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Report from Orlando 2007:
Coverage of Selected Sessions of ABS East 2007

12 November 2007

by Mark Adelson

Introduction

The general mood at last week's ABS East 2007 event in Orlando was somber. According to some estimates, attendance at the event was roughly 1,500, far below the typical level in recent years.

The dominant theme was the sub-prime mortgage situation. The consequent problems in the ABS CDO and SIV sectors also received much attention from delegates. The concerns expressed by participants at last year's event all seem to have come home to roost.

Much discussion centered on the subject of what went wrong. Panelists in some sessions disagreed about whether the primary cause of the sub-prime troubles is home prices or lax lending standards. Arguably too little discussion focused on how to prevent or dampen similar episodes in the future. Maybe that will come at the next major securitization industry event.

The following summaries reflect remarks of the panelists who participated in selected sessions at the conference. For the most part, the summaries have been drawn from notes taken during the sessions. The summaries have not been reviewed or approved by the panelists. While I have tried to capture panelists' remarks accurately, I apologize in advance for any inaccuracies and omissions. In addition, I wish to acknowledge the excellent work of Information Management Network in organizing and hosting the conference.

The following summaries do not necessarily reflect the views of Adelson & Jacob Consulting, LLC or its members.

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Sunday, 4 November 2007

2:00pm – Reg AB Compliance: Status Check

Issuers and servicers have received various comments from the SEC about their 10-K filings. The SEC staff is reviewing '34 Act filings on a random basis. Most comments have focused on annual 10-K filings, rather than on monthly reports or 8-Ks.

The servicer for a deal does not have to obtain separate assessments of servicing compliance from vendors if the following conditions are satisfied: (1) the vendor is not a "servicer" within the meaning of Reg AB, (2) the servicer has and applies policies and procedures to monitor the vendor's compliance with the servicing criteria, and (3) the servicer takes responsibility for the vendor's compliance with the servicing criteria.[1]

The SEC staff has questioned why some servicers have omitted certain servicing criteria specified in Item 1122(d) from their filings. If a servicer does so, it must explain that the specified criteria are not applicable and not required under the transaction documents.

If a servicer reports a material non-compliance with the servicing criteria, the staff wants to know whether it has been corrected. The staff also wants to know if the issuer (*i.e.*, the entity that issued the ABS that are the subject of the filing) was affected by the non-compliance or if the non-compliance affected only assets outside the issuer.

[1] SEC Division of Corporation Finance, Manual of Publicly Available Telephone Interpretations, Regulation AB and Related Rules, Interpretation No. 17.06, http://www.sec.gov/interps/telephone/cftelinterps_regab.pdf.

Certifications by management required under the Sarbanes-Oxley Act must follow the prescribed forms exactly.[2]

If the correct answer to a reportable item is "none," the response should not be "not applicable."

The staff has made it difficult for ABS issuers of deals where the servicers have gone into bankruptcy where the issuer, therefore, cannot supply the required assessment of servicing compliance. So far, the staff has insisted that each issuer in that situation seek specific approval or waivers. However, there has recently been some indication that the staff may grant blanket waivers covering certain servicers that went bankrupt. Some members of the staff feel that if an ABS issuer cannot obtain the assessments, its annual 10-K filing is necessarily defective. On the other hand, many members of the private bar feel that Rule 12b-21 applies and that the filing should not be deemed defective because of the inability to get something that cannot be obtained without unreasonable effort and expense. The problem of bankrupt servicers is likely to become very significant for filings in the near future.

One panelist feels that changes are needed in the Reg AB process. First of all, there are traps; ABS issuers are vulnerable to actions or omissions by third parties. For example, a major servicer experienced a reportable event and filed an 8-K for its own deals. It did not inform the aggregators for which it acted as a third-party servicer, and all those aggregators were late in filing required 8-Ks. Now the aggregators have difficulties with their shelf registrations.

There is a related issue with respect to swap providers. Most deals provide for termination or replacement of the swap before there would be a requirement to report on the financial condition of the swap provider.

<u>Static Pool Data</u>: Web-based access to static pool data must provide unrestricted access free of charge and data must remain available for five years.[3] The issuer must decide what information is material.

There are still open issues regarding static pool data: materiality… requirements for providing third-party static pool data… hardship exemptions… updating data.

Some issuers have violated Reg AB requirements by (1) failing to indicate the specific deals for which data is provided, (2) removing the web site that contains the data (it must persist for five years), or (3) changing the "prospectus" data over time (*i.e.*, the data on the website was altered from the data that was originally there when the prospectus for the subject deal was finalized).

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[2] SEC, *Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, Release Nos. 33-8238, 34-47986, IC-26068, 68 Fed. Reg. 36636 (18 Jun 2003).

[3] Regulation S-T, Rule 312, 17 C.F.R. § 232.312.

3:30pm – The Evolution of SIVs: Structural Innovations and Management Strategies in a Challenging Environment

SIVs originally were envisioned as highly diversified vehicles that would be more closely match-funded than today's SIVs actually are. The global glut of investment capital prompted some SIVs to concentrate their investments too heavily in certain areas, such as sub-prime mortgages. SIVs need to re-invent themselves in order to regain investor confidence.

Another panelist asserts that the SIVs encountered a "perfect storm." In theory, the level of backstop liquidity lines, combined with the SIVs' highly rated status, *should* provide them with sufficient liquidity to survive. However, because of investor worries, SIVs have encountered an inability to sell commercial paper (CP) and that inability has persisted for a period of unprecedented length. Investors did not receive complete information about what was being financed through the SIVs and, accordingly, they pulled away from the market. Naturally, because SIVs are market-value structures, they encountered pressure to sell assets when they could not issue new liabilities. Although the SIV assets had not suffered severe fundamental deterioration, the market values of the assets were depressed.

Bid-ask spreads for structured finance assets have become very wide. This is clobbering the SIVs that are forced to sell assets.

U.S. and U.K. SIVs have several differences. Some U.K. SIVs have passed through stages of enforcement and have had receivers appointed. The security trustee for such a SIV convenes a meeting of all the senior creditors. Prior to "insolvency," there is a temporal subordination of a SIV's medium-term notes (MTNs) to its CP. A further issue is whether insolvency is determined on the basis of cash flow (the ability to meet its obligations as they come due) or balance sheet (when the value of liabilities exceeds the value of assets). The ability to bring an action against an SPV is different under U.S. and U.K. law. It is easier to attack an SPV under U.S. law than under English law, because a non-petition covenant may not be enforceable under U.S. law.

Capital note investors (*i.e.*, investors who have purchased a SIV's subordinated notes) in some SIVs are being asked to put up additional capital for restructuring the SIVs. The problem is that doing so may amount to throwing good money after bad.

One panelist asserts that most of the SIVs would have a triple-A likelihood of repaying all their senior liabilities if they can extend the term of their liabilities. A second panelist agrees, asserting that most SIVs have just a liquidity problem rather than a credit problem.

This is not the first time that the SIV market has had trouble. Junior creditors in the SIV market have lost money before. Part of the evolution of the market was to change structures to be less harsh on the holders of junior debt.

Parties to the SIVs are scrutinizing documents to determine the circumstances under which debt can be accelerated.

SIVs differ significantly in their operating manuals and in the methods that they use for valuing their assets. SIVs also differ in their capital models; some use full-blown Monte Carlo

simulations and others do not. SIVs differ in how closely their capital models track or conform to the rating agency capital models.

The $64,000 question is whether the market-value paradigm upon which SIVs are based is a viable construct. The fact that the SIVs could survive if they could delay the repayment of their liabilities essentially fails to address the core problem of using a market-value paradigm for supporting their senior liabilities.

