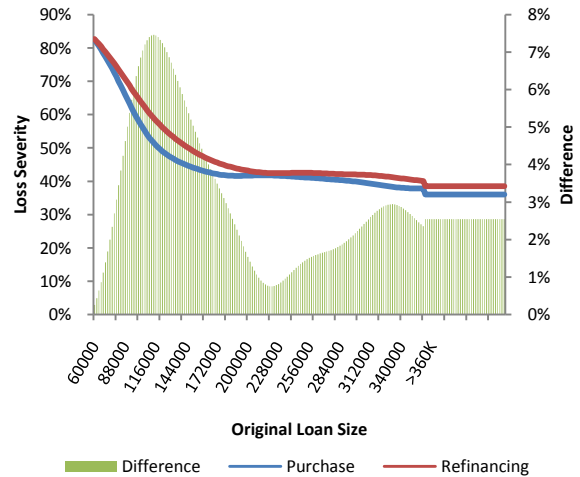
Quant Corner

With 60+ delinquencies and voluntary prepayments having slowed from their respective increases and default rates starting to ramp up our quants have been devoting an increasing focus to the severity of loss. With so much uncertainty around HPA it is imperative to understand the other drivers of severity which

can contribute equally if not more to the eventual loss on a mortgage.

One issue we have paid particular attention to is the potential for appraisal fraud. Appraisal fraud has the potential to increase severity beyond what one would expect using a pure HPA and fixed cost of default approach to modelling loss severity. To investigate this, we have compared loss severity for purchase loans to refinanced loans. If appraisal fraud is prevalent we would expect the loss severity to be higher on the refinanced loans as they have the opportunity to use a valuation on the property which is not based on a specific transaction but rather a market-based estimate of property value.

The below chart shows the loss severity for first lien loans that defaulted over the last six months. It shows at all loan values, the loss severity on purchased loans is lower than the loss severity on refinanced loans.



Interestingly however, the difference is not constant, peaking at a loan size of around \$120,000 and declining thereafter. This may indicate that most appraisal fraud around refinancing was concentrated at the lower loan sizes where increasing the value of the property by \$10,000 or more would have a greater incremental impact on the resultant loss severity.

SCR View

With U.S. earnings season in full swing the equity market has rallied and with it albeit with less impetus credit markets have also rallied. In the ABS space a number of large lists have traded, and traded reasonably well. Despite increasingly bearish technicals, investors are beginning to look rationally at structure and concluding that most 2005 and 2006 vintage AAA's will be very hard to break regardless of any government intervention.

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