4:15pm – Credit Analytics for Mortgage Investors

Last year's version of this session was held in a very different environment. Today, many market participants are questioning the value and relevance of models. The three big points are: (1) the mortgage and asset-backed markets are fundamentally based on the performance of the underlying borrowers, (2) models should be based on a combination of past data and judgment, and (3) different borrowers have different incentives and behave differently.

Last year, as the nature of the loans changed, it changed the performance that the loans would later achieve.

A borrower faces three choices: make his payment, prepay his loan, or default. Mortgage investors need to analyze both prepayments and delinquencies/defaults. A new wrinkle on today's mortgage landscape is that borrowers can get modifications of their loans only if they are delinquent by two months or more. This is prompting some borrowers to become delinquent even though they could afford to pay. A surveillance issue on which market participants should focus is whether seriously delinquent borrowers are making payments on their loans.

Market participants can gain insight by considering the incentives facing mortgage loan originators. Some investors backed away from deals by originators that had made themselves vulnerable to funding squeezes.

In 2001 and 2002 there were no early signals that loans were performing poorly. That was not the case in 2006 and 2007, when poor performance appeared within a year after the deals closed. In addition, the later deals had higher proportions of second lien-loans and higher average loan-to-value ratios (LTVs).

Every model involving mortgage loans is a mix of theory and data. A good model is one that makes sense in theory, but is still consistent with the observed data. A poor model is one that ignores the data or that is based on a deficient theory. The theory of why loans prepay is fairly well developed. However, the theory of why loans default is not as fully developed. Most mortgage loan default models are based on fitting the data but they do not have solid underlying theories. A delinquency/default theory based on a homeowner's equity does not sufficiently explain the performance difference between prime and sub-prime loans. It is necessary also to consider the borrower's ability to pay.

The data behind many of the models was based on a distorted market environment that has persisted for most of the past 10 years. In addition, there is a strong possibility that data about home values and borrowers' ability to pay became unreliable from late 2005 to the present.

The housing bubble motivated some borrowers to become real estate speculators; they became homeowners for the main purpose of trying to capture home price appreciation.

"Numbers-based underwriting" seemed to replace traditional underwriting. This was arguably a very damaging shift in business practices. The process of underwriting loans should be primarily about ***validating*** numbers rather than simply ***collecting*** them.

Historically, "low doc" loans performed nearly as well as "full doc" loans. More recently, low doc loans are displaying roughly twice the level of delinquency as full doc loans. This is likely a reflection of how low doc loans are more frequently used for lying and for telling bigger lies than in the past. Instead of being for self-employed borrowers (who may want to lie to the IRS), low doc loans are more frequently for W-2 borrowers who want to lie to their lender.

Simply using an old model in today's environment would be folly. The better approach is to use the theory behind a model to guide adjustments to the model.

Even the pundits who predicted trouble as far back as three years ago did not anticipate the strength of the negative feedback loop or the degree to which controls on risk in the whole origination process would break down.

5:00pm – ABS Secondary Market Pricing Transparency: Is It Time for TRACE?

Arthur Levitt, former Chairman of the SEC, believes that TRACE[4] should be extended to cover MBS and ABS. The U.S. system of securities regulation rests on disclosure rather than on merit regulation. The same arguments against applying TRACE to MBS and ABS were applied to oppose the original adoption of TRACE in the corporate bond market. Some argued that increasing transparency would kill the corporate bond market. Obviously, TRACE did not kill the corporate market. TRACE can bring the same benefits to the MBS-ABS sector that it brought to the corporate bond market. It can foster competition to lower costs and promote fair dealing. The benefits of transparency far outweigh any costs.

TRACE was launched on 7/1/2002. Starting on that day, all OTC trades in corporate bonds were reported through the system. Trades are supposed to be reported within 15 minutes, but most are reported within five minutes, and many within one minute. The release of reported trades to the public was phased-in over a three year period. Transactions over $5 million in investment grade bonds are reported as $5 million+ and trades over $1 million on junk bonds are reported as $1 million+. Trace data includes trade time, price, and yield. FINRA[5] sees no empirical evidence of damage to the market from implementing TRACE. About the same

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[4] TRACE stands for "Trade Reporting and Compliance Engine." It is the system for collecting and disseminating information about over-the-counter secondary trades in fixed income securities. So far, TRACE applies only to corporate debt securities.

[5] FINRA is the Financial Institution Regulatory Authority. It was created in June 2007 through the consolidation of the regulatory functions of the NASD and the NYSE.

number of dealers effect trades each day as did at the inception of TRACE. The percentage of large trades has increased slightly since the inception of TRACE.

Data from the initial implementation of TRACE showed that the secondary market was much more liquid than most market participants had believed. The number of trades, the number of trading entities, and the dollar volume of trading activity were all much larger than had been anticipated. Interestingly, TRACE also revealed that the retail marketplace was much more active than professionals had believed. About 65% of the activity (by number of trades) was retail-sized transactions.

Academic research concludes that TRACE facilitates improved price discovery by promoting price competition (among dealers) and, therefore, investor confidence. It improves regulatory compliance and encourages broader investor participation in the market. *Potential* costs of TRACE include motivating some dealers to leave the market or decreasing their willingness to take principal positions. Execution costs (*i.e.*, the bid-ask spread) for TRACE-eligible bonds declined by 50% following the implementation of the system. Interestingly, execution costs for non-TRACE-eligible bonds declined by 20%. Other studies confirm that trading costs are lower for TRACE-eligible bonds. One study shows that TRACE had less impact on triple-B bonds and on less-actively traded bonds.

On the other hand, there are arguments against extending TRACE. TRACE was created by the regulatory community even though there was no perceived market failure that triggered the creation of the system. Additionally, while there is retail participation in corporate bonds, there is virtually no retail participation in ABS. The number of MBS/ABS CUSIPs is much larger than the number of corporate CUSIPs. Of the TRACE bonds that traded in 2006, most traded four times per day. The academic studies focus on the bid-ask spread as the main measure of liquidity. Possibly a more meaningful measure would be how long it takes to enter or exit a position. Some investors feel that TRACE has made the high-yield market more difficult because dealers are less willing to commit capital and it takes longer to sell bonds.

Monday, 5 November 2007

8:45am – Industry Leaders Speak Out: Predictions for the Short and Medium Term for the ABS Market (General Session)

"When the winds of change blow hard enough, the most trivial of things can become deadly projectiles." "It's always darkest just before it goes pitch black."[6]

The predictions of the last year's opening panel at ABS East 2006 were as follows: volume would be down 10%, spreads would be flat, consumer health would start to decline, and the CDO sector would be able to withstand mortgage issues.

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[6] The moderator introduced the session with selected quotes from products designed by Despair Inc. http://despair.com/viewall.html

This year's panel described the troubles that the ABS market experienced this summer as a "staggering punch" (4 on a scale of 1-5). One panelist notes that two CEOs of major firms (Merrill and Citi) have been removed. Five heads of fixed income have been removed. The credibility of securitization is being tested. Fundamental questions, such as the validity of the "originate to sell" model, are being asked. The most surprising event of the summer was the 90-day T-bill auction, because the market did not know where rates were, even for T-bills. Another panelist agrees, observing that the sub-prime sector sparked a contagion that spread through other areas. The rate of deterioration of sub-prime loans was unexpectedly fast.

Another surprise was the dislocation of the ABCP market. Panelists expressed a wide range of views about what happened in the ABCP market. One panelist felt that the inability to roll ABCP proved that the programs were generally structured appropriately, with 100% A-1+/P-1/F-1 liquidity support that enabled them to repay maturing ABCP. It is surprising that investors fled such programs, but the programs were able to pay their obligations. With Basel II[7] coming, and the reduction of the "arbitrage" between credit enhancement and liquidity facilities (*i.e.*, the lower regulatory capital requirement for liquidity facilities), more ABCP program sponsors may seek to use alternative or structural liquidity. Extendible ABCP programs are not likely to need restructurings because they are essentially dead in the water. Investor appetite for extendible ABCP has completely disappeared.

The ABCP portions of SIVs (*i.e.*, CP issued by SIVs) are a completely different story. The ABCP portions of SIVs are not fully protected against market value risk. When the ABCP investors fled the market, the amount of time that SIVs had in which to liquidate their assets got shorter. Some SIV ABCP has already defaulted. Some SIV sponsors are examining ways to reduce or eliminate liquidity risk in their programs by adding liquidity facilities for the ABCP similar to what the bank-sponsored conduits have. Some SIVs have already entered receivership.

Another panelist notes that the ABCP market should be viewed as being composed of separate pieces. The bank-sponsored multi-seller conduit sector is moving toward more disclosure and more transparency. Pricing is returning to pre-crisis levels. Other areas of the market, including non-bank programs, extendible programs, and SIVs, have tougher issues. Some of those areas will need to change to survive, if they can survive at all. Asset originators are focusing increasingly on viable long-term funding strategies rather than just looking for the cheapest short-term solutions.

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[7] Basel II refers to the internationally agreed upon framework for bank capital standards. U.S. bank regulators are in the process of preparing regulations to implement the Basel II framework in the U.S. Some aspects of it have already been adopted. A key feature of the Basel II framework is that it bases the capital requirements for banks on the credit ratings of the assets that the banks hold. The sub-prime mortgage situation and its fallout in the ABS CDO and SIV sectors has caused some market participants to question the reliability of rating agency ratings. That loss of confidence calls into question one of the key underlying premises of the whole Basel II framework.

On November 1, the Office of the Comptroller of the Currency announced that it had approved the final version of the rule for implementing key features of the Basel II framework. http://www.occ.gov/ftp/release/2007-123.htm. The Federal Reserve also has made a similar announcement. http://www.federalreserve.gov/newsevents/press/bcreg/20071102a.htm.

Most panelists feel that the SIV market will either shrink dramatically or will cease to exist in its current form. One panelist feels that the SIV market can survive, but that it will be smaller than it was before the summer. In addition, transparency needs to improve so that investors can tier their pricing of different SIVs. Another panelist has a much darker outlook. He compares a typical SIV to Annaly Mortgage (a mortgage REIT). He asserts that SIVs use 20:1 leverage, take credit risk, and fund themselves primarily with short term liabilities.[8] In contrast, Annaly takes no credit risk and has leverage of only 10:1. That makes no sense. The structured finance world needs to de-lever. SIVs should have leverage of 5:1 rather than 20:1. The MLEC proposal[9] is an obscenity. The solution is that people should take losses and move on. The structured finance sector must undergo a sea change if it is to survive.

Panelists have widely divergent outlooks for 2008 ABS issuance volume. Many expect volume to decline by 20% to 25%. However, one panelist expects issuance volume to be up 10% and another expects it to be down 80%.

Legislative proposals for mortgage industry reform might push lenders to refrain from offering hybrid loans. Under one proposal, a lender would have greater potential liability from originating "risky" loan products (from the consumer standpoint) than from originating regular ones.[10] An area of concern to the mortgage industry is the possibility of assignee liability included in some of the legislative proposals.[11]

Panelists have widely divergent views on whether ABS spreads are likely to widen or tighten in the first half of 2008. One panelist feels that the prices of the ABX indices are reaching their bottom. New management teams at major firms are using the ABX to hedge the positions that they have inherited from prior management. The hedging activity is creating an imbalance between supply and demand that has put downward pressure on the prices (see chart on next page). He also favors IO (interest-only) securities because prepayment speeds are slow and likely to remain slow for the near term.

Panelists have differing views about the outlook for consumers. Most expect that consumers will experience some pain. Panelists generally feel that the mortgage sector will have some impact on credit card, auto, and student loan sectors. Panelists generally feel that conditions in the ABS market will feel "normal" again in late 2008 or 2009. One panelist feels that the market will not become "normal" until it embraces lower levels of leverage. Investors feel that the ABS market faces multiple obstacles.

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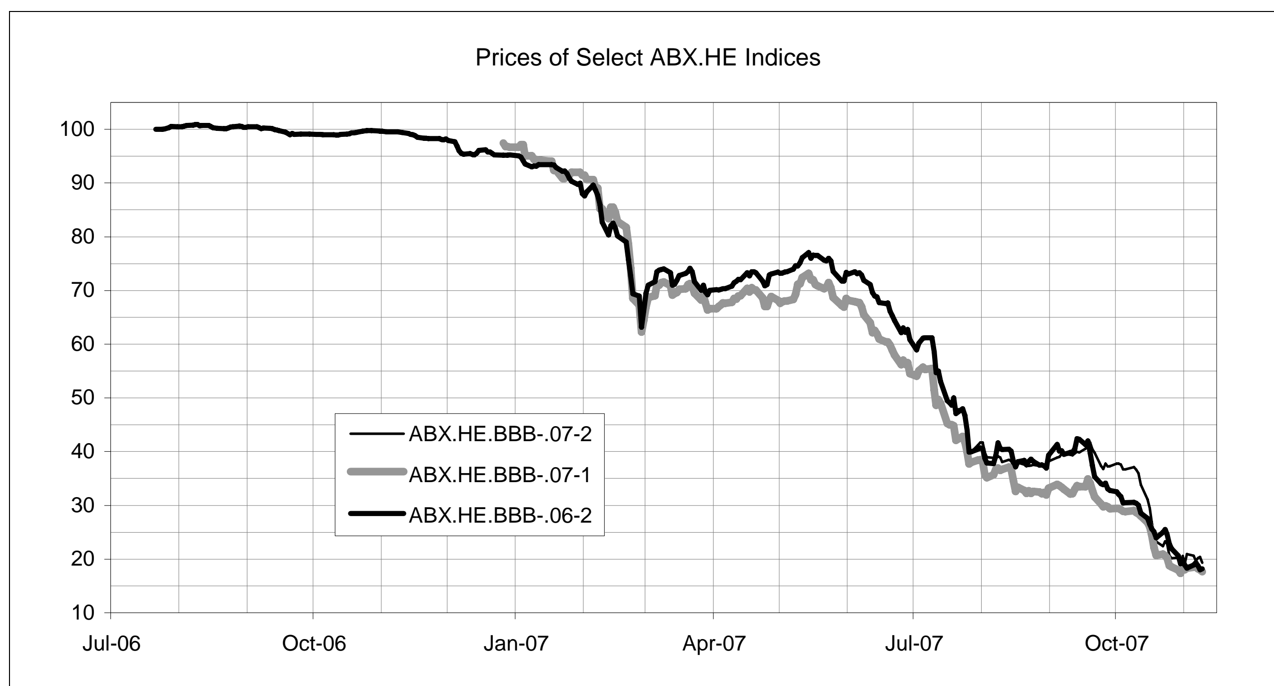
[8] A panelist in a later session challenged the assertion concerning 20:1 leverage in SIVs. He stated that many SIVs provide for maximum leverage of 20:1, but that their actual leverage is between 10:1 and 15:1, on average.

[9] MLEC stands for Master Liquidity Enhancement Conduit. Major banks announced their intent to create MLEC in mid-October, but the details of the plan have not been finalized. The designers intend MLEC to provide liquidity to existing SIVs (by purchasing assets) so that the SIVs can avoid being forced to sell sound assets at fire sale prices during distressed market conditions.

[10] *See* Mortgage Reform and Anti-Predatory Lending Act of 2007, H.R. 3915, 110th Cong., 1st Sess. § 203 (2007) (creating subsection (c) of § 129B of the Truth in Lending Act and the defined terms "qualified mortgage" and "qualified safe harbor mortgage").

[11] *Id.* § 204.



Source: Informa Global Markets

9:45am – The Economists' Roundtable: Assessing the Impact of the U.S. Mortgage Markets on the Global Economy

One panelist feels that the housing market is evaporating, that it will remain under pressure through 2008, and that the bottom will be in the second or third quarter of next year. Housing starts will bottom in the spring or summer, at an annual rate of less than one million starts. Home prices are down about 5% and will fall by at least another 5%. The total decline likely could reach 15%. There are about 750,000 unsold homes. The inventory overhang will likely get worse before it gets better. Second, mortgage credit quality will suffer through 2008 and into 2009. There will likely be as many as three million foreclosures in 2008 and 2009, of which about two million will run through the full process. Third, the economy will remain weak through the spring or summer of next year. The "wealth effect" is strong and it will curtail spending. Nonetheless, a recession is unlikely because business is doing well. Another source of optimism is the strength of overseas economies and the weakness of the U.S. dollar, which should help boost U.S. exports. Fourth, there are exogenous factors that can be positive and negative. Oil could reach $100, which could push the economy into recession. Loan modifications could help. Proposed changes to the bankruptcy code could hurt.

Another panelist agrees on the housing outlook. He expects the housing recession to be a "normal" one (in a long-term historical context) and generally similar to what the U.S. experienced in 1991. The anticipated housing recession is really just the one that should have happened in 2001 but which was delayed for several years by the housing bubble. The housing bubble was a global phenomenon. Home values in the U.S. appreciated by 72%, which was about average for industrialized economies. The expected decline in home values should be about 11%, peak to trough. The mortgage problem is not as big as it seems because the proportion of borrowers affected is actually quite modest. Strong economies overseas and a

weak dollar exert a positive influence. Even though home prices are falling, many homeowners have substantial equity in their homes and can still extract equity to support spending. Home improvements are rising. The odds of a recession are about 1 in 3. Oil prices and legislative initiatives are a threat and could trigger a recessions. Another factor that could trigger a recession would be a withdrawal of foreign investment, which has strongly helped to support capital expenditure in the U.S. over recent years.

A third panelist focuses on the extreme character of the recent housing bubble. Home prices ran up unreasonably. It is not surprising that home prices are pulling back in the areas that experienced the fastest home price appreciation. However, the fact that home prices have given up some of their prior gains does not necessarily mean that borrowers have negative equity. This means that the Mid-west is arguably riskier than California and Florida, because home prices never rose quickly in the Mid-west, so a greater proportion of borrowers have negative equity. A bright spot on the landscape is that delinquencies of prime-quality loans have remained stable while the delinquency rate on sub-prime loans has grown dramatically. Housing and real estate are cyclical phenomena and the economy will survive the cycles. The prospect of higher oil prices is a bigger factor. Consumer confidence also is a critical factor.

Economists collectively have a very poor record at predicting recessions. They failed to predict any of the last nine U.S. recessions. Most recessions are triggered by unanticipated shocks. One panelist feels that the Middle East is the major risk factor and that the housing situation will take longer than expected to work through the system. Another panelist feels that oil may reach $100 in the near term but then it will drop to $50 in two years. He notes that U.S. gasoline consumption has declined over recent years. The third panelist acknowledges the significant of geo-political factors. However, he notes that another important issue is the mispricing of risk in the credit markets. Investors now seem to be overestimating risk. The two other panelists disagree, arguing that today's pricing of risk reflects realism and a reasonable correction from complacency that has persisted for many years.

Panelists generally feel that inflation is not a major threat to the U.S. economy in the near term. Even with rising food and energy prices, the rate of inflation is quite modest by historical standards. Over the longer term, there may be global pressures for a faster rate of inflation.

One panelist asserts that home prices will have reached the bottom when the number of *unoccupied* homes for sale declines for two consecutive quarters.

Panelists agree that the odds of inflation next year are about one in three.

11:15am – Keynote Address by L. William Seidman: Surviving the Sub-prime Mortgage Market

Seidman says that he is at fault for today's sub-prime mortgage situation because, under his leadership, the RTC embraced tranched structures as a means to get the best price when selling thrift assets. Today's securitization market is an outgrowth of the RTC's practices. The problem with what the RTC did, and which remains a problem today, is that it separates the borrowers from the ultimate lenders. The process places too much reliance on third party assessments (primarily from rating agencies) of the credit quality of the assets. The disintermediation of

credit undermined the key element of a lender caring about the collectability of the loans that it originates.

The S&L crisis developed from a mismatch between the rates that S&Ls had to pay on deposits and the rate that they earned on assets. Asset quality also was a factor, but a secondary one.

At the time of the RTC securitizations, there was little if any repackaging of the issued securities. There was little if any boosting of leverage in second and third generation structures such as CDOs, SIVs, and others. Today's securitization market has created too many illiquid instruments that are too hard to value reliably. New management teams at major players are likely to write down old positions very harshly. Further writedowns are likely. Fannie Mae and Freddie Mac may have to take writedowns and they are likely to be buying fewer mortgage loans in the near future because of their capital limits.

A key difference between the S&L crisis and the current sub-prime mortgage situation is that the S&L crisis involved government-insured institutions while the current situation is a purely private sector matter. During the S&L crisis, both Citibank and B-of-A were insolvent. During the S&L crisis, the regulators had to close nine of the 10 largest financial institutions in California. The sub-prime mortgage situation is a much smaller problem than the S&L crisis was in the 1980s. Seidman does not expect that the federal government will step in to absorb the losses from sub-prime loans.

It is not clear what Citibank will do now, after having dismissed Charles Prince as CEO. How is it possible that Citibank executives could have thought that they were not taking risk? In its recent teleconference, Citibank claimed that it relied on the rating agencies. However, that is not a valid excuse because Citibank knew exactly how the rating agencies worked and it had a duty to make independent determinations. The top executives at Citibank had a duty to manage the risk based on their own judgments and assessments.

We don't know where the losses will come to rest around the world. Much of the risk may have been repackaged and sold overseas.

The RTC learned that a building would lose much of its value, often 25%, as soon as it became vacant. This means that there is a strong economic incentive for investors/lenders to be willing to negotiate with borrowers to modify loans in way that allow borrowers to stay in their homes.

MLEC is designed to put liquidity into the market by buying the best part of SIV assets to provide some funding to the SIVs. It is similar to what New York City did when it took its best taxes and allocated them to raising funds to avoid financial collapse. Seidman is skeptical; he questions whether taking the best assets out of the SIVs will actually accomplish curing the situation or reducing ultimate losses to investors.

Seidman's Humor:

- Things were so bad in NJ that the mafia had to fire three judges.

- When the tide goes out, you'll see who's swimming without a bathing suit.
- The problem with marrying your mistress is that it leaves a vacancy.
- The captain of a destroyer is sitting with his officers in the wardroom. The radioman enters and tells the captain that he has a message from the admiral. The captain asks the radioman to read it. The radioman hesitates, saying that the message is personal. The captain orders him to read it. The radioman reads the admiral's message: "Your seamanship today is the worst that I have seen in thirty years at sea." The captain immediately says to the radioman, "Chief, take that message below and have it decoded."

12:00pm – The U.S. Sub-prime MBS Market: Assessing the Fallout

The session focused on remedial measures that can be taken to restore the sub-prime mortgage market so that it can resume providing mortgage loans to low- and moderate-income Americans.

There are only around $780 billion of sub-prime mortgage loans, out of a universe of nearly $11 trillion of residential mortgage loans in America. The amount of defaulted sub-prime mortgage loans is around $107 billion. The default rate for sub-prime mortgage loans was around 10% in 2001 and 2002; then it fell to 5.3% in 2005. But then it has risen to nearly 20% recently.

One panelist asserts that higher credit enhancement levels in sub-prime mortgage ABS are a boon to investors. Some lenders have stopped making the riskiest types of loans, such as piggyback seconds. Also, declining home prices mean that the true LTVs of newer loans are lower than those of loans originated last year.

Rating agency models have had to address the loosening of underwriting standards, an increase in exceptions, and increases in the layering of risks:

- interest-only payment terms
- piggy-back second-lien financing in lieu of traditional down payments
- reduced- or no-documentation of borrower income or assets
- amortization periods longer than 30 years
- shorter fixed-rate periods before loans convert to have adjustable interest rates

Rating agencies need to map an originator's underwriting standards to their own criteria. Rating agencies have responded to layered risks by adding "penalty factors" for risk layering.

Another panelist asserts that the rating agencies failed to educate the market about the limited nature of their role; they are not auditors and they do not independently verify the data that they receive. The number one thing that the rating agencies failed to do was to draw on the knowledge and expertise of their corporate rating groups about what was happing in the markets. They over-relied on models; they over-relied on assumptions rather than on experience. The mortgage lending business became fee-based and front-loaded, so that originators and issuers

were no longer exposed to the ongoing performance of their deals. The underlying sub-prime market grew and evolved faster than the rating agencies' ability to assess reliably the risk of the new products. Also, the quantitative models failed to discriminate adequately between loans originated through different channels: retail, brokers, and correspondents.

Another panelist feels that the issue of rating agency credibility is a different issue from rating agency ratings. There are key difference between a quantitative model and a subjective analysis. There was too little attention to the margin of error or band of uncertainty around the results of the quantitative models. It would help the market if the rating agencies would express their views about how loans produced by different originators have performed relative to initial expectations (*i.e.*, to help the market understand which originators' loans have performed better than expected and which have performed worse than expected).

The quality of data upon which rating agencies rely is an issue. Rating agencies perform periodic operational reviews of originators. However, rating agencies do not audit information for each deal that they rate. It would be desirable for both investors and rating agencies to receive the due diligence reports that dealers prepare.

Another panelist contends that the rating agency models got too lenient on sub-prime loans. Due diligence on the loans in a deal is critical. Originators allow huge numbers of exceptions to their underwriting guidelines, sometimes more than 50%. The solution to the sub-prime situation is simple: require borrowers to have more equity in their homes and to fully document their income and assets.

Another panelist notes that when the bond insurers pulled away from the market that should have signaled that something was wrong with how risk was being priced.

One panelist feels that the creation of the ABS CDS and the ABX indices has greatly improved price transparency. Along with transparency, the derivatives improve pricing discipline. The TABX indices revealed that ABS CDOs were overpriced.

One panelist notes that his firm marks its portfolio daily based on dealer quotes. The ABX and TABX products had an influence. A problem developed when traders delegated responsibility for producing quotes to their back office. Another panelist argues that the ABX and TABX pricing have been pretty accurate.

Longevity is a reasonable basis for tiering originators. Those that have been around through several cycles and who have lengthy data on their loan production are likely to be better than those that have not survived cycles. Likewise, tiering can be based on whether lenders retain risk positions in their loans.

2:15pm – The Mortgage Research Analysts' Roundtable

Roots of the Problem: Why is the sub-prime mortgage market in its present condition? Leverage is the key. Trouble started with a Fed Funds rate of 1% in 2003, which sparked bubble home prices and a sub-prime boom. In the ABS structures, the credit enhancement levels were too low. In CDOs, the rating agencies underestimated correlation. Also, the very low capital

requirement applicable to triple-A rated securities under Basel II made the pricing of risk unrealistic. The estimated level of ultimate losses is in the range of $150 billion to $200 billion, of which only about $40 billion or $50 billion has been recognized to date. The financial sector will likely have to recognize at least another $70 billion.

Another panelist feels that losses from the sub-prime sector will amount to $150 billion in the cash market and again as much in the synthetic market. There will be additional losses in the alt-A, HELOC, and other sectors. The trouble started with the Federal Reserve, which encouraged the creation of risky loans. Most participants in the food chain realized that the loans were risky (or that they did not make sense), but they did not care because they believed that they were not taking or retaining any meaningful risk.

A third panelist notes that the political establishment seemed to endorse the expansion of sub-prime lending as a means to promote homeownership. Loan production from 2005 is likely to have losses of less than 10%. The production in 2006 got progressively worse but nobody realized it at the time. Nobody originally expected that losses on the 2006 vintage would be in the 20% range (which is what many expect now).

<u>Rating Agencies</u>: Last year panelists projected losses in the range of 9% to 10%, but now they are projecting twice that amount. The rating agencies were too slow to update their forecasts to reflect the changes in market conditions. The rating agencies waited for performance data to appear before they took action (*i.e.*, watchlistings and downgrades). There are likely to be many more rating actions because the downgrades and watchlistings that have occurred to date do not capture the full magnitude of the problem. Another panelist counters that ABS ratings are <u>actuarial</u> and, therefore, inherently backward looking. Maybe the ratings should be done differently, but the fact is that they have been actuarial. A third panelist sharply criticizes the rating agencies, arguing that Basel II should not be based on ratings and that the rating agencies should not be allowed to operate as for-profit entities.

Another panelist believes that the Fed and Basel II are larger causes of the current situation than the rating agencies. Rating approaches implicitly assumed that home prices would continue to rise because all the data for the models came from environments in which home prices *were* rising. Many pitch books for CDOs highlighted that falling home prices had never been observed on a national level.

Another panelist counters that the slight drop in home prices that has occurred cannot explain the horrible delinquency performance observed in sub-prime mortgage loans. Instead, the problem comes from poor underwriting; the FICO scores and the LTVs became unreliable. Too much important and relevant information about the underlying loans was omitted from term sheets for deals. One example of such a data item is how long a borrower has been in his house. Another is the identity of the broker through whom the loan was originated. A second panelist disagrees, noting that the slight drop in home prices is much less significant than the huge drop in the *rate* of home price appreciation, which previously had mitigated the impact of poor underwriting.

A panelist explains the difference between the Case-Schiller index and the OFHEA index. The CS index is market weighted, which means that it overemphasizes high value homes, which have high betas. The CS index leads OFHEA index both on the way up and on the way down.

Policy Responses/GSEs: Many of the legislative proposals emphasize preventing a repeat of the current problem rather offering a plan to rescue today's distressed borrowers. It seems unlikely that there will be a major bailout of distressed borrowers. One policy response that may help current borrowers is the proposal to allow cramdowns of residential mortgage debt in a borrower's bankruptcy.[12] Today's proposal to allow cramdowns of residential mortgage loans is not the first. There was a similar proposal in 1993 in response to the California real estate situation.

The GSEs will not be part of a bailout of the weakest borrowers. However, the GSEs accept many loans with FICOs as low as 600 and, therefore, GSE loans could be a refinancing solution for the top half or the top third of today's sub-prime borrowers. However, there is probably no possible legislative or policy solution for a substantial portion of sub-prime borrowers.

Servicing: Servicers and the quality of servicing will exert a strong influence on the final outcome of the sub-prime situation. There are conflicts of interest in the servicing process; servicers theoretically should service loans in the best interests of the related securitization trust, but some servicers don't always do so. For example, foreclosures are a profit center for some servicers. A servicer's behavior may be influenced by fear of being sued by investors or by community activist groups.

One panelist contends that servicers are motivated not to process loan modifications because they do not get paid for modifications but they do get paid for processing foreclosures. In addition, many borrowers are not really interested in modifying their loans. Another panelist notes that sub-prime borrowers are often not interested in retaining ownership of the homes when they see that they can live more cheaply by renting.

ABX: The ABX indices now have little or no value as either a speculative tool or as a hedging tool. Nonetheless, valuations arguably should be higher than they are. One way to kill the alt-A market would be to include alt-A deals into the next ABX series, if there is one. The ABX has turned into an unmitigated disaster.

Another panelist feels that the ABX is a great tool for bringing transparency to the sub-prime mortgage market. ABX helps to reveal the market's view. It helps for marking CDO positions. Some market participants have been over-optimistic in marking their holdings and the ABX shows real valuations.

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[12] Emergency Home Ownership and Mortgage Equity Protection Act of 2007, H.R. 3609, 110th Cong., 1st Sess. § 3 (2007) (to amend § 1322(d) of the Bankruptcy Code). In the context of a mortgage loan in a bankruptcy proceeding, the term "cramdown" refers to a situation where the amount of the mortgage debt exceeds the value of the property and the borrower petitions the court to "cram down" the amount of the debt to equal the value of the property. The excess is then treated as an unsecured claim.

The first panelist counters that trusting the pricing of the ABX is risky because it is never clear how much trading volume is behind the reported prices. "Never before has trading by so few driven pricing and marks for so many."

3:45pm – CDO Valuation: CDO Researchers, Managers and Traders Speak Out

The first topic is transparency. Intex arguably provides a very high level of transparency on CLOs. CLO managers provide detailed monthly reports and are willing to talk to investors about any specific position in their CLOs' underlying portfolios. Another panelist disagrees, arguing that some loan managers started including structured products in their CLOs in order to boost yield. There are CLOs that allow up to 20% structured finance investment in the portfolio.

Today there is fairly widespread disclosure down to the company level, but disclosure about the companies themselves varies.

ABS CDOs have a transparency problem. The amount of information available to an ABS CDO manager about the underlying ABS is vast. However, that information does not reveal price. Another panelist argues that the problem with the ABS CDO sector is not a lack of transparency but rather a failure on the part of investors to look at and to understand the underlying sub-prime mortgage market. There are actually no surprises in borrower behavior, but ABS CDO investors did not bother to focus on analyzing the underlying ABS. A third panelist agrees, emphasizing that the real problem is "complexity risk." Really analyzing an ABS CDO in terms of prepayments, delinquencies, defaults, triggers, servicing, and other factors is extremely difficult. By comparison, analyzing and understanding a CLO is relatively simple.

One panelist feels that the market is mis-pricing CDOs from 2004 and 2005. Based on scenario analysis, he expects everything below the junior triple-A's to be wiped out. He feels that the price levels of the ABX sub-indices give an indication of loan quality. He notes that the idea of a "superior" ABS CDO manager is illusory because all managers were required to buy across the whole sector for purposes of diversification. He says that everything but the triple-A tranches should be viewed as IOs. He feels that a price equal to one year's worth of interest payments is a reasonable price for double-A tranches of ABS CDOs. The TABX prices are a fair reflection of value. Mezzanine and subordinate tranches of ABS CDOs should all have prices below 10¢ per dollar of face amount.

Another panelist claims that he talks to many CDO investors who do not use Intex and, therefore, cannot examine the underlying deals. Those investors may place too much reliance on credit ratings and fail to conduct any independent analysis.

The quantitative models of borrower behavior appear to have performed well in light of the change in the rate of home price appreciation. However, the models of how bonds behave ignored the underlying microeconomic issues and were based instead on historical bond default rates and rating migration rates.

One panelist states that the worst thing that anyone could do for the alt-A sector would be to create an index. Another panelist notes that Deutsche Bank is in the process of doing just that. It

plans to include only the best deals and, therefore, the players who short the index stand to get clobbered. A third panelist argues that many of the loans that had been packaged in alt-A deals were really sub-prime loans in disguise. The danger of alt-A deals is in the tails (*i.e.*, the performance of the weakest loans in a pool).

Basel II is a problem now that the rating agencies have lost credibility. One panelist thinks that rating agencies will start to back away from complex structures. Another panelist remarks that the CDO sector has had trouble in the past. He notes the widespread melt-down of high yield CBOs in 2001-2003 following the bursting of the tech bubble.

One panelist feels that the Fed's 0.50% interest rate cut will not make a significant change in the level of losses that are likely to come in the sub-prime sector.

Another panelist feels that leverage has to decline at all levels of the credit market. The Fed's rate cuts help in general, but many areas need to adjust. Relative value is in corporate bonds and, by extension, in CLOs. If there is a recession, it would be better to be in cash (but not necessarily in U.S. dollars).

One panelist expects around 35% to 40% of sub-prime mortgages to default and that cumulative losses on securitized pools will be in the range of 15% to 20%. If home prices decline, the real price of housing will also decline. He asserts that the only way to salvage the mortgage market is to lower the cost of borrowing. However, the Fed does not have room to lower rates. Another panelist partly disagrees. He notes that not all borrowers are in trouble. Many borrowers are doing fine. In the prime sector, borrowers who have fixed rate loans are in a materially better position than those who have option ARMs.

Global Credit Derivatives: The TLCDX is a tranched index based on LCDX series 9. It should do better than the TABX has done.

One panelist argues that it is not necessary to run hundreds of scenarios to understand what can go wrong in an ABS CDO; rather it is only necessary to run a few of the right scenarios to understand the cliff risk. The current problem with ABS CDOs was not a failure of rating agency models, but rather a failure of imagination on the part of all types of professionals in that sector.

4:45pm – The CDO Investor and Manager Roundtable

ABS CDOs: There were a large number of downgrades of ABS CDOs in July. What exactly are "Events of Default" in a CDO? An Event of Default is a trigger that can be tripped by breaching an overcollateralization threshold. Downgrades of underlying assets can trigger Events of Default because assets in the double-B and triple-C rating levels are counted at less than 100¢ on the dollar for purposes of measuring overcollateralization.

One panelist feels that the occurrence of an Event of Default is the first time that most deal participants actually read the indenture for the affected deal. Another panelist notes that indenture language varies sharply among deals. He remarks that CDOs are the only kinds of

deals where a simple decision by a human being (i.e., the downgrade of underlying assets by a rating agency) shuts off cash flow to investors.

There are some documents that allow a super-senior CDO investor to liquidate the assets regardless of the consequences to the other classes. Another panelist asserts that a very large proportion of CDOs with overcollateralization triggers include such a feature.

Panelists disagree about whether managers of mezzanine ABS CDOs can take actions today to improve the prospects for their CDOs. One panelist feels that there is insufficient liquidity in the market to allow for taking action. Another feels that there is some opportunity to sell cash bonds to investors who took short positions (because those investors may want to cover the shorts).

Some investors are being forced to liquidate positions. They are not driven by fundamental value. That creates opportunities for other players who can analyze and price risks reliably. Another investor somewhat disagrees on the issue of complexity. He argues that the ABS CDOs are simply re-REMICs with rating triggers.

Many investment managers are creating "opportunity funds" to buy distressed CDOs and distressed ABS. There is a flood of such funds and yet the distressed securities do not seem to be moving. An interesting thing about current conditions is the combination of a credit crisis and a liquidity crisis. The strategy for investors should be to focus on positions that are distressed because of liquidity issues rather than credit issues.

Super Seniors: One panelist feels that holders of super senior tranches of ABS CDOs will have to wait for the underlying collateral to run off before they find out whether they will suffer a loss and, if so, how big it will be. It may be possible to hedge super senior positions with positions in high grade deals.

It is probably not practical to hedge positions bought at very low dollar prices.

The Landscape for CDO Managers: Small shops may not survive. Consolidation is likely. Some managers will lose deals. Some managers will no longer have rational business plans. There will be an opportunity for those managers who acted responsibly to live to fight another day.

Some players started managing CDOs as a side business. Deals for those shops will likely appear on the block. Managers whose sole business is managing CDOs are likely to retain management responsibility for the lives of their deals.

Outlook for New Deals: Will there be CDOs of ABS next year? One panelist feels that the market will wait for the rating agencies to finish with downgrades and for a period of stability. The market will wait until the rating agencies firmly state that the downgrades are over. The panelist feels that assets originated in 2008 will be of much higher quality (*i.e.*, borrowers will have to make down payments to buy homes). With better assets there will be better ABS and a possibility for both the ABS market and the ABS CDO market to come back.

Another panelist disagrees. He argues that the ABS CDO market was ill conceived. It was a mistake for market participants to have believed that diversification could be achieved by investing in sub-prime mortgage ABS from different issuers. Therefore, it is likely that the ABS CDO market will never return in the form that it had in 2006. A third panelist adds that, once burned, triple-A investors will be very reluctant to return to the market. He agrees that the ABS CDO market is unlikely to come back in the form in which it existed in 2006.

Monoline Bond Insurers: Panelists disagree on the extent of losses that the bond insurers will suffer from sub-prime mortgages and from ABS CDOs.

Correlation: One panelist remarks that he was surprised by the rating agencies' views of correlation in ABS CDOs. He was *shocked* by rating agencies' views of correlation in CDOs-squared. Another panelist asserts that the rating agencies were fooled into allowing a rating arbitrage. A third panelist argues that the rating agencies made incorrect assumptions on all three of the key modeling inputs: default probability, loss severity, and correlation. Another panelist observes that the structured finance market has a history of over-reaching. The fees earned by market participants might have clouded their judgment. Some participants were very persuasive and effective in swaying the rating agencies.

Tuesday, 6 November 2007

1:30pm – Finding Relative Value in the U.S. ABS Market amidst the Turmoil: The Domestic and Foreign Buyer Perspective (General Session)

How Did We Get Here?: Answer: Excessive growth in leverage, weakening underwriting standards, rising home prices, introduction of affordability products, and separation of the ultimate lender/investor from the loan origination process.

Mortgage debt as a percentage of GDP has grown significantly over the past 10 years. Home prices rose as well, but the rising debt was the dominant factor. Another key factor was rising leverage from sub-prime ABS and ABS CDOs. Affordability products and declining underwriting standards became a strong force in 2006. The market is going to have to de-lever over the next few years.

Is the ABS Market Dead?: The market never really dies because participants have short memories. The market always comes back, but sometimes in a somewhat different form. Sub-prime borrowers will be able to get loans and the market will securitize those loans. However, the securities will likely be different in that the deals will have more equity and the servicers will retain some risk.

Another panelist feels that it is a mistake to view today's problems primarily in terms of sub-prime loans. He expects that alt-A loans and option ARMs are likely to experience significant performance deterioration. He feels that the problems affect the entire non-conforming mortgage market. The large volume of interest rate resets coming over the next few years means that there is a huge problem coming down the pike. He feels that investors with large balance sheets (*i.e.*, investors who are not vulnerable to margin calls and mark-to-market issues) and can find great

opportunities. Another panelist counters that the big-balance-sheet investors are reluctant to act because they think that things will get cheaper. A third panelist remarks that investors with strong balance sheets are not making refinance loans to distressed borrowers because they cannot charge sufficiently high interest rates to make the loans profitable.

Policy Solutions: More than 99% of the audience feels that the proposed MLEC "super SIV" will not help the sub-prime mortgage sector. Panelists disagree about whether MLEC can really save the SIV sector. One panelist remarks that MLEC's real purpose is to try to preserve Citibank's ability to use off-balance sheet vehicles (*i.e.*, SIVs and ABCP programs).

One panelist notes that a major portion of today's troubles stem from the declining dominance of "real money" investors in the ABS market. Too many of the investors today are subject to mark-to-market requirements and do not have the ability to hold positions through cyclical fluctuations. The fact that ABS prices were so stable for so long lulled many market participants into thinking that they would remain stable forever.

ABS CDOs: One panelist feels that ABS CDOs will eventually come back in a different form. He notes that after the demise of the multi-asset-class ABS CDOs in 2001-2003 the market bounced back with ABS CDOs focused on residential mortgages. CDO managers and Wall Street firms will push to find a way to bring CDO technology back to the ABS area because it is so profitable for both groups to do so.

Only a small fraction of the audience thinks that ABS CDOs backed by residential mortgage loans will be issued during 2008.

Relative Value: One panelist favors going short. He expects further technical pressure on the market from SIV unwinds (*i.e.*, SIVs that are forced to sell securities). He suggests shorting the higher tranches of the ABX indices.

Another panelist feels that there is opportunity to go long on seasoned bonds being sold at unreasonably low prices. He recommends senior ABS backed by fixed rate loans. He feels that the ABX paints a negative image on the whole sector and that investors can exploit that sentiment by getting good bonds at cheap prices.

A third panelist focuses on non-residential ABS. He asserts that contagion has driven an unwarranted spread widening in credit card, auto, and student loan ABS. Those sectors have stable structures, consistency of originators and platforms, and long performance histories. Credit performance deterioration in those sectors has been quite slight.

A fourth panelist notes that there are huge opportunities in alt-A RMBS, where prices do not sufficiently differentiate between deals that are performing well and those that are performing poorly. He also notes that there is good value in ABS CDOs, where some distressed tranches can be bought for single-digit prices.

One panelist emphasizes the goal of finding sectors that are liquidity challenged rather then credit challenged.

Another panelist recommends new issue single-A to triple-A tranches for investors that do not have the pressure of marking positions to market.

Opportunities Overseas: The U.K. market has some of the same liquidity challenges that the U.S. market is facing. Although the U.K. market has some similarities to the U.S. market (non-conforming loans, investor properties, low-doc loans) it has lower LTVs and is more highly regulated than the U.S. market.

Outlook: By this time next year, the market should have a good idea of what the total amount of losses is likely to be on sub-prime mortgage loans from the 2005 and 2006 vintages. By the end of next year, many of the defaults that are likely to occur will have occurred. Losses on the securitized pools will likely be in the range of 15% to 20%.

A second panelist disagrees, arguing that losses will be in the high single digits, though 2006 deals may have higher losses. He asserts that losses in the range of 5% to 6% should occur during the first half of a pool's amortization. He anticipates a higher rate of losses, but on a lower aggregate balance, during the second half of a pool's amortization.

Other parts of the U.S. economy could eventually feel stronger effects of a contagion from the sub-prime sector. However, it is still too early to tell what the magnitude of the effects will be.

Home Prices: Many audience members feel that home prices will fall by 25% in California, Florida, Nevada, and Arizona. However, most audience members feel that home prices will fall by more than 15% but less then 25%, peak to trough, in other areas. Audience members are evenly divided on whether home prices will hit bottom in 2008 or 2009.

ABX: No members of the audience expect there to be an 08-1 series of the ABX indices.

5:00pm – What's New in Mortgage Products and Innovations

Where We Are – What It Takes to Get Deals Done: Although many issuers have had trouble executing deals, originators that produce super-prime loans (70% LTV, full doc, high FICO score) have been able to get deals done. There is a credibility crisis in the mortgage business because investors do not trust the representations and warranties. Another panelist notes that rating agencies have proposed introducing third-party oversight for deals to police or to enhance "data integrity."[13]

New Products – Reverse Mortgage Loans: Reverse mortgages are loans to seniors that allow them to extract value from their homes. The level of activity in the product has been doubling every year since 2000. Projected volume for 2008 is around $15 billion, of which half will likely be FHA-insured HECM (home equity conversion mortgage) loans and half will be purely private

[13] The need for third party oversight was highlighted four years ago at ABS East 2003. *See* Gregory, M., *"Pistol-whipping CFOs": Is ABS Fundamentally Flawed?*, Asset Securitization Report (13 Oct 2003); O'Connor, C., *Murrayhill Positions Itself As a 'Deal Cop'*, Asset Securitization Report (20 Oct 2003).

loans. The issue with "securitizing" reverse mortgage loans is that cash is flowing ***to*** the borrowers. Thus, there is not cash flow to service the bonds until the seniors start moving out of their homes or start dying.

Ginnie Mae is about to issue its first security backed by HECM loans. A unique feature of the security is that it will be based on a "funded balance" concept. That means that fractional portions of a single loan can appear in pools backing different securities. This differs from the regular HELOC ABS structure in which both past and future advances on a HELOC are funded through a single securitization trust. The Ginnie Mae program requires the originators to retain a portion of the securitized loans. Ginnie Mae's goals in securitizing HECMs are to foster affordable housing and to provide low-cost loans for seniors.

HECM loans can have fixed interest rates, adjustable rates tied to the one-year constant maturity Treasury yield, or adjustable rates tied to LIBOR.

Small Balance Commercial Loans: Small balance commercial loans are those with balances of less than $1 million. The loans have a mixed flavor with elements of both residential and commercial mortgage loans. The loans traditionally were held on the balance sheets of community banks. Securitization of small balance commercial loans remains a small sector but it has grown steadily in recent years. The credit quality of the loans is better than sub-prime; the average FICO score of the borrowers is over 700. Values of small commercial properties have been less volatile than values of single-family homes. More securitizing lenders are likely to enter the small balance commercial loan area as a way to diversify their businesses away from purely residential lending. Rating agencies have been very conservative in setting credit enhancement levels in the area. Many of the loans have hybrid FRM/ARM structures. Some have fixed interest rates. Some loans have balloon terms.

Market participants sometimes differ in how they define small balance commercial loans. Those who come from CMBS backgrounds often view loans of less than $3 million as small balance loans. Typical deal size for small balance commercial loan securitizations is $400 million to $500 million.

New Versions of Old Products: The original NPL (non-performing loan) deals were the ones done by the RTC in the aftermath of the S&L crisis. Such deals will likely resurface over the next few years for non-performing residential loans.

FHA Secure: The FHA Secure program is intended to provide loans for non-defaulting sub-prime borrowers and for sub-prime borrowers who have defaulted because of interest rate resets. The market did not want the FHA Secure loans to be included in the regular GNMA I and GNMA II pools. It turns out that the FHA Secure loans will be packaged into custom securities that will not be eligible for TBA delivery.

Miller-Watt-Frank Bill:[14] The bill is moving very fast through the committees in Congress. It is likely to pass quickly through the House but it might get held up in the Senate. If passed and signed into law, the bill probably would not take affect for 12 to 18 months.

A key feature of the bill is that it provides for predatory lending liability on a "securitizer." It is not fully clear yet what entities would fall within the definition of "securitizer."[15] Securitizer liability provisions would cover high cost loans but would not cover traditional, prime-quality loans. To qualify for safe harbor treatment a loan must include: (1) full documentation, (2) underwriting based on the fully-indexed rate, (3) no negative amortization, (4) any other characteristics determined by the bank regulators, and (5) one of (i) fixed rate, (ii) maximum DTI, or (iii) maximum APR.[16] For loans that do not fit within the safe harbor, the lender must determine that the borrower has a reasonable ability to repay the loan.[17] If an originator makes a loan in violation of the requirements, the borrower has the right of rescission, but there are no class actions or treble damages.[18]

Confidence in Ratings: Credit ratings remain very important for new asset classes. Another panelist feels that the rating agencies need to restore investor confidence. In addition, investors will not trust originators and issuers that fail to comply with their repurchase obligations. Rating agencies should refuse to rate deals from issuers that have defaulted in their obligations to repurchase loans for breaches of representations and warranties. Another problem is that rising delinquencies may overburden servicers and servicers may start to make mistakes that produce losses for investors. Deals should provide for investors to have recourse against servicers to recover unnecessary losses that the servicers cause.

Wednesday, 7 November 2007

9:00am – Real Estate CDOs

Are CRE (commercial real estate) CDOs dead? The press does not sufficiently differentiate between different kinds of CDOs.

ABS CDOs got tripped up by high correlation among the sub-prime mortgage ABS included in the deals. There should be a lower degree of correlation among commercial real estate assets.

Some CRE CDOs include residential MBS in their asset portfolios. The range of RMBS concentrations ranges from less then 10% to more than 70%.

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[14] Mortgage Reform and Anti-Predatory Lending Act of 2007, H.R. 3915, 110th Cong., 1st Sess. (2007).

[15] *Id*. § 121 (inserting the definition of "Securitizer" at § 103(cc)(9) of the Truth in Lending Act).

[16] *Id*. § 203 (inserting the definition of "qualified safe-harbor mortgage" at § 129B(c)(3)(C) of the Truth in Lending Act).

[17] *Id*. § 201 (inserting § 129B(a) of the Truth in Lending Act).

[18] *Id*. § 204

The 2006 and 2007 vintages of CMBS are expected to perform somewhat worse than earlier vintages, and there may be pressure on CRE CDOs with concentrated exposure to those vintages.

In contrast to the residential mortgage sector, the commercial mortgage sector is premised on the idea of working out distressed loans rather than mechanistically processing foreclosures.

The rating agency models have an unfortunate side effect of motivating CRE CDO sponsors to sacrifice loan quality in order improve diversification.

Some panelists contend that CRE CDOs have the advantage of having asset managers that can actively address (or sell) deteriorating assets. In contrast, traditional CMBS are just static pools.

The single-A layer of CRE CDO capital structures has always been the most difficult to sell. That layer does not offer enough yield to attract high-yield buyers and it is too risky (hard to analyze) for high-grade buyers.

9:45am – Hybrid CDOs

Fitch just concluded its review of structured finance CDOs and placed tranches from 159 deals on review for possible downgrade.[19] Not surprisingly, the cohorts that Fitch expects to have the worst performance are the mezzanine ABS CDOs with high exposures to sub-prime production from 2006 and 2007 vintages.[20] This result confirms what many market participants had expected.

ABS CDOs differ significantly on the issue of whether an overcollateralization deficiency for the senior class constitutes and Event of Default. They also differ on the issue of which class or classes have the power to exercise remedies.

The reason that some dealers (*e.g.*, Merrill Lynch) accumulated huge inventories of CDOs is that they ended up retaining unsold tranches from many deals for which they served as placement agent.

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[19] Barberio, V., et al., *U.S. RMBS and SF CDO Rating Actions*, Fitch special report (7 Nov 2007).

[20] Schiavetta, J., et al., *Global SF CDO Rating Review: Performance and Outlook*, Fitch special report (30 Oct 2007